FOR AGENDA

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August 20, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Panama - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Panama.

This subject will be brought to the agenda for discussion on a new date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Stephens (ext. (5)8638).

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INTERNATIONAL MONETARY FUND

PANAMA

Staff Report for the 1984 Article IV Consultation

Prepared by the Western Hemisphere Department

(In consultation with the Exchange and Trade Relations, Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by Eduardo Wiesner and Manuel Guitian

August 20, 1984

I. Introduction

The 1984 Article IV consultation discussions 1/ with Panama were held in Panama City during the period June 26-July 11, 1984. The Panamanian representatives in the discussions included the Minister of Planning and Economic Policy; the Minister of Finance and Treasury; the Ministers of Commerce and Industry, Labor, and Agriculture; the Comptroller General; the General Manager of the National Bank; and other senior officials of the Government, the National Bank, and various public agencies and enterprises. The mission also held discussions with the President-elect who accedes to the Presidency on October 11, 1984.2/ Mr. Hernando Arias, Advisor to the Executive Director, participated in the policy discussions.

The last Article IV consultation discussions with Panama were held in the periods January 31-February 19, 1983 and March 13-23, 1983. Concurrently, negotiations on a financial program for 1983-84 also were conducted. The resulting reports were considered by the Executive Board on June 24, 1983. On that occasion the Executive Board approved a stand-by arrangement with Panama (EBS/83/102; 5/24/83) for the 18-month period through the end of 1984 in an amount equivalent to SDR 150 million or 147 percent of quota. A review of the stand-by arrangement was conducted in the period November 7-23, 1983 at which time quantitative targets for 1984 were negotiated. The ceilings and targets for calendar year 1984 were approved by the Executive Board on February 8, 1984 (EBS/84/8; 1/11/84).

1/ Panama has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

2/ The staff mission consisted of Samuel Stephens (Head), Esther Suss, Alfredo Baumgarten, David Hoelscher, Augusto Lopez-Claros, and Teresita Puri (Secretary), (all WHD).

Panama has to date made all scheduled purchases under the stand-by arrangement. As of August 15, 1984, total outstanding purchases from the Fund to Panama stood at SDR 258 million or 252.5 percent of Panama's quota, of which SDR 125.3 million was financed from ordinary resources and the remainder from borrowed resources under the policy on enlarged access. Further information on Panama's relations with the Fund is presented in Appendix I.

II. Background and Performance Under the Stand-By Arrangement in 1983

1. Background

Panama has no central bank and the U.S. dollar circulates freely as legal tender and as the medium of exchange. In these circumstances domestic demand pressures are directly reflected in the balance of payments, while the behavior of domestic prices tends to reflect changes in import prices and world prices for domestically traded exportables. The size of the current account deficit is limited by the availability of foreign financing and the overall balance of payments is always in equilibrium. Panama holds no official international reserves. Panama's liberal banking legislation enables the international banks operating in Panama to freely determine their domestic exposure. Economic management therefore rests predominantly on fiscal policy.

In the 1980-82 period real GDP growth averaged more than 5 percent per year while inflation, as measured by the GDP deflator, decelerated from 10 percent in 1980 to below 5 percent in 1982 (Table 1). The start of two large construction projects--a transisthmus petroleum pipeline and the hydroelectric generation complex at La Fortuna--contributed substantially to real GDP growth in 1982. Unemployment increased slightly from 8.2 percent in 1980 to 9.4 percent in 1982.

The overall deficit of the nonfinancial public sector, which was equivalent to 5.5 percent in both 1980 and 1981, widened to 11 percent of GDP in 1982 as the authorities sharply raised spending in part to compensate for a slowdown in private sector activity. The sharply increased public sector deficit in 1982 was financed almost entirely with foreign credits, and the external public debt increased by almost 20 percent to US$3.2 billion at year-end, the equivalent of 76 percent of GDP; the debt service rose to 36 1/2 percent of exports of goods and services.

At the end of 1982, a sharp reduction in the public sector borrowing requirements became necessary, as Panama's access to international capital markets was severely limited. In response, the Government adopted an adjustment program supported by a stand-by arrangement with the Fund. The basic aim of the program was a strengthening in the public finances with a reduction targeted in the public sector deficit from B 462 million (11 percent of GDP) in 1982 to B 270 million (6 percent) in 1983, to be followed by a further reduction to B 250 million

Table 1. Panama: Selected Economic and Financial Indicators

	1981	1982	1983 Prog.	1983 Prel.	1984 Prog.	1984 Proj.
(Annual percent changes, unless otherwise specified)						
National income and prices						
GDP at constant prices	4.2	4.7	1.0	-1.7	2.0	0.6
GDP deflator	6.1	4.8	5.0	3.2	4.0	2.0
External sector (on the basis of U.S. dollars)						
Exports, f.o.b.	-5.7	-1.6	23.1	-10.5	7.9	-2.0
Imports, f.o.b.	9.2	2.2	2.6	-9.6	5.9	-3.8
Non-oil imports, f.o.b.	13.1	4.8	-1.8	-10.9	7.1	0.2
Export volume	(-16.0)	(-2.0)	(17.1)	(10.9)	(...)	(...)
Import volume	(-6.9)	(-1.1)	(1.4)	(12.6)	(...)	(...)
Terms of trade deterioration (-)	(-7.4)	(-1.5)	(--)	(-0.4)	(...)	(...)
Central Government						
Revenue and grants	11.5	9.4	5.9	4.7	5.3	-2.0
Total expenditure	7.3	16.6	-3.3	-1.2	4.2	-1.8
Money and credit						
National Bank net credit to public sector 1/	1.9	-1.8	--	-1.0	--	3.6
Interest rates 2/	...	...	...	...	...	...
(In percent of GDP)						
Public sector saving	4.1	1.3	2.7	2.5	4.0	2.3
Overall public sector deficit	-5.5	-11.0	-6.0	-5.8	-5.5	-6.2
Domestic financing	(--)	(-0.8)	(--)	(-1.2)	(--)	(0.5)
Foreign financing	(3.5)	(11.8)	(6.0)	(7.0)	(5.5)	(5.7)
Gross domestic investment	30.8	29.2	24.6	22.6	24.0	19.8
Gross national savings	20.4	18.8	18.6	18.1	18.5	12.5
Current account deficit of balance of payments	10.4	10.4	6.0	4.5	5.5	6.2
External debt	66.1	71.7	74.7	74.9	78.7	76.4
Inclusive of use of Fund credit	68.6	73.7	77.3	79.6	81.0	83.3
(In percent of exports of goods and nonfactor services)						
Debt service	29.4	36.6	28.4	26.4	34.3	32.3
Interest payments	16.7	19.6	17.3	16.0	18.6	19.0
(In percent of public sector revenue)						
Debt service	40.1	48.9	37.4	32.4	39.8	46.7

Sources: Office of the Comptroller General; and Fund staff estimates.

1/ Measured in terms of liabilities to the private sector at the beginning of the period.

2/ Freely fluctuating in line with international rates.

(5.5 percent of GDP) in 1984 (Table 2). Under the program the fiscal deficit was to be financed exclusively from bilateral and multilateral agencies as the nonfinancial public sector was not expected to have any net recourse to external commercial credit or to credit from the National Bank except to cover normal seasonal financing requirements. The program assumed that output would expand by 1 percent in 1983 while inflation was targeted to remain at around 5 percent.

In order to effect the fiscal adjustment, the authorities took a number of measures in 1983 to increase revenue and limit expenditure growth. The revenue measures included increases in import tariffs on manufactures, machinery, and transport equipment, the substitution of tariffs for existing quota restrictions on about 150 products, increased sales taxes on petroleum products, and a program to improve customs administration.1/ On the expenditure side, the program called for a fall in capital outlays from 12 percent of GDP to 9 percent as the public investment program was cut back by eliminating or postponing a number of projects. Total outlays were reduced correspondingly as general government's current spending were programmed to change only marginally in relation to GDP. In addition, the authorities instituted new control procedures in all public sector entities to ensure that spending would remain within budgeted levels. The 1983 budget also incorporated the results of a thorough review of the operations of decentralized agencies and public enterprises. As a result, a number of entities were liquidated and the operations of others were sharply curtailed.

In 1983, real GDP declined for the first time in seven years, reflecting a decline in construction and a much reduced demand for shipping and commercial services. In particular, the services provided by the Colon Free Zone were severely affected by the economic problems experienced in Latin America, and its activity and employment fell sharply in 1983. Construction also declined in line with the winding down of the La Fortuna hydroelectric project and the completion of the oil pipeline. The price developments were much better than had been expected with inflation decelerating to 3.2 percent in 1983, in line with the slowdown of inflation in Panama's trading partners. Public sector wages increased by over 11 percent in 1983 reflecting large wage concessions made to teachers, doctors, and nurses in late 1982. This was in excess of the 5.5 percent wage gain obtained by the private sector in collective bargaining negotiations. The current account deficit of the balance of payments narrowed to 4.3 percent of GDP from 10.4 percent in 1982. This reflected the combined effect of an improvement in the trade balance and an increase in net services and transfers receipts following the first full year operation of the oil pipeline. The narrowing of the trade deficit stemmed from higher domestic exports mainly sugar and miscellaneous manufactured products and a sharp drop in retained imports (principally manufacture, machinery, and transport equipment).

1/ For a more complete description of these measures, see EBS/83/102, May 24, 1983.

Table 2. Panama: Operations of the Nonfinancial Public Sector

	1981	1982	1983 Prog.	1983 Actual	1984 Prog.	1984 Proj.
	(In millions of balboas)					
Consolidated public sector revenue	1,169.0	1,264.5	1,392.3	1,399.1	1,472.5	1,432.0
General government 1/	1,106.6	1,223.3	1,340.5	1,328.7	1,359.0	1,306.4
Public enterprises' operating balance	62.4	41.2	51.8	70.4	113.5	125.6
Surplus or deficit (-) of nonconsolidated public sector	6.6	-2.0	—	17.6	—	—
Consolidated public sector total expenditure	1,383.5	1,726.5	1,662.3	1,663.8	1,722.5	1,702.3
General government current expenditure	1,013.6	1,208.1	1,272.8	1,255.9	1,289.1	1,332.4
Capital expenditure	369.9	518.4	389.5	407.9	433.4	369.9
Public sector savings 2/	155.4	56.4	119.5	126.8 2/	183.4	99.6
Overall deficit of consolidated public sector	-214.5	-462.0	-270.0	-264.7	-250.0	-270.3
Overall public sector deficit	-207.9	-464.0	-270.0	-247.3	-250.0	-270.3
External financing (net) 3/	208.7	495.6	270.0	298.4	250.0	250.0
National Bank financing (net)	-0.8	-31.6	—	-51.1	—	20.3
	(Annual percentage change)					
Consolidated public sector revenue	15.9	8.2	9.3 4/	10.6	5.8 4/	2.4
Consolidated public sector expenditure	14.8	24.8	-4.3 4/	-3.6	4.3 4/	2.3
General government current expenditure	13.8	19.2	4.5	4.0	5.6	6.1
Capital expenditure	17.8	40.1	-24.9	-21.3	0.7	-9.3

Table 2. Panama: Operations of the Nonfinancial Public Sector (Concluded)

	1981	1982	1983 Prog.	1983 Actual	1984 Prog.	1984 Proj.
	(As percent of GDP)					
Consolidated public sector revenue	30.8	30.0	31.1	32.6 2/	32.3	32.6
Surplus of the non-consolidated public sector	0.2	0.1	—	0.4	—	—
Consolidated public sector expenditure	36.5	41.0	37.1	38.8	37.8	38.7
General government current expenditure	26.7	28.7	28.4	29.3	28.3	30.3
Capital expenditure	9.8	12.3	8.7	9.5	9.5	8.4
Public sector savings	4.3	1.4	2.7	2.9 2/	4.0	2.3
Overall public sector deficit	-5.5	-11.0	-6.0	-5.8	-5.5	-6.2
External financing	5.5	11.8	...	7.0	5.5	5.7
Domestic financing	—	-0.8	...	-1.2	—	0.5

Sources: Office of the Comptroller General; and Fund staff estimates.

1/ Includes foreign grants-in-aid.
2/ Includes surplus of the nonconsolidated public sector and in 1983 excludes proceeds of B 34 million from the sale of a hotel.
3/ Includes net disbursements from the Fund, FIVEN, and PEMEX intermediated through the National Bank.
4/ Percentage changes incorporated in the program were calculated on the basis of preliminary data for the previous year.

2. Performance under the stand-by arrangement in 1983

Panama's performance in 1983 under the stand-by arrangement was satisfactory. The overall public sector deficit amounted to B 247.3 million for the year (5.8 percent of GDP), about B 23 million below the program limit of B 270 million (6 percent of GDP) and public sector savings were equivalent to 2.9 percent of GDP, compared with the target of 2 1/2 percent. While the limit on net external borrowing of B 270 million was exceeded by B 33 million, the excess was exclusively used to strengthen the liquidity position of the National Bank (Table 3).

The current revenue of the general government fell slightly below the program target in absolute terms but was equivalent to 31.8 percent of revised GDP. The shortfall affected nearly all categories of revenues but was most pronounced in the income taxes and in receipts from the Panama Canal. However, the Government received some B 47 million from discounting the promissory notes of the Panama Petro-Terminal Pipeline Company (PTP). This was a new major source of revenue that was not envisaged in the program.1/ Revenues of the decentralized agencies and the Social Security Agency also fell below expectations. However, the shortfall in general government revenue was offset in part by an increase in the operating surplus of state enterprises and a realized surplus equivalent to 0.4 percent of GDP in the operations of the non-consolidated public sector as against a projected balance. A decentralized agency also sold a hotel for B 34 million which raised total revenue of the public sector to the programmed level. Total expenditure of the public sector was on target in absolute terms as a reduction in general government current expenditure stemming from lower interest payment in line with a fall in interest rates abroad was offset by higher capital outlays.

Net external borrowing by the public sector in 1983 amounted to US$298 million and raised the external public debt to about 80 percent of GDP at the end of 1983. The proportion of debt from commercial sources declined somewhat, however, as virtually the entire amount of new borrowing originated in official bilateral and multilateral lending agencies. Debt service ratio fell to 26 percent of export of goods and services because of lower interest and amortization (Table 4). In September 1983, the Government of Panama reached agreement with foreign commercial banks on a US$278 million loan to cover the amortization of loans from commercial banks and of external bonds in 1983-84. Approximately US$130 million was disbursed and an equal amount amortized in 1983 under the agreement.

1/ During the first five years of its operations, the oil pipeline company is permitted to pay its income tax liabilities with promissory notes issued on a quarterly basis.

Table 3. Panama: Performance Under the Stand-By Arrangement

(In millions of balboas)

	1983				1984 1/	
	Mar.	June	Sept.	Dec.	Mar.	June
Nonfinancial public sector deficit						
Cumulative limit	...	150.0	210.0	270.0	350.0	410.0
Actual	48.0	93.8	133.3	247.3	286.1	400.4
Margin or excess (-)	...	58.2	76.7	22.7	63.9	9.6
Net National Bank credit to nonfinancial public sector						
Ceiling 2/	...	334.0	259.0	214.0	234.0	234.0
Adjusted ceiling	...	420.1	395.4	369.2	413.1	439.0
Actual	324.2	345.4	322.5	322.3	335.7	429.7
Margin or excess (-)	...	74.7	72.9	46.9	77.4	9.3
Net foreign borrowing of public sector						
Cumulative limit 3/	...	30.0	165.0	270.0	330.0	390.0
Adjusted limit	...	-43.5	69.9	153.9	407.4	399.3
Actual	-58.3	-45.0	68.4	186.4	364.9	393.3
Margin or excess (-)	...	1.5	1.5	-33.2	42.5	--
Net commercial borrowing of public sector						
Cumulative limit	...	--	40.0	--	--	--
Actual	-73.3	-78.8	-18.9	2.1	-0.6	-10.6
Margin or excess (-)	...	78.8	58.9	-2.1	0.6	10.6
Outstanding commercial debt with maturity of less than one year						
Ceiling	...	...	...	64.0	...	...
Actual	...	...	37.8	41.0	...	...

Sources: Office of the Comptroller General; and National Bank of Panama.

1/ In cumulative terms from January 1, 1983.
2/ Ceiling will be adjusted upward to the full extent of the net purchases from the Fund and of net disbursements from the Mexican and Venezuelan oil facilities intermediated through the National Bank.
3/ Limit will be adjusted downward to the full extent of any net purchases made from the Fund.

Table 4. Panama: External Public Debt Indicators

(In percent)

	1979	1980	1981	1982	1983	Proj. 1984
Debt service ratios 1/						
Public sector receipts 2/	53.1	42.6	40.1	48.9	32.4	44.5
Interest payments	26.4	23.2	22.8	26.2	19.6	26.2
Amortization	26.7	19.4	17.3	22.7	12.8	18.3
GDP	14.5	13.4	13.2	15.5	11.1	15.3
Interest payments	7.2	7.3	7.5	8.3	6.7	9.0
Amortizaton	7.3	6.1	5.7	7.2	4.4	6.3
Exports of goods and nonfactor services	34.9	28.4	29.4	36.6	26.4	32.3
Interest payments	17.3	15.5	16.7	19.6	16.0	19.0
Amortization	17.6	12.9	12.7	17.0	10.4	13.3
External public debt ratio to GDP	77.4	68.0	68.6	73.7	79.6	83.3
Multilateral and bilateral agencies	20.9	18.1	21.4	23.5	30.1	35.9
Of which: IMF	(1.5)	(0.6)	(2.5)	(2.0)	(4.7)	(6.9)
Debt contracted at commercial terms	56.5	49.9	47.2	50.2	49.5	47.4
Effective interest rates 3/						
On total external public debt	9.8	11.2	11.3	12.3	8.9	11.1
On debt contracted at fixed rates	6.6	7.2	6.6	6.8	4.7	5.7
On debt contracted at variable rates	12.6	14.3	15.1	16.6	11.1	12.0
Memorandum item						
Six-month LIBOR 4/	12.2	14.0	16.6	13.5	9.8	12.0

Sources: Office of the Controller General; National Bank of Panama; and Fund staff estimates.

1/ Because Panama has no central bank and uses the U.S. dollar as its medium of exchange, the debt service ratio to public sector receipts and to gross domestic product are a more meaningful measure of debt burden than the more traditional ratio to export of goods and nonfactor services.

2/ Public sector receipts are defined as the sum of general government revenue and the operating surplus of the state enterprises before interest payments.

3/ Interest rate on average debt outstanding during the period.

4/ Period average.

III. Developments in 1984

1. The 1984 financial program

The program for 1984 called for the continuation of the adjustments initiated in 1983. The overall public sector deficit was expected to decline to B 250 million,1/ or the equivalent of 5.5 percent of GDP. While public sector savings were targeted to increase to 4 percent of GDP, the targeted deficit was to be financed entirely from bilateral and multilateral sources. Inasmuch as the program provided for no net increase in commercial debt, the program envisaged a further reduction of the share of commercial debt in the total public external debt. In addition, the Government was expected to continue substituting import quotas for tariffs, reducing its control over pricing policies, and modernizing Panama's system of investment incentives.

The 1984 program had been planned on the assumption that output would expand at a rate of 2 percent with an inflation rate of approximately 4 percent. Consolidated public sector revenue, including the operating surpluses of the state enterprises, was projected to rise by about 6 percent. No new revenue measures were contemplated, but improvements in customs administration and the ongoing conversion of import quotas into tariffs were expected to contribute to revenue and to offset a decline in income tax receipts resulting from a fall in corporate profits in 1983. A member of the Fund's Fiscal Affairs Department's panel of experts has been assisting the Panamanian authorities in customs administration.

Total expenditure was projected to increase by about 4 percent in 1984, mainly on the basis of a 5.6 percent rise in general government current expenditures. The full-year effect of a general pay increase in mid-1983, together with other pay adjustments originating in commitments made in 1982, were projected to increase the wage bill by 12 percent. Interest payments by the public sector were expected to show a small decline while the other current account expenditures were to remain below their 1983 level in real terms. Meanwhile, public sector capital expenditure was programmed at B 433 million, or 9.5 percent of GDP, a level consistent with the public sector investment program agreed with the World Bank under Panama's structural adjustment loan.

2. Performance under the stand-by arrangement in 1984

During the first half of 1984, there has been compliance with the program's targets although there were indications that the targets for the year as a whole would be difficult to attain.

1/ The performance criteria for the public sector deficit under the program was set on a cumulative basis from January 1, 1983. Thus, the deficit for 1984 may exceed the B 250 million limit by B 23 million, or the margin accumulated in 1983.

The ceiling on National Bank net credit to the public sector was observed with a margin of B 9.3 million on June 30, 1984, and the limits on external borrowing were met. The public sector deficit amounted to B 153 million, B 10 million below the cumulative 18-month limit, (the one on commercial debt was met with a margin of B 10.6 million). While the public sector deficit was below target, the reduction in the B 23 million margin that existed at the end of 1983 implied that the deficit in the first six months of 1984 was larger than targeted which placed performance for the year as a whole in jeopardy.

Public sector revenue was some 9 percent lower in the first half of 1984 than in the comparable period a year earlier, while current expenditures rose by 9 percent and capital outlays remained approximately unchanged. The lackluster revenue performance was partly explained by unanticipated economic developments. According to the latest estimates, output is now projected to grow by less than 1 percent in 1984, while inflation is expected to be about 2 percent. The projected slower growth in real GDP has been based on a steeper than expected decline in the services sector, which is expected to be offset by a better than anticipated performance in manufacturing and construction; this latter appears to be a response to the removal of rent controls. The current account deficit of the balance of payments is now forecast to widen to 6 percent of GDP in comparison to 5.5 percent targeted in the program and 4.3 percent in 1983. The prospective deterioration stems mainly from higher interest payments on the official external debt and reduction in net receipts from services and transfers.

IV. Summary of Policy Discussions

The consultation discussions centered on Panama's performance under the stand-by arrangement. In view of the changed economic outlook, the adequacy of existing policies was examined to ensure compliance with the performance criteria during the remaining period of the program.

1. Fiscal policies

The Panamanian authorities characterized the fiscal performance of the public sector in 1983 as having been very satisfactory. The sharp reduction in the overall deficit and the strong savings performance of the public sector had been achieved notwithstanding the decline in economic activity. They noted, in particular, the contribution that had been made to the realization of the Government's fiscal targets by the exercise of effective expenditure control at all levels of the public sector and, more generally, by improvements in the efficiency of public administration.

The Panamanian authorities indicated their firm commitment to an overall public sector deficit in 1984 that would be no larger than the limit permitted under the program. They regarded such an outcome as consistent with the Government's medium-term objective of reducing the size and relative importance of the public sector.

The authorities noted that a reassessment of the public sector's operations in May indicated that, in the absence of corrective measures, total revenue for the year as a whole could be B 80 million lower than originally estimated and expenditures some B 54 million higher largely because of larger interest payments stemming from a rise in interest rates abroad. This would have raised the estimate of the overall public sector deficit in 1984 to B 384 million (8.7 percent of GDP) compared with the target of B 250 million (5.5 percent of GDP). The projected shortfall in revenue, which in the authorities view largely reflected the weaker than anticipated economic performance, was in income tax receipts (B 24 million); taxes on foreign trade (B 10 million); contributions to the Social Security Agency (B 33 million); the net operating surplus of state enterprises (B 8 million); and grants (B 9 million). In order to bring the program back on track the authorities instituted a series of adjustment measures in early June. Expenditure cuts totaling B 74 million were effected, of which about B 50 million represented a reduction in general government estimated purchases of goods and services and B 24 million in planned capital outlays, mainly by the decentralized agencies. Estimated revenue of the Central Government was expected to be boosted by B 24 million representing possible dividend payments by the oil pipeline company (PTP), and the estimated net operating surplus of state enterprises by B 16 million that would be derived from tightened expenditure controls and planned cuts in spending on goods and services.

There was some doubt, however, that dividends would be paid by PTP in 1984 to its shareholders, including the Government which has a 40 percent equity in the company. Under PTP's existing financing arrangement, no dividend should be paid until all promissory notes issued to the Government had been redeemed.1/ The Panamanian Government has been negotiating with foreign commercial banks a refinancing of PTP's outstanding debt of US$200 million. The authorities expected that any new financing arrangement would allow for the liquidation of already issued promissory notes and for the start of dividend payments by the PTP. The authorities were confident that at least B 12 million would be received in 1984 but they noted that, if necessary, other fiscal measures would be taken to compensate for any shortfall in dividends.

Altogether, the authorities now expect to contain the overall deficit of the consolidated public sector to B 270 million. This would be financed by net external borrowing of B 250 million as originally planned, and by a drawdown of B 20 million in the balances built up in the National Bank at the end of 1983. These levels of borrowing would permit the authorities to comply with the financial program. Public sector savings, however, were not expected to exceed 2 1/2 percent of GDP this year, compared with the program target of 4 percent.

1/ The promissory notes have a five-year maturity and a maximum interest rate of 12 percent.

The authorities noted that the weakness in revenue collections in 1984 had not been fully appreciated by the authorities until several months had elapsed. With respect to central government revenue, they felt initially that the slower growth in income tax receipts was due largely to delays in the settlement of income tax liabilities by businesses during the period of uncertainty leading up to the presidential elections in May. Likewise, it was not known until May when an in-depth review of public sector operations was conducted that income tax receipts from the pipeline company would be lower than anticipated because of reduced throughput.

During the first five months of the year, expenditure was somewhat higher than programmed because of outlays related both to the elections and to higher interest payments. The slowdown in economic activity also had adversely affected the operations of the Social Security Agency, which had been expected to generate a substantial overall surplus in 1984. Contributions were running below expectations because of an increase in the level of unemployment while payments of benefits were forced upwards. Concurrently, the implementation of the Agency's capital spending program had also accelerated (outlays for housing in January-May were nearly as large as the total planned for the full year).

The staff commended the authorities on the measures already taken to put the program back on track but noted that they would need to exercise vigilance in this regard in the remainder of the year. The staff acknowledged the Government would comply with the performance criteria under the program if the revised projections were realized. However, the level of the overall deficit in relation to GDP would have increased in 1984 rather than fallen and the level of projected public sector savings would represent a significant departure from a main objective of the program. Furthermore, the planned drawdown of balances built up in the National Bank, though not inconsistent with the program, would not only weaken the liquidity position of the National Bank but would also limit the Government's operational flexibility. The staff, therefore, recommended that efforts to curtail current expenditures in 1984 should be intensified so as to keep the overall deficit to at most B 250 million and to raise the level of public sector savings.

5. Although the staff placed emphasis on expenditure restraint, it also felt that there was scope for additional revenue measures. In particular, it repeated a suggestion made by a previous staff mission to Panama that the Government should intensify its efforts to improve customs administration. The staff also recommended the reinstatement of the portion of the 13-month contribution by workers to the Social Security Agency, or the adoption of alternative measures that would yield at least an equivalent amount. The elimination of that contribution reduced fiscal revenues by about B 30 million in 1984. The staff was also disturbed that the overall operations of the Social Security Agency deteriorated so sharply in 1983 and that the prospect for 1984 differed so significantly from earlier estimates. The magnitude of the

divergence suggested that the overall position of the Social Security Agency could be boosted through further improvements in administrative efficiency. The operating surplus of the electricity company could also be increased through modification of its pricing policy. The La Fortuna hydropower project began limited operations in May 1984, at which time electricity charges were reduced with a further reduction planned for late this year or early in 1985. The staff argued that although there was an obligation to reduce the fuel surcharge, the authorities might revise upwards basic electricity rates.

The authorities indicated that they would give serious consideration to the staff's suggestions and observations. However, with respect to the electricity rates they noted that the relatively high cost of electricity was among the factors that constrained their efforts to attract foreign investors.

2. External debt management

A key objective of the Government's financial program was to slow down the rate of increase of the external debt while improving its maturity structure. The limits on the overall public sector deficit in 1983 and 1984 were therefore set at amounts that could be financed from multilateral and bilateral sources. As a result, outstanding debt contracted on commercial terms is expected to fall to 47 percent of GDP at the end of 1984.

The authorities are concerned about the external debt situation over the medium term. There is bunching of debt repayments to foreign and domestic commercial banks, with US$250 million falling due in 1985, US$420 million in 1986, and US$520 million in 1987. On the assumption of a moderation in new external borrowing, this pattern of debt repayment is projected to raise the debt service ratio from 32 percent of exports of goods and services in 1984 to an average of 48 percent in 1986-87 (Table 5).1/ Meanwhile, disbursements of development credits are expected to taper off following the completion of the La Fortuna hydroelectric project this year. At the same time, the bilateral credit arrangements with Mexico and Venezuela, which in recent years had provided substantial net disbursements, would require net amotization in 1985-87.

The authorities recognize the difficulties lying ahead. However, they do not contemplate any further net recourse to commercial borrowing and they are planning to negotiate the refinancing of maturities falling due in 1985-86 with commercial banks later this year. In that connection, the authorities expressed their wish to negotiate a new stand-by

1/ These ratios are based on indicative rates of growth in output and export of goods and services to obtain a general idea of trends. The authorities expressed a strong preference to discuss future economic trends only within the framework of the government financial program for 1985-86.

Table 5. Panama: Outstanding External Debt

	1981	1982	1983	Projected 1984	1985	1986	1987	1988
	(In millions of U.S. dollars)							
Public sector external debt outstanding (at end of period) 1/	2,698.0	3,197.6	3,500.5	3,750.5	3,975.5	4,200.5	4,425.5	4,650.5
Public sector debt service	498.7	653.1	476.3	668.8	814.7	1,084.3	1,213.7	1,221.5
Principal 2/	215.2	302.8	187.8	393.6	398.1	641.7	759.8	723.5
Interest 3/	283.5	350.3	288.5	275.2	416.6	442.6	453.9	498.0
	(In percent)							
Ratio of public sector debt to GDP 4/	71.1	75.9	81.7	83.3	85.3	85.0	82.9	80.7
Ratio of debt service payments to exports of goods and nonfactor services 4/	29.4	36.6	26.4	32.3	38.0	47.7	49.5	46.1

Sources: Office of the Comptroller General; National Bank of Panama; and Fund staff estimates.

1/ The figures are based on the public debt including bonds placed locally contracted as of December 1983; assumes annual net increase of US$225 million after 1984.
2/ Amortization of medium- and long-term debt outstanding.
3/ Interest on total debt outstanding.
4/ These ratios differ slightly from those shown in Table 4 because of the inclusion of bonds placed locally for purposes of the financial program.

arrangement with the Fund covering the period 1985-86 to succeed the current one which expires at the end of this year. They believe a new two-year Fund program, in addition to providing the macroeconomic framework for their policies, would greatly assist them in their negotiations with commercial banks regarding the refinancing of amortization payments due in those years.

3. Commercial policy

Panama does not maintain restrictions on payments and transfers for current and capital international transactions, but a number of trade restrictions do exist. As explained below, the Government's tariff policy and protection practices are being modified in accordance with its development strategy. In 1983, the authorities began to implement an earlier Presidential decree which called for the substitution of ad valorem tariffs for quotas as an instrument of protection. Quotas on nearly 150 products were eliminated in 1983 and the corresponding imposition of tariffs has been accompanied by the elimination of price controls on most of the affected items. Quotas on additional products have been eliminated in 1984 and it is planned that by March 1985, only seven product groups 1/ would remain subject to quotas. The initial level of tariffs has been established on a case-by-case basis and a timetable for tariff reduction has been agreed with the World Bank and has been included in a draft Industrial Incentives legislation. The ultimate objective is to limit the level of effective protection given to new industrial activities in the first year of operation to a maximum 125 percent protection, which in Panama is roughly equivalent to an average ad valorem tariff of 40 percent. The level of tariff protection would thereafter be reduced toward a low and uniform level of 10 percent ad valorem.

4. The structural adjustment

The fiscal adjustment, which the Government initiated in 1983 coincided with a period of stagnant economic activity. Inasmuch as it was very clear that Panama's access to foreign credit was severely limited, the authorities had to reassess the Government's role in the economy; this reassessment culminated in a program of economic reorientation, which was also supported by a structural adjustment loan of US$60 million from the World Bank; the second and final tranche of that loan was disbursed on June 30, 1984. The underlying theme of the structural adjustment program has been a reduction in the public sector's influence over economic activity and the encouragement of the private sector to play a dominant role in the economy.

1/ Corn, hides and skins, tomatoes, salt, onions, powdered milk, and cement posts.

The authorities noted that Panama's industrial and commercial policies had favored the development of a competitive service sector. They were not conducive, however, to labor intensive, export-oriented manufacturing activities. Similarly, the Government's agricultural policies were also geared more toward the achievement of social objectives than toward the pursuit of economically sound productive endeavors. They tended to encourage import substitution through the establishment of protected domestic markets while public sector investments in agriculture were designed to ease unemployment pressures, resulting in substantial transfers of resources from the rest of the economy without commensurate increase in agricultural production. Furthermore, the authorities noted that the regulation of the labor market in Panama through the Labor Code that was enacted in 1972 has also tended to inhibit employment creation because of provisions for relatively high severance pay and the curtailment of the freedom to adjust employment.

The World Bank has assisted the authorities in identifying policy measures that are consistent with the Government's newly formulated development strategy. These policies have been designed, in particular, to (1) reduce the scope and increase the efficiency of the public sector; (2) to reorient the incentive structure in the industrial sector toward exports and employment generation; and (3) to increase productivity and output in agriculture (see Appendix II, EBS/84/8; 1/11/84).

a. The public sector

The Government's 1983-84 financial program represents an important aspect of its efforts to reduce the size of the public sector and to improve its efficiency. The program takes fully into account the World Bank's recommendation that, in order to achieve these objectives, public sector capital outlays should be reduced progressively from 12 percent of GDP in 1982 to about 7 1/2 percent by 1985. Such a reduction in the size of the public sector's capital program has necessitated the elimination or postponement of low priority projects.

b. Industrial incentives

In early 1983, the Government announced that new industrial contracts would be offered for five-year periods (in contrast to the existing average of ten years) and that extensions would be granted only sparingly. Tariff protection was also made more selective. These administrative changes have been incorporated in a new draft Industrial Incentive legislation, which was approved by Cabinet in May 1984 and is expected to be enacted into law by the new administration. The Bill establishes equal incentives for all firms, requiring only their registration at the Ministry of Commerce and Industry. The basic objective of the Bill is to reorient the structure of incentives to stimulate exports through a substantial but gradual reduction in tariffs in accordance with a timetable agreed with the World Bank, tax exemptions for exporters, and the removal of price controls.

c. Agriculture

In early 1983, the Government reduced the support price for rice, eliminated price controls on expensive cuts of meat and on potatoes, removed export restrictions on five agricultural products, and reclassified and established a new pricing system for milk. In addition, the state-owned banana corporation and a sugar mill, both of which had recorded large operating deficits, were closed. An Agricultural Incentive Bill that received Cabinet approval in May 1984 provides for the elimination of price controls on horticultural products by late 1984, and a further reduction of the support price for rice by early 1985. The Bill also provides for the elimination of price controls on agricultural equipment and a reduction in interest rate subsidies to agriculture. The World Bank has also provided financing for a comprehensive study of agricultural institutions that would aim at identifying "the main institutional factors impeding the implementation of the Government's new agricultural strategy, and the extent to which policy discourages higher output." It is expected that further reforms in agriculture would be made on the basis of recommendations made in the study.

The President-elect assured the staff that he fully endorsed the new development strategy and was committed to implement the policy measures that have already been included in the draft Industrial Incentive and Agricultural Incentive legislation. As regards to further economic policy adaptation, he stated that his Administration intended to make a request for a multiple-year structural adjustment loan from the World Bank and that policy actions, if any, would be identified within that context.

V. Staff Appraisal

Following a substantial weakening of the public finances in 1982, the Government of Panama adopted in early 1983 an adjustment program supported by a stand-by arrangement from the Fund. The principal aim of the program was to reduce the overall financing requirements and raise savings of the nonfinancial public sector to levels consistent with the external financing available from bilateral and multilateral sources. The program called for a reduction of the overall deficit of the nonfinancial public sector from 11 percent of GDP in 1982 to 6 percent of GDP in 1983 and to 5.5 percent in 1984.

The program has been implemented successfully so far, even though economic circumstances have been less favorable than originally envisaged. Real GDP declined in 1983 for the first time in seven years and is expected to recover only marginally in 1984. At the same time, the slowdown in inflation has been more pronounced than expected earlier. In 1983 the overall deficit of the nonfinancial public sector was reduced below the program ceiling and a strong savings performance was registered. Although external borrowing from bilateral and multilateral sources exceeded programmed levels in 1983, the excess was entirely used to build up the liquidity position of the National Bank.

The quantitative performance criteria under the program through June 30, 1984 have been met. The public sector deficit was B 10 million below the cumulative 18-month limit and the ceiling on National Bank net credit to the public sector was observed with a similar margin. There was also compliance with the limits on total external borrowing and on net commercial borrowing by the public sector. However, the public sector deficit exceeded the targeted level for the first six months of 1984 by B 13 million. This implies that the margin that existed at the end of 1983 has been largely used up and that measures would be required to ensure compliance with the program in the rest of the year.

The authorities have taken revenue and expenditure measures aimed at containing the size of the overall public sector deficit to a level consistent with the limits on public sector borrowing contained in the program. They recognize, nevertheless, that public sector savings would fall short of the program's indicative target of 4 percent of GDP by a sizable margin. In the view of the staff, the measures taken by the Panamanian authorities go a long way toward achievement of the program's performance criteria. There are questions, however, about the recent revenue measures, and the staff would encourage the authorities to take any necessary action to guard against slippages in the implementation of the program. More generally, the staff would note that, consistent with the medium-term objective of a progressive reduction of the deficit and the debt burden, it would be important for the authorities to avoid an increase in the overall deficit in 1984 (relative to 1983) and to ensure a strengthening of public sector savings.

The staff has stressed that, in strengthening the public finances, emphasis should be given to curb current expenditure. However, action to raise revenue also would be needed. In this connection, the staff would advise the authorities to persist in their efforts to improve customs administration. Also, active consideration should be given to the reinstatement of the employees' wage contribution to the Social Security Agency or alternative measures should be taken that would yield an equivalent amount.

Although the authorities have been successful in slowing down somewhat the rate of accumulation of external debt and in improving its maturity structure, the debt service ratio remains high. The authorities have expressed concern about the problems of servicing the external debt over the medium term in view of the large principal repayments due to foreign commercial banks in the next few years. The staff would reiterate that a lasting solution to Panama's debt problem would require a sufficient reduction of the overall financing requirements of the public sector so as to obviate the need for commercial borrowing. The authorities have expressed interest in a two-year stand-by arrangement from the Fund on the expiry of the present one in order to provide an appropriate macroeconomic framework and to assist them in their negotiaations with commercial banks on debt refinancing.

The adjustment in the public finances constitute an integral part of the Government's strategy to reduce the size of the public sector and to encourage the private sector to play a more dominant role in the economy. The staff welcomes the authorities' determination to persist in their efforts to deregulate the economy, including the substitution of tariffs for import quotas and the elimination of price controls.

Finally, it is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Fund Relations with Panama
(As of July 31, 1984, unless otherwise indicated)

I. Membership Status

(a) Date of membership: March 14, 1946.
(b) Status: Article VIII.

A. Financial Relations

II. General Department

(a) Quota: SDR 102.2 million.

(b) Total Fund holdings of balboas: SDR 335.22 million or 328.0 percent of quota.

(c) Fund credit:

Of which:	Amount	Percent of Quota
Fund credit	233.02	228.00
Credit tranches	(66.38)	(64.95)
Compensatory financing	(58.90)	(57.63)
Supplementary financing	(37.47)	(36.66)
Enlarged access	(70.27)	(68.76)

III. Current Stand-by Arrangement and Special Facilities

(a) Current stand-by arrangement:

(i) Duration: From June 24, 1983 to December 31, 1984.
(ii) Amount: SDR 150 million.
(iii) Utilization: SDR 100 million.
(iv) Undrawn balance: SDR 50 million.

(b) Compensatory financing facility:

(i) Date of approval: June 24, 1983
(ii) Amount: SDR 58.9 million

IV. SDR Department

(a) Net cumulative allocation: SDR 26.32 million

(b) Holdings: SDR 3.53 million or 13.41 percent of net cumulative allocations.

B. Nonfinancial Relations

V. Exchange Rate: The exchange value of the Panamanian balboa is fixed to the U.S. dollar at a rate of B 1 per US$1. The Fund's holdings of balboas are valued on the basis of a representative exchange rate under Rule O-2, paragraph (b)(i). The currency of the United States (notes and coins) is legal tender in Panama.

VI. Last Article IV Consultation: The 1983 consultation discussions were held in the period January 31- February 19, 1983 and March 13-23, 1983 and were concluded by the Executive Board on June 24, 1983.

VII. Technical Assistance: A Fiscal Affairs Department panel expert has been assigned beginning October 1982 to provide assistance in the area of Customs Administration. A Central Bank panel expert was assigned in November 1983 to provide technical assistance to the National Banking Commission.

Panama--Basic Data

Area and population	
Area	77,082 sq. kilometers
Population (est. mid-1983)	1.97 million
Annual rate of population increase (1979-83)	2.5 percent
GDP (1983)	SDR 4,089 million US$4,286 million B 4,286 million
GDP per capita (1983)	SDR 2,035.2

	1981	1982	1983	Proj. 1984
Origin of real GDP		(percent)		
Agriculture and mining	10.6	10.2	10.7	11.0
Manufacturing	9.7	9.5	9.5	9.5
Construction	7.1	8.4	6.2	6.7
Commerce	14.0	13.3	12.6	12.2
Oil pipeline	1.2	2.3	5.7	5.6
Government	12.3	12.3	13.0	12.9
Other	45.1	44.0	42.3	42.1
Ratios to GDP				
Exports of goods and nonfactor services	44.8	42.3	42.1	47.2
Imports of goods and nonfactor services	44.7	44.7	39.9	43.6
Current account of the balance of payments	-10.4	-10.4	-4.3	-6.1
Central government revenues	20.9	20.5	21.1	20.2
Central government expenditures	26.0	27.2	26.5	25.3
Central government savings	0.6	-1.3	-0.1	-1.3
Central government overall surplus or deficit (-)	-5.1	-6.7	-5.3	-5.1
External public and government-guaranteed debt (end of year) 1/	71.1	75.9	81.3	85.3
Gross national savings	20.4	18.8	18.1	13.4
Gross domestic investment	30.8	29.2	22.4	19.5
Money 2/ and quasi-money (end of year)	45.4	46.2	45.9	...
Annual changes in selected economic indicators				
Real GDP per capita	1.7	1.6	-4.2	-1.9
Real GDP	4.8	4.7	-1.7	0.6
GDP at current prices	7.4	11.1	1.7	2.6
Domestic expenditure (at current prices)	12.6	8.9	6.0	...
Investment	(26.5)	(6.9)	(-5.6)	(...)
Consumption	(9.4)	(10.8)	(10.1)	(...)
GDP deflator	3.0	6.1	3.4	2.0
Consumer prices (annual averages)	7.3	4.2	3.6	3.5
Central government revenues 3/	11.5	9.4	4.7	-2.0
Central government expenditures 4/	12.6	19.9	-1.1	4.1
Money and quasi-money	18.3	13.2	1.0	5.2
Money 2/	(7.2)	(6.2)	(-2.4)	(8.7)
Quasi-money	(21.5)	(15.1)	(1.9)	(3.6)
Net domestic bank assets 5/	33.7	17.8	6.5	4.8
Credit to public sector (net)	(8.6)	(7.4)	(7.8)	(3.8)
Credit to private sector	(28.1)	(4.1)	(0.1)	(-0.2)
Merchandise exports (f.o.b., in U.S. dollars)	-5.7	-1.6	-10.5	-2.0
Merchandise imports (f.o.b., in U.S. dollars)	9.1	2.2	-9.6	-3.8

Central government finances	1981	1982	1983	Proj. 1984
	(millions of balboas)			
Revenues 3/	791.1	865.3	906.2	888.0
Expenditures 4/	767.4	919.8	909.5	947.0
Current account surplus or deficit (-)	23.1	-54.5	-3.3	-59.0
Overall surplus or deficit (-)	-193.5	-282.3	-227.8	-225.8
External financing (net)	61.2	304.5	98.5	122.0
Internal financing (net)6/	132.3	-22.2	129.3	103.8
Balance of payments	(millions of U.S. dollars)			
Merchandise exports (f.o.b.)	496.2	488.2	436.7	428.2
Merchandise imports (f.o.b.)	-1,464.9	-1,496.8	-1,353.2	-1,302.0
Travel (net)	109.5	93.2	100.0	105.0
Investment income (net)	-275.6	-372.1	-320.1	-420.0
Other services and transfers (net)	740.2	848.7	951.4	918.5
Balance on current and transfer accounts	-392.6	-438.8	-185.2	-270.3
Official capital (net)	203.9	509.1	295.6	270.3
Private capital and errors and omissions (net)	225.6	-73.3	-22.2	--
Other official bank transactions (net)	-36.9	3.0	-88.2	--

International reserve position	December 31 1981	1982	1983	June 30 1984
	(millions of SDRs)			
National Bank (gross)	103.1	90.6	191.1	108.4
National Bank (net)	-134.4	-201.2	-267.1	-286.3

1/ Includes short-term debt and debt to branches of foreign banks located in Panama.
2/ Demand deposits only.
3/ Includes grants.
4/ Excludes capital expenditures.
5/ In relation to the stock of money and quasi-money at the beginning of the period.
6/ Includes credit from FIVEN, PEMEX, and the Fund intermediated through the National Bank.