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Panama Post-1989 A.I.D. Program Evaluation

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Glossary

A.I.D.	U.S. Agency for International Development
APEDE	Asociación Panameña de Ejecutivos de Empresa (Panamanian Association of Business Executives)
BNP	Banco Nacional de Panamá (National Bank of Panama)
BOP	balance of payments
CD	certificate of deposit
CNB	Comisión Nacional Bancaria
CDIE	Center for Development Information and Evaluation
DESAA	Dire Emergency Supplemental Assistance Act
ERC	Economic Recovery Credit
ESF	Economic Support Funds
FREN	Fondo de Recuperación Ecónomica Nacional (Private Sector Reactivation Program)
FY	fiscal year
GAO	U.S. General Accounting Office
GDP	gross domestic product
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFI	International Financial Institution
IG	A.I.D. Inspector General
IMF	International Monetary Fund
INCAE	Instituto Centroamericano de Administración de Empresas
LAC	Latin America and the Caribbean
LIBOR	London Interbank Offer Rate
MOF	Ministry of Finance
PAAD	Program Assistance Approval Document
PSIP	Public Sector Investment Program
QR	quantitative restriction
SAL	structural adjustment loan
USAID	A.I.D. Mission
USG	U.S. Government

Preface

This evaluation was prepared for A.I.D./POL/CDIE under Contract No. 525-9999-C-00-2278-00 from September through December 1992, by a team consisting of Dr. Jacques Polak, Dr. Anne Krueger, and Dr. John Newton. After carrying out initial interviews and background review in September 1992, the team traveled to Panama in early October and interviewed the principal actors and beneficiaries of the USAID/Panama program, including private sector investors and bankers, Government of Panama officials, and USAID and U.S. Embassy officers. A draft report based on subsequent analysis was presented to A.I.D. for review in early November. This final version of the evaluation responds to all comments on drafts by A.I.D./POL/CDIE.

The evaluation team would like to thank CDIE Director, Dr. John Eriksson, and his staff for their support during this evaluation. Dr. Juan Buttari, the Project Officer, was particularly helpful. Thanks are also due to the many Government of Panama, private sector, and USAID officials who took time to be interviewed by the team during the project. These officals, too numerous to mention here, are listed in Appendix A.

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1. Introduction and Executive Summary

This report presents the first independent formal evaluation of the support program for the economy of Panama, administered by the U.S. Agency for International Development (A.I.D.) after Operation Just Cause in December 1989. That program, designed to promote the economic recovery of the country and to address certain serious social needs, has been the subject of audits by A.I.D.'s Inspector General (IG), a draft report by the General Accounting Office (GAO), and informal press reviews. This evaluation will complement those reviews with an economic analysis of the impacts of the program and of its initial objectives and goals, as well as a discussion of the applicability of the program approach to future, perhaps similar situations.

Chapters 2 through 4 address the three major components of the post-1989 Panama A.I.D. program—private sector reactivation, public sector investment, and the settlement of arrears with the international financial institutions (IFI). In Chapter 5, the evaluation team presents its analysis of A.I.D.'s planning and monitoring process before and during the Panama program, and Chapter 6 presents a review of lessons learned from the experience. The remainder of this introductory chapter consists of a more detailed treatment of the objectives and background of the Panama program and a summary of the results of the evaluation.

PROGRAM BACKGROUND

The economy of Panama had deteriorated seriously in the 2 years before the U.S. military action code-named Operation Just Cause, due in part to economic mismanagement by the Panamanian military government and public corruption and in part to U.S. and international sanctions and payments embargoes. Although the economy was characterized, then as now, by a relatively high per capita income for the region and by the use of the U.S. dollar as both the local currency and the currency (and basis) of the country's international financial center, these advantages were largely nullified by sanctions-related events beginning in early 1989. With suspension of U.S. tax payments and canal fees to the Government of Panama and freezing of National Bank of Panama (BNP) reserves and check clearing by the Federal Reserve, Panama's international banking center activities collapsed. By the end of 1988, offshore deposits had fallen from $22 billion to $4.5 billion, and Panamanian residents also had begun to withdraw deposits, leading to declaration of a 9-week bank holiday. The results were universally negative for the economy of Panama during 1988, with GDP dropping by 16 percent; domestic deposits

and credit dropping by 11 and 17 percent, respectively; and imports and exports dropping by 35.3 and 13.5 percent, respectively.

Although Panamanian economic activity did not decline much further in 1989, the recession continued on all fronts, with continued balance of payments (BOP) and fiscal deficits. Perhaps more important, the process of public policy and structural reform, formerly supported by U.S. and multilateral aid and lending programs, was suspended and reversed during this period, engendering difficulties both immediately and in the long term with reviving growth, productivity, and public revenues. Concomitantly, the stock of analytical reports and background material normally prepared by multilateral donors, USAID Missions and A.I.D./Washington, and used for development planning, began to lag events in Panama by a substantial margin.

Against this backdrop, the A.I.D. program begun after the surrender of General Manuel Noriega in December 1989 faced much more serious and immediate objectives and scheduling than the usual USAID Mission effort. Approximately one-half of the $1 billion assistance package announced by President Bush on January 25, 1990, was to be disbursed by A.I.D., largely as Economic Support Funds (ESF).[1] Although the recovery-related objectives of the program were of immediate importance to the economy of Panama, the need for a U.S. political consensus on funding meant that the enabling legislation—the Dire Emergency Supplemental Assistance Act (DESAA)—was not finally passed until May 25, 1990. All of this funding was obligated by A.I.D. within the next 16 months (the end of FY 1990), and 82 percent of the funds were actually disbursed by February 1992. To place this funding in a worldwide context, the Panama aid program is the largest program administered by A.I.D. in per capita terms, surpassed only by programs in Israel and Egypt in absolute terms. Moreover, in the case of Israel, administration is often not required at all, and no short-term emergency programming is involved. The Panama program, in terms of both planning and implementation, presented unique problems.

The program's objectives, as stated in the Mission Project Papers and Program Assistance Approval Documents (PAAD) listed in Appendix C were (1) to alleviate the condition of low-income groups directly and immediately affected by Operation Just Cause, (2) to support economic recovery in general and lay the groundwork for sustained growth, and (3) to support the democratic process. Although the program elements are closely integrated, certain components relate more directly to specific program objectives and to specific conditions of the Panamanian economy. The immediate objective of relieving the needs of affected low-income groups was addressed early on (February 1990) by the program's *emergency assistance component* of $41.1 million, directed at low-income housing guarantees and employment programs. The full DESAA, passed May 25, 1992, provided an additional $420.0 million in grant funds, of which $351.8 million was directed at macroeconomic recovery, re-establishing a stable credit standing with the IFIs,

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[1]The remainder of the package ($577.0 million) included grant food aid and access to trade and investment guarantee funds and trade preference systems. These elements of aid are not addressed in this evaluation.

and backing renewed investment by both the private and public sectors. This *economic recovery component* of the program is the major focus of this evaluation. An additional $54.2 million of the original DESAA $420.0 million was allocated to the *development assistance component* for supporting long-term human and institutional needs.

The urgency of the needs addressed by the A.I.D. Panama program and the understandable disarray of the newly established Panamanian government in early 1990 required innovative planning and implementation on the part of USAID/Panama. The decisions to indicate "re-reform" of certain economic policies as the conditionality for public sector ESF transfers, to provide private sector ESF transfers without policy conditionality, and to channel a major portion of program support through the private banking sector are outstanding elements of such innovation, addressed in later sections of this evaluation.

EVALUATION OBJECTIVES

Against the background described in the previous section, this evaluation was commissioned to address several issues specific to Panama, in addition to the standard objectives of an ESF evaluation. As for most such evaluations, the analysis of the Panama post-1989 A.I.D. program is directed at the planning, implementation, and monitoring of separate program components, as well as Government of Panama compliance with conditionality and the economic impacts resulting from the program. Additional objectives for this evaluation include a more in-depth analysis of several issues that have arisen from the Inspector General, General Accounting Office, and press reports mentioned earlier, as well as an assessment of the basic design, appropriateness, balance, and timing of the program and the analysis of specific economic impacts. (See Appendix B for a more detailed list of target issues.) The specific goals and means of implementation of this program—including short-term alleviation of suffering by low-income groups affected by Operation Just Cause and the innovative use of the private banking sector as the vehicle for distributing a major portion of the funds—indicate the need for a more complete assessment of impacts on the specific subsectors involved.

SUMMARY OF RESULTS

When Panama's most immediate needs in the early months of 1990 had been met by the A.I.D. $41 million emergency program, a $420 million economic assistance program was gradually phased in, starting in the fall of 1990. It consisted of three components: a private sector reactivation program, a public sector investment program, and a program to assist Panama in settling its arrears with the international financial institutions. These three subprograms are discussed in this executive summary. The full report concludes with two short sections, which are not resummarized here, bringing together the team's findings on aid program planning (Chapter 5) and lessons drawn from the Panama program experience (Chapter 6).

Private Sector Reactivation Program

A Safety Net for the Banks

The capital flight that had taken place in 1987 and 1988 posed serious liquidity problems for the Panamanian banking system, which had in part been countered by the freezing of bank deposits. To facilitate the greatly needed unfreezing of deposits, A.I.D. had designed a "safety net" for the banks and set aside for this purpose $108 million. However, the reflow of Panamanian money into the banks, both from returning flight capital and from mattresses, did much to relieve the banks' liquidity position in the first half of 1990. The banks, concerned about the impending unfreezing of deposits, hastened this process by offering high interest rates, well above London interbank rates (LIBOR), for deposits. The improved liquidity of the banks—reflecting in part the confident anticipation that the financial system *would* be safeguarded—made future claims on a safety net unlikely, although it did not provide a case for dropping the concept. The safety net thus remained, though as a second leg, in the formal proposal for a Private Sector Reactivation Program.

The widespread discussion of a safety net, as distinct from its actual creation in July 1990, was credited by many in the financial field as an important factor in the smooth liberalization of deposits. More broadly, the January 25 announcement by the President of the United States of a $1 billion support package for Panama and the emergency package of $41 million made available in February, followed by action by the U.S. Congress in May authorizing an additional $420 million, increasingly served to convince the people of Panama that the financial might of the United States was backing Panama's economic and financial structure. This feeling probably constituted a more important prop to the system than the specifics of the safety net.

Reactivation of the Economy

As the probability of the need for a safety net receded, new ideas for the use of the money originally set aside for this purpose began to be developed, namely to reactivate, or "jump start" the economy by funneling A.I.D. resources through the banking system to the private sector. Under the program as finally designed (designated FREN, for Fondo de Recuperación Económica Nacional), A.I.D. made available $108 million to the National Bank of Panama, which used the money to buy certificates of deposit (CDs) from participating banks for the equivalent of 50 percent of loans that met the terms of the facility. The main feature required of such loans was that they be medium-term, between 1 and 5 years.

The banks chose to whom to lend and on what terms. They carried the full risk of the loans they made under this program. It followed from this approach to the program that A.I.D. money could not be "tracked" to particular expenses in Panama or abroad except in the most general terms, such as the industrial breakdown of loans. The evaluation team fully endorses A.I.D.'s choices in this matter. Moreover, if the banks had been pressured to actively pursue other aims in their use of the A.I.D. money, such as the promotion of

small businesses or credit to agriculture, the primary aim of giving a strong push to economic recovery would have suffered.

In the period from mid-1990 to March 1992, total loans of all private banks in Panama increased by nearly $1 billion, compared with the increase by $284 million of the medium-term loans of participating banks. Clearly, the banking system was in an expansionary phase that preceded the start of FREN in late 1990 (loans had increased by $210 million in the second half of 1990) and continued after the end of FREN. The expansion was particularly strong in the Panamanian-owned banks, which accounted for more than 75 percent of the increases of both loans and private sector deposits in the banking system between June 1990 and March 1992.

Although the FREN program was open to all private banks, Panamanian banks accounted for more than 93 percent of its use, even though they had only about 40 percent of the loans and half of the private sector deposits of all private banks (end 1990 data). This was because the foreign banks had ready access to international capital markets, at interest rates close to LIBOR (below the rates charged on the CDs under the program), while the Panamanian banks generally had to pay substantially higher rates to attract private deposits. Given the difficulty the Panamanian banks had in accessing the world money markets for resources, it is reasonable to assume that the $108 million provided under FREN added that much to investment in Panama, or some 14 percent of total investment in 1991.

Taking into account, also, the income effects of subsequent rounds of spending, a rough estimate of the total impact of the program on Panama's GDP would produce a figure of, for example, $125 million, or 2½ percent of the total 1991 GDP ($5,075 million). The effect of FREN on employment would appear to be on the order of 13,000 person-years. While FREN and other stimuli (including a $90 million swing in direct investment and a $20 million increase in exports) had a positive effect on the employment situation, the overall unemployment rate declined only slowly from the high level reached during the crisis years (16.3 percent in 1988 and 1989, as against 11.8 percent in 1987). Unemployment for 1991 still stood at 15.7 percent and is estimated at 15.0 percent for 1992.

On the occasion of the midcourse review of the program there was certainly no reason to discontinue it when it became evident during 1991 that the economy was on a solid expansionary course. Moreover, switching to some alternative expenditure program would have involved delays that would have risked interrupting the tempo of the ongoing recovery.

Use of the Reflows from FREN CDs

Was the portion of the A.I.D. program devoted to FREN well spent? Perhaps the most accurate answer would be that it was *not* spent. Rather, that component of the aid grant to Panama has been preserved for later use and in the meantime has been invested in bank CDs. For accounting purposes the purchase of CDs may be registered as disbursement, but unlike the purchase of brick, mortar, and machines the purchase of CDs represents in no

way a final disposition of the money. There is every reason to expect that the money will continue to return, with interest, and that only then will the Government of Panama finally disburse that portion of American aid.

The reflow of aid money, once used, is not a new experience, but the form it takes in Panama is unusual. In countries that have their own currencies, the reflow takes the form of local currency balances, or counterpart funds. These arise, for example, as goods financed from aid dollars are sold in the country. In most cases, A.I.D. has had little interest in supervising the use of these balances, since the receiving government could readily circumvent any restrictions applicable to their use by printing additional amounts of its own currency. But because Panama uses the U.S. dollar as its currency, the aid reflows are the equivalent of a new $100 million aid program over the next 4 years. There is a provisional understanding between A.I.D. and the Government of Panama that this money will be used to repay nonmilitary debt to the United States. But because these debt payments will in any event have to be made, the reflows will in fact become available as general budgetary support.

In view of the fact that the conditionality attached to the public investment program will come to an end with the release of the third tranche of this program, there would have been good reason to prolong the policy impact of A.I.D. money by making the use of CD reflows conditional on the country continuing to perform in line with the undertakings vis-à-vis the IFIs.

As far as the conditionality of the FREN program is concerned, the evaluation team shares the position taken by A.I.D. that U.S. interests in economic reform in Panama were sufficiently safeguarded by the conditionality that was attached to the use of the portion of aid devoted to public investment (see the discussion in Chapter 3) and that it would have been counterproductive to delay the availability of FREN until the conditions applicable to the release of the remainder of the $420 million aid package had been fulfilled.

Applicability of the FREN Program to Other Countries

The unique aspects of the Panama aid program do not make it highly probable that the need for a program like FREN would present itself in another country. But if A.I.D. did become involved, some time in the future, in another situation that (1) required a stimulatory policy and where (2) A.I.D. had the resources to backstop such a policy, it would be well advised to insist, as a condition for its assistance, that the scheme for credit expansion that it was backing be soundly conceived. In the case of Panama, the plan that resulted from the long deliberations with the Government of Panama met that requirement.

Nevertheless, as a general experience, governments that have tried to channel additional credit to the private economy, whether through the central bank or otherwise, have had a very uneven record. An extensive analysis—leading to a mostly negative conclusion—of the widespread practice of "directed credit" is provided in the *1989 World Development Report* of the World Bank (chapters 4 and 9). Fortunately, the Panama program avoided most of the risks of directed credit. Any future program to stimulate bank lending by

adding to the banks' liquidity should be wary of the risks of distorting the flow of capital by excessive regulation of the purposes or the terms of the banks' lending.

Public Sector Investment Program

One of the worst casualties of the squeeze on government finance in the crisis years 1987-1988 in Panama was public investment, and it took a long time to reverse the trend. Even under the new government, the budget resources available for public investment remained constrained; moreover, it took a major effort to bring official spending under proper control. As a consequence, few projects became ready for financing in 1990, and the slowdown in the project portfolio stretched well into 1991.

Need for a Public Sector Investment Program (PSIP)

The resulting backlog in public sector investment made a Public Sector Investment Program a natural element in A.I.D.'s recovery program for Panama. The funds were used for priority investments in agriculture, health, education, justice, other social sectors, natural resources, and infrastructure. Of the total available, $20 million was channeled through the Social Emergency Fund to fund a large number of small, labor-intensive, local social development programs. But healthy growth of the economy of Panama also required the removal of many structural impediments to growth, such as

- Excessive employment in the public sector,
- Inefficient operation of public sector enterprises,
- Inadequate public investment and maintenance,
- A tax system that discourages investment and the use of labor,
- Very high trade protection aimed at import substitution and self-sufficiency in food,
- Extensive price controls in support of protective trade and agricultural policies,
- An overregulated labor market,
- An underfunded and overly generous social security system, and
- Technical insolvency of four public banks and a weak regulatory and supervisory framework of the commercial banks.

Structural change was, accordingly, the central focus of the World Bank and the Inter-American Development Bank (IDB) in their relations with Panama. A.I.D. pursued the same objective by attaching its conditionality for the PSIP to that of these two international lenders.

Conditionality for the PSIP

Specifically, A.I.D. made the release of the second and third tranches of the PSIP program conditional on the progress made by Panama in its negotiations with these IFIs. The release of the first tranche (in October 1990) was made conditional not on *action* taken by

Panama in the structural field, but on submission of specific plans for action in the subsequent period, covering public finance, privatization, trade liberalization, and improvement of Panama's international competitiveness. Given Panama's limited personnel resources, this initial focus on broad careful planning, rather than quick action on a few measures, was appropriate, in the view of the evaluation team.

By linking the release of the next two PSIP tranches to the appraisal of Panama's structural effort by the IFIs, releasing its last tranche when the IFIs released their first one, A.I.D. could not have the same assurance as the IFIs that its money would buy the hoped for adjustment. In spite of this, the evaluation team believes that A.I.D. has applied a proper degree of conditionality. For A.I.D. to have designed its own conditionality could only have caused confusion in Panama about what policy elements "Washington" considered essential. At the same time, A.I.D. acted wisely in designing its disbursements in a somewhat different time frame from that of the IFIs, by giving somewhat greater weight to political considerations. Also, because A.I.D.'s high profile association with Panama was intended to be short-lived, it could not stretch its disbursements over as long a period as the IFIs.

A.I.D.'s association with structural adjustment in Panama was not limited to the conditionality of its grants. With a larger continuous presence in Panama than any of the IFIs, A.I.D. acted in fact as a conditionality expediter for the new government in Panama, which was critically shorthanded.

Settling Arrears with the IFIs

In order to be able to receive new credits from the IFIs, it was essential for Panama to settle the arrears that it had incurred with these organizations during the crisis years. It took much longer than had been expected to complete the necessary negotiations; agreement was not reached until February 1992. The resources required to achieve settlement—which in the end amounted to $658 million—consisted of $130 million from the U.S. aid program, a $3 million grant from France, a cash payment by Panama of $248 million, loans from Japan and Taiwan, and the initial disbursements made by the IFIs from their new loans.

Because this part of the U.S. program was not disbursed until the required arrangements had been agreed on with the IFIs, its conditionality was automatically linked to Panama satisfying the conditions of these institutions. That linkage was, in the view of the evaluation team, entirely appropriate.

2. The Private Sector Reactivation Program

As submitted in PAAD 525-0304, dated July 12, 1990, this program consisted of two components. The first component was designed to provide liquidity to the banks in order to encourage additional investment in the private sector. The second component was intended to assist any bank needing additional liquidity as a result of the planned unfreezing of time deposits. The second purpose was referred to as the "safety net" provision; the first was frequently referred to as a means of "jump starting" the economy. Over time, in the period before the program was launched, the emphasis had gradually shifted from the "safety net" to the "jump start" component. The safety net is discussed in the first section of this chapter and reactivation of the economy is discussed in the second section.

SAFETY NET

The capital flight that had taken place in 1987 and 1988 posed serious liquidity problems for the Panamanian banking system. By the end of 1989, a freeze on deposits introduced in 1988 had been only partially lifted. With a low level of liquidity, the banks had reduced their loan portfolio as rapidly as possible, but the quality of the loans had deteriorated as a result of the decline in business activity in general and the looting of the inventories of many firms in particular.

A specific Panamanian complication in this situation was that Panama, unlike almost all other countries, has no currency system of its own, and hence no central bank that could act as lender of last resort. Reliance on the U.S. dollar as its monetary unit has, on the whole, served Panama well: while other countries used their central banks to print money to finance government deficits, and in the process suffered all the distortions of inflation, the absence of a central bank forced Panama to stick to a noninflationary course.

Financial stability and the absence of exchange restrictions were also beneficial to the country in that they provided a favorable climate for the development of an offshore financial center, which became an important source of employment in Panama in the last two decades. There was never any dissent from the view that the fundamental strength that the country received from its reliance on the U.S. dollar should be maintained. Instead, the earliest thinking on an assistance program for Panama envisaged dealing with the question of illiquidity of the banking system (and perhaps in the case of a few banks, insolvency) through the U.S. aid program.

These considerations induced A.I.D. to design a safety net and to set aside a portion of the total funds available for Panama for this purpose. The figure of $108 million that was in the end allocated for this purpose represented an inevitably very rough estimate of the amount that might be necessary to support the freeing of deposits to avoid (and if

necessary to meet) a run on some of the weaker banks and to encourage the banks to resume their lending activities on an adequate scale.

However, the developments in the early months of 1990, while the planning of the safety net proceeded and U.S. support for the Panamanian financial system became evident, made the likelihood of a run on the banks increasingly remote. The reflow of Panamanian money into the banks, both from returning flight capital and from mattresses, did much to relieve the banks' liquidity position in the first half of 1990. Concerned by the impending unfreezing of deposits, the banks hastened the reflow process by offering high interest rates, well above LIBOR, for deposits. The improved liquidity did not immediately lead to larger bank lending. The demand for credit was also weak, as borrowers remained concerned about the outlook for a new economic policy on the part of the coalition government. In the first quarter of 1990, credit continued to contract somewhat (by about $50 million); in the second quarter it increased by about $70 million (Table 2-1).

Table 2-1. Panamanian and Foreign Banks, Loans and Deposits (US$ million)

	Loans			Private Sector Deposits		
	Panamanian Banks	Foreign Banks	Total	Panamanian Banks	Foreign Banks	Total
End of December 1989	805	1,298	2,103	699	753	1,452
End of March 1990	810	1,247	2,057	739	819	1,558
End of June 1990	839	1,282	2,121	800	880	1,680
End of September 1990	890	1,361	2,251	901	924	1,825
End of December 1990	954	1,366	2,320	997	987	1,984
End of March 1991	982	1,439	2,421	1,055	1,018	2,073
End of June 1991	1,049	1,449	2,498	1,144	1,049	2,193
End of September 1991	1,227	1,450	2,677	1,265	1,093	2,358
End of December 1991	1,386	1,471	2,857	1,441	1,199	2,640
End of March 1992	1,551	1,516	3,067	1,573	1,115	2,688

Source: Bank of Panama.

The fact that deposits increased—by $230 million in the first half of 1990—before the freeze on time deposits was lifted, was strong evidence that confidence in the banking system had returned and that the unfreezing of deposits in early July would not entail any serious risk of a run on the banks. This judgment was confirmed by a careful study that the Comision Nacional Bancaria (CNB) made in April 1990. It concluded that by that time the banks did have enough liquidity to meet any demands for withdrawals that might occur as time deposits were unfrozen (Reported in PAAD 525-0304, p. 27).

These observations—reflecting in part the confident anticipation that the financial system would be safeguarded—made future claims on a safety net unlikely; they did not make a case for dropping the concept. The safety net thus remained as a second leg in the formal proposal for a Private Sector Reactivation Program dated July 12, 1990, two days after the government of Panama had unfrozen all deposits (having rejected such intermediate solutions as unfreezing an initial 25 percent) without waiting for the formal establishment of a safety net. This courageous action by the Government of Panama turned out to be a full success, and although the safety net came into effect two weeks later, there were never any calls on it. The nonuse of the safety net may also have been helped by the stiff terms laid down for its use: a penalty interest rate of 5 percent above LIBOR or 13 percent (whichever was the higher) and the requirement of a deposit of assets equal to twice the emergency credit sought.

It should be added, however, that the widespread discussion of a safety net, as distinct from its actual creation in July 1990, was credited by many in the financial field as an important factor in the smooth liberalization of deposits. More broadly, the January 25 announcement by the President of the United States of a $1 billion support package for Panama, the emergency package of $41 million made available in February, followed by the action by the U.S. Congress in May authorizing an additional $420 million, increasingly served to convince the people of Panama that the financial might of the United States was backing up Panama's economic and financial structure. This feeling probably constituted a more important prop to the system than the specifics of the safety net.

REACTIVATION OF THE ECONOMY

As the probability of the need for a safety net receded, new ideas for the use of the money originally set aside for this purpose began to be developed, both by the Mission and by Panamanian authorities, namely to reactivate, or "jump start" the economy by extending credit to the private sector through loans to the banks. (The Mission's program for Panama as it stood in March 1990 had envisaged injecting liquidity into the banking system indirectly by rapid expenditure of funds by the Social Emergency Fund, and keeping the safety net money in its entirety available for bank failures.) Although their immediate liquidity problems had been lessened, the banks were still not liquid enough by the high standards that they traditionally observed to resume lending on a scale required for a strong expansion of the economy. Also, the traumatic experience they had undergone in 1987 and 1988 made the banks less willing to resume active lending in the form of medium- and long-term credits. Before 1987, banks had been willing to lend on such terms even though their deposits were mostly short-term. The crisis years had made them painfully aware of the resulting assets and liabilities mismatch, as loans could not be reduced as rapidly as deposits were being withdrawn. Once burnt, the banks had by 1990 become more cautious and hesitated to greatly enlarge their medium-term portfolio unless they could obtain a strengthening of their medium-term deposits.

Initial plans for the use of A.I.D. money to provide medium-term finance, for example, by cofinancing or various forms of rediscounting of bank loans, tended to suffer from

moral hazard in that they put official money at risk in the banks' investment activities. As ultimately worked out, however, these drawbacks were eliminated. A.I.D. resources were funneled through the banking system to the private sector, but in a manner in which loans extended by the banks were fully at their risk. Both A.I.D. and the Government of Panama avoided the temptation to make the choices that are properly those of the banks: to what firms or what industries or for what purposes money should be lent (minor exceptions are noted below). This meant that A.I.D. money could not be "tracked" to particular expenditures, in Panama or abroad, except in the most general terms, such as the industrial breakdown of loans, which was quite broad, with heavy emphasis on construction—both residential and business—trade and services (see Table 2-2).

The evaluation team fully endorses A.I.D.'s choices in this matter. The provision of additional funds to banks will induce them to lend more. To whom the banks lend will have to be decided by them, unless the government is willing to bear part of the risk of the loans. Any rules about the direction of the additional funds have little if any effect on the direction of the total lending by banks: since money is fungible, they can direct the money from other sources to the uses that the rules forbid. (As a matter of fact, consumer credit—the only major exclusion from eligible lending of the private sector facility—expanded rapidly in 1991 as banks found that the facility freed their own resources for this purpose). Moreover, if the banks had been pressured to actively pursue other aims in their use of the A.I.D. money, such as the promotion of small businesses or credit to agriculture, the primary aim of giving a strong push to economic recovery would have suffered.

The technique used in these operations is important for the understanding of the economic function of the facility. A.I.D. made available $108 million to the National Bank of Panama, which used the money to buy CDs from participating banks on the presentation of packages of disbursed loans that met the terms of the facility. The money was made available promptly; if *ex post* auditing proved (as it did in a substantial number of cases) that a particular loan did not qualify, the transaction was later reversed. However, CDs covered only 50 percent of the amount of the underlying loans. For purposes of A.I.D. accounting, the purchase of CDs was considered disbursement, and thus the end of the tracking process of the A.I.D. money. The main feature required for such loans was that they were medium-term, between 1 and 5 years. Loans could be made for any economic activity (though not for consumer credit), with only a few political and social exceptions—loans for the military, for abortion clinics, or for projects that would cause damage to the environment. Loans had to be for *new* investments, not to refinance investments made before mid-1990.

Table 2-2. Percentage Distribution of FREN-supported Loans by Economic Activities

Residential construction	23.3
Trade	22.5
Services	21.8
Manufacturing	17.3
Business construction	6.9
Agriculture	3.2
Husbandry	3.0
Pisciculture	1.8
Mining	0.2
Total	100.0

Source: Bank of Panama.

A question has been raised by the Inspector General of A.I.D. about whether loans made after July 1, 1990, but before the lending bank had formally associated itself with the FREN program, could legally qualify for CD financing—assuming they met all the other requirements of the program. This evaluation team is not qualified to judge the legal merits of this issue, but we would hold that there is no significant economic issue involved. If, contrary to the practice followed by A.I.D., such loans did not qualify, the available FREN resources would merely have been spent slightly more slowly and more money would have been left to satisfy pending applications at the end.

The maturities of the CDs followed those of the underlying loans, and most of the CDs were near the long end of the range; the modal maturity of those outstanding in July 1991 was 50 months. The CDs carried a fixed rate of interest, based on the 6-month LIBOR rate at the time of the deposit and independent of the length of the deposit. The premium over LIBOR was initially set at 1 percent. In early February 1991, when FREN did not take off as rapidly as had been hoped, the premium was lowered to ½ percent; it was returned to 1 percent in July. For the Panamanian-owned banks, these were relatively low rates. In December 1990, these banks were paying 1½ percent over LIBOR for 6-month CDs, 2½ percent over LIBOR for 1-year CDs, and even higher premiums for such longer deposits as they could capture. The terms were not particularly attractive to foreign-owned banks, which typically paid interest rates close to, or even lower than, LIBOR.

The rate offered by FREN could be said to contain a subsidy element for some of the banks in the sense that it was below what these banks would have to pay in the market. That market, however, was a fragmented one in which a residual lack of confidence forced the Panamanian banks to pay premiums over the rates paid by foreign banks.

FREN was right in not charging the banks as high a premium as the market, both from the point of view of equity and because such a high premium would have limited use of the facility to the weakest banks and would have interfered with the objective of the program—the rapid expansion of bank lending.

Because the rate was at all times above LIBOR, the capital invested in the FREN program gained at least some additional income above the yield available in world markets. (Some of the specifics of rate setting under FREN would need careful reconsideration if such a program were ever replicated. We refer to the fixing of the rate over time—the consequences of which are noted in footnote 2—and the use as the base rate of the 6-month LIBOR rate, whatever the maturity of the CD).

FREN did not attempt to regulate the interest rate charged by banks for projects partially financed with FREN CDs. This seems to be a correct application of the principle that FREN was intended to stimulate bank credit, not to regulate it.

How much stimulus to the economy—how much of a jump start—did this facility provide? To what extent was it responsible for the rapid (9.3 percent) growth rate of the economy in 1991? These questions break down into two parts:

- How much additional lending by the banks did the disbursement of $108 million under the facility bring about?
- What was the contribution of this additional lending to the growth of Panama's GDP, both directly and indirectly?

These two questions are discussed in the next subsections "Impact of FREN on Lending" and "Impact of FREN on the economy of Panama," respectively.

Impact of FREN on Bank Lending

The grant agreement for this part of the A.I.D. program sets out in advance how the first question is to be answered, indeed how the success of the program should be measured (para. B.3):

> The effect on the banking system and on the economy must be measured by the medium-term effect of the total level of loans outstanding. Therefore, program success will be measured on the basis of the annual increase in loans outstanding to the private sector. The base line for comparison will be June 30, 1990.

This definition raises two issues. First, it attributes any increase in loans since the base date to FREN, as if no increase would have taken place in the absence of the program. Second, it appears to give FREN credit for the increase in any kind of loan, although only medium-term loans qualified for FREN support.

The second ambiguity may reflect a slip in the drafting of the grant agreement.[2] In applying the formula in his memorandum of June 17, 1992, to the Inspector General, Ambassador James H. Michel refers only to the increase in "medium-term loans" by the banks since the base date. The actual figure he uses ($415 million) also includes long-term loans (those over 5 years), which did not qualify for FREN financing and perhaps partly for that reason increased by the smallest percentage of any category of loans.

The figures underlying Mr. Michel's appraisal, as provided by A.I.D., are presented in Table 2-3. For the reasons indicated, we cannot accept these figures as measuring the effect (or the success) of the program, but they do shed interesting light on the development of the Panamanian banks during the period of the program. (The dates in Table 2-3 are those used on A.I.D.'s appraisal of the program. Actual FREN lending took place almost entirely in calendar year 1991, as shown in Table 2-4.)

1. At the end of June 1990, when term deposits were still frozen, and in March 1992, when both depositors and banks had adjusted their balance sheets in accordance with their preferences, loans over 1 year were much larger than deposits over 1 year, and between the two dates such loans increased much more than such deposits ($415 million versus $151 million). Clearly, the banks in Panama, like banks everywhere, relied on the *de facto* continuity of short-term deposits to finance medium-term loans and mortgages. One bank, which did not accept any private deposits with more than 1-year maturity, explicitly stated this to be its policy.
2. The total loans of *all* banks increased by nearly $1 billion, compared with the increase by $284 million of the medium-term loans of participating banks. Clearly, the banking system was in an expansionary phase that had preceded the start of FREN (loans had increased by about $200 million in the second half of 1990) and continued after the end of FREN. The expansion was particularly strong in the Panamanian-owned banks, which accounted for more than 75 percent of the increases of both loans and private sector deposits in the banking system between June 1990 and March 1992.
3. FREN did have a noticeable effect of slanting loans toward the medium term, especially the 2- to 5-year period during which the interest advantage was greatest. A very large proportion of these loans by participating banks ($216 million out of $284 million) was supported by 50 percent FREN financing.
4. FREN also provided a very large proportion of the 1- to 5-year deposits that participating banks attracted: $90 million out of a total of $152 million.

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[2]If so, it would not be the only one. Par. B.2.d. states that "all private banks with general licenses will participate in the credit expansion subprogram, while only *Panamanian* private banks will participate in the liquidity subprogram." In fact, banks had the option of participating in the first program, and only some did.

Table 2-3. Bank Loans and Deposits by Maturity (US$ millions)

	Date			
	6/30/90	3/31/92	Increase	Percent
I. Banks Participating in FREN				
Medium- and Long-term Loans and Deposits				
A. Loans				
1-2 years	75	154	79	105
2-5 years	131	336	205	256
More than 5 years	503	634	131	26
Total, more than 1 year	709	1,124	415	59
B. Deposits				
1-2 years	63	129[a]	66	108
2-5 years	94	190[a]	96	102
More than 5 years	23	11	-12	-52
Total, more than 1 year	180	330[a]	151	84
II. All Private Banks, All Loans and Deposits				
Loans[b]	2,024	3,011	987	49
Deposits	1,680	2,688[c]	1,008	60

[a]These figures include FREN CDs.
[b]These figures differ from those in Table 2-1 in the exclusion of small amounts of loans to the public sector.
[c]These figures do not include FREN CDs ($90 million). See Table 2-4.
Source: National Bank of Panama.

However, for all the valuable information in Table 2-3, it does not provide the answer to the first question posed earlier, namely, the effect of the program on the total amount of lending in the Panamanian economy. The answer to this question depends crucially on the ease with which banks at that time had access to other sources of liquidity. Here, a distinction must be made between the Panamanian and the foreign banks. The latter had, on the whole, access to the world's money markets, as is evident from the interest rates they paid; the former had generally no such access. The consequence of this was that FREN, although open to all private banks, was overwhelmingly used by the Panamanian banks. They accounted for more than 93 percent of the FREN CDs, even though they had

only about 40 percent of the loans and one-half of the private sector deposits of all private banks (end-1990 data).[3]

Given the difficulty the Panamanian banks had in accessing the world money markets for resources, it is reasonable to assume that the full $108 million provided under FREN led to additional lending. Even though some of the banks may have reduced their reliance on other sources of funds because of the availability of FREN funds, it would seem likely that these monies found other investment outlets in Panama. There would seem to be no reason to deviate from the standard assumption that a capital inflow of $108 million financed by A.I.D. added that much to investment in Panama.

The question that might perhaps be raised is whether an initial injection of $108 million into the banking system should not be assumed to induce banks to expand their deposits by, for example, three times that amount (assuming a monetary multiplier for Panama of about 3) and their loans by two times $108 million. The answer to that question is that one cannot legitimately apply a money multiplier to an *initial* change in base money without taking into account the induced changes in base money—in this case in particular, the reduction resulting from the additional imports caused by the first round of investment spending and the subsequent rounds of consumption spending, as discussed in the next subsection.

A.I.D. has suggested that, because banks had to submit loan contracts for $216 million in order to receive $108 million in CDs, the impact of FREN on investment was in fact $216 million. That claim is based on the "leverage" implied in the 50/50 provision. But the concept of leverage, where one party conditions its contribution on the other party making a suitably matching contribution, does not apply in this case. True, in other settings an aid donor can multiply the impact of its contribution by conditioning it on a special effort by others, either the aid recipient or other donors. For example, A.I.D. may provide the pump only if the villagers put up the effort to install it. U.S. insistence on contributions from a Panama Support Group produced part of the money needed to pay off Panama's arrears to the IFIs. But in the case of FREN, no matching effort was requested from the banks. Collecting deposits and making loans is the regular business of the banks, FREN or no FREN. All that the banks had to do to get access to the special FREN CDs was to train their loan officers so that a large enough proportion of loans would qualify under FREN, and to fill out the necessary forms. The amount of lending the banks would be willing to engage in would still depend on the demand for credit and the

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[3]One American bank told us that it used FREN for only a small amount because, expecting a decline in LIBOR, it disliked the fixed-rate feature of the program. Another American bank began as one of the largest users of FREN but agreed, as late as March 1992, to have most of its CDs, covering 106 out of its original 139 loans, canceled rather than disclose what it considered confidential clients' information; one may surmise that the decline in U.S. interest rates that did take place in the course of 1991 might have played some role in this decision.

supply of deposits, which FREN raised by $108 million. All that the CD percentage ratio determined was how quickly the available FREN money would be disbursed.

Of course, the provisions of the facility may well have slanted the banks' lending more toward term loans (see the data in Table 2-3), but it is not obvious why this was an A.I.D. objective. The PAAD spelled out the purposes of the loans to be promoted by FREN: "for investments in new plant and equipment, for construction, for mortgages for newly constructed buildings, or for incremental working capital" (p. 29). But no argument is presented as to why loans for these purposes must also be between 1 and 5 years—why, for example, construction loans for more than 5 years would not qualify for FREN financing. It is not possible to conclude, therefore, that the concentration of new loans in this range was better for the economy or employment than if the loans had been made with more conventional maturities.

Table 2-4. Use and Reflow of FREN Deposits (US$ million)

	1990		1991				1992
	September	December	March	June	September	December	March
1. CD's bought[a]	-	4.2	31.1	58.7	87.9	108.4	111.5
2. CD's repaid[b]	-	-	-	-	-	12.3	21.5
3. Net outstanding[c]		4.2	31.1	58.7	87.9	96.1	90.0

[a]Sum of lines 2 and 3. Exceeds $108 million because of accumulated interest.
[b]"Reactivation account."
[c]"CDs in other banks."
Source: Balance Sheet of National Bank of Panama.

Impact of FREN on the Economy of Panama

To arrive at an estimate—which at best can only be a very rough one—of the impact of the FREN program on the growth of Panama's GDP, allowance will also have to be made for the large import component in both investment and consumption expenditure in Panama, and for subsequent rounds of consumption as the income resulting from the additional investment is respent. This requires an estimate for a marginal import ratio and a marginal propensity to consume. There is no model available for the economy of Panama from which these coefficients could be lifted, but rough guesses might put the former ratio at 40 percent and the latter at 90 percent. This would produce a Keynesian multiplier of 2, which would lead to an estimate for the increase in GDP resulting from the FREN program of $125 million, or 2½ percent of the total 1991 GDP ($5,075 million), when applied to an initial income round of 60 percent of $108 million.

The relative contribution of FREN to total investment could be estimated as follows. Total private sector investment in 1991 was estimated at $939 million. Without the extra funds supplied through FREN, investment might have been about $830 million. Thus FREN can be credited with having raised private investment in 1991 by some 14 percent.

The figure for the effect of FREN on Panama's GDP could also be used for an estimate of the effect of FREN on employment by applying the same percentage to an employment figure comparable in scope to the sectors of the economy to which the bank credits were largely directed. Taking for this figure the total employment outside agriculture and government (529,000), the effect of FREN on employment would appear on the order of 13,000 person-years.

Although FREN and other stimuli (including a $90 million swing in direct investment and a $20 million increase in exports) had a positive effect on the employment situation, the overall unemployment rate declined only slowly from the high level reached in the crisis years (16.3 percent in both 1988 and 1989, as against 11.8 percent in 1987). No employment survey was conducted in 1990; the figure for 1991 stood at 15.7 percent and is estimated at 15.0 percent for 1992.

These contributions of FREN to growth and employment amply justified its costs (a subject to be commented on later), and there was certainly no reason to interrupt the program when it became evident during 1991 that the economy was on a solidly expansionary course. To begin with, this course was not as clear when the decision to continue FREN was made as it is now with the benefit of hindsight.

In his November 1991 report for A.I.D. on the FREN facility, Marco Fernandez estimated that growth in 1991 was not likely to be much higher than the poor performance of 1990, which would have meant that at the end of 1991 output was still below the 1989 level.[4] Moreover, switching to some alternative expenditure program would have involved delays that would have risked interrupting the tempo of the ongoing recovery.

In addition, in any appraisal of FREN, attention has to be paid to the situation that existed in the first half of 1990, when the program was designed. At that time, there was little evidence of a robust recovery. Such a recovery was essential for the political success of the Panama aid program, and this justified the use of the sum available in the program for the private sector to jump start the economy. In retrospect, the effect of the flow of money through the FREN program, which started late in 1990, was to strengthen the ongoing recovery. Apart from one essentially token operation with the Bank of Hong Kong, the Bank of Panama did not buy CDs from the commercial banks until November 1990, and the total amount purchased in 1990 was only $4.2 million.

With the restoration of confidence and the unfreezing of deposits in July, the economy had turned upward from the middle of the year. During the second half of the year, the private banks increased their lending, as mentioned earlier, by $210 million. After a 16 percent decline in 1988 and an essentially flat 1989, the rate of growth of real GDP for 1990 was 4.6 percent, 9.3 percent for 1991 and, according to the latest estimates, about 8 to 9 percent for 1992. But because it is generally agreed that little if any growth occurred over the 1989 level in the first half of 1990 (although there was a recovery from the disorganization prevailing in December and January), the growth rate in the second half of

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[4]Marco A. Fernandez. *The Banking Sector Performance in Panama During 1990 and the Role of the National Economic Recovery Program*, page 56 (see Bibliography).

that year must have been in the same range as that of the two following years. Nor is it particularly surprising that an economy that had been knocked down by a severe shock, which then not only ceased but was reversed—from U.S. sanctions to massive U.S. financial support—would have a number of years of rather steep growth, after which it would presumably return to its sustainable growth path (projected at 5 to 6 percent by the World Bank).

Use of Reflows from FREN CDs

This discussion of the benefits that the FREN program contributed to the economy of Panama needs to be rounded out by introducing a different dimension. If the question is asked whether the portion of the A.I.D. program devoted to FREN was well spent, perhaps the most accurate answer would be that it was *not* spent. Rather, that component of the aid grant to Panama has been preserved for later use and in the meantime has been invested in bank CDs. For accounting purposes the purchase of CDs may be registered as disbursement, but unlike the purchase of brick, mortar, and machines, the purchase of CDs represents in no way a final disposition of the money. There is every reason to expect that the money will continue to return, with interest, and that only then will the government of Panama finally disburse that portion of American aid.

The reflow of aid money, once used, is not a new experience, but the form it takes in Panama is unusual. In countries that have their own currencies, the reflow takes the form of local currency balances, or counterpart funds. These arise, for example, as goods financed from aid dollars are sold in the country. In the typical receiving country with weak financial policies, the dollar value of these local currency balances may rapidly shrink as the currency depreciates. In most cases, A.I.D. has had little interest in supervising the use of these balances, since the receiving government could readily circumvent any restrictions applicable to their use by printing additional amounts of its own currency.

Table 2-5. Future Reflows from FREN CDs (US$ million)

	1993	1994	1995	1996	1997
Capital	28.7	24.6	19.9	9.3	0.3
Interest	3.4	4.6	5.0	2.6	0.1
Total	32.1	29.2	25.0	11.9	0.4

The situation in Panama is completely different. The reflow in Panama of the money invested in CDs consists of U.S. dollars. To the extent that there is some loss in purchasing power, it is due to inflation in the United States, not to the lower inflation in Panama. It can thus be said that the reflows constitute a new aid program for Panama, ranging from $32 million to $12 million over the next 4 years (see Table 2-5). When the provisions on the handling of reflows were agreed upon in 1990, this aspect was not fully

worked out. Under a provisional understanding—which might be changed by later agreement—the Government of Panama could use this money to repay nonmilitary debt to the U.S. Government.

Given the fact that the annual debt payments that Panama will in any event be making to the United States are larger than the expected CD repayments, the true meaning of the understanding is that this money becomes available to Panama as general budgetary support. This support will permit the country to make a corresponding amount of additional expenditure of its own choosing without a corresponding rise in taxes. This choice appears to reflect the desire on the part of the United States to disengage from anything that might look like a large, intrusive aid program in Panama.

Nevertheless, there would have been better ways to arrange for the release of the reflows into the Panamanian budget. One such way would have been to provide that, in an agreement between the Government of Panama and A.I.D., the funds could be used to finance projects not adequately funded in the budget. Alternatively, or in addition, the spending of the funds could have been made subject to some conditionality. The conditionality attached to the public investment program will end when the third tranche of this program is released. (Contrary to what the evaluation team had been given to understand during its visit in October, A.I.D. recently decided not to release the last tranche of the public sector program—in spite of the fulfillment of the stipulated release conditions—on the grounds that Panama was not in compliance with its program with the World Bank.) Given the importance that USAID has attached to Panama persevering its program of structural adjustment as agreed with the IFIs, there would have been good reason to prolong the policy impact of A.I.D. money by making the use of CD reflows conditional on the country continuing to perform in line with the earlier undertakings vis-à-vis the IFIs.

As far as the conditionality of the FREN program is concerned, the evaluation team shares the position taken by A.I.D. that U.S. interests in economic reform in Panama were sufficiently safeguarded by the conditionality attached to the use of the portion of aid devoted to public investment (see the discussion in Chapter 3) and that it would have been counterproductive to delay the availability of FREN until the conditions applicable to the release of the remainder of the $420 million aid package had been fulfilled.

Applicability of the FREN Approach to Other Countries

As discussed previously, FREN made a substantial contribution to the growth of the Panamanian economy in 1991. However, the program did not become fully operational until late 1990, because it took A.I.D. considerable time to work out the particulars of the program in collaboration with the authorities in Panama. What can be learned from this experience that might be useful in future A.I.D. operations in other countries?

In attempting to answer that question a number of country-specific aspects of the A.I.D. program for Panama must be kept in mind. In the first place, A.I.D. was called on, with little time for preparation, to mount a very large assistance program in Panama. The program was authorized by Congress in a specific law for that country. Even in its

absolute amount, the program was the third largest, exceeded only by the programs for Israel and Egypt. Beyond the amounts set aside for an array of specific objectives, the program contained from the start three subprograms (settlement of Panama's accounts with the IFIs, support for a government investment program, and reactivation of the private sector). Although the dollar amounts that might be required for each of these subprograms could not be forecast with any precision in early 1990, the allocation of the total among these three subprograms appears to have been *de facto* frozen from the beginning in the magnitudes that had been communicated to Congress when the legislation was proposed.

A second unusual aspect of the operation in Panama was the deflated state of the economy. In the typical country where A.I.D. operates, the macroeconomic risk is almost always excess demand and inflation, not stagnation due to lack of demand and lack of credit expansion. In such cases, A.I.D., in accord with the IMF, will be concerned with keeping a lid on credit, not with expanding it. In such countries credit for the private sector may well be inadequate; but excessive use of credit by the public sector (to finance government deficits) will still make it inadvisable to promote additional credit to the private sector until the government's absorption of credit has been curtailed.

The third difference between Panama and almost all other countries—the fact that Panama does not have a central bank—turns out to be of less importance in this context. It is true that a central bank disposes of the technical means to stimulate larger credit by the banks to the private sector, assuming that sector has an unfilled demand for credit. The central bank can lower reserve requirements, open more generous rediscount facilities, lower its discount rate and perhaps—if the financial market is well developed—engage in open-market operations. But the typical central bank in a developing country with balance-of-payments difficulties would not be justified in resorting to any of these techniques to stimulate the private sector unless it were assured of an additional supply of foreign exchange to meet the additional demand resulting from the expansion of credit. On plausible assumptions, that demand might over time build up to an amount equal to the credit expansion. Hence A.I.D. (if that were the source of foreign exchange support to the country) would have to provide as many dollars to backstop a policy of credit expansion in such a country as it would have to put up front in Panamanian conditions.

If A.I.D. were to become involved some time in the future in another situation (1) that required a stimulatory policy and (2) where A.I.D. had the resources to backstop such a policy, it would be well advised to insist, as a condition for its assistance, that the scheme for credit expansion that it was backing be soundly conceived. In the case of Panama, the plan that resulted from the long deliberations with the Government of Panama met that requirement. But it is well to recall that, in general, governments that have tried to channel additional credit to the private economy, whether through the central bank or otherwise, have had a very uneven record.

In that context, it is useful to recall that rediscounting by the central bank of certain categories of commercial bank credit (or the equivalent thereof used in the FREN scheme: the purchase by the central bank of commercial bank CDs linked to categories of commercial bank credit) is one approach to "directed credit"—government intervention in

credit allocation. An extensive analysis of this widespread practice is provided in the *1989 World Development Report* of the World Bank (Chapters 4 and 9). Three other approaches have also frequently been used: (1) nationalization of banks to give governments direct control over at least part of the flow of credit; (2) rules laid down to the banks, or to other private financial intermediaries, on the distribution of their credit by sector or industry, including rules on the maximum rate of interest to be charged to certain protected borrowers; and (3) creation of development finance institutions with the specific function of providing long-term finance to particular sectors.

In part, these various forms of directed credit were aimed at correcting a serious weakness in these countries' financial structure: the absence of (to all but a few privileged borrowers) medium- and longer-term credit (and sometimes of any credit) at reasonable interest rates. Frequently, however, the aims were more questionable: to provide cheap credit to state enterprises or politically important groups to offset the effect of an over-valued exchange rate and restrictive trade practices. As a result, directed credit schemes in many countries did not correct the inadequacies of financial markets but resulted in new distortions in these markets and bestowed subsidies on favored groups of borrowers.

As was mentioned previously, the FREN program in Panama avoided almost all of the negative aspects of directed lending that have been so common in other countries. Its main aim was to add to the supply of loanable funds, not to redirect it. The program allowed the banks almost complete freedom with respect to the loans that could be refinanced under it, thus making for at most very minor distortions. The program contained no element of cofinancing or credit guarantee by the Bank of Panama; it was entirely clear that the commercial banks would have to repay the CDs on their due dates, whether their debtors paid on time or not. The interest rate, at slightly over LIBOR, contained no subsidy as far as the Bank of Panama or the ultimate beneficiary, the Government of Panama, were concerned, although it was clearly advantageous to the Panamanian-owned banks. The advantage was not so great that there were any great difficulties in discontinuing the scheme in mid-1992.

It would appear that the Panamanian authorities were as anxious as the A.I.D. Mission to avoid the disadvantages that other countries have incurred when they entered into programs of directed credit. On any future occasion, the cards might not be stacked so favorably. If another case presented itself whereby A.I.D. money was to be used to underwrite a policy of credit expansion, the Panama program would serve as a good example—because it avoided most of the risks of directed credit. Any future program designed to stimulate bank lending by adding to the banks' liquidity should emphasize the liquidity aspect of the program and be wary of imposing limitations on the purposes or the terms of the banks' lending, realizing that any such limitations on the use of part of a bank's resources are likely to have only a limited impact on the bank's lending portfolio as a whole.

There is a further lesson to be learned from A.I.D.'s experience in Panama. As mentioned earlier, the plan in early 1990 was to inject liquidity into the banking system indirectly, by quickly disbursing aid through the Social Emergency Fund. On any future

occasion, a similar approach might well look appealing as providing two benefits for the price of one. Unfortunately, this option is not available. Social expenditure may well be as effective (or perhaps even more effective) in creating income as the provision of funds to the banking system to expand lending. Although some of the money spent on social programs, and respent by those who receive it in further income rounds, will pass through the banking system, it will not stay there; therefore, it will not provide the banks with a solid deposit base on which to extend more credit.

In a wide open economy such as that of Panama, a substantial proportion of each income round will be spent abroad. As a consequence, most if not all of the dollars spent on social programs will leave the country as payments for additional imports; they will not stay in the banks. Of course, the same thing can be expected to happen to dollars made available to the banks directly, for example, through the FREN program. The point is not that one approach is in general better than the other, but that one stone will kill only one bird at a time. A choice will have to be made between spending money on social projects or on additional bank-financed investment, with the knowledge that repayment of the bank loans will, in due course, permit another round of spending.

3. The Public Sector Investment Program

One of the worst casualties of the squeeze on government finance in the crisis years of 1987-1988 in Panama was public investment, and it took a long time to reverse the trend. As a percentage of GDP, public investment had been around 5 percent in the mid-1980s. It declined to 3.7 percent in 1987, 1.5 percent in 1988, and 1.4 percent in 1989. It declined even further in 1990—to 1.1 percent—and made only a modest recovery in 1991, to 2.4 percent. There were a number of reasons for this slow recovery. Even under the new government, the budget resources available for public investment remained constrained; moreover, it took a major effort, after years of cronyism and corruption, to reinstitute proper budgeting controls, bidding practices, and auditing in short to bring official spending under democratic control. The effect of this radical change in the ways in which public investment expenditure was handled was that very few projects became ready for financing in 1990, and the slowdown in the project portfolio stretched well into 1991.

NEED FOR A PUBLIC SECTOR INVESTMENT PROGRAM

The backlog in public sector investment that had developed in the crisis years made a Public Sector Investment Program (PSIP) a natural element in A.I.D.'s recovery program for Panama. The funds were used for priority investments in agriculture; health, education, justice, and other social sectors; natural resources; and infrastructure. Out of the total available, $20 million was channeled through the Social Emergency Fund to fund a large number of small, labor-intensive, local social development programs.

Healthy growth of the economy of Panama, however, required more than improvement in the infrastructure and the replacement of worn-out equipment of state enterprises. As the new Government of Panama was fully aware, it was equally essential to remove the structural impediments to growth that prevented the launching of a lasting economic expansion. These structural weaknesses included

- Excessive employment in the public sector;
- Inefficient operation of public sector enterprises;
- Inadequate public investment and maintenance, leading to a poor state of public-sector services ill-suited to serve a rapid recovery in the private economy;
- A tax system that discourages investment and the use of labor;
- Very high trade protection aimed at import substitution and self-sufficiency in food, a particularly ill-advised approach for a country with a very small domestic market and whose comparative advantage clearly lies in the provision of services;
- Extensive price controls in support of protective trade and agricultural policies;

- An overregulated labor market;
- An underfunded and overly generous social security system; and
- Technical insolvency of four public banks and a weak regulatory and supervisory framework of the commercial banks.

In addition to these chronic weaknesses of the economy, poverty had increased in the second half of the 1980s, necessitating urgent attention to a wide range of social issues. Structural change was, accordingly, the central focus of the World Bank and the Inter-American Development Bank (IDB) in their relations with Panama. Any lending to Panama by these two international financial institutions would be directly linked, through the conditionality attached to such loans, to progress in the areas of structural change listed above. Moreover, Panama had no option but to apply for new loans from the World Bank and the IDB because even with the aid promised by the United States and other donors (see below) it did not have enough money at its disposal to pay off the arrears to the IFIs. The three IFIs had taken the position that before any one of them made a new loan to the country, the arrears to all should have been paid off. In this way, understandings of Panama with the World Bank and the IDB on a program for structural reform became an indispensable element in the process toward regularizing the country's arrears to the three IFIs, as well as to obtaining new credit from the International Monetary Fund (IMF).

CONDITIONALITY FOR THE PSIP

The dispositions that A.I.D. took with respect to the conditionality for the PSIP made the release of the second and third tranches under this program also conditional on the progress made by Panama in its negotiations with the IFIs. The release of the first tranche—which took place in October 1990—was made conditional not on *action* taken by Panama in the structural field, but on the submission of specific plans for action in the subsequent period.

These plans covered the following broad fields:

- Management of public sector finances with respect to revenues, expenditures, salaries, savings, reduction of external debt, and investment.
- Identification of the first public enterprises to be privatized and a plan to implement these privatizations. Five enterprises were identified for this purpose.
- Lowering of tariffs, elimination of quantitative trade restrictions, and reduction of the number of products subject to price control.
- Improvement of the competitiveness of Panamanian products on world markets.

It is evident from these fields that the structural "menu" on which A.I.D. wanted Panama to proceed was a broad one on which a new coalition government with limited personnel resources could hardly be expected to make rapid progress in its first year in office. Accordingly, the focus on careful planning on a broad canvas, rather than on quick

action on a few immediately feasible measures, was appropriate. Given the inevitable delays on the part of the authorities in Panama, the time taken by this planning process—about 10 months—did not involve undue delays in making resources available for actual expenditure. To have insisted on widespread structural action would have had that effect.

The critical condition for the release of the second tranche constituted a direct link with Panama's negotiations with the World Bank and the IDB, namely agreement with these two institutions on a program of structural reform. (A.I.D. documentation refers to a "program of economic reactivation," but this is a misnomer; by the time the second tranche was released in January 1992, the economy had long been reactivated and the contents of the program agreed with the two IFIs focused on means to raise growth over the medium term, not on immediate stimulation.) Two other conditions for the release of the second tranche did not in fact prove binding; agreement with the United States on measures to limit the laundering of narcotics money and "acceptable progress in implementing policy reforms in areas of public sector finances, privatization, labor policy and trade and commercial policy." The first condition had been met in July 1991 and agreement with the IFIs implied that a reasonable list of such progress could indeed be presented.

The release of the third tranche was similarly attached to Panama's relations with the IFIs, namely the "receipt of first tranches of assistance from IBRD and IDB in support of the medium-term economic reactivation program." The first $60 million from the IBRD was received in July 1992, and the first $50 million was received from the IDB in September 1992, whereupon A.I.D. was set to release its third tranche in October 1992. (The formal conditions for the third tranche included again evidence on "reasonable progress..." like that requested in the second tranche, but there is no evidence that this was intended as a binding condition. The money was held up until the two IFIs released their first tranches, after which the third A.I.D. tranche was to become available).

The conditionality of the World Bank and the IDB covered, in considerable detail, all areas of structural deficiencies listed above. Given the close cooperation between A.I.D. and the IFIs both in Washington and in Panama, this could only have been expected. Many of these issues had also been covered in A.I.D.'s list of items to be dealt with in the 1990 planning phase of its own program. It should be noted, however, that for the World Bank and also the IDB, release of the first tranche of their loans did not signify their full satisfaction with Panama's policies for structural reform. In fact, release of the second tranche of the World Bank loan, which had originally been expected in fall 1992, is likely to be delayed until some time in 1993, depending on the progress by the Government of Panama on trade liberalization, further reduction in official employment, and privatization of the telephone company. As far as the IDB loan is concerned, it is too early after the release of the initial tranche to judge whether Panama's performance will qualify it to receive the second or later tranches.

The use of a two-stage linkage (via the IFIs) of the release of A.I.D. money to the Government of Panama's performance implies that A.I.D. (releasing its last tranche when

the IFIs released their first one) could not have the same assurance as the IFIs that its money would buy the hoped for structural adjustment. In spite of this, the evaluation team believes that A.I.D. has applied a proper degree of conditionality. In the first place, it was appropriate for A.I.D. to attach its conditionality to that of the IFIs, rather than to design a conditionality of its own. Whether this conditionality had been more lenient, harsher, or simply different from that of the IFIs, it could only have caused confusion in Panama about what policy elements "Washington" considered essential. At the same time, A.I.D. acted wisely in designing its disbursements in a somewhat different time frame from that of the IFIs. The PSIP had an economic and a political importance of its own, which properly carries a somewhat greater weight in the considerations of A.I.D. than in those of the IFIs. Moreover, A.I.D.'s high profile association with Panama was intended to be short-lived, which meant that it could not stretch its disbursements over as long a period as might be appropriate for the World Bank or the IDB.

As it turned out, the cautionary process of Panama's investment planning referred to earlier meant that the funds from the first tranche could probably not have been spent in any event, had they been released earlier. The general expectation in the fall of 1990 was that all the elements necessary for the settlement of arrears with the three IFIs would fall into place within a few months, permitting the early release of the second tranche. The difficulties Panama had in meeting the many components of the conditionality package of the World Bank—difficulties that would take too long to analyze—unexpectedly delayed release of the second tranche by about another year. This produced a hiatus of about 3 to 5 months between the spending by Panama of the first tranche and the availability of the second tranche—a consequence that A.I.D. would have preferred to have avoided.

It should be emphasized that in a case such as this one, where the amounts to be lent by the IFIs were a multiple of the resources to be provided under the PSIP of A.I.D., the primary purpose of A.I.D. associating itself with the conditionality of the IFIs is not to "heavy up" that conditionality, but rather to make it clear to the client country that A.I.D. fully shares and gives its moral and financial support to the policy changes recommended by the IFIs. Under the conditions prevailing in Panama, that position could hardly have been in doubt in any event. With the new government in Panama critically shorthanded to deal with the many requests coming from the IFIs, it fell to the A.I.D. Mission on the spot to act as the conditionality expediter. With a larger continuous presence than any of the IFIs, A.I.D. could assist the Government of Panama in its search for measures that would satisfy the requirements of the IFIs in the face of the many administrative and political constraints in Panama. Without its help, agreement might have taken even more time to be reached.

In a setting such as the one in Panama, A.I.D. could have gained additional flexibility, without undermining in any way the force of the conditionality of the IFIs, if it had from the beginning left the door open for the release of some part (e.g., one-half) of each tranche before fulfillment of the stipulated conditions under circumstances spelled out in advance. These circumstances could have been that (1) the conditions stipulated for the release of the tranche were unexpectedly delayed, and (2) further delay in the

disbursement of the tranche risked serious harm to the orderly execution of the program. Any such exceptional provision would have to be laid down (e.g., in the grant agreement) *in advance*. For A.I.D. *ex post* to loosen its link to specified IFI conditionality would inevitably be interpreted as a signal of disassociation from the merits of these conditions.

4. Settling the Arrears with International Financial Organizations

In the crisis years, Panama failed to make the required payments (interest and amortization) to the international financial institutions—IMF, World Bank, IDB, and, for a small amount, IFAD; it also defaulted on its bonds and its credits from commercial banks. After the change in government it was a matter of first priority to re-establish Panama's position with the IFIs, from which it could then expect to receive considerable amounts of credit for the future.

During the planning stage, A.I.D. developed the following approach to the problem. At the end of 1989, Panama's debt to the IFIs was approximately $540 million. This total amount would have to be settled in a single operation (executed within a few weeks) because each of the IFIs required settlement with the two others before it was willing to extend new loans, and without such new loans, Panama would be unable to settle. Loans from the IFIs would be disbursed in installments, but for purposes of settlement Panama would be able to use only the first installments from each IFI, which could be estimated at some $150 million. The United States was willing to provide a bridge loan for this amount. This would reduce the need for immediate cash to $390 million, and the United States envisaged splitting this amount in three equal parts. Panama would use $130 million of its own money (for this purpose, that amount was separated when Panama's frozen balances were unfrozen and put into escrow); the United States would put in an equal amount from its A.I.D. program for Panama; and other countries would be asked to provide the third $130 million as their contribution to a support fund for Panama in a manner similar to that used in a few other cases where countries needed to be assisted in settling large arrears to the IFIs.

In the application of this approach, three developments caused the outcome to be considerably different from what had been hoped for.

- Although Panama reached agreement with the IMF in September 1990, negotiations on new credits (and the attending conditions) from the World Bank and the IDB took much longer because Panama encountered difficulties in taking the prior actions that these institutions required. As a result, the settlement of arrears dragged on until early 1992.
- Because much of the debt that Panama owed to the IFIs was expressed in currencies other than the U.S. dollar, the gradual depreciation of the dollar in the 2 years since the end of 1989 raised the dollar value of that debt to $658 million.

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- No European country (except France, which made a grant of $3 million) proved willing to join the support group; neither did Canada. Japan and Taiwan contributed in the form of loans to cofinance World Bank and IDB loans.

The net result was that even though the initial disbursements of the new loans by the IFIs were brought to $188 million, Panama's own contribution needed to be raised, according to World Bank calculations, by $118 million. Since all but $133 million contributed by the U.S. and France was in the form of loans at market interest rates, it would probably be more accurate to say that Panama paid $555 million to settle its arrears, $248 million in cash and the rest by borrowing from the IFIs, Japan, and Taiwan.

The conditionality for the release by the United States of the $130 million in A.I.D. money for the settlement of arrears was directly linked to the conditions posed by the three IFIs for the release of the first tranches of their respective new credits to Panama. Since the purpose of this component of U.S. aid was to facilitate settlement with the IFIs, that linkage of conditionality was, in our view, entirely appropriate.

5. A.I.D. Program Planning

The primary concerns of the evaluation team, in the limited time available, were the economic effects of the A.I.D. program for Panama and the conditionality applied in order to obtain the greatest long-term beneficial impact from A.I.D.'s intensive association with Panama in the period 1990-1992. Our study of the case of Panama during that period also gave us an opportunity to observe the planning technique of A.I.D. in this case to which the following comments are addressed.

The program for Panama had to be organized in an extremely short time, in the wake of a military operation, and without full knowledge of the economic situation in the country or the economic policies of a new coalition government. At the same time, not only emergency action, but also the announcement of a broad program of economic reactivation, were politically urgent. The fact that this program required special congressional action, which in turn required specific indications of size and composition, made for a set of specifics that left A.I.D. less room to respond to circumstances as they developed in Panama than would have been desirable. In particular, the fact that the private sector reactivation program did not become operational until the fall of 1990 was a drawback.

At various points, A.I.D. had a choice between direct involvement in investment decisions in Panama or leaving these decisions to be made by the market (for the private sector program) or the Panamanian government (for the public sector investment program). In both cases, the choice was made against exercising excessive foreign paternalistic influence on the course of the Panamanian economy—a choice that we endorse. The criticism these choices provoked—that "A.I.D. did not know what happened to the money provided"—is fundamentally mistaken. It is based on the assumption that A.I.D. knows better than the banks in Panama what are good investments in the private sector, or the Government of Panama what are the most urgent investment needs in the public sector.

The principle of a modest A.I.D. staff involvement was also responsible for the decision that the FREN program should be run by the National Bank of Panama, not by A.I.D.. We did not conduct an intensive study of the actual operation of this program, but what we saw of it and what we heard about it from the commercial banks would fully support the choice that A.I.D. made on this issue.

As mentioned earlier, A.I.D. did not outline a set of conditionality criteria of its own to serve as performance triggers for the release of installments of its various programs, but adopted for this purpose certain benchmarks in the relations of Panama with the IFIs. This economized A.I.D. work in an area of decision making for which the IFIs are better equipped, but the primary advantage of the approach taken was that it avoided confusion on the part of the Government of Panama as to the adjustment priorities of A.I.D. and the IFIs. The approach did not mean that A.I.D. paid little attention to the need for structural

adjustment in Panama. On the contrary, its presence in the country helped to emphasize the importance of the common requirements in this area and proved helpful for a new and understaffed Panamanian government in its efforts to reach the structural objectives that it also shared.

6. Lessons from the Panama Experience

The setting for the A.I.D. program for Panama was in many respects atypical for the agency's program in other countries. For example,

- It followed immediately after a military operation, leaving limited time for observing the country's needs and planning how to meet them.
- Panama's per capita income (in the range of $2,000) put it outside the normal scope for high-intensity A.I.D. assistance.
- The absence of a central bank and of a currency of its own—the complete reliance of the Panamanian economy on the U.S. dollar—gave Panama a financial structure radically different from that normally encountered in aid-recipient countries: full convertibility, a high-quality banking system, and, perhaps most important, the inability of the government to finance a budget deficit by inflationary means.

The result of these differences between Panama and other (current or potential) A.I.D. clients is that much of the experience gained in Panama is country-specific and of limited relevance to other countries.

Nevertheless, there are a number of lessons that would seem potentially applicable to a wider range of countries and thus deserve general attention throughout A.I.D.. These lessons, which have been presented and justified in the earlier chapters of this report, are briefly summarized as follows.

1. If the problem in an aid-recipient country is a lack of demand, A.I.D. can use part of its resources to overcome this deficiency either by sponsoring a fast-disbursing domestic program or by pumping additional resources into the banks, thus inducing them to step up lending. It cannot be expected that a domestic spending program will also improve the liquidity or the tempo of lending of the banks.
2. If the second alternative is chosen (e.g., because there is severe unemployment), A.I.D. should be careful to supply finance to the banks without assuming any risks from the loans made by the banks. The CD technique used in Panama met that test. The corollary of this approach is that the government should leave the choice of debtors, terms, and projects overwhelmingly to the banks and resist the temptation to use this program for the pursuit of a wide variety of other objectives.
3. A.I.D. may supply a grant to the recipient country, but funds supplied to the banks in support of their lending activity should return to the government as the loans are due for repayment (even if the borrower fails to repay). A.I.D. should consider this reflow as a new aid program to which it can suitably attach some degree of

conditionality—the more so if the original "disbursement" to the banks has been made without conditionality in order to speed up the process.

4. Where the programs of the IFIs in the country carry a broad spectrum of conditionality that meets substantially (even if not in every detail) A.I.D.'s objectives in the area of structural adjustment, and where the financial involvement of the IFIs is a multiple of that of A.I.D., it is advisable for A.I.D. not to specify its own conditionality, but to piggyback onto suitably selected release conditions of one of the IFIs.
5. In the setting described in the preceding paragraph, the support by A.I.D. of the conditionality of the IFIs is primarily moral rather than financial; therefore, it is not inappropriate for A.I.D. to exempt from this conditionality certain subprograms, or portions thereof, that it considers too urgent to wait for the fulfillment of the IFIs' performance criteria. In the case of Panama, A.I.D. did so for the private sector reactivation program, which was already late when it went into effect in the fall of 1990. It might also have taken similar action for some portion (e.g., one-half) of each of the three tranches of the public sector investment program, provided it had specified in advance the circumstances under which such action could be taken.
6. Finally, the experience in Panama showed the drawbacks of a program that is rigidly allocated into three parts long before the magnitude of the needs (and, in the case of the IFI arrears-settlement program, the contributions from other sources) could be defined. The origin of these drawbacks did not lie with A.I.D.; they were associated with, first, the political process of high-level interagency decision making on a program that the U.S. Government could support and, second, the process of piloting this program through Congress. Consequently, if a similar situation recurred, any remedial action would also have to be taken at these earlier stages, before A.I.D. is given a program to administer. Nevertheless, in such a situation it would be up to A.I.D. to wield all the influence it could bring to bear in the design stage against any undue rigidity of the emerging program.

Appendix A

PERSONS INTERVIEWED

A.I.D./WASHINGTON

Craig Baier
Desk Officer

Juan Buttari
POL/CDIE

John Eriksson
Director
POL/CDIE

James Fox
POL/CDIE
(Former LAC Chief Economist)

Cressida McKean
POL/CDIE

James Michel
Assistant Administrator
AID/LAC

Mary Ott
LAC Chief Economist
(Former Pamana Mission Economist)

Thomas Stukel
Mission Director
USAID/Philippines
(Former Mission Director for Panama)

GOVERNMENT OF PANAMA

Aurelio Barria
Executive Director
Social Emergency Fund

Mr. Rubén Darío Carles
Controller General

Ernesto Boyd
Panama National Banking Commission

Guillermo Ford
Vice President

Leg. Milton Henriquez
Legislative Assembly

Miguel A. Lee
Deputy General Manager
National Bank of Panama

Juan Luis Moreno
Advisor to the Ministry of Planning

Luis H. Moreno
General Manager
National Bank of Panama

Luisa de Soto
Director
Ministry of Planning

INTERNATIONAL FINANCIAL INSTITUTIONS

John M. Abbott
Advisor to U.S. Executive Director
International Monetary Fund
(Former Panama Embassy Economist)

Yalcin M. Baran
World Bank, Washington

Leonardo Cardemil
International Monetary Fund, Washington

Judith Gold
International Monetary Fund, Washington

Luis Sánchez Masi
Inter-American Development Bank
Panama

Moazzam Mekan
World Bank, Washington

Felix A. Quiros
Advisor to Executive Director
International Monetary Fund

Fred Schiek
Inter-American Development Bank
(Former Dept. Ass't Administrator for AID/LAC)

Milan Zavadjil
International Monetary Fund, Washington

OTHER U.S. GOVERNMENT

Daniel E. Coates
Economist, Office of the Chief Economist, GAO

John Dawson
Director, Office of Panamanian Affairs
U.S. Department of State

Hon. Deane R. Hinton
U.S. Ambassador to Panama

Donald L. Patton
Assistant Director
Foreign Economic Assistance Issues, GAO

PANAMANIAN PRIVATE SECTOR

Raúl Alemán
General Manager
Banco General

Ricardo Alfaro
Banco Nacional de París

Nicolás Ardito Barletta
Economist
(Former President of Panama & Minister of Planning)

Héctor Castillo T.
Associate
Peat, Marwick, Mitchell & Co.

Ricardo Cazorla
Vice President
Chase Bank

Guillermo Chapman
President
INDESA

Fernando Barría
Vice President
Chase Bank

José Chong-Hon
Associate Director
Peat, Marwick, Mitchell & Co.

Alejandro Cordero
President
Association of Economists

René Díaz
General Manager
Banco International de Panamá (BIPAN)

Marco A. Fernandez
INCAE

Victoria H. Figge
President
APEDE

José Galán
INDESA

Rubén Lashman
Director del Centro de Estudios Económicos

Eduardo Lee
Associate
Peat, Marwick, Mitchell & Co.

Antonio Niño
Past President
APEDE

Domingo de Obaldia G. de P.
Executive Director
APEDE

Ricardo E. Ortega C.
Sr. Vice President
APEDE

Juan Pascual
Owner
Pascual Candy Manufacturing Co.

Paul Smith
General Director
Banco Continental

Eduardo C. Urriola
Vice President
Citibank

Octavio A. Vallarino
Owner, Empresas Vallerino

Ruben Lachman Varela
Director, Center of Economic Studies
APEDE

USAID/PANAMA

John Clary
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Harry Dorcus
Controller

Joslyn Fearon
Economist

Felipe Frederick
Economist

Kevin Kelly
Panama Mission Director

Bob Mathia
Project and Program Officer

Kermit Moh
Private Sector Officer

Jose Sanchez
Engineer

Nilka de Varela
Economist

Appendix B

STATEMENT OF WORK

ISSUES

The rationale for some components of the A.I.D. assistance program for Panama, and the assessment of the overall economic impact of the program, has raised the following issues.[1]

- Was the overall program conceptually sound in view of the immediate problems facing the economy?
- Did the program provide an appropriate balance between short-term and long-term measures?
- Was program implementation adequate for achieving both short and long-term measures?
- Did the short-term stabilization program contribute to the economic recovery?
- Did the rate of disbursement for both short and long-term measures affect the success of the various programs?
- Did the program help alleviate the lot of low-income population groups that suffered as a result of Operation Just Cause and related events?
- What were the most important program elements that provided the basis for sustained growth and development?
- How effective was A.I.D.'s administration of the foreign assistance program in Panama? Did A.I.D. establish appropriate and consistent benchmarks for disbursement of funds?
- Were there serious administrative problems that caused disbursement delays? How well did the Government of Panama (GOP) meet the policy and institutional reforms agreed upon? Were there differences with Panama in agreeing to and determining whether conditions were achieved? If the pace of Panamanian reforms did not meet expectations, did A.I.D. take the appropriate steps to ensure compliance?
- Did the information available to the planning team indicate that immediate action was necessary in the banking sector to improve liquidity and promote medium to

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[1]The controversy revolves around technical points made in reports by the office of A.I.D.'s Inspector General and, more recently, in press accounts of a draft report by the U.S. Government Accounting Office (GAO). The GAO report had not been submitted to A.I.D. at the time this scope of work was prepared. The GAO report was legislatively mandated.

long-term private sector investment? Was there a "crisis in confidence" that prevented the banks from carrying out their normal accredit activities? Was concern about the threat of a run on the banking system justified?

- Did emphasis on the banking sector compromise actions in other sectors that could have provided a greater amount of short-run benefits to the economy?
- What have been the economic impacts of the A.I.D. assistance program?
- Did the injection of the $107.8 million raise the level of private sector term investment? What are the channels through which the increased liquidity to the banking sector shows up in the economy? How can the economic impacts be measured?

EVALUATION TEAM TASKS

The team will provide a report to the contract officer that addresses the issues specified above, as well as other related issues raised in the press, the A.I.D. Inspector General's Report on Panama, and in a forthcoming GAO report (if it becomes available during the conduct of this evaluation). In the report, the contractor will specify appropriate indicators, both quantitative and qualitative, to assess and measure program impacts. The analysis will discuss whether the A.I.D.-administered assistance package:

- Was appropriate to the economic circumstances in Panama and the mandate of the Administration and the Congress,
- Was founded on sound economic reasoning and evidence,
- Served U.S. interests well, and
- Was adequate in terms of the political context in Panama.

Likewise, the analysis will evaluate program implementation bearing the same issues in mind. Moreover, it should address whether alternative program designs or implementation modes could have been more effective as circumstances in Panama changed during 1990 and 1991.

Based on its analysis of the Panamanian experience, the evaluation team will present recommendations regarding the most desirable future courses of actions, for economic assistance, under conditions similar to those of Panama in 1990 and 1991.

In such light the evaluation team will explicitly address in its analysis the questions relevant for the objectives of the evaluation, the issues raised above, and the tasks just mentioned. A nonlimiting set of questions follows; the analysis will address them, as well as any other question implicit in this scope of work. In addressing the questions, the analysis will elaborate on the theoretical and empirical foundations for its conclusions, indicate the lessons learned, and make clear recommendations for alternative action courses as appropriate.

Program Design

Taking into account the political and economic contexts, was the program well grounded on correct analysis and realistic in terms of goals and implementation means?

In connection with program design, was there adequate balance between short and long-term goals? Did the state of the economy in 1989 warrant the level and mix of programs recommended by the planning team?

Did A.I.D. react in a timely and effective way to changing circumstances in Panama? Did the amount of funding available for Panama affect the balance between short-term stabilization and removal of the obstacles to long-term development?

On the funding for private sector reactivation, was the need for additional liquidity in the banking sector a correct response, given the perception of a potential run on the banking sector after the elimination of controls on deposits and the installation of the government? Once the threat of a run on the banks diminished, was the continued injection of dollars in the banking sector appropriate?

Given conditions in the banking sector and the Panamanian economy, was the concept of providing funds to influence the term profile of loans sound? What was the impact of such funding on term investment? Was the mechanism under which the funding took place appropriate to influence additional term investment?

USG Planning

In view of the difficulty involved in negotiating with a fragile, newly established government, in a context where the legislative and the executive were fragmented, and in a country with a tradition of corruption in much of the public and private sector, was the internal decision making process in the U.S.G. adequate to ensure that:

a. the funds met their objectives and,
b. the opportunity costs of pursuing the program objectives remained reasonable?

Disbursements

Did A.I.D. exercise adequate leadership in connection with the allocation of funds and speed of disbursement? Did Washington provide appropriate and timely guidance on difficult policy issues?

Were the conditions agreed upon with the GOP for the disbursement of the economic recovery assistance package adequate for achieving program objectives? Was A.I.D.'s role in discussing the conditions, and in its interaction with other international funding agencies appropriate to the circumstances? If disbursement of the funds relating to helping the GOP settle arrears with the IFIs took longer than anticipated because of lack of agreement with other international organizations, did A.I.D. act appropriately by withholding disbursement? Could a more effective course of action have been taken? Once the disbursement took place, what was its impact?

Economic Impacts

Did the program have the desired macroeconomic impact on the Panamanian economy? What evidence exists, if any, that the growth in the Panamanian economy over the past two years would have occurred in the absence of the A.I.D. program? How much of the 4.6 percent and 9.3 percent real GDP growth in Panama in, respectively, 1990 and 1991 was due to the U.S. foreign economic assistance?

Did the program subcomponent designed to strengthen the public sector investment budget accomplish its intended objectives effectively and in a timely way? What was the impact of these funds?

Did the emergency needs assistance program effectively reach its target population groups in a timely fashion?

Did the increase in liquidity resulting from the banking program provide a basis for new activity in the private sector? What evidence is there to suggest that a primary catalyst was the A.I.D. program of providing additional resources?

METHODOLOGY

To meet evaluation objectives, and to address and answer all issues and questions raised in this scope of work, as well as other relevant issues or questions, the evaluators will work as a team making use of the comparative advantage of each team member.

As appropriate, the evaluation will build on the application of standard economic theory, and quantitative and qualitative methods to the issues at hand. In all aspects, the evaluation will take into account the political context—both in what relates to internal conditions in Panama, as well as U.S. interests as reflected in the relevant legislation and public statements.

The gathering of needed information will take place through review of pertinent documentation in Washington and Panama, and interviews with relevant USG and GOP officials, private sector representatives in Panama and in the U.S., and meetings with officials in other funding institutions.

DELIVERABLES

The evaluation team will present a written report which covers all the points mentioned in the preceding sections and which meet the objectives of the evaluation, no later than 40 days after the contract start date. Prior to the submission of the final version of the report, the contractor will submit to A.I.D.'s Center for Development and Evaluation a complete draft of the report and allow up to ten working days for comments from A.I.D. prior to the submission of the final version.

In addition to the written report, the evaluation team will provide oral briefings to A.I.D. and other interested officials on the main findings of the report. The briefings will take place on A.I.D. premises or in designated locations.

SCHEDULE

The evaluation team will start its work immediately after the outside contractor formalizes an agreement with A.I.D. The schedule calls for:

- 3 to 5 working days in Washington for document review and consultations
- up to 10 working days in Panama for document review and consultations
- up to 3 weeks back in the U.S., preferably in Washington, D.C., for the final report preparation and the oral debriefings.

The contract completion date is January 31, 1993.

Appendix C
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