

REPORT AND RECOMMENDATION  
OF THE  
PRESIDENT OF THE  
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT  
TO THE  
EXECUTIVE DIRECTORS  
ON A  
PROPOSED LOAN  
IN AN AMOUNT EQUIVALENT TO US\$60.2 MILLION  
TO  
THE REPUBLIC OF PANAMA  
FOR A  
STRUCTURAL ADJUSTMENT LOAN.

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# IBRD : STRUCTURAL ADJUSTMENT LOAN TO THE REPUBLIC OF PANAMA

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## CURRENCY EQUIVALENTS

Currency Unit = Balboa (B/.)  
US\$1 = B/.1

Note: The issue of Balboas is restricted to coins. The US Dollar (US\$) is accepted as currency.

## Fiscal Year

January 1 - December 31

## WEIGHTS AND MEASURES

Metric System

## GLOSSARY OF ABBREVIATIONS

BDA	-	Banco de Desarrollo Agropecuario (Agricultural Development Bank)
BHN	-	Banco Hipotecario Nacional (National Mortgage Bank)
CALV	-	Corporacion Azucarera La Victoria (La Victoria Sugar Corporation)
CFF	-	Compensatory Finance Facility
COFINA	-	Corporacion Financiera Nacional (National Finance Corporation)
COBAPA	-	Banana Corporation
CSS	-	Caja de Seguro Social (Social Security Agency)
EEC	-	Empresa Estatal de Cemento (Bayamo) (Cement State Corporation)
ENS	-	Empresa Nacional de Semillas (National Seed Company)
ENM	-	Empresa Nacional de Maquinaria (National Machinery Company)
IDB	-	Interamerican Development Bank
IMA	-	Instituto de Mercadeo Agropecuario (Institute of Agricultural Marketing)
ISA	-	Instituto de Seguro Agropecuario (Institute for Agricultural and Livestock Insurance)
MICI	-	Ministerio de Comercio e Industrias (Ministry of Commerce and Industry)
MIDA	-	Ministerio de Desarrollo Agropecuario (Ministry of Agriculture and Livestock Development)
MIPPE	-	Ministerio de Planificacion y Politica Economica (Ministry of Planning and Economic Policy)
MIVI	-	Ministerio de la Vivienda (Ministry of Housing)
OPE	-	Office of Projects Execution
PAHO	-	Pan American Health Organization
SAL	-	Structural Adjustment Loan
TAL	-	Technical Assistance Loan
UNDP	-	United Nations Development Programme
USAID	-	U.S. Agency for International Development

PANAMA

STRUCTURAL ADJUSTMENT LOAN

LOAN SUMMARY

Borrower: Republic of Panama

Amount: US\$60.2 million equivalent, including a capitalized front-end fee of US\$160,000.

Terms: Payable in 15 years, including 3 years of grace, at the standard variable interest rate.

Loan Description: The proposed loan would support the Government's structural adjustment program and economic recovery by directing economic activity towards areas of Panama's comparative advantage. The strategy aims at creating new growth opportunities by re-orienting the economy towards accelerated production, by the private sector, of goods for export. The main areas covered include (i) greater efficiency in both the allocation of resources within the public sector and reduction of its scope; (ii) re-orientation of agricultural pricing policy and State intervention in the agricultural sector so as to encourage greater efficiency and a higher volume of goods for exports; (iii) stimulation of a competitive export-oriented industrial sector (iv) strengthening of the Social Security Agency's ability to meet its current and future managerial and financial obligations; (v) improvement of the equity, effectiveness and efficiency of the Health System, as well as the determination of methods to finance the health services (vi) optimum utilization of the existing transport infrastructure in the area of the Canal Zone, which is of considerable economic importance as an inter-ocean service and transportation link.

Benefits & Risk: The main benefits of the program would be improved management and performance of the Panamanian economy, higher growth, and employment and increased export earnings. The main risks associated with the SAL is possible delay in implementation of the agreed recommendations of the technical assistance studies. Such risk is minimal since a consensus exists between the Government and the major opposition parties on the need for the new direction of the economy. Close monitoring would also be maintained and counterpart staff would be closely involved in carrying out the studies and their recommendations.

Disbursement  
Estimates:

Bank FY84      US\$60.2 million

Appraisal  
Report:

None



INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE IBRD  
TO THE EXECUTIVE DIRECTORS ON  
A PROPOSED STRUCTURAL ADJUSTMENT LOAN  
TO THE REPUBLIC OF PANAMA

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1. I submit the following report and recommendation on a Proposed Structural Adjustment Loan (SAL) to the Republic of Panama for the equivalent of US\$60 million. The loan would have a term of 15 years, including 3 years of grace, with interest at the standard variable rate.

PART I. THE ECONOMY

2. An Economic Memorandum entitled "Panama: Special Economic Report on Metropolitan Unemployment" (3833-PAN) was distributed to the Executive Directors on June 7, 1982. Since then, there has been a sustained dialogue between the Government and the Bank leading to the development of a policy framework to confront the challenges of a more difficult international economic environment. The Government first formally requested a SAL in December 1982; after a series of identification missions, an appraisal mission for the proposed loan visited Panama in June 1983. Country data are given in Annex I.

A. Main Features of the Panamanian Economy

3. Panama's geographic location has traditionally determined its economic development. Situated strategically on a narrow isthmus, joining North and South America, midway between Europe and Asia, Panama functioned as an important center for Spanish colonial trade for nearly four centuries. Following independence from Spain, this entrepot role was enhanced by two major investments in the transport infrastructure. The first was the building of the trans-isthmian railway in the 1850's. The second, of much greater significance, was the construction of the Canal in the early years of this century. The Canal, and the employment and income it generated, brought relative affluence and economic growth until the early 1970's.

4. Panama has capitalized on its geographic location and international transport facilities to build an important export-oriented service sector. The main areas of recent expansion have been in banking, tourism and international commerce. During the 1970's, the banking sector grew by 11 percent per year in response to legislative incentives. By 1982, there were about 120 banks physically established in Panama, among them subsidiaries of leading money center institutions; they employ over 7,000 people. Tourism has grown by 10.6 percent per year since 1970. The activities of the Colon Free Zone--warehousing, display and transshipment of merchandise mainly towards the markets of Latin America--expanded by an annual 14 percent. By 1982, these and other services accounted for 70 percent of total value added.

5. The growth of export-oriented services has been facilitated not only by Panama's geographic location and transport infrastructure, but also by its financial characteristics which are unique to the Region. There is no Central Bank, the U.S. dollar circulates inside the country and there is no restriction on the movement of capital. Because of this dollar standard, there is no foreign exchange constraint in the conventional sense, and the country's credit-worthiness is directly linked to Government finances. It is easily monitored through such indicators as the size of the public deficit in relation to GDP and the Government's ability to meet all debt obligations as they come due. Moreover, the extent to which relative and absolute factor and product prices can be manipulated by Government intervention is limited.

6. The historical importance of the Canal has concentrated economic activity in the two terminal cities, Panama City and Colon. Today, the metropolitan area formed by these two cities and the corridor between them, adjacent to the Canal, contains more than half the nation's population and produces over 70 percent of total value added. Panama's essentially urban nature contributes to its relatively high standard of living with the Region. Per capita income in 1981 was approximately US\$1,900 compared with an average of US\$930 for Central America and US\$1,700 for Latin America and the Caribbean as a whole.

#### B. Political Background

7. A major watershed in Panama's modern history occurred in October 1968, when the National Guard overthrew the Government of President Arnulfo Arias and soon thereafter established a new administration under the de facto control of General Omar Torrijos. The Torrijos Government had three major goals: to increase national economic sovereignty, particularly over the Panama Canal; expand the Panamanian political and social process to the rural poor and urban workers; and deepen the country's development process, stimulating growth through increased and diversified exports and investment in human resources. The high point of the regime was reached in 1979 with the signing of a Canal Treaty with the United States. Following this, the Government reduced the military control of the country and began a gradual restoration of democratic institutions. In the economic field, more emphasis was placed on the role of the private sector which partially restored confidence following a period of uncertainty associated with the Canal Treaty negotiations.

8. After the accidental death of General Torrijos in July 1981, Panamanian politics went through a turbulent year, as political leaders began to jockey for power. The prior fiscal austerity was relaxed and several public sector agencies exceeded their budgets by wide margins. There was considerable uncertainty as to the direction of policy, particularly in the economic field. In April 1982, General Torrijos' successor as head of the National Guard was replaced by General Ruben Dario Paredes; President Aristides Royo resigned in August and was replaced by Vice-President Ricardo de la Espriella. A new Constitution, laying the foundations for presidential and congressional elections was approved by popular referendum in May, 1983. Also, political parties have been legalized and campaigning for the presidential elections, scheduled for mid-1984, is to begin in September.

9. Despite this uncertain political atmosphere, the Government has shown its determination to confront a deteriorating economic situation and carry through a number of necessary measures. Not only have strong budgeting control and discipline been restored, but the Government has also embarked on a program of fundamental structural reforms which, although politically unpopular in the short-term, are vital for medium-term economic recovery.

10. The results of the forthcoming elections will likely not threaten the ongoing process of structural adjustment: there is widespread consensus concerning the economic outlook and the measures necessary to confront its challenges. Moreover, the principal opposition parties represent factions which also favor policies encouraging private initiative.

### C. Past Economic Trends and Recent Changes

11. The 1960's saw rapid economic expansion in Panama, with GDP growth averaging 8 percent per year (or 5 percent per capita). Much of the impetus came from buoyant-Canal related activities, and the effects of the Remon-Eisenhower treaties which transferred some economic activities from the Canal Zone to Panama. Real agricultural output increased by nearly 5.3 percent per year, based largely on expansion of grass-fed beef production and on increased output of bananas following important disease eradication measures. These were major factors contributing to a substantial growth of exports. Industrial growth was also strong, with a 10.9 percent annual average increase in real value added, though most of this was directed towards the domestic market. Almost as impressive was the growth of the construction and services sectors at over 8 percent per year. It was during this period that the petroleum refinery near Colon began operations, selling its output in the form of bunker to ships traversing the Canal as well as refined products for home consumption and for export to third countries. Other important service activities included the rapid expansion of the Colon Free Zone, which had been established in the early 1950's. The principal source of investment finance and entrepreneurial talent for this growth was from the private sector. Private domestic savings averaged about 15 percent of GDP, while private investment increased at a real 12.5 percent between 1960 and 1970, rising from 11.9 percent to 18.0 percent of GDP. Total employment grew at 3.5 percent per year, well in excess of the 2.5 percent annual increase in population. Nearly all the expansion in employment opportunities was provided by the private sector, and occurred in the urban areas; in the agricultural sector, employment expanded at only 0.7 percent per year.

12. The benefits of this rapid development were, however, concentrated in relatively few hands. Real wages were held down; the nominal minimum salary remained constant between 1960 and 1963. Acute poverty persisted, mostly in the countryside. Moreover, the social and economic infrastructure, particularly in rural areas, were inadequate to ensure continued economic and social improvement outside of the metropolitan corridor.

13. Accordingly, the development strategy initiated by the Torrijos Government in 1968 aimed at major social reforms while attempting to sustain growth through increasing and diversifying exports. Greater national integration was achieved by increasing and improving the communications and linkages among the regions of the country; social improvements were made by supporting human resources development, agrarian reform and the provision of basic needs, and by strengthening the country's institutional framework. The strategy was executed through expanded and improved social services (particularly in health and education), through the development of infrastructure by constituting public utilities (electricity, telephones, water) into single state entities, and by an ambitious public investment program. Private investment was encouraged, especially in the construction and service sectors linked to the international transportation systems. Panama's status as an entrepot center was enhanced by legislation of 1970 which led to the establishment of a major international banking sector. It was given further impetus by public sector investments in the international airport, tourism infrastructure, rapid expansion of the international free zone, an international re-insurance center, the growth of commerce, and other export services. The system of hydro-electric generation, roads, educational, water and health facilities which was built up throughout the country provided services to wide sections of the population which had not previously enjoyed them.

14. Initially, this strategy was successful in combining growth with social reform; between 1968 and 1973 real GDP rose by 7.3 percent per year. However, from 1973 to 1977, the economy was adversely affected by both external and domestic developments. The increase in world oil prices and inflation brought about international economic uncertainty, while Canal activities slowed after the end of the Vietnam war in 1973. Domestic uncertainty stemmed mainly from the intensive Canal Treaty negotiations. Per capita income stagnated and private investment fell in absolute terms by over 50 percent between 1973 and 1977 (or from 20.4 percent of GDP to 6.8 percent). Private sector confidence was also undermined by some actions which adversely affected the entrepreneurial environment. Among these were a highly restrictive Labor Code, price controls, housing rental regulations and exaggerated concentration of subsidized credit and technical assistance on the state supervised agricultural cooperatives. These regulations were not only inimical to the growth of agricultural and industrial output; they were also costly in fiscal terms. The increased state subsidies and high support prices were absorbing nearly 15 percent of Central Government revenues. Public sector employment grew at an annual 12.2 percent and accounted for over 80 percent of the new jobs created. In the 10 years ending in 1977, real public consumption grew by 7.5 percent per year compared to 4.7 percent for GDP.

15. The Government compensated for the retrenchment in private sector activity through further investments in large infrastructure projects (a fishing port, Convention Center, hydroelectric power, extended telecommunications systems and an improved national road network), and by the creation or acquisition of a number of directly productive enterprises. These included four sugar mills, two banana corporations, a cement plant, a citrus plantation and several agro-industries and agricultural/regional development corporations. Public investment increased from an average of \$79.1 million per year between 1968 and 1973 to \$271.6 million per year

between 1974 and 1977, or from 7.0 percent to 13.7 percent of GDP. During the latter period, it accounted for half of total investment compared with only a quarter during 1968-73.

16. Without additional revenue measures, the cost of this expansion was quickly reflected in a sharp increase of the public sector deficit: from an average of 5.6 percent of GDP in the five years ending in 1974, to an average of 15.6 percent in 1976-78. Owing to the absence of a Panamanian central bank and an independent currency, the deficit had to be financed through dollar-denominated debt, whether locally or internationally issued. Thus, public sector medium-term debt increased from \$195 million (18.6 percent of GDP) in 1970 to \$1,940 million (nearly 80 percent of GDP) in 1978.

17. After 1978, the public sector entered into a period of retrenchment as several large capital projects were completed, no further state enterprises were created, and the Government began a sustained effort to reduce the public deficit through increased taxes and tighter controls on expenditures. The deficit was reduced from 15.4 percent of GDP in 1978 to 11.8 percent in 1979, and to 5.2 percent in 1980. This improvement was maintained in 1981, so that the country fully complied with the targets established under IMF Standby Arrangements.

18. This improvement in public finances was accompanied by some restoration of private sector confidence. This was enhanced by the ratification of the Torrijos-Carter Canal Treaties in 1979, and by the introduction of new export, investment and employment incentives. These covered not only direct financial assistance to exporters (through redeemable tax certificates called CATS based on a percentage of value added), but also tax exemptions and a more flexible interpretation of Labor Legislation for certain specified categories of export-oriented industries. However, private investment did not recover to the levels of the 1960's and early 1970's. Between 1978 and 1982 it was still less in real terms, and as a percentage of GDP, than between 1968 and 1973. Furthermore, although the service and construction sectors once again flourished, agriculture and industry continued to be adversely affected by the policy and institutional environment. Real per capita agricultural output was less in 1982 than in 1977, while industrial value added declined from 11.5 percent of GDP to 9.8 percent.

19. In 1982, Panama began to feel the impact of the world recession in general, and of the deepening economic and financial crisis in Latin America in particular. Growth in the financial sector was less than half that of recent years, while value added in tourism and in the Colon Free Zone declined sharply. Private investment fell in real terms following the completion of the trans-isthmian oil pipeline project in 1981. Partly to compensate for this, and partly because of increased political pressures (para.8), controls on public expenditure were loosened. Several entities exceeded their capital budgets by wide margins, particularly the public electricity company, IRNE, and the Social Security Agency. Meanwhile, public revenues were adversely affected by the economic slowdown, and by mid-1982 it had become clear that Panama's fiscal targets would be grossly exceeded. The consolidated public sector deficit for the year as a whole was 11 percent of GDP, almost double the amount stipulated in the Government's Standby

Arrangement with the IMF. Public investment was over 12 percent of GDP as against a target of 10 percent. Net foreign borrowing by the public sector amounted to over \$500 million, and the outstanding public medium-term debt reached \$3.1 billion at the end of 1982, equivalent to 73 percent of GDP. Interest on the debt absorbed over 30 percent of total Government revenues <sup>1/</sup>.

20. The recession deepened in late 1982, and in 1983 real GDP is expected to stagnate. The necessary fiscal adjustment (paras. 25-27) is inevitably having a contractionary effect on economic activity—especially the construction sector—while access to foreign bank credit is now severely limited. Through 1984, there will likely be little if any growth in the traditionally buoyant sectors of the economy. The banking sector has reached an advanced stage of maturity, while the Colon Free Zone and tourism are dependent upon financial and economic recovery in the rest of Latin America. This is unlikely to materialize before 1985. Reduced Government spending will, in the absence of compensating investment by the private sector, lead to further deterioration in the employment situation; unemployment is already estimated at about 20 percent of the available labor force in the urban metropolitan area.

21. In the face of these difficulties, the Government has formulated a new medium-term development strategy. This strategy, which has already been translated into a number of important actions, involves remedying existing policy inconsistencies, encouraging private investment, promoting and diversifying exports and improving public sector efficiency.

#### D. The Government's Development Strategy

22. The principal objectives of the Government's development strategy are the creation of new employment opportunities and the reorientation of the economy towards a new growth path. Given the small size of the domestic market and the limited prospects for the service and public sectors, these opportunities must be sought in Panama's external markets for goods and services through the accelerated production of goods for export. Such a strategy would be fully consistent with Panama's comparative advantages and its unique economic characteristics (paras 3-6). These assets could be a springboard for access to foreign markets provided industrial and agricultural goods are produced at competitive cost.

23. Given the country's relatively high wage structure, efficiency in agricultural and industry must be increased to improve competitiveness and reduce upward pressures on wage rates. In many countries increased wage competitiveness can be achieved through an adjustment in the exchange rate. Panama's monetary structure rules this out, and it is therefore necessary to address the causes of inefficiency both directly and individually in each sector of the economy. Since the financially weakened public sector can no longer expand in relative terms, the private sector is to be the main source of investment finance and entrepreneurial talent. Public sector intervention is to be restricted to the provision of the necessary social and economic

<sup>1/</sup> Defined as the current revenues of Central Government and autonomous agencies plus the current surplus of the public sector enterprises.

infrastructure, much of which is already in place. In order to release resources for growth-oriented activities, public sector expenditures are being rationalized. This involves reductions in subsidies and the sale, close-down or restructuring of loss-making public enterprises. State intervention in product and factor markets is to diminish. Price controls are to be greatly reduced and the question of the Labor Code addressed in order to bolster private sector confidence. Industrial incentives are to be directed more towards exports and less towards import substitution. Consequently, the scope and depth of effective protection is to be substantially reduced. Similarly, the bias inherent in the current incentive structure in favor of capital-intensive production techniques is to be reversed. So as to increase efficiency and productivity in the agricultural sector, policies are to be re-oriented towards higher production at competitive prices and less towards the redistribution of income.

24. This process of structural adjustment will take some years to complete. Moreover, it can only be fully successful if the economies of the OECD and Latin America recover in the mid-1980's together with world trade and services. If this occurs, the Government visualizes Panama as having a more open, export-oriented economy in which the efficiency of the productive sectors would be on a par with that already achieved by Panama's international services. A more fully employed urban workforce would be dedicated to a broader variety of industrial and service tasks undertaken at competitive world costs. Clearly the policy is not without risk, but Panama's private sector responded well to market signals in the 1960's. Furthermore, the strategy is based on the Government's recognition that re-orientation towards the export of goods provides the best, if not the only, alternative to continued economic stagnation and increasing unemployment.

#### E. Short Term Stabilization Measures

25. To provide the necessary context of financial stability for its new development strategy, the Government is now carrying out a major fiscal adjustment to reduce the public sector deficit to no more than \$270 million in 1983, or about 6 percent of GDP. Additional revenue is being raised through an increase in the minimum tariff and crude petroleum import taxes. Substantial cutbacks are planned in current and capital expenditures (paras 34-41). Except for school teachers and low-paid workers, who were given public assurances of wage increases in mid-1982, no increase in wages is allowed in the 1983 Budget. External commercial borrowing by state entities is now coordinated by the Ministry of Planning which has created the new post of Director of Public Credit for this purpose.

26. These measures led to successfully concluded negotiations with the IMF for a two year Standby Arrangement of SDR 150 million (about \$173 million) of which one third will be available in CY1983 and the rest in CY1984. The IMF Board approved the Standby in late June, 1983. In addition, Panama will receive some \$60 million in 1983 from the Compensatory Financing Facility. The main conditions attached to the Standby, which will be monitored every three months, are a public sector deficit of no more than 6 percent of GDP in 1983 and 5.5 percent in 1984, and no net increase in commercial foreign borrowing in 1983 or 1984 by the public sector.

The current account saving and gross borrowing requirement implied by the program agreed with the Fund are shown in Table 1.

Table 1: SUMMARY PUBLIC FINANCES  
(US\$ Million)

	1979	1980	1981	1982	1983	
	Actual			(Prel.)	(Proj.)	% of GDP
				(\$ million)		
Public Sector Savings	-42.4	126.7	172.8	60.6	120	2.7
Capital Expenditure	303.6	299.8	390.1	524.6	390	8.7
Overall Deficit	346.0	173.1	217.3	464.0	270	6.0
Amortization	191.3	213.8	215.2	388.2	280	6.2
Gross Borrowing Requirement	537.3	396.3	460.8	852.2	550	12.2

27. While this program will reduce the deficit in the short term, it is important to point out that Panama already has a relatively highly taxed economy; the tax burden is about 20 percent of GNP. Consequently, the structural requirement for a lower public sector deficit must primarily be met through a rationalization of expenditures rather than further taxes. Thus, as part of its medium term structural adjustment program, the Government is to reduce the scope of the public sector and make the remainder more efficient.





## PART II - THE STRUCTURAL ADJUSTMENT PROGRAM

### A. Introduction

28. The policy measures designed to give practical shape to the Government's medium term development strategy may be divided into three main areas: first, to reduce the scope and improve the efficiency of the public sector; second, to reorient the incentive structure in the urban, industrial sector; and, third, to increase productivity and output in the agricultural sector. Changes in the latter two areas are designed to permit and encourage accelerated agricultural and manufactured exports. In the services and energy sectors, there is little need for structural reforms. The former already benefits from a favorable legislative regime and substantial private sector participation. In the energy sector, as indicated in a recent Bank sector review, pricing policy is generally adequate (regular grade gasoline retails at US\$2.10 per gallon) while recent measures have been taken to enable the private petroleum company to operate at lower unit cost. IRHE, the public power company, is well run and makes the legal 3.75 percent return on its assets. Moreover, the Bank has had a direct and beneficial influence on the energy/power sector through project lending and related institution building.

29. The Government has already taken a considerable number of important actions in each of the three areas emphasized in its program. The following sections review the progress achieved and describe further actions which the proposed loan supports.

### B. Public Sector Efficiency

#### Overview

30. The financial constraints that the public sector is likely to face in the years immediately ahead make it of vital importance that policies be aimed at fostering greater efficiency in the allocation of resources. Accordingly, the Government's structural adjustment program is concentrating reforms in those areas of public sector activity which are significant and continuous sources of fiscal drain; which result in the misallocation of resources through, for example, inappropriate pricing policies; and which suffer from inadequate institutional or budgetary control. The overall aims of the reforms would be to significantly increase public sector savings both absolutely and in relation to GDP in order to release resources for the private sector; to reduce the scope of the public sector's investment activities to the provision of the necessary infrastructure for private sector activities; and to improve the maturity structure, and hence reduce the servicing burden, of the public external debt.

31. The major components of the Government's action program for improved public sector efficiency include: (i) a major review of public sector enterprises; (ii) the preparation of a coherent investment program for the period 1983-1985 consistent with the priorities of the new development strategy; (iii) reform of public sector housing policy; (iv) reform of the

public health and social security systems; (v) more effective management of state-owned assets especially those located in the old Canal Zone, recently reverted to Panama; (vi) reform of the Customs Administration; and (vii) improved public sector debt management.

### Public Sector Enterprises

32. In February, 1983, the Government concluded a comprehensive financial review of all State enterprises and decentralized agencies, concentrating on those that have been dependent on large government subsidies. As a result, a number of these entities have been liquidated and the operations of others, which still have the potential of becoming economically viable, have been rationalized. Some of these operate in the agricultural sector and are discussed in paragraphs 30-32 below. Actions taken or planned for other entities will together result in immediate savings equivalent to about 12 percent of the 1983 public sector deficit and eventually lower public sector product prices. The principal reforms are the following:

- In January, 1983, a major, money-losing hotel was sold to a group of Japanese interests. The Government, which had guaranteed the loan to the hotel, had inherited it when the hotel encountered financial difficulties. The sale price was \$34 million; since its cost to the Government had been \$54 million, it was publicly forced to accept a major loss. Plans are well advanced for the sale of another money-losing hotel (La Contadora Panama) for which specific offers are currently being considered.

- On March 14, 1983, the Government announced a timetable for ending the contractual arrangement by which the state-owned cement company, Cemento Bayano, cross-subsidizes the only private cement company operating in Panama by charging a higher final price for cement. This will permit, by May, 1984, a 35 percent drop in the domestic cement price. The Government is studying further means of improving the efficiency of Cemento Bayano, including switching from fuel oil to use of coal.

- The Government is now undertaking a major restructuring of its development finance corporation, COFINA. A recent analysis of its portfolio revealed losses of some US\$37 million in nonrecoverable loans and interest. A new manager, appointed in August, 1982, has commenced the difficult task of recovering as much as possible from the portfolio and restructuring the Corporation's ownership with a view to only a minority of the shares being held by the Government. In April, 1983, COFINA engaged a well-known international auditing company to carry out a full financial audit and an evaluation of the portfolio as of June 30, 1983. Targets have also been set for substantial staff reductions and other measures designed to permit a more efficient operation.

- The Government is actively considering a number of options for divesting itself of all or part of the national airline, Air Panama. After making heavy losses for a number of years, the airline's debts were taken over by the Central Government from COFINA in June, 1981. The accumulated deficit of Air Panama on December 31, 1981 (the latest date for which comprehensive data are available) was US\$30.9 million compared to total assets of US\$17.4 million) while the loss for the calendar year 1981 was

US\$3.1 million. The authorities are considering selling part of the enterprise to another international airline (with the Government having assumed the net liabilities); or disposal of the physical assets together with sale or leasing of the routes and landing rights to other international carriers.

33. While the majority of other non-agricultural entities do not require current subsidies, the Government recognizes the scope for increasing their efficiency and hence reducing their cost to the consumer. Accordingly a number of studies are to be commissioned to determine how costs can be reduced in the context of each agency's individual circumstances. Some of these are already supported by Bank project loans (e.g.. technical assistance to the Port Authority, institution building in the power and water utilities) while others will likely be financed by other multilateral or bilateral agencies. This work is expected to be completed by late 1984, so that recommendations may be implemented by the newly elected Government.

#### Public Investment

34. The preparation of the public investment program in Panama is the responsibility of the Direction of Economic and Social Planning in the Ministry of Planning and Economic Policy (MIPPE). This Ministry, and not that of Finance, also produces and monitors the current budget. The investment budgets are prepared with a high standard of professional competence, and the institutional framework for the formulation of a coherent investment program is therefore in place. Estimates of financial requirements are prepared on a project by project basis by each Ministry or agency, but the overall responsibility for matching them with available financial resources belongs to MIPPE. General development policy objectives are detailed on a sector by sector basis, and the total investment requirement for each sector determined accordingly. Considerable importance is now attached to the calculation of economic rates of return, and the staff of MIPPE who prepare the budget are well versed in the techniques of project appraisal. Controls have been tightened, and rare departures from the MIPPE budget must be approved by the Finance Commission, a body which includes the entire Economic Cabinet, and is chaired by the Vice President of the Republic. These controls are applied not only to individual Ministries but also to each autonomous entity, while all public borrowing (short, medium and long term) is now monitored by, and subject to the approval of, the new Director of Public Credit, also in MIPPE (para 57).

35. These procedures represent a considerable improvement upon past practices. Previously, although the Government's development program was theoretically sound, control of investment expenditures was often poor in practice. A number of projects, particularly in the agricultural, transport, tourism and housing sectors, were initiated without clear economic justification. Others went ahead without being included in the budget. These latter were frequently financed from the current savings of the entity concerned or by its independently borrowing commercial funds.

36. Within the context of preparation of the proposed SAL, the Government has focussed on further improving the quality of the 1983-85 investment program. The 1983 budget involves a reduction of 26 percent from 1982 and 29 percent from the amount originally requested by the different

Ministries and agencies. Investment <sup>2/</sup> is budgeted at US\$389.5 million compared with US\$516.9 million in 1982. These cuts have necessitated a careful reconsideration of priorities and the program has been formulated in strict accordance with economic criteria and the demands of the new development strategy. The Government's freedom of action in making cuts was severely limited by the substantial cost overruns of the vital La Fortuna project. This now accounts for over one fifth of total budgetted capital expenditures in 1983. Almost all other outlays of the public electricity company have been deferred. Most of the projects left out have less pressing priority, while nearly all those that remain are economically sound. Profitable state entities, such as the telephone company and the Airport Authority are to be restricted to investments financed from their own resources. Because of its critical financial situation, the State Finance Corporation, COFINA, is being restructured and is permitted no new net lending. The inefficient state sugar corporation is also being reformed; its highest cost mill was recently closed (para 81), and the other three are being rationalized, so that no new gross investment is proposed. Most transport investments are for necessary maintenance and rehabilitation, since a developed infrastructure is largely in place. Despite diplomatic and contractual difficulties, the Government cancelled a low priority but expensive (approximately US\$200 million) Canal bridge project sponsored by a neighboring country. A US\$30 million road project with a low economic rate of return has also been dropped. Nearly all the projects remaining in the budget, which are not to be financed from internally generated resources, are supported by bilateral and multilateral aid agencies. Loans from concessionary sources are expected to finance almost half of total net outlays in 1983 and 1984.

37. After the severe curtailment of 1983, capital expenditures are projected to fall slightly in nominal terms in 1984, to US\$388.7 million thereby implying a sharper reduction in real terms, and as a percentage of GDP (from 8.7 percent in 1983 to 7.9 percent in 1984). In 1985, a small nominal increase is foreseen to US\$392.3 million, though this will again likely signify a real reduction. According to economic projections prepared by Bank staff (paras 95-105), this implies that public investment will have fallen to 7.2 percent of GDP in 1985. This is consistent with the Government's medium term target of substantially reducing the share of public sector investment in the GDP from the average of 13 percent prevailing between 1976 and 1982 to about 7 percent by the mid 1980's. It is expected that the institutional procedures established in 1983 to increase control over the execution of the budget and approval of new projects will be retained and strengthened.

38. The sectoral priorities of the 1983-85 program are reasonable and in accordance with the structural adjustment strategy (Annex VI, page 2). Investment in the directly productive sectors would represent about 25 percent of total public investment over the period, and about 75 percent of this would be in agriculture. Emphasis in this sector would, as in the past, be on direct credit to farmers, irrigation projects and shrimp farming.

This refers to net investment by the nonfinancial public sector and does not include credits from financial entities financed out of loan proceeds.

Resources are also set aside for projects to stimulate production of raw materials for local agroindustries.

39. In energy, which accounts for about one fifth of total expenditures, the Fortuna project dominates, absorbing practically all resources in 1983 and about 40 percent thereafter. This project will enable virtually all demand to be met from hydroelectricity from 1985 onwards, leading to anticipated savings of US\$65 million per year. In 1984 and 1985, there will be important projects for improving transmission and distribution systems for which Bank support is being requested. After revising demand forecasts, IRHE has postponed initiation of the next major hydroelectric project (Changuinola) until the end of the decade.

40. Infrastructure investment other than energy amounts to about 21 percent of the total. As already indicated, most transport expenditures are for rehabilitation and maintenance, the exception being the continuation of Bank-supported port improvements and a low cost improvement to the urban transport infrastructure in Panama City and other centers.

41. Social sector investment would represent about 27 percent of expenditures in the 1983-85 period. Outlays are being significantly reduced from the high levels recorded up to the end of 1982. Over half the contemplated investment is in public housing and community projects where the emphasis is on providing adequate shelter for poor urban communities. Severely deteriorated slum areas of Panama City and Colon are to be provided with low cost apartment buildings. The Colon Urban Development Project (Loan No. 1873) of August 7, 1980, supports part of this program. In the health sector, the program emphasizes rehabilitation and remodeling of existing hospitals and health centers as well as Bank-supported improvements in water supply and sewerage facilities. The education sector has been sharply cut back in the light of an already well-developed infrastructure, and again the program concentrates on the upgrading and rehabilitation of existing facilities.

#### Public Sector Housing Policy

42. As part of its structural adjustment program, the Government has recently taken a number of important measures designed to strengthen institutions and financial control in the public housing sector. Prior to these reforms, the sector's financial situation was becoming increasingly precarious.

43. Since its creation in 1973, the Ministry of Housing (MIVI) has rapidly increased its housing construction from a level of 1,200 units to over 6,000 per year in the early 1980's. The purchase of these low income houses is normally financed by loans from the National Mortgage Bank (BNM), which was established as a subordinate agency of MIVI to undertake the financial management of the Ministry's activities and also promote the expansion of private housing finance. This expansion was to be achieved by strengthening the savings and loan system and, eventually, by creating a secondary mortgage market.

44. Up to the end of 1982, little progress had been made in achieving these objectives. In a number of cases, MIVI housing projects were initiated

without proper control or disbursement procedures, and in the absence of any guarantees that the necessary finance would be forthcoming. This frequently led the BHN to obtain external commercial credits to supplement its finances; the terms and conditions attached to these loans were inconsistent with the nature of the bank's portfolio and its activities. Moreover, interest rates on BHN loans were fixed arbitrarily on a case-by-case basis by MIVI. In some cases, rates were granted which were insufficient to cover costs and ensure recuperation of the loan.

45. The situation became further complicated in 1981 and 1982 by the intervention of the Social Security Agency (CSS) in direct mortgage financing at heavily subsidized rates of interest. This impeded efforts by the BHN to establish a more realistic interest rate structure. In addition, the CSS program grew beyond the Agency's management capacity (over US\$.100 million were spent in 1981 and 1982) with consequent control failures and substantial losses. As of mid-1983 the total losses had still not been finally determined, but are estimated to have exceeded US\$.40 million.

46. To ameliorate this situation, the Government has carried out a number of important reforms. The CSS has formally undertaken not to engage in further direct mortgage financing. This would be a condition of the proposed SAL (Section .... of the draft Loan Agreement). Instead, the Agency will invest in BHN bonds. A procedure has been established by which MIVI only receives money from the BHN for projects backed by proper studies, which meet the correct social criteria; also disbursements will only be made against vouchers of work performed. Projects cannot commence until MIVI has received formal assurance from the BHN that there are funds available to finance them. The BHN will no longer be permitted independent and uncontrolled access to commercial bank credit, while its direct Central Government subsidy is to be gradually eliminated. Consequently, it is to rely much more on loan recoveries, bond placements with the CSS and loans on favorable terms and conditions from concessionary agencies. The BHN has also revised its interest rate policy. All future loans will carry a standard rate of interest, initially of 10 percent annually for low income housing, which will be sufficient to cover the cost of finance to the bank, plus its operating expenses. The Government has announced its intention to gradually adjust the rate towards full compatibility with market conditions.

#### Social Security and Health

47. The Social Security Agency (CSS) is financially the most important public sector institution outside the Central Government. In 1982, the CSS had a total cash income of nearly US\$.320 million (7.6 percent of GDP), generated cash savings of US\$.52 million (1.2 percent of GDP), and was responsible for nearly one fifth of the total public sector capital expenditure. Despite its apparently healthy current financial situation, there is growing recognition that the CSS will face serious financial problems in the medium term unless remedial action is taken. These problems, should they arise, will be extremely difficult to solve in Panama where the authorities have no recourse to Central Bank finance to cover shortfalls. A financial crisis in the social security system would, therefore, have potentially grave political as well as economic consequences.

48. After the change of Government in August 1982, a new management team was appointed to the CSS. This team has reversed the short term difficulties associated with the Agency's intervention in direct housing finance and is now concerned with the more fundamental problems. These include an inappropriate management and decision making structure, lack of adequate statistical and internal financial information, the absence of an accurate, up-to-date actuarial evaluation and an inappropriate investment policy. The CSS's coverage is continuously being extended in all three of its principal areas of activity, which are health and maternity; old age, disability and death; and professional risks. Not only this, but benefits are sometimes increased without always considering the consequences for the CSS's long term financial viability.

49. Another area of concern which is intimately linked to the financial well-being of the CSS is that of the Integrated System of Health Care. This is meant to cater for low income patients located in areas outside the main Metropolitan Zone of Colon-Panama City. In theory, it is operated jointly with the Ministry of Health, but since the Ministry's budget is insufficient, it is the CSS which in practice finances the System. The quality of service is generally poor and there is a considerable amount of wastage.

50. In order to tackle these sensitive and complex problems, the authorities have requested technical assistance to help establish an effective and financially sound health and social security system. This assistance would take the form both of studies and of experts to implement new methods and train CSS staff in their use. It is anticipated that the policy recommendations from this assistance, for which Bank support has been requested, will be ready for the Government's consideration before the end of 1984.

#### Management of State-Owned Assets

51. Under the provisions of the Canal Treaty, signed in 1979, considerable assets in the previous Canal Zone reverted to Panama for its immediate use and/or development. These included three ports, a trans-isthmian railway, two unused airports, and a large amount of high quality residences. Besides these important facilities, Panama received a substantial amount of land, the most valuable being that near Panama City and Colon. Included with this land are all ancillary facilities (streets, utility distribution systems, etc.) and the Bridge of the Americas over the Canal. While their physical assets are worth much less, all of the service outlets of the Panama Canal Company also reverted to the country.

The Government has undertaken a number of actions, some of them with Bank support, to increase national benefits from these reverted assets. A new container facility is being constructed on the Atlantic side, and the Pacific port of Balboa has also been provided with modern container handling facilities. An oil pipeline has been built across the Isthmus, from which Panama will likely derive some US\$80 million per year in net profits plus income tax proceeds<sup>3/</sup> from 1985 onwards, after debt associated with the project becomes fully amortized. The Colon Free Zone has been expanded into

<sup>3/</sup> 10% on export charges and volume transhipped (US\$0.65 per barrel for 100,000 barrels per day).



previous Canal Zone territory. This enabled it to overcome a serious land constraint, and hence permitted rapid growth until the Latin American financial crisis took its inevitable toll in 1982.

53. Despite this impressive progress, much remains to be done if the country is to secure the full benefits from the reverted lands. They could, for example, be used for export-oriented industrial and service activities in accordance with the Government's new industrial strategy (paras 59-74). Such activities could concentrate on light industrial products, presently being shipped in their final form through the Canal, enhanced tourist facilities, and commercial operations particularly in the Colon area where the unemployment problem is at its most grave. In addition to the Colon Free Zone, other duty free areas and industrial estates could be established as well as modern wholesale markets for agricultural produce brought to the Metropolitan Area. Albrook Field on the outskirts of Panama City has been considered as a site for such activities for some time.

54. However, full exploitation of the assets is impeded by current legislation. The only public sector institution with the legal authority to rent or sell facilities in the old Canal Zone to the private sector is the Canal Authority, which was established after the signing of the Treaty. With the laudable aim of not creating another cumbersome bureaucracy, the Canal Authority was provided with no budgetary support, and cannot, therefore, operate. Legislation has been prepared, and presented to the Legislative Assembly, to permit the Ministry of Finance, as custodian of National Assets, to lease or sell the lands. This will not only facilitate their productive utilization, but will also be an important potential source of revenue for the public sector.

55. A good transport system is essential for the smooth functioning of the industrial-commercial complex which Panama expects to create on both sides of the Canal. Current land transport facilities are clearly inadequate for expanded modern cargo shipment. The two-lane trans-isthmian highway is already congested during peak hours, while the railway is rundown, and would require considerable modernization to handle more container traffic. From a fiscal viewpoint, the railway is already an important drain on resources. The current operating subsidy in 1982 was nearly US\$4.5 million, and substantial sums also had to be spent on emergency maintenance. The Government has requested Bank support for a study to assess the future land transport requirements of the trans-isthmian corridor, and to make recommendations on appropriate transport policy and investments, taking account of Panama's obligations under the Canal Treaty.

#### Reform of the Customs Administration

56. The Panamanian Customs Administration does not operate efficiently and, consequently, substantial sums are lost each year in the form of potential but uncollected revenues. The staff of the Administration are poorly trained and their methods of operation are inadequate to cope with the complex problems of modern commerce. This slows down, and at times even prevents, the introduction of desirable reforms to tariff policy. The Government is receiving technical assistance from an IMF expert who is preparing detailed recommendations concerning:

- (a) changes in the method of payment of customs duties to impede false declarations of value;
- (b) the introduction of the Brussels Nomenclature (for which a detailed study has already been prepared) following a period of intensive training for Customs staff;
- (c) a change from specific to ad valorem tariffs (this is already being implemented in the case of the tariffs replacing quantitative restrictions—see paragraphs 62-64);
- (d) a change from FOB to CIF as the basis for the assessment of tariffs.

Except for (c), the above reforms require fresh legislation and will probably be ready for implementation when the new Assembly takes office in October, 1984. The authorities are, however, currently studying the legal possibility of authorizing some partial reforms by Ministerial Decree.

#### Improved Public Sector Debt Management

57. Prior to early 1983, Central Government control and monitoring of the commercial borrowing of public sector enterprises and autonomous agencies was largely ineffective in practice. Moreover, up-dated statistical information was inadequate. As a consequence, several agencies were permitted to borrow short term funds to finance projects and activities with a return that would only materialize in the long term if at all. Not only has the Government improved control over public sector borrowing (para 34), but the statistical information on public sector debt is now among the best in the region. The terms, conditions and sources of each individual credit, together with amounts outstanding to each agency, are fully documented and easily accessible. In order to assist recent negotiations with commercial banks, coverage has been extended to short term credit lines to the National Bank of Panama and the Savings Bank as well as to the non-financial public sector.

58. One of the key objectives of both the short term stabilization and the structural adjustment programs is to slow down the rate of accumulation of external debt, while improving its maturity structure and thus the cost of servicing it. To this end, the rate of growth of public external indebtedness is programmed to fall sharply to 8+ percent in 1983 from 20 percent in 1982, and to an average of 6 percent per year, in nominal terms, for the rest of the 1980's. The investment program does not contemplate any net use of commercial bank credit, suppliers credits or foreign bond credits by the public sector in 1983 or 1984. In the medium term, the reduced scope of the public sector, the consequent smaller share of public investment in the GDP, combined with an improved public sector savings performance, is expected to significantly lower both the debt and the servicing burden (paragraphs 95-105).

## C. Industrial Policy, Trade Liberalization and Employment

### Overview

59. While Panama's previous policies have encouraged the development of a large, competitive service sector, they have not been conducive to labor-intensive, export oriented manufacturing activities. Manufacturing accounts for only about 10 percent of GDP and employs about the same percentage of the labor force. Production has been oriented almost entirely to the domestic market and consists mostly of food processing, light industries and petroleum refining. In the 1960's growth in manufacturing value added was slightly faster than that of GDP; since 1970, however, the sector has lagged behind with output growing at only 60 percent of the rate for the economy as a whole. Employment in the sector doubled from 24,000 in 1960 to 48,000 in 1970; since then, it has stagnated and was only just over 50,000 in 1982. Firms have become increasingly capital-intensive, and many manufacturing plants operate below full capacity, often with only one shift. In 1982, manufactured exports were 13 percent of total exports and only 2.6 percent of industrial output.

60. The trends described above are wholly consistent with the prevailing structure of incentives. The usual incentive mechanism for manufacturing investment is a contract with the Government under which the investor undertakes to carry out an investment project in return for exemptions from income tax and import duties, reduced rates of taxation and/or tax credit certificates. On expiring, these contracts have been renewed, almost automatically. In addition, benefits usually include protection against foreign competition normally through import quotas or other quantitative restrictions. Incentives such as re-investment and accelerated depreciation allowances favor the intensive use of capital relative to labor. Effective protection of final goods produced for the local market is frequently excessive, has diverted entrepreneurial and financial resources away from exports, and indirectly raises Panama's already high wage bills. Individual contracts relate benefits to negotiating strength rather than desirability of the project, increase dispersion of effective protection, and discriminate against small firms. Quota protection is usually accompanied by price controls which limit profitability, favor consumption over savings and discourage investment.

61. The regulation of the labor market in Panama through a detailed Labor Code<sup>4/</sup> is a further factor militating against employment creation. It reinforces the country's relatively high wage levels through high severance pay, the curtailment of the freedom to adjust employment and high wage-based welfare taxes. Minimum wage regulations, while not regarded as pushing up wage costs, are unduly detailed. Ad hoc increases in wages decreed by the Government and a history of intervention in collective bargaining increase uncertainty and encourage entrepreneurs to build higher labor cost assumptions into their project planning.

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<sup>4/</sup> The Labor Code, legislated in 1972, is administered by the Ministry of Labor.

62. As part of its structural adjustment program, the Government has therefore embarked upon a liberalization of its industrial and commercial policies. The ultimate aim of the new policy framework is to establish a much more uniform level of tariff protection for all private industrial activities, implying an end to quantitative restrictions and exonerations. The first steps in this process--the substitution of quantitative restrictions by tariffs--are already being taken. These have been accompanied by other specific measures to encourage employment and exports. The program and actions are described in the following paragraphs.

#### Conversion of Quantitative Restrictions into Tariffs

63. In late 1982, the Government began to implement an earlier Presidential Decree, calling for the elimination of import quotas as an instrument of protection. Initially, however, progress was slow. The Ministry of Commerce and Industry studied the mechanics of conversion to tariffs on a case-by-case basis so as to ensure the "adequate" amount of protection. This work was extremely time consuming, especially given the limited technical resources at the Ministry's disposal. By the end of February, 1983, studies had been completed on only eight products. Moreover, the Ministry was unable to effectively coordinate work on the quantitative restrictions administered by other government agencies.<sup>5/</sup> At appraisal, however, the Government informed the Bank that the conversion of quantitative restrictions would be considerably accelerated. A working group, headed by the Director of Economic and Social Planning at MIPPE, and made up of senior representatives of MIPPE, the Ministry of Finance, the Ministry of Commerce and Industry and of the other agencies directly administering quantitative restrictions has been formed to carry out the program. The universe of quantitative restrictions has been more precisely defined to include not only quotas of industrial products administered by the Ministry of Commerce and Industry, but all quantitative restrictions of whatever type,<sup>6/</sup> administered by any government agency. This universe includes 304 tariff categories; of these 38 were eliminated by June 30, 1983. Of the remainder, a further 101 were lifted between June 30 and October 15, 1983. Thus, by the latter date, nearly 50 percent of the total universe of quantitative restrictions had been eliminated or substituted by tariffs. These actions have been put into effect by the issue of Ministerial Decrees after appropriate Cabinet authorization. They do not require new legislation.

64. The remaining quantitative restrictions, which are applied to products of a particularly sensitive nature, will be eliminated more gradually. Studies will be undertaken, some of them supported by the Bank, to assist in determining the initial level of tariff protection to replace the quota. These studies are expected to be completed by the end of May, 1984, at which time the Government will have prepared a timetable for the elimination of the remaining quantitative restrictions, and the proposed initial levels of tariff protection which will replace them. Approval of these would be conditions for the release of the second tranche of the proposed SAL (para. \_\_\_ of Schedule 1 to the draft Loan Agreement).

<sup>5/</sup> Nearly all quantitative restrictions are administered by the Ministry of Commerce and Industry, the Price Regulation Office, the Agricultural Marketing Institute, and the Ministry of Agriculture.

## Maximum and Minimum Tariff Levels

65. The Government has announced that it will limit tariff protection afforded to new industrial activities to a maximum 125 percent effective protection in the first year, falling to 100 percent thereafter, and then progressively towards the minimum tariff level. In Panama, given the average proportion of value added in local manufacturing, these are equivalent to average nominal ad valorem tariffs of about 40 and 33 percent respectively. With regard to existing industries, most of the tariffs replacing quotas so far lifted are moderate, ranging from an equivalent of 25 to 75 percent ad valorem, with the average around 40 percent. While the government clearly anticipates cases where higher initial tariff protection may be required, this will never exceed 100 percent ad valorem in more than 25 industrial tariff categories (about 7.5 percent of the total universe).

66. The new minimum tariff level will be established by May 31, 1984, and will be incorporated into the new industrial incentives legislation to be drafted by that date (paragraph 68). The adoption of the minimum tariff will, by implication, end exonerations and will be applied to some industrial inputs, machinery and food product imports which now have very low or zero tariffs. This will help reduce effective protection for the production of final goods while increasing it for agricultural and intermediate inputs, activities traditionally penalized by the current structure of protection. The minimum tariff will be as nearly uniform as possible, while allowing for flexibility in exceptional cases. Also by the end of May, 1984, the Government will have prepared a timetable for reduction of initial tariffs the minimum range. This timetable will include a more rapid speed of adjustment for those industries favored by higher levels of initial protection. However, assistance will be provided, through the National Investment Council (paragraph 72), to help firms plan the transition from essentially import-substituting to more efficient export-oriented activities.

## Industrial Incentives Legislation

67. The industrial incentives described in paragraph 59 are governed by a specific piece of legislation, Law No. 413 of December, 1970. Contracts under this Law are signed for up to 20 years. To date, no contract proposal by a company has been refused. As of March, 1983, there were 483 firms which had contracts in force, and the average contract has another six years to run. About 60 percent of existing contracts will have expired by 1990.

68. In view of the undesirable features of the contract system, the Government will replace Law 413 by a general system of incentives to a wider potential group of beneficiaries, thereby eliminating the concept of individually negotiated contracts. The Government is to prepare a draft revision of the new legislation by the end of May, 1984, and will ask the Bank to comment upon it. It is anticipated that the new Law will be considered by the Legislative Assembly before the end of 1984. The signing of new contracts and the renewal of existing ones under Law 413 will cease when the new legislation comes into effect. In the interim period, new contracts and renewals will be for a period of five years, the maximum allowed by the current law. It is essential to enhance the new legislation's acceptability. Only 6 percent...

of existing contracts are due for renewal before the end of 1984. Moreover, new contracts will offer no quota protection and no guarantee of return on capital, while tariff protection is to be limited (paragraph 65). Approval of the draft industrial legislation, including the proposed minimum tariff, and of the timetable for reductions in tariff protection would be conditions for the release of the second tranche of the proposed SAL.

### Price Controls

69. Panama's present price controls were established by Law No. 60 of 1969 with the principal objective of maintaining the supply and orderly distribution of basic foods and other goods for low income families. The Law provides for a Price Regulation Office <sup>7/</sup> consisting of a Director and Price Adjustment Committee comprising seven members: one from the Economic Cabinet, two representing labor unions, and representatives for wholesalers, retailers, farmers and manufacturers. At present, the price controls are applied to about 75 items, 50 of which are food and food products. Fuel and items such as inexpensive clothes, ~~12~~ <sup>12</sup> medicines and pharmaceuticals are also included as are cement and some other construction materials. Prices for locally produced food are set at each stage of the production and distribution process, starting with the farmer. Other controls are enforced at the retail level. The Price Regulation Office does not appear to have a clear formula to determine prices. The private sector constantly complains of a long time lag between the petitioning and granting of a price increase. In some cases, this is more than a year. The increases, when granted, often take the form of one large hike, rather than incremented adjustments. This practice not only has a negative impact on sales, but also squeezes profit margins and discourages investment.

70. All the products with price controls also benefit from import quota protection administered by the Price Regulation Office. The elimination of most import quotas will render price controls on industrial products redundant since domestic prices will be regulated automatically by competition from imports. Local firms will be protected through tariffs. The Government has therefore decided to accompany the abolition of quantitative restrictions with the dismantling of price controls. This will provide an important stimulus to private investor confidence, and the consequent reduction in bureaucratic intervention will help to compensate firms for reduced quota and tariff protection. Following this, the role of the Price Regulation Office will be confined to a few very basic and politically sensitive items.

71. As well as the proposed easing of price controls on industrial products, the Government, in March 1983, freed rent controls on all new housing projects which carry a monthly unit rent of US\$250 or more. This is an important signal to the private sector and will help to ease supply constraints for middle class housing.

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<sup>7/</sup> This Office, although theoretically under the authority of the Ministry of Commerce and Industry, enjoys a considerable measure of political autonomy.

## Export Incentives

72. In 1982, the Government established a National Investment Council to promote export industries and assist investors in dealing with the local bureaucracy. The Council is headed by a leading Panamanian businessman. In the relatively short time since beginning operations, it has already been successful in attracting a number of investors to Panama despite the difficult international economic climate. The Council is to receive a substantial amount of technical assistance from USAID to enable it to expand its promotion activities abroad.

73. Direct export stimulation is difficult in Panama, as the exchange rate mechanism cannot be used and there is a fiscal constraint to export subsidies. At present, the tariff protection afforded to domestic production activities is counterbalanced by an export incentive in the form of redeemable tax certificates (CATs), currently 20 percent of the value added of non-traditional <sup>8/</sup> exported goods. The CATs are negotiable and their holders may use them to meet a variety of tax obligations. Despite complicated and lengthy application procedures, CATs are considered an important incentive by the private sector and have undoubtedly contributed to the recent growth in manufactured exports. <sup>9/</sup> The authorities are studying a simplification of the process for obtaining CATs and relating their value to the wage bill of the factory workforce. This will provide incentives not only for exports but for employment also. Moreover, an appropriate mechanism will be devised for compensating exporters for their loss of import duty exonerations. The new incentives system is expected to be ready for inclusion in the new draft industrial legislation by the end of May, 1984 (para 68). Considerable care will be taken to prevent discrimination against smaller firms with lower paid workers and adverse fiscal repercussions. The Government would aim to finance additional expenditures on the export/employment subsidy by the extra revenues generated by replacing quotas by tariffs and eliminating import duty exonerations.

## Employment

74. In its efforts to stimulate employment, the Government attaches much greater importance to improvements in the investment climate than attempting to reduce costs by direct intervention in the labor market. Panama will likely remain a relatively high wage center, even with a labor subsidy. This has to be counterbalanced by stressing its compensating comparative advantages, and by reforms in labor legislation (para 61). Despite its political sensitivity, the Government has already introduced some modifications in the Labor Code's interpretation, while small firms have been

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<sup>8/</sup> Principal traditional exports are bananas, sugar, shrimp, coffee and fishmeal.

<sup>9/</sup> Since 1974, when the CATs were introduced, non-traditional exports have increased at a rate of 21.5 percent per year (albeit from a low base) compared to 4.8 percent for total exports, and the proportion of non-traditional exports benefitting from CATs has risen from 36 percent to 67 percent.

exonerated from severance payments. The Government has established a Legal Commission, headed by the Attorney General, to examine further possible changes in interpretation. With a view to more fundamental reforms, it intends to commission a study, financed by USAID, to ascertain the extent to which private investment and job creation have been discouraged by the Code, and to suggest appropriate modifications. The results of the study will be available to the Government before the end of 1984.

#### D. Agricultural Policy

##### Overview

75. For a considerable period of time the agricultural sector has been the least dynamic of the Panamanian economy. Its average annual growth from 1970-72 to 1980-82 was only 1.7 percent, compared with 5.7 percent for non-agricultural GDP. This reflects the duality of sectoral policy in the 1970's, which attempted to transfer income to specific rural groups as well as stimulate higher output. This low growth occurred despite the investment of substantial public resources, both in terms of finance and personnel. The total number of public employees in the sector is nearly 7,600; 5 percent of the total agricultural labor force. The 1982 budget for the Ministry of Agriculture and Livestock Development (MIDA), and the autonomous and semi-autonomous agencies operating in the sector, is about US\$175 million, over 40 percent of agriculture's value added.

76. During 1969-73 the Government undertook an ambitious land reform; over 16 percent of Panama's land changed hands in 5 years. More than 140 agrarian reform settlements (asentamientos) were formed on this land, and considerable government attention was paid to them. The lending of the state-owned agricultural bank was increased rapidly, and much of its lending went to them. Asentamientos were linked strongly to the political system, while new institutions were formed to assist in marketing their output. Even the traditional services of MIDA were channelled towards their needs during the 1970s. Because the asentamientos produce almost entirely for the domestic market, most MIDA policies emphasize import substitution. To encourage exports, the Government made major investments in three new sugar mills, took over a financially weak citrus establishment, and opened new state enterprises in bananas and other export crops. Unfortunately, these actions resulted in many unrecoverable loans, an inflexible price support system, and poorly managed state enterprises. An indirect, unquantifiable cost was the adverse effect they had on the previously buoyant private agricultural sector.

77. There is no agronomic reason why considerably higher rates of agricultural growth--perhaps as much as double historical rates--cannot be reached. Such a goal would imply production based more on Panama's comparative advantages and less on protection against foreign competition. Panama's long term advantage seems to lie principally in: (a) forestry in the central mountain areas, based on reforestation with fast growing lumber and pulp species; (b) dual purpose semi-intensive cattle raising in the central and western coastal plains and foothills; (c) small scale, labor intensive production of tropical export crops (e.g. coffee, cacao), and of temperate zone vegetable and fruit crops in the upper altitudes; and (d) equally small



scale, labor-intensive growing of selected vegetable and fruit crops with irrigation near the rivers of the central provinces. Movement toward this, or a similar output pattern, would reduce the importance of crops with marked seasonality of employment, such as sugar cane, which have high labor costs during peak periods.

78. The Government is aware that the execution of this development strategy implies the need for a fundamental change in agricultural policy which would orient the sector towards higher productivity and output. This new policy aims to increase productive employment in agriculture, reduce the costs of basic foodstuffs by increasing efficiency and productivity, and expand exports. The specific measures to achieve this include: (a) reducing price controls and subsidies to inefficient producers; (b) separating policies aimed at improving the social welfare of the rural poor from production policies; (c) revising the role of public institutions in agriculture to achieve these objectives; (d) reducing and eventually eliminating subsidies for state-owned agricultural corporations and enterprises; and (e) increasing productivity through more effective and selective research and technology transfer.

79. A number of important reforms have already been carried out, covering public sector institutions in agriculture, the legislative framework, and pricing and trade policy. However, further progress in the execution of this complex program is considerably impeded by lack of knowledge. Accordingly the Government is accompanying specific measures with a series of studies to determine how best to ameliorate many of the sector's remaining problems.

#### The Public Sector Institutions

80. State intervention in Panama's agriculture extends from the MIDA itself, to credit and marketing and to direct production by parastatal enterprises. While much of MIDA's efforts are directed towards the asentamientos, it has neglected the bulk of small and medium-sized farmers and thus many of the rural poor. Moreover, it has not developed the capacity to analyze policy or to guide and coordinate the rest of the state sector in agriculture. Consequently each entity tends to take decisions in a policy vacuum. The Agricultural Marketing Institute (IMA) is primarily involved in implementing the Government's pricing policies (para 85). The Agricultural Development Bank (BDA) is practically the sole lender to small and medium-sized farmers, reflecting the lack of interest of other banks. Most of its lending goes to rice producers, and only a small proportion is directed towards crops where Panama has a greater comparative advantage. Because of excessive lending costs (estimated to be 6 percent), it operates at a loss despite charging a strongly positive rate of interest <sup>10/</sup>. The Institute for Agricultural Research, IDIAP, focusses on traditional crops such as corn and rice and has paid inadequate attention to the special agronomic problems of Panama. Another service institution, the Agricultural Machinery Enterprise, ENDEMA, hires out agricultural equipment at heavily subsidized rates with priority given to asentamientos. The most important directly productive state enterprise is the La Victoria Sugar Corporation (CALV), which consists of four mills, three of them built during the 1970's. Total milling capacity is some 18,000 tons per day. CALV has required large

<sup>10/</sup> 9 percent as of June 30, 1993.

subsidies every year since 1975; 1982 operating losses by the Corporation were about US\$40 million, 8.6 percent of the total public sector deficit. Other state producers are the Chiriqui Citrus Company, the Bayano Development Corporation, and two banana producers, COBAPA and COBANA; all have required operating subsidies.

81. The Government's comprehensive review of state enterprises in the agricultural sector has resulted in a number of important actions, reducing subsidies by about 10 percent of the 1983 public sector deficit:

- On March 12, 1983, the Government announced the closure of the Felipillo sugar mill, the largest and most inefficient of the CALV complex. Felipillos' losses in 1982 amounted to US\$15.5 million (39 percent of the Corporation's total). At the other mills, the harvesting season was cut short. The average cost per pound of sugar produced by CALV as a whole in 1982 was just over 30 cents; at Felipillo it was 48.5 cents. This compares with an average FOB price, received by Panama, of 22.5 cents per lb. The closure of Felipillo is the first step in a rationalization program for the Corporation as a whole. This program will be further developed, as a result of the studies of agricultural institutions financed under the proposed Technical Assistance Loan.

- In 1982, the state-owned banana corporations COBAPA and COBANA<sup>11/</sup> were closed down generating savings of about US\$1.5 per year in subsidies. They had incurred heavy losses since 1980 following a change of management, labor problems and marketing difficulties. COBAPA's plantation in Chiriqui Province occupied about 1,300 hectares which previously belonged to the United Brands Corporation. The bulk of Panama's banana crop is currently produced by United Brands on their existing Pacific Coast plantation of some 10,000 hectares, and by independent producers.

- At the beginning of 1983, the Government announced that state subsidies for the Bayano Development Corporation (BDC) and the Chiriqui Citrus Company would cease, involving a saving of just over US\$1 million per year. The BDC was created in 1975 to protect the watershed of the Bayano hydroelectric reserve, and to develop the lands around the reservoir. Most of its output consists of timber, rice, sugar cane and beef cattle. Despite substantial capital expenditures, yields have remained generally low. BDC's financial situation, already weak from poor operating results, has suffered from heavy outlays on technical assistance to tenant farmers and social services to surrounding rural communities. The Chiriqui Citrus Company incorporating orchards and a processing plant, was taken over by the Government after it was abandoned as unprofitable by a US corporation. Initially, after takeover, it suffered heavy operating losses; however, these have been reduced in recent years. Alternatives for disposing of BDC and the Chiriqui Company will be studied under the proposed Technical Assistance Loan.

<sup>11/</sup> Although they were two corporations, COBAPA managed both operations since 1979.

- A number of actions have been taken to reduce losses at the Agricultural Development Bank (BDA). A new management team, appointed in August 1982, is making a serious effort to reduce the number of bad debts in the bank's portfolio. Recent credit restrictions will lower the bank's lendable funds to about US\$33 million in 1983, compared to US\$44 million in 1982. No further access to commercial bank credit will be permitted. This tightness of funds will force the bank to be more selective in terms of credit risks. The interest rate subsidy has been reduced from 7 to 3 percentage points since 1981, and is now wholly financed from a surcharge on all other commercial loans by the banking system. Losses will be further reduced in 1983 by increasing to 95 percent the proportion of new loans covered by adequate crop insurance.

82. Further institutional reforms would be determined with the assistance of a comprehensive study of agricultural institutions, financed by the proposed Technical Assistance Loan. The study would aim to reveal the main institutional factors impeding the implementation of the Government's new agricultural strategy, and the extent to which policy discourages higher output. Using its recommendations, the Government will adopt measures to ameliorate many of the sector's remaining problems. Specific issues to be addressed will include:

- Design of a management system to provide more effective coordination of the state institutions in the agricultural sector;
- Creation of a more viable and financially sound Agricultural Development Bank;
- Reducing state intervention in marketing and eliminating some state marketing monopolies.
- Reducing wholesale and retail price controls of agricultural and agroindustrial products;
- Institutional strengthening of the reformed settlements and conversion of some of them into cooperatives or individual land holdings in accordance with the law;
- Strengthening the capability of the Agricultural Research Institute;
- Strengthening formulation and execution of policy in the forestry subsector.

#### Agricultural Legislation

83. The Government has undertaken to drastically revise the Agricultural Incentives Law. Just as policy in the industrial sector is dominated by the provisions of Law 413 (para 68), so the Agricultural Incentives Law encapsulates the philosophy of past agricultural policy into one legislative instrument. According to the Law, imports of foodstuffs are quantitatively restricted and annual percentage targets are established for

their replacement by home produced goods. Price controls on the family food basket are maintained. The Law permits and encourages state intervention in factor and input prices, capital markets and agricultural production. The existence of this Law is clearly contrary to the new development strategy for the economy and the sector, and the actions described in paragraphs 81 and 86 are against its spirit if not its letter. Accordingly, it is to be substantially modified. The same timetable is to be followed as in the case of the Industrial Incentives Law—a draft version of the new legislation is to be prepared by the end of May, 1984, on which the Bank will be asked to comment. It is the intention to present the proposed new Law to the Legislative Assembly before the end of 1984.

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#### Agricultural Trade and Pricing Policy

84. The principal objective of the Government's new trade and pricing policy for agriculture is to reduce resource misallocations, and hence stimulate higher output, by reorienting price signals and incentives towards areas where Panama has a greater comparative advantage. This implies a reduction of the state's role in agricultural marketing, elimination of most monopolies and greater reliance on market forces in determining the allocation of resources among alternative crops. It does not imply a complete disappearance of the state's role in the sector; it is understood that a certain amount of regulatory intervention will be necessary to smooth out sharp fluctuations in supply and the price movements that result from them. In certain specific cases, the authorities also wish to retain the legal capability of quantitatively controlling imports and exports to prevent shortages, and large surpluses resulting from dumping.

85. Previous price policy in the agricultural sector has been oriented towards providing incentives for certain basic products (rice, corn, beans and sugar), in most cases with the aim of achieving national self sufficiency. In order to subsidise domestic consumption, price controls are imposed and restrictions placed on exports of other products (notably, beef and coffee until recently, fishmeal and cacao). This has led to the overconcentration of resources in areas where Panama's comparative advantage is weak while providing disincentives for the production of export goods. Support prices are high, especially for rice, and this has encouraged substantial overproduction plus illegal importing from neighboring countries. In order to finance its rice operation, IMA has a monopoly as importer of maize, onions, beans, sorghum and edible oils, which it directly retails, or sells to private traders. Since mid-1982, however, these profits have not sufficed and IMA's financial situation has considerably worsened due to the large volume of rice accumulated.

86. The Government has already taken a number of important actions to modify its trade and pricing policy in accordance with its overall strategy for the sector:

- In March 1983, the support price for rice was reduced by US\$22 per ton (3 percent). This will discourage surplus production and lead to annual fiscal savings of over US\$4 million. In order to reduce the impact on farmers' incomes of further support price reductions, the Government is introducing a system of production and distribution of

certified seeds with special emphasis on rice, corn and sorghum. This system, which is supported by the IDB, will be ready for implementation in early 1985. It will enable substantial increase in productivity in these crops and thereby permit an accelerated reduction in support prices toward border levels.

- In March 1983, beef exports were liberated. Export quotas had resulted in output stagnation during the 1970s. Prior project work, including a recent Bank study, had underlined the importance of ending the export quota system. Future actions will concentrate on rehabilitating slaughter houses and processing plants to export standard.
- Domestic price controls on the higher quality cuts of meat were lifted in September, 1983.
- The price of potatoes, another major staple, was freed in March, 1983.
- Export quota restrictions on coffee were lifted in September, 1983.
- Milk was previously classified as either Grade A or industrial quality. As a result, low income groups were restricted to extremely poor quality fresh milk. Also, many farmers, technically incapable of producing Grade A milk, had no incentive to improve quality and increase production. In March, 1983, milk was reclassified into three grades, including an intermediate Grade B; the corresponding price adjustments are to be made before the end of 1983.
- In September 1983, import quotas were lifted for five agricultural products and a considerable number of processed items. A timetable for further liberalization measures will be prepared by the end of May 1984, and its approval will be a condition of the proposed second tranche of the SAL (para 63).

87. To assist its efforts in further policy modifications, the Government will cover price and trade policies in its agricultural institution study (para 82). The study will examine the impact of price and trade policies on sector growth, and make detailed recommendations of specific measures. These will be ready for implementation before the end of 1984.

### PART III - THE PROPOSED LOAN

*Prerequisite: Approval to \$500M LOANS*

#### A. Background

88. The proposed loan would support the Government's strategy of structural adjustment and economic recovery. The principal objective of this strategy is to create the environment conducive to directing economic activity towards areas of Panama's comparative advantage. The loan was

prepared during the intensive dialogue with the Government since December 1982, on its structural adjustment program and in close consultation with the IMF. It was appraised in June 1983 and negotiations were held in October 1983. The Panamanian delegation was led by..... Annex III contains a supplementary loan data sheet.

89. The growth of the public sector and the development of Panama's infrastructure in the 1970s, combined with social reform and the effect of international inflation increased the budget deficit, which the Government financed through heavy dollar borrowing. Higher interest rates in the 1980s added to the burden on the budget. Additionally, Government pricing and trade policies and direct intervention in production led to misallocation of resources (paras 15-18). The world recession, the financial crisis in Latin America and local political uncertainties in the last two years have had their toll on the Panamanian economy and Government revenues. Since the second half of 1982 the Government has had to resort to strict fiscal discipline and to retrench its expenditures. With the support of the Bank it has initiated a strategy aiming at accelerating economic development and the creation of job opportunities through remedying existing policy inconsistencies, encouraging private investments, promoting and diversifying exports and improving public sector efficiency (paras 19-23).

#### B. Relationship with the Government's Short Term Stabilization Program and the Standby Arrangement with the IMF

90. Following two years of favorable trends in public sector finances in 1980 and 1981, a number of internal and external factors contributed to a sharp deterioration in 1982, while the economy entered into a deepening economic recession (paras 19-21). The Government, recognizing the difficulties the country would face for some time, started to take a series of actions in late 1982 and early 1983. These may be divided into two broad groups: structural reforms to enable the economy to meet the challenges of the more difficult international environment of the 1980's; and short term stabilization measures to provide the necessary context of financial stability for the new development strategy. While the latter is supported by the Fund through the Standby-cum-CFF facility (paras 27-28), the Government has requested structural adjustment support from the Bank for the former. This broad division should not, however, obscure the fact that in several important senses the stabilization and structural adjustment measures form an integral part of the same program of economic reform. Both share the goals of a more limited and more efficient public sector, better budgetary and institutional control, a more open and less regulated economy in the productive sectors, and consequently improved resource allocation.

91. During the preparation of the Standby and the proposed SAL, there has been close collaboration between Bank and Fund staff to ensure consistency between short term stabilization measures and medium term structural changes. This collaboration has aimed to achieve complementarity and the best use of each institution's resources. Because Panama uses the US dollar as legal tender and has no independent monetary policy, Fund staff

usually emphasize the reduction of the public finance disequilibrium in their agreements; Bank staff generally concentrate on specific actions, not only in the public finance areas, but in the economic sectors as well. The Bank's identification mission for the SAL overlapped with the Fund mission which negotiated the Standby. Information has been freely interchanged and there have been discussions between Bank and Fund staff on various draft documents including aide memoires, the Government's Letter of Intent and Letter of Economic Policy. The Bank's review of the public sector investment program was included in the Fund's Standby documents. There has been agreement both on matters of general approach and on specific measures. Bank and Fund staff have also worked together in supporting the Government's presentation to commercial banks for a new credit to enable amortization obligations to be met in 1983 and 1984. We will continue to liaise closely with the Fund staff, especially during the monitoring of the 1984 investment budget and action program.

### The Structural Adjustment Program and the Proposed Loan

92. The proposed loan would support measures taken by the Government in 1983 and to be taken in 1984 and 1985 as part of its structural adjustment program. Action taken so far reflect understandings reached with the Government during its continuing dialogue with the Bank on economic policy. Most of the measures to be taken in 1984 and beyond require further studies to assist in identifying policy options, strategies and technical assistance for public sector institutions in the economic field. It is therefore proposed that the proposed loan be supported by a technical assistance project to help carry out these studies and activities. In addition, USAID and UNDP are providing technical assistance for the strengthening of the planning capabilities of MIPPE and MIDA, for the strengthening of other public sector institutions and the revision of labor laws. The Pan American Health Organization is carrying out a study financed by IDB, of the Health Systems in Panama, while IDB is also financing an Industrial Sector Study.

93. The specific actions supported by the proposed SAL (set out in the Government's letter dated August..., 1983) were reviewed in detail during appraisal and are summarized in Annex V. Actions already taken by the Government in 1983, include (paras. 32 -....):

- (a) improvement of the planning process and control of investment expenditures for the 1983-85 programs;
- (b) improved control of public sector borrowing through the establishment of a new post of Director of Public Credit in MIPPE;
- (c) substitution of tariffs for import quotas and advalorem tariffs for specific tariffs;
- (d) abolition of support price for rice;
- (e) institution of an intermediate grade B milk for direct consumption;
- (f) abolition of quotas on beef exports;
- (g) initiation of IMF technical assistance to the Customs Administration;
- (h) improvement of the management of the public-owned development finance corporation and agreeing to the restructuring of its ownership, by which the Government will take a minority share;

- (i) discontinuing direct mortgage financing of housing by CSS;
- (j) setting a firm timetable for rationalization of the publicly-owned cement company;
- (k) sale of a major money-losing hotel the ownership of which had passed to the Government in settlement of a Government guaranteed loan;
- (l) closure of an inefficient sugar mill and of a banana corporation;

94. In addition, the following measures are expected to be taken in 1984 and 1985, after completion of the necessary studies and, in some cases, necessary legislative action:

- (a) abolition of restrictions on the export of coffee, fishmeal and cacao;
- (b) further reduction in agricultural support prices and freeing of other agricultural prices;
- (c) reduction in state intervention in agriculture;
- (d) reform and strengthening of agricultural institutions, including EDA and research institutions;
- (e) extension of program of land titling;
- (f) program for conversion of some reformed settlements into cooperatives or individual ownership;
- (g) creation of effective agricultural policy coordination;
- (h) reduction of state role in direct agricultural production;
- (i) issuing new Agricultural Incentives Law;
- (j) issuing new Industrial Incentives Law;
- (k) linking industrial incentives to employment;
- (l) further removal of import quotas;
- (m) dismantling of price controls on industrial products;
- (n) reduction of tariff protection;
- (o) rationalization of the Labor Code;
- (p) reform of the Customs Administration;
- (q) disposal of unprofitable public enterprises;
- (r) reduction of domestic cement price;



- (s) restructuring of the capital of COFINA and reforming its management; and
- (t) completion of studies for the strengthening of the Health System, and of the Social Security Agency.

Bank review of the studies and the draft Bills for the Agricultural and Industrial Incentives Laws would be conditions for the release of the US\$20 million second tranche of the proposed loan (para ....of Schedule 1 to the draft Loan Agreement).

### Impact of the Structural Adjustment Program

#### Economic Prospects with the Program

95. After passing through a period of stagnation in 1983, and of projected slow growth in 1984, the Government's adjustment program will likely return the economy to a new growth path by the mid-1980's. The projections outlined in table 2 assume a gradual recovery in the economies of the OECD countries, with real growth of 2 percent in 1983 and 3.7 percent thereafter <sup>12/</sup>. It is also assumed that the majority of Latin American economies resume growth of 5 percent per annum after 1985. These are critical assumptions, particularly with regard to non-traditional and service exports. On this basis, Panama's GDP could grow by 3.5 percent in 1984, and by just over 5 percent per year between 1985 and 1990,

96. The principal engine of growth would be private sector initiative in the industrial and service sectors geared towards export markets. Industrial growth could reach 8 percent by the latter part of the decade, and exports of non-traditional goods, since they start from a very low base, could grow at about 13 percent per year. The greater part of these exports would be manufactured goods. This rapid growth reflects the inclusion of the goods sectors among the beneficiaries of Panama's geographical and institutional advantages. Services could also expand, though at a somewhat lower growth rate than that experienced during the 1970's. The Colon Free Zone will have to become less dependent on the Latin American market although significant recovery there, and in the financial services subsector, will depend upon a resumption of growth in the Region. Value added from the Canal and related activities is expected to be relatively stagnant, although this will be compensated for by diversification into new services activities stemming from the more efficient use and development of the old Canal Zone assets.

97. Agricultural output should begin to expand again as a result of the important institutional and policy reforms to be carried out as part of the structural adjustment program. Growth is forecast at 3.5 percent per year from 1985 onwards, compared to 1.7 percent during the 1970's. Much of the stimulus for growth is expected to come from the livestock subsector, where Panama has its greatest comparative advantage, and which will benefit from the lifting of export restrictions and the introduction of a new intermediate milk grade for direct consumption. Construction and utilities are projected to grow in line with total value added, while government services are to grow more slowly than GDP.

98. The projections imply a decline in investment as a percentage of GDP. This results partly from a sharp reduction in the relative importance of public sector investment, which declines to about 7 percent of GDP by 1990 compared to an average of over 13 percent between 1976 and 1982. The decline also reflects an increase in the efficiency of capital. This stems both from the switch to private from public sector investment, and from a change in the structure of private sector incentives. These will no longer encourage the use of highly capital intensive techniques in inefficient activities.

99. Traditionally, economic expansion in Panama has been fueled to a significant extent by foreign financial resources. This has been facilitated by the openness of the economy and the integration of its financial system with international capital markets. Now, however, the era of easy access to foreign finance is at an end. Commercial banks are clearly anxious to limit their total exposure in the country. The availability of credit to the private sector, therefore, now depends on limiting the public sector's demands as well as on confidence in the economy's future. The structural adjustment program is vital to ensure a continued flow of necessary resources. Public sector savings would increase as a result of institutional reforms and higher tax revenues from economic growth. Public investment would be at a lower relative level and financed to a larger extent by concessionary sources. These improvements would reduce the public sector deficit to just over 3 percent of GDP by 1990, compared to 11 percent in 1982. Moreover, total public sector debt would fall substantially in relation to GDP, and commercial debt even more. Debt servicing would absorb a considerably lower proportion of public sector revenues.<sup>13/</sup> All these developments would mean a much greater availability of foreign commercial bank credit for the private sector. Its share of total net external capital inflows is expected to increase from 52.5 percent in 1982 to 63 percent by 1990.

100. The openness of Panama's economy, and its importance as an entrepot center, signify a high marginal and average propensity to import. Despite the considerable acceleration in exports, therefore, it is anticipated that the gap between exports and imports of goods and nonfactor services will decline only slightly over the period, from 5.4 percent of GDP in 1982 to 5 percent in 1990. However, due mainly to the decreasing public sector debt burden and reduced interest rate cost to the economy, the overall current account deficit is expected to decline from 12.6 percent of GDP in 1982 to 8.6 percent in 1990.

101. Another important long-term benefit from the structural adjustment program would be higher employment generation. While a quantification of this effect is not feasible with the information available, the difference in total output (21.2 percent by 1990) could be taken as a minimum estimate. The reduction of anti-labor biases which the program contemplates (para 74) will undoubtedly enhance the employment generation effects of the increase in output; accordingly, the relative increase in employment could be considerably higher than that in GDP.

<sup>13/</sup> Assuming real international interest rates of about 3 percent in the medium term.

\* *Impare E/P de 1.0 implicitamente!*

102. Finally, attention must be drawn to the assumptions which underly these projections and the inevitable uncertainty which accompanies them. This chiefly concerns the prospects for economic recovery in the Western Hemisphere and in the rest of the world economy. Should this take longer than expected, or should its impact on Panama be weakened by other factors (e.g., higher protectionism, continued reluctance of commercial bankers to lend), then the necessity of the structural adjustment program for Panama's economic survival would become even more clearly pronounced. Furthermore, the positive effects from the program will continue to be felt well beyond 1990. It will be in that later period that the structural transformation of the Panamanian economy will bear full fruit. The analysis presented above can therefore only be a partial estimate of the program's potential impact on Panama's future development.

#### Economic Prospects Without the Program

103. In the Structural Adjustment Program, important steps have been and are being taken with regard to liberalization of the economy, the encouragement of private investment, reorientation of incentives towards exports and employment, and improved resource allocation through the strengthening of the market system and greater public sector efficiency. In the program's absence, private sector confidence, and hence investment, would likely remain at a very low ebb. The extent to which the public sector could compensate for this would be limited by the availability of credit. Under these circumstances, the inflow of external capital would be drastically reduced and total investment would fall by over half in 1983 and 1984. From 1985 onwards some recovery could occur; however, in the absence of the proper environment, investment in real terms would still be 25 percent less by 1990 than in 1982. Furthermore, the investment that would take place might well be far less efficient. The share of the public sector would increase to over 50 percent, while the private sector would be limited to services, and industries geared to the local market. The incremental capital/output ratio could very well remain at high historical levels.

104. The consequences of these trends are clearly shown in table 2. Growth of GDP would be around 2 percent per year for the period as a whole, implying a decline in per capita incomes. Due to lower savings and a higher relative level of public investment, the public sector deficit would be more than double that forecast under the program. The public sector external debt would increase in relation to GDP, and the decline in the debt servicing burden would be insignificant, reflecting only marginal changes in assumed interest rates. In the absence of incentives and confidence, the productive sector of the economy would continue to stagnate and exports would increase by even less than GDP.

105. Even this gloomy scenario is probably optimistic in that it assumes that a public sector deficit of some 6 or 7 percent of GDP could be sustained despite very low growth rates. In reality the authorities would find it acutely difficult to finance such a deficit, and would be forced to reduce current and capital outlays accordingly. The resulting economic contraction would not only feed back on public sector revenues in a downward spiral, but would also lead to a deepening social crisis. The point would soon be reached where the country would no longer be considered creditworthy and would be unable to meet its external obligations.

## E. Benefits and Risk

106. The main benefits of the SAL would be the expected reorientation of the Panamanian economic activity and incentives towards areas of Panama's comparative advantages in agriculture, industry and services, and the redirection and strengthening of public agencies towards supporting these activities. Major agencies that would benefit would be MIPPE, MIDA, the Customs Office, the Social Security Agency, institutions working in the agricultural sector, COFINA and the Integrated Health System. The environment would also be provided for the private sector to invest in areas of Panama's comparative advantage. This should pave the way for sustained economic development, and would increase job opportunities, resource inflows and Government revenues, as well as reducing wasteful expenditures and subsidies.

107. The main risk associated with the SAL is possible delays in implementation of the recommendations to be agreed after completion of the technical assistance studies. Such risk is in fact minimal since a consensus exists in the Government and in major opposition parties on the need for the new direction of the economy. In addition progress of the studies and their policy recommendations will be closely monitored and we plan to maintain an intensive dialogue thereon under both the SAL and the proposed Technical Assistance project. The Technical Assistance project is designed to ensure close involvement of staff of beneficiary agencies in carrying out the ensuing recommendations and reforms.

## F. Loan Amount

108. The proposed loan of US\$60.2 million (including the capitalized front-end fee) would meet about six percent of Panama's total gross external capital requirements for 1983/84, and would finance just over two percent of the merchandise imports for the two years.

## G. Disbursement and Procurement

109. The proposed loan of US\$60.2 million equivalent would be disbursed in two tranches. The first in an amount of US\$40.2 million equivalent would be made available upon effectiveness of the Loan Agreement to finance the CIF cost of eligible imports and the front-end fee. All imports into Panama from eligible countries, except for military equipment and luxury consumer goods ~~would be eligible for financing.~~ The second tranche of US\$20 million equivalent would be made available upon satisfactory review of the progress of the technical assistance studies and the draft Bills of the Agricultural and Industrial Incentives Laws (paras 68 and 83).

110. Disbursements would be made against Customs Declarations evidencing importation of the goods to be financed and their countries of origin. Public and private sector imports would be eligible for financing. All purchases under contracts of US\$5 million equivalent or more each would be procured through international competitive bidding. Public sector imports under contracts below US\$5 million equivalent would be in accordance with standard Government practices, which ensure adequate competition. Private sector imports under contracts below US\$5 million equivalent would follow normal commercial practices.

Table No. 2: SELECTED ECONOMIC INDICATORS UNDER ALTERNATIVE ASSUMPTIONS

		With Structural Adjustment				Without Structural Adjustment			
	1977-82	1983	1984	1985	1986-90	1983	1984	1985	1986-90
<u>Growth Rates (constant 1982 prices)</u>									
Market prices	5.7	0.0	3.5	5.0	5.1	0.0	1.8	1.8	2.1
Construction	5.4	2.0	8.1	7.4	5.3	7.2	6.9	0.6	2.5
Domestic investment	9.2	-18.2	0.2	0.4	4.0	-47.4	-6.1	5.2	3.4
% of GNS	9.8	-1.8	1.9	2.7	5.3	-1.8	-1.1	0.0	1.3
% of GFS	7.9	-9.4	9.3	5.3	5.0	-26.3	6.3	-1.4	2.5
% of non-traditional goods	(4.5)	(5.0)	(7.5)	(10.0)	(13.5)	(5.0)	(2.5)	(1.0)	(0.8)
Meat and Livestock	1.7	0.0	2.4	3.5	3.5	0.0	1.7	1.7	1.7
Industry and Mining	4.0	2.5	5.5	7.5	8.2	2.5	1.0	1.0	1.0
Construction	17.5	-4.8	3.5	5.0	5.1	-4.8	1.8	1.8	2.1
Transport services	4.7	5.0	4.0	3.0	2.5	5.0	2.8	2.6	3.4
Other services	7.9	-0.1	3.2	5.2	5.3	-0.1	1.8	1.8	2.1
<u>Indicators</u>									
	1982	1985		1990		1985		1990	
Investment as percent of GDP	27.7	20.9		19.8		13.9		14.8	
Domestic investment as % of total investment	67.5	65.6		64.0		50.3		49.8	
Foreign investment as % of total investment	32.5	34.4		36.0		49.7		50.2	
Investment as % of GDP	10.5	7.2		7.1		6.9		7.4	
% of total investment financed by	60.7	51.2		56.5		57.8		44.8	
Domestic savings									
% of total investment financed by	39.3	48.8		43.5		42.2		55.2	
Foreign savings									
Capital/output ratio	6.9	4.4		3.9		7.4		6.7	
Public sector outstanding external debt	71.0	69.3		52.3		73.3		76.3	
% of GDP									
Public sector deficit as % of GDP	11.0	4.2		3.2		5.2		7.4	
Interest payments on public external debt	30.8	24.8		17.8		26.2		25.9	
% of public sector revenues									
Public external debt service as	55.3	46.8		32.3		48.8		45.0	
% of public sector revenues									
Cultural value added as % of GDP	10.1	9.9		9.1		10.1		9.9	
Material value added as % of GDP	10.0	10.7		12.3		10.1		9.5	
Non-traditional exports as % of total	26.4	30.1		39.6		27.1		24.0	
Exports									

## H. Counterpart Funds

111. The local currency funds generated by the sale of foreign exchange provided under the loan to the Importers would be credited to an account held by the Government in the National Bank of Panama. The funds would be used to finance the Government's development expenditures which form part of the agreed 1983-85 investment program (Section..... of the draft Loan Agreement).

## I. Monitoring

112. The progress of the Government's structural adjustment program, of the measures supported by the SAL and of the technical assistance studies would be closely monitored through regular supervision. The Government would submit to the Bank quarterly reports on such progress, the first such report would be submitted by February 29, 1984 (Section....of the draft Loan Agreement).

## PART IV - BANK GROUP OPERATIONS

113. The Bank has to date made twenty-seven loans to Panama totalling US\$467.9 million (net of cancellations). Of these, 13 loans for US\$159.0 million are fully disbursed, two for roads totalling US\$13.1 million; one for an airport project for US\$20 million; three for agriculture totalling US\$5.7 million; two for fisheries totalling US\$8.2 million, three for power for US\$76 million; one for ports for US\$24 million; and one for water supply and sewerage for US\$12.0 million. Ongoing operations include one project for livestock credit; one for development of tropical tree crops; two for development banking; two for highway maintenance and rehabilitation; three in the power sector (for generation, transmission and distribution); one to support energy planning and petroleum exploration; one to help develop the water supply and sewerage sector; one for the urban development of Colon; and one for port development. The most recent loan to Panama, a sixth power project, was approved by the Executive Directors on June 9, 1983.

114. IFC has made three investments in Panama. The first was a commitment in 1971 to acquire US\$0.3 million of equity in the Corporacion de Desarrollo Hotelero, S.A. and to lend to the Corporacion US\$1.2 million to build a new international hotel. The second was a commitment in December 1977 to lend US\$2.4 million and acquire US\$1.4 million in equity in Vidrios Panamenos, S.A., the first glass container factory in Panama. These projects have been satisfactorily completed. The third is a commitment in 1979 to acquire US\$2.5 million in equity in the Banco Latino-americano de Exportaciones (BLADEX), a regional export bank promoted by the Government of Panama.

115. While there are some difficulties, satisfactory overall progress in the implementation of ongoing projects is reflected in the steady increase in Bank disbursements from US\$17 million in FY79 and US\$16.1 million in FY80, to US\$31 million in FY81, US\$39 million in FY82, and US\$39.7 million in FY83. Annex II contains a summary statement of Bank loans and IFC investments as of March 31, 1983, and notes on the execution of ongoing projects.

116. Bank lending to Panama is designed to support the Government's development strategy particularly as regards the further development of Panama's infrastructure and service industries, the diversification of production and exports, and the rationalization of economic policies in order to create the climate conducive to stimulating economic activity. Specifically, the Bank assists those sectors in which it can make a special contribution in terms of: (i) developing policies and institutions; (ii) removing remaining infrastructure bottlenecks; and (iii) better utilizing the country's natural resources, including its geographic location. In addition to the proposed project, projects under active consideration for Bank lending include the technical assistance project submitted for consideration with the proposed project, a livestock project and a further power project.

117. Both USAID and the Inter-American Development Bank (IDB) have invested substantial amounts in agriculture and social services (including family planning in the case of USAID). Past lending patterns are likely to persist, at least as regards the social services, because the Government prefers to borrow on concessionary terms for these sectors, while utilizing other assistance for projects which are expected to result in more immediate economic benefits. In addition to agriculture and social services, the IDB is financing road construction, industry and telecommunications, sectors in which it is likely to continue lending. The IDB also participated with the Bank and bilateral and commercial sources in financing the Fortuna Hydroelectric Project and is financing a rural electrification program. In addition, USAID is lending for alternative sources of energy (other than petroleum). USAID expects to continue its efforts in manpower training and projects oriented toward environmental protection. USAID and UNDP are also providing additional technical assistance to increase the planning capacity of MIPPE and MIDA and to carry out additional studies to assist the Government in its policy reorientation efforts.

118. The Bank's share of Panama's publicly-guaranteed external debt outstanding and disbursed was 6.2 percent at the end of 1982 and the Bank's share of public external debt service was less than 4 percent in 1982. These percentages are expected to increase slightly in the 1980s.

#### PART V - LEGAL INSTRUMENTS AND AUTHORITY

119. The draft Loan Agreement between the Republic of Panama and the Bank, and the Report of the Committee provided for in Article III, Section 4(iii) of the Articles of Agreement are being distributed separately. Review of the progress of the technical assistance studies and the draft Bills of the Agricultural and Industrial Incentives Laws would be a condition of disbursement of the second tranche of the proposed loan (para. 118). Special conditions of the loan are listed in Section III of Annex III.

120. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank.

PART VI - RECOMMENDATION

121. I recommend that the Executive Directors approve the proposed loan.

A. W. Clausen  
President

Attachments  
August 19, 1983  
Washington, D. C.





• Not applicable  
• Not available

[illegible]