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UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D.C. 20523

PANAMA

PROJECT PAPER

FINANCIAL STABILIZATION AND ECONOMIC RECOVERY II
PAAD
(Amendment #1)

AID/LAC/P-309 &
AID/LAC/P-243

Loan Number:525-K-602A/A1
Project Number:525-0282

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AID 1120-1

PAAD

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT

1. PAAD NO. 525-0282
525-K-602A Amendment No. 1

2. COUNTRY
Panama

3. CATEGORY
Cash Transfer

4. DATE
July, 1986

5. TO:
AA/LAC Dwight Ink 142

6. OYB CHANGE NO.

7. FROM:
LAC/DR, Terrence Brown

8. OYB INCREASE

TO BE TAKEN FROM:
Economic Support Funds

9. APPROVAL REQUESTED FOR COMMITMENT OF:
$ 5,742,000

10. APPROPRIATION -
LESA-86-35525-KG31 (637-65-525-00-50-61)

11. TYPE FUNDING
☐ LOAN ☒ GRANT

12. LOCAL CURRENCY ARRANGEMENT
☐ INFORMAL ☐ FORMAL ☒ NONE

13. ESTIMATED DELIVERY PERIOD
July, 1986

14. TRANSACTION ELIGIBILITY DATE

15. COMMODITIES FINANCED

16. PERMITTED SOURCE
U.S. only:
Limited F.W.:
Free World:
Cash: 5,742,000

17. ESTIMATED SOURCE
U.S.:
Industrialized Countries:
Local:
Other:

18. SUMMARY DESCRIPTION

The purpose of this amendment is to increase the budgetary support to the Government of Panama to $25,742,000 from the present $20,000,000 and to include additional conditionality concerning the reduction in size and cost of the GOP civilian workforce. Other conditions of the PAAD authorized on August 28, 1985 remain the same.

19. CLEARANCES

		DATE
LAC/CEN:PAskin		7/1/86
LAC/DP:WWheeler		7/2/86
LAC/DR:ABisset		7/3/86
GC/LAC:PJohnson		7/2/86
M/FM/PAFD:EOwens	for	7/22/86
DAA/LAC:MButler		

20. ACTION
☒ APPROVED ☐ DISAPPROVED

Malcolm Butler 8/15/86
AUTHORIZED SIGNATURE DATE

Assistant Administrator (LAC)
TITLE

CLASSIFICATION: UNCLASSIFIED

FINANCIAL STABILIZATION
AND ECONOMIC RECOVERY II
— PAAD AMENDMENT —

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I. SUMMARY AND RECOMMENDATIONS

A. Summary

USAID/Panama proposes an amendment to PAAD 525-K-602 authorizing an additional cash transfer of $5.742 million to the Government of Panama. Upon approval of this PAAD amendment, USAID/Panama will negotiate an amendment to its August 30, 1985 Grant Agreement obligating the additional funds. The Grant Agreement will contain additional covenants affirming the GOP's intention to reduce the size and costs of its civilian work force. The funds will be attributed to specific projects in the Government's investment budget in rough proportion to the sectoral allocations of the original grant agreement.

B. Grantee

The Grantee will be the Government of Panama, represented by the Ministry of Finance. The ESF grant funds will be deposited in the Banco Nacional de Panama and will be utilized by the GOP for budget support requirements.

C. Conditions

Conditions are discussed in Section IV and V of the PAAD amendment.

D. Recommendations

The U.S. Mission recommends authorization of an amendment to PAAD 525-K-602 for an additional $5,742,000 grant in Economic Support Funds for the Government of Panama. The grant is to be obligated and disbursed in the form of a cash transfer for budget support requirements. Obligation and disbursement ($5,742 million) will occur in July 1986.

II. CONTEXT

Panama faces continuing economic problems requiring financial discipline, continued policy reform, and external assistance. It must stabilize its precarious financial situation and find a growth path that generates adequate employment opportunities in the face of a huge public debt which effectively constrains the public sector from its prior role as the dominant employment generator in Panama. As it is, the Government is struggling to pay its foreign debt and there is little in the way of overall per capita growth. Such growth as there is, occurs largely in the so called "autonomous sector" (the canal, the transisthmian oil pipeline and the free zone) and generates disproportionately low employment opportunities. Unemployment is high and rising, and threatens to erode living standards for lower income groups. In the face of its fiscal problems and the inward migration to the Colon — Panama City metropolitan corridor the Government can neither sustain the current level of social services nor maintain major physical infrastructure investments, let alone meet the rising level of expectations resulting from the Torrijos era. Crime, one measure of harder times, is rising. The falling dollar is likely to increase the import bill and add a measure of instability to the currently high but stable price level. In the medium- to long-term, unless there is a reversal of Panama's economic prospects, all this can translate into serious social discontent and another challenge to already tenuous political stability.

An interventionist public sector philosophy has held sway since the early 1970s, bloating the public sector, distorting the economy's price structure and resource allocation, and building a huge foreign debt. The exhaustion of Government financial options, together with persistent encouragement from creditors, the IMF, the IBRD, and ourselves has brought a more realistic policy perspective to the Government. Fiscal austerity commenced in 1983 and by the end of 1985, the public sector deficit, exclusive of debt repayment, was down to about $100 million, nearly manageable proportions. Thus far, the burden of austerity has fallen largely on public sector investment expenditures. It will be difficult to sustain these reductions let alone eliminate the remaining deficit. Moreover, if existing investment is to be protected, it should be the current expenditures budget (especially the payroll), not the development budget that takes the brunt of expenditure curbs.

Concurrently, Panama must deal with a debilitating public debt of some $5.1 billion, 3.6 billion of which is external. A 1986 rescheduling package has been agreed upon and awaits final implementation. The country's commercial bank creditors will roll-over $378 million and provide another $60 million in fresh credit. This funding is strictly conditioned on a reactivation of the IMF stand-by, a second IBRD Structural Adjustment Loan (SAL II) and strict adherence to their respective terms and conditions for fiscal restraint and structural reform. At this writing, it appears that the IMF and agreement will be back on track by the end of the month and that the IBRD SAL agreement will be completed by year's end.

Only continued restructuring of economic policies can put Panama on a growth path leading to adequate employment opportunities. Prodded by the Bank, the Fund, USAID, and most importantly by sheer necessity, the GOP has haltingly begun the process. Fiscal restraint and deep-rooted structural economic reforms are required under GOP agreements with the IMF, IBRD, and USAID. There will be unavoidable economic dislocations as excessive price supports, price controls and import protection are phased down, a number of state enterprises liquidated or privatized, and the economy increasingly deregulated. A considerable measure of continued austerity will be required particularly for the public sector. While all this is prerequisite to a restoration of economic health, it is important to bear in mind that too discordant an adjustment can carry serious adverse political-economic consequences.

III. MACROECONOMIC OVERVIEW

Panama's 2 million people enjoy a per capita income of just over $2,000. High levels of health, education, and other social services are provided, and the country possesses a trained, literate work force. The income distribution is skewed but, though no recent figures are available, probably much less so than in 1970. The economy is heavily service oriented.

Roughly three quarters of GDP derives from services, of which 15 percentage points is directly accounted for by the canal and the transisthmian oil pipeline. Primary activities (agriculture and mining) account for only 11% of income but 29% of employment.

The economy is closely tied to the external sector. The Canal is the dominant feature of the economy. The transisthmian oil pipeline adds to the importance of interoceanic transport. The Colon Free Zone serves as a regional entry port and Panama city as the regional banking center (129 private banks with over $32 billion in deposits). U.S. Government payments are of major proportions. (The U.G. Government non-US citizen payroll and retirement payments in Panama amount to $270 million; procurement of goods and services another $101 million; payments required under the 1977 Canal treaty, $76 million; and personal spending by U.S. Government citizen personnel is estimated at $77 million. In all some $525 million in 1985.)

The Panamanian Balboa, except for fractional coinage, is strictly a nominal currency tied on a 1:1 basis to the US dollar. It is the latter which is the medium of exchange and the legal tender. There are no controls on financial flows to and from the country. As a result, the Government has little control over monetary aggregates, interest rates, or exchange rates. This is a source of confidence to the financial sector and precludes printing press inflation so common in many parts of the world. At the same time, without exchange rate movement to buffer the effect, the full burden of affecting ajustment to international trends falls on domestic prices. In the process, distortions and dislocations caused by institutional rigidities in the prices of labor and many goods are effectively magnified.

A. GROWTH AND EMPLOYMENT

During the 1960s Panama sustained an exceptionally impressive 8% average growth rate. This growth was highly unbalanced, benefiting largely the metropolitan corridor and increasing income disparity between the urban and rural population, and between the domestic and internationally oriented sectors of the economy. The military government which took power in late 1968 attempted to correct this with a rising level of social services, social reforms, economic infrastructure, and state economic activism financed with deficit spending. The economy averaged a 7% growth rate through 1973 when high energy prices, the cummulative deficit, and the economic rigidities inherent in state economic activism caught up. Growth fell below two percent for the five year period ending in 1977. Following the Canal Treaty, there was a spurt of public sector driven growth (7% average rate) from 1978 to 1982, with a large increase in public debt. With the end of easy credit from abroad and the imposition of austerity on the public sector, the growth rate in 1983 and 1984 fell to zero levels.

According to preliminary official statistics, Panama's 1985 growth rate measured 3.3%, showing a modest recovery from the stagnation of the previous two years. However, this is deceptive in that much of the economy continued to stagnate. Virtually all this recent growth is accounted for by the "autonomous" sector — the Canal, Free Zone and pipeline; none of which is particularly labor intensive. The statistics suggest a 2% growth in employment, insufficient for the need. Further, roughly half this employment growth was in the stagnant agricultural sector, suggesting that much of it is really underemployment. Preliminary official statistics for 1985 show an 11.8% unemployment rate with some 84,500 unemployed and an estimated 70,000 underemployed. Many observers (e.g. the IBRD and others) believe that actual unemployment is in the 15 to 17% range surging to 25-30% in areas such as Colon.

This is the most fundamental economic problem facing Panama - the inability of the economy to generate adequate employment. Panama's economy is moving along a growth path inconsistent with underlying demographic trends. During the 1970s increased schooling and early retirement were used (at considerable cost) as artifices to lower the labor force participation rate. Complementing these measures, public sector employment grew steadily and accounted for about three-quarters of the economy's increase in employment during this period. These policy options for dealing with unemployment are no longer available. Currently, some 22,000 to 25,000 Panamanians enter the labor market each year while the economy is creating only some 10,000 to 15,000 new jobs, creating an employment deficit accumulating at more than 12,000 jobs per year.

GDP SUMMARY TABLE

Sector	% Composition By Value (1985)	% Composition By Employment (1983)	Annual % Increase in Value 1981	1982	1983	1984	1985
GDP	100	100	4.2	5.5	0.4	-0.4	3.3
Agriculture	11	29	8.3	-1.5	3.3	0.2	2.9
Manufacturing	10	10	-3.3	2.2	-1.8	-0.6	1.0
Utilities	3	1	5.0	5.3	9.6	-0.3	5.3
Construction	5	6	3.2	20.6	-31.2	-11.3	-1.1
Commerce, hotels and restaurants	12	14	1.4	-0.8	-4.6	0.6	1.1
Transportation, warehousing and communications	25	6	5.7	12.6	8.8	-4.0	5.1
(Colon FZ)	(3)		(1.2	-16.2	-27.9	3.9	17.2)
(Canal Com.)	(9)		(7.3	8.7	-14.5	-0.2	1.4)
Finance, insur. and real estate	14	5	7.2	3.7	4.0	2.9	2.2
Social & community services	9.1		5.3	8.8	3.4	4.7	2.5
Gov't. Serv.	13.2	27	8.8	3.4	4.7	2.5	
Domestic Serv.	1.0		4.5	4.3	0.5	3.1	3.5
Import Duties	1.8		-1.4	6.9	10.5	1.5	9.6

B. GROWTH CONSTRAINTS AND REFORM REQUIREMENTS

Panama desperately needs to broaden the base of economic growth. This will require continued restructuring. Panama's economic prosperity has rested on the "autonomous" service sector. The Canal and the pipeline are largely unaffected by domestic economic policy. They are run autonomously and, in any event, Panama has a unique comparative advantage in transoceanic surface shipment. Similarly, the Free Zone and the international banks based in Panama operate more or less without hindrance from domestic economic policy. Income and growth in these areas are highly invariant against the rules that govern the domestic economy. But Panama requires greater growth than the autonomous sector alone can generate, and in this, economic policy is the crucial factor.

Income from the autonomous sector has masked increasing inefficiency throughout the domestic components of the economy. Panama's cost structure in terms of dollars or man-hours is high. A restrictive labor code, agricultural price supports, and marketing controls consumer price controls, a patchwork system of import protection, and general over-regulation have distorted the economy's cost and incentive structure. Studies commissioned by the USAID-supported Development Studies Project show a significant decline in the economy's overall level of productivity during the 1970s. If productivity had remained constant, GDP would have been at least 20% to 30% higher in 1980 than it was. It seems fair to conclude that the economy is producing many of the wrong things and producing them inefficiently. High costs are apparent even to the casual observer. Business that Panama should be ideally positioned for, e.g., ship repairs, goes elsewhere in the Caribbean where costs are lower.

Faulty policy has been at the heart of the problem. Agricultural policy has aimed at self-sufficiency in basic food stuff. The widespread system of price supports, price controls and quantitative import restrictions misdirected agricultural production, raised consumer costs and added to the Government deficit. There was a proliferation of state enterprises such as sugar mills, and the Agricultural Marketing Institute as well as state support for large communal farms. As a result, value added by the agricultural sector fell on a per capita basis and is now more than 10% below that of 1970.

The industrial sector suffers from a policy of import substitution begun during the 1960s. Protection was applied through an ad hoc system of duties and quotas. A highly restrictive labor code was introduced in the 1970s, sharply raising labor costs and reducing flexibility in virtually every aspect of labor-management relations. Benefits were expanded, hours were regulated, bonuses once given became entitlements and it became extremely costly to remove anyone. This appears to have led simultaneously to both an excessive increase in the economy's capital output ratio and a decline in labor productivity.

These policies and the rigidities and misallocations resulting from them are responsible for the economy's structural current account deficit, its debilitating foreign debt, and its inability to generate sufficient income and employment opportunities to prevent erosion of lower class living standards. With the passage of reform legislation early this year the stage is set for a realignment of the country's economic parameters and greater reliance on market forces.

— The labor code reform, now in effect, allows for productivity bonuses and piecework payments without racheting up salary entitlement by the same amount.

— The Industrial Incentives Law now under implementation will reduce tariffs, eliminate most import quotas and do away with a system under which individual firms negotiate their own protection levels with the Government on an ad hoc basis.

— The Agricultural Incentives Law eliminates the goal of agricultural self-sufficiency and encourages production of commodities for which Panama has a comparative advantage.

The reform momentum is being sustained. The latest agreement with the IMF contains stringent fiscal restraints; i.e., the 1986 fiscal deficit (after ESF grants) cannot exceed $62.4 million. (In effect this is a zero level since the GOP is required to repay $63 million of 1985 borrowing from the National Bank.) Quarterly performance targets are imposed on this and on external and internal borrowing, with tranched drawings of IMF and commercial bank funds conditioned on compliance. Staff level negotiations for the IBRD second Structural Ajustment Loan (SAL-II) are now being concluded. Under SAL-II, the GOP commits itself to very substantial and highly specific economic reform measures, together with short implementation deadline and a binding timetable. Public sector employment must fall 2% in 1986; the agricultural marketing agency is restricted to market information dissemination and warehousing (no procurements); several state enterprises must be closed or divested; the social security program must be restructured; remaining import quotas must be removed, and a host of price controls and price supports must be abolished.

The cumulative requirements of IMF, IBRD, and AID conditionality will go a long way toward creating the basis for sustained growth. However, a great deal more is needed. The new laws have to be fully implemented. The trend towards deregulation must be maintained, accelerated if possible. The Labor Code is still highly restrictive and, among other things, makes it prohibitively expensive to fire employees. Panamanian and U.S. businessmen cite the code, although improved, as a major inhibitor of foreign investment. Plans for implementing the new Agricultural Incentives Law remain to be completed. The USAID-supported Agricultural Policy Project technical assistance may be instrumental in doing so. In contrast, the Industrial Incentives Law contains a detailed implementation schedule for the phase-down of import protection and this will be well underway by the end of August. Privatization is another important area in which significant progress appears possible. Divestiture of state enterprises, both revenue producing and revenue draining is highly desirable and is being encouraged strongly by both the IBRD and AID. FY 1987 ESF funds will also be used to further leverage additional GOP effort in the privatization/divestiture area. More generally, there is a need to correct the long-standing structural imbalance in the current account and begin to repay the foreign debt. To do this is going to require that the economy experience an increase in the price of internationally tradeable goods with respect to the price of non-tradeables; i.e., a fall in the "real" exchange rate of such items as wages in relation to import prices. Lastly, the size of the Government deficit must be kept to minimal levels.

C. CURRENT FISCAL SITUATION

Panama has a classic structural deficit, the budget has been in deficit every year for as far back as our data goes. However, at the same time, the current account has always shown positive; i.e., a surplus before capital investment spending. Panama is a relatively highly taxed economy — with tax burden at about 20% of GNP. Hence higher taxes are not a practical solution to the deficit problem and hardly consistent with the aim of private sector driven dynamic growth. Rather a reduction in and rationalization of

Government spending is called for. Fiscal austerity commenced in 1983. By 1985, the annual Government deficit was reduced to some $100 million, down by two-thirds from the previous year, and well within the IFM ceiling of $160 million. However, the Government was not able to avoid borrowing $55 million from the National Bank. As any net Government borrowing from the National Bank violates IMF performance criteria, these funds (with interest and fees of $8 million) will have to be repaid in 1986.

Public Sector Revenues and Expenditures
(in millions of dollars)

	1982	1983	1984	1985	1986*	1987*
Revenues	1265	1387	1395	1503	1593	1690
(taxes)	615	662	635	689	740	
(non-tax)	650	725	760	814	853	
Expenditures	1727	1652	1699	1622	1685	1794
(ordinary)	1209	1245	1334	1374	1409	1479
(capital)	518	407	365	248	276	315
Net Excluded items	-2	+17	+8	+16	+15	+5
DEFICIT	-464	-243	-296	-103	-77	-100

The biggest factor in the reduction of the deficit was the decline in public sector capital investment which fell 40% from the 1981-84 average to $248 million in 1985.

FINANCING OF THE DEFICIT
(in millions of dollars)

	1984	1985	1986*	1987*
	296	103	77	99.5
External	121	48	140	99.5
(ESF)	(30)	(20)	(15)	
Banco Nacional	175	55	-63	

* Note: 1986 and 1987 figures shown here represent the latest Budget Office, Ministry of Planning and Economic Policy figures, for remaining in compliance with IMF and differ from figures shown in the Government budget. Also, GOP figures have been ajusted to subtract ESF grants from the revenues figure and to add them to the external financing entries.

The 1986 situation looks slightly better than that of 1985. The Government deficit appears nearly under control and sufficient additional funds to cover the remaining gap are in sight. Revenues were up 7.5% in 1985 and may rise by another 5% or 6% in 1986. This increase reflects developments in the autonomous sector. The revival of international commerce generated higher non-tax revenues and the progressive extension of tax liability to former Canal Zone entities generated higher tax revenues. A modest increase in public sector investment is projected for 1986 and 1987 but the overall levels will still be below those of the late 1970s and early 1980s. The reduction in the deficit reflects not only Government political will and donor encouragement but also the end of easy access to fresh credit from the international banks.

A note of caution is in order. While at this writing adequate financing appears at hand, this is based on optimistic assumptions by the GOP on likely foreign assistance disbursements, its ability to restrain spending and otherwise maintain compliance with IMF, IBRD, and AID conditionality, and on the availability of external financing. There is little margin for error. A miscalculation could result in violation of its agreements with the IMF and others, and if confidence were lost, this could unravel the entire delicate package and precipitate a financial crisis.

D. DEBT MANAGEMENT

Because Panama is a small, open, dollar-based economy without its own currency, the cumulative Government deficit and foreign debt are very closely related. Panama's debt is the consequence of heavy deficit spending in the late 1970s and early 1980s. At the end of 1985 total Government debt stood at some $5 billion; the equivalent of one year's GDP. Some $3.6 billion of the debt is external; and of this $1.5 billion is owed to official entities. (The IMF, the IBRD, AID, the Venezuelan and Mexican Oil facilities account for almost all of this.) The remaining $2.1 billion of external is owed commercially, largely to banks. Of the $1.4 billion of internal debt more than half is owed to the Social Security Fund and the National Bank. The interest on debt alone amounts to a quarter of the entire Government budget or roughly $400 million per year. ($330 million in external debt).

A 1986 debt rescheduling package has been put together involving a reactivation of the IMF Standby with some $44 million in 1986 IMF SDR purchases; a commercial bank roll over of $378 million in maturing debt; and $60 million of fresh commercial bank credit. The commercial bank credit is strictly conditioned on new IMF fiscal performance targets and reaching agreement with the IBRD on a second SAL. Funding will be tranched, with disbursements conditioned on continued compliance with the IMF conditions. In addition, a second IBRD Structural Ajustment Loan (SAL-II) of $80 million seems to have been agreed upon and the GOP anticipates that $50 million of this will disburse in 1986. As of this writing (early June) the IMF resources and the new commercial bank funds seem assured and a SAL-II is at hand. Under the terms of the 1986 standby, the current year deficit will have to be reduced to $62.4 million (after ESF) for the year as a whole, $63 million in 1985 borrowing and interest will have to be repaid to the National Bank, and strict ceilings will be placed on new borrowing. Failure of the government to meet any of the IMF quarterly performance targets will jeopardize the entire package.

Some $406 million in external debt matured in 1985, another $610 million matures in 1986, $667 million in 1987. In 1985, amortizations of debt to official organizations were more than covered by new disbursements from these same organizations; and the Government successfully rolled over its $225 million in maturing commercial bank obligations. The GOP apparently expects to sustain this pattern and is in the process of rolling over $378 million of 1986 commercial debt. (Since Panama cannot pay the principal, the bankers may have little immediate choice, but the Government needs to be careful. Problems here could reflect on Panama's investment climate and on its role as a regional banking center. Moreover, the GOP still needs more commercial credit.)

External Financing

	1985	1986	1987
		(in millions of dollars)	
Amortizations	-414	-610	-667
IMF, IBRD, IDB, & AID	76	99	
Commercial Banks	227	378	
Other	111	133	
Disbursements	+458	+721	+649
IMF IBRD, IDB, & AID	162	230	
Commercial Bank roll-overs	225	+378	+459
Fresh bank credit		+60	
Other	71	53	
Balance	+44	+111	-18
Exclusions and inconsistencies	+4	+29	
Net External Finance	+48	+140	

E. THE BALANCE OF PAYMENTS

The balance of payments is largely driven by external factors, and the GOP has little control over it. Merchandise exports are a small portion of the total and in any case are primary commodities whose prices and demand are externally determined. The terms of trade on merchandise items have not been particulary good for Panama with sugar, bananas, coffee, and shrimp accounting for the bulk of exports. The prices of manufactured items and oil which account for most imports has risen throughout recent years, though oil prices are now declining. Panama's basic contribution to the international economy is in the form of non-factor services, particularly interoceanic transport, the demand for which fluctuates with the global level of trade. Free Zone service demand is driven by trade and prosperity in South and Central America. Similarly, the purchase of services by the U.S. military establishment and its employees is largely unrelated to events in Panama.

BALANCE OF PAYMENTS
(millions of dollars)

	1982	1983	1984	1985	1986(proj.)
CURRENT ACCOUNT	-389	-173	-259	-176	-225
Trade Balance	-242	-263	-196	-201	-166
Exports	322	307	279	313	340
Imports	-1087	-968	-972	-1004	-1061
Services Balance	583	711	582	633	577
(int. on pub. debt)	-350	-289	-317	-229	-331)
Unreq. Transfers	36	41	48	83	79

The merchandise trade account, as could be expected from the composition of earnings, is always strongly negative, compensated in large measure by a strong surplus in the services account. Overall the current account has been negative every year for at least the last 35 years, underwritten by external credit. Throughout the late 1970s and early 1980s high interest rates impacting on a rapidly accumulating external debt enlarged the overall deficit. Total debt became unmanageable in 1983 and led to the drying up of external credit in 1983, government austerity and a sharp fall in the current account deficit that year.

Lacking a central bank and with limited local savings, Panama's current account deficit relates closely to the availability of foreign financing. Moreover, given the relative freedom from financial controls and reporting it is difficult to distinguish between domestic and foreign financing.

In 1984 and 1985 there was some improvement in the accounts owing to the drop in petroleum prices and interest rates. Panama's oil bill has fallen by $10 million per month and every percentage point drop in LIBOR reduces the average annual interest charge on Panama's external debt by some $40 million. Unfortunately, the downward slide of interest rates and petroleum prices may be over. With respect to the capital account, direct foreign investment has been dominated in the early 1980s by the building of the pipeline. With its completion, in 1983, net private foreign investment turned mildly negative.

F. CURRENT ECONOMIC CONDITIONS

Thus far, 1986 looks marginally better than 1985 when the current mild recovery began. As yet, there is little in the way of official statistics but impressionistic reports suggest that again it is the autonomous sector that is advancing with little forward motion elsewhere. Pipeline revenues are reported to be running some 5-7% ahead of last year, Free Zone business is thought to be up on the order of 1[illegible]%, canal revenues are running some 8-10% over the comparable period last year and bankers report business good and growing. All this reflects the increasing recovery of the international economy. On the domestic side the situation is more negative. Manufacturing continues to stagnate with little or no new investment as businessmen try to position themselves for the impact of the new industrial incentive law which will reduce effective import protection on existing industry - very sharply in some cases. Agriculture is unlikely to increase — the $4 million reduction in U.S. sugar export quotas and a month-long banana strike being important negative factors. The rest of the economy is thought to be largely unchanged from last year.

IV. PROGRESS IN MEETING FY85 ESF CONDITIONALITY

A. Summary of Covenants:

By August 1986, the Government of Panama will:

1. Prepare and publish a national housing policy which sets forth objectives and strategy for meeting low income housing needs over the next 5 years, and which defines the respective rolls of public and private sector in meeting the needs.

2. Turn over the operation and management of three grain silos, previously financed by USAID, to the private sector.

3. Prepare an in-debth report on the history and prospects of all state-owned enterprises, recommending which should be closed, and assessing the utility and feasiblity of divestiture for each, and evaluate the amounts that might be recieved for each.

4. Present to the Legislature a draft Civil Service Law which includes plans for professionalizing public administration by detailing job descriptions and qualifications required.

B. Status

1. A draft National Housing Policy has been produced and is circulating within the government. USAID/Panama has reviewed the document and finds it to be satisfactory. We expect that the document will be presented to the legislature within the time frame required.

2. USAID funded consultants are preparing a report for the GOP recommending the best way to turn over the operation and management of the silos to the private sector. Progress has been slow but steady progress is being made.

3. Reports on the following state-owned enterprises have been prepared:

- Corporación Azucarera La Victoria
- Banco de Desarrollo Agropecuario
- Empresa Nacional de Maquinaria Agrícola
- Instituto de Mercadeo Agropecuario
- Cítricos de Chiriquí
- Corporación Bananera del Atlántico
- Empresa Nacional de Semillas
- Instituto de Seguro Agropecuario
- Asentamientos
- Sistema de Control Gerencial
  Capacitación Gerencial
- Sale of other assets has been proposed and studied: Aeroperlas, Contadora and Panama Hilton

While studies have not been made of all state-owned enterprises (there are at least 27) we believe these nine studies, when considered with other GOP actions such as the closing of the Felipillo sugar mill, the selling of a hotel to a Japanese investor group, their agreement to close or divest the Las Cabras sugar mill, to transfer to IDIAP the seed research activities of the state seed company (ENASEM), to terminate ENASEM's seed marketing activities, to dispose of the assets of the State's agricultural machinery enterprise (ENDEMA) and to divest an additional three government- owned enterprises during 1986 indicates a resolution on the part of the GOP to press ahead with divestiture.

4. A draft civil service bill has been prepared and is being circulated within the GOP for comment before being presented to the Legislature. It appears, therefore, that the covenant will be met.

While the civil service code as drafted meets the conditionality requirements as to content, USAID and a USAID funded consultant will assess the bill to determine if revisions may be desirable.

With the exception of number two above, USAID/Panama is satisfied with progress to date.

V. THE PROPOSED PROGRAM

The emphasis of the policy dialogue pursued by USAID/Panama under the December 1984 ESF agreement focused on reducing distortions in the labor market, the industrial sector and the agricultural sector. The current policy dialogue highlights the implementation of the new laws while reducing the role and size of government. To this end, the conditionality proposed under this

PAAD amendment complements the conditionality in the August 1985 ESF by requiring a significant reduction in government employment through attrition. The FY 87 ESF program will take this effort a step further through a significant divestiture program and additional reductions in government employment.

The proposed ESF cash transfer will provide urgently needed funds to assist the Government in dealing with its difficult financial position and maintaining compliance with the IMF conditions that are the basis of IMF, IBRD, and commercial bank support. Without these funds, further cuts would be required in an already under-funded investment budget. Public capital infrastructure such as roads, railways, schools and hospitals are noticeably deteriorating. Moreover, this evidence of USG cash support will help reassure international bankers whose financial goodwill is essential. The Government has just concluded a staff-level agreement with the IBRD requiring extensive and essential, but politically painful reforms. The package is fully consistent with USAID's policy dialogue and warrants our support. Our conditionality for the proposed ESF add-on will be used to reinforce and extend this IBRD package. The amount of this funding increment is small but will be effectively utilized to reinforce the central theme of our policy dialogue, IMF and IBRD conditionality, and to carry them one important step further along. This PAAD Amendment should be viewed in the context of our overall ESF program. ESF conditionality and resources, taken together with those of the World Bank and the IMF, allow for the creation of an orderly and directed austerity that is politically manageable. A context is being provided in which the reforms needed for the long term can be implemented without disastrous short term consequences. The balance is a delicate one.

In consideration of the Grant, the GOP will use its own resources to finance selected high priority activities in the investment budget. The activities consist of the infrastructure projects listed in Annex A. The criteria used to select the activities included the following key considerations: (1) implementation of the activities would not increase the number of employees in the public sector; (2) the activities would be implemented rapidly; (3) construction activities would be carried out by private sector firms and (4) the activities would contribute to political stability and economic develoment.

VI. NEW COVENANTS

(Sent by cable separately in Panama 8979)

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ANNEX A

LISTA DE OBRAS DEL PROGRAMA DE INVERSIONES A MANTENERSE EN EL PRESUPUESTO FINANCIADAS CON FONDOS DEL GOBIERNO DE PANAMA

SECTOR	RENGLON	SUB. SEC.
TRANSPORTE		
	A. Ministerio de Obras Públicas	
	1. Construcción Camino Puerto Quimba-Meteti	$ 50.0
	2. Construcción de Drenajes Pluviales	
	a. Canalización del Río Matasnillo	67.2
	b. Dragado de Cauces y Cortes de Taludes	58.8
	3. Mantenimiento de la Carretera Panamericana-Darién	200.0
	4. Reparación de Calles de Veracruz	180.0
	5. Reparación del Puente de las Américas	100.0
	6. Rehabilitación de Equipos (Tractores, camiones, etc.)	200.0
	7. Mejoramiento Vial Urbano	
	a. Mejoras a intersecciones	109.9
	b. Pavimentación de Avenidas y Calles	1,825.0
	8. Obras adicionales en Pasos Elevados	501.1
	9. Construcción del Camino Batería 35-Achiote-Piña	175.0
	10. Construcción del Camino Coquira Chinina	175.0
	B. Ferrocarril de Panamá	
	11. Ferrocarril de Panamá	500.0
SALUD		
	C. Dirección Metropolitana de Aseo	
	12. Saneamiento Ambiental de Panamá Viejo y Equipamiento	600.0
	D. Ministerio de Planificación - MIPPE	
	13. Proyectos de PROINCO	500.0
	14. Obras en el Distrito Especial de San Miguelito	500.0
	TOTAL	$5,742.0

ANNEX B

The country and non-project assistance checklists as presented in Annex 1 of the original PAAD remain valid.