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CREATION OF A NATIONAL MONETARY SYSTEM
IN PANAMA

NOTE BY THE SECRETARIAT

The CIAP Subcommittee which met in September 1965 recognized that the Panamanian monetary system up to now appears to have functioned adequately. However, with a view to the future and taking into account the intensive development effort proposed by the government, the CIAP Subcommittee reiterated the recommendation made by the Ad Hoc Committee that evaluated the Panamanian Development Plan regarding the importance of continuing the studies of the monetary system in order to arrive at the appropriate policies in this field. Some consideration was also given in the Subcommittee last year to a closely related problem, namely the effects of the various U.S. policies linked to the U.S. balance of payments problems, on the flow of U.S. capital to Panama.

In the Secretariat Document (CIAP/31) prepared for the CIAP Subcommittee on Panama which will meet 31 August to September 3, 1966 in Washington, the importance of continuing studies designed to define the kind of monetary policies and institutions which Panama will require in the future was again mentioned among the important policy issues that might be reviewed in the discussion during the Subcommittee meeting. The following supplementary paper on "Creation of a National Monetary System in Panama" is a CIAP Secretariat contribution to the discussion of these basic and important issues.

CREATION OF A NATIONAL MONETARY SYSTEM IN PANAMA

1. Indroduction

The currency unit of Panama is the balboa, equal in value to one dollar. This currency was introduced in 1904. It is issued in the form of the silver balboa and subsidiary coins. Despite this, Panama does not have a truly national monetary system. By far the greater part of the money in circulation consists of U.S. dollar notes and coins. The banking system accepts deposits in balboas and dollars and a large part of the banking reserve consists of dollar currency and dollar deposits in the United States. The Government of Panama's capacity to guide credit policy to meet the needs of the Panamanian economy is very limited.

From the point of view of the individual or the business firm, Panama's monetary system seems very attractive. The fundamental currency unit is the U.S. dollar; and the balboa, to the extent that it is used, has absolute equivalence with it. Panama's inability to affect credit policy is a guarantee against inflation, even though it prevents any action from being taken to prevent or offset deflation. The fact is that prices have been remarkably stable. The cost of living index in March 1966 was 106 on a 1958 base. This is essentially a retail commodity price index, including very little services. In fact, the rise in prices is almost the same as in the "all commodities" component of the U.S. consumer price index which was 106.0 in April 1966 (1957-59=100).

From the national point of view, the monetary system has serious defects, which are as follows:

1. It involves the high cost of using a commodity currency in circulation and in bank reserves. From the point of view of Panama the U.S. dollar is a commodity currency in exactly the same way as if gold coins were in common circulation and were held as bank reserves.
2. It imposes on Panama the same credit policy as that decided by the Federal Reserve for the United States, regardless of the credit needs of the Panamanian economy. The banking system has very little independent flexibility.
3. It exposes Panama to the uncertainties and the risks resulting from action taken by the United States in dealing with its own balance of payments. Thus, for example, Panama is not exempt from the guidelines restricting foreign credits of U.S. banks.
4. The balboa component of the currency in circulation is a high-cost money commodity as it consists of silver now valued at US\$1.30 an ounce. Furthermore, because the balboa component is exclusively silver, it is subject to the practical risks of being melted down if the price of silver rises further.

2. High Cost of Dollar Currency

There is no way of determining with certainty how much U.S. currency circulates in Panama. A useful estimate for this purpose can be made on the basis of currency in circulation in the five Central American republics, where it ranges from 5 to 8 percent of the gross national product. These data are for 1964, but in two instances for 1963. The highest

ratio of currency is in Guatemala which has a monetary unit equal to the U.S. dollar, a high degree of price stability, and a very conservative credit policy. It may be assumed that the preference for currency holding in Panama would not be far different from that in Guatemala. On this basis, the amount of currency in circulation in Panama would be about 8 percent of the gross national product--say, about US\$45 million in 1964, and probably well over US\$50 million at present.

CURRENCY AND DEPOSITS IN CENTRAL AMERICA, 1964

Country	Millions of national units			Percent of gross national product		
	Currency	Demand deposits	Time deposits	Currency	Demand deposits	Time deposits
Panama	569 n.a.	60	51	n.a.	10.5	9.0
Costa Rica	3 651 228	340	166	6.2	9.3	4.5
El Salvador <u>a/</u>	1 784 111	123	154	6.2	6.9	8.6
Guatemala	895 72	66	70	8.0	7.4	7.8
Honduras	921 46	44	40	5.0	4.8	4.3
Nicaragua <u>a/</u>	2 989 177	220	53 <u>b/</u>	5.9	7.4	1.8

a. Data are for 1963.

b. It should be noted that there has been a sharp increase in time and savings deposits in Nicaragua (to 180 million cordobas) since 1964.

Demand deposits and time and savings deposits in Panama are slightly higher, relative to GNP, than in the Central American republics. In addition, there is a substantial amount of foreign deposits (denominated in U.S. dollars) in the private banks, all or mainly held by foreign residents. At the end of 1965, the foreign deposits amounted to US\$35 million--about 65 percent of the demand deposits denominated in balboas.

On the assumption that there is about US\$50 million of U.S. currency in circulation in Panama, the cost to the country of having this rather than a national currency equivalent in every respect to the dollar is now about US\$2.5 million a year. This can be seen from a simple assumption. If Panama were to have a Currency Board system such as that which was in common use in British territories in the past (and for that matter, originally in the Philippines), the Currency Board could hold US\$50 million of assets in the United States on which it would earn US\$2.5 million a year. It could issue with 100 percent U.S. dollar backing (that is what a Currency Board does) B/50 million. The currency would be just as good as the U.S. dollars now in circulation and because of the 100 percent backing they would actually be Panamanian dollars.

The banks hold balboas and U.S. dollars as reserves against bank deposits. The dollars are either in the form of coins and notes, for vault cash, or held as assets in the United States. To the extent that the dollars held as bank reserves are in the form of income-earning assets in the United States, they represent no direct monetary cost as distinguished from the economic cost of holding Panamanian assets in this form instead of using them for other purposes. On the other hand, the dollar currency held as vault cash has the same monetary cost to the country as the circulation of dollars. In short, if there were a Currency Board system, the dollars held in vault cash would be turned over to the Currency Board for balboas and the dollars would have been invested in liquid assets in the United States.

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From Panama's point of view, it is evident that the use of dollar currency, whether for circulation or for vault cash in banks, is precisely the same as using gold. The U.S. dollar is for Panama a true commodity currency. Every dollar must be earned or borrowed. Every dollar represents an assets performing a domestic monetary function that could be as well perfomed by concentrating the dollars in the hands of the monetary authorities and issuing domestic currency backed 100 percent by dollars.

From an economic point of view, the money cost of using the dollar as currency is only part of the economic cost. Panama is a relatively poor country with a shortage of capital for development. A major part of the dollars in circulation represents the use of capital for an unnecessary purpose. Even with a very conservative monetary system, a reserve of 40 percent in dollars against balboas would be adequate to assure convertibility of the national currency into dollars. This 40 percent reserve could be invested in income-earning assets in the United States. The remaining 60 percent could be used to pay for imports of capital equipment which could make a positive contribution to the development of the economy.

The use of the dollar as the basic money in Panama is an inducement to people in Panama to hold a considerable part of their savings in dollars in the United States. It has already been noted that there are large dollar deposits in Panama. These presumably are mainly held by nationals of the United States resident in the country. But it is very likely that large sums are held as dollar deposits by nationals of Panama within the

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country, and to an even greater extent in the United States. Reports of U.S. banks to the U.S. Treasury showed that at the end of May 1966, there were US\$129 million of short-term dollar assets held in the United States by residents of Panama other than the Panamanian government and Panamanian banks. While most of such dollar assets belong to U.S. residents of Panama, a not inconsiderable amount probably belongs to Panamanian nationals.

3. Effect on Panamanian Credit Policy

Panama's dependence on the dollar as the true basis of its monetary system results in a high degree of responsiveness to the credit policy of the United States. In countries with a monetary system based on a foreign currency--that is, where there is no independent monetary authority--seasonal and even cyclical needs for credit depend upon borrowing by domestic banks (including foreign banks operating in the country) from banks abroad. This was true under the Currency Board system used in British territories and in the Philippines when the gold exchange fund held a 100 percent reserve in gold and dollars against pesos.

Under the present system, when there is a need for additional bank credit in Panama, this need can be met by banks only if they hold excess reserves (probably in dollars, in order to earn income on these funds) or if they can borrow dollars in the United States. The cost and availability of credit from U.S. banks depends upon the credit policy of the Federal Reserve system. When credit is tightened in the United States, it becomes somewhat harder for Panamanian banks to borrow the funds they

need as a basis for expanding bank credit to their own customers. Even foreign banks in Panama would find their head offices more reluctant to make advances to them when credit is tight in the United States. Thus tight credit in the United States means tight credit in Panama and easy credit in the United States means easy credit in Panama. As U.S. credit policy is made with reference to the needs of the U.S. economy, the monetary system imposes on Panama the same credit policy as that of the United States, regardless of national needs.

This is not to imply that there is no flexibility of credit policy in Panama. To the extent that Panamanian banks hold excess reserves, they can extend additional credit even without borrowing from U.S. banks. Even this, however, would provide only a limited degree of flexibility. There is a money cost to the banks in holding excess bank reserves in dollars. Therefore, the amount of excess reserves is likely to be moderate at best. Once they have been used up, the flexibility they provide is exhausted. The flexibility could then be restored only by building up excess reserves again. The holding of excess reserves is not an attractive policy for private banks eager to maximize their earning power. It would be a reasonable public policy, however, for the government banks.

It would also be possible for the Government to use its deposits as an instrument of credit policy. That is to say, when credit should be eased in Panama, the government could reduce its deposits in one form or another; and when credit should be tightened, it could increase its deposits. Such a system under which the government undertakes open market

operations would require it to hold its assets outside the domestic banking system or, if deposited in domestic banks, would require the banks to hold a higher reserve ratio against government deposits. This would bear some resemblance to the Independent Treasury of the United States which used to undertake such operations in times of crisis before the establishment of the Federal Reserve. It is a possible, but not practical, way of introducing a slightly greater degree of flexibility in the banking system.

One should be careful not to exaggerate the limitations on flexibility of credit policy in Panama imposed by the present system. A country that is determined under any and all conditions to maintain stability of prices and stability of the exchange rate would have to be restrained in its credit policy, regardless of the authority vested in the domestic monetary authorities. This is all the more true in Panama where about 30 percent of the gross national product is represented by exports and by services sold to the Canal Zone and to the Colon Free Zone. Under the circumstances, the growth of bank credit to the private sector in Panama in the past few years has been about as much as might have been possible or appropriate with a national monetary and banking system subject to policies decided by domestic monetary authorities. In the seven years from 1958 to 1965, Panama had a much larger increase in bank credit to the private sector than any of the other five Central American republics.

BANK CREDIT TO THE PRIVATE SECTOR IN CENTRAL AMERICA, 1953-65

	Million national units			Percent increase from 1953 to	
	1958	1963	1965	1963	1965
<u>Panama, total</u>	<u>67.6</u>	<u>134.7</u>	<u>185.2</u>	<u>99.3</u>	<u>174.0</u>
Government banks	(33.1)	(54.2)	(66.6)	(42.3)	(74.8)
Private banks	(29.5)	(80.5)	(118.6)	(172.9)	(302.0)
Costa Rica <u>a/</u>	522.9	811.9	1,025.6	55.3	96.1
El Salvador	283.4	349.6	426.2	23.4	50.4
Guatemala	34.7	122.3	152.0	45.0	79.5
Honduras	37.0	67.4	94.2	32.2	154.6
Nicaragua	421.3	452.3	712.3	7.2	69.0

a. Total bank credit. Costa Rica does not show bank credit separately for the private and public sectors.

4. Risks and Uncertainties

When one country bases its monetary system on the currency of another, it assumes certain risks and burdens. The most obvious of these is that the exchange rate is tied to that of the other currency. In the case of Panama, with the balboa tied to the dollar and the dollar the actual working currency of the country, the risk of an unwanted devaluation of the dollar is negligible. Even when the dollar was devalued in 1933-1934, it was in an environment in which the economic interests of Panama as well as those of the United States were served by this action. As a matter of fact, the tie to the dollar is neither a risk nor a burden, but an element of certainty that is welcomed by most people in Panama. Needless to say, the same tie could be maintained by a monetary system subject to the control of national monetary authorities.

There is another risk and burden that is inescapable. As already noted, with a dependent monetary system, credit policy in Panama must reflect to a reasonable degree the state of credit policy in the United States. This has not seriously affected the expansion of domestic credit in Panama since 1958, although United States credit policy has until recently been very easy. But there is a risk that arises from the fact that the relationship between the monetary system of Panama, based on the dollar, and that of the United States involves obligations that are not reciprocal. Panama is by the nature of its monetary system linked not only to the dollar as a currency, but to the credit policy of the United States. However, in the formulation of its monetary policies the

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United States assumes no obligation to take account of Panama's special relationship to the United States monetary system or the needs of the Panamanian economy.

In this respect, the relationship of Panama to the United States is less favorable than the relationship of the United Kingdom to the territories that had Currency Boards with note issues based on 100 percent sterling reserve. Even after the United Kingdom established exchange control, capital movements to the sterling area were free, although, of course, the other countries in the sterling area were required to establish the same exchange controls. The difference in the responsibility assumed by the United Kingdom toward the sterling area and that of the United States to countries with a dollar monetary system is underlined by the recent action taken to improve the United States balance of payments. As part of that program, the Federal Reserve limited the increase in outstanding bank credit to foreigners in 1965 to about 5 percent of the amount outstanding at the end of 1964. The new guidelines this year placed a limit of 10 percent on the increase in bank credit from the end of 1964 to the end of 1966.

Under this program, United States banks actually reduced the outstanding amount of short-term claims on foreigners between December 31, 1964 and May 31, 1966. This program was much more stringent than the Interest Equalization Tax. At least, security issues of less developed countries, including all of Latin America, were exempt from this tax. No such exemption is made in the guidelines on bank credit. For all

Latin American countries as a group, outstanding short-term claims of United States banks were reduced from the end of 1964 to May 31, 1966. The significance of the reduction is evident from the fact that short-term banking claims on Latin America increased by nearly US\$150 million in 1963, and by about US\$470 million in 1964.

Panama has been more fortunate than other Latin American countries. The short-term claims of United States banks on Panama increased by US\$10 million in 1965 and by US\$5 million in the first five months of 1966. This is a larger increase in United States short-term bank credit to Panama than in 1963 and 1964. The point is not that the guidelines for limiting bank credit to foreigners has actually had a restrictive effect on credit to Panama, but that it could. The United States banks are aware of the complete dependence of the monetary system of Panama on the dollar and because of this some United States banks, particularly those operating in Panama, do give consideration to the special position of that country in allocating their foreign lending.

5. High Cost of Balboa Currency

A great deal of emphasis was given to the fact that the United States currency used in Panama is really a commodity currency and that there is a high monetary cost in maintaining such a currency. The same objection can be made to the balboas issued by the Government of Panama which circulate as coins alongside the dollar notes. In their physical aspects--size, weight, silver content and fineness--the balboa and the fractional silver coins issued by the Government of Panama are precisely

the same as those of United States silver coins. This is obviously a great convenience, particularly as the coin-operated machines are the same in the two countries.

At the same time, it should be pointed out that the balboa has become a full-bodied commodity coin worth precisely as much as its silver content. The balboa contains $371\frac{1}{4}$ grains of fine silver. The fractional coins contain 6 percent less silver by weight, relative to the nominal value. At the present market price of silver (US\$1 293 a fine troy ounce), the silver in the balboa is worth US\$1. To maintain such a currency in circulation, Panama incurs an imputed real cost of one dollar for each balboa. That is to say, if the silver balboas were withdrawn and replaced by one-balboa notes, the Government of Panama could realize US\$1 per balboa from its sale as silver.

There is a more urgent monetary problem in connection with the circulation of the balboa coins issued by the Government of Panama. It will be very difficult to maintain the present market price of silver once the United States Treasury exhausts its saleable stock of silver. The price would then rise above the melting point of the balboa (US\$1 293 a fine ounce) and of the fractional balboa coins (US\$1 375 a fine ounce). The coinage issued by the Government of Panama would completely disappear and be replaced with United States coins, particularly the new coins with less silver. Apart from the inconvenience that this would cause, Panama would become a country with a national monetary unit none of which circulates in the country.

As a matter of economy, the Government of Panama should consider the withdrawal of the present balboa and fractional silver coins. For convenience, the balboa should be replaced by a one-balboa note. This is what the United States is doing with the silver dollar. If the customs of Panama do require the circulation of a silver balboa, a new coin should be issued of the present weight but with a fineness of 500 rather than 900 parts in a thousand. The fractional silver coins should also be withdrawn and be replaced either with non-silver coins, silver-capped coins, or silver coins with a melting point of at least US\$2 a fine ounce. In this respect, Panama would do well to follow the example of the United States Treasury.

It should be noted that it is not essential to withdraw the coins, but it is essential to replace them. As Panama would have to pay US\$1 293 a fine ounce for the coins that are withdrawn, it might just as well buy new silver and issue the new coins. Of course, the old coins would be hoarded or exported, but there would be little profit in that until the market price rises. In the meantime, the issue of the new coins would assure continued availability of fractional silver to meet the economic needs of the country and there would, incidentally, be a considerable seigniorage if the melting point of the new coins were set at US\$2 or more an ounce.

6. Establishing a National Monetary System

Panama has reached a stage of economic development where it should have an independent national monetary system. The best way to do that is to convert the national bank into a central bank. Such a central bank

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could be established on a very conservative foundation--for example, with a very high percentage dollar backing for the currency and other liabilities of the central bank. Furthermore, the maintenance of a stable exchange rate at parity with the dollar and the maintenance of price stability could be made the primary objectives of the policy of the central bank. Other Central American republics have been quite successful in keeping the dollar value of their currencies and stable prices.

More than enough dollars necessary to back the new currency issues would come from the withdrawal of the dollar notes and the replacement of the present United States fractional silver coins and balboa coins with new coins having a much higher melting point. Besides, Panama would have access to its quota in the International Monetary Fund. Furthermore, it would be desirable to continue the closest possible monetary ties with the United States. For this purpose, the Government of Panama could enter into a stabilization agreement with the United States after a central bank is established. It is recommended that the Government of Panama request the International Monetary Fund to appoint a technical mission to recommend the measures that should be taken to establish a central bank.

As an alternative, and as an interim measure, it would be possible for Panama to establish a National Currency Board authorized to issue notes and coins in balboas against a reserve of 80 percent in U.S. dollars (the dollars to be kept as income-earning assets in the United States). The first step would be to authorize the issue of balboa notes and to replace the existing silver balboa coinage with new coins with a melting

point of US\$2 a fine ounce. The balboa and only the balboa would be made legal tender for payments to the government. Alternatively, the government could turn over to the National Currency Board the dollars it receives in taxes and take in return balboas deposited in the form of notes by the National Currency Board in the national bank. The National Currency Board would also have responsibility for the issue of coins. It would replace the existing coins with the new coinage, purchasing the silver and having the coins minted in the United States. As the United States mints are very busy now, this could only be done with some delay. After an interim period of, say, five years, the circulation of dollars would be terminated. This would not be done, of course, by forbidding people to use dollars, but by requiring banks to accept deposits in balboas and to pay out balboas exclusively. The retention of dollar deposits could be permitted either as an interim or permanent feature of the system.

Obviously, a central bank would be preferable to a National Currency Board. Nevertheless, until there is wide support for a central bank, a National Currency Board would be able to add an important element of flexibility to the present monetary system. For this purpose, it would retain the seigniorage from the reissue of the silver coins. While it would not be engaged in any lending operations, it should be permitted to deposit in the national bank the notes it issues in excess of its dollar reserves, including the seigniorage profits.

The National Currency Board could consist of three members--one representing the Ministry of Finance, one representing the national bank, and one representing the private banks. Because of a possible crisis in silver coinage, the immediate appointment of a National Currency Board is desirable even if its functions are limited to the replacement of the existing silver coinage with notes and new fractional coin; and even if the National Currency Board is required to maintain a 100 percent reserve in dollars against the notes and coins it issues. On this question too, the Government of Panama might wish to request the technical assistance of the International Monetary Fund.

A monetary system under the control of national monetary authorities will facilitate the achievement of the economic objectives of Panama. These objectives are economic development in an environment of monetary stability. In order to achieve these objectives, Panama may find it desirable to become a member of the Central American Common Market. One aspect of the economic integration of Central America is the coordination and ultimately the unification of the monetary system of the region. If Panama is to cooperate with other Central American republics in the monetary sphere, it will have to have a monetary system that is under the control of its national monetary authorities. The establishment of a central bank, or at least of a National Currency Board, is an essential part of the national monetary system.