

UNCLASSIFIED

Country Development Strategy Statement

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PANAMA



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A. COUNTRY SITUATION AND BACKGROUND

1. Political, Economic and Social Situation

a. Political Update

Panama has just held its first direct Presidential election in 16 years. The new President, Dr. Nicolás Ardito Barletta, is scheduled to take office on October 11, 1984, for a five-year term. Representing the governing Revolutionary Democratic Party (PRD), supported by a coalition of smaller political parties, and backed by the military, he was declared the winner by a tiny plurality over his 82-year-old, charismatic opponent, Dr. Arnulfo Arias, amidst charges of fraud by the opposition which had waged a bitter struggle against corruption and the 16-year hegemony of the PRD and its military backers.

Dr. Ardito Barletta campaigned on a platform of "evolutionary change," and as an economist, former Planning Minister and senior World Bank official, he is fully aware of the need for major economic policy reforms if the Panamanian economy is to grow dynamically over the long term. He has been involved from the start in the IBRD's structural adjustment loan to Panama which supports economic policy reform.

The election was neither fought nor decided on the basis of major economic issues facing Panama. The economic programs of the two principal contenders were essentially similar and consistent with the new directions which we support. We are therefore hopeful that the economic measures which require a degree of public consensus to put into effect will not fall victim to the strong partisan emotions generated by the election.

During the pre-electoral period little forward movement was possible. We are optimistic that the government will now work toward an orderly transition of power in October and in so doing will help lay the basis for economic reforms.

b. Economic Update

In the 1960s, Panama's GDP grew rapidly but the benefits of economic growth were concentrated in few hands and the social and economic infrastructure outside the metropolitan corridor remained at a low level of development. The government which came into power in 1968 sought to introduce major social reforms and to improve the economic and social infrastructure, while attempting to sustain the rapid GDP growth experienced during the 1960s. Between 1968 and 1973 the GDP grew at an annual rate of 7.3% and basic needs indicators began to show significant improvements, suggesting that Panama had devised a successful growth-with-equity model. However, beginning in 1973 private economic activity stagnated and the relatively low rates of economic growth in the period 1973-77 were due to a large extent to increasing levels of government spending financed through foreign borrowing. As a

consequence, Panama has one of the most serious foreign debt problems in the world today.

In 1978 the canal treaties were signed, ending a period of uncertainty related to the negotiations, and this resulted in an increase in confidence and in private investment. However, by 1982 Panama was feeling the impact of the world recession, both generally and particularly through declining exports of services resulting from sharp cutbacks in the income and trade of other Latin American countries. Real private investment fell after completion of the transisthmian oil pipeline. Cost overruns and increases in public spending designed to compensate for the decrease in private investment pushed the public sector deficit up to 11% of the GDP, nearly twice the amount stipulated under the GOP's stand-by arrangement with the IMF. This expansionary fiscal policy offset the effects of world recession and contributed to an increase in GDP of 5.5% in 1982 but required a 19% increase in the external public debt.

In mid-1983, the GOP reached an eighteen-month stand-by agreement with the IMF which imposed strict constraints on public spending, limiting the overall deficit of the public sector to the equivalent of 6% of GDP in 1983. Panama was able to comply with the IMF targets after it instituted a public austerity program. The fiscal austerity, as well as the reduced level of economic activity of Panama's trading partners, resulted in economic stagnation in 1983. Preliminary statistics show a 0.2% increase in GDP in 1983. However, this increase resulted entirely from the value added by the oil pipeline across the isthmus. If value added by the oil pipeline is excluded, the GDP would show a decline of 5.1% in 1983. An important distortion introduced in the national accounts by the pipeline is that the deflator used for that activity is based on a composite index of oil shipping rates, and this index was in 1983 significantly lower than the GDP implicit deflator. If value added by the pipeline is deflated by the GDP implicit deflator, then the GDP would be lower in real terms in 1983 than in 1982.

The economic outlook for 1984 is not bright. Government and private sector economists have stated that an optimistic forecast for 1984 would be zero growth. Beyond 1984, the public sector will be unable to expand significantly and growth in Panama will depend on private sector investment and on world economic recovery. Although in the past the Panamanian economy has responded rapidly to U.S. economic growth, the debt crisis in Latin America will impede significant growth in that region in the immediate future, and this will delay economic recovery in Panama.

c. Social Update

Panama achieved impressive improvements during the 1970's in the provision of schools, health and family planning services, potable water, electricity and communications for its rural population. This achievement required heavy public investment and is reflected in a comparison of social progress indicators for the years 1970 and 1980. (See Annex A.) Having financed these and other less well chosen investments through massive foreign

borrowing, the GOP is now obliged to shift its attention toward economic development and limit public expenditures in order to remain solvent. Without economic growth, the social development which has been achieved cannot be sustained or expanded.

Notwithstanding the change of emphasis from social to economic problems, the government cannot ignore the people's expectations. At a minimum, the existing level of services must be sustained, consolidated and expanded to the extent necessary to keep pace with population trends.

There remain some areas of severe poverty in the countryside as well as the urban areas, with accompanying malnutrition. Affected in rural areas are isolated communities and others which offer little opportunity for off-farm employment, especially in the central provinces. Urban areas are affected by growing unemployment and continued migration from the countryside. The plight of the urban poor is most evident in the congested, decaying tenements of the inner city and sprawling squatter settlements on the fringes of the metropolitan area. In Colon, which is hardest hit by unemployment, street crime has reached proportions which make it unsafe for visitors to go out alone even in the middle of the day.

It is the projected growth of unemployment over the next five years and beyond which gives greatest cause for concern. If the increasing numbers of new labor force entrants are unable to find jobs and the burden of their support must be borne by others, urban poverty will deepen and spread. The GOP's restricted resources will permit only limited measures to alleviate directly the most severe effects of increased poverty. A solution can only be provided by the private sector through a rapid increase in the generation of employment.

d. Major Development Problems

1) Economic Policy

Panama's economic policies differ markedly between sectors. While the service sector developed with a minimum of government regulation and control there has been significant intervention in other sectors. Agricultural policy emphasized self sufficiency in basic food commodities through a pricing policy that raised the prices of deficit commodities and lowered the prices of surplus commodities, resulting in a misallocation of resources. Additionally, price policy was used to some extent as a mechanism to transfer income from urban areas to rural areas. With the advent of the Torrijos administration, there was increased Government intervention manifested through the establishment of government owned enterprises, such as sugar mills, large-scale marketing activities, and the creation and support of agrarian reform comunal farms (asentamientos). Employment in the public agriculture sector and in the government as a whole mushroomed. The Ministry of Agricultural Development (MIDA) emphasized the provision of social services and gave relatively less emphasis to promoting agricultural production, particularly by private farmers. In the industrial

sector, the policy of import substitution which began in the early 1960s was continued. Protection of domestic industries was accomplished basically through a system of import quotas, and the domestic prices of items subject to quotas were regulated through price controls administered by the Office of Price Regulation. The Torrijos government enacted a labor code which has increased significantly labor costs and has restricted the flexibility of entrepreneurs in areas such as productivity payments and apprentice training. The Government attempted to reduce housing costs by establishing rent controls, and by providing loans at subsidized interest rates. As a consequence, the supply of rental housing and of private mortgage financing was restricted.

The set of policies pursued resulted in a misallocation of resources and constrained growth in all sectors with the exception of the service sector. The need to stimulate the economy to compensate for the private sector slack, the expensive nature of many government programs, and the losses sustained by most government enterprises resulted in levels of government spending which greatly exceeded revenue and which required high levels of foreign finance. In the future, economic growth in Panama will have to depend almost exclusively on a reactivation of the private sector that can be achieved only through the implementation of a more appropriate and coherent set of policies. This redirection of economic policy will not be universally welcomed as there is significant opposition from interest groups which benefit from present policies, and some elements in the coalition which won the recent election can be expected to oppose policy changes in some areas.

2) The Public Debt

During the 1970s and 1980s, Panama sustained significant fiscal deficits which were financed mostly by foreign borrowing. The overall deficit of the consolidated public sector averaged over 10% of GDP in the period 1973 to 1983. During that period, the total public debt of Panama increased from US\$800 million (43% of GDP) to US\$4 billion (92% of GDP), a level that cannot be sustained indefinitely. Given this level of debt, Panama will have to maintain strict limits on government spending for at least the next six years.

In Annex B, we have projected the consolidated operations of the non-financial public sector for the period 1984-1989 under the assumption that the GOP will be able to maintain strict fiscal austerity. Under this assumption, the overall deficit of the public sector would be reduced from 6% in 1984 to 2.3% of GDP, and the debt as a percentage of GDP would decline from 92% to 71%.

If fiscal austerity is maintained, it would be possible for the GOP to begin to reduce its commercial foreign debt by 1988. A commitment to fiscal austerity during at least the next six years is absolutely necessary if Panama is to be successful in reworking its commercial debt on terms short of a formal restructuring. Estimates of amortization to commercial lenders

for 1985 and 1986 range from US\$400 million to US\$500 million for the two years.

3) Unemployment

In order to understand the nature of the unemployment problem in Panama today, and the prospects for the future, it is necessary to analyze what occurred in the labor market in the 1970s. Although the rate of job creation in the 1970s ^{1/} was only one half of the rate of the 1960s, the unemployment rate remained stable because of a reduction in the rate of growth of the economically active population, a consequence of a decline in the participation rate. This decline in the overall participation rate was due entirely to a decline in the rates of 15-19 year olds, and of those older than 54 years, an indication that the fall was due to increased levels of high school and university enrollments, as well as a reduction in the retirement age. Although it has been argued that the drop in the participation rate was the result of the "discouraged worker effect," available evidence does not support that conclusion.

The most recent official figures of unemployment are based on the August, 1982 household survey. Unemployment in that year reached 8.4%, and visible underemployment ^{2/} reached the equivalent of 2.1% of the labor force. The data from the 1983 household survey have not been processed completely, but available data indicate that the unemployment rate has increased to about 11.3%, and that unemployment and visible underemployment together had reached about 14%. Fully 73% of the unemployed are concentrated in the Metropolitan region which comprises Panama and its adjacent cities, and Colón. In certain areas adjacent to Panama City, such as San Miguelito, unemployment is close to 20%, and it is said to exceed 25% in the city of Colón. The concentration of unemployment in a few urban areas contributes significantly to the explosiveness of the unemployment issue, which is viewed by many as the most important problem facing Panama today.

Based on the 1982 data, the unemployed in Panama are largely the new entrants to the labor market (44% of total unemployment) and women, with an unemployment rate two times higher than the unemployment rate of males. In fact, the unemployment rate among males 25-50 is about 2%, a rate which would be due entirely to frictional unemployment, i.e., those who are changing jobs. The characteristics of the unemployed are detailed in a recent USAID/Panama report titled "Labor Force Employment - Unemployment in Panama." This report is being distributed to LAC/DP.

^{1/} Roughly three-fourths of these jobs were created in the public sector after 1973.

^{2/} Defined as those who work less than 40 hours per week but would be willing to work more.

Projections for unemployment for the period 1985-89 are shown in Annex C. Given a historically based employment/GDP elasticity coefficient of 0.4, unemployment would increase to 21.7% by 1989.

2. U.S. Objectives

U.S. Panamanian relations are driven by our shared responsibility for the Panama Canal, the presence here of U.S. military bases, Panama's importance as a banking and trading center, and its proximity to the troubled Central American region. U.S. interest here--including heavy U.S. private investment (the third largest in Latin America) and trade exceeding that with the rest of Central America combined--will be preserved and enhanced by promoting democracy and economic and social stability, and by supporting the search for peace in Central America in which Panama is playing a lead role with the Contadora group.

3. Rationale for U.S. Assistance

Long-term political stability in Panama requires a growing economy which can provide short-term benefits and expectations of a better future to the majority of its population. Over the past 16 years Panama was successful in providing education and basic health benefits to an extent not found elsewhere in Central America except in Costa Rica. But it has yet to institutionalize a model of economic growth capable of sustaining steady improvements in economic and social well-being in a changed international economic environment.

The transition to a more market-oriented economic model, now in process, is at a critical juncture. The economic benefits deriving from the structural adjustment of the economy cannot be fully realized for several years. Meanwhile, Panama is faced with a period of rapidly rising unemployment and mounting pressures from various interest groups which stand to lose special advantages with these policy changes.

This economic transition must also take place in an atmosphere of political uncertainty and polarization as Panama strives to return to civilian, elected government after 16 years of military dominance. It will not be easy for the new government to achieve the degree of internal or public consensus necessary to implement such changes as phasing out of import quotas and price controls, revision of labor and housing laws, restricting public sector employment and divesting state enterprises.

The difficulties of the transition process are compounded by Panama's critical financial situation. Without a central bank or currency of its own, Panama cannot resort to a devaluation or to the self-defeating, but often practiced, policy of monetary expansion. Commercial borrowing alternatives are also effectively restricted. Moreover, recourse to the IMF may be temporarily lost or nearly lost after 1984 because Panama will have reached or approached the maximum limits of its IMF borrowings. Although the GOP is committed to further cuts in its already austere budget, the requirements of servicing its \$4.0 billion total public sector debt leave a serious financial gap unfilled.

Targeted financial support by the U.S. is needed if Panama is to sustain essential public services and a minimal level of public investment, as is necessary for the government to overcome political obstacles to economic reforms. More importantly, our support will enable the U.S., in concert with the World Bank, effectively to encourage the government to carry out the new policies. As somewhat higher levels of public investment become feasible in the latter part of the decade, the increment must be directed to those activities which will contribute most effectively to long-term economic growth. By contributing financial and technical resources, the U.S. can have an influence in helping to establish a sound basis for long-term growth, without which all of our objectives will be jeopardized. At the same time, the U.S. can play a useful role in identifying and stimulating key private sector activities directly while supporting GOP efforts to provide facilitative assistance to the private sector and less direct intervention in its functions.

B. GOALS

1. Financial Stability

In order to prevent the decline of the Panamanian economy in 1982 as a result of the world recession, the GOP borrowed heavily to finance an expansion of public investment. While immediately successful in maintaining growth, the result was a 19% jump in external debt and an unsustainable budget deficit of 11% of GDP. Commercial banks, already stung by potential Latin American defaults, began to worry about their Panamanian exposure. Refusal by these banks to at least renew outstanding credits, if not provide net additional financing, would send the declining economy into a tailspin.

As a result, the GOP moved to put its financial house in order. It instituted an austerity budget, postponing new investment and curtailing operating expenditures, and restricted additional debt. It then signed a standby agreement with the IMF committing itself to meet spending and debt limitations over the immediate future. With the IMF agreement in hand, the Government then negotiated a two-year agreement with its commercial bank creditors for financing essentially equal to principal payments coming due during the period 1983-84.

The Government was, thus, successful in resolving its immediate

problem. However, it will again have credits in significant amounts coming due in 1985 and beyond, and a sine qua non for commercial banks to consider another loan will be an agreement on appropriate expenditure and debt restrictions similar to those of the present GOP agreement with the IMF. Given the level of Panama's outstanding debt, we see a continuing need for careful management of Panama's finances in order to assure access to international credit until such time as debt levels begin to fall to prudently acceptable levels. The GOP financial stabilization goal is, therefore, to ensure that in a period of restricted international credits it maintains the internal financial stability which will assure its access to that credit and permit it to reduce its debt levels and debt service burden to acceptable levels.

In the Panamanian context, the best indicator of financial stability is the overall deficit of the non-financial public sector. Under the IMF program this has been limited to about 6% of GDP for 1984, a target which will be met by the GOP. We believe that a tough but realistic program for the future should bring the deficit down gradually to 2.5 or 3% of GDP in 1989, reducing the debt as percentage of GDP from 92% in 1984 to 71% in 1989. (Complete financial projections for the consolidated public sector are provided in Annex B.)

2. Economic Growth

The GOP has been faced with the stark prospect of a stagnating economy and mounting unemployment throughout the 1980s as a result of the world recession but more importantly because the growth strategy it pursued in the 1970s has played out. The leading growth sectors of that decade (international banking, free-zone operations) have matured. In addition, the easy credit to finance public infrastructure is no longer available.

A renewal of economic growth will depend on (i) identifying and providing incentives for new growth leaders of the 80s; (ii) reliance on and stimulation of the private sector as the primary engine of growth; and (iii) stable and improving economic conditions in the Hemisphere. With its financial stabilization package firmly in place, the GOP has initiated a structural adjustment program, with IBRD and AID support, to identify, develop and implement the necessary consistent set of policies required to restore long term growth and efficiency to the economy. With these policies in place and improving economic conditions worldwide, we see improved economic performance stemming from the reactivation of the service sector and expansion in manufacturing, agriculture and construction.

In 1984, we expect zero growth in GDP, with economic growth resuming in 1985 and increasing gradually to 6% by 1989 as shown in Annex B.

Our projections show unemployment increasing to 21.7% by 1989, a politically explosive level. This level is based on expected GDP growth, and on the historical relationship between employment and GDP growth. Our goal is

to increase labor intensive production, and by doing so to begin to decrease the unemployment rate by 1987. To achieve this goal, incremental investment in labor intensive industry would have to be US\$28 million in 1985, US\$62 million in 1986 and US\$104 million in 1987.

3. Equity

The principal goal for the next five years is the maintenance and consolidation of Panama's present, well-developed system of social services and continued broad participation in the benefits of renewed economic growth. In order for social services to keep up with population trends the government must effect economies and reallocate resources within current levels of public spending.

Although the main thrust of our program, except for housing, is not directed to expanding social services, we will closely monitor these areas to determine if as a result of the austerity program any significant reduction in these areas begins to occur. Proxy indicators we will watch will be the percentages of material budget devoted to health, primary education, family planning and rural electrification.

Unemployment is a serious and growing social and economic problem. In the recent past public sector spending and large-scale increases in permanent public jobs have served to keep the lid on the problem. This option has been more than exhausted by the GOP and leaner days are in view for the public payroll, a tough task facing the new administration. As the new administration confronts this hard reality and carries out the policy reforms and structural adjustment program to establish the bases for a reinvigorated economy, it will need some protection from this problem in the very short term. USAID, with modest ESF funds, will help by funding temporary, productive employment for already planned activities (e.g., reforestation, access roads) over the next 18 months. The longer term solutions must come from a reinvigorated private sector as discussed elsewhere in this document.

In the area of most critical need, urban housing, our goal is to double the current annual production of shelter solutions by 1990 through development of financing capacity in the private sector. By developing this capacity in the private sector more lasting employment opportunities can also be envisioned.

4. Strengthening Democratic Institutions

The USG role in furthering democracy in Panama is crucial and the AID role is an important element in that role. However, AID is not directly attempting through its projects to promote democratic institutions in Panama, except insofar as we are effective in supporting institutions such as cooperatives and private sector associations which are representative and work more in harmony with the national government.

The return to democracy in Panama will require nurturing. The spirit

of compromise and issue-orientation (rather than personalities) which is vital to any democratic process needs to be strengthened. A new generation of civilian political leadership is in process of developing, after a gap of 16 years.

The USG country team effort, including USAID, to support the new civilian government will be crucial to encourage and maintain progress. The GOP will be facing several years of difficult economic conditions and fiscal austerity. Its ability to cushion the effects of the difficult times ahead will depend on access to external credit sources and, hence, international financial opinion. The view of the USG and whether it is supporting the Government will be determinant.

5. New Government Directions

With the advent of the De La Espriella administration, Panama began a program of economic policy reform designed to reactivate the economy by stimulating the private sector and promoting exports. The USAID, working in close cooperation with the World Bank, has been instrumental in accelerating the process of policy reform through active support and encouragement. Some initial policy measures already have been undertaken, while others are being defined by a studies program which USAID is assisting. The De la Espriella government announced intended policy changes which include: a) freeing prices of agricultural commodities; b) divestiture of state enterprises; c) ending export restrictions; d) revising labor legislation; e) eliminating import quotas and replacing them with tariffs; f) establishing a low, uniform level of tariff protection and g) changing the structure of institutions in the public agricultural sector, as required by the new policies.

During the recent political campaign, the pro-government and the opposition coalitions enunciated economic platforms which were supportive of the new policy directions defined under the De la Espriella administration. The platforms were basically the same, but the opposition came out more specifically in support of modifications of the labor code, of supporting increased productivity in agriculture and transforming the asentamientos into cooperatives, and of reducing the size and activity of government. However, these were mostly differences in emphasis and less in the substance of their agendas.

Dr. Ardito Barletta, who supported the policy reforms from his former position at the World Bank, is well qualified to guide the country in the direction it must follow to achieve continuing economic and social development. Although it will not be easy, we anticipate that he stands a good chance of being able to muster sufficient support from the members of his coalition, as well as from the opposition, who recognize that Panama's future development depends heavily on a reactivation of the private sector and a streamlining and reorienting of the public sector.

C. Program Strategy

1. Financial Stability

Panama's public debt reached 92% of GDP at the end of 1983, an unsustainable level. Our projections of the operations of the public sector for the next six years indicate that the GOP will have to maintain strict limits on government spending. In the period 1985-87, the public sector net borrowing requirements will average around US\$290 million while the average gross borrowing requirements will exceed US\$600 million per year.

The projections assume that the investment budget of the GOP will be maintained in real terms at the same level as in 1984. USAID assistance would help finance priority elements of the GOP investment budget, and we would expect to review, together with the government and the World Bank, the overall investment budget to determine priorities. We will give priority to projects and programs which are supportive of the private sector, that do not expand the responsibilities of government, and which are otherwise consistent with the structural adjustment program. At the same time we will recognize the government's need to allocate sufficient resources for maintenance and expansion of social services.

Notwithstanding the reliance on the private sector for generation of employment over the longer term, the government will find it impossible to ignore the worsening employment situation in 1985 and 1986. In determining priorities for its restricted investment budget, the GOP is taking into account the immediate employment effects of alternative projects. USAID's budgetary assistance for 1985 and 1986 (including some ESF from the FY 1984 supplemental appropriation) is expected to provide an estimated \$23 million for the support of investment projects which generate substantial, productive employment. Among the projects presently being considered are rural access roads, expansion of seedling production and reforestation, and improvement of streets in rural towns and poorer metropolitan districts. These activities are well worth undertaking from a developmental standpoint, and it is not likely that they could be financed without USAID's assistance.

Our assistance would be conditioned on the implementation of the economic policy reforms discussed below. As we have done in the past, we expect to coordinate closely with the World Bank in the definition of the necessary policy measures. Our assistance will be conditioned also on the maintenance of the austerity program, and we will encourage the GOP to reach a stand-by agreement with the IMF. Our role in promoting financial stability will be supportive of the IMF but we will analyze in greater detail the means by which the overall deficit of the public sector is reduced, particularly the types of expenditures that are reduced. As explained in section 4, below, we will assist the GOP in increasing its efficiency so that the performance of essential governmental functions may be enhanced rather than diminished as a result of fiscal austerity.

2. Economic Growth

a. Policy Reform

Faced with a tight financial situation, and recognizing that most of the sources of economic growth of the 1960s and 1970s have reached a level of maturity which would limit growth in the future, the GOP has undertaken a program of structural adjustment. The government is committed to a reactivation of the private sector and greater reliance on market mechanisms as the basis for economic renewal. With a reversal of interventionist policies, market prices would provide the necessary incentives to the private sector, while public investment would be concentrated in areas supportive of directly productive activities in the private sector. Non-traditional exports would be promoted. USAID, working in close cooperation with the World Bank, has actively encouraged this significant redirection of economic policy, and the major thrust of our country program is to continue our support of the process of economic policy reform. Our policy agenda is summarized in Annex D.

A number of reform measures have been initiated by the GOP since 1982. However, progress virtually halted in 1984 with the approach of the elections and official reluctance to address any issue which might be controversial. Now that the governing party's candidate has won the election, we expect a group will be formed, probably within the Ministry of Planning, to develop an initial economic program for the new government. The group will almost assuredly draw upon the economic studies financed by USAID and the IBRD and will play an important role in developing the policy basis for subsequent AID and IBRD financial assistance.

It is our intent to work with this group in seeking agreement on a statement of principles governing future economic policies. Existing as well as proposed economic policy measures would be tested against these principles so that a coherent and consistent body of economic policy may gradually be put in place. The statement would serve as a point of departure for all subsequent discussions of budgetary and project assistance with USAID and the World Bank, and adoption of the principles should be well publicized. With this knowledge, the private sector as well as public agencies will be able to anticipate policy changes and plan accordingly.

Our most important role in bringing about policy reform is to assist in establishing the analytical basis for choosing the most appropriate policy measures, developing the degree of consensus necessary for their adoption, and overcoming the practical obstacles to their effective implementation. This three-part role is uniquely suited to USAID because of our continuing presence in the country and our greater flexibility as compared to the IMF and IBRD. We will continue to finance expert analytical assistance for the Ministry of Planning (MIPPE) in developing the basic framework of economic policies. At the same time we will furnish similar assistance for sectoral policy development to the ministries of agriculture, housing, commerce and labor.

Since 1982 USAID has been involved in encouraging and financing as necessary the exposition and discussion of policy issues within interested organizations and in public fora. Our efforts have helped to create more open attitudes toward policy change, and they will be continued. The policy studies MIPPE is producing with our assistance will be widely disseminated, and experts participating in these and other studies will explain their findings to appropriate groups. A labor education program carried out with OPG financing will provide a vehicle for reaching labor union members.

The practical obstacles to implementation of new policies are largely institutional. To help overcome them we will finance technical services and training to aid in the restructuring of governmental organizations and development of needed managerial capacity. A project with MIPPE will assist in strengthening the Ministry's capability in its coordinating role.

Our budgetary assistance to the GOP will be conditioned, like that of the IBRD, on fiscal and economic policy measures of the government. While such conditions help strengthen the GOP's resolve to carry out politically difficult policy reforms, results are more likely to be achieved not by the periodic application of leverage but by the exercise of persuasion and presentation of acceptable options for accommodating conflicting private sector agendas. Our ability to respond to immediate needs of the government for technical expertise, to train their personnel, and to compensate for some of their administrative problems makes our support especially useful; it brings us into regular contact with key officials and permits close and effective relations. Through these frequent contacts we are able to reinforce the will of the government to move forward with the new policies to which it is committed.

b) Industry

Panama's past economic policies created conditions which favored the development of a dynamic international service sector which has been characterized by its flexibility and lack of government interference. At the same time, the government promoted the development of an industrial sector based on import substitution and protected from foreign competition by a system of import quotas. While the service sector grew at an annual compound rate of 6.8% in the 1970's, manufacturing grew by only 2.4%. The GOP now recognizes that although the service sector will continue to be a leading sector in the future, manufacturing based on exports will, if appropriate conditions are created, be a major contributor to economic development.

A condition of our financial assistance will be a public statement by the GOP of its intent to implement policies already agreed upon with USAID which would: (a) encourage non-traditional exports; (b) eliminate quotas and substitute them with low and uniform tariffs; (c) encourage increases in productivity, particularly labor; (d) lower input prices through revision of the labor code and of electricity and port tariffs; (e) emphasize market incentives as opposed to administrative incentives; and

(f) move MICI out of activities which are better carried out by the private sector such as small business lending.

On balance the foreign investment climate is favorable. The attractiveness to foreign investors is afforded by: (a) a relatively competitive wage structure, absence of foreign exchange risk and of restrictions on profit and capital transfers; (b) geographic location with good access to important markets; (c) a well developed financial system; (d) an educated, and easily trainable labor force; (e) relative political stability; and (f) the access to the U.S. market afforded by CBI preferences.

These advantages are offset in part by (a) some aspects of a labor code which are not compatible with productivity requirements, (b) relatively high cost of electricity, and (c) relatively high transport and port charges.

The industrial development strategy of the GOP, developed with our participation and supported by USAID financed activities, calls for:

1. Improving the competitive position of Panama.
2. Facilitating the transition of Panamanian producers from total reliance on domestic and Central American markets to greater participation in world markets.
3. Inducing foreign producers to shift production facilities to Panama.
4. Assuring wide dissemination of the direct and indirect benefits of industrial development.

This strategy has as an ultimate social goal reduction of already unacceptable levels of unemployment and underemployment. The relative stagnation of the Panamanian economy, the inability of the government to absorb workers at the high rates which characterized the 1970s, offer bleak prospects to new entrants into the workforce. The President Elect in his platform statement calls for the creation of 25,000 jobs per year. The accomplishment of this objective rests with the private sector.

The governmental efforts, though substantial, can only support and facilitate efforts made by the private sector. Therefore, other major USAID activities will be designed to directly assist private sector entities, from associations to individual companies, in pursuit of markets, in acquisition of technology, and in raising productivity.

USAID support for industrial development falls into five categories: policy development, institutional development, capital mobilization, infra-structural development, and human resources development. Activities planned under each category are directed to private sector components and to complementary components in the public sector. Thus,

provision will be made for accomodation of private sector needs by public sector institutions.

The primary impetus for more efficient industrial production and expansion of industrial exports will be provided by the elimination of import quotas in favor of tariffs which will move toward a low, uniform level. The entire, complex structure of industrial incentives is being reviewed and is expected to be phased out in favor of uniform treatment for all new industrial investment. These and other changes in commercial policy should provide a clear set of rules for industry, facilitating investment decisions. However, the transition from a protected, domestically-oriented to an unprotected, externally oriented industrial sector poses a difficult problem of accomodation. Implementation of these policy changes, though linked to financial support for the Government from the IBRD and AID, cannot be accomplished without a process of education and consensus building and will require public and private resources for facilitating industrial adaptation. USAID will continue to encourage and provide resources for this process. AID-assisted studies being carried out through the Ministries of Planning (MIPPE) and Commerce and Industry (MICI) are providing the insights and issues to feed the policy dialogue.

Despite a high degree of liquidity within the Panama banking community, long-term developmental credits are rarely available. Given the need for substantial new investment in refurbishing of existing plants, construction and equipping of new plants, financing of export transactions, and product development and marketing, USAID will support the creation of a private export development bank. The bank, aided by an in-house trading company and a project development department, would provide financing for all stages of export development activities. Approximately \$8 million in loan and grant funds will be provided to support the activity.

The vast majority of Panamanian enterprises are small ones. They represent an important proportion of private sector activity, a source of potential for economic growth and for increased employment. In order to permit small business to participate directly and indirectly in the opportunities provided by expansion of exports and increasing economic activity, USAID will assist programs to tap the liquidity of the private banking system (in lieu of the public sector), remove obstacles to small business credit, and support assistance to small firms, largely on a more efficient basis through private banks and more extensive use of associations and groups of small enterprises. A small business development project responding to these objectives is currently under development. Approximately \$9.5 million in loan and grant funds will be allocated to the program.

Institutions in the private as well as the public sector which affect industrial development are in need of strengthening and rationalization of their functions. MICI is being substantially affected by policy changes and will require assistance for restructuring. In a \$5.0 million ESF supported program for restructuring and strengthening the Ministry and external operational units which come under the Ministry's purview, special

attention will be given to the department of MICI most directly concerned with exports. Our support for investment promotion and investor services activities of the Investment Council of Panama will continue. In the private sector we will work with such associations as the Society of Industrialists, Chamber of Commerce and Association of Exporters.

Problems related to infrastructure required for industrial development have yet to be defined by studies which are planned or underway. They include internal and external transport systems and rates, cargo handling and charges in ports, the high cost of electric power, expensive and inadequate telecommunications service, and industrial parks with poor facilities and administration. The reverted areas of the former Canal Zone offer possibilities for industrial development which have yet to be seriously considered by the government. Most of these problems can be ameliorated through management or policy measures, but others may require public or private investment with financing from international donors. We expect to assist in Industrial Park development with funding of about \$4.5 million.

Essential to increased productivity are capable management and an appropriately skilled workforce. Appropriately skilled, productive labor also becomes a more attractive factor of production, enhancing employment prospects in a growing economy. We will support private sector organizations in providing management and operations reviews to assist firms in determining their requirements for training. The Mission will provide \$3.7 for in-service skills training for workers and supervisors which is tailored to the needs of firm through a joint program with the GOP and private sector. Regional Scholarship funds will be used for short-term managerial and technical training programs in the U.S. as well as a large number of academic scholarships for graduate level studies. Training of vocational school instructors and administrators through the Regional Scholarships will also be encouraged, as will other assistance to the poorly performing vocational education system in concert with the private sector, possibly the Society of Industrialists, representing the largest users of vocational institute graduates. A major program to expand and strengthen the private university in the latter part of the planning period will focus on business administration and related fields.

c. Agriculture

The GOP's development strategy for the agriculture sector is in transition. The sector's poor performance and high cost, in a time of fiscal austerity, is forcing a redefinition of the respective roles of the public and private sectors. A new strategy for the sector has become a key element of the GOP's program of structural reform supported by the IBRD and AID. However, this new strategy direction has not been clearly defined nor has it been publicly adopted by the government. Before we commit substantial financial support to public investment programs in the agriculture sector, we will expect the GOP to publicly announce its intention to adopt revised policies which:

- (i) emphasize increased efficiency and output,
- (ii) place responsibility on private initiative for growth in the agriculture sector,
- (iii) rely on the free market system to determine prices of agricultural commodities,
- (iv) move toward elimination of the government's direct role in agricultural production and marketing,
- (v) encourage development of agriculture exports,
- (vi) promote production consistent with comparative advantage, and
- (vii) differentiate between social welfare programs and those directed toward increasing production and incomes.

The specific policies consistent with such an orientation will be defined based on studies which are in progress. The agricultural sector's development requires changes in production (crop or activity mixes which respond to comparative advantages); increased productivity (output per unit of input of land, labor and/or capital); and increased value added (through increased processing and agroindustrial development.)

Increasing output of the agriculture sector while decreasing unit production costs implies shifting production to take advantage of domestic comparative advantages rather than to achieve national self-sufficiency goals. It will mean increasing productivity through improved research and technology transfer, and increasing value added through encouragement of agroindustrial development. It will also mean separating those policies aimed directly at improving the social welfare of the rural poor from private sector oriented production policies, and understanding the development costs and benefits of each.

The performance of the agricultural sector is a function of the behavior of agricultural producers. This, in turn, depends on a series of natural and other factors -- including consistent and coherent public policies. The GOP is looking more to the private sector to revitalize agriculture. This increased reliance on the private sector requires that the government clearly establish and communicate the "rules of the game," i.e., develop a coherent set of policies for the agricultural sector which can be implemented, monitored, modified or sustained.

The first priority in this effort must be the establishment of an analytical capacity within the government to evaluate alternative policies and anticipate their effects. The first area for action is in the realm of administered prices which should be phased out in favor of reliance on market mechanisms which will provide more appropriate incentives to producers and allow domestic prices to move closer to international prices. Products which

appear to have a comparative advantage over the long-term include: (a) cattle raising (dairy, meat); (b) tropical export crops (coffee, bananas, cacao); (c) vegetable and fruit crops; and (d) forestry products.

To achieve the above-outlined sector aims, the role of Panama's public sector in agriculture will have to undergo a fundamental change. The activities of the public sector with respect to provision of inputs, direct production, transport, processing, and marketing must be shifted to the private sector. The Ministry's role must change to one of providing supporting services and information in response to demand from the private sector. Those functional areas in which the public sector has a legitimate role should be developed, and enhanced. These include:

- (i) agricultural research and dissemination of results,
- (ii) collection and distribution of agricultural information (e.g., production, price information, world marketing opportunities),
- (iii) establishment of quality standards, and enforcement or control of such standards,
- (iv) animal and plant health control,
- (v) preservation of the national patrimony, especially land and water resources.

As a necessary part of our strategy for encouraging policy reform, USAID will support such production-oriented services as crop research and extension programs. Improved and expanded agribusiness and marketing (both domestic and export) opportunities must be developed and encouraged. Finally, the overriding concern of Panama's public agriculture sector must be conservation of the country's natural resources. Nowhere is this more important than in the canal watershed where deforestation threatens the continued existence of the commercial waterway as the keystone of the Panamanian economy.

To encourage GOP follow-through with respect to these new directions, the USAID agricultural strategy over the next five years will have four thrusts: Policy Formulation, Technology Development and Dissemination, Agribusiness and Marketing, and Natural Resources Management. All are directed towards a reorientation of Panama's agricultural sector.

Policy formulation:

AID proposes a series of agricultural sector programs funded by ESF and providing institutional support to reorient the major agricultural institutions to the new policy direction. The initial year would be a small program of \$2-3 million which would be expanded to \$10 million in the second year and similar amounts every other year through FY 1989. While the new

government which takes office in October has outlined the general policy directions it wishes to take, it has yet to put together a well-defined strategy. Recommendations from the ongoing World Bank-financed policy and institutional studies are expected to have a significant influence on future GOP agricultural policies, stressing a shift to the private sector, avoiding government interventions wherever feasible and improved support services, e.g., technology generation and extension. Consequently, the first year would be programmed on the basis of a statement of principles indicating the direction the GOP plans to go in the sector. Included in this will be an acceptable statement of pricing policy changes. This statement of principles would be compared annually with actual performance as a basis for proceeding with additional annual tranches of the sector program.

AID will sign this FY a major planning project to provide technical assistance and training to institutionalize the process of agricultural policy analysis and formulation within the Ministry of Agriculture as well as a strengthened capability for program planning and evaluation. Over the next year we will be working actively to identify a private sector organization to involve in the policy process. Grant funding, possibly through an OPG, will be provided to support the entity and its capability to assess policy alternatives in a continuing dialogue with the public agriculture sector.

Technology Improvement and Dissemination:

Building on the first project which has helped create the Panamanian Agriculture Research Institute (IDIAP), the Mission is considering an extension and provision of additional loan (including deob-reob) and grant funds in late FY 84 to expand IDIAP from its present limited, priority areas to a nation-wide system of agricultural research. Transfer of technologies will be supported through the ongoing Agriculture Technology Transfer project and will be expanded geographically with institutional support (ESF) funds channeled to the new national extension service.

To improve the level of technology and to accelerate the production of qualified middle-level technicians with a practical orientation, AID will consider for FY 86 funding a program developing the capacity of the University of Panama's Faculty of Agronomy. This program will be based on the pilot Education for Rural Development project experience and will be conditioned on the Faculty's projected role as an agriculture training institution with a more practical orientation.

Finally, in FY 87 we will consider developing a national food technology lab to support our agro-industry effort. This program would conduct research and development efforts in food processing, preparation, and marketing. Among the results would be the identification of additional potential production lines and further improvements in quality control emphasizing export production.

Agribusiness and Marketing:

In FY 84 we will sign a Cooperative Marketing Loan to support the processing,

transport and marketing of produce of cooperative members, as well as the institutional strengthening of cooperative organizations.

We have begun a survey of Panama's agribusiness potential which is identifying some interesting projects and which we expect will lead to an agricultural export trading company and/or an agribusiness development banking operation in FY 85. In FY 83, we will consider a loan to finance an integrated agribusiness program involving, perhaps, United Brands in marketing fruits under contracts with individuals and groups of farmers which will include technical assistance for new production, Technoserve in supporting production cooperatives, and MIDA extension in producing fruits and vegetables for the U.S. market.

Natural Resource Management:

AID is presently assisting Panama's Renewable Natural Resource Institute (RENARE) to protect three major watersheds, including that of the Panama Canal. A second major program is planned for FY 85 to improve the national level planning capability and to extend its program to cover other priority natural resources management/environmental problem areas, e.g., Darién deforestation and mangrove depletion and possibly to support the development of a Watershed Management Authority, in the first instance for the Canal Watershed. An additional promising area for financing in support of more rational use of dwindling forest resources will be provided for RENARE support to private commercial forestry enterprises through nurseries and agreed upon schemes for commercial forestation.

An OPG with World Wild Life Foundation was recently signed to help create a Panamanian private sector conservation foundation to conduct public awareness and education programs. This will also support RENARE's efforts in the public sector through joint demonstration projects among others.

d. Training

Panama's achievement of sustained economic growth will depend in part on the development of its human resource base. Shortages of adequately trained personnel in both the public and private sectors present obstacles now to economic recovery. As economic activity increases these shortages will become more pronounced.

The first priority for training is provision of the managerial and technical personnel to fill key positions in private industry and government during the economic recovery period. We can best assist in this task through the scholarship programs financed by AID and USIA, providing short-term and academic training in the U.S. and third countries. Large scale training outside the country is important for economic growth to gain momentum. If growth is to be sustained, however, the quality and relevance of education provided by Panamanian institutions must be improved.

Our overall training strategy for "Governmental Efficiency," is

described under the section with that title which follows. These funds will be targeted on a broad range of public sector institutions, both those line agencies of significance in terms of the Mission's overall strategy and those upon which the line agencies depend for support and efficient performance to enable them to carry out their functions. These Scholarship funds will also directly support proposed DA projects and ESF activities, although reduced amounts of training funds will in some cases continue to be included in projects. An example of this might be the Agriculture Technology Transfer project which has begun to develop and put in place an extension system in a limited geographic area. Project funds provide for training related to this limited area, but more will be required to prepare the personnel for a nationwide extension system. Regional scholarship funds will be provided to train the extensionist and managerial and technical personnel necessary as the system is expanded over the next few years.

Effective use of scholarship funds (currently planned on a regional basis by LAC Bureau) in both the public and private sectors will depend to a large extent upon a massive expansion of English language training facilities under the USIA funded portion of the program. There is a backlog of demand for academic scholarships to the U.S., but many of those who could otherwise qualify cannot meet English requirements. Another weakness of many candidates is in math and science, preventing them from passing exams that are required for entering programs in the U.S. One approach to both problems which is being explored by USIS in Panama is the development of a U.S.-type junior college for students who would complete their undergraduate training in the U.S. Such a junior college could be developed from one of the U.S. based university programs which now operate in the former Canal Zone and might serve Central American as well as Panamanian students.

Scholarships for graduate academic programs will be offered on a competitive basis. While the public sector training will be concentrated on priority needs in key institutions and limited to those with a commitment to public service, the general program will be open to the public and will include all fields of study permitted under the regional project which are applicable to Panama's development needs. GOP employees may apply for the general program and seek government sponsorship if they are accepted. In FY 1985 it will be necessary to include in most scholarships English language training and orientation of up to 6 months in the U.S. Later, USAID will finance intensive English training in expanded Panamanian facilities.

Short-term technical training will be coordinated through firms and organizations in the private sector with a view toward maximizing the use of tailored programs conducted in Spanish. AID will consider additional financing for programs such as the Private Sector Scholarship Foundation and the Rural Youth project which finances on-farm experience in the U.S. for Panamanian farm youth. Such opportunities may emerge with the Association of Industrialists or the planned association of agricultural groups, for example. Also, special emphasis will be given to the preparation of instructors to conduct in-service training in Panama in conjunction with private sector groups. To the extent permitted under the regional funding,

financing will also be provided for in-country courses.

We do not envision renewed AID assistance for formal public education. However, substantial numbers of public school teachers and faculty members of the University of Panama would benefit from USIA and AID scholarships and short-term training programs. Participation of vocational school instructors would be encouraged through linkages with industry designed to make vocational training more immediately applicable to needs of the private sector. Additional assistance to vocational training institutions, public and private, will be considered but always linked closely with the private sector to ensure results matching its needs.

One of the most productive uses of increased ESF funding projected for FY 1988 and FY 1989 would be strengthening of the private University of Santa María la Antigua. Emphasis would be placed on business administration and related disciplines. Development of an expanded, full-time faculty, additional physical facilities, and the joint endowment of chairs with private sector organizations would be included in the program.

3. Equity

a. Housing and Urban Development

As it approaches the mid 1980s, Panama faces several major shelter and urban development challenges: (1) a continuously increasing disparity between the shelter needs of its people and the country's production of affordable shelter solutions; (2) a shelter finance system which is inadequate; (3) a critical need to develop a mechanism to guide urban growth in a rational and efficient manner; and (4) continuing fiscal austerity.

Current estimates place the shelter needs of the country for all income levels at about 25,000 solutions per year, while during the past five years construction has averaged less than 6,000 units per year. Low and middle income families have been most seriously affected by the shortfall. While population growth has slowed during recent years, the urban growth rate has remained high as a consequence of rural to urban migration, and has resulted in the establishment of new squatter areas on the periphery of Panama City and in increased pressure on dilapidated tenement buildings of the inner city.

The institutional system for the financing of housing is currently in a period of transition. The commercial banking system has traditionally financed upper income housing, a market which is now saturated. The private savings and loan system has received AID support in the past but has never evolved into a major source of financing for housing due to internal management problems, a lack of leadership and legal constraints of which the most important one has been interest rate ceilings. The Social Security system initiated a substantial middle income housing development effort in 1980, but encountered such severe financial and implementation problems that the GOP has now prohibited it from direct mortgage lending. Finally, the

National Mortgage Bank (BHN), the country's principal source of financing for low and middle income housing, is also losing a primary source of funds for relending; workers and employers contributions for housing which were lent to the BHN at favorable interest rates by the Social Security system are being eliminated in 1985. Thus, in order to address the increasing shelter deficit, the financial system must develop new mechanisms to attract additional resources.

In the past, AID has supported innovative programs designed to provide minimum cost shelter solutions. At the same time, we have used the leverage given by the size of our program in the sector to support policy reforms such as ending direct mortgage financing by the Social Security System, raising interest rates for publicly supported housing from as low as 7% to 12%, and elimination of rent controls on new housing and for housing renting for more than \$250 per month.

AID will assist the new government to develop a coherent shelter and urban development policy. We are financing a national housing policy study as well as an urban development assessment. The national housing policy study will address, among other things, the appropriate role of the public and private sectors, mobilization of domestic resources, and the establishment of necessary financial and regulatory mechanisms to meet shelter and urban development needs. The urban development assessment will identify the technical, administrative and financial requirements for controlling and directing the continued rapid growth of the country's major urban areas, particularly the Panama City metropolitan area. An important component will be the definition of an approach to planning for the rational exploitation of the areas reverted to Panama under the Canal Treaties. These studies will provide the analytical basis for our future policy dialogue with the GOP. At the same time, the studies are a first step towards the establishment of an urban policy analysis capability in the GOP.

The housing sector has to date been unable to develop a self-sustaining finance mechanism. The creation of such a mechanism and greater participation of private sector financial institutions remain key features of our strategy. To further our efforts in this regard we are proposing to make a new line of funding available to the National Mortgage Bank (BHN) to discount or otherwise finance mortgages made by primary lending sources such as the savings and loan associations, private mortgage banks and other financial institutions. This, together with the elimination of interest rate ceilings, will allow BHN to attract additional funds. We will also be exploring the involvement of other savings institutions such as the Caja de Ahorros in the financing of local shelter. We also are promoting the development of a secondary mortgage market with the participation of savings and loan associations, mortgage banks, Caja de Ahorros, and possibly insurance companies.

In FY83 an HG agreement for \$25.0 million was entered into with the GOP. Further agreements are anticipated in FY85 (\$25.0 million); FY86 (\$10.0 million) and FY89 (\$15.0 million) for a total of \$75.0 million during

the FY1983-89 period. We estimate that this financing, together with related ESF projects and that generated in the private sector, will create 10-15 thousand jobs in the same period.

b. Population

Due in large part to AID population assistance and to the rapid social progress of the past decade, Panama's natural rate of population growth dropped from 3% in 1970 to 2.2% in 1980 and is believed to be continuing its decline. Health facilities providing family planning services increased from 5 to 354 during the same period, and more have been added. There remains room for improvement in information and education efforts as well as the delivery of family planning services by the public health system. However, the difficulty of achieving improvement is such that we cannot justify further prolonging AID population assistance to the government for the diminished returns that might be obtained. The final obligation for the current, Population II project will be made in FY 1985. For FY 1986 we will consider funding a PVO (approximately \$1 million) to conduct a two-year program for expanding the commercial sales of contraceptives. Any further assistance will be limited to that which is available through centrally funded programs.

c. P.L. 480

Our P.L. 480, Title II program will terminate in December, 1984. The phase-down through 1986 which had been scheduled is not feasible because the GOP is not prepared to assume the responsibilities of a government-to-government program, and the CARE mission is being withdrawn at the end of this year.

4. Governmental Efficiency

This is a major concern which will confront the new Panamanian administration. The measures which will be required to manage the public debt and to implement new economic policies imply a virtual transformation in the management and makeup of the public sector. While it is too early to gauge just how the new government will react to this challenge, it is likely that their response will include a call for AID-financed technical assistance and/or training to help them address the most pressing public management problems.

There is presently an organization within the Ministry of Planning and Economic Policy (MIPPE) which is charged with responsibility for training and management improvement in the central government and could provide a logical channel for AID assistance. Initial assistance could take the form of a grant for contracting of management consultants to carry out studies of specific problem areas and recommend short-term solutions for the most pressing problems. Such immediate concerns might include: a systematic means of controlling expenditures without halting necessary activities; the establishment of an equitable basis for progressively reducing personnel costs; and plans for dealing with organizations whose functions are eroded by

policy changes. The grant would supplement funds available under the existing Development Administration project.

Following the first phase of priority studies and immediate action plans, contractors would assist in the design and initiation of a continuing program of organizational and administrative reform and management improvement. Such a program would provide expanded in-service training courses and a range of expertise in public administration and specialized fields to assist agency heads in planning and carrying out measures needed to meet austerity and policy objectives of the GOP. It could eventually be staffed by a small group of trained Panamanians with resources for contracting outside expertise as required. The potential of the program for advancing the government's objectives would be enhanced by its location within the Ministry which controls the national budget and economic policy.

More important for the long-term development of efficient government is raising the competence of managers and technical personnel. MIPPE has made very effective use of scholarships through the LAC Training Initiatives project, using them to attract outstanding people to be trained for key positions. What is needed is a manifold expansion of this effort together with a program to ensure that academic trainees are effectively integrated and retained in the government when they return. Experience with past trainees has shown that AID participants have been highly influential in improving the quality of government and almost invariably rise to positions of leadership within a relatively short time. If large numbers are to be trained, however, they will require the support of a centralized program of placement and follow-up similar to intern programs in the U.S., or they may become lost in the bureaucracy or leave the government. Short-term and in-country training also have an important role in upgrading essential operations of the government.

We estimate that a competitive scholarship program with assured public service employment upon completion of training would make effective use of up to one fourth of the financing to be available for academic programs under the proposed regional scholarship project.

Emphasis on the training of new employees for government may seem out of place in Panama, but this is not the case. Short of a massive dismissal of public employees (which would be extremely difficult in a time of growing unemployment), the only feasible means of reducing the government to manageable proportions is by the progressive application of efficiency measures. The latter approach demands capable and flexible management which is hard to find in the government today and can only be developed over time. Key to resolving the problems of stabilization and economic growth are the continuing substitution of quality for quantity in government, and the effective implementation of consistent policies. Neither can be accomplished if the GOP does not attract and develop competent managers.

D. SPECIAL CONCERNS

1. Absorptive Capacity

Generally speaking, absorptive capacity should not be a problem in Panama with its relatively high levels of education, relatively well-developed physical infrastructure, extensive financial institutions and its wide range of well-staffed public sector institutions. Given this setting it is certainly possible to effectively channel funds among institutions of varying capacities.

Yet, the USAID has experienced difficulties, especially in the last two years. There has been considerable instability and lack of consistent direction within the Panamanian Government. In two years, we have dealt with three presidents, and changes of cabinet ministers have been more frequent. These changes have affected third and fourth echelon officials in the ministries. Together with the further heightened uncertainty of the pre-electoral period, and serious fiscal problems, the frequent changes have led to fits and starts in government activity, making continual discontinuity the norm.

The return to an elected government in October, 1984, should bring a period of stability and continuity, coinciding with the planning period of this strategy paper. With capable, strong and consistent leadership, the new government can be expected to move forward with a coherent program to confront Panama's problems.

Panama's development record over the past two decades demonstrates the country's capacity to absorb effectively major capital inflows in both the private and public sectors. In recent years the government has lost many of its more competent personnel with consequent loss of effectiveness. Many, if not most, public agencies are in need of a general overhaul. However, the GOP will be restricted to austerity budgets and striving for greater efficiency in order to maintain its investment program. USAID's project assistance to the GOP will be limited to activities which do not present major problems of absorptive capacity. In priority areas, e.g., strengthening productive agriculture, ESF will be directly used to support the budget and ensure smooth operations in key agriculture sector institutions. At the same time USAID will be providing major technical assistance in a broad effort to improve the efficiency of government.

GOP expenditures will not be increased in real terms above current austerity levels, and ESF assistance provided as cash transfers represents only a minor portion of the government's investment budget. Therefore, these funds raise no problem of absorptive capacity.

Austerity measures of the government have caused only occasional, minor difficulties in project implementation. Also, on occasions short delays can be experienced due to the GOP budgetary process which, like our own, is

slow in making initial allocations at the beginning of a fiscal year and, with austerity, has cash flow problems at the end of the year.

A more troublesome obstacle, which we are already discussing at the highest levels of the GOP, involves GOP procedures for the procurement of goods and services. These procedures, which were already cumbersome, with the advent of austerity measures have become almost unworkable in many cases. While some contracts make it through the labyrinth of special controls in 60 days, we have experienced delays of 6 months up to a year or more. The Mission has suggested to the Government that contracting authority for goods and services under approved bilateral project agreements, such as ours, be delegated to the Minister charged with project execution. We have had no response to date on this suggestion and have advised the Minister of Planning that this question must be resolved as a precondition for ESF assistance.

An increasing proportion of our project assistance is to be channeled directly to the private sector. The magnitude of the assistance proposed is not, however, sufficient to raise issues of absorptive capacity, given the needs that exist and the capabilities of the entities to which it will be directed.

2. Relations with Other USG Agencies

The only operational USG agency in Panama which has a significant role in relation to the proposed program is the U.S. Information Agency. We have maintained close coordination with USIS/Panama in beginning to plan for the use of Regional Scholarship funds and the corresponding program proposed by USIA. We are fully agreed on relative priorities and a preliminary division of responsibilities, subject to further definition of roles at the agency level in Washington. Continued effective coordination depends, in our opinion, on the assurance of adequate flexibility for country programming to permit USIS and USAID/Panama to work out together arrangements which will best serve our program objectives. Given this flexibility and our excellent working relations and convergence of interests, USAID anticipates no interagency problems. However, should any such problem arise we would expect it to be resolved promptly within the Country Team.

3. Use of PVO's and Cooperatives

USAID projects being initiated in FY 84 have a life-of-project cost of approximately \$29 million. Of this amount, \$11.7 million or 40% will go to cooperatives and PVO's. It would be most difficult to maintain this percentage with the expanded program that is proposed. Nevertheless, we expect to continue extensive use of PVO's and will be alert to further opportunities for strengthening and expanding cooperatives in Panama. One such opportunity may be presented by the GOP's need to reduce its expenditures on the uneconomic system of asentamientos. To the extent that these have potential as profit-making enterprises, they are candidates for the establishment of agricultural cooperatives. As the GOP withdraws from other functions it has assumed but can no longer sustain, there will be further need

for development of private organizations to fill gaps that may be left. Private industry and small business in particular need services in the areas of marketing and technology which can best be provided through their own organizations rather than by government. We can help develop their organizations directly and through U.S. PVO's, using the OPG mechanism.

4. Management and Staffing

USAID/Panama presently has 17 USDH personnel (including one JCC), 42 FNDH, and 41 FN Contract assigned to the bilateral program plus a Regional Housing and Urban Development Office with staff dedicated to the Panama program. There is a Regional Contracting Officer and a Regional Legal Advisor, who, in addition to their regional responsibilities, shoulder an important share of the USAID workload. The current staffing was planned based on an expected program of (i) \$15.0-20.0 million annually of new obligations; (ii) an outstanding portfolio on the order of \$65 to 70 million in grants and loans and \$35 to \$40 million in HGs; and (iii) a major involvement in policy dialogue at the macro-economic and sectoral levels. This would imply the development of two major projects a year and one or two smaller projects.

To carry out the much larger proposed program, the Mission will need to adjust the level of staff as indicated in the table below. We will need to add USDH personnel for increased design responsibilities and implementation oversight. This will include both the relevant staff offices and technical offices. We will also continue to upgrade the quality of FN staff. Some reorganization of functions will be required, and measures such as computerization in the Office of the Controller and those described in the following section will reduce the need for additional personnel. In addition, we will exercise care in the planning of new activities to ensure that they are less staff intensive than those the Mission has undertaken in the past.

DIRECT HIRE STAFFING

<u>CATEGORY</u>	<u>FY-84</u>	<u>FY-85</u>	<u>FY-86</u>	<u>FY-87</u>	<u>FY-88</u>	<u>FY-89</u>
U.S.*	16	20	20	21	22	22
F.N.	36	42	41	42	42	42

* Excludes RCO, RLA, JCC's, IDI's and Resident Hire.

5. Monitoring and Evaluation

The increased monitoring responsibilities for the proposed program will require the use of personal services contractors funded under projects, or with program development and support funds to conduct site visits and maintain regular contact with GOP and private sector implementing agencies and project personnel. With the proposed modest augmentation of our USDH staff, the demands of program management will oblige USAID project managers with multiple responsibilities to spend most of their time with counterparts in the capital, carefully scheduling and combining itineraries in order to make an adequate number of visits to more distant project sites.

A key to maintaining adequate monitoring of our assistance will be the development of appropriate information systems within the GOP and other cooperating organizations. Such information systems will be designed for each major activity, based on financial and implementation plans, and personnel trained to maintain them. Liaison personnel (PSC's) will furnish some of the information and conduct spot checks to verify other inputs. Computers will be used to the extent feasible to maintain and organize information and prepare regular and special reports. Conversion to the MAC system by our Controller's Office should begin to show returns in increased efficiency in FY 1986. Computers in use by our economic staff and project development and management staff should bring improvements in information management even earlier.

The maintenance of more current and complete information on program implementation will facilitate formal progress evaluations and timely corrective measures when problems arise. Formal evaluations will be carried out largely by contract with project, ESF technical assistance grant or PD & S funds.

RESOURCE REQUIREMENTS TABLE
(\$ Million)

		BYCDSS Planning Period....				TOTAL
		<u>FY 1986</u>	<u>FY1987</u>	<u>FY1988</u>	<u>FY1989</u>	<u>FY86-89</u>
I.	Development Assistance					
	Total	<u>22,600</u>	<u>28,900</u>	<u>26,600</u>	<u>26,600</u>	<u>104,700</u>
	Grant	10,800	20,900	21,600	22,600	75,900
	Loan	11,800	8,000	5,000	4,000	28,800
	ARDN					
	Total	<u>15,850</u>	<u>8,340</u>	<u>14,600</u>	<u>4,000</u>	<u>42,780</u>
	Grant	6,050	6,340	9,600	4,000	25,980
	Loan	9,800	2,000	5,000	0	16,800
	PN					
	Total	<u>660</u>	<u>660</u>	<u>80</u>	<u>60</u>	<u>1,460</u>
	Grant	660	660	80	60	1,460
	Loan	0	0	0	0	0
	EHR					
	Total	<u>2,750</u>	<u>5,500</u>	<u>2,500</u>	<u>10,540</u>	<u>21,290</u>
	Grant	1,750	5,500	2,500	10,540	20,290
	Loan	1,000	0	0	0	1,000
	SDA					
	Total	<u>3,340</u>	<u>14,400</u>	<u>9,420</u>	<u>12,000</u>	<u>39,160</u>
	Grant	2,340	8,400	9,420	8,000	28,160
	Loan	1,000	6,000	0	4,000	11,000
II.	Economic Support Fund					
	Total	<u>15,000</u>	<u>15,000</u>	<u>25,000</u>	<u>25,000</u>	<u>80,000</u>
	Grant	15,000	15,000	25,000	25,000	80,000
	Loan	0	0	0	0	0
III.	Housing Guarantees	<u>10,000</u>	<u>0</u>	<u>0</u>	<u>15,000</u>	<u>25,000</u>
IV.	Total Resource Requirements	<u>47,600</u>	<u>43,900</u>	<u>51,600</u>	<u>66,600</u>	<u>209,700</u>
	Grant	<u>25,800</u>	<u>43,900</u>	<u>51,600</u>	<u>51,600</u>	<u>172,900</u>
	DA	10,800	20,900	21,600	22,600	75,900
	ESF	15,000	15,000	25,000	25,000	80,000
	Loan	<u>11,800</u>	<u>8,000</u>	<u>5,000</u>	<u>8,000</u>	<u>11,800</u>
	DA	11,800	8,000	5,000	8,000	28,800
	ESF	0	0	0	0	0
	Guarantees	<u>10,000</u>	<u>0</u>	<u>0</u>	<u>15,000</u>	<u>25,000</u>

ANNEX A

Summary of Social Indicators

	<u>Panama</u>		<u>Middle Income Latin American Country</u>
	<u>1970</u>	<u>1980</u>	<u>1980</u>
GNP/Capita	760	1910	2090
Life expectancy at birth	66	71	65
Infant mortality rate (per 000)	49	21	63
Access to safe water			
(% of population)	69	85	65
Access to excreta disposal			
(% of population)	78	89	55
Population per physician	1580	980	1776
Population per nurse	550	420	1012
Population per hospital bed	330	250	477
Primary school enrollment (%)	106	113	105
Secondary school enrollment (%)	39	65	40
Adult literacy rate (%)	78	85	80

ANNEX B

PROJECTIONS OF THE OPERATIONS OF THE CONSOLIDATED PUBLIC SECTOR

Assumptions based on the estimation of the overall deficit of the public sector

A.	GDP real growth	Inflation	Growth in nominal terms
1984	0.0	6.0	6.0
1985	2.5	6.0	8.7
1986	3.0	7.0	10.2
1987	3.5	7.0	10.7
1988	5.0	7.0	12.4
1989	6.0	7.0	13.4

B. The elasticity of current revenue to changes in GDP has been estimated at 0.95.

C. Current expenditure is expected to increase at a real annual rate of 2.5%. This increase is due mostly to increases in interest payments, and therefore current expenditures in real terms would have to remain almost constant; optimally, there would be a reduction in payroll in real terms accompanied by an increase in other operating expenses.

D. Capital expenditure, composed of direct investment plus net lending by the public sector, is estimated to remain constant in real terms from the levels of 1984.

The capital expenditures for 1984 can be summarized as follows (in \$ million):

Central Government investment	174
Decentralized agencies investment	166
Net lending	58
Gross lending	167
Repayments	109
TOTAL	398

Net lending by government would increase faster than inflation and as a consequence direct investment by the central government and decentralized agencies would decrease in real terms.

E. For 1984 and 1985 we have sufficient information to estimate net finance available. Beyond 1985, we have assumed that in general gross disbursement will stay constant in real terms. In 1984, we estimate that net financing from commercial banks and bond holders will be minus 30. This can be broken down as follows (in million):

	<u>Disbursement</u>	<u>Amortization</u>	<u>Net</u>
Commercial banks	160	144	16
Bonds	-	46	-46
Total	160	190	-30

It is assumed that in 1985-87, disbursements will equal amortization payments, and that there will be no net increase in the internal debt.

TABLE 1

CONSOLIDATED OPERATIONS OF THE NONFINANCIAL PUBLIC SECTOR

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
Current Revenue	1444	1585	1738	1913	2133	2396
General Government	1360	1473	1616	1781	1991	2244
Public enterprise current account surplus	84	112	122	132	142	152
Current Expenditure	1334	1450	1576	1713	1862	2024
Capital Expenditure	398	422	451	483	517	553
Savings	110	135	162	200	271	372
Overall Deficit	-288	-287	-289	-283	-246	-181
Net Financing						
Gross disbursements by multilateral and bilateral agencies						
AID/DA	15	14	17	18	22	23
AID/HIG	6	15	12	12	12	12
PL 480	1	-	-	-	-	-
IFAD	4	4	5	5	5	6
IBRD Project lending	55	58	62	67	71	76
IBRD SAL	20	60	64	68	73	78
IDB	97	103	110	118	126	135
FIVEN	1	1	1	1	1	1
Mexico and Venezuela oil facility	52	30	33	37	42	48
Suppliers credit	5	5	6	6	6	7
IMF	115	-	-	-	-	-
Subtotal	371	290	310	332	358	386
Amortization to multilateral and bilateral agencies	83	88	94	101	108	115
Net financing by multilateral and bilateral agencies	288	202	216	231	250	271
Net financing by banks and bond holders	-30	-	-	-	- 4	- 90
Unfinanced Gap	30	85	73	52	-	-

Report on Labor Force Employment and UnemploymentSummary

This report is centered primarily on 1982 data, the latest year for which most data is available. The summary of main issues examined are as follows:

1. Unemployment was 8.4% in 1982 based on 53.7% economically active population - the lowest EA percentage in 20 years or more. Low EA figures decrease unemployment rates.
2. Crude projections based on projected GDP employment/output elasticity coefficients project over 21% unemployment of forecast EA by 1989 for those 15 years and older.
3. Based on 1982 data, the unemployed are primarily (a) female with approximately twice the male unemployed level in all age groups, and (b) under 25 years of age. Females account for over 22% heads of household, and of these female headed households, almost 27% have no working members of the family.
4. Of a 1982 sample of 28,799 unemployed in 1982, about 32% report it is considered "impossible to find work." Less than half the sample have been unemployed 6 months or less.
5. New entrants seeking first jobs are 43.5% of the unemployed.
6. Occupations with unemployment higher than the 8.4% average in 1982 are clerical at 9.3%, craftsmen at 12%, and service workers at 14%.
7. Educational level shows almost 88% of E.A. have secondary level schooling or less. However, looking at only the cohort with some or completed secondary education, almost 24% of this group are unemployed - made up of 12.2% new entrants plus 11.7% laid off workers.
8. By industry, the highest employment was in agriculture (28.0%) followed by services (27.5), trade (13.2%), and manufacture (9.7). However, for years 1979-82, employment increased at the fastest average annual rate in construction (7.7%), finance (7.1%), electricity and transport both increasing 6.4% each. At least two of these, construction and electricity, tend to be very cyclical and may not offer continued employment expansion.
9. Unless new manufactured products or assembly operations are introduced, the manufacture sector has shown less than 1% employment expansion 1979-82.
10. The labor market for males aged 30-50 shows an extraordinary employment rate of over 97% of those E.A., and males 25-29 are employed at almost a 95% rate. Once again E.A. women in these same age groups are employed at rates less than half these levels (37 to 48%).

11. Adjustments in minimum wages were made in 1979 and 1983 and Labor Code modifications were made to liberalize provisions considered detrimental to job creation and labor mobility. Overall there have been decreases in real wages, particularly in the public sector, decreasing about 7% from 1979 to 1983. With excess labor supply, decreases in real wages, adjustment in institutional Labor Code provisions, market forces may dominate in the future.

12. Questionnaire data from the Household Survey indicates existing underemployment of the labor force of 4.9%. This is made up of visible underemployed who work less than 40 hours a week and want more work (2.1%) and invisible underemployed who work 40 hours per week but earn less than 30 Balboas a week (2.8%). Agricultural workers make up more than 40% of the visible underemployed.

POLICY AGENDA

Listed below by sector are policy measures which are being sought by USAID/Panama.

INDUSTRIAL SECTOR

- a) Instituting a system of low and uniform tariff protection, and the elimination of quantitative restrictions on imports and of price regulation of industrial products.
- b) Modification of labor code provisions and/or interpretations to permit productivity payments to workers and to provide for apprentice training.
- c) Simplifying export procedures.
- d) Review of the effects of industrial incentive measures and adoption of a simplified and uniform system.
- e) Review of customs procedures to simplify the import of goods, including raw materials.
- f) Review of factors making up electric power rates and identification of cost reduction measures in IRHE.
- g) A study of port charges and measures needed to reduce those charges.

AGRICULTURE AND NATURAL RESOURCE SECTOR

- a) Freeing of prices of horticultural products and substantial reductions in the support prices for rice, corn and sorghum. Retention of supports and eventual price levels for grains would depend on the results of an on-going study of agricultural pricing.
- b) Establishment of an agricultural policy coordination capability in the Ministry of Agricultural Development (MIDA).
- c) A progressive shift in the allocation of MIDA's resources to reflect activities which respond to the needs of private producers.
- d) Elimination of remaining restrictions on the export of agricultural products.
- e) Establishing a Canal Watershed Management Authority.
- f) Modification of existing laws to guarantee land tenure for individuals who reforest private lands.
- g) Reaching of an agreement between MIDA and the Ministry of Health to implement a meat inspection program that would enable Panama to resume meat exports to the U.S. market.

HOUSING AND URBAN DEVELOPMENT SECTOR

- a) Restructuring of the National Mortgage Bank (BHN) to allow it to operate as an autonomous financial institution.
- b) Elimination of regulations on deposit and lending interest rates for the savings and loan system.
- c) Completion by the GOP of a study on rent control and other constraints on the housing market, followed by action on the study's recommendations.

- d) Strengthening of the Ministry of Housing (MIVI) to allow it to function as the leading institution in urban planning.
- e) Elimination of the recently established 0.5% tax on loans, the proceeds of which are being used to subsidize interest rates on housing loans.
- f) Further adjustments in the standards for housing construction and for urban land development, to reduce costs and encourage private investment.
- g) Establishment of a functioning authority for planning and promoting the economic use of the reverted areas of the former Canal Zone.