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EBS/83/192

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September 6, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Panama - Staff Report for Review Under Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the review under the stand-by arrangement for Panama. A draft decision appears on page 11.

It is proposed to bring this subject to the agenda for discussion on Friday, September 16, 1983 subject to agreement by the Executive Board to request to shorten the circulation period for the document to less than the usual four weeks.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Baumgarten, ext. (5)7152.

Att: (1)

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INTERNATIONAL MONETARY FUND

PANAMA

Staff Report for Review Under Stand-By Arrangement

Prepared by the Staff Representatives for the Stand-By Review with Panama

Approved by Eduardo Wiesner and W. A. Beveridge

September 2, 1983

I. Introduction

On June 24, 1983, the Executive Board approved a stand-by arrangement with Panama (EBS/83/102; 5/24/83), extending through the end of calendar 1984, in an amount equivalent to SDR 150 million (222.2 percent of Panama's quota of SDR 67.5 million), of which SDR 29.7 million is from ordinary resources and SDR 120.3 million is from borrowed resources. At the same time, the Board approved a request for a purchase under the CFF in an amount equivalent to SDR 58.9 million (87.3 percent of quota). Panama had no purchases outstanding under this facility up to that point. Panama made a purchase of SDR 10 million upon approval of the stand-by arrangement, and in accordance with provisions under the arrangement, purchases in the remainder of 1983 could amount to SDR 40 million (Table 1). Further information on Fund relations with Panama is provided in Appendix I.

In a letter dated April 29, 1983 requesting the stand-by arrangement, the Panamanian authorities stated that they would review with the Fund before September 30, 1983 the progress made in the implementation of the financial program for 1983. The review discussions were held in Panama City from August 8-17, 1983.1/ Representatives for Panama included the Minister of Planning and Economic Policy, the Minister of Finance and Treasury, the General Manager of the National Bank, the Comptroller General, and other senior government officials. The mission was also received by the President of the Republic.

II. The Program for 1983 and 1984

Following steady economic growth and the pursuit of prudent financial policies in the three-year period ended 1981, the fiscal stance shifted to an expansionary course in 1982. The overall deficit of the nonfinancial public sector widened to the equivalent of 11 percent of

1/ The staff team consisted of Armando Linde (Head-WHD), Alfredo Baumgarten (WHD), Enrique Matayoshi (STAT), and Valerie Rowles (Secretary-WHD).

Table 1. Panama: Projected Purchases and Scheduled Repurchases June 1, 1983 - December 31, 1984

	Operations During Period of Arrangement								
	Out-standing May 31, 1983	June-July 1983	Aug.-Oct. 1983	Nov. 1983 Jan. 1984	Feb.-Apr. 1984	May-July 1984	Aug.-Oct. 1984	Nov.-Dec. 1984	Out-standing Dec. 31, 1984
	(In millions of SDRs)								
Purchases									
Under tranche policies		10.0 1/	20.0	20.0	25.0	25.0	25.0	25.0	
Ordinary resources		(6.3)	(9.1)	(9.1)	(5.2)	(--)	(--)	(--)	
Enlarged access		(3.7)	(10.9)	(10.9)	(19.8)	(25.0)	(25.0)	(25.0)	
Compensatory financing		58.9 1/	--	--	--	--	--	--	
Repurchases									
Under tranche policies		--	--	--	--	1.1	1.6	4.7	
Ordinary resources		(--)	(--)	(--)	(--)	(1.1)	(1.1)	(4.7)	
Supplementary financing		(--)	(--)	(--)	(--)	(--)	(0.5)	(--)	
Net purchases		68.9	20.0	20.0	25.0	23.9	23.4	20.3	
Memorandum items									
Total holdings (end of period)	142.8								344.3
Quota	67.5								67.5
Under tranche policies	75.3								217.9
Ordinary resources	(37.8)								(60.6)
Enlarged access	(--)								(120.3)
Supplementary financing	(37.5)								(37.0)
Compensatory financing	--								58.9
	(In per cent of quota)								
Total holdings (end of period)	211.5								510.1
Excluding compensatory facility	211.5								422.8

Source: International Monetary Fund.

1/ Actual transactions.

GDP in 1982, from less than 5-1/2 percent of GDP in the preceding two years, and the external public debt increased by almost one fifth to US$3.2 billion at the end of 1982, or the equivalent of 75 percent of GDP.

The need to ease the growing burden of debt service payments and restrictions on access to foreign financing made it necessary to reduce sharply the public sector borrowing requirements. The financial program for 1983 and 1984, therefore, called for a reduction in the public sector deficit from B 464 million in 1982 to B 270 million or the equivalent of 6 percent of GDP in 1983, and for a further decline to the equivalent of 5-1/2 percent of GDP in 1984.

The magnitude of the deficit that would be permitted was established on the basis of available financing from multilateral and bilateral international agencies; thus, the program calls for no net recourse to commercial credits during the program period. The outstanding external public debt contracted at commercial terms was projected to decline from 50 percent of GDP at the end of 1982 to 47 percent of GDP at the end of 1983 and to some 43 percent of GDP at the end of 1984. To protect the liquidity position of the National Bank, the program also stipulated that there would be no net recourse to National Bank credit by the public sector, except to cover normal seasonal needs which were taken into account in phasing the credit ceilings.

The authorities have taken a number of revenue and expenditure decisions to make feasible attainment of the fiscal targets. The revenue measures that have been adopted include tariff increases on a large number of imported goods as well as a replacement of existing quota restrictions on a number of consumer goods with tariff protection. Taxes on imported petroleum and ship registration fees also were raised and the pricing policies of the public enterprises have continued to be reviewed periodically; the latest such revision led to increases in water rates and port fees.

On the expenditure side, the authorities undertook a thorough revision of the operations of a number of decentralized agencies and public enterprises that have required in the recent past large government subsidies. In the process some of these entities were liquidated and the operations of others have been sharply streamlined.1/ The investment budget was also pared back by eliminating or deferring to a future date a number of projects that did not have high priority. Because a good part of the adjustment in the public finance was to come through investment cuts, the Panamanian authorities requested World Bank assistance in assessing the adequacy of Panama's investment plans. Negotiations with the World Bank on a stuctural adjustment loan have progressed smoothly, and the Bank staff is preparing at present the required documentation.

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

III. Developments Through July 1983 and Report on Discussions

1. Performance under the financial program

Panama's financial performance in the first half of 1983 was better than expected. Through June 1983, the overall deficit of the nonfinancial public sector amounted to only B 73 million, compared with a program limit of B 150 million for that period and with a deficit of B 238 million during the first half of 1982. The ceiling on National Bank net credit to the public sector was observed with a margin of B 75 million, and the limits on net external borrowing by the entire public sector were met as well (Table 2). Heavy interest payments on the external debt in July raised the public sector deficit to B 109 million through that month (Table 3).

Fiscal developments in recent months have reflected a better than anticipated revenue performance and a very tight control over public expenditure. In the first six months of 1983, total public sector receipts increased by 13 percent in relation to the same period of last year, and were higher than had been projected. The buoyancy of receipts is related in part to proceeds from the purchase by a foreign firm of a large luxury hotel that the Government put on auction last January. The sale price was US$34 million, and two of three installments for a total of US$20 million already have been received. Leaving aside these proceeds, total receipts still show an increase of close to 9 percent, ahead of estimated nominal GDP growth.

New restrictions that the authorities have recently imposed on public spending also have served to keep the public sector deficit in check. These restrictions involve mainly procedural changes in the expenditure control process. Under previous rules, the authorization of expenditure required only that quarterly appropriations for the ministries and other spending agencies were based on the availability of budgetary allocations as certified by the Office of the Comptroller General. These rules have been modified to include a thorough post-audit on expenditure that is conducted by the Comptroller's Office at the beginning of each calendar quarter to ascertain whether the allocations in the previous quarter had been fully utilized and applied solely as provided for in the budget. These changes have made it possible for budget officials to identify areas of waste in government spending, while ensuring that resources are being used only as intended. Often in the past, the slow implementation of investment projects because, for example, of adverse weather conditions or other physical impediments, allowed spending units to gain access to funds, which were not always spent as required. This situation occasionally gave rise to requests for extrabudgetary credits to continue projects or to provide services for which funding had been exhausted. In addition to the strict enforcement of expenditure control procedures, the Government also has imposed a hiring freeze since May, and this is expected to keep the public wage bill below budgeted levels.

Table 2. Panama: Performance Under the Stand-by Arrangement

(In millions of balboas)

	1983			
	Mar.	June	Sept.	Dec.
Nonfinancial public sector cumulative deficit				
Cumulative ceiling	...	150.0	210.0	270.0
Actual	48.0	72.8		
Margin or excess (-)	...	77.2		
Net National Bank credit to nonfinancial public sector				
Adjusted ceiling	...	420.1		
Ceiling 1/	...	334.0	259.0	214.0
Net purchases from IMF	-0.5	73.5		
Changes in liabilities to Venezuela oil facility	--	-0.2		
Changes in liabilities to Mexico oil facility	3.9	12.8		
Actual	324.2	345.4		
Margin or excess (-)	...	74.7		
Net foreign borrowing of public sector				
Adjusted ceiling	...	-43.5		
Ceiling 2/	...	30.0	165.0	270.0
Net purchases from IMF	-0.5	73.5		
Actual	-58.3	-45.0		
Nonfinancial public sector debt	-62.5	-58.8		
National Bank 3/	4.2	13.8		
Margin or excess (-)	...	1.5		
Net commercial borrowing of public sector				
Ceiling	...	--	40.0	--
Actual	-73.3	-59.7		
Margin or excess (-)	...	59.7		

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

1/ Ceiling will be adjusted upward to the full extent of the net purchases that the National Bank might make from the Fund during the period of the stand-by arrangement, and of net disbursements on loans to Panama from Venezuela's Investment Fund and from the Mexico oil facility intermediated through the National Bank.

2/ This limit will be adjusted downward to the full extent of any net purchases made from the Fund by Panama.

3/ Excludes net purchases from the Fund.

Table 3. Panama: Operations of the Nonfinancial Public Sector

	1979	1980	1981	1982	1983 Prog.	Jan.-June 1982	Jan.-June 1983
	(In millions of balboas)						
Consolidated public sector revenue	708.2	1,032.6	1,177.3	1,274.1	1,392.3	611.0	688.8
General government 1/	704.7	978.8	1,110.8	1,246.8	1,340.5	596.1	658.3
Public enterprises current account surplus	3.6	53.8	66.5	27.3	51.8	14.9	30.5
Consolidated public sector total expenditure	1,054.2	1,229.3	1,391.8	1,736.1	1,662.3	856.8	770.9
General government current expenditure	750.6	915.3	1,021.9	1,217.7	1,272.8	596.3	581.0
Capital expenditure	303.6	314.0	369.9	518.4	389.5	260.5	189.9
Consolidated public sector savings 1/	-42.4	117.3	155.4	56.4	119.5	14.7	107.8
Overall deficit of consolidated public sector	-346.0	-196.7	-214.5	-462.0	-270.0	-245.8	-82.1
Overall surplus or deficit (-) of nonconsolidated public sector	15.4	12.6	6.6	-2.0	--	3.0	9.3
Overall public sector deficit	-330.6	-184.1	-207.9	-464.0	-270.0	-242.8	-72.8
External financing	196.1	227.6	61.6	435.8	270.0 2/	300.2	-54.7
National Bank	139.9	-40.5	131.1	31.2	--	-54.2	131.6
Other domestic financing	-5.4	-3.0	15.2	-3.0	--	-3.2	-4.1
	(Annual percentage changes)						
Consolidated public sector revenue	19.0	45.8	14.0	8.2	9.3	8.1	12.7
Consolidated public sector expenditure	9.7	16.6	13.2	24.7	-4.3	22.5	-10.0
General government current expenditure	(21.0)	(21.9)	(11.6)	(19.2)	(4.5)	(16.2)	(-2.6)
Capital expenditure	(-10.8)	(3.4)	(17.8)	(40.1)	(-24.9)	(40.0)	(-27.1)
	(As per cent of GDP)						
Consolidated public sector revenue	25.3	29.4	30.3	30.1	31.1	...	...
Consolidated public sector expenditure	37.6	35.0	35.8	41.1	37.1	...	...
General government current expenditure	(26.8)	(26.0)	(26.3)	(28.8)	(28.4)	(...)	(...)
Capital expenditure	(10.8)	(9.0)	(8.5)	(12.3)	(8.7)	(...)	(...)
Consolidated public sector savings	-1.5	3.3	4.0	1.3	2.7	...	...
Overall public sector deficit	-11.8	-5.3	-5.4	-11.1	-6.0	...	...
External financing	7.0	6.5	1.6	10.4	...	...	...
Domestic financing	4.8	-1.2	3.8	0.7	...	...	...

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

1/ Includes grants in aid.
2/ This limit is to be adjusted downward to the full extent of any net purchases from the Fund, and net disbursements from Mexico and Venezuela under the San Jose Agreement that the National Bank is to channel to the nonfinancial public sector.

The upshot of these measures has been a contraction in public spending. Through June 1983, total public sector outlays were almost 10 percent lower than in the first six months of last year; the program had contemplated a decline in public spending of 4-1/2 percent. The overperformance with regard to the expenditure target was particularly pronounced in the case of current outlays. Current general government expenditures dropped by 2-1/2 percent from last year's level in the first half, whereas the program allowed for a 4-1/2 percent increase in these outlays.

Capital expenditure was to drop in 1983 by almost one fourth from the unsustainably high level recorded in 1982. Because those projects that were retained in the investment budget were judged to be economically sound, the authorities thought it important to prevent slippages in the implementation of the investment program. Nonetheless, some slippages have occurred, especially in the construction of the Fortuna hydroelectric plant and in government housing projects. As a result, investment spending by the public sector is falling at a somewhat faster rate than expected. The authorities have said that some of the problems that caused the slow execution of the investment budget, such as delays in the delivery of construction equipment, have now been resolved and the pace of capital spending is likely to quicken in the closing months of the year.

2. Report on discussions

The authorities expressed optimism in being able to meet comfortably the limit on the public sector deficit through September 1983, and they considered that the limit of B 270 million for the year as a whole could also be met with margin to spare. This margin, which on present trends may turn out to be B 30 million, should reflect a better than expected savings performance by the public sector. The program aimed at achieving a savings level equivalent to 2-3/4 percent of GDP. It now appears that savings might exceed 3-1/2 percent of GDP. In the first semester of 1983 the public sector current account surplus had reached B 108 million, a substantial improvement from the B 15 million surplus recorded last year, and close to the target for all of 1983.

This improvement has occurred despite a significant deterioration in the operating surplus of the electricity company (IHRE). A severe drought that has affected many regions of the country curtailed the power generating capacity of the Bayano hydroelectric plant and made it necessary to revert to thermal units. As a result, fuel consumption by IHRE has increased sharply. The authorities have indicated that electricity tariffs are to be adjusted in August 1983, under a formula that automatically passes on to consumers any increases in IHRE's fuel costs.

The authorities were pleased with the progress that has been made in negotiations with the World Bank on a structural adjustment loan. According to the staff of the World Bank, Panama has already put in place all the necessary stuctural changes to qualify for a disbursement late in 1983. The staff of the World Bank is now preparing the President's report and presentation to the loan committee and Board discussion should take place around the middle of November. The main characteristics of Panama's structural adjustment program were also described in some detail in EBS/83/102, May 24, 1983.

Panama has been engaged in an effort to raise a US$278 million loan from the international banking community. This loan is to cover amortization payments on external commercial debt falling due in 1983 and 1984, including bonded debt held by foreigners. Because of these repayments to foreign bondholders, Panama's external debt to banks would rise by US$80 million, or by about 6 percent over the two-year period.

At the time this paper was being prepared, the loan placement had yet to be finalized, but it appeared that the marketing phase was nearing completion. The last report indicated that commitments for US$268 million had been received from 125 banks. Most commitments were made conditional on full subscription of individual shares by the major creditors. At the same time, some banks had indicated that they would be willing to increase their participation if the placement were to fall short of full subscription. Only a few banks had yet to communicate their final decision, and only one of them is among the 30 largest creditors.

Assuming successful completion of the placement, the loan would be disbursed in six quarterly tranches beginning in the third quarter of 1983. The initial disbursement of US$90 million was established in accordance with the requirement of the financial program. The phasing of the ceilings on National Bank net credit to the public sector took into account scheduled amortizations on external debt due in the first half of 1983, which were to be met with advances to the Government by the National Bank. The phasing also assumed that a portion of the loan would be disbursed to the Government before September 30, 1983, and accordingly, the National Bank credit ceilings decline from June to September by an amount consistent with the expected initial disbursement. Subsequent disbursements would take place on a quarterly basis in amounts ranging from US$33 million to US$45 million set in accordance with scheduled commercial debt repayments.

Notwithstanding the progress being made in implementing their stabilization program, the authorities were concerned about the overall state of the economy. Despite the economic recovery in the United States, there were indications that the recession that began in Panama in the second half of 1982 was becoming more pronounced. Foreign demand for Panamanian goods and sevices seem to be more sensitive to economic conditions in the Latin American region than to overall world trade. The authorities expressed confidence that the economic recovery in the United States eventually would improve the economic situation in Panama, as it manifested itself through increased United States and world trade with the Latin American countries.

The services provided by the Colon Free Zone to international commerce have been severely affected by the economic problems experienced in the region. After advancing rapidly by more than 20 percent a year in the four years ended in 1980, the value added of these services (mainly wages) experienced an abrupt deceleration in 1981, and a sharp contraction in 1982. Earlier forecasts had been that activity in the Free Zone might level off in the course of this year. However, the slide in activity has continued and employment in that sector is declining. Recession in neighboring countries also has had a detrimental impact on the tourist trade and the commercial sector. Also, activity in the construction sector has been sluggish and the agricultural sector is showing the effects of the severe drought referred to above. The political climate, with elections scheduled for May 1984, also appears to have inhibited somewhat private investment. All in all, it appears unlikely that the economy will expand by about 1 percent in 1983 as had been anticipated. The latest forecast is for stagnation or perhaps some decline in real GDP in 1983.

The authorities indicated that, in the short run, they saw few policy options that might be instrumental in arresting this situation. The emphasis will be in continuing the ongoing rationalization of government regulatory policies to permit a freer play of market forces, which should set the stage for a resumption of entrepreneurial activity when conditions become more propitious. In this regard, special emphasis continues to be placed on the progressive elimination of administrative trade restrictions, the easing of controls over private pricing decisions, and the reassessment of industrial incentives and farm price policies.

IV. Staff Appraisal

The magnitude of Panama's external debt, the pressing need to ease the burden of servicing it, and the reluctance of foreign banks to increase their exposure in the country had led the authorities to the conclusion that there was little scope left for policies of gradual fiscal adjustment.

Accordingly, the financial program for 1983 and 1984 called for a drastic reduction in the deficit of the public sector, from the equivalent of 11 percent of GDP in 1982 to no more than 6 percent and 5-1/2 percent of GDP, respectively, this year and next. Financing was to come from available assistance from bilateral and multilateral international agencies, and there was to be no net recourse to the sum of commercial bank credits, suppliers' credits, and foreign bond placements during 1983 and 1984.

Panama's financial performance in the first half of 1983 has been fully in compliance with the quantitative target of the financial program. Through June 1983 the overall deficit of the nonfinancial public sector stood at B 73 million, which left a large margin under the program limit of B 150 million; with respect to the same period of last year, the deficit was cut by more than two thirds. By the end of July 1983, the deficit was B 108 million, which was still much below the amount expected. The ceiling on National Bank net credit to the public sector also was met comfortably through June 1983, and the limits on net external financing were observed as well.

The improvement in the public finances so far this year is related in part to a better than expected revenue performance. However, tight control on public spending through a hiring freeze and strengthened expenditure control procedures have played by far the key role in reducing the public sector deficit.

The staff believes that, on present trends, the public sector net borrowing requirement for 1983 as a whole may be below the limit established under the financial program. In view of the considerable difficulties that have been encountered in raising foreign commercial credit, the staff would find it advisable that any such margin not be dissipated by a relaxation of spending policies.

In the Panamanian context, use of Fund resources are channelled to the Government through the National Bank. Therefore, to the extent that the fiscal performance turns out to be better than expected, the staff is of the view that a portion of the Fund purchases should be set aside to strengthen the foreign reserve position of the National Bank.

V. Proposed Decision

Accordingly, the following draft decision is proposed for adoption by the Executive Board:

The Fund and Panama have conducted the review of the progress made in implementing the program pursuant to paragraph 4(b) of the stand-by arrangement for Panama (EBS/83/102, Supplement 1) and paragraph 21 of the letter of intent of April 29, 1983, attached thereto, and concluded that no new understandings are necessary regarding circumstances in which purchases may be made by Panama until January 15, 1984.