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PANAMA

PRIVATIZATION AND BANKING

MAY 1990

PRIVATIZATION AND BANKING - PANAMA

A Report

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CENTER FOR PRIVIVATIZATION

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SCIENTEX INTERNATIONAL

THE CENTER FOR PRIVATIZATION

The Center for Privatization was organized and established by Scientex in response to a contract awarded by A.I.D. to provide expert advisory services to the governments of developing countries, to A.I.D. and to USAID Missions, in planning and implementing programs for the divestiture and privatization of state-owned or-controlled enterprises and activities.

The Center and its subcontractors have undertaken over 150 privatization assignments in over 50 countries during the past four years. Recently, the Center has begun work in the Eastern Bloc countries. The Center is also assisting UNIDO in the formulation of a framework for its global privatization strategy. Over 160 individual consultants with a wide range of skills, including industry and agriculture engineering, investment banking, asset valuation, accounting, general management and data processing have been involved in the Center's activities. In Honduras and Tunisia, the Center has placed long-term staff whose work has been supplemented by short-term technical specialists engaged for specific privatization-related transactions.

The Center's work has involved all phases of the privatization process from general diagnosis, strategy development and organization planning, to prioritizing, valuing, preparing and marketing the specific enterprises selected for privatization. These enterprises have ranged from utilities (telephone, electricity, transportation and waste collection/disposal) to large and small industrial and agricultural firms, including agricultural marketing organizations, cement companies, cotton and dairy products producers, food processors, foundries and steel mills, hotels, sawmills, sugar refineries and textile factories, as well as banks and holding companies, to name just a few.

The Department of Research at the Center has also developed a Publication Series to provide the reader with insight into the many divergent and frequently vexing issues inherent in the privatization process. These issues have been recorded and analyzed first hand by Center staff, consultants and senior advisors and presented in the Occasional Papers, Critical Issues and the Case Studies Series. The Bibliographic Report and Survey of Privatization in Developing Countries are essential background readings for those interested in keeping abreast of the rapidly evolving literature and baseline data on privatization.

PRIVATIZATION AND BANKING - PANAMA

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ABOUT THE AUTHOR

Joseph J. Borgatti is the Senior Advisor for The Center For Privatization of Washington, DC and President of J.J. Borgatti Associates. He has a BA from Harvard College and a MBA from Harvard Business School. For almost forty years he has specialized in International Finance, concentrating mainly on Carribbean Central and South America. He has provided privatization planning and capital market development in such countries as Guatemala, Argentina, Mexico, Ecuador, Dominican Republic and El Salvador. He was President & CEO, Adela Investment Company; Vice President, CITIBANK in Argentina; and Resident Vice President, Central America CITIBANK.

PRIVATIZATION AND BANKING - PANAMA

I. EXECUTIVE SUMMARY

Since the new government has taken over, no privatization activities have taken place. While businessmen feel that the GOP should be stressing privatization, it must be remembered that it has only been in office for four months. Its first order of business, with one out of three persons reportedly unemployed, has been creation of jobs.

PRIVATIZATION OBJECTIVES

The GOP as yet has not enunciated an economic reactivation program, of which privatization would be part. GOP envisages an extensive privatization program, mainly selling off state-owned enterprises, but also privatizing some services. A more precise statement of objectives probably awaits technical advice, for, as Minister Galindo said: "No one in the Government has experience in privatization". Meanwhile, Government action is characterized by caution and sensitivity to the politics of privatization.
Officials, wish to proceed slowly almost transaction-by-transaction, doing the easiest operations first, openly and in accord with legal norms.

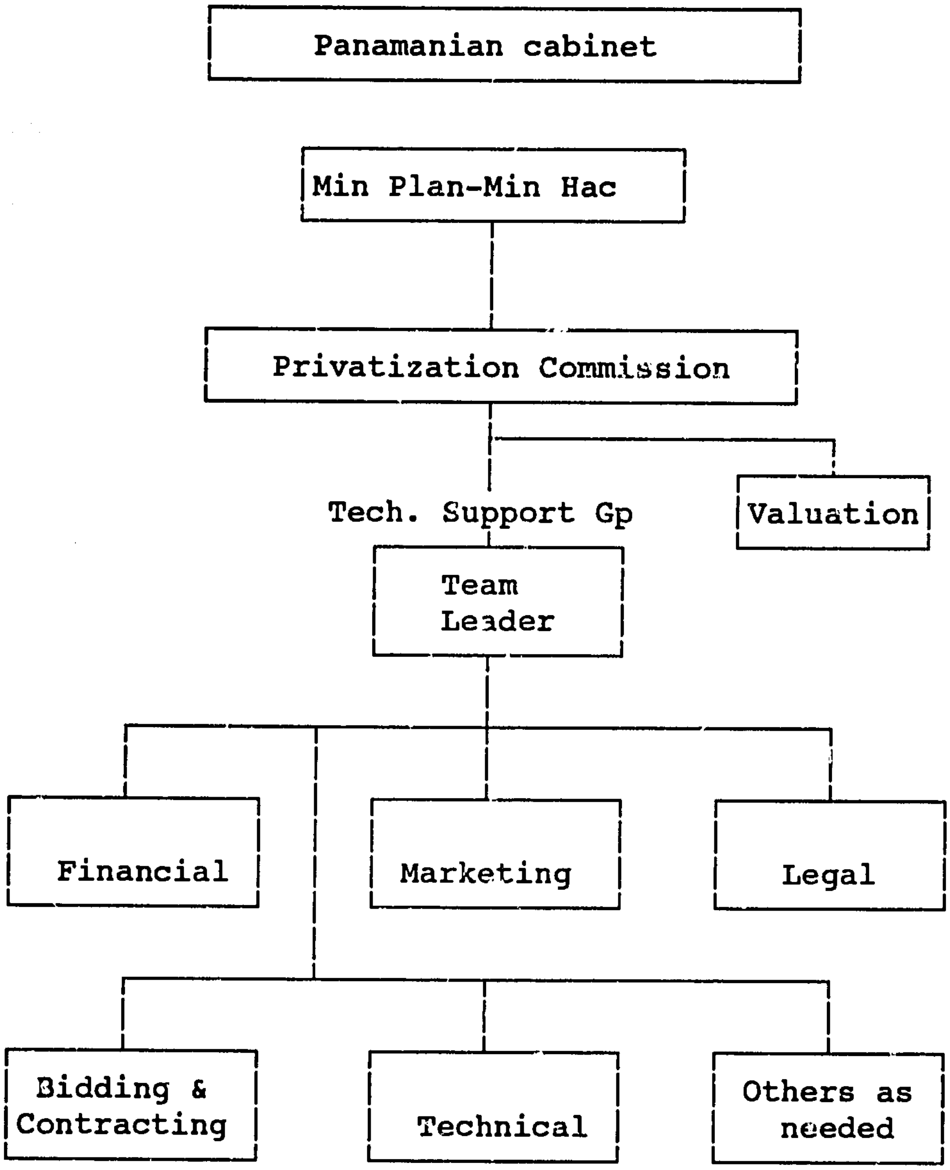
POTENTIAL UNIVERSE OF PRIVATIZEABLE ENTERPRISES

Some 37 candidates for privatization have been identified from reviewing documents and holding discussions. Our impression is that there are many more. The Ministry of Agriculture, IMA and the Port authority seem to be prime sources of candidates for sale, lease, or contracting out.

RECOMMENDED ADMINISTRATION OF PRIVATIZATION

The GOP has provided a skeleton structure for building a privatization program. At this writing, a Presidential Decree was in the making to name a 12-person Privatization Commission to be chaired by Mr. Ricardo Brin. The recommendations which follow are designed to enhance the GOP program.

A graphic depiction of the proposed structure is as follows:



The Cabinet will approve privatization proposals. It should also provide for coordination and cooperation among the different ministries under whose jurisdictions fall the various units and services to be privatized.

Proposals would be presented to the Cabinet jointly by two of its members, the Second Vice President, Minister Ford (Planning), and the Minister of Finance Mr. Galindo. Those two would jointly oversee the Privatization Commission.

The Privatization Commission will comprise 10 prestigious businessmen, plus two key labor leaders. The Ministry of Planning will be represented at its sessions. The two labor leaders should provide the conduits for coordination with labor early in the program. The businessmen are well-versed in the local business environment. As a group, with the presence of two Ministers, the Commissioners can add the political element to the equation.

Chairing the Commission will be Ricardo Brin, who should provide overall leadership and become its spokesman. Mr. Brin has long years of executive experience, including as management of a joint public/private sector service company, and was recently named Chairman of Panama's fledgling stock exchange.

The Commission should have a support team of foreign and local technical advisors who would bring credibility, technical know-how and organizational skills.

This **Technical Support Team** would be headed by a person with hands-on privatization experience, and familiar with the political as well as the technical complexities of implementing a privatization strategy.

The support team would help the Commission in deciding on goals, identifying the obstacles/constraints, and assisting in transactions. Team capabilities would include financial, Legal, marketing, technical (including valuation), and bidding/contracting.

Complementing the Technical Support Team would be the Controller's Office in the valuation of entities for sale and contracts to be let.

Recommended privatization procedures
Once the Privatization Commission Chairman is named, a mandate should be given to him, along with an initial budget. The Chairman should then form a skeleton team and start collecting information on what is privatizeable, the legal basis for proceeding, and the constraints to be faced.

With guidance from the Commission and the Ministers, the Director, aided by an experienced advisor from outside (probably the Support Team Leader) should draw up a basic plan. This plan would include objectives and methods for reaching them, priorities and a budget to accompany. Once the plan was approved, presumably by the Cabinet, the team would be enlarged considerably, each member with assigned roles.

As the team began to work on the first privatization, a review and reporting system would be set up by the Team Leader to control the program and keep the Commission informed.

Timing
The sooner that the Privatization Chairman is named and begins putting together his support group, the better. First, there are definite (both positive and negative) expectations in the community. Also, privatization experts have found that this has a way of escaping from those responsible for their implementation.

ASSESSMENT OF CAPABILITY OF PANAMANIAN BANKING SYSTEM FOR PRIVATIZATION AND REACTIVATION

CONCLUSIONS

The banking system has to be normalized before it can expand. Normalization is tied to unfreezing the banking system's time deposits. The seriousness of this step is not only that large deposits may leave the system, but that it comes at a time when, more, not less, liquidity ought to be entering the system, in order to fuel economic recovery.

The threat that time deposits, once unfrozen, may flee is real. Their owners are not tied to the country in the way that savers are; in fact, they have ready access to and familiarity with external markets.

The problem area will be the time deposits in local banks, principally those belonging to non-residents. Precise, up-to-date information is hard to come by but, based on the figures available and their knowledge of the banking scene, bankers strip away tied deposits (tied to offsetting loans to the same person or group) and arrive at a range of $600-700 million in time deposits among the local banks, of which some $200-350 million belong to non-residents. This is the heart of the problem, and it seems to be mainly with the mortgage banks.

Nevertheless, it appears to be a problem that is manageable. Based on collaboration between AID and the local banking system, there is a solution through pooling funds; e.g. recycling bank reserves plus injecting AID funds. The larger the fund the greater the probability that it will not need to be used. But, as a preliminary step, before spreading the net, it will be necessary to deal with the insolvency of certain institutions, otherwise the net will fill with them.

There is a reservoir of goodwill and resourcefulness locally that should be put to use to clean up the system and create a backstop facility. Doing so opens the way to external help to provide additional liquidity. If the banking system is to finance privatization and economic reactivation, it will need to draw in more funds from abroad. But first, it must be able to hold on to the funds it has, or accommodate withdrawals in an undisruptive way. The unfreezing of time deposits, and the way it is handled, will be a major test. A second test will be its operational strategy.

External funds can be accessed through securing mortgages and other loan forms for packaging and sale abroad. "Cedulas Hipotecarias" for example, can be brought into play both for the external market and as a trading instrument for the new stock exchange.

The bank/AID pool itself could be a source of the paper. With the increase in liquidity gained through this means, the system should be able to participate in financing privatization and other developmental activities.

Assuming that the authorities view these proposals favorably, and that AID funding comes through, should the GOP make a decision to free time deposits? And could they create a backstop facility such as described above before June 30, 1990? Local private bankers believe so. We are inclined to agree, if sufficient protection is built up and the other preliminary steps are taken. Whether or not the deadline is realistic is a matter of the speed with which they get started and how fast they proceed.

In any event, it would be necessary to move swiftly, with the Government taking the initiative. There is a need to formulate it all into a plan, and this is a task for Mr. Boyd, the Head of the National Banking Commission who is working with the banks and AID. Our feeling is that he will need outside technical assistance in this endeavour.

As a corollary to these normalization steps, attention must be paid, also, to improving bank reporting and inspection, so that the system is put in order and remains so. Improved information systems, featuring simpler and more timely reporting, are needed; also needed are better-trained people who understand bank inspection. To achieve this improvement, the Banking Commission needs more resources, both financial and human.

RECOMMENDATIONS

The goal ought to be to free all time deposits at simultaneously as soon as possible. The timing ought to be within the next 60 - 90 days.

AID could use the formalization of its financial aid package, to meet with Mr. Boyd and the Banking Commission, possibly along with the Ministers of Planning and Hacienda, to seek agreement to form a small working group to come up with a plan for creating a safety net, using the banks' funds first and AID's funds as a last resort, but pooling both into one fund. This group would vet the more serious proposals that have already been presented, and work with the proponents to come up with a single plan.

Meanwhile, another line should be pursued: Detailed information, must be obtained, bank by bank, on the liquidity (or solvency) of each, the quality of its portfolio and profile of its time deposits. To help the Banking Commission with this task, AID could provide it with an outside banking advisor (possibly a retiree of stature from the Federal Reserve) and probably a Panamanian attorney experienced in trust work.

The principals of all the banks should be called together by the Commission to explain and discuss the program and secure its cooperation, in setting up a working group. The basic theme would be that, if they all cooperate and if each takes the actions expected of him, there will be provided, over and above what they and the banking authorities can come up with, a $100+ million back-up from AID. It would be explained at the meeting that this proposal hinges on their introduction of a feasible program, and that the safety net is their comfort. The working group would immediately begin organizing the standby facility and trust fund.

Meanwhile, each bank would be asked to come up with its own confidential estimate of what it might lose if the unfreezing took place next month. (The confidential aspect would have to be stressed and somehow assured to those present)

The estimates from each bank would be reviewed by the Head of the Banking Commission with the head of that bank and would involve a very careful review of which time deposits are real, which are tied to loans or are, in reality, capital injections disguised as time deposits for tax considerations. In addition, the liquidity position of each bank would be appraised.

After corrections are made for excessive optimism or pessimism, a final set of figures should be developed, by bank and banking class, giving a range of expected time deposit losses.

From these figures, a plan would be prepared which lays out the basic steps to be taken to provide for expected withdrawals, including improving liquidity early on. Also, and important, this plan should provide not simply for dealing with deposit losses, but with expanding the funds in the Panamanian banking system.
Its key elements should include the following:

1. The insolvent banks would be dealt with -through sale of assets, capital increase, merger or closure and transfer of deposits to a stronger bank. This would include privatizing the Caja de Ahorros, either by contracting out the management, or transferring of ownership to the private sector in such a way that employees as well as private investors acquired shares.

2. The system for pooling reserves would be established as the first line of defense. The Fidecomiso, or trust fund, form would be used. Into this fund, AID would deposit its $100+ million safety net money. The details would be worked out between the Banking Commission, with the help of its advisor, and AID officials, and would provide for access by solvent domestic banks, public as well as private, excluding the Banco Nacional. A clear set of procedures for rediscounting of assets would be enunciated.

3. Each bank would try to extend the maturities of its time deposits by offering interest rate inducements, and possibly non-penalty withdrawals after a certain date.

4. Each bank, with problems, should develop a realistic plan for improving its liquidity, including tightened collections, asset sales, and new capital injections.

5. Contact would be made with institutions in and out of Panama that have proposed offshore funds to buy Panamanian securities and invitations extended to them to submit proposals.

6. A separate working committee would be formed to develop a program to improve and modernize the bank reporting system and the quality of bank inspections. The program, to be supported by AID, would include training workshops, on-the-job training by experts brought in from outside, plus systems and equipment review and redesign.

DIAGNOSIS OF AIR PANAMA (API)

Current status: API ceased flying several months ago. No financial or other statements are available, but an audit has been ordered.

Assets: There is one airplane, owned free and clear, a Boeing 727-100, worth only $1.5-2 million. With any luck, API has $3 million in assets.

Liabilities: These are estimated by Mr. Ford at $17-30 million.
Published reports show amounts owed to Panamanian Government agencies at $3.1 million, of which $1.5 million is to Social Security and $1.4 million to DAC. Labor obligations to API's more than 300 employees (some say 600) are estimated by Mr. Ford at $5 million.

Several sources reported that there are many legal claims in the United States (the numbers stated were 14-15, although one source went as high as 40), Mexico, Peru, and Columbia. It is not known how many are real; e.g.for maintenance, overhauls, services, etc.

Overall appraisal: Viewed strictly as an airline, API is not a viable enterprise. The accounting review may turn up some hidden values, but is not likely enough to change things. If there is any real value, it is in the Panamanian registry which gives access to North and South American routes, and the location and facilities of Panama airport as an inter-hemispheric hub.

Value of the routes: API's value to a foreign carrier is lessened by the requirement that ownership be 51% Panamanian. In addition, at least in the past, the reciprocating nation liked its reciprocity to go to the other nation's airline, not indirectly to a third country's line.
But, with capital markets and firms going global so that even U.S. lines have a percentage of foreign ownership, this requirement appears to have lost some of its rigidity.

Routes like Panama-Miami, Panama-Mexico, Panama-Caracas are said to be money makers, and some businessmen have even set multi-million dollar values on them. We feel these to be exaggerated, even admitting that there can be value accruing to the GOP in the way it handles the disposition of API's routes

Interest in the airline: Although there seems to be mild interest, more likely for some of API's routes than for the airline as such, the major multinationals have not appeared among the interested parties.

COPA has said that it made an offer which included taking on some 200 API employees. With its Caribbean and Central American routes (30% of the C.A. traffic) and, since December, Panama-Miami, COPA sees the possibility of connecting north with south. It further predicts that, with API's routes, it could form a perfect hub and also gain economies of scale.

TACA, the private Salvadoran airline, which had been thwarted by the previous government, has renewed its expression of interest. TACA has recently bought into Guatemala's Aviateca and Costa Rica's LACSA, and could conceivably be willing to tie in with a South American carrier and/or local investors in creating a Panama-based line.

One international bank, a leader in this field, has presented a project to conduct an appraisal of API, make projections, develop an information memo, perform a marketing program by contacting its worldwide customer base, and collect a fee on a deal realized basis.

The GOP's interest and objectives: The GOP, perhaps echoing national sentiment, if not misconception, appears to have a great interest in the revival of API; however it is more interested in rehabilitation than in money, perhaps because it also favors pursuing the idea of Panama as a hemispheric Atlanta.

Regarding the 300+ person workforce, the GOP has expressed willingness to make a deal with them to exchange their claims for shares in API, or, in the worst case scenario, give the employees another job in government.

The GOP would prefer to sell its shares, and do so right away, and believes it has all the legal authority to do so. At present, however, now, it is trying to determine the exact condition of the airline especially for the value of its routes. The GOP has requested technical assistance in doing the latter and also in putting the line up for bids.

The perspective within which to see the airline - Panama may have unique potential as an air hub for the hemisphere due to: its geographic location, long runways at sea level, pool of labor familiar with repair work, free zone for storing merchandise, and dollar-based financial system.

Today's planes do not have to stop in Panama for refueling when traveling between North and South America, no more than they do in Atlanta and O'Hare. But, as a place to gather people and cargo, Panama could become an important aviation center.

Conclusions about API

The GOP should be prepared for a very negative auditor's report. The reality must be faced that API is not viable. Its internal debt to the GOP will have to be written off in great measure. Labor obligations will have to be satisfied by the GOP. API's external debt may well prove to be sovereign debt to friendly nations; therefore, arrangements will have to be made for its orderly cancellation.

The responsible course will be to liquidate API and let the government recuperate what it can. But, given the emotional quotient in dealing with Panama's flag carrier, which is likely to be heightened by the efforts of the API employees' union, and compounded by popular misconceptions of API's value, Panama's new civilian government will want to proceed very deliberately, correctly and openly to take all the steps that the law and prudence dictate.

The auditors' report will have to be completed, studied and, in an appropriate manner, made public. A formal, professional appraisal will have to be made to determine the value of the assets (including the routes).

The shares of the airline will have to be publicly offered for sale to fulfill minimum legal requirements and satisfy critics and skeptics. But it should also be done to ascertain just what kind of interest develops for buying API's assets and/or taking over API's routes. At worst, the shares go unsold, bankruptcy is declared, the airline is liquidated, and the GOP nets its losses against whatever the assets can bring. At best, Panama does not just give its routes away, but turns the bidding into an opportunity to add major capacity to its air hub. In between these two extremes may lie the opportunity to negotiate arrangements to relocate a share of API's employees and to realize some financial gain in return for access ' Panamanian registry and routes.

It will be important to establish broad bidding ground rules that, while establishing pre-qualification requirements to screen out adventurers, encourage a variety of legitimate proposals that range from joint ventures (including the formation of a new national carrier, with the State participating) to a parceling out of routes to separate carriers.
To ensure a good response, the GOP should have the benefit of an international air-transport consultant. Also, there should be pre-bid orientation sessions with those who have expressed interest, including the banks, to provide a frank discussion of the airline's condition and of the GOP's objectives.

TECHNICAL ASSISTANCE REQUIREMENTS FOR PRIVATIZATION, IMPROVEMENTS IN BANKING SYSTEM, AND DIVESTITURE OF API

1. **Technical assistance for privatization**

Two kinds of help are needed, general and specialized.

a. **General**- A generalist (could be a team of 2) is required, early-on, who can come down intermittently, over a 3-4 month period:

- to help Mr. Brin plan and organize the program;
- to clarify the objectives of the program; e.g. define what is to be achieved, relate it to overall GOP goals, and help strategize how it is to be realized;
- to familiarize the Privatization Commission with the issues involved. This would lead to the development of a strategic plan for implementing the program and avoid forming policy on an ad hoc and often contradictory basis. It also might well stiffen resolve so that there is little back-off when the going gets tough. The idea is to help organize an initial workshop (possibly with INCAE) for the Privatization Commission to help the members identify and deal with the issues most critical to the privatization process.
- to organize the privatization team. This would include an investigation of options as to which type of arrangement should be used to bring in the needed talent from the outside to work alongside the locally recruited team.
- to circumscribe the universe of privatizeables, develop criteria for prioritizing them, and a plan of action for going about the privatization.

b. **Specialized** -Specialized help would be brought in, as needed, to work on the mechanics of privatization. This work would include prioritization, valuation, financial and legal cleanups, marketing, prospectuses, bidding procedures and negotiations; the development of policies for dealing with redundancy, financing of buy-outs, employee-management buy ins, etc.

As there will be need to deal with expected opposition from organized labor and other interest groups, specialized help could be provided for identifying the groups involved, and preparing awareness sessions and other means of communicating back and forth with them.

2. **Technical assistance for improvements in the banking system**
One type of assistance would be for the unfreezing of deposits and reactivation of credit provision: The Banking Commission could do with an outside banking advisor (possibly a retiree of stature from the Federal Reserve) to work with them on the steps leading to the unfreezing of time deposits, plus a local attorney experienced in trust work.

Specialized assistance is required for: a. improving the calibre of bank inspectors and the quality of bank inspection and supervision; b. modernizing the bank reporting system;
c. reviewing the banking rules and regulations with a view to updating them, including Article 65 of the Banking Law which prohibits bank examiners from looking into credit files.

This assistance would involve training the inspectors and auditors in workshops led by professionals from outside, supplemented by travel abroad to attend specialized courses, and/or obtain on-the-job training.

With reference to the Caja de Ahorros, a specialist could be provided to develop a plan to spin it off into the private sector, either on a management contract basis to be run as a commercial savings bank, while it is being cleaned up, or to be sold off from the outset to private investors, with or without employee participation.

3. **Technical assistance for the divestiture of API**
What is needed is a specialist in valuation in the air industry who, in collaboration with whichever local official is given the task, will come up with market values for the assets of API as well as for the Panamanian registry and route structure.

Also required would be a specialist from the airline industry, to help the GOP market whatever is of value related to API and see the authorities through the bidding/selection/negotiation process.

II. SCOPE OF WORK

1. Review the Government of Panama's (GOP) current privatization objectives;

2. Identify the potential universe of enterprises eligible for privatization and analyze data (as available) on the economic and financial performance of SOE's in the aggregate and at the level of the firm;

3. Recommend administrative mechanisms, structures and procedures for initiating and executing privatization;

4. Assess the capability of the Panamanian banking system to participate in privatization and other private investment activities, with special emphasis on the short-term results of unfreezing bank deposits, and new requirements for credit to spur economic reactivation;

5. Produce a diagnosis of Air Panama (API), with a view to its privatization, including estimates of its fair market value preparatory measures for marketing and effecting its sale, means of resolving work-force issues that may arise; and

6. Specify technical assistance requirements for subsequent phases of action by the GOP on privatization in general, banking system improvements, and divestiture of Air Panama.

III. REVIEW OF GOP CURRENT PRIVATIZATION OBJECTIVES

1. Background

After years of paternalistic government, the first real attempt to formulate a privatization program in Panama was in 1985, as part of a standby agreement with the IMF and a structural agreement loan with the World Bank. These agreements committed the Government to the privatization of a number of companies taken over by the government in the 1970s. But the times were not propitious, and the details of the program were never publicly known.

One year later, a report on privatizeable companies that had been prepared for AID was "leaked" (Annex D) and became a political issue from which the President of the Republic had to disassociate himself.

Nevertheless, in the past 4-5 years some sales of government companies have actually taken place. These were: Contadora tourist complex, Hotel Marriott, Hilton hotel and Aeroperlas.

Since the new government has taken over, no assets have been sold. While businessmen feel that the GOP has been slow to act, in fairness, the coalition administration has only been in office four months. Its first order of business, with one out of three persons reportedly unemployed, has been reconstruction to create.

2. The objectives
Based on two in-depth meetings each with Planning Minister-Vice President Ford, Treasury Minister Galindo and Privatization Director-to-be, Ricardo Brin, plus other meetings with officials and private sector leaders, our understanding is that, while the GOP as yet has not enunciated an economic rehabilitation program, of which privatization would be a part, they have in mind a very extensive program, mainly selling off state-owned enterprises, but also privatizing some services.

The Minister of Finance, for example, speaks of privatizing all that is privatizeable. Both he and the Vice President speak of turning headaches or money losers into positive gains for the economy, and of not wanting the government to own and operate companies. They mention candidates such as Air Panama, Citricos Chiriqui, Cemento Bayano.

While those two Ministers speak of selling companies, other Government officials, as in the Ministry of Agriculture, speak more broadly: of privatizing services, of leasing out farms, or contracting out their administration, of using debt equity conversions to attract interest to the agricultural sector, and even of complementary policy changes such as the lifting of agricultural price controls. Bringing workers into the process was also expressed as a goal. But it remains to be decided as to how far the GOP wants to go in using the disposition of state-owned assets to widen the base of ownership among the people.

A more precise statement of objectives probably awaits technical advice, for, as Minister Galindo said: "No one in the Government has experience in privatization".

Meanwhile, Government action is characterized by extreme caution and great sensitivity to the politics of privatization. Mr. Ford, for example, expressed concern that there could be a cry that AID funds were used to buy assets that belonged to the people. Political considerations, indeed, seem to out weigh all other factors.

Officials, logically express the wish to proceed slowly but surely, almost transaction-by-transaction, doing the easiest, facilities first. They also state their desire to do the transactions openly and in accord with legal norms; e.g. putting alternatives out for public bids.

IV. POTENTIAL UNIVERSE OF PRIVATIZEABLE ENTERPRISES

IMA officials mention privatizing an island used as a penal colony, privatizing a series of silos, selling the chicken processing factory, and leasing out some farm lands. Port officials talk of privatizing 14 ports. Private sector groups propose an integrated, automated system, with the railroad as the base, for shuttling containers across the isthmus.

Also, there may well be important services related to the utilities that can be contracted out without disturbing the special interests involved. Among them would be activities such as meter reading-billing-collection for the electric company, water works or parking authority.

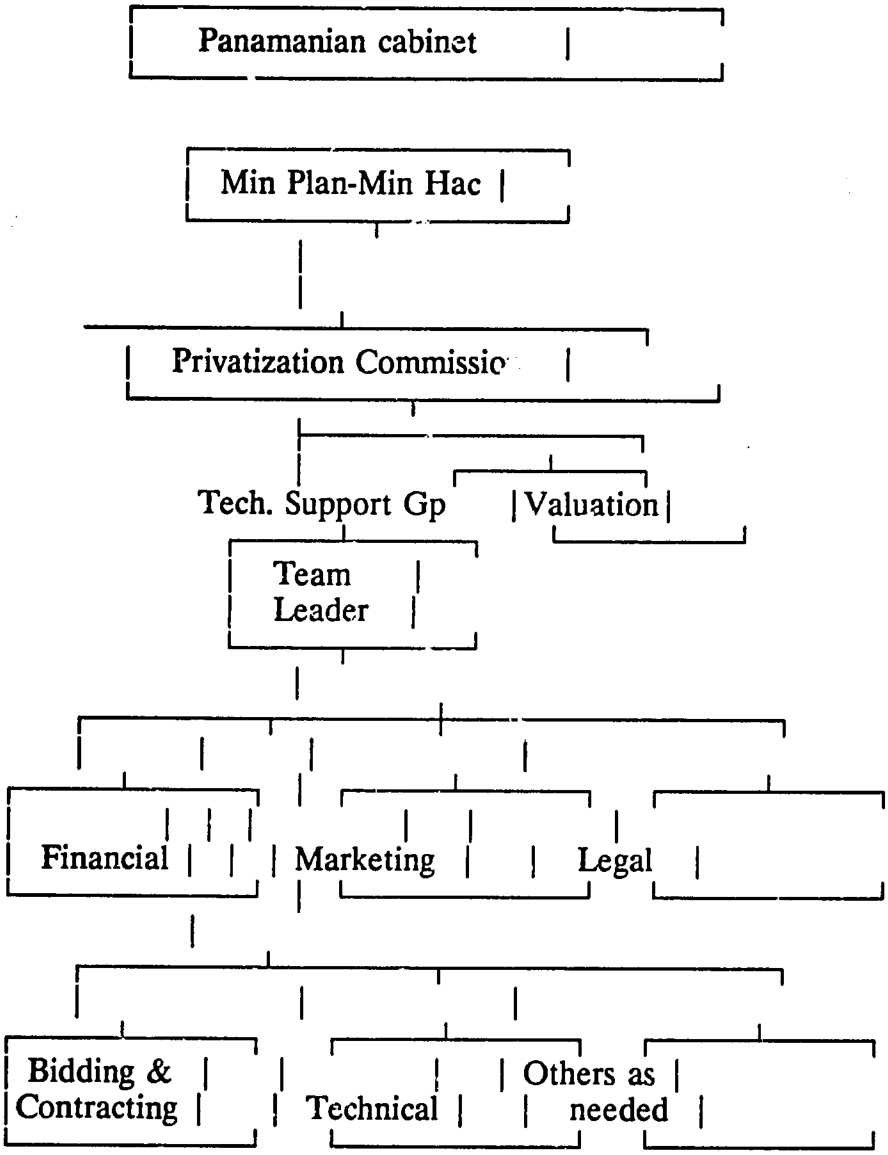
Undoubtedly, once the privatization team leader is in place and begins to form a strategy and plan, additional ideas will surface. What is important is not the quantity but the objectives, the process, the direction and pace. As privatization is about having private enterprise do what the State has formerly done, and Panama has traditionally been a paternalistic state, there will be plenty to privatize. The initial emphasis ought to be on selecting the right one(s) with which to lead off, doing them right, and building confidence and support as successes come along.

V. RECOMMENDED ADMINISTRATIVE MECHANISMS, STRUCTURES AND PROCEDURES FOR PRIVATIZATION

1. The administration

The GOP, it is understood, has designed an administrative mechanism which provides a skeleton structure for building a privatization program, which at the same time responds to the Administration's political situation as a coalition government formed on the ruins of long time military misrule. As this report was written, a Presidential Decree was in the making to name a 12 person Privatization Commission to be chaired by Mr. Ricardo Brin. The recommendations which follow attempt to fill out the skeleton.

First, a graphic depiction of the proposed structure is as follows:



The Cabinet
This is the body that will approve privatization proposals. It should also provide for overall coordination and cooperation among the different ministries under whose jurisdictions fall the various units and services to be privatized. We would think that the Cabinet's decisions should be made official by Presidential decrees (to be checked by counsel).

Proposals would be presented to the Cabinet jointly by two of its members, the Second Vice President, Minister Ford (Planning), and the Minister of Finance (Hacienda), Mr. Galindo. Those two would jointly oversee the Privatization Commission. The reason for this tandem oversight would in part be to avoid singular action in such a politically sensitive area, but also because each minister commands necessary resources for privatization. Finance has the controller general's department, which handles fiscal and other aspects of alienation of Government property and should have an important role in valuations. Planning has the human resources for planning and implementing programs. Moreover, its Minister, as Second Vice President, has special stature in the administration and with the public at large. Fortunately, the two ministers have very similar views on privatization and are compatible.

The Privatization Commission
It is envisioned that this will comprise a group of 10 prestigious businessmen who can give it the necessary time, plus two key labor leaders. In addition, the Ministry of Planning will be represented at its sessions. The presence of the two labor leaders should provide the means for getting together with labor early on, rather than when a plan has been carved in stone and could cause labor to suspect that something is being carried out sub rosa. The businessmen can input their knowledge of the local business environment. Together, as a group with the two Ministers, the Commissioners can add the political element to the equation.

Chairing the commission will be Ricardo Brin, who should provide overall leadership and become, in effect, the public figure or spokesman. Mr. Brin has long years of executive experience as Manager of Shell, and as manager of a joint public/private sector service company. He is currently a Director of COPA airline and was recently named Chairman of Panama's fledgling stock exchange.

The Commission is envisioned to have a support team of foreign and local technical advisors who would have credibility, technical know-how and organizational skills. They would be organized as follows:

The Technical Support Team
This team would be headed by a person with hands-on privatization experience (or business experience in asset/company purchases and sales), who can coordinate the talents of different specialists.
This team leader, or "Principal Advisor", as he was referred to in the Jamaican privatization program, should be a private sector person who has the confidence the Commission Chairman, and is familiar with the political as well as the technical complexities of implementing a privatization strategy.

Under his direction, the support team would bring experience and know-how to bear in helping the Commission decide what it wanted to achieve, identifying the obstacles/constraints, and conducting transactions. The team would be responsible for designing the overall privatization program, developing criteria for assigning priorities to privatization, and preparing and carrying through each one.

The team should comprise the following minimum capabilities:

a. **Financial**
   - to perform financial analysis and restructuring of companies preparatory to their privatization
   - to do the financial engineering for the transfer

b. **Legal**
   - to assure the legal basis for privatization in each case
   - to oversee cleanups of pending claims or suits against the entity being privatized
   - to verify documentation of ownership and provide the documents required to legally transfer ownership or administration of the entity

c. **Marketing**
   - to develop marketing strategy, identify potential investors, prepare marketing materials, and be a point of contact for potential investors

d. **Technical/economic**
   - to be concerned with the technical and economic viability of entities to be privatized, and to direct the contracting on technical specialists when required
   - to appraise units for valuation purposes

e. **Bidding/contracting**
   - to provide expertise in bidding procedures, contracting mechanisms and negotiating techniques

Controller's office:
Complementing the Technical Support Team would be the Controller's Office. As the one responsible for the fiscal side of things, the Controller (Contralor), if he is not already charged by law/custom, should be involved in the valuation of entities for sale and contracts to be let. Whether this function is performed as part of an independent team (mandated by law or not), or in conjunction with the Technical Support Team remains to be worked out by the authorities.

Such an official valuation function can complicate the support team's work and cause frustration. But it is a small price to pay to ensure transparency, clarity and credibility.

2. Recommended procedures
Once the Privatization Commission Chairman is named, a mandate should be given to him, along with a starting budget. The mandate should state generally what the government wants to achieve.

The Chairman or Director should then form a skeleton team and start collecting information on what is privatizeable, the legal basis for proceeding, and the constraints to be faced.

With guidance from the Commission and the Ministers, the Director, aided by an experienced advisor from outside, who should properly be the Team Leader, should draw up a basic plan, including objectives and methods for attaining them, priorities, and a budget.

The plan would be approved and funded (presumably by the Cabinet), after which appropriate members would be added to the team.

At that point, either, some SOE's would be transferred to the jurisdiction of the Ministry of Planning so that the Support Team had direct access to them, or the Cabinet would arrange for the Team to have whatever access and authority were needed.

As the team began to work on the first privatization, a review and reporting system would be set up by the Team Leader to control the program and to keep the Commission informed.

3. Timing

The sooner that the Privatization Chairman is named and begins putting together his support group, the better. First, there are natural expectations in the community, and secondary because projects like this have a way of escaping from the control of those responsible. Already, for example, there is news that in IMA a small privatization committee has been created. Finally, while there may be a few privatization that are easy and can be done quickly, it is more often the case that the preparation routine takes a lot longer than could have been expected, especially with such things as proving ownership, establishing a sales price, and cleaning up balance sheets.

VI. ASSESSMENT OF CAPABILITY OF PANAMANIAN BANKING SYSTEM TO PARTICIPATE IN PRIVATIZATION AND OTHER PRIVATE INVESTMENT ACTIVITIES, WITH SPECIAL EMPHASIS ON THE SHORT-TERM RESULTS OF UNFREEZING BANK DEPOSITS, AND NEW REQUIREMENTS FOR CREDIT TO SPUR ECONOMIC REACTIVATION

Any assessment of the Panamanian Bank system's capability to finance privatization and economic reactivation must take into account the system's capacity to weather the mandatory expiration of time deposit rollovers on June 30, 1990 and the system's ability to access external funds.

1. The confidence factor
Confidence depends on political stability and political competence, as well as confidence in the banking system. At present, confidence is in the early-construction stage, helped by the non-event unfreezing of savings accounts[1] and the U.S. Government's unblocking of other funds. Prompt and significant financing from U. S. Government/AID can produce a quantum leap in public confidence. Assuming that it comes through reasonably soon, and that the GOP continues to consolidate and move expeditiously, it makes sense to assess the Panamanian banking system's resources and resourcefulness for absorbing the unfreezing of time deposits and participating in the financing of privatization and other economic reactivation programs.

A useful place to start is the present condition of the Panamanian banking system.

2. The condition of the banking system and its vulnerability to withdrawals
This is a system that has been downsized over the past several years. More recently, it has been debilitated by U.S. imposed sanctions in 1988 and the resultant two year freeze on savings and time deposits. A factor limiting recovery has been the difficulty of rebuilding foreign credit lines, principally because Panama has made not payments on its foreign debt since 1987, and owes about $700 million in back interest.

Reflecting the above, the economy declined 25% in 1988 and an estimated 10% in 1989.

The banking system, today, comprises 78 banks, -65 foreign and 13 local- and reports deposits of some $11-12 billion. Time deposits represent some $9 billion or 78%. Subtracting inter-bank time deposits, the net figure is some $4 billion.

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1 When some $280 million, out of $463 million total savings deposits were freed in April 1990, the result was that only 3%, or $13 million, were lost. Of that amount, according to the head of the National Banking Commission (NBC), only $ 3 million left the country. This says something positive about confidence in the banking system. In the meantime, time deposits have gone up by $9 million, which could signify that many of those savings deposits went to higher interest paying time deposits (deposit interest is tax free in Panama).

The foreign banks which, it is assumed, should be able to take care of their own liquidity, account for almost $3 billion. (however, there is concern about some of the Colombian banks)

The remaining $1.1 billion in time deposits is in:

1 national mortgage bank)		
1 national (central) commercial bank)	$339 million	32%
10 local, private commercial banks)		
3 local, private mortgage banks)	$726 million	68%
Total:	$1,065 million	

The head of the National Banking Commission (NBC) puts this figure at $970 million, CITIBANK at $1 billion.

The Head of the NBC and the heads of leading local and foreign banks suggest that the problem area will be the time deposits in local banks, principally those belonging to non-residents. Precise, up-to-date information is hard to come by but, based on the figures available and their knowledge of the banking scene, the bankers strip away tied deposits (tied to offsetting loans to the same person or group) and come up with a range of $600-700 million in time deposits among the local banks, of which some $200-350 million belong to non-residents (Mr. Boyd, Head of the NBC, puts it at $340 million). This is the heart of the problem, and it seems to be mainly with the mortgage banks.

Liquidity in the system, formerly at 30% of assets, and still close to that in the foreign banks, has declined among the local banks. For the system as a whole, at year end, liquidity was estimated at $500 million below desired levels. Since then, there has been a build up of some $100 million. Some private commercial banks have been rebuilding cash reserves, and now appear strong enough to absorb fairly substantial withdrawals. The Government-owned Caja de Ahorros and the private mortgage banks are considerably less liquid, especially the former. Moreover, two or three private banks appear to be insolvent.

It is difficult to do more than make an educated guess as to the real situation of each bank with regard to liquidity, solvency, and portfolio quality. By mid-May, for example. the first quarter's reports were not yet submitting. The bank reporting system in use dates from pre-computer days, and is, first of all, not timely because the banks are given 20 days to report month-end figures, most of which they seem to take. Secondly, the reports, despite being voluminous. (a 40-page monthly report) do not provide the kind of information to permit assessments of liquidity and solvency.

Moreover, inspection and supervision lack the desired level of professionalism and have not permitted the authorities to deal with portfolio quality in a timely, salutary way.

Banks concerned about liquidity and about a possible flight of funds, once the time deposits are unfrozen, have been taking steps on their own to prepare for that eventuality. Some are now in a campaign to extend maturities, by offering higher rates. Since this is a rate sensitive market, it is believed that this will lessen the problem of withdrawals. It should be noted, also, that not all deposits will mature at the same time.

Individual banks have been working on overall plans for protecting the system as a whole. To guard against massive withdrawals once the freeze is ended, various bankers have thought about the establishment of a backstop fund. One local bank has made calculations that some $200 million would be needed. The Head of the NBC estimates that $220 million will be required; CITIBANK puts it at $180 million, calculating that a maximum of $100 million might be withdrawn. Interesting proposals for creating such a fund have come forth from some of the banks, and they deserve to be considered seriously.

The gist of the proposals is to create a standby facility using, in the first instance, the banks' own money -a privatization, if you will, of the legal reserves. This standby facility, to be underwritten by the banks, would be of substantial proportions in order to combat lack of confidence. It would represent insurance in case the banks had encountered liquidity problems.

The proposals have centered on operating the facility as a rediscount line for discounting **seasoned** loans (loans that have been paying regularly for a considerable time). Mortgage loans, where the borrower has been paying for 10-15 years on a 20 year mortgage would be the main source. The spread would be a high one, to make it attractive for the risk taking banks, and punishing (at 12-13%) to the users so that they will work to get out as soon as possible.

The amount of legal reserves which could go into the fund has been variously calculated at around $100-200 million. Adding the $120 million of AID financing, even the lower figure would represent a safety net of reasonable proportions.

The mechanism of a trust (Fide Comiso) has been suggested as the way to establish and administer the fund. A reading of the legislation on trusts in Panama, which has been around for a long time and recently modernized, followed by a check with a banker and a lawyer, suggests that this is a well established form in Panama which could well meet the requirements of the banks and AID.

3. The system's access to external funds

There is an apparent need for medium term, reactivation credit all across the board, including and probably beginning with employment creation projects at the microbusiness level, and extending to the larger units, for construction and for business to restock, rehabilitate and expand. Absent liquidity in the system, it requires access to external funding.

While this really awaits the nation's timely payments to external creditors or making new arrangements with them, and generally rebuilding investor confidence that the Government is making the right economic moves, nevertheless, there are some things that can be done, not immediately, but in the medium term. What the GOP can do is use its best offices in Washington and Wall Street to achieve a high priority for one or the other of the proposals to create a fund that will invest in Panamanian mortgages and/or external debt.

To be more explicit, more than one Proposal has been put forth to securitize Panamanian mortgages held by banks in the system and sell them abroad. One such proposal, The Panama Economic Recovery Fund, a privately-owned limited partnership having an invested capital of $40 million, would raise cash by issuing promissory notes guaranteed by OPIC. This proposal is described in Annex D. Bank of Boston has proposed a different type plan to buy up mortgages; CITIBANK has proposed a similar fund to OPIC on a Caribbean-wide basis, to include Panama, similar to the sub-Sahara Africa fund which it pioneered with OPIC and has just launched.

4. CONCLUSIONS

It seems fairly clear that the banking system has to be normalized before it can expand. Normalization is tied to unfreezing the banking system's time deposits. The seriousness of this step is not only that large deposits may leave the system, but that it comes at a time when more, not less, liquidity ought to be going into the system to fuel economic recovery.

The threat that time deposits, once unfrozen, may flee is real. Their owners are not tied to the country in the way that savers are; in fact, they have ready access to and familiarity with external markets.

Nevertheless, it appears to be a problem that is manageable. Based on collaboration between AID and the local banking system, there is a solution through pooling funds - recycling bank reserves plus injecting AID funds. The larger the fund the greater the probability that it will not need to be used. But, as a preliminary step, before spreading the net, it will be necessary to deal with the insolvency of certain institutions, otherwise the net will fill with them.

It will be necessary to go through the portfolios of the banks in trouble. Some have dubious loans that will never support the deposits from which they were created. Those banks may have to sell off their good assets and call for capital injections from shareholding groups; some may have to be taken over by bigger, more solid banks, or be liquidated, even with the risk that some people will lose their savings. The Caja de Ahorros, for example, may have to be intervened by seasoned private bankers and its administration privatized.

The possibility definitely exists of a collaborative effort to achieve the normalization of the banking system. For one thing, the relationship between the banks and the National Banking Commission is no longer antagonistic. The banks still feel that the inspectors and the commission are on the other side of the fence, but they have rapport with and respect for Mr. Boyd, the NBC Chief.

There is a reservoir of goodwill and resourcefulness locally that can/should be put to use to accomplish the clean up of the system and creation of a backstop facility. Doing so opens the way to external help to provide additional liquidity. If the banking system is to finance privatization and economic reactivation, it will need to draw in more funds from abroad. But first, it must be able to hold on to the funds it has, or accommodate withdrawals in an undisruptive way. The unfreezing of time deposits, and the way it is handled, will be a major test. A second test will be the way it cleans up its act.

External funds can be accessed through securitization of mortgages and other loan forms for packaging and sale abroad. "Cedulas Hipotecarias" for example, can be brought into play both for the external market and as a trading instrument for the new stock exchange. The bank/AID pool itself could be a source of financing. With the increase in liquidity gained through this means, the system should be able to participate in financing privatization and other developmental activities.

Assuming that the authorities view these proposals favorably, and assuming that AID funding comes through, would and should the GOP make a decision to free time deposits? And could it create a backstop facility such as described above before June 30? Local private bankers believe so. We are inclined to agree, if sufficient protection is built up and the other preliminary steps are taken. Whether it is too soon by June 30 is a matter of how soon they get started and how fast they proceed. In any event, it will be necessary to move swiftly, with the Government taking the initiative. There is a need to formulate it all into a plan, and this is a task for Mr. Boyd, the Head of the NBC working with the banks and AID. Our feeling is that he will need outside professional help in this endeavour.

The fact that the $420 million AID package had been approved may encourage Mr. Boyd to take the initiative.

Improving bank reporting and inspection, so that the system is put in order and remains so . Improved information systems, (featuring simpler and more timely reporting) also needed are more qualified people -professionals who understand bank inspection. To achieve this improvement, the Banking Commission needs more resources, both financial and human.

RECOMMENDATIONS

These comments are offered in the knowledge that Mr. Boyd surmises the situation correctly, has identified what needs to be done, and enjoys the confidence of the bankers with whom he has to work.

The goal ought to be to free all the time deposits, as soon as possible. To do it partially and/or gradually is to portray uncertainty, concern and lack of confidence. If, for example, depositors are told that they can only take a certain amount out at the beginning, and the rest later, they are likely to take out that amount. If foreigners -the largest depositors- are discriminated against, by allowing residents to withdraw first, then, when their turn comes, they will have ample reason to seek other havens.

The timing ought to be within the next 60 - 90 days and the key ingredient must be that the banks in the system, private and official, foreign and domestic) all pull together.

AID could use the formalization of its financial aid package, i.e. the occasion of Congressional approval of funding, to meet with Mr. Boyd and the Banking Commission, possibly along with the Ministers of Planning and Hacienda, to discuss the application of the funds.

AID should seek his agreement to form a small working group to come up with a plan for creating a safety net, using the banks' funds first and AID's funds as a last resort, but pooling both into one fund. This group would vet the more serious proposals and work with the proponents to come up with a single plan along the lines mentioned earlier.

Meanwhile, another line should be pursued: of obtaining detailed information, bank by bank on its liquidity (or solvency), the quality of its portfolio and a profile of its time deposits.
To help the Banking Commission with this task, AID could see to providing it with an outside banking advisor (possibly a retiree of stature from the Federal Reserve) to work with them, and probably a local attorney experienced in trust work.

The heads and managers of all the banks should be called together by Mr. Boyd and the Commission to explain and discuss the outline of the program and secure their cooperation, as well as agreement to set up a working group.

The basic theme would be that if they all work together as a team and each takes the actions expected of him, there will be provided, over and above what they and the banking authorities can come up with, a $100+ million back-up from AID.

It would be explained at the meeting that the main reliance would be in perfecting their act; that the safety net is their comfort factor.

The working group would immediately begin setting up the standby facility and trust fund.

Meanwhile, each bank would be asked to come up with its own confidential estimate of what it might lose if the unfreezing took place next month. (the confidential aspect would have to be stressed and somehow assured to those present)

The estimates from each bank would be reviewed by the Head of the Banking Commission with the head of that bank. This would involve also a very careful review of which time deposits are real and which are tied to loans or are, in reality, capital injections disguised as time deposits for tax considerations.

The total expected time deposit losses of each class of bank -official, mortgage, private commercial-domestic, and private commercial-foreign, should be reviewed against the experience of 1984, when some 30% of deposits were lost. (Also the 1984 experience should be reviewed for the measures taken to deal with the crisis, so that lessons learned can be applied to today's thinking). In addition, the liquidity position of each bank would be appraised.

The withdrawal estimates should also be reviewed against the overall calculation which some of the banks and institutions have made (among them, Indesa, CITIBANK and Banco Continental).

Finally, correction should be made for what Mr. Boyd and the Commission judge to be excessive optimism or pessimism, and a final set of figures developed, by bank and banking class, giving a range of expected time deposit losses.

Then a plan should be drawn up which lays out the basic steps to be taken to provide for the expected withdrawals, including improving liquidity early on. Also, this plan should provide not simply for dealing with deposit losses, but with expanding the funds in the Panamanian banking system.
Its key elements would provide for the following:

1. The insolvent banks would be dealt with -through sale of assets, capital increase, merger or closure and transfer of deposits to a stronger bank.

   This would include privatizing the Caja de Ahorros, either by contracting out the management, or transfer of ownership to the private sector in such a way that employees as well as private investors acquired shares.

2. The system for pooling reserves would be established, with reserves becoming the first line of defense. The Fide Comiso, or trust fund form would be used. AID would deposit its $100+ million safety net money into the trust fund. The details would be worked out between the Banking Commission, with the help of its advisor, and AID officials, and would provide for access by solvent domestic banks, public as well as private, excluding the Banco Nacional.

   A clear set of procedures for rediscounting of assets would be enunciated.

3. Each bank should set out to extend the maturies of its time deposits and achieve staggered redemption dates, by offering interest rate inducements, and possibly non-penalty withdrawals after a certain date.

4. Each bank that needs to should develop a realistic plan for improving its liquidity, including tightened collections, asset sales, and new capital injections.

5. Contact would be made with institutions in and out of Panama that have proposed offshore funds to buy Panamanian paper and invitations extended to them to submit proposals.

6. A separate working committee would be formed, to include the banking advisor, to develop a program to improve and modernize the bank reporting system and the quality of bank inspections. The program, to be supported by AID, would include training workshops plus on-the-job training by experts brought in from outside, in addition to a systems and equipment review and redesign.

VII. DIAGNOSIS OF AIR PANAMA (API)

(For a separate treatment of API, see Annex F, which contains a report by W. Spohrer, President of Challenge Air Cargo, who has owned and operated Central American passenger airlines as well one based in Miami. While Mr. Spohrer worked with this writer in developing the section which follows, he also worked on his own, after leaving Panama. Time did not permit incorporating his report into this one. Nevertheless, the conclusions and recommendations stated below do not differ materially from what Mr. Spohrer wrote on his own)

1. The condition of the airline

A. Current status

API ceased flying several months ago. The staff has been laid off, and has claimed unpaid wages. Large creditor claims have been reported, at home and abroad. The line's name has lost prestige. The 100,000+ passengers per year it is estimated to have carried, seem to have been divided mainly among Eastern, Panama and COPA.

No financial or other statements are available. The GOP has contracted a firm of auditors to produce reliable statements, which are to show the reality of what API has and what it owes abroad, who are the creditors, and how much are the undisclosed liabilities. While it is expected that the report will be completed in 30 days, we understand that the auditor is not yet on the project.

B. Assets

There is one airplane, owned free and clear, a Boeing 727-100, worth only $1.5 million, according to Mr. Ford. This is an outdated plane, expensive to operate, overdue for a major overhaul (DCK). Some of its parts have reached their expiration date, according to airline sources (the landing train was mentioned as one). A second plane, used by Gen. Noriega, is in much better condition and worth considerably more. But there is no indication that the plane ever belonged to API. In point of fact, the considerable doubt about its ownership suggests that it could be tied up in litigation for a long time.

With any luck, API has $3 million in assets, according to COPA.

Aviation authorities have mentioned that the GOP could add value by including the right to use a large hangar, suitable for maintenance of large planes.

C. **Liabilities**
These are estimated by Mr. Ford at $20 million, and by Treasury Minister Galindo at $25-30 million. COPA puts the figure at $17-18 million.

Published reports show amounts owed to Panamanian Government agencies at $3.1 million, of which $1.5 million is to Social Security and $1.4 million to DAC.

Labor obligations to API's over 300 employees (some say 600) including salary, for they are without pay at the moment; overtime; pay increases and severance, under the labor code; are estimated by Mr. Ford at $5 million.

From several sources came reports that there are many legal claims in the United States (the numbers stated were 14-15, although one source went as high as 40), Mexico, Peru, and Columbia. It is not known how many are real -for maintenance, overhauls, services, etc., and how many are scams of one sort or another.

D. **Overall appraisal**
The accounting review may turn up some hidden values, but not likely enough to change things. If there is any real value it is in the Panamanian registry which gives access to North and South American routes, and the location and facilities of Panama airport as an inter-hemispheric hub.

2. **Value of the routes**
The routes are not the property of API, therefore it cannot to do with it as it pleases. They are a government-to-government arrangement based on reciprocity to one country's line for reciprocity to another's. Moreover, their value to a foreign carrier is lessened by the requirement that ownership be 51% Panamanian, and by the fact that, at least in the past, the reciprocating nation liked its reciprocity to go to the other nation's airline, not indirectly to a third country's line. Nevertheless, with capital markets and firms going global so that U.S. lines have a percentage of foreign ownership, this requirement appears to have lost some of its rigidity.

There is interesting precedent in the privatization-rescue of Mexicana Airlines where a group of Mexican and foreign investors, including Sir James Goldsmith and Chase Manhattan Bank paid $140 million in cash for a 25% managing share (the Mexican Government retained a 58% interest). Equally illustrative is the case of state-owned and unreliable Aeromexico which, two years ago, was declared bankrupt and then sold to a group of prominent businessmen. The new private owners took over the routes. They shed the unprofitable internal ones and concentrated on the external ones supported by the Government of Mexico which made an air-transportation agreement with the United States (that also benefited Mexicana Airlines).

At any rate, routes like Panama-Miami, Panama-Mexico, Panama-Caracas are said to be money makers. Some businessmen have even set multi-million dollar values on Air Panama's South American routes plus Panama-Miami under Panamanian registry. We feel these to be exaggerated, but do believe there can be value accruing to the GOP in the way it handles the disposition of API's routes.

3. Interest in the airline

There seems to be mild a interest for some of API's routes, not for the airline itself. The major multinationals have not appeared among the interested parties.

COPA has said that it made an offer which included taking on some 200 API employees. This privately-held, conservatively managed, 100% Panamanian company, is, by all accounts, a profitable regional airline with an excellent safety record. COPA has three 737 planes and 320 employees. With its Caribbean and Central American routes (30% of the C.A. traffic) and, since December, Panama-Miami, COPA sees the possibility of connecting north with south and feels that with API's routes it could form a perfect hub, and also gain economies of scale. Copa doesn't feel it needs to associate itself with a large foreign airline and, as a Panamanian carrier, considers itself the rightful heir to the routes abandoned by API. As such, it could be expected to oppose a foreign entry. Seen in this light, its offer to take up to 200 API employees may seem generous.

TACA, the private Salvadoran airline, which had been thwarted by the previous government, has renewed its expression of interest. TACA has recently bought into Guatemala's Aviateca and Costa Rica's LACSA, and could conceivably be willing to tie in with a South American carrier and/or local investors in creating a Panama-based line.

Reportedly, KLM has expressed some interest. Two relatively unknown U.S. companies have expressed interest: Buffalo Airways and Aviation Group; and also a local lawyers group (possibly for outside interests) has made inquiries. Ryder, a well-known name in the industry, has suggested providing aircraft on a lease basis.

Florida Western and King International, both reputable companies have inquired about setting up aircraft maintenance facilities.

Two international banks have expressed their interest helping. One, a leader in this field, has presented a project to: do an appraisal of API, make projections, develop an information memo, do a marketing program by contacting its worldwide customer base, and collect a fee on a deal realized basis.

4. The GOP's interest and objectives

The GOP, perhaps echoing national sentiment, if not misconception, appears to have a great interest in the revival of API. The GOP is much more interested in rehabilitation than in money, perhaps also because it favors pursuing the idea of Panama as an Atlanta, a hub of hemispheric aviation. But, the GOP doesn't want a government airline because, as Vice President Ford put it: "We don't want to lose another $20 million, we want an airline that stands on its own feet".

The GOP seems open to several possibilities: bringing in a foreign airline as part owner and manager, with Panamanians owning a majority; liquidating API and forming a new airline on a joint venture basis, with the GOP accepting responsibility if new claims arise; selling the assets to a new entity and using the results to pay labor claims. Because API's business is not escalating, it is realistic enough to to say that if API cannot fly, the GOP would liked to be informed.

Regarding the 300+ person workforce, the GOP has expressed willingness to make a deal with them to exchange their claims for shares in API, or, in the worst case scenario, give the employees another job in government.

The GOP would prefer to sell its shares, and do so right away, and believes it has all the legal authority to do so. But, right now, it is trying to find out where the airline stands, and to get a feel for the value of the routes. The GOP would like help in doing the latter and also in planning for putting the line up for bids.

5. **The perspective within which to see the airline**

Panama has possibly unique potential as an air hub for the hemisphere due to:

1. **Its geographic location** midway between north and south America.
2. **It facilities**
   a. the airport: it has a sea level airfield, extra long runways, good flying weather, the ability to handle the biggest planes heavily laden, and the ability to handle volume and bulk. Moreover, it has a labor force, already grounded in repair work, which could be developed as a low cost alternative to US and more distant ports, for aircraft maintenance and overhaul.
   b. the free zone, world's second largest: The Panama Canal brings freight from the Far East en route to the eastern coasts of this hemisphere and to Europe and Africa, and vice versa; cargo is off-loaded to the free zone and, from there, goods are distributed to Central America, the Caribbean and South America.

   c. its financial/economic system: A dollar based financial system free of exchange risk/controls, and without taxes on money earnings. Reportedly, 14% of GDP is air related.

Today's planes do not have to stop in Panama for refueling when traveling between North and South America, no more than they do in Atlanta and O'Hare. But as a place to gather people -from South America going to different countries in Central America, or to different cities in North America, and vice versa- and as a place for the wealthy to come and visit their money (not all banking is done electronically); for the merchants to come and buy wares; and as a place to send planes for maintenance, Panama could become an important hub. In a very small way, it already is a hub of passenger exchange/ connections through COPA, Pan American and Eastern. On the cargo distribution side, this is represented by the growing business of Challenge Cargo Airline.

6. **Conclusions about resolving the API dilemma and realizing its potential as an air hub**

The GOP should be prepared for a very negative auditor's report. The reality must be faced that API is not viable. Its internal debt to the GOP will have to be written off in great measure.

Labor obligations will have to be satisfied by the GOP. API's external debt may well prove to be sovereign debt to friendly nations; therefore, arrangements will have to be made for its orderly cancellation. The responsible course will be to liquidate API and recuperate what the government can.

Given the emotional quotient in dealing with Panama's flag carrier, which is likely to be heightened by the efforts of the API employees/union, and compounded by popular misconceptions of API's value, Panama's new civilian government will want to proceed very deliberately, correctly and openly to take all the steps that the law and prudence dictate.

The auditors report will have to be completed, studied and, in an appropriate manner, made public. A formal, professional appraisal will have to be made to determine the value of the assets (including the routes).

The shares of the airline, or what is left of it, will have to be publicly offered for sale, if for no other reasons than to fulfill minimum legal requirements and satisfy critics and skeptics. But it should also be done to ascertain just what kind of interest develops for buying API's assets and/or taking over API's routes. At worst, the shares go unsold, bankruptcy is declared, the airline is liquidated, and the GOP nets its losses against whatever the assets can bring.

At best, Panama does not just give its routes away, but turns the bidding into an opportunity to add major capacity to its air hub. In between these two extremes, may lie the opportunity to negotiate arrangements to relocate a share of API's employees and to realize some financial gain in return for access to Panamanian registry and routes.

It will be important that the GOP establish broad bidding ground rules that, while establishing pre-qualification requirements to screen out adventurers, encourage a variety of legitimate proposals that range from joint ventures (including the formation of a new national carrier, with the State participating) to a parceling out of routes to separate carriers. To ensure a good response, it may be the best course, in the first place, to have the benefit of an international air-transport consultant and, secondly to have some pre-bid orientation sessions with those who have expressed interest, including the banks, to ensure a frank discussion of the airline's condition and of the GOP's objectives. The GOP could then develop criteria and procedures for qualifying bidders and negotiating final arrangements.

VIII. TECHNICAL ASSISTANCE REQUIREMENTS FOR PRIVATIZATION, IMPROVEMENTS IN BANKING SYSTEM, AND DIVESTITURE OF API

1. Technical assistance for privatization

Two kinds of help are needed, general and specialized.

a. General

A generalist (could be a team of 2) is required, early-on, who can come down intermittently, over a 3-4 month period, spending 2-3 weeks at a time helping the Administrator, Mr. Brin, to plan and organize the program. More specifically, the generalist would help:

- clarify the objectives of the program -define what is to be achieved, relate it to overall GOP goals, and help strategize how it is to be realized.

- familiarize the Privatization Commission with the issues involved. This would lead to the development of a strategic plan for implementing the privatization program. Such an approach would avoid forming policy on an ad hoc and often contradictory basis, and might well stiffen resolve so that there is little back-off when the going gets tough.

What is envisioned here is to help organize and conduct a workshop (possibly using the resources of INCAE) for the Privatization Commission to help the members identify and deal with the issues most critical to the privatization process, such as:

> **in the procedural area** -valuation methods, financing of buy-outs, debt-equity swap mechanisms, bidding & negotiation, labor-management participation, etc.
> **in economic policy** -labor legislation, foreign ownership/control, interest rates and capital markets, taxes, government regulatory authority and procedures

- organize the privatization team. This would include an investigation of options as to which type of arrangement should be used to bring in the needed talent from the outside to work alongside the locally recruited team: whether to engage a private, financially oriented merchant or other banking institution, a la Jamaica;, or to contract with a more technically oriented institution, like the Center for Privatization, that would supply talent as needed, a la Honduras; or a single institution for each major privatization such as Morgan Stanley-Banco Roberts for the Argentine telephone company, or simply to directly engage specific consultants as needed.

- circumscribe the universe of privatizeables, develop criteria for prioritizing them, and a plan of action for going about the privatization.

b. **Specialized**

Specialized help would be brought in, as needed, to work on the mechanics of privatization -prioritization, valuation, financial and legal cleanups, marketing, prospectuses, bidding procedures and negotiations. Specialists would also help develop policies for dealing with redundancy, financing of buy-outs, employee-management buy ins, etc.

As there will be need to deal with expected opposition from organized labor and other interest groups, some of them within government ministries, specialized help could be provided in identifying the groups involved, and in preparing awareness sessions and other means of communicating back and forth with them. Out of these contacts, it would be expected that there would come important mutual understanding. Moreover, the sessions should help shape policies for dealing with some of the major concerns.

2. **Technical assistance for improvements in the banking system**

One type of assistance would be for the unfreezing of deposits and reactivation of credit provision:

The Banking Commission and its Chief could do with an outside banking advisor (possibly a retiree of stature from the Federal Reserve) to work with them on the steps leading to the unfreezing of time deposits, In addition, they could use the services of a local attorney experienced in trust work.

Specialized assistance to the head of the NBC is required for:

a. improving the calibre of bank inspectors and the quality of bank inspection and supervision

b. modernizing the bank reporting system

c. reviewing the banking rules and regulations with a view to updating them, including Art 65 of the Banking Law which prohibits bank examiners from looking into credit files.

This assistance would involve training the inspectors and auditors in workshops led by professionals from outside, supplemented by travel abroad to attend specialized courses (CITIBANK, for example, has run training courses in Puerto Rico on a regular basis; ditto the Federal Reserve in Washington, DC), and/or to get on-the-job training.

With special reference to the Caja de Ahorros, a specialist could be provided to develop a plan to start off into the private sector, either on a management contract basis to be run as a commercial savings bank, while it is being cleaned up, or to be sold off from the outset to private investors, with or without employee participation.

3. **Technical assistance for the divestiture of API**

What is needed, first of all, is a specialist in valuation in the air industry who, in collaboration with whichever local official is given the task, will come up with market values for the assets of API as well as for the Panamanian registry and route structure.

Also required would be a specialist from the airline industry, to help the GOP market whatever is of value related to API and see the authorities through the bidding process, and finally to selecting the right offer and negotiating a deal.

ANNEX A

LIST OF PERSONS INTERVIEWED

Alvarado, Omar - Vice President, CITIBANK
Asselin, Robert - Director, Office of Investment, PRE/AID
Bass, Gerry W. - EVP, Aviation Sales, Co., Ryder Systems
Bazan, D. Kaiser - Executive Director, Fundacion ANDE
Bello, Juan - Vice President, CITIBANK
Bennett, John - Director Aviacion Civil
Bloch, Federico, Executive Vice President, Taca Intl Airlines
Boyd, Ernesto - Exec. Director, Comision Bancaria
Brin, Ricardo - Director Copa, Pres. (new) Stock Exchange
Cazorla, Ricardo -Vice President, Chase Manhattan Bank
Chapman, Guillermo - President, INDESA
Chiriboga, D. -Deputy Director, USAID
De La Ossa, Jose - Vice President, CITIBANK, New York
Diaz, Antonio - President Panama International Airline
Diaz, Raul - Pres. Ford Sosa Y Morrice, Insurance
Fabrega, Jaime - former head of Civil Aviation
Ford, Guillermo - Second Vice President of Panama & Min. Planning
Galan, Jose - Vice Minister, Planificacion
Galindo, Dr. Mario J., Minister of Treasury (Hacienda)
Goldfield, H. P. - Swidler & Berlin, Wash. DC
Gonzalez Revilla, Emanuel, President BANCOMER
Heilbron, Pedro - Vice Pres. Compania Panamena de Aviacion (COPA) Icaza, Roy - Presidente, Cemento Panama
Lugo, Guillermo - Regional Vice Pres., Adela Investment Co.
Marciacq, Ing. Rodrigo - Director General, IMA
Moh, Ing. Kermit -Private Sector Director, USAID, Panama
Motta, Alberto, - President, Copa Airlines
Motta, Roberto - Pres. Empresas Financieras Continental
Ratton, Jean - Admin. Director, Cemento Panama
Reyes, Rafael - Gerente de Credito, Banco Continental
Shea, James W. - Director, AIFLD (AFL-CIO)
Smith, Paul - General Manager, Banco Continental
Stukel, Thomas - Director, USAID Panama
Vallarino III, Joaquin J. - Chairman, Coca-Cola de Panama
Versari, Gianni - Second Vice Pres. Chase Manhattan Bank
Yung, Conrado - Regional Manager, Challenge Air Cargo

ANNEX B

LIST OF DOCUMENTS REVIEWED

Algunos Aspectos de la Deuda Interna Panamena, Abril 1990
Boletin Negocios - Abril 1990
Cabinet Dceree No. 238 of JUly 2, 1970 - amendment to banking system & creation of Banking Commission
Directorio Bancario 1990
El Sistema Moentario Panameno - Marco Fernandez, May 1986
Indicadores de la Evolucion Economica -Mayo de 1990, by Grupo INDESA
Informe del Contralor General de la Republica, 3/1/90
Informe Estadistica Mensual - Centro Bancario International, Enero 1990 - Comision Bancaria Nacional
Informe Sobre la Situacion de las Finanzas Publicos Y Algunos Aspectos de la Crisis Fiscal - Ruben Carlos, 3/1/90
Investment Promotion PLanning - Transportation Services Sector Study - June 1987 by Intl Planning & Analysis Center (IPAC)
Investment Promotion Planning - Agricultural Sector Study June 1987 - by IPAC
Legislacion Sobre Fideicomisos - Arosmena, Noriega & Castro 1987
Letter to the President of Panama, from Rubcn Carles, Contralor General - re Privatization Program - 3/26/90
Panama Banking System - Percent Foreign & Domestic Deposits
Panama - New Law on Trusts - De. Jose A. Noriega Perez, University of Paris
Partial List of Panamanian Decentralized Entities - 4/23/90
Private Sector Reactivation Credit -Pages 6-8 of an AID memo
Privatization In Latin America 1988-1989, Report by Dr. P. Accolla, US Department of Labor
Propuesta de INDECA Para La Normalizacion del Sistema Bancario Panameno - 9 Abril 1990
Summary of Labor Laws on Dismissals, courtesy of AIFLD
Unfreezing Panamanian Bank Deposits - An Approach
USAID/Panama - Supplemental Package - Discussion Paper 4/26/90

ANNEX C

POTENTIALLY PRIVATIZEABLE ENTITIES

1. Air Panama International (API) -grounded, insolvent
2. Autoridad Portuaria Nacional -National Port Authority
   administers 14 ports and the canal
3. Banco de Desarrollo Agropecuario (BDA) -Ag Develpt. Bank [1]
4. Banco Hipotecario Nacional (BRN) -National Mortgage Bank [1]
5. Banco Nacional de Panama -like a central bank, but has commercial operations too [1]
6. Bingos Nacionales
7. Caja de Ahorros -savings institution
8. Caja de Seguro Social -Social Security Institute [1]
   -facing a $120 million deficit in 1990; government owes it $51.5 million
9. Cemento Bayano -the Bayano Cement Co. -1 of 2 in Panama
10. Casinos Nacionales [1]
11. Citricos de Chiriqui A.N. -Chiriqui Citrus company
12. Consejo Nacional del BAnano
13. Corporacion Azucarera La Victoria -Victoria Sugar corp.
    -Ingenio La Victoria
    -Ingenio Felipillo
    -Ingenio Alanje
    -Ingenio Azuero
    -properties in Cocle for a 5th mill
14. Corporacion Para el Desarrollo Integral de Bayano
    - administers a farm (rami), has never been self-sufficient; has lands to sell
15. Corporacion Para el Desarrollo Integral de Bocas del Toro
16. Corporacion Financiera Nacional (COFINA) [1]
17. Direccion de Aeronautica Civil [1]
18. Direccion Metropolitana de Aseo (DIMA)
    -solid waste removal
19. Empresa Estatal de Cemento Bayano
20. Empresa Nacional de Semillas (ENASEM) -the National Seed Corporation
21. Empresa Nacional de Maquinaria Agricola (ENDEMA) -the Machinery Pool, provides farm machinery rental and repair services
22. Ferrocarril de Panama
23. Ferrocarril Nacional de Chiriqui
24. Hipodromo Presidente Ramon
25. Instituto de Aquaductos Y Alcantarillados Nacionales (IDAAN) -the National Water and Sewage Institute [2]
26. Instituto de Investigacion Agropecuaria de Panama

ANNEX C POTENTIALLY PRIVATIZEABLE ENTITIES (CONT.)

27. Instituto de Mercadeo Agropecuario (IMA) -Agricultural marketing Institute -runs slaughter house; owns a chicken processing plant which is shut down; markets hides & skins, imports food stuffs [1] [2]
28. Instituto de Recursos Hidraulicos Y Electrificacion (IRHE) -the Hydroelect. Resources Instit. supplies (high cost) electricity [2]
29. INRENARE - Institute of Natural Resources [1]
30. Instituto de Seguro Agropecuario (ISA) -Crop Insurance Agency [1]
31. Instituto Nacional de Telecommunicaciones (INTEL) -the National Telecommunications Institute (telephones)
32. IFARHV -the Human Resources Development Institute -makes student loans, in deep financial trouble [1]
33. Loteria Nacional de Beneficiencia
34. Universidad de Panama
35. Universidad Tecnologica
36. Zona Libre de Colon -Colon Free Zone [1]
37. EXPLONSA (owned by Panama Defense Forces)

Previously sold:

Panama Hilton Hotel
Marriott Hotel
Contadora tourist complex
Aeroperla

[1] were profitable in 1988, no figures for 1989

[2] together, IDAAN, IMA & IRHE owe $660 million to foreign lenders

ANNEX D

"LEAKED REPORT"

ANNEX D

C 50

MEXICO

ECONOMY

Guarded optimism after IMF deal

OIL PRICES AND SALES MAKE GROWTH TARGET UNLIKELY

Spirits have been lifted by the signing in late July of a letter of intent with the IMF. But some are voicing doubts over the capacity of the economy to respond, and meet the target of a 3-4% growth rate in 1987 after an anticipated shrinkage of 4% in 1986.

What has been described as a 'landmark' agreement with the IMF, allowing a start to be made on restoring growth while structural economic reform gets under way, has led to a marked improvement in the mood of both government officials and leaders in the private sector, who have made a point of expressing their confidence in the economy.

The general response has been favourable. At the beginning of August the stock-market staged one of its most impressive rallies ever, breaking through the psychologically significant 20,000 points barrier. The Mexican peso has remained basically stable in the free exchange market.

But many have expressed scepticism over medium- and long-term prospects.

■ Loans to service debts

'We cannot rule out a 3% growth in 1987, especially after the depressed levels of 1986', a top financial analyst has told us. 'But it is going to be very inflationary growth.' He explains this by [illegible] that the economy will have to be fuelled principally by public investment.

Clemente Ruiz Duran, a former technical secretary at the Banco de Mexico and now a private economic consultant, believes that the new loans being contracted by the government will serve little purpose other than to enable Mexico to continue servicing its huge foreign debt of close to US$100bn. He maintains that, in practice, new loans will only increase the country's difficulties.

By the end of 1987 the foreign debt will be around US$[illegible]bn, meaning that, should the rates of interest remain steady, we [illegible] have to pay an additional US$[illegible] notes Duran.

But he emphasises the country will not have the resources for servicing the increased foreign debt. Following a marginal surplus in 1985, Mexico's current account is expected to be in the red by US$3.5bn in 1986, and by at least US$3bn in 1987. What is more, these figures are based on the assumption that international oil prices will remain at around US$11 a barrel.

At present this would seem over-optimistic, with preliminary figures issued by Pemex showing that the average price for Mexican light and heavy crudes was around US$8.26 a barrel in July. Even though sales registered a considerable improvement on February and March levels, they were still 1.5m barrels a day below the Pemex target.

■ Little private investment

Because of an increase in financing late last year, the government is depending on the private sector to lift the country out of the recession. But there seems to be little interest on the part of the private sector in investing; many deeply indebted companies are trying to get help from the state banks, and are hardly in a position to consider new investments. And an increase in government revenue in 1987, called for in the IMF agreement, is expected to come from higher taxes and an end to business allowances, further discouraging new private investments.

It is again Duran who has told us that 'the debt problem has not been solved but, rather, postponed. Even if the private banks do agree to meet the request for a contribution of US$6bn to help Mexican revenues, the country will have to return to the negotiating table within 18 months. The timing is important', says Duran, who maintains that the IMF has 'manoeuvred to have the next round of negotiations in late 1987 so as to include the new official candidate to the presidency and thus guarantee that the present economic policies are maintained'. ■

PANAMA

ECONOMY

Tensions over sale of state companies

CONTROVERSIAL REPORT CALLS FOR TOTAL 'PRIVATISATION'

A political storm is brewing over the proposed sale to the private sector of loss-making state companies.

Both the 1985 standby agreement with the IMF, and the World Bank's 1986 structural adjustment loan, committed the government to the 'privatisation' of a number of companies taken over by the government in the 1970s to prevent their closure and unemployment for thousands. The companies in question were Contadora Resort S.A., operating in the tourism sector; the Aeroperlas airline; the machinery rental company Enderna; the Las Cabras mill; the Citricos de Chiriqui fruit plantation and concentrate plant; and the facilities of the Felipillo mill, closed in 1983.

In a statement made public by the civil servants' Frente de Servidores Públicos it is claimed that 'action being taken to privatise state companies is in line with the current climate of pressures and blackmail, both internal and external, aimed at eroding the state's economic resources and creating economic chaos.'

Nevertheless the civil servants' national secretary, Benjamin Colamarco, says that 'we have no problems with the sale of these companies. What we want to know is the likely future for the workers' who, he maintains, in working for such companies, are in effect civil servants.

■ Report condemned

Adding provocation is a 'leaked' report which suggests that all the state sector should be transferred to private control; this is to include electricity and water services, telecommunications, the civil aviation and port authorities, the national lottery and casinos.

The transfer would be achieved through the sale of shares in both the domestic and international markets, or by converting the state companies into joint ventures with local and foreign private capital.

The report was prepared by the US consultancy company Arthur Young together with the Washington Capital Markets Group at the request of the Panamanian national investments council, USAID and the Washington-based Center for Privatization.

Reacting to the report's suggestions, through its national executive council the Partido Revolucionario Democrático (PRD), the largest party in the ruling Unión Nacional Democrática (Unade) coalition, has declared a 'state of alert', maintaining that it will not permit the privatisation of autonomous state entities.

Ramiro Vásquez, assistant secretary of the PRD, has told us that 'we must be on the alert because it could happen that in the future international agencies demand the consideration of this document as a condition for negotiations.'

President Eric Delvalle has disassociated himself from the report, maintaining that he is considering the transfer of only five loss-making companies to the private sector. In public the President has the backing of the parties in the Unade coalition, although many individual members, including PRD businessmen, have commented privately that they would support a programme for the privatisation of the whole state sector. This, say observers, is creating a good deal of tension within the PRD and the Unade coalition.

For his part Rolando Ordóñez of the Consejo Nacional de Trabajadores Organizados (Conato) has warned that the proposed privatisation will have severe adverse effects on the Panamanian labour movement. He has demanded from the government an explanation on the proposed sale of Enderna, 'a company created with the taxes of the people, for the people and not for the government'.

Opposition parties have so far kept clear of the growing controversy, although privatisation figured prominently in their 1984 election campaign. At that time they emphasised that the public sector was costly and inefficient, chiefly because of gross over-manning. ■

HONDURAS

FOREIGN RELATIONS

Sandinista charges to be ignored

DISAGREEMENT OVER REJECTION OF WORLD COURT JURISDICTION

The government does not accept the jurisdiction of the International Court of Justice in The Hague, and will ignore charges filed by Nicaragua that Honduras is breaking international law by harbouring anti-Sandinista *contra* rebels, President José Azcona says.

His government knew that Nicaragua might file a complaint and so took the 'precaution' earlier this year to renounce World Court jurisdiction. 'Just like the government of President Ronald Reagan in a similar situation' in 1984, is how President Azcona describes the move. He dismisses the Sandinista accusations as 'a propaganda trick'.

The government's decision not to abide by a World Court ruling on the matter has generated a heated debate in Honduras.

Echoing the government's position, Carlos Montoya, president of the national congress, argues that the international court can only act with the agreement of all parties concerned. Honduras' withdrawal therefore invalidates any ruling on Nicaragua's charges.

But many disagree. Lawyer Rigoberto Espinal, a university lecturer, maintains that, 'as a signatory of the United Nations charter, Honduras has the implicit obligation to accept the court's ruling.' He says that, should the court rule against Honduras, 'it will be difficult for us to escape enforcement of this sentence.'

To the former Honduran ambassador in Rome, Edgardo Dumas Rodríguez, the government is acting 'irresponsibly'. It could be making a costly mistake, says Rubén Palma, president of the Partido Demócrata Cristiano (PDC), who notes that Honduras may soon have to go before the World Court to find a solution to its border problems with El Salvador. ■

EXCHANGE RATES

The US dollar in Latin America & the Caribbean

Country	Currency	Rates
Argentina	austral	0 9 0 9 (p)
Barbados	dollar	2
Belize	dollar	2
Bolivia	peso	1.9m 2 0m (p)
Brazil	cruzado	13 8 20 3(c)
Chile	peso	192 6 200 (p)
Colombia	peso	197.1 198 (p)
Costa Rica	colon	58 4 58 (p)
Cuba	peso	0 9 5 0 (p)
Dominican Republic	peso	2 8
East Caribbean	dollar	2 8
Ecuador	sucre	110 166 5 (free)
El Salvador	colon	5 (c) 6 (p)
Guatemala	quetzal	1.0 (pref) 2 5 (c) 2 9 (p)
Guyana	dollar	4 3 10 0 (p)
Haiti	gourde	5 0
Honduras	lempira	2 0 2 7 (p)
Jamaica	dollar	5 4
Mexico	peso	627 1 (c) 642 5(free)
Nicaragua	cordoba	70 (c) 975 2.100 (p)
Panama	balboa	1
Paraguay	guarani	240 655 (p)
Peru	inti	14 0 (c) 17 4 (p)
Suriname	guilder	1 8 6 0 (p)
Trinidad & Tobago	dollar	2 4 (pref) 3 6 (c)
Uruguay	peso	147 8
Venezuela	bolivar	7 5 (c) 19 4 (free)

(c) commercial
(f) financial
(p) parallel exchange rate
(pref) preferential

ANNEX E

PANAMA ECONOMIC RECOVERY FUND

ANNEX E

March 5, 1990
10:00 AM

PANAMA ECONOMIC RECOVERY FUND

Informational summary

Purpose: The Panama Economic Recovery Fund is an innovative investment vehicle designed to raise capital for creating, expanding and/or rehabilitating productive business enterprises in Panama and provide liquidity among Panama-based financial institutions, thereby generating vital new economic activity, private-sector growth and employment opportunities in an area critical to U.S. security interests.

Structure: The Panama Economic Recovery Fund will be a privately-owned limited partnership having investment capital of $40 million. Equity capital will total $20 million in the form of limited partnership interests offered to substantial American corporate investors. ($10 million will be paid in cash and $10 million will be raised from discounted Government of Panama paper.) Debt capital of $20 million will be raised through U.S. Government-guaranteed promissory notes issued to qualifying American financial institutions. The Fund is intended to be a 15-year no-load investment vehicle.

Philosophy: The Panama Economic Recovery Fund will seek to achieve long-term appreciation and a current return on its capital primarily through:

(1) purchasing a "cherry picked" portfolio of discounted seasoned mortgages held by Panamanian and U.S. financial institutions, thereby providing banks with the liquidity to finance sound new construction projects, especially those geared to low and lower middle income housing;

(2) lending money through Panamanian banks to middle and upper market Panamanian companies which have proven past commercial profitability, but which are suffering from the unavailability of short and medium term credit (especially after the looting and destruction which occurred last December and

January, these companies need to restock their merchandise and repair/expand their facilities);

(3) investing in targeted Panamanian companies, joint ventures, privatization opportunities and debt-for-development swaps; and

(4) establishing discrete political risk insurance fund to induce both Panamanian and foreign banks to make additional credit available in Panama within the next one to two years; the fund would cover a selective portfolio of new loans against repayment risk attributable to a general collapse of the Panamanian economy.

Loans and investments will be on the basis of sound financial conditions and/or attractive growth potential, as well as their positive developmental benefits for Panama. The Fund intends to purchase interests in established companies that are planning to expand or modernize, requiring significant capitalizations to increase their competitiveness, or intending to implement privatization from a previously state-owned structure. Fund assets will be invested in selective instruments (e.g., "seasoned" mortgages) and a broad spectrum of Panamanian industries, such as construction, retail, insurance, agribusiness, chemicals, aviation, fishing and aquaculture, machinery and equipment, power generation, telecommunications, electronics, banking and finance, international trading, transportation and port facilities. [No more than 15 percent of the Fund's total assets will be invested in any one project or company.]

Principals: The principal participants in the Panama Economic Recovery Fund:

- <u>Overseas Private Investment Corporation</u> (OPIC), will serve as guarantor of the Fund's promissory notes as well as overall supervisor of the Fund's investment decisions. Created by Congress in 1969, OPIC is a U.S. government agency, backed by the full faith and credit of the United States,

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that fosters economic growth in the world's developing nations by insuring U.S. business investment in those nations against political risks and/or providing financing for such investments through the issuance of direct loans and/or loan guaranties.

o Strategic Resources Corporation (SRC), will serve as the Fund's general partner through the creation of one or more special purpose entities to obtain equity financing and help manage the Fund's assets in cooperation with the Local Financial Partner. SRC is a Washington, D C.-based international trade and consulting firm, which specializes in creating trade and investment opportunities for its clients and for its own account. Assisting SRC in this project are Craig L. Fuller, President of Wexler, Reynolds, Fuller, Harrison and Schule, and Robert B. Shanks, Esq. of Sidley & Austin.

o Local Financial Partner (Bank), one of the largest U.S. banks operating in Panama, will serve as the Fund's local financial partner. The Local Financial Partner will identify investment opportunities and manage the day-to-day operations of the Fund. Established in [ ], [Local Partner] Bank is one of the [ ] largest banks in Panama, providing trade and investment financing, import-export trading, marketing and management consulting services.

o U.S. Private Lending Institutions will purchase the Fund's $20 million worth of guaranteed promissory notes, thereby providing one-half of the Fund's capital.

o U.S. and Panamanian Business Corporations will provide $20 million of the Fund's capital, through the purchase of limited partnership units. Such partnership interests will be offered in units of $1 million each.

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Investment Targets:

Panama offers a broad range of potential lending and investment opportunities. We are preparing a listing of attractive potential investments to illustrate the type and diversity of investments that might be considered by the Fund.

Investor Profile:

Limited partnership participation in the Panama Economic Recovery Fund will be suitable only for sophisticated, substantial corporate investors with the financial capability to undertake the risks associated with this form of investment vehicle. Within this context, the Fund will provide an innovative and practical vehicle for American business to pursue investment opportunities in this vitally important country, generating substantial developmental benefits and future growth potential in the process.

Details:

For additional information on the Panama Economic Recovery Fund, contact:

ANNEX F

MR. SPOHRER'S REPORT ON THE POSSIBLE PRIVATIZATION OF API

CHALLENGE AIR CARGO, INC.
P.O. BOX 523979
MIAMI, FLORIDA 33152
(305) 871-8212 • SITA: MIAOWWE
FAX: (305) 871-3078

ANNEX F

CAC

May 22, 1990

Mr. Joe J. Sconce
Assistant Director - Latin America & Caribbean
Center for Privatization
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006

Dear Joe:

Enclosed please find my report on initial inquiry into the possible privatization of Air Panama.

Although we had very little "hard" information available with which to form an opinion, it is fairly obvious that Air Panama probably is not worth saving. One very real fear is that an auction of Air Panama shares, even with pre set conditions and qualifications, could result in the airline carcass falling into the hands of speculators, and this would only further damage the credibility of the Panamanian government in international commercial aviation matters.

Panama is fortunate in that it does have an existing international airline, COPA, that can fill the vacancy left by the demise of Air Panama, and perhaps absorb many of Air Panama's employees.

If you feel that the matter of Air Panama requires additional study, I will be glad to help, time permitting. I enjoyed working with Joe Borgatti on project, and would welcome the opportunity to do so again.

Sincerely,

Bill

B. F. Spohrer
President

cc: Joe Borgatti
Encs.

MAY 21, 1990

REPORT ON INITIAL INQUIRY INTO THE POSSIBLE PRIVATIZATION OF AIR PANAMA

Air Panama Internacional, S.A. ("Air Panama") began international operations in 1969 when the U.S. C.A.B. awarded it authority to operate the route between Panama and the coterminal points of Miami and New York. However, Air Panama never activated the New York portion of the route.

By 1975, when Air Panama's U.S. permit was scheduled for renewal, Iberia Airlines of Spain had taken an ownership position in the airline, causing the C.A.B. to have serious questions as to whether or not Air Panama was "substantially owned and effectively controlled by citizens of Panama."

The C.A.B. determined that 33% of Air Panama was owned and controlled by Iberia who also appointed three of nine board members, including one Vice President. In addition, five employees of Iberia served as full-time key advisors to Air Panama.

The C.A.B. stated that "one may not overlook the ability of Iberia to exercise some measure of dominion over Air Panama through its ability to control its purse strings", but none-the-less granted renewal of Air Panama's U.S. operating authority.

At about the same time, the U.S. C.A.B. awarded to Air Panama additional authority to operate the route between Panama and Los Angeles with an intermediate stop in Mexico City, but without traffic rights between Mexico City and Los Angeles.

By 1983, when Air Panama's C.A.B. authority was once again renewed, the government of Panama had purchased 100% of the capital stock of Air Panama putting to rest any question of ownership or control by non-Panamanians. With its renewal application, Air Panama submitted financial statements as of December 31, 1981 which showed:

Total Assets	$17.4	millions
Total Liabilities	8.8	
Owner's Equity	8.6	
Operating Loss 12 months ending 12/31	(3.0)	

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At that time, Air Panama owned and operated 3 Boeing 727-100 aircraft on routes between Panama and Miami, Mexico, Los Angeles, Caracas, Bogota, Guayaquil and Lima. Panama-Havana was added later as the Noriega government sought ties with enemies of the U.S.

By early 1989 Air Panama had ceased to operate the routes between Panama and Miami and between Panama, Mexico and Los Angeles. The World Aviation Directory for Winter 1988 listed its fleet as two Boeing 727-100 and placed the number of employees at 662. By that time Air Panama's financial problems were well known in the industry and were well emphasized when employees were put on half salary. By late 1989 Air Panama has ceased operations entirely.

At the present time it is difficult to form any valid opinion as to Air Panama's financial condition, its assets, liabilities or even the number of employees on the payroll at the time operations ceased. The President of the Airline resigned and has not been replaced, employees scattered when pay checks stopped, and only a care-taker staff remains.

I have heard Air Panama's assets estimated variously as somewhere between $2 and $5 million. The principal asset seems to be one Boeing 727-100 aircraft whose value could be $2.5 million to $4 million depending upon its mechanical condition. It also has been said that the aircraft is due a main overhaul which could cost $1 million or more. Other possible assets could include spare parts and engines, ramp equipment and vehicles, real estate, reservations office, and communications equipment, deposits and accounts receivable. I estimate that the name/goodwill of the company is a liability and not an asset. Likewise, the routes per se have no intrinsic value.

I have heard Air Panama's liabilities estimated variously as somewhere between $20 million and $30 million. The company owes at least $1.5 million to Social Security, and no one has yet estimated how much may be owed to dismissed employees as severance benefits under Panamanian law. Accounts payable probably include major items such as fuel, aircraft and/or engine rentals, insurance premiums, maintenance, repairs, landing fees, overflight and navigational fees, and taxes. Another potential liability peculiar to the airline industry is "Unearned Transportation Revenue": tickets paid for but never utilized by the passengers.

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The Minister of Finance has stated that a financial audit of Air Panama will be undertaken beginning in June, but as of the date of his statement no audit firm had yet been selected and no estimate had been made of the time necessary to complete the audit. Any audit will be complicated by the fact that assets and obligations must be verified in every country in which Air Panama operated. For example, the Panamanian Ambassador to the United States has contracted a Miami-based attorney to handle what he describes as a "flood of claims" against Air Panama in the U.S.

Any opinion as to Air Panama's financial condition must necessarily be speculative at this time, and can only be verified upon the completion of the audit. See Exhibit A for an example of a typical balance sheet of an airline.

Whether or not Air Panama can be salvaged, and whether or not it is worth saving, there is no doubt that Panama has the geographic location and the facilities that can be very advantageous to well-managed, international airline.

Centrally located between the northern and southern land masses of the western hemispheres, Panama lies astride the major air routes linking North and Central America with South America. Its geographic location makes it an ideal technical stop for short to medium range aircraft operating these routes. Since airlines that utilize Panama for technical stops find it advantageous also to pick up and drop off passengers at Panama, Tocumen International Airport, began to develop in the 1940's as an international airlines hub.

The airport features a recently built, modern passenger terminal, and two parallel runways, one 8800 feet long, 200 feet wide of concrete/asphalt construction and the other 10,006 feet long, 148 feet wide of concrete construction. Both runways are free of obstacles and maximum elevation is 135 feet above sea level. The airpoit's altitude and runways make it possible for the largest wide-body aircraft to use the airport.

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Since Panama has a limited population a large international airline could not support itself on passengers originating in and destined for Panama alone. Rather, such an airline would have to depend in large part on passenger traffic passing through Panama to beyond destinations. For example, a passenger originating in Miami whose final destination is Lima may make a technical stop or change aircraft in Panama. A route New York-Miami-Panama-Lima-Santiago combined with a route Los Angeles-Mexico-Panama-Rio-Buenos Aires with coordinated arrivals and passenger transfers in Panama would permit all points north of Panama to sell all destinations south of Panama and vice versa. Panama could thus become the hub of an "X" route pattern serving much of north and south America. See Exhibit B.

However, having pointed the <u>potential</u> value of air routes that may be granted by the Panama government, it should be recognized that air routes are only as valuable as the airline's ability to operate them profitably. A good case in point are the "valuable" routes operated by Air Panama which became, not an asset, but the road to bankruptcy.

Any disposition of Air Panama must take into consideration Panama's other international airline, Compania Panamena de Aviacion, S.A. ("COPA"). COPA is a long-established, conservatively managed, well run airline. It operates two Boeing 737-100 aircraft on routes between Panama and Cartagena, Guatemala, Kingston, Managua, Medellin, Miami, Port-au-Prince, San Jose, San Juan, San Salvador, and Santo Domingo. COPA only began service to Miami early this year and currently operates five weekly flights.

COPA's financial statement as of December 31, 1986 showed stockholders' Equity of $2,988,308 and net earnings for 1986 of $449,862. Indications are that the company continues to make an annual profit. All of COPA officers, directors, key management personnel and stockholders are Panamanian citizens or Panamanian corporations. See Exhibit C.

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While obviously it is premature to make any recommendations at this stage, my inclination would be to suggest that any solution to the Air Panama situation would include steps to:

1) Complete the audit of Air Panama.
2) Obtain professional appraisals of the value of assets.
3) Follow normal Panama bankruptcy procedures of appointing a trustee, selling off the assets and paying off obligations to the extent possible.
4) Negotiate with COPA to absorb as many Air Panama personnel as possible.

The procedures outlined above would, in effect, turn over Panama's international airline operations to COPA. COPA is professionally operated, has had no fatalities, offers excellent service, and best of all, it actually makes money! In addition, COPA is owned and controlled 100% by citizens of Panama. Any revival of Air Panama would doubtless require foreign control of a Panamanian airline which might be overlooked for some time by the Panamanian government and the governments of other countries to which the airline would operate. But eventually, the foreign control issue would create serious problems for the airline. It might also be argued that Panama's size really justifies only one international airline.

B.F. Spohrer

BALANCE SHEET

Air Carrier

ASSETS	Account Number	AS AT	
CURRENT ASSETS:			
Cash			
Short-term investments	[illegible]		
Notes receivable	1110		
Accounts receivable	[illegible]		
Net investment in direct financing and sales-type leases - current	[illegible]		
Less: Allowance for uncollectible accounts	[illegible]		
Notes and accounts receivable—net	[illegible]		
Spare parts and supplies	[illegible]		
Less: Allowance for obsolescence	[illegible]		
Spare parts and supplies—net	[illegible]		
Prepaid items	[illegible]		
Other current assets	1412		
	1420		
Total current assets	[illegible]		
INVESTMENTS AND SPECIAL FUNDS:			
Investments in investor controlled companies	[illegible]		
Investments in other associated companies	[illegible]		
Advances to associated companies	1520		
Other investments and receivables	[illegible]		
Special funds	[illegible]		
Investment in leveraged leases	1570		
Net investment in direct financing and sales-type leases - noncurrent	[illegible]		
Total investments and special funds	[illegible]		
OPERATING PROPERTY AND EQUIPMENT:			
Flight equipment	[illegible]		
Ground property and equipment	1640		
Less: Allowance for depreciation	1668		
Property and equipment—net	[illegible]		
Land	[illegible]		
Equipment purchase deposits and advance payments	[illegible]		
Construction work in progress	[illegible]		
Leased property under capital leases	[illegible]		
Leased property under capital leases - accumulated amortization -	[illegible]		
Total operating property and equipment	[illegible]		
NON-OPERATING PROPERTY AND EQUIPMENT:	1791		
Less: Allowance for depreciation	[illegible]		
Leased property under capital leases	[illegible]		
Leased property under capital leases - accumulated amortization	[illegible]		
Property on operating-type lease to others and property held for lease	[illegible]		
Property on operating-type lease to others and property held for lease - accumulated depreciation	[illegible]		
Nonoperating property and equipment	[illegible]		
OTHER ASSETS:			
Long-term prepayments	1820		
Unamortized developmental and preoperating costs	1830		
Unamortized debt expense	1840		
Property acquisition adjustment	1870		
Intangible assets	[illegible]		
Other assets	1890		
Total other assets	[illegible]		
TOTAL ASSETS	[illegible]		

* Denotes inverse amount

Schedule B-1

LIABILITIES AND STOCKHOLDERS' EQUITY	Account Number	AS AT	
CURRENT LIABILITIES:			
Current maturities of long-term debt	[illegible]		
Notes Payable—Banks	[illegible]		
Notes Payable—Others	[illegible]		
Trade accounts payable	[illegible]		
Accounts payable—Others	[illegible]		
Current obligations under capital leases	[illegible]		
Accrued salaries, wages	2110		
Accrued vacation liability	2120		
Accrued interest	[illegible]		
Accrued taxes	2130		
Dividends declared	2140		
Air traffic liability	2160		
Other current liabilities	2190		
Total current liabilities	2199		
NONCURRENT LIABILITIES:			
Long-term debt	2210		
Advances from associated companies	2240		
Pension liability	2250		
Stock purchase plan liability	[illegible]		
Noncurrent obligations under capital leases	[illegible]		
Other noncurrent liabilities	[illegible]		
Total noncurrent liabilities	[illegible]		
DEFERRED CREDITS:			
Deferred income taxes	2340.1		
Deferred taxes arising from leveraged leases	2340.2		
Deferred investment tax credits	2345		
Other deferred credits	[illegible]		
Total deferred credits	2399		
COMMITMENTS AND CONTINGENT LIABILITIES: (See Footnote)			
STOCKHOLDERS' EQUITY:			
Capital stock:			
Preferred shares issued ____	[illegible]		
Common shares issued ____	[illegible]		
Subscribed and unissued	[illegible]		
Total capital stock	[illegible]		
Additional capital invested	[illegible]		
Total paid-in capital	[illegible]		
Retained earnings	[illegible]		
Net unrealized loss on noncurrent marketable equity securities	[illegible]		
Total stockholders' equity	[illegible]		
Less: Treasury stock shares ____	[illegible]		
Net stockholders' equity	[illegible]		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	[illegible]		

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EXHIBIT A

EXHIBIT B

PANAMA TO:		STATUTE MILES	APPROXIMATE FLIGHT TIME
1	SAN JOSE	334	1. HOURS
2	BOGOTA	469	1.5
3	QUITO	639	1.5
4	SAN SALVADOR	731	2
5	GUAYAQUIL	777	2
6	GUATEMALA	847	2
7	CARACAS	850	2
8	SANTO DOMINGO	917	2.5
9	SAN JUAN	1105	3
10	MIAMI	1156	3
11	LIMA	1465	3.5
12	MEXICO CITY	1498	3.5
13	NEW ORLEANS	1605	4
14	WASHINGTON	2061	4.5
15	NEW YORK CITY	2206	5
16	SANTIAGO	2986	6.5
17	LOS ANGELES	3007	6.5
18	SAO PAULO	3159	7
19	RIO DE JANEIRO	3289	7
20	BUENOS AIRES	3323	7

EXHIBIT C

COMPANIA PANAMENA DE AVIACION: S.A.

Names, addresses, and citizenship of officers, directors and key management personnel.

ALBERTO MOTTA, President, #9085 6th St., Cristobal, Colon, Rep. of Panama.

RICARDO M. ARIAS, Vice-President, #47, 57th Street, Golf Heights, Rep. of Panama.

ROBERTO HEURTEMATTE, Treasurer, #34, 50th Street, Bella Vista, Rep. of Panama.

RICARDO BRIN, Vice-Treasurer, #27, 4th Avenue, Bella Vista, Rep. of Panama.

ENRIQUE ESCALA, Secretary/Manager, #14, 2nd. St. La Loma, Rep. of Panama.

STANLEY MOTTA, Director, #65, 6th St., Golf Heights, Rep. of Panama.

JAIME ARIAS, Director, #25, 7th St., Golf Heights, Rep. of Panama.

OSVALDO HEILBRON, Director, Via Italia, Punta Paitilia, Rep. of Panama.

RICARDO A. ARIAS, Director, #10, I St. Parque Lefevre, Rep. of Panama.

MANUEL ARIAS, Director, #64, L St., La Loma, Rep. of Panama.

JORGE GARCIA A., Director, #34, 4th St., E. Bella Vista, Rep. of Panama.

ALBERTO C. MOTTA JR., Director, #10086, 9th St., Cristobal, Colon, Rep. of Panama.

FELIPE MOTTA JR., Director, #L-F-9, Nuevo Reparto El Carmen, Rep. of Panama.

ALVARO ARIAS A., Director, Elvira Mendez St., Rep. of Panama.

EXHIBIT C

ANEL WONG, Operations Manager, F St. Villa Guadalupe, Rep. of Panama.

MOISES VELIZ, Marketing Manager, #13, Urbanizacion, La Colina, Rep. of Panama.

PEDRO SIMPSON, Maintenance Manager, #3, D St. Nueva California, Rep. of Panama.

FERMIN VILLALOBOS, Administrative Mgr., #C-45, Urbanizacion La Pulida, Rep. of Panama.

SEBASTIAN CHAVEZ, Finance Manager, #29, West. St., El Dorado, Rep. of Panama.

JORGE LIZARRAGA, Airport Manager, #18, 12th St., Los Caobos, Las Cumbres, Rep. of Panama.

DALYS BENNINGHOFF, Exec. Assistant, #6244, Boqueron St. Los Rios, Rep. of Panama.

All persons listed above are citizens of the Republic of Panama.