PD-ABS-730
ISN 68158

UNCLASSIFIED

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

PANAMA

PROJECT PAPER

ECONOMIC RECOVERY PROGRAM

AID/LAC/P-521

Project Number: 525-0303
Grant Number: 525-K-604

UNCLASSIFIED

PD-ABB-730

CLASSIFICATION UNCLASSIFIED

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE
APPROVAL DOCUMENT
(PAAD)

1. PAAD Number: 525-0303 525-K-604
2. Country: Panama
3. Category: Cash Transfer
4. Date: June 12, 1990
5. To: AA/LAC, James H. Michel
6. OYB Change Number: N/A
7. From: LAC/DR, Jeff Evans
8. OYB Increase: None
To be taken from: Economic Support Funds (ESF)
9. Approval Requested for Commitment of: $ 243,850,000
10. Appropriation Budget Plan Code: LES090-35525-IG31;72-110/11037
11. Type Funding: ☐ Loan ☒ Grant
12. Local Currency Arrangement: ☐ Informal ☐ Formal ☒ None
13. Estimated Delivery Period: 7/30/90 - 2/91
14. Transaction Eligibility Date:
15. Commodities Financed: N/A

16. Permitted Source		17. Estimated Source	
U.S. only		U.S.	
Limited F.W.		Industrialized Countries	
Free World		Local	243,850,000
Cash	243,850,000	Other	

18. Summary Description

The purpose of this program is to support the Government of Panama (GOP) in implementing policy reforms for economic recovery and to help restore the creditworthiness of the Panamanian public sector. Upon GOP compliance with conditionality, the ESF will be disbursed into a separate non-commingled account for use in two subprograms: (1) $130 million for repayment of GOP debt in arrears to the IMF, IBRD, and IDB within a Support Group effort (payments will go directly to recipients from the separate account), and (2) $113.85 million for budget support to the GOP's 1990-91 public investment budget (with prior A.I.D. approval, monthly withdrawals from the separate account will be deposited in the GOP's "Special Priority Investment Fund" which will channel funds provided by A.I.D., the GOP and other donors for public sector investments in key sectors). Conditionality for subprogram (1) is related to Support Group requirements (e.g. IMF ready to sign a Stand-by and the full financial package ready for the arrears clearing), and for subprogram (2) on policy reforms focusing on fiscal, labor, trade and tariff policies, and privatization of public enterprises, as well as on GOP agreement on measures related to money laundering. Local currency will not be generated.

19. Clearances	Date
GC/LAC:TGeiger	6/15/90
LAC/CEN:GDaniels	6/15/90
ARA/ECP:DMarshall	6/18/90
PPC/EA:JLaPittus	6/15/90
M/PFM/A:RBonnaffon	6/18/90
LAC/DR/CEN:LOdle	6/15/90
LAC/DP:BSchouten	6/18/90
LAC/CONT:CAdams	
DAA/LAC:ESchiek	

20. Action

☒ APPROVED ☐ DISAPPROVED

Authorized Signature: James H. Michel
Date: 6/19/90
Title: ASSISTANT ADMINISTRATOR, LAC

CLASSIFICATION: UNCLASSIFIED

Approval of Methods of Financing

This PAAD complies with current Agency guidance on methods of financing and has provided for adequate audit coverage in accordance with the Payment Verification policy Implementation Guidance.

E. Cecile Adams, Controller, LAC

USAID

PANAMA

USAID/PANAMA
PROGRAM ASSISTANCE
APPROVAL DOCUMENT

USAID

PANAMA

ECONOMIC RECOVERY PROGRAM

NO. 525-0303

USAID/PANAMA
PROGRAM ASSISTANCE APPROVAL DOCUMENT
ECONOMIC RECOVERY PROGRAM, NO. 525-0303

		Page
I.	SUMMARY AND RECOMMENDATIONS	1
	A. Summary	1
	B. Recommendations	3
II.	RECENT ECONOMIC PERFORMANCE AND FUTURE PROSPECTS OF THE PANAMANIAN ECONOMY	3
	A. Structure of the Panamanian Economy	3
	B. The Panamanian Economy in the 1980s	4
	C. Prospects for the Panamanian Economy in 1990	7
	1. Public Sector Finances	7
	2. Clearing of Debt Service Arrears	8
	3. The Banking Crisis	9
	4. Inefficiency and Lack of Competitiveness	10
	5. Outlook for 1990	12
	D. Panama's Outlook in the Medium Term	14
III.	PROGRAM STRATEGY AND RATIONALE	15
	A. U.S. Interests and Objectives	15
	B. Rationale for Program Assistance	16
	C. Linkages with Other Program and Project Assistance	17
	D. Coordination with Assistance Efforts of Other Donors	17
IV.	PROGRAM DESCRIPTION	18
	A. Objectives of the Program	18
	B. Program Conditionality	19
	C. Program Accountability	22
	1. Dollars Used for External Payments	22
	2. Dollars Used for Budget Support	22

Page

D. Status of Negotiations and Program Timetable 26

ANNEXES:

Statistical Tables
Statutory Checklists

USAID/PANAMA
PROGRAM ASSISTANCE APPROVAL DOCUMENT
ECONOMIC RECOVERY PROGRAM, NO. 525-0303

I. SUMMARY AND RECOMMENDATIONS

A. Summary

Panama is emerging from a severe political and economic crisis which culminated in the December military action by the United States, necessary to restore democracy to a country that had been trapped in a ruinous dictatorship. The loss of national income and employment in the last two years has been enormous: the GDP has declined by nearly one-fifth, and the national unemployment rate is about 20 percent, with higher rates in the urban areas of Panama City and Colon. The new government now faces the formidable task of reactivating the economy. The urgency of its task is heightened by high, perhaps unrealistic, expectations of the Panamanian people that their standards of living, substantially eroded over the past several years, will quickly and tangibly improve.

Panama's economic institutions - in both public and private sectors - have emerged from the crisis intact but considerably weakened. A resumption of strong external financial flows coupled with institutional strengthening will be paramount to returning Panama to a path of sustainable growth. Financial and technical assistance, however, can achieve its maximum benefit only in a supportive policy environment. Long unattended weaknesses in Panamanian economic policy must now quickly be addressed by the new government lest they become a damper on the country's recovery efforts.

The United States will provide $420 million in assistance to Panama in FY 1990 to give the country, in concert with resources of other international institutions and donors, the capital it needs to rebuild the economy and set it quickly on a path of sustainable growth. This PAAD provides the rationale and framework for a subset of the U.S. assistance - $243.85 million in Economic Support Funds to be obligated in FY 1990 as cash transfer assistance. The GOP has made a firm commitment to implement a program for the adjustment and recovery of the Panamanian economy. Recent negotiations between the GOP and USAID/Panama have resulted in an agreement on a set of measures to be implemented in the short term. These, together with follow-on measures to be taken in late 1990 or early 1991, will be the basis for the GOP's 1990-1991 Economic Program.

This set of measures is based on the realization that implementation of the Economic Program must begin right away. In their first months in office, President Endara, his cabinet, and other elected representatives have focused their efforts in organizing the functions and administration of the executive, judiciary, and legislative branches to allow the proper functioning

of a political democracy; instituting transparency and accountability in public sector management; and fostering national debate on the many issues of public concern to pave the way for national consensus on the role and direction of government policy. With these foundations well in place, the GOP is increasing its attention towards its policies and programs for national economic recovery.

The purpose of this program is to support the GOP in implementing policy reforms for economic recovery and adjustment and help restore the creditworthiness of the public sector. Disbursement by A.I.D. of the ESF will be triggered by Panama's commitment to and implementation of a concrete policy reform program, described in section IV of this PAAD. The ESF funds will go into a separate account in the name of the GOP in the Federal Reserve Bank of New York, and the funds so disbursed will be used to bolster the resources of the public sector in two key areas: (1) repayment of debt in arrears to the international financial institutions, where the existence of arrears is blocking the resumption of lending to Panama, and (2) budget support to the public sector to supplement the resources available to it for implementation of a priority investment program. The program description and provisions for accountability are presented in section IV of this PAAD.

From the outset, the reader is advised that the structure of an ESF cash transfer program for Panama will differ in some aspects from similar programs in other countries. The typical ESF cash transfer program conforms to the foreign assistance law, which requires that the ESF dollars be maintained in a separate account and not be commingled with any other funds (the "Separate Dollar Account"). Agency policy furthermore provides that ESF dollars be used for external U.S. dollar-denominated payments to finance imports and nonmilitary debt service. Typical ESF cash transfer programs that result in the generation of local currencies of the host country are also subject to the legislative requirement that such local currencies be deposited into a separate account (the local currency "Special Account"), and it is Agency policy that the local currency be either sterilized or used for domestic payments denominated in the national currency for providing budget support and/or financing other local cost activities.

Panama's national currency is called the Balboa. As the country's Constitution forbids issuance of fiat money (i.e., money not fully backed by hard currency or gold) as legal tender, Panama has chosen to use the U.S. dollar as its paper money, while issuing its own coins. Thus, the rules for management of dollars and local currency associated with an ESF cash transfer did not anticipate a case like Panama, where the U.S. dollar is, for all practical purposes, the currency used for both domestic and external payments. USAID/Panama has designed this program taking into account not only the needs of Panama to restore and restructure its economy, but also (1) the purposes for which assistance to Panama has been agreed to by the Congress, (2) the guidance received from the LAC Bureau which recognizes that the Agency's policy on uses of cash transfer assistance does not neatly fit the specific case of Panama, and (3) consultations with the Regional Inspector General's Office on program accountability, audits, and program evaluation.

The proceeding sections of this PAAD describe the economic setting within which the GOP and USAID/Panama will implement the proposed program, including the antecedents to the recent political and economic crisis. Later sections provide the program rationale and the specifics of program design, including policy conditionality, implementation details and likely timing.

B. Recommendations

USAID/Panama recommends authorization of a $243.85 million Economic Support Fund grant cash transfer to the Government of Panama (GOP) to assist in that country's program for economic recovery through (1) normalization of relations with the International Financial Institutions (IFI)s resulting in Panama's renewed access to external resources ($130 million), and (2) provision of budget support to the GOP's "Special Priority Investment Fund" ($113.85 million).

To implement the first component, USAID/Panama requests that the AA/LAC approve the use of ESF dollars for external debt service payments to the IFIs. To implement the second component, USAID/Panama requests AID/W to confirm that the use of ESF cash transfer dollars for budget support is consistent with Agency policy on cash transfers. Furthermore, USAID/Panama recommends that the appropriate Congressional committees be notified that, given the nature of budget support, the end use of the ESF dollars granted for budget support is the program contribution to the GOP's "Special Priority Investment Fund" and hence that the tracking of the dollars ends there.

II. RECENT ECONOMIC PERFORMANCE AND FUTURE PROSPECTS OF THE PANAMANIAN ECONOMY

A. Structure of the Panamanian Economy

Panama's economic history is rooted in geography. Situated on a narrow isthmus between North and South America, the country has served as a hub of international business activity, whether commodity trade in Spanish colonial days or banking and transport at present. Panama's success in providing services to the international market is evident in its achievement - despite a narrow resource base - of a per capita income (about $1,649 in 1989) well above those of its Central American neighbors.

The construction of the Panama Canal in 1904 made transport the leading sector of the economy well into the early 1970s. Two additional centers of growth then emerged. Banking services grew rapidly once favorable banking legislation was passed in 1970. According to the World Bank, the sector grew by 11 percent per year during the decade, so that by the early 1980s there were 130 banks active in Panama employing over 7,000 people. Similar growth was seen for economic activity associated with the Colon Free Zone. Warehousing, transshipment and related free zone activities grew by 14 percent per annum during the same period. By 1989, shipping, banking and other services amounted to about eighty percent of GDP.

Agriculture and manufacturing are less important than elsewhere in Central America, and only contribute about ten percent each to GDP. The small size of these two sectors results from Panama's comparative advantage for service exports as well as a restrictive policy environment businessmen in these sectors confront, particularly price controls, high wages, and government intrusion into marketing and production.

The early 1970s were years of relative prosperity for Panama, but the decade ended in recession due to soaring petroleum prices, uncertainties over the renegotiation of the Canal Treaty. Still, by the early eighties, standards of living had improved at all levels including the poorest. Infant mortality, a key indicator of health standards, fell from 59 infant deaths per 1000 live births in 1965 to only 21 in 1981. The number of doctors per inhabitant increased by more than 60 percent in the 1970s. Secondary school enrollment rose over the same period from 39 percent in 1970 to 63 percent by 1981. Economic growth slowed during the decade of the eighties, and further improvement in social indicators was modest.

B. The Panamanian Economy in the 1980s

A feature of the Panamanian economy key to understanding its macroeconomic performance is that the country has no central bank and uses the U.S. dollar as its paper currency. This arrangement means that the number of macroeconomic management tools the country has at its disposal is limited. Monetary policy is restricted to actions by the state to regulate banking, principally through interest rate policy and reserve requirements, but central bank "creation of money" does not occur. Public sector options for financing its deficit from domestic sources are limited to borrowing from the local banks or individuals, as there is no central bank "maquinita" (printing press) from which the public sector can seek financing. On the balance of payments side, the government cannot use exchange rate adjustments to bring outflows in line with inflows. Inflation at home is a direct consequence of price movements in international markets.

As was the case throughout Central America, Panama responded to the adverse events in the world economy of the late seventies through expansionary fiscal policy designed to buffer the impact of the world recession on its population. As also was the experience elsewhere, this strategy did preserve GDP growth for a few years, but at a cost. The deficit of the nonfinancial public sector jumped from marginal levels in the late 1970s to over ten percent in 1982, and increased foreign borrowing led to a public sector debt to GDP ratio of more than 80 percent by 1983.

The increased level of foreign borrowing needed to maintain growth proved unsustainable, and Panama was forced to adopt a strong adjustment program in 1983. Reduction of the public sector deficit accompanied by structural reforms in the areas of agricultural, industrial and labor policy served to increase efficiency and expand output over the next few years. Panama also alleviated its heavy public sector debt burden through reschedulings of commercial and official debt. The adjustment effort was successful, and the economy experienced growth and stability through 1987.

Political developments in the latter half of the decade reversed these hard-won gains. Growing civil unrest and popular demands for elections precipitated a political crisis in 1987 which led to the suspension of A.I.D.'s programs with the public sector and the subsequent GOP decision to ask A.I.D. to leave Panama. In February of 1988, the Noriega regime replaced President del Valle after the latter tried to retire General Noriega. The United States imposed economic sanctions in April of 1988 to protest the Noriega regime's derailing of the democratic process, a step which greatly exacerbated the country's economic troubles. Included in the sanctions were (1) the freezing of payments to the GOP arising from tax revenues of U.S. companies and Canal fees, and (2) the freezing of the National Bank of Panama (BNP) deposits in the Federal Reserve Bank, and (3) the suspension of the Federal Reserve's check clearing arrangement with the BNP.

Banking center activities quickly collapsed. Between June and December 1987, offshore deposits fell from $22 billion to only $4.5 billion. While the contraction of offshore banking activity had limited impact on the domestic economy, the figure serves to show how rapidly international financial market confidence in Panama dissipated with that country's political problems. More significant to the domestic economy, during the same time period, Panamanian residents withdrew deposits from commercial banks in large amounts. Between June and December 1987, deposits by residents declined by 11 percent ($300 million). To stem this sudden outflow, the Banking Commission imposed a bank holiday that lasted for nine weeks. Commercial banks reopened in May of 1988, but with significant restrictions on withdrawal of deposits. Restrictions on both demand and savings deposits eased slightly during the course of the year.

The drastic decline in deposits and other liabilities of the banks caused a chain reaction of problems for the Panamanian economy in 1988. Domestic credit fell in 1988 by more than 17 percent, with lending to the agricultural sector and letters of credit for import activities sharply curtailed. Importers were forced to pay for their goods either with cash or sight letters of credit. In addition, offshore bank operations which had provided both foreign financing and employment for Panama were reduced to only about one-fourth of their mid-1987 level. Real GDP fell by 16 percent in 1988, led by declines in the manufacturing, construction and financial sectors.

The impact of the crisis can be seen just as easily in the public finance and balance of payments accounts. On the public sector side, total revenue fell from 31 percent of GDP (1985-87) to 23 percent in 1988. Total current expenditure was only marginally reduced, while capital expenditures were slashed to less than 40 percent of their 1987 level. The public sector deficit ballooned from only 1.0 percent of GDP (1985-87) to 10.5 percent. With no central bank to tap, the only means the GOP had to finance the deficit was nonpayment of external and domestic debt - during 1988, $460 million in external interest and domestic payments arrears accumulated, equal to more than ten percent of GDP.

The external sector accounts tell a similar tale. Panama normally finances its large trade balance deficit with a positive balance on the service and capital accounts. In 1988, sharp drops in inflows from these two sources by necessity caused a reduction in imports. Scarce credit and contraction of business activity led imports to drop from $1,054 million in 1987 to $666 million in 1988. Export earnings also slowed to $305 million in 1988, from $367 million the previous year. Large capital outflows due to the crisis of confidence in banking, coupled with a shut-off of credit lines and foreign assistance inflows, left Panama with an overall balance of payments deficit of $1.7 billion, or 38 percent of GDP in 1988. The deficit was financed with an accumulation of external payments arrears and, to a lesser extent, with a drawdown of reserves.

In 1989, Panama's economic situation did not improve. Preliminary data suggest that real growth in GDP was just above zero (some estimates are as low as -3.0 percent), with the most positive factor a slight recovery of the agricultural sector. Value-added from manufacturing and the Colon Free Zone also expanded slightly in real terms, compensating for continued slowdowns in construction, mining and transport services (particularly the oil pipeline).

A small reduction in the deficit of the nonfinancial public sector was achieved in 1989, reflecting further contractions of noninterest current expenditures and investment. As was the case in 1988, the GOP operated without a formal budget. Although state enterprises are engaged in the provision of critical services including power generation, water supply and sanitation, the financial constraints imposed by the economic crisis of 1988 and 1989 precluded maintenance or repair of the capital stock of such enterprises. The deficit was nonetheless large in 1989, at 9.6 percent of GDP, and was again financed through accumulation of external arrears.

On the balance of payments side, the trade deficit grew to $611 million, as businesses restocked their depleted inventories. Net earnings from services fell by about twenty percent, as greater value-added from Colon Free Zone activities was more than offset by further declines in Canal Zone income and other services. Again in 1989 Panama financed its overall balance of payments deficit through accumulation of external payment arrears. By the end of 1989, external payments arrears (principal and interest) totalled $2.4 billion.

In December of 1989, with the surrender of General Noriega, the U.S. government lifted its economic sanctions against Panama. The incoming Endara government inherited an economy in recession and with its public finances in disarray. Civil disturbances and looting that occurred in late December damaged the country's private sector productive capacity (the looting is estimated to have caused losses of over $400 million), while public sector infrastructure was already in bad shape due to several years' neglected maintenance. In addition, the process of structural adjustment and policy reform, begun in the mid-1980s, had been left incomplete and with some backsliding. The new Panamanian leadership has made rapid resumption of the unfinished structural adjustment agenda one of its imperatives.

C. Prospects for the Panamanian Economy in 1990

With its democratic government restored and private sector confidence on the upswing, Panama is poised to achieve rapid economic growth this year and well into the 1990s. Successful reactivation of the economy depends on the ability of the Panamanian leadership to take immediate and decisive action on several key areas of economic policy weakness. The paragraphs below summarize the economic problem areas the Endara government must take action on in the near term, and progress to date.

1. Public Sector Finances

As explained above, the most important macroeconomic policy variable for Panama is the size of its public sector deficit. The Endara government faces the difficult task of bringing the budget deficit down to a level that can be financed comfortably with available external and domestic resources. This task is complicated by (1) the high level of external payment arrears that must be repaid out of the public sector budget, (2) the lagged impact on tax collections of the disruption to private production in 1989 and early 1990, (3) the need to accelerate public investment to make up for the lack of maintenance and new investment during the last few years, and (4) the political and social implications of making necessary reductions in public employment, whose level is high in comparison with other countries in Latin America (about 150,000 of the estimated 800,000 men and women in the labor force work for the public sector).

The Endara government moved quickly to request an IMF mission in March to review the fiscal situation and make recommendations. The consolidated public sector budget presented to the Panamanian legislature in April reflects nearly all of the IMF's suggestions. One technical area where more work is needed is better incorporation of external debt repayment into the budget, in order to correct underbudgeting for commercial debt repayment and to fully incorporate the arrears clearing exercise.

On the current side of the budget, the GOP used an extremely conservative projection of revenues, citing the need to be absolutely sure the budget could balance. Tax revenues were estimated using very low rates of GDP growth for 1989 (income tax) and 1990 (sales taxes) based on the most pessimistic scenario. Any economic performance above the worst-case scenario will lead to higher revenues than projected and free up funds for more rapid repayment of debt. Current revenues are supplemented in 1990 by the one-time windfall of $287 million transferred to the GOP from the $427 million in accounts blocked in the U.S. as a result of the sanctions imposed on Panama by the U.S. Government in April, 1988.

Current expenditures are also tightly budgeted. Budgeted wage and salary payments for the consolidated public sector will contract by $41 million over 1989's estimated expenditure, according to GOP budget documents. This cutback reflects the new government's efforts to reduce the public sector wage bill through attrition and dismissals. Measures have also been taken to reduce public sector fringe benefits (e.g., the 13th month salary) and to roll

back excessive wage increases instituted by the Noriega regime. These cutbacks will permit nonsalary expenditures (including interest) to grow by 26.4 percent over the 1989 level, a move that is expected to increase public sector efficiency. Overall, current expenditures will grow by 9.8 percent over their estimated level in 1989, which is reasonable given the substantial (58.1 percent) increase in interest payments included in the current budget for 1990.

In keeping with the need for austerity, the legislature approved only $272.9 million for Panama's public sector investment budget, a fraction of the $458.4 million identified by the public sector Ministries and agencies as priority investment expenditures. This figure includes "financial investment" which incorporates lending by state banks. A more representative figure would be the $177.5 million for investment expenditure shown in the consolidated public sector accounts prepared by the GOP. This number represents an increase of $106.6 million over the investment executed last year according to the GOP accounts. Of this amount, $39.1 million is budgeted for investment of the Central Government Ministries, an increase of $16.4 million over investment in 1989. The Central Government investment budget is largely ($37.6 million) composed of fixed capital investment. The 1990 investment budget, while an improvement over the past two years, still is well below the Panamanian norm and the amount needed to reactivate growth. By comparison, according to IMF statistics, consolidated public sector investment in the period 1985-87 averaged above $200 million per year and Central Government fixed capital formation more than $100 million.

Within the approved investment budget, some existing programs will be funded at a lower level, some externally financed projects already underway will be slowed due to a lack of counterpart funding and some new activities will be postponed. The government is seeking additional external resources to permit a higher level of public investment, and will submit a revised version of the investment budget to the Legislative Assembly as soon as financing is confirmed.

2. Clearing of Debt Service Arrears

The problem of Panama's $2.4 billion in external payment arrears is closely linked to management of public finances, as the arrears almost entirely belong to the public sector. Most troublesome is approximately $540 million in arrears to the International Monetary Fund, World Bank and Interamerican Development Bank, which, by the norms of those institutions, cannot be rescheduled. As long as IFI arrears are pending payment, the lending windows of the three institutions are closed to Panama. In addition, as of December 31, 1989, Panama had accumulated payment arrearages of $130 million to bilateral official creditors, and about $1,552 million to commercial banks. An additional $146 million in overdue payments to external suppliers and bondholders had accumulated through the end of 1989, bringing the total arrearages to approximately $2.4 billion. This amount represents more than two-and-a-half times Panama's 1989 public sector revenue and more than half of 1989 GDP.

The new GOP has taken steps to repay and reschedule its external payment arrearages in an orderly fashion. The GOP has begun to make 1990 current debt service payments to the IFIs. For IFI arrears accumulated through 1989, the GOP has requested formation of a Panama Support Group and has set aside $130 million of its recently unfrozen reserves as its contribution to the IFI arrears clearing. At the GOP's request, an additional $130 million from the U.S. assistance package will be channelled into IFI arrears clearing. For bilateral debt, Panama plans to seek rescheduling under the auspices of the Paris Club as soon as it can normalize relations with the International Monetary Fund and enter into a Stand-by arrangement. Vice President Ford met with representatives of the commercial banks in New York in May to begin the process of negotiating repayment of overdue commercial debt.

3. The Banking Crisis

The impact of the banking crisis on macroeconomic performance was briefly discussed in earlier sections of this PAAD. The crisis of confidence lingers on, despite the lifting of U.S. sanctions. Restoring confidence to the banking system is a priority of the new government, as expanded and more efficient bank operations are a sine qua non for reactivation of the economy. Expansion of construction, replenishment of inventories, and rebuilding of Panama's financial service sector all depend on resumption of commercial bank credit operations at levels approaching those which prevailed prior to the crisis.

Several barriers remain. The Banking Commission must move quickly to liquidate or otherwise resolve the problem of insolvent banks. Local branches of international banks which are not sufficiently liquid will be left to seek assistance from their home offices, while state banks can be bolstered, if necessary, out of the public sector budget. The banking crisis, however, may have left a few of the 13 private Panamanian commercial banks in poor financial health. The potential existence of a core of insolvent banks threatens the health of the financial sector as a whole. Steps are now being taken to review banks' financial positions to identify the borderline banks.

In addition, although savings deposits were unfrozen in April without causing a run on the banks, the remaining step of unfreezing time deposits is much more delicate and risky. Currently available data indicate that about $900 million in frozen time deposits are held by general license banks (Panamanian and foreign-owned), of which about one-third is owned by foreign depositors. As time deposits tend to be larger in scale and more oriented toward foreign clients, there is a risk that many of these deposits will begin to be withdrawn from the Panamanian banking system after the freeze is lifted, depending on the maturities of the deposits. A sudden contraction in deposits in Panama, which has no deposit insurance and no central bank to serve as "lender of last resort," runs the risk that withdrawals by depositors could exceed liquid assets, at least in some banks, and this could trigger a run on all the banks. A run on the banks, if triggered, would result in a contraction of credit to the private sector, potential bankruptcies of businesses and individuals, and lingering damage to Panama's investment climate.

The current freeze on time deposits expires on July 9, 1990. The GOP is developing a plan for liberating these deposits, and has asked U.S. assistance to design and partially finance a mechanism for assuring adequate bank liquidity in the period after this measure is taken. The plan for directing U.S. assistance to help maintain private sector confidence in Panama's banking sector is outlined in a separate PAAD.

4. Inefficiency and Lack of Competitiveness

Unlike the other areas described above, the general inefficiency of the Panamanian economy is a problem that dates back to the 1970s or earlier, and one whose solutions will be more complex and difficult to implement.

Economists observed a marked reduction in the overall efficiency of the Panamanian economy during the 1970s and early 1980s. The incremental capital-output ratio (the number of units of investment required to increase output by one unit) rose from 4.5 observed in 1965-73 to 6.0 in 1973-80 and to 9.2 during 1980-85. USAID financed a study of the sources of growth in Panama that concluded that the decline in efficiency during the 1970s amounted to the equivalent of over 35 percent of GDP.

External factors such as reduced Panamanian service exports arising from stagnation of the world economy certainly account for part of the loss in efficiency. Of greater interest, however, is inefficiency resulting from factors under the control of the Panamanian government. The chief public policy weaknesses in this regard are:

(a) both the labor code and tax structure artificially inflate the cost of employing labor,

(b) trade and commercial policies are biased against export,

(c) public resources are not well allocated, particularly in the public enterprise sector, and

(d) there is excessive public sector involvement in private production and price-setting.

Each of these weaknesses merits brief elaboration.

a. Labor Costs

The cost of labor is high in Panama. While high wages compared to elsewhere in Central America partly reflect Panama's relatively well-educated work force, the provisions of the national labor code and tax policies price Panamanian labor out of the world market. Growth in export agriculture and manufacturing, for example, will not take off until concrete steps are taken to restore competitiveness.

Other countries have more tools at hand to control real labor costs. For example, some countries devalue to restore an appropriate balance between the costs of domestic labor and imported capital. Panama cannot resort to devaluation, and has little choice but to intervene directly to lower the cost of employing labor. The direct approach to lowering wage costs elicits political and social criticism, but probably less so than allowing the current 20 percent unemployment problem to fester.

There are two areas which merit priority attention. The private sector labor code provides for extraordinary levels of fringe benefits and job security for workers, making it virtually impossible to let an employee go and ruinous to ask him or her to work overtime, at night, or on weekends and holidays. Private sector employers are left with so little flexibility to manage their labor forces that it makes most sense in Panama to structure production to use as little labor as possible. The disincentives to job creation are at odds with the urgent need to find productive private sector employment for Panama's substantial population of jobless workers.

Compounding the problem is the tax code. Wage and social security taxes are high, and represent yet another factor inflating labor costs. At the same time, tax provisions lower the cost of capital, which in the Panamanian context is largely imported.

The new Panamanian leadership has begun work on a strategy for addressing the problem of high labor costs. An immediate policy option is to exempt production in free zones from the strictures of the labor code. This step would constitute a "foot in the door" to demonstrate to workers and the private sector that there are benefits to a more flexible labor policy. Another option under study is to work directly to modify the existing private sector labor code, perhaps by standardizing it with the less rigid public sector code. As regards the tax structure, the Panamanian government is reviewing a proposal made by the World Bank that the GOP initiate a systematic overhaul of the tax structure. USAID expects that action in these two areas will take place over the medium term, with a strategy for action and initial concrete steps set in motion this calendar year.

b. Anti-Export Bias

Trade and commercial policies create unnecessary economic distortions and discourage expansion of exports. While Panama has been a pioneer in adopting liberalized laws for private sector financial and other services, for agriculture and manufacturing the country more closely resembles an old-fashioned import substitutor.

Panama's structural adjustment programs with the World Bank in the early eighties addressed trade and commercial policy. The maximum tariff rate was reduced to sixty percent, and a maximum rate of 30 percent was established for new products. Some specific rates were converted to ad valorem, and standardized to fit under the tariff rate ceilings. Some but not all quantitative restrictions on imports were lifted.

The process toward trade liberalization subsequently stalled, and there was some backsliding. It is now opportune for Panama to pick up the process and identify ways it can shift from inefficient import substitution to a more open export orientation. Some reductions in import duties have already taken place, and others are under consideration, as is elimination of remaining quantitative restrictions on trade. Import monopolies created through licensing requirements also merit attention by the new government. As a longer-term initiative, the GOP will consider modification of fiscal incentives for investment and export so that they are more in line with international norms and create less distortion within the domestic economy. For example, exemption of customs duties for some categories of investors induces a preference for imported capital.

c. Public Sector Inefficiency

Injecting greater efficiency into public sector operations is an essential counterpart to measures balancing the fiscal accounts. One area where the new GOP moved quickly was to strengthen public sector financial management. Once a capable and highly respected Controller General was put into place, the GOP took steps to root out corruption and install responsible financial management procedures throughout the public sector. A.I.D. is assisting in the effort through provision of a technical assistance team now resident in the Controller General Office.

Efforts are also needed to strengthen the financial position of the decentralized agencies of the government. The publicly owned utilities are high-cost operations, in part because of chronic inattention to repair and maintenance, and also because their employment rolls are unnecessarily high. The incoming government has made privatization a priority for action. It is also looking at ways to reduce the cost of its Social Security program, another factor inflating labor costs in Panama. Already, the government has moved to lower the maximum monthly Social Security pension payments from $7,000 to $1,500, raise the retirement age for women to match that of men (60 years) and eliminate the option of early retirement.

d. Regulatory Environment and Price Controls

Finally, the GOP must seek ways to reduce excessive public sector intrusion into the productive sectors. One area for action being discussed in the context of the Food for Progress Program is elimination of price ceilings on food commodities. Government direct involvement in production must also be scaled back or eliminated - for example, public enterprises producing palm oil, sugar and citrus are contemplated as candidates for privatization.

5. Outlook for 1990

The policy agenda that the new Panamanian leadership must seize hold of would be considered ambitious and difficult within almost any context. That the agenda must be pursued in a setting of national recovery

from a severe political and economic crisis, and sold to a population suffering high unemployment and reduced real incomes, makes the task that much more complex. One bright spot, however, is the surprising resiliency of the Panamanian economy. Private sector output in some sectors (e.g. commerce) appears to be rebounding quickly with the lifting of the U.S. sanctions. Also, there appears to have been less disruption to public revenues from the U.S. military action than anticipated, and bank liquidity has spontaneously and dramatically improved during the first trimester of 1990.

What economic response can be expected if the GOP pursues the necessary policy agenda, supported by U.S. and IFI assistance? Immediate stabilization measures combined with the impact of removal of U.S. sanctions earlier this year could produce real GDP growth in 1990 of 5 percent or more over last year's depressed level of output. A fundamental assumption underlying this optimism is that time deposits will be unfrozen early in the second half of this year, without inducing massive capital flight.

The bulk of the growth can be expected to occur in construction and services. Preliminary data (See Appendix Table 2) suggest that utilities, Colon Free Trade Zone and commerce will increase at the fastest pace, and that the financial services sector will recover once the uncertainty surrounding the freeing of time deposits passes. The public sector services component of GDP will not grow, on the other hand, as a result of necessary budget austerity. If Panama moves quickly to normalize its financial relations with multilateral and bilateral institutions, the resulting resumption of foreign assistance and credit inflows may have a positive impact by late in 1990. It is more likely, however, that resumed assistance flows will not have much influence on GDP until 1991.

The other macroeconomic accounts are also expected to show improvement in 1990. The expected state of public finances has already been discussed. For the balance of payments, the current account balance is projected to increase to -3.4 percent of GDP from -1.4 percent in 1989. This figure reflects an expansion in the trade deficit, slow growth in the export of net services and an increase in payments of interest obligations. Exports will be greater than in 1989, principally due to the restoration of the U.S. sugar quota and in growth in exports of apparel. Acceleration of imports will overshadow that of exports, as the private sector restocks its inventories. Growth in overall services is not expected to recover due to a reduction in revenue from oil transshipments.

The key difference in this year's balance of payments is seen in the capital account. Whereas capital flight resulted in an overall deficit on the capital account of 18 percent of GDP in 1989, the same account is expected to be near equilibrium in 1990. Some public sector arrears may accumulate during the year, but private sector capital flight should cease. Strong capital inflows are expected, but such inflows are likely to be matched by investments of the banking center in U.S. capital markets. Exceptional financing equivalent to almost 8 percent of GDP is expected as is the payment of arrears to the international financial institutions.

The statistical appendix to the PAAD provides greater detail on the projected economic performance in 1990.

D. Panama's Outlook in the Medium Term

Once the immediate stabilization program has taken hold, economic growth in Panama is likely to accelerate. With the adoption of appropriate structural adjustment policies as outlined in the preceding section, Panama can reasonably expect sustained growth in the area of 5-7 percent per annum throughout the decade. The bases for growth, however, will differ from those of previous years.

During the 1950s and 1960s, Panama acted as the region's principal entrepot. In the following two decades, public sector investment provided the largest impetus to both growth and employment generation. Because the revenue base of the government was weak, most of the resources for public investment came from external sources. During the 1990s, as Panama seeks to remain current on its large external debt, net external inflows are likely to be small or even negative. The source of medium-term growth must be private sector participation in export-oriented activities.

Panama is largely a service-oriented economy. About 80 percent of GDP is generated from the service sectors, the highest ratio in the world according to the World Bank. Production and export of services will have potential to play an increasingly important role over the medium term, despite the sector's lackluster performance in the recent past. The off-shore banking center, a major employment generator and source of financial resources, underwent a secular decline during much of the 1980s, reflecting both political and economic problems within Panama and the scaling back of international bank operations in Latin America.

The region is now seeing a dramatic change in economic conditions. Growth has revived in many countries, and liberalization of national financial markets has taken root. With these changes, new and innovative financial services are increasingly in demand, including the sale of floating interest rate instruments, futures markets for exchange rates, and money-market services. For Panama to take advantage of these opportunities, its banking law - a model of innovation in 1970 but now somewhat antiquated - must be modernized and bank supervision activities must be strengthened.

Reestablishment of Panama's banking sector will not be enough to guarantee strong growth in the medium term. Creation of a supportive policy framework will allow Panama to exploit a series of advantages that can make possible a more diversified, export-led growth. Four factors are particularly important.

(1) Panama is close to both U.S. and Latin American markets. With the existence of the canal, shipping facilities are close at hand.

(2) The country possesses a skilled, largely bilingual work force. Although wages are relatively high, the wage structure does reflect the skill mix and education of the population. The characteristics of the labor force suggest that high technology services have potential as a source of growth.

(3) The dollar economy reduces the risk for foreign investors.

(4) The transfer of the Canal Zone to national ownership makes available substantial new land near the canal and close to infrastructure, providing an important resource for the expansion of export-oriented facilities.

Industries that could profit from Panama's unique advantages include export processing zones, regional maintenance facilities, regional distributional operations for all of Latin America, tourism, nontraditional agriculture, and satellite-based services.

One fact is clear. The public sector cannot be responsible for initiating these activities, nor can expanded public expenditure be an engine of growth. The GOP has neither the resources nor the ability to successfully carry out productive activities. Nevertheless, the public sector leadership does have the responsibility to foster a climate where domestic and foreign investors can respond to market signals. Private entrepreneurs need the flexibility to make decisions without long delays and with a reasonable certainty about the rules of the game. Government regulations need to be clear, and regulations must be streamlined. Once a transparent and responsive regulatory environment is in place, private sector activities will begin to accelerate.

III. PROGRAM STRATEGY AND RATIONALE

A. U.S. Interests and Objectives

As the site of a key interoceanic canal and of associated U.S. military bases, Panama is of great strategic importance to the United States. The U.S.-Panamanian partnership in operating the Canal as established in the 1977 Panama Canal Treaties has worked well. This positive relationship will continue to be crucial as we turn complete control of the Canal over to Panama, a process which by virtue of the Treaties is to be completed on December 31, 1999. U.S. economic interests in Panama apart from the Canal are also strong: U.S. private investment in the country is substantial, ranking among the largest in all of Latin America. U.S. objectives are to assist the GOP to restructure government policy and administration in order to allow the proper functioning of a market economy and political democracy.

The U.S. is committed to supporting Panama in the improvement of the country's medium-term growth prospects. Such improvement requires both the immediate reconstruction of the economy as well as the adoption of policies that will free the private sector from the constraints imposed by previous

governments. Some of these tasks can be quickly achieved, as Panama has a skilled and dynamic private sector that can respond rapidly to incentives. Other tasks may require a longer timeframe. Policy reform - with special attention to tax structure, banking laws, the labor code, trade and tariff policies, and privatization of public enterprise - must be well designed and then implemented over the medium term. Moreover, some areas of policy reform must be reinforced through institutional strengthening. Care must be taken to ensure that public sector activities do not interfere with, but rather facilitate, private sector initiatives and possibilities.

B. Rationale for Program Assistance

The fastest possible recovery of the Panamanian economy will help solidify the country's political and social stability. It is essential that the high unemployment level be reduced and that the erosion of family income be reversed. The public perceives the new Endara government to be acting effectively to address the many serious problems it faces in the political, economic and social spheres. It is essential that the positive public perception be sustained. The new GOP has made a visible departure from the past in fostering national debate and consensus-building as its approach to problem-solving. All levels of society are embracing their new democratic freedoms, and have expressed a willingness to share in the economic sacrifices implied in restructuring the economy and its institutions. The strong national goodwill existing at present represents an extremely favorable opportunity for the GOP to make a running start on its economic reform agenda. The GOP needs to take advantage of this opportunity, and it needs to do so quickly. The process of change will encounter increasing difficulties if public support for the GOP is eroded by lack of results and rising social tensions.

The overriding priority for the recovery of the Panamanian economy is judicious injection of additional external resources to revitalize private enterprise and bolster public sector investment, thus stimulating economic activity and generating employment. Quick-disbursing ESF assistance, especially for public sector investment, can address the pressing problem of urban unemployment and demonstrate to the population that its new government is capable of delivering results. Public sector investment alone, however, will not carry the day. The resumption of private financial flows is central to rebuilding private sector confidence and investment in the Panamanian economy. By pumping liquidity into the Panamanian financial system, quick disbursing nonproject assistance will help resuscitate Panama's dynamic banking center.

Another essential ingredient in Panama's recovery is other donor support. Panama's relations with IFIs need to be normalized through payment of arrears to trigger a resumption of assistance in support of the GOP's economic program. The availability of quick-disbursing ESF will permit the U.S. to participate in a Support Group to encourage the GOP to adopt and implement its medium-term economic restructuring program and resolve the arrears problem. Thus, the nature of the constraints to the recovery of the

Panamanian economy - in the near and longer term - calls for quick relief through cash transfer assistance to alleviate the short-term liquidity and budgetary resource shortages and to encourage adoption of policy reforms to ensure sustained growth in the future.

C. Linkages with Other Program and Project Assistance

In analyzing the constraints to the recovery of the Panamanian economy, the Mission, in consultation with the LAC Bureau, has determined that the proposed nonproject assistance should be authorized and provided under two agreements: one to provide productive liquidity for private sector revitalization (to be presented in a separate PAAD), and another (presented in this PAAD) to provide resources for payment of arrears to the IFIs and budget support for the public sector investment budget including program audit and evaluation. The two programs are interrelated and mutually reinforcing. They have been separated because of differing arrangements for managing and monitoring the assistance.

The Mission is currently providing project assistance under the Immediate Recovery Project which finances housing for families who lost their homes during the U.S. military action, credit for small businesses that suffered damages during that action and subsequent looting, a public works program to repair public infrastructure and generate temporary jobs, technical assistance in financial management and economic policy formulation, and commodity assistance for several GOP entities. With Supplemental funding, the Mission will also provide project assistance to reinforce long term change in several priority areas. The project portfolio will thus include assistance for improving Panama's new civilian police services; strengthening its public administration, focusing on implementation of reforms in the judicial, financial management, and economic policy areas; human resource development; export and investment promotion; and protection of the Panama Canal watershed. These longer-term efforts will sustain support for policy reforms, thereby contributing to the longer term development goals in Panama.

D. Coordination with Assistance Efforts of Other Donors

Panama's mid-term recovery program will require the participation of the IFIs and bilateral donors, preferably within the context of a Consultative Group. Before a formal Consultative Group can be formed, a Support Group will need to be brought together to pledge support for the GOP's economic program, thereby providing some of the resources for the clearing of approximately $540 million in arrears to the IFIs. Repayment of amounts in arrears will pave the way for normalizing the GOP's relations with the IFIs and subsequently with bilateral donors and commercial creditors.

The IMF, which made its preliminary recommendations to the Panamanian authorities during a visit in March, is optimistic that a Stand-by can be agreed to relatively quickly. The conservative budget passed by the Panamanian legislature is consistent with nearly all of the IMF recommendations. The IMF believes the GOP will move forward quickly on the

policy agenda underpinning a Stand-by and also on measures necessary for an economic recovery loan under consideration for co-financing by the IDB and IBRD. The clearance of arrears should go forward in a matter a months, depending on how quickly the Support Group can be brought together and come forward with the needed amounts.

The plan is for Panama to go directly into a Stand-by once the arrears are cleared. There will be no "shadow program" intermediate step. A Paris Club rescheduling of bilateral official debt will take place after the signing of the Stand-by, as well as negotiations with commercial banks to adjust debt service payments to Panama's ability to service its external commercial debt. The GOP has already initiated discussions with a bank advisory committee representing its commercial creditors.

An IBRD mission visited Panama in mid-May and left a policy agenda matrix for consideration of GOP officials. The policy agenda is a comprehensive one, encompassing measures related to the labor code, a long-term plan for debt management and national recovery, the financial sector, public expenditure, trade and commerce, prices, the tax system, the social security system, and poverty and social sectors, as discussed in earlier sections of the PAAD. The IBRD will send another mission to Panama later to move the policy agenda towards definition of conditionality for the $200 million program loan to be co-financed by the IBRD and IDB.

The negotiation of the IBRD-IDB program is a key part of the arrears clearing process. One source of resources for repayment of the $540 million in IFI arrears is a $150 million U.S. Treasury bridge loan - a short-term credit likely to extend no more than 180 days. The arrears-clearing plan is for the IMF, the IBRD, and the IDB to disburse a first tranche of $50 million each from their respective new programs to permit timely repayment of the Treasury bridge loan.

The proposed A.I.D. assistance to Panama will complement and reinforce the policy measures of IMF and IBRD-IDB assistance efforts to provide consistent support for Panama's recovery program. As the GOP's policy agenda becomes better defined, USAID/Panama will coordinate with other donors and IFIs to ensure consistency of efforts.

IV. PROGRAM DESCRIPTION

A. Objective of the Program

The purpose of the program is two-fold: to assist Panama in the implementation of an economic reform program and to restore creditworthiness to the Panamanian public sector. The proposed $243.85 million cash transfer grant of Economic Support Funds will be used for two subprograms. For the first subprogram, $130 million will be provided as the United States contribution to a Panama Support Group arrangement for assisting Panama in carrying out its economic recovery program, and thereby clearing the country's approximately $540 million in arrears to the IFIs. For the second subprogram,

$113.85 million will bolster the public sector investment program to assist in the construction and repair of essential infrastructure. In addition, $150,000 in ESF PD&S funds will be used to cover costs of independent financial review and program evaluation of the investment program. Both subprograms will be conditioned on adoption by the GOP of both short-term stabilization policies and a medium-term policy reform program to achieve structural adjustment and growth.

B. Program Conditionality

The two proposed subprograms will share conditions precedent and covenants relating to the general adoption of a sound economic policy program by the GOP and to management and oversight norms applied by A.I.D. to cash transfers. In addition, there will be items of subprogram-specific conditionality relating to the individual objectives of each subprogram and their likely timing.

Shared Conditionality for Both Subprograms

Shared conditionality that will appear in the grant agreement will relate to the usual ESF program requirements, i.e.:

(1) Establishment of a separate, interest-bearing dollar account in a U.S. bank.

(2) Presentation of a legal opinion that the ESF agreement is a binding agreement for the GOP, and of specimen signatures of the designated Panamanian officials who will sign grant-related documentation.

(3) Presentation of a letter detailing financial management and reporting procedures for both subprograms, including provisions for an independent financial review and inspection of the budget support subprogram to be carried out by a local CPA firm.

Conditionality for the Subprogram to Normalize Panama's Financial Relationships with the IFIs

Conditionality for the subprogram relating to clearing of arrears is by necessity limited to that agreed upon by the Support Group. Thus, for the subprogram to provide $130 million for the clearing of IFI arrears, there will be the following additional conditions precedent to disbursement, i.e.:

(4) Adoption of a short-term stabilization program that meets the requirements for an IMF stand-by program. (This requirement can be met through presentation to A.I.D. of a signed letter of intent with the IMF or an appropriate signal from the IMF that the as-yet unsigned letter of intent has been approved by the IMF Managing Director.)

(5) A letter expressing that the GOP has set aside $130 million to be used as Panama's contribucion to the clearing of IFI arrears.

(6) Evidence that no additional IFI arrearages have accumulated beyond those payments overdue as of December 31, 1989, or as of any other date agreed to by the Panama Support Group.

(7) Evidence that the Panama Support Group has identified sources of funding sufficient to repay the full amount of Panama's arrearages with the IFIs and is ready to proceed with the debt-clearing exercise. (This condition could be met, for example, with a letter from the Chair of the Support Group.)

Conditionality for Budget Support Subprogram

For the subprogram relating to investment budget support, the U.S. will pursue a policy agenda with the Government of Panama relating to policy actions necessary (as discussed in previous sections of the PAAD) for accelerated growth in the medium term. There will be significant complementarity between the measures detailed below and the policy commitments Panama will make as part of its policy-based program to be signed with the IBRD and IDB. The existence of the A.I.D. assistance will help Panama adopt initial measures according to an accelerated timetable. The A.I.D. program will also provide financial support to reactivate the economy in 1990, whereas resources to become available from the IFIs cannot come on stream until the arrears clearing process is complete.

The disbursement of the $113.85 million will be divided into three tranches to support the GOP's public sector investment budget. Splitting the program into tranches reflects two concerns. First of all, because the grant will come available relatively late in the Panamanian fiscal year, the full amount of funds cannot be easily absorbed into 1990 investment activities. Secondly, many of the needed policy actions will take time to develop.

The latter point bears elaboration. The economic adjustment measures the GOP is contemplating cannot be executed through a stroke of the pen. Privatization plans, for example, will require actions such as inventory of assets and drafting of legislation. A three-tranche approach allows us to support initial and priority actions the GOP will undertake in the near term, as well as use the second and third tranche disbursements to encourage the GOP to maintain momentum as it carries out its economic program.

Conditions Precedent to First Tranche Disbursement

The following program-specific conditions precedent will apply to the first tranche of ESF ($29.85 million) designated as investment budget support:

(8) Presentation of an assessment and plan to rationalize public sector finances, containing actions already taken and projections for the medium term with respect to revenues, current expenditure, salaries, savings, reduction of internal debt, and investment.

(9) Presentation of a letter identifying the first several public enterprises that will be privatized as part of its economic program, and a plan of action to implement these privatizations.

(10) Presentation by the Executive to the Legislative Assembly of a proposed Constitutional amendment which would provide for administrative and financial autonomy of the Social Security System.

(11) Presentation of a plan to lower tariffs, eliminate quantitative trade restrictions and reduce the number of products whose prices are subject to control, as part of a strategy to improve commercial and trade policy.

(12) Formulation of a plan of action to improve competititiveness of Panamanian products on world markets.

Second Tranche Disbursement

Prior to disbursement of the second tranche of support to the public sector investment budget ($42 million), the GOP will demonstrate that it has fulfilled the following conditions precedent:

(13) Evidence that Panama has reached agreement on a medium-term economic reactivation program supported by the IBRD and IDB.

(14) Evidence of acceptable progress in implementing policy reforms in the areas of public sector finances, privatization, social security, labor policy and trade and commercial policy, as relates to the plans and programs identified in conditions (8) through (12) above.

(15) Evidence that the GOP has reached agreement with the U.S. for exchanging records on international currency transactions in connection with narcotics investigations and proceedings and is making steady progress towards signing a Mutual Legal Assistance Treaty.

Third Tranche Disbursement

Prior to disbursement of the third tranche of support to the public sector investment budget ($42 million), the GOP will demonstrate that it has fulfilled the following conditions precedent:

(16) Evidence that Panama has received the first tranches of program assistance from the IBRD and IDB.

(17) Evidence of acceptable progress in implementing policy reforms in the areas of public sector finances, privatization, social security, labor policy and trade and commercial policy, as relates to the plans and programs identified in conditions (8) through (12) above.

(18) Evidence of satisfactory progress towards signing a Mutual Legal Assistance Treaty.

C. Program Accountability

The norm is to discuss financial tracking arrangements for the U.S. dollar-denominated Separate Account and the local currency-denominated Special Account in this section of the PAAD. Because Panama uses the U.S. dollar as its currency, the usual taxonomy does not apply. This section will be divided into two discussions, one detailing the financial management process to be followed for ESF used for external payments (i.e., repayment of external debt service) and the other for ESF used for domestic payments (i.e., budget support). In developing the following accountability system, USAID/Panama has adhered to agency policy and Bureau guidance.

1. Dollars Used for External Payments

Of the $243.85 million grant, $130 million will be available for payment of debt service in arrears to the International Monetary Fund, the World Bank and the Interamerican Development Bank. While the Support Group may establish a joint fund where individual donors can deposit their contribution to arrears-clearing, the United States will maintain its contribution in an uncommingled "Separate Account" in the name of the National Bank of Panama in the Federal Reserve Bank of New York until it is withdrawn by the GOP for the purpose of making debt payments. The GOP will commit to repaying the IFIs directly from the Separate Account, without placing the funds in an intermediate account. The GOP will also agree to providing USAID with a monthly statement from the account, copies of telex orders relating to withdrawals from the account which indicate the institution and loan number for which payment is made, and copies of the telex receipt of funds from the IFI paid. With this documentation, USAID will track and monitor that funds are used only for eligible transactions. The ESF agreement will contain a redeposit clause in the event that a withdrawal is made for an ineligible use.

2. Dollars Used for Budget Support

In line with the legislation authorizing the assistance, USAID/Panama is proposing use of a portion of the grant - $113.85 million plus any interest generated by the Separate Account - for general budget support to the GOP consolidated public sector investment budget. The investment budget contains both direct capital investment undertaken by the central government and decentralized agencies, and "financial investment" which includes financial transfers to decentralized agencies for credit programs and other

types of investment. As discussed earlier, the budget support is necessary to help Panama engage in essential repair of infrastructure and other priority activities.

Assessment of Public Sector Budget Process - In developing its proposal that ESF funds be programmed for budget support, the Mission undertook an analysis of the public sector budgeting process and financial management system. Unlike in previous years, in 1990 the public sector is operating within the confines of a formal budget approved by the Legislative Assembly. Prior to approval of the national budget by the Ministry of Planning and then the Legislative Assembly, each Ministry and decentralized agency must present a profile for each activity it proposes containing an activity description, cost estimate, execution plan and schedule and the implementing agency's assessment of the activity's relative priority. The Ministry of Planning then plans the investment budget within the available level of resources, using a system of prioritization that is transmitted to the Ministries and decentralized agencies in writing. For example, priority is given to covering counterpart requirements of externally-funded projects. The budget proposal is presented to the Legislative Assembly for approval, as are any amendments which revise and/or expand the overall level of expenditure. USAID/Panama believes the budgeting system to be formalized, with proper checks and balances, and based on adequate analysis and prioritization.

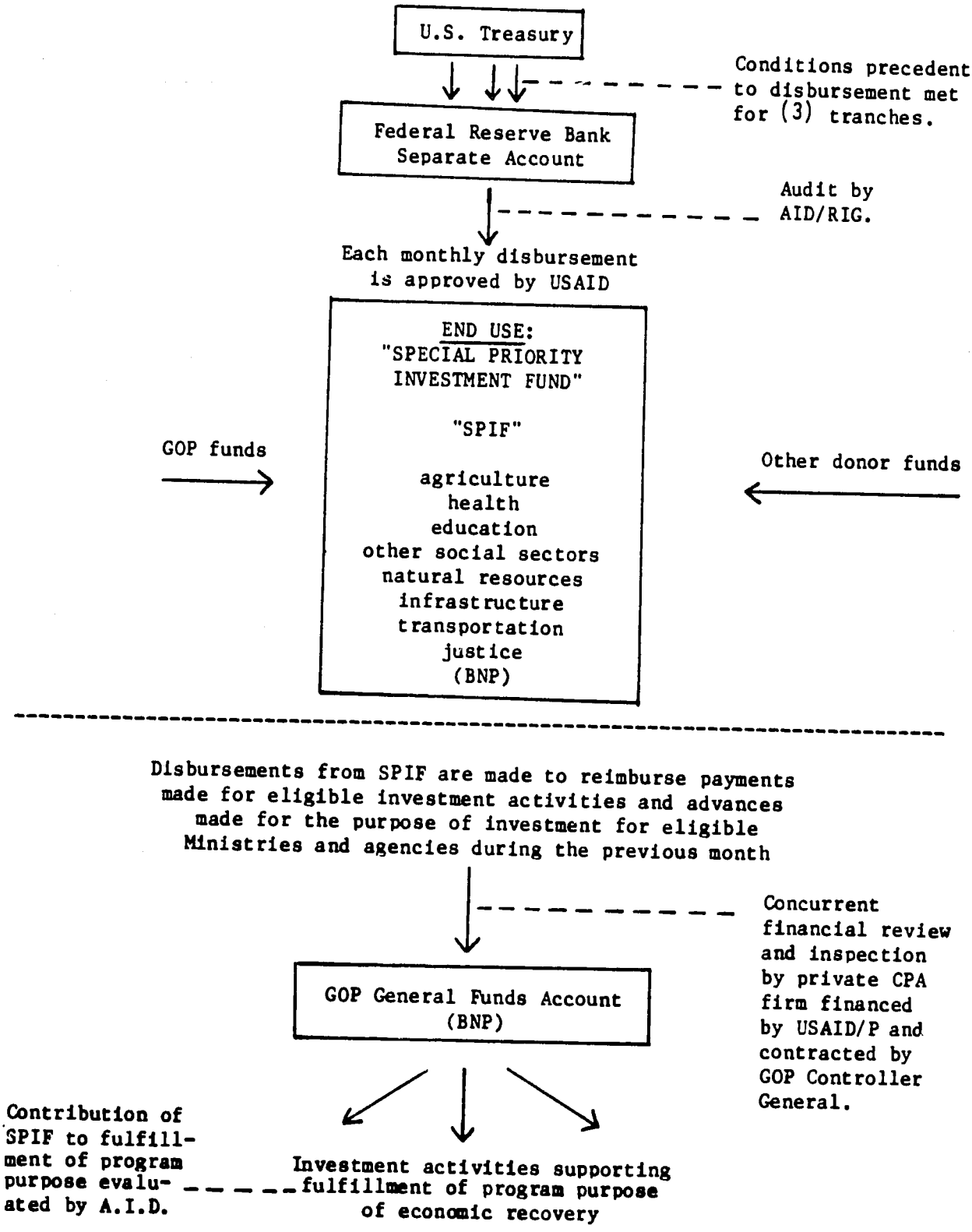
Disbursement into the Separate Account - Once Panama has complied with the conditions precedent to disbursement for each tranche of the budget support program, the associated dollar funds will be deposited into Panama's Separate Dollar Account (in the name of the National Bank of Panama) in the Federal Reserve Bank and will be recognized as expenditure once so deposited. The same account will be used for both subprograms, and will be interest-bearing.

Withdrawals from the Separate Dollar Account - Withdrawals will be made on a monthly basis according to GOP projections of the financing needs of its priority investment program and will be deposited in the GOP's "Special Priority Investment Fund" (SPIF) in the National Bank of Panama. Each withdrawal from the Federal Reserve account will be approved in advance by USAID.

The first disbursement from the Federal Reserve Bank will be based on an estimate by the GOP of the implementation requirements for the following two months. Thereafter, the GOP will present to USAID, 30 days prior to the desired withdrawal from the Federal Reserve Bank account, its estimate of implementation funding requirements, the amount of funds to be available from GOP and other donor sources, and the amount of A.I.D. funds which will be needed. USAID/Panama will review the estimate, and approve the amount of the monthly withdrawal from the the Federal Reserve Bank account.

Diagram No. 1

FLOW OF FUNDS - BUDGET SUPPORT COMPONENT OF PROGRAM



- 23a

Financial accountability will center on documentation demonstrating that the GOP transferred the approved amount from the Separate Account into the SPIF. Withdrawals from the Separate Account will be subject to audit by staff of the RIG.

The Special Priority Investment Fund - The monthly disbursements will be deposited into the Government of Panama's "Special Priority Investment Fund" (SPIF) account in the National Bank of Panama. The deposits will be the end use for the funds granted for the budget support subprogram.

The SPIF channels resources for priority investments in agriculture, health, education, justice, other social sectors, natural resources, and infrastructure designated by the GOP as most necessary for rapid reactivation of the economy and creation of short-term employment. A.I.D. will not have approval rights over specific projects to be included in the SPIF, nor will A.I.D. provide guidelines for prioritization, but will rely on the normal investment budget activity selection process established by the GOP.

The budget support mechanism will work in the following way. The SPIF account will channel funds provided by A.I.D., the GOP and other donors, in order to assure that all sources of funding are in place and ready for priority investments. Because of its focus on a certain few sectors which the GOP has indicated to be of highest priority, the SPIF will not by definition contain any A.I.D.-prohibited uses. (The prohibited uses of funds will be nonetheless specified in the grant agreement.) Because deposits into the SPIF represent the end use of the ESF grant, the funds will not be tracked or audited by A.I.D. beyond this point. Financial and administrative control systems will consist of A.I.D.'s approval of withdrawals from the Separate Account, audit by the RIG of such transfers, GOP reporting on the SPIF, and USAID/Panama program monitoring.

GOP Financial Management of the SPIF - All payments of the state (including those of the decentralized agencies) are approved in the GOP's Controller General Office and all checks are drawn on public sector accounts held in the National Bank of Panama. This means that the locus of control for the SPIF (as with all public sector expenditures) is the Controller General Office. The GOP issues all checks for all payments approved by the Controller General Office through a revolving account in the National Bank of Panama known as the General Funds Account. All SPIF activity payments will be made in this manner, then once per month approved expenditures of SPIF activities will be reimbursed from the SPIF to replenish the General Funds Account.

Under the LAC Financial Management Improvement Project, a Price Waterhouse team is working in the Controller General Office to assess and help improve public sector financial accountability. The initial assessment of the Price Waterhouse team is that financial controls, while improved, are still weak. For this reason, during the period in which technical assistance and other support will be provided to bolster the Controller General Office's

capabilities, USAID will finance an independent financial review of disbursements out of the SPIF to activities it finances as well as inspection of the investment activities. These review activities will be carried out on an ongoing basis by a private sector accounting firm contracted by the Controller General Office so that if problems are found the Controller General Office can suspend payments until problems are corrected. As the ESF funds will lose identity, the financial review will focus on verifying that financial management and control functions relating to SPIF activities are being carried out in a responsible and thorough way. The financial review will supplement the normal audit function executed by the Controller General Office. USAID will reserve $100,000 in ESF PD&S funds to cover the costs of the independent financial review and inspection.

Reports - The GOP financial reporting will be as follows. The Controller General Office will report monthly on disbursements from the Separate Account into the account holding funds for the SPIF, and will provide documentation that clearly demonstrates that withdrawals of the amount for budget support were deposited into the SPIF account in the National Bank of Panama. In addition, the Controller General Office will provide quarterly information on the execution of the priority investment activities to be financed with monies of the SPIF.

Program Evaluation - USAID will finance evaluations shortly after the end of the Panamanian 1990 and 1991 fiscal years to look at the impact of funds available through the SPIF on meeting the program purpose. For example, the evaluation will look at short-term employment generation, relationship of investment activities on economic reactivation, and the speed of execution of high priority investments. USAID will allocate $50,000 of ESF PD&S funds to cover the costs of the evaluation for which it will contract directly.

Adherence to Guidance - The financial management system USAID/Panama is proposing was reviewed with staff of the Regional Inspector General Office for its conformity with the foreign assistance legislation and A.I.D. policy. The RIG staff reviewed the Mission's approach to financial accountability of both components of the ESF program, and cautioned that the budget support component will likely require an exception to the "tracking to end use" requirement for the ESF cash transfer assistance. The RIG recommendations are consistent with the LAC Bureau guidance for program design, which acknowledges that the purpose of the assistance should be served when funds are disbursed from the Separate Account to the investment account(s) of the GOP ministries and ideally tracking should end there.

In addition, Bureau guidance notes that modifying the (program) proposals to make them fit into current standards for one category of assistance or another (program versus project) is not consistent with the purposes of the Panama program as stated in A.I.D.'s representations to the Hill. To implement the budget support component, USAID/Panama requests AID/W to confirm that the use of ESF cash transfer dollars for budget support is

consistent with Agency policy on cash transfers. Furthermore, USAID/Panama recommends that the appropriate Congressional committees be notified that given the nature of budget support, the end use of the ESF dollars for the budget support is the program contribution to the GOP's "Special Priority Investment Fund" and hence that the tracking and audits by the RIG of the ESF by definition must end there.

D. Status of Negotiations and Program Timetable

1. Status of Negotiations

The GOP has reviewed its economic performance with staff of USAID, the IMF and the World Bank, and has prepared an economic policy program to enable it to draw upon fast-disbursing assistance from all three sources. The program is now being vetted within the public sector prior to being presented publicly during June, 1990. The GOP hopes to proceed with the detailed version of its economic program relatively quickly, so that the Support Group can complete its process of arrears clearing within the next three months and an economic recovery sector loan can be arranged with the World Bank shortly thereafter. A great deal of work will be involved in adhering to this ambitious timetable, but the GOP is committed to moving rapidly, conscious of the need to reactivate the economy as quickly as possible.

Now that the U.S. assistance for Panama has been approved by Congress, the Congressional Notification has been submitted, and the ESF funds apportioned, USAID/Panama will seek authorization of this PAAD by AID/W. Once the PAAD has been authorized and the final language regarding the policy commitments outlined in this PAAD can be agreed to by the two parties, the ESF grant agreement will be signed. USAID/Panama estimates that signing can take place within a few days of program authorization.

The date of disbursement of the portion of the grant for arrears clearing depends entirely on the pace set by the Support Group. The first tranche of the budget support component most likely will disburse at about the same time, but disbursement could take place somewhat before or after, as the two subprograms have different conditionality. The second tranche of the budget support component would most likely be disbursed during the fourth quarter of calendar year 1990, followed by the third tranche in the first calendar quarter of 1991.

2. Program Timetable

USAID/Panama has prepared the following illustrative timetable of the likely timing of the signing and implementation of the program. The schedule as shown represents an optimistic scenario where the steps that A.I.D. must take are handled as expeditiously as possible. The unknown element is the timing of the Support Group meetings and the amount of time that will be necessary for the individual donors to arrange disbursement of their portions of the financial package for arrears clearing.

DATE	IFI NORMALIZATION SUBPROGRAM
5/29/90	USAID/Panama cables CN and ESF apportionment request to AID/W.
6/1/90	U.S. Treasury formally requests formation of Panama Support Group.
	AID/W sends Congressional Notification forward to Hill.
	Program funds apportioned.
6/4/90	USAID/Panama sends PAAD to AID/W.
6/11/90	IMF arrives in Panama to finish work on Stand-by Program.
6/12/90	DAEC approves program.
6/16/90	CN expires.
6/17/90	USAID/Panama receives cable authorizing program.
6/18/90	IMF draft letter of intent approved by GOP, and IMF staff return to Washington.
6/19/90	Grant agreement for both subprograms is signed.
--	Support Group identifies sources of full amount of financing.
--	Stand-by Program receives informal approval at IMF staff level.
--	Stand-by Program receives informal approval at IMF management level.
--	Support Group financing fully in place (namely, all donors are ready to disburse).
--	U.S. and other Support Group members disburse (U.S. disburses the portion of assistance programmed for arrears clearing into the Separate Account).
--	Treasury Bridge Loan extended.
--	IFI arrears are cleared. GOP enters into Stand-by Arrangement with IMF.
--	World Bank team returns to Panama to negotiate economic recovery loan.
--	Panama enters into process of official debt rescheduling under auspices of Paris Club.

DATE	IFI NORMALIZATION SUBPROGRAM
--	GOP and World Bank agree on economic program loan.
--	World Bank/IDB loans approved and first tranche disbursed.
	Treasury bridge loan repaid.

DATE	BUDGET SUPPORT SUBPROGRAM
5/29/90	USAID/Panama cables CN and ESF apportionment request to AID/W.
6/1/90	AID/W sends Congressional Notification forward to Hill.
	Program funds apportioned.
6/4/90	USAID/Panama sends PAAD to AID/W.
6/12/90	DAEC approves program.
6/16/90	CN expires.
6/17/90	USAID/Panama receives cable authorizing program.
6/19/90	Grant agreement for both subprograms is signed.
--	GOP presents materials demonstrating that all conditions precedent to disbursement for budget support first tranche have been met. First tranche disbursed.
--	Conditions precedent to budget support second tranche met and disbursement takes place.
--	Conditions precedent to budget support third tranche met and disbursement takes place.

Table 1
Panama
Selected Economic Indicators

	1985	1986	1987	1988 p/	1989 e/	1990 e/
POPULATION						
Thousands	2180	2227	2274	2322	2371	2421
Growth Rate (%)	2.2	2.2	2.1	2.1	2.1	2.1
NATIONAL ACCOUNTS						
GDP current prices (m. US$)	4902	5145	5310	4518	4563	n.a.
GDP 1970 prices (m. US$)	1997	2063	2111	1774	1780	1869
Real GDP Growth Rate	4.8	3.3	2.3	-16.0	0.3	5.0
Real Per Capita GDP Growth Rate (%)	2.6	1.1	0.2	-17.7	-1.7	2.8
Gross Domestic Investment/GDP (%)	15.4	16.7	17.5	7.4	10.3	n.a.
Public	4.8	4.2	3.7	1.9	1.7	n.a.
Private	10.6	12.5	13.8	5.5	8.6	n.a.
Gross National Savings/GDP	12.5	17.5	17.2	14.1	8.9	n.a.
Public	3.3	4.3	3.0	-5.0	-4.4	n.a.
Private	9.2	13.2	14.2	19.1	13.3	n.a.
Foreign Savings/GDP	2.9	-0.8	0.3	-6.7	1.4	n.a.
PRICES						
Consumer Prices (1975=100) Annual Change (%)	0.9	0.0	1.0	0.2	-0.1	n.a.
EXTERNAL PUBLIC DEBT						
Debt Outstanding, as of Dec. 31, ($m.) 1/	3692	3830	3991	4046	4053	n.a.
Debt Outstanding/GDP	76.8	76.0	72.1	88.3	87.8	n.a.
External Payments Arrears (amount accumulated each year) 2/	0.0	0.0	26.9	1449.0	888.5	n.a.

SOURCE: International Monetary Fund

NOTES: 1. Includes short-term and IMF
2. Total Outstanding at end of 1989 was $2,364.4 million.
p/ = preliminary
e/ = estimated

(table prepared 5/24/90 with data of 1/90)

TABLE 2
PANAMA
Selected Indicators of Short-term
Economic Performance

	Jan-Mar 1989	Jan-Mar 1990	April 1989	April 1990
Industrial Electricity Consumption (000 KWH)	61801	62894	21778	22402
Residential Electricity Consumption (000 KWH)	152803	156506	50093	53125
Production of Cement (m. tons)	29858	24272	17530	5054
Construction Permits ($'s 000)	2987	4818	1361	n.a.
Hotel Occupancy (%)	33	29	32	n.a.
Panama Canal - Tonnage Transported (000 l. tons)	37601	37962	12668	n.a.
Colon Free Zone - Value of Reexports ($ 000)	529.4	651.7	185.0	214.7
Oil Pipeline - Barrels Transported (000)	33191	25786	3803	8416

SOURCE: Ministry of Planning and Economic Policy

5/25/90

TABLE 3
PANAMA
Balance of Payments
(millions of US $'s)

	1986	1987	1988	1989 e/	1990 p/
Current Account	40.3	-16.3	301.7	-61.9	-165.0
Trade balance	-767.6	-798.2	-432.0	-611.5	-770.0
Exports	359.4	367.3	304.7	300.0	355.0
Imports	-1127.1	-1165.6	-736.7	-911.5	-1125.0
Public Sector Interest	-324.1	-300.3	-353.9	-384.9	-395.0
Paid	-324.1	-295.0	-1.8	0.0	-95.0
Arrears	0.0	-5.3	-352.1	-384.9	-300.0
Other services	1036.9	1017.7	1002.5	849.4	900.0
Transfers	95.1	64.6	85.1	85.1	100.0
Capital Account	-40.3	-418.4	-1364.9	-826.6	-355.0
Official Capital	-287.7	-462.8	-732.2	-598.8	-335.0
Disbursements	225.8	106.1	60.3	0.0	0.0
Amortization	-513.5	-568.9	-628.0	-503.6	-515.0
Funds in Escrow	0	0	-164.5	-75.2	130.0
Private Capital	247.4	44.4	-632.7	-227.8	-20.0
Exceptional Financing	0.0	434.7	1063.2	888.5	520.0
BOP Grants 1/	0.0	0.0	0.0	0.0	410.0
Refinancing	0.0	408.7	-385.8	0.0	0.0
Old Arrears	0.0	26.9	1449.0	888.5	-540.0
Interest	0.0	5.3	352.1	384.9	-212.0
Capital	0.0	21.6	711.9	503.6	-328.0
New Arrears	0.0	0.0	0.0	0.0	650.0
Interest	0.0	0.0	0.0	0.0	300.0
Capital	0.0	0.0	0.0	0.0	350.0

SOURCE: 1986-89: International Monetary Fund,
1990: Controller General Office and USAID projections 3/90

e/ = estimate
p/ = projection

NOTES: 1. Includes U.S. $130 million ESF for arrears clearing in 1990.

TABLE 4
PANAMA
Financial Operations of the
the Central Government
(in millions of balboas)

	1986	1987	1988	1989 e/	1990 p/
Total Revenue	1033.9	1073.8	601.1	566.0	1049.1
Direct Taxes	383.5	402.0	231.2	178.3	217.3
Foreign Trade	154.1	147.8	54.4	65.2	94.5
Exports	11.5	12.3	0.1	0.1	12.8 1/
Imports	140.4	134.0	53.1	64.4	81.7
Consular Fees	2.2	1.5	1.3	0.7	1.0
Transactions Taxes	239.6	249.1	181.5	174.1	225.2
Nontax Revenues	256.7	275.0	133.9	148.4	247.7
Frozen Deposits	0.0	0.0	0.0	0.0	264.4
Total Expenditures	1098.4	1173.3	1130.9	1161.6	1195.4
Current Expenditure	1010.5	1078.2	1095.7	1131.6	1165.3
Wages and Salaries	436.8	459.8	451.3	447.3	411.4
Goods and Services	95.2	131.0	104.7	109.7	124.8
Transfers	183.5	216.5	187.8	238.0	236.0
Interest	265.8	242.0	329.2	336.6	393.0
Internal	28.1	27.3	43.5	34.6	40.0
External	237.7	214.7	285.7	302.0	353.0
Capital	87.9	95.1	35.2	30.0	30.1
Surplus/Deficit	-64.5	-99.5	-529.8	-595.6	-146.3

SOURCE: International Monetary Fund, USAID estimates
1989 estimate is based on IMF projection updated with GOP fiscal projections. 1990 projection is based on GOP budget and USAID estimates of execution rates. The U.S. cash transfer is not factored in, nor is the impact on the budget of the IFI arrears clearing exercise.

NOTES: 1/ Revenue from tax on banana exports.

5C(1) - COUNTRY CHECKLIST

Listed below are statutory criteria applicable to: (A) FAA funds generally; (B)(1) Development Assistance funds only; or (B)(2) the Economic Support Fund only.

A. GENERAL CRITERIA FOR COUNTRY ELIGIBILITY

1. FY 1990 Appropriations Act Sec. 569(b). Has the President certified to the Congress that the government of the recipient country is failing to take adequate measures to prevent narcotic drugs or other controlled substances which are cultivated, produced or processed illicitly, in whole or in part, in such country or transported through such country, from being sold illegally within the jurisdiction of such country to United States Government personnel or their dependents or from entering the United States unlawfully? No.

2. FAA Sec. 481(h); FY 1990 Appropriations Act Sec. 569(b). (These provisions apply to assistance of any kind provided by grant, sale, loan, lease, credit, guaranty, or insurance, except assistance from the Child Survival Fund or relating to international narcotics control, disaster and refugee relief, narcotics education and awareness, or the provision of food or medicine.) If the recipient is a "major illicit drug producing country" (defined as a country producing during a fiscal year at least five metric tons of opium or 500 metric tons of coca or marijuana) or a "major drug-transit country" (defined as a country that is a significant direct source of illicit drugs significantly affecting the United States, through which such drugs

are transported, or through which significant sums of drug-related profits are laundered with the knowledge or complicity of the government): (a) Does the country have in place a bilateral narcotics agreement with the United States, or a multilateral narcotics agreement? and (b) Has the President in the March 1 International Narcotics Control Strategy Report (INSCR) determined and certified to the Congress (without Congressional enactment, within 45 days of continuous session, of a resolution disapproving such a certification), or has the President determined and certified to the Congress on any other date (with enactment by Congress of a resolution approving such certification), that (1) during the previous year the country has cooperated fully with the United States or taken adequate steps on its own to satisfy the goals agreed to in a bilateral narcotics agreement with the United States or in a multilateral agreement, to prevent illicit drugs produced or processed in or transported through such country from being transported into the United States, to prevent and punish drug profit laundering in the country, and to prevent and punish bribery and other forms of public corruption which facilitate production or shipment of illicit drugs or discourage prosecution of such acts, or that (2) the vital national interests of the United States require the provision of such assistance?

(a) Yes, The U.S. and Panama signed a bilateral Narcotics Agreement on January 10, 1990.

(b) Yes.

3. 1986 Drug Act Sec. 2013. (This section applies to the same categories of assistance subject to the restrictions in FAA Sec. 481(h), above.) If recipient country is a "major illicit drug producing country" or "major drug-transit country" (as defined for the purpose of FAA Sec 481(h)), has the President submitted a report to

Congress listing such country as one: (a) which, as a matter of government policy, encourages or facilitates the production or distribution of illicit drugs; (b) in which any senior official of the government engages in, encourages, or facilitates the production or distribution of illegal drugs; (c) in which any member of a U.S. Government agency has suffered or been threatened with violence inflicted by or with the complicity of any government officer; or (d) which fails to provide reasonable cooperation to lawful activities of U.S. drug enforcement agents, unless the President has provided the required certification to Congress pertaining to U.S. national interests and the drug control and criminal prosecution efforts of that country?	(a) No. (b) No. (c) No. (d) No.
4. <u>FAA Sec. 620(c)</u>. If assistance is to a government, is the government indebted to any U.S. citizen for goods or services furnished or ordered where: (a) such citizen has exhausted available legal remedies, (b) the debt is not denied or contested by such government, or (c) the indebtedness arises under an unconditional guaranty of payment given by such government or controlled entity?	No.
5. <u>FAA Sec. 620(e)(1)</u>. If assistance is to a government, has it (including any government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities?	No.

- 25

6. FAA Secs. 620(a), 620(f), 620D; FY 1990 Appropriations Act Secs. 512, 548. Is recipient country a Communist country? If so, has the President: (a) determined that assistance to the country is vital to the security of the United States, that the recipient country is not controlled by the international Communist conspiracy, and that such assistance will further promote the independence of the recipient country from international communism, or (b) removed a country from applicable restrictions on assistance to communist countries upon a determination and report to Congress that such action is important to the national interest of the United States? Will assistance be provided either directly or indirectly to Angola, Cambodia, Cuba, Iraq, Libya, Vietnam, South Yemen, Iran or Syria? Will assistance be provided to Afghanistan without a certification, or will assistance be provided inside Afghanistan through the Soviet-controlled government of Afghanistan? — No.

7. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, damage or destruction by mob action of U.S. property? — No.

8. FAA Sec. 620(l). Has the country failed to enter into an investment guaranty agreement with OPIC? — No.

9. FAA Sec. 620(o); Fishermen's Protective Act of 1967 (as amended) Sec. 5. (a) Has the country seized, or imposed any penalty or sanction against, any U.S. fishing vessel because of fishing activities in international waters? (b) If so, has any deduction required by the Fishermen's Protective Act been made? — No.

10. FAA Sec. 620(q); FY 1990 Appropriations Act Sec. 518 (Brooke Amendment). (a) Has the government of the recipient country been in default for more than six months on interest or principal of any loan to the country under the FAA? (b) Has the country been in default for more than one year on interest or principal on any U.S. loan under a program for which the FY 1990 Appropriations Act appropriates funds?

(a), (b) Yes. However, the FY90 Supplemental Appropriation, H.R. 4404, pursuant to which the assistance will be provided, waived the application of FAA Sec. 620(q) and of FY90 Appropriations Act Sec. 518 (Brooke Amendment) to the assistance to Panama.

11. FAA Sec. 620(s). If contemplated assistance is development loan or to come from Economic Support Fund, has the Administrator taken into account the percentage of the country's budget and amount of the country's foreign exchange or other resources spent on military equipment? (Reference may be made to the annual "Taking Into Consideration" memo: "Yes, taken into account by the Administrator at time of approval of Agency OYB." This approval by the Administrator of the Operational Year Budget can be the basis for an affirmative answer during the fiscal year unless significant changes in circumstances occur.)

The Administrator's annual 620(s) report takes into account all A.I.D. recipient countries. While assistance to Panama was not included in the Agency's initial FY90 04B, such assistance was resumed after U.S. economic sanctions were removed in March 1990. Moreover, because Panama has eliminated its military forces, the issue of military expenditures is moot.

12. FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have relations been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?

No.

13. FAA Sec. 620(u). What is the payment status of the country's U.N. obligations? If the country is in arrears, were such arrearages taken into account by the A.I.D. Administrator in determining the current A.I.D. Operational Year Budget? (Reference may be made to the "Taking into Consideration" memo.)

Panama is in arrears on payment of its U.N.obligations. These arrearages were not taken into account in the Administrator's "Taking into Consideration" memo, dated Dec. 1989, because at that time U.S. assistance to Panama was not contemplated. Subsequently, assistance to Panama was authorized by the Congress. Arrearages to the U.N. do not prohibit U.S. assistance.

14.	FAA Sec. 620A. Has the President determined that the recipient country grants sanctuary from prosecution to any individual or group which has committed an act of international terrorism or otherwise supports international terrorism?	No.
15.	FY 1990 Appropriations Act Sec. 564. Has the country been determined by the President to: (a) grant sanctuary from prosecution to any individual or group which has committed an act of international terrorism, or (b) otherwise support international terrorism, unless the President has waived this restriction on grounds of national security or for humanitarian reasons?	(a) No. (b) No.
16.	ISDCA of 1985 Sec. 552(b). Has the Secretary of State determined that the country is a high terrorist threat country after the Secretary of Transportation has determined, pursuant to section 1115(e)(2) of the Federal Aviation Act of 1958, that an airport in the country does not maintain and administer effective security measures?	No.
17.	FAA Sec. 666(b). Does the country object, on the basis of race, religion, national origin or sex, to the presence of any officer or employee of the U.S. who is present in such country to carry out economic development programs under the FAA?	No.
18.	FAA Secs. 669, 670. Has the country, after August 3, 1977, delivered to any other country or received nuclear enrichment or reprocessing equipment, materials, or technology, without specified arrangements or safeguards, and without special certification by the President? Has it transferred a nuclear explosive device to a non-nuclear weapon state, or if such a state, either received or detonated a nuclear explosive device? (FAA Sec. 620E permits a special waiver of Sec. 669 for Pakistan.)	No.

19.	FAA Sec. 670. If the country is a non-nuclear weapon state, has it, on or after August 8, 1985, exported (or attempted to export) illegally from the United States any material, equipment, or technology which would contribute significantly to the ability of a country to manufacture a nuclear explosive device?	No.
20.	ISDCA of 1981 Sec. 720. Was the country represented at the Meeting of Ministers of Foreign Affairs and Heads of Delegations of the Non-Aligned Countries to the 36th General Assembly of the U.N. on Sept. 25 and 28, 1981, and did it fail to disassociate itself from the communique issued? If so, has the President taken it into account? (Reference may be made to the "Taking into Consideration" memo.)	Yes. For FY90, after the U.S. military interventio in Panama, the Administration determined that assistance to Panama was in the U.S. National interest when it requested such assistance under a supplemental appropriation which the Congress has authorized.
21.	FY 1990 Appropriations Act Sec. 513. Has the duly elected Head of Government of the country been deposed by military coup or decree? If assistance has been terminated, has the President notified Congress that a democratically elected government has taken office prior to the resumption of assistance?	President Del Valle was deposed by Gen. Noriega in Feb. 1988. Assistance was terminated in March, 1988. As a result of U.S. military intervention in Dec.1989, Gen. Noriega surrendered and the democratically elected government of Pres.Endara took office. On Jan.17,1990, the Secr. of State certified that democracy was restored in Panama.
22.	FY 1990 Appropriations Act Sec. 539. Does the recipient country fully cooperate with the international refugee assistance organizations, the United States, and other governments in facilitating lasting solutions to refugee situations, including resettlement without respect to race, sex, religion, or national origin?	22. Yes.

B. FUNDING SOURCE CRITERIA FOR COUNTRY ELIGIBILITY

1. Development Assistance Country Criteria

a. FAA Sec. 116. Has the Department of State determined that this government has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, can it be demonstrated that contemplated assistance will directly benefit the needy? — No.

b. FY 1990 Appropriations Act Sec. 535. Has the President certified that use of DA funds by this country would violate any of the prohibitions against use of funds to pay for the performance of abortions as a method of family planning, to motivate or coerce any person to practice abortions, to pay for the performance of involuntary sterilization as a method of family planning, to coerce or provide any financial incentive to any person to undergo sterilizations, to pay for any biomedical research which relates, in whole or in part, to methods of, or the performance of, abortions or involuntary sterilization as a means of family planning? — No.

2. Economic Support Fund Country Criteria

c. FAA Sec. 502B. Has it been determined that the country has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, has the President found that the country made such significant improvement in its human rights record that furnishing such assistance is in the U.S. national interest? — No.

d. FY 1990 Appropriations Act Sec. 569(d). Has this country met its drug eradication targets or otherwise taken significant steps to halt illicit drug production or trafficking? — Yes.

3(A)2 - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED? Yes.

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 1990 Appropriations Act Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project.

   A Congressional Notification for this program will be sent to Congress.

2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

   Legislative approval of a revised public investment budget is expected to proceed in a timely fashion.

3. FAA Sec. 209. Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.

   No.

4. FAA Sec. 601(a). Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.	Assistance is being provided to support policy reforms which will have positive impacts on (a), (b), (d), and (e).
5. FAA Sec. 601(b). Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).	The policy reforms being supported by the program will liberalize Panama's trade regime and the cost structure of productive investment in Panama, thus encouraging U.S. private trade and investment in Panama.
6. FAA Sec. 121(d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds?	N/A

FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA?	Yes, the assistance will promote economic and political stability in Panama and is consistent with Part I of the FAA.
b. FAA Sec. 531(e). Will assistance under this chapter be used for military or paramilitary activities?	No, assistance will not be used for military or paramilitary activities.

c. <u>FAA Sec. 531(d)</u>. Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?	The assistance will not generate local currencies.
d. <u>FAA Sec. 609.</u> If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made?	The assistance will not entail the granting of commodities to the recipient country.
e. <u>FY 1990 Appropriations Act, Title II, under heading "Economic Support Fund," and Sec. 592.</u> If assistance is in the form of a cash transfer: (a) Are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds? (b) Will all local currencies that may be generated with funds provided as a cash transfer to such a country also be deposited in a special account, and has A.I.D. entered into an agreement with that government setting forth the amount of the local currencies to be generated, the terms and conditions under which they are to be used, and the responsibilities of A.I.D. and that government to monitor and account for deposits and disbursements? (c) Will all such local currencies also be used in accordance with FAA Section 609, which requires such local currencies to be made available to the U.S. government as the U.S. determines necessary for the requirements of the U.S. Government, and which requires the remainder to be used for programs agreed to by the U.S. Government to carry out the purposes for which new funds authorized by the FAA would themselves be available? (d) Has Congress received prior notification providing in detail how the funds will be used, including the U.S. [illegible] served by the assistance, and, as appropriate, the economic policy reforms that will be promoted by the cash transfer assistance?	(a) ESF cash disbursements will be kept in a separate account. A portion of the ESF funds will go from the separate account directly to the IMF, IBRD and IDB for payments of debt arrearages. Another portion of ESF funds will be drawn down periodically from the separate account and deposited in the GOP's "Special Priority Investment Fund"(SPIF) in the National Bank of Panama for use as budget support for the GOP's investment program. The SPIF account will contain the ESF funds and funds of the GOP and other donors. The nature of budget support means that the ESF dollars deposited into the SPIF represent the end use of the ESF for budget support. (b) No local currencies will be generated. (d) Prior to obligation of the ESF funds, the Congress will be notified how the funds will be used, the U.S. interests that will be served, and the policy reforms that will be promoted by the assistance.

2. Nonproject Criteria for Development Assistance

a. FAA Secs. 102(a), 111, 113, 281(a). Extent to which activity will: (1) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (2) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (3) support the self-help efforts of developing countries; (4) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (5) utilize and encourage regional cooperation by developing countries? N/A

b. FAA Secs. 103, 103A, 104, 105, 106, 120-21. Is assistance being made available (include only applicable paragraph which corresponds to source of funds used; if more than one fund source is used for assistance, include relevant paragraph for each fund source): N/A

(1) [103] for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made; (b) extent to which assistance is used in coordination with efforts carried out N/A

under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value; improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration programs explicitly addressing the problem of malnutrition of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

(2) [104] for population planning under Sec. 104(b) or health under Sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems, and other modes of community outreach. N/A

(3) [105] for education, public administration, or human resources development; if so, (a) extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, and strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education N/A

and training of people of developing countries in such disciplines as are required for planning and implementation of public and private development activities.

(4) [106] for energy, private voluntary organizations, and selected development problems; if so, extent activity is: N/A

(i)(a) concerned with data collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of research on and development and use of small-scale, decentralized, renewable energy sources for rural areas, emphasizing development of energy resources which are environmentally acceptable and require minimum capital investment; N/A

(ii) concerned with [illegible] and development, especially with U.S. private and voluntary, or regional and [illegible] development, organizations; N/A

(iii) research into, and evaluation of, economic development processes and techniques; N/A

(iv) reconstruction after natural or manmade disaster and programs of disaster preparedness; N/A

(v) for special development problems, and to enable proper utilization of infrastructure and related projects funded with earlier U.S. assistance; N/A

(vi) for urban development, especially small, labor-intensive enterprises, marketing systems for small producers, and financial or other institutions to help urban poor participate in economic and social development. N/A

46

(5) [120-21] for the Sahelian region; if so, (a) extent to which there is international coordination in planning and implementation; participation and support by African countries and organizations in determining development priorities; and a long-term, multidonor development plan which calls for equitable burden-sharing with other donors; (b) has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of projects funds (dollars or local currency generated therefrom)?	N/A

DRAFTER:GC/LP:EHonnold:3/20/90:2169J

LAC-IEE-90-29

ENVIRONMENTAL THRESHOLD DECISION

Project Location	:	Panama
Project Title	:	Economic Recovery Program (FY 90 ESF Balance of Payments Program)
Project Number	:	525-0303
Funding	:	$243,850,000 (ESF)
Life of Project	:	1 Year (FY 90)
IEE Prepared by	:	John O. Wilson LAC Deputy Environmental Officer
Recommended Threshold Decision	:	Categorical Exclusion
Bureau Threshold Decision	:	Concur with Recommendation
Comments	:	None
Copy to	:	Jeffrey Evans, Director Office of Development Resources
Copy to	:	Toni Wagner, LAC/CEN
Copy to	:	Mark Silverman, LAC/DR/CEN
Copy to	:	Lawrence Odle, LAC/DR/CEN
Copy to	:	IEE File

John O Wilson Date JUN 15 1990

John O. Wilson
Deputy Environmental Officer
Bureau for Latin America
and the Caribbean

48

INITIAL ENVIRONMENTAL EXAMINATION

Project Location:	Panama
Project Title:	Economic Recovery Program (FY 90 ESF Balance of Payments Program)
Project Number:	525-0303
Funding:	$243,850,000 (ESF)
Life of Project:	1 year (FY 90)
IEE Prepared by:	John O. Wilson LAC Deputy Environmental Officer

Recommended Threshold Decision:

a. Recommendation:

The project consists of a cash transfer to provide balance of payments assistance to support economic recovery and adjustment in Panama in FY 1990. The purpose of the program is to support the Government of Panama (GOP) in implementing policy reforms for economic recovery and to help restore the creditworthiness of the Panamanian public sector. Upon GOP compliance with conditionality, funds from this program will be disbursed into a separate account for use in two subprograms: (1) $130 million for repayment of GOB debt in arrears to the IMF, IBRD, and IDB; and (2) $113.85 million for budget support to the GOP's "Special Priority Investment Fund (SPIF)," which will channel funds provided by A.I.D., the GOP, and other donors for public sector investment in key sectors. Tracking of dollars will end with their deposit into the SPIF. Moreover, A.I.D. will not have approval rights over specific projects to be included in the SPIF, nor will A.I.D. provide guidelines for prioritization, but will rely on the normal investment budget activity selection process established by the GOP.

Pursuant to A.I.D. environmental regulations [22 CFR 216.2(c)(1)(ii)], an IEE is generally not required when:

"A.I.D. does not have knowledge of or control over, and the objective of A.I.D. in furnishing assistance does not require, either prior to approval of financing or prior to implementation of specific activities, knowledge of or control over, the details of the specific activities that have an effect on the physical and natural environment for which financing is approved by A.I.D."

Based on A.I.D. regulations in Handbook 3, Chapter 2, it is recommended that no further environmental study be undertaken for this PAAD and that a "Categorical Exclusion" be approved.

Concurrence: _____
Jeffrey Evans, Acting Director
Office of Development Resources

50