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May 28, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Panama - Review Under Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1986 review of the stand-by arrangement for Panama. A draft decision appears on pages 22 and 23.

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

Mr. L. Pérez (ext. 7154) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

PANAMA

Staff Report for the 1986 Review of Stand-By Arrangement

Prepared by the Western Hemisphere Department

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

Approved by S. T. Beza and Manuel Guitián

May 28, 1986

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I. Introduction

On July 15, 1985 the Executive Board approved a stand-by arrangement for Panama (EBS/85/152, 6/17/85) for a period of 21 months through March 31, 1987 in the amount of SDR 90 million (equivalent to 50 percent of Panama's quota on an annual basis), comprising SDR 45 million each from ordinary resources and from borrowed resources. Panama made three purchases in 1985 for the equivalent of SDR 35 million; no purchases have been made in 1986 because of the nonobservance of performance criteria as of December 31, 1985 (Table 1) and because of delays in completing the review scheduled to establish the performance criteria for 1986. As indicated in their letter to the Managing Director dated June 17, 1985 requesting the current stand-by arrangement, this review was to be completed before February 15, 1986 in order to reach understandings on the policies and measures for 1986.

A mission visited Panama in late 1985 to negotiate ad referendum with the authorities the performance criteria for 1986, but was unable to complete the negotiations owing to uncertainties concerning the financing of the 1986 program. After further discussions at headquarters, a mission returned to Panama during March 19-28, 1986 to continue the negotiations, which were concluded at headquarters in mid-April. ^{1/} Representatives for Panama in the negotiations included the Minister of Planning and Economic Policy, the Minister of Finance and Treasury, the Comptroller General, the General Manager of the National Bank, the Director of the Budget, and other senior government officials. Mr. Hernando Arias, Alternate Executive Director for Panama, also participated in the meetings. In the attached letter dated May 27, 1986, the Government of Panama describes the policies and measures that it intends to implement in the remaining period of the arrangement.

Under the provisions of the arrangement, the purchases remaining in 1986 amount to SDR 44 million, and a final purchase of SDR 11 million is scheduled for 1987 (Table 2). Preliminary information indicates that policies for 1986 are broadly on track and, in particular, the public sector finances during the first quarter of the year were stronger than envisaged in the fiscal program of the authorities. In view of this, the original phasing of Panama's purchases from the Fund for the remaining period of the stand-by arrangement is considered to be appropriate. Therefore, Panama will be entitled to make a purchase of SDR 22 million immediately after the completion of the review. If all purchases and all scheduled repurchases are made by the end of the arrangement, Fund credit would then amount to the equivalent of

^{1/} The first mission consisted of Mr. Perez (Head), Mr. Gronlie, Ms. Suss, Mr. Terrier and Ms. Kriegsmann (Secretary) (all WHD). The second staff team consisted of Mr. Perez (Head), Mr. Clifton, Mr. Roncesvalles, Ms. Suss, Mr. Terrier and Ms. Bustillo (Secretary) (all WHD).

Table 1. Panama: Performance Under the Stand-By Arrangement 1/

(In millions of balboas/U.S. dollars)

	1985			
	Mar.	June	Sept.	Dec.
<u>Deficit of nonfinancial</u>				
<u>public sector</u>				
Cumulative limit	14.6	68.0	108.0	160.0
Actual	14.6	28.7	38.0	82.8
Margin (excess -)	--	39.3	70.0	77.2
<u>Net credit from BNP to the</u>				
<u>nonfinancial public sector</u>				
Limit <u>2/</u>	45.2	70.0	30.0	--
Adjusted limit	28.0	45.9	21.3	-7.9
Actual	28.0	3.3	20.7	54.9
Margin (excess -)	--	42.6	0.6	-62.8
<u>Net external borrowing of the</u>				
<u>total public sector</u>				
Cumulative limit <u>3/</u>	-31.1	-2.0	78.0	160.0
Adjusted limit	-21.3	55.1	79.3	153.8
Actual	-21.3	16.2	9.0	15.4
Margin (excess -)	--	38.9	70.3	138.4
<u>Net commercial borrowing</u>				
<u>of the public sector</u>				
Cumulative limit	-19.9	5.0	30.0	32.0
Actual	-19.9	-3.4	-5.8	-39.0
Margin (excess -)	--	8.4	35.8	71.0
<u>Outstanding commercial debt with</u>				
<u>maturity of less than 1 year</u>				
Cumulative limit				40.2
Actual				41.8
Margin (excess -)				-1.6

Sources: Central Statistical Office; National Bank of Panama.

1/ Limits are cumulative from January 1, 1985.

2/ Limit adjusted upward to the full extent of the net purchases from the Fund and of net disbursements by Mexico and Venezuela under the San Jose oil agreement intermediated through the National Bank.

3/ Limit adjusted downward to the full extent of any net purchases made from the Fund by Panama and upward to the full extent of net repurchases to the Fund; also adjusted upward by any margin on the limit for National Bank credit to the nonfinancial public sector.

Table 2. Panama: Projected Transactions During 1986-87

	Outstanding December 31, 1985	Transactions During 1986				Transactions During 1987 Jan.-Mar.
		Jan.- Mar.	Apr.- June	July- Sept.	Oct.- Dec.	

(In millions of SDRs)

<u>Transactions under tranche</u>						
<u>policies (net) 1/</u>		-9.4	18.4	2.0	9.1	2.8
Purchases		--	22.0	11.0	11.0	11.0
Ordinary resources		--	11.0	5.5	5.5	5.5
Enlarged access resources		--	11.0	5.5	5.5	5.5
Repurchases		-9.4	-3.6	-9.0	-1.9	-8.2
Ordinary resources		-4.7	-3.6	-4.4	-1.9	3.1
Borrowed resources		-4.7	--	-4.6	--	5.1
<u>Transactions under special</u>						
<u>facilities (net) 2/</u>		--	--	-7.4	-7.4	-7.4
Purchases		--	--	--	--	--
Repurchases		--	--	-7.4	-7.4	-7.4
<u>Total Fund credit outstanding</u>						
(end of period)	283.4	274.0	292.4	287.0	288.7	284.1
Under tranche policies 1/	224.5	215.1	233.5	235.5	244.6	247.4
Special facilities 2/	58.9	58.9	58.9	51.5	44.1	36.7

(As percent of quota)

<u>Total Fund credit outstanding</u>						
(end of period)	277.3	268.1	286.1	280.8	282.5	278.0
Under tranche policies 1/	219.7	210.5	228.5	230.4	239.3	242.1
Special facilities 2/	57.6	57.6	57.6	50.4	43.2	35.9

Source: Fund staff estimates.

1/ Ordinary and enlarged access resources.

2/ Compensatory financing facility.

278 percent of Panama's quota (36 percent under the CFF and 242 percent related to the credit tranches), virtually unchanged from the end-1985 level.

II. Background and Performance Under the Arrangement

In the face of restricted access to international capital markets, Panama adopted an adjustment program for the period 1983-84 which was supported by an 18-month stand-by arrangement from the Fund. The adjustment program was implemented satisfactorily, as the overall deficit of the nonfinancial public sector was reduced from 11 percent of GDP in 1982 to 5.9 percent of GDP in 1984.^{1/} As a result, the rate of increase in the public external debt slowed from an annual average of 13 percent in 1981-82 to an annual average rate of about 7 percent in 1983-84. At the same time, the debt service ratio dropped from 38 percent of exports of goods and nonfactor services in 1982 to 36 percent in 1984.

Economic activity in Panama was depressed in 1983-84, with real GDP declining by a cumulative 2 percent over the period (Table 3), but price developments were more favorable than expected as the rate of inflation decelerated to 1.6 percent in 1984, in line with the slowdown of inflation in Panama's major trading partners. The current account deficit of the balance of payments (before transfers) declined from 10.5 percent of GDP in 1982 to 5.6 percent in 1983, but then widened to 7.5 percent of GDP in 1984 reflecting higher interest payments abroad and reduced net service receipts.

While progress was made under the 1983-84 program, the authorities were of the view that further adjustment efforts were needed in 1985-86, particularly in light of the continued relatively heavy debt service burden and the limited availability of foreign financing. Under the current arrangement, the authorities targeted a decline of the overall deficit of the nonfinancial public sector from 5.9 percent of GDP in 1984 to 3.5 percent of GDP in 1985 and to 2.6 percent of GDP in 1986 (Table 4). The program also envisaged a reduction in the current account deficit of the balance of payments from 7.5 percent of GDP in 1984 to 6.1 percent in 1985, and to 4.7 percent in 1986.

The fiscal goal of the program was to be achieved through a number of measures to strengthen revenues, to reduce the rate of growth in current outlays, and to scale down investment expenditures; the latter

^{1/} In Panama macroeconomic policy rests predominantly on fiscal policy. The country has no central bank, holds no official international reserves, and the U.S. dollar circulates freely as legal tender and the medium of exchange. Under these circumstances the size of the external current account deficit is limited by the availability of foreign financing.

Table 3. Panama: National Accounts and Prices

	1982	1983	1984	1985		Proj.
				Prog.	Prel.	1986
(Annual percentage change, unless otherwise specified)						
GDP at current prices	10.3	2.2	3.8	1.9	5.7	5.6
GDP at constant prices	4.7	-1.5	-0.5	0.4	3.1	2.5
GDP deflator	5.4	3.8	4.3	1.5	2.5	3.0
Consumer price index (period average)	4.2	2.1	1.6	1.5	1.1	2.0
Wholesale price index (period average)	8.3	2.4	1.0	1.5	3.8	...
Average monthly wages	6.2	3.8	7.0	1.8
Unemployment rate (as a percent of labor force)	...	8.4	9.7	...	9.9	...
(In percent of GDP)						
<u>Total domestic demand</u>	<u>103.1</u>	<u>100.0</u>	<u>101.4</u>	<u>100.4</u>	<u>98.7</u>	<u>99.4</u>
<u>Domestic consumption</u>	<u>75.5</u>	<u>78.6</u>	<u>83.6</u>	<u>81.1</u>	<u>81.7</u>	<u>81.6</u>
<u>Gross domestic invest-</u> <u>ment</u>	<u>27.7</u>	<u>21.4</u>	<u>17.7</u>	<u>19.3</u>	<u>16.9</u>	<u>17.7</u>
Public sector	9.5	8.6	6.8	7.1	4.7	4.9
Private sector <u>1/</u>	18.2	12.8	10.9	12.2	12.2	12.8
<u>Gross national savings</u>	<u>17.1</u>	<u>15.7</u>	<u>10.3</u>	<u>11.8</u>	<u>11.5</u>	<u>11.8</u>
Public sector <u>2/</u>	1.3	2.9	2.2	2.3	3.4	4.3
Private sector	15.9	12.8	8.1	9.5	8.1	7.5
<u>Foreign savings</u>	<u>10.6</u>	<u>5.7</u>	<u>7.4</u>	<u>7.5</u>	<u>5.4</u>	<u>5.9</u>

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

1/ Includes changes in inventories.

2/ Includes grants.

Table 4. Panama: Operations of the Nonfinancial Public Sector

	1983		1984		1985		1986
	Prog.	Actual	Prog.	Actual	Prog.	Prel.	Prog.
(In millions of balboas)							
<u>Revenue and grants of consolidated public sector</u>	<u>1,375.0</u>	<u>1,385.5</u>	<u>1,461.5</u>	<u>1,424.6</u>	<u>1,531.8</u>	<u>1,523.3</u>	<u>1,607.8</u>
General government	1,306.0	1,315.1	1,339.0	1,260.5	1,392.2	1,378.6	1,447.7
Central Government	873.5	862.6	893.0	858.6	975.8	961.5	1,013.2
Social Security Agency	349.7	331.6	358.0	312.4	328.5	336.8	365.8
Decentralized agencies	82.8	120.9	88.0	89.5	87.9	80.3	68.7
Operating balance of public enterprises	69.0	70.4	113.5	134.1	139.6	124.7	145.1
Grants	--	--	9.0	30.0	--	20.0	15.0
<u>Expenditure of consolidated public sector</u>	<u>1,645.0</u>	<u>1,650.2</u>	<u>1,711.5</u>	<u>1,699.0</u>	<u>1,696.8</u>	<u>1,619.0</u>	<u>1,684.7</u>
<u>Current expenditure of general government</u>	<u>1,255.5</u>	<u>1,243.0</u>	<u>1,278.1</u>	<u>1,333.6</u>	<u>1,383.9</u>	<u>1,373.9</u>	<u>1,408.9</u>
Central Government	844.7	814.1	815.8	898.0	907.7	883.2	895.6
SSA	287.7	313.2	339.3	334.4	365.0	384.4	425.2
Decentralized agencies	123.1	115.7	123.0	101.2	111.2	106.3	88.1
<u>Capital expenditure 1/</u>	<u>389.5</u>	<u>407.2</u>	<u>433.4</u>	<u>365.4</u>	<u>312.9</u>	<u>245.1</u>	<u>275.8</u>
<u>Public sector savings 2/</u>	<u>119.5</u>	<u>125.9</u>	<u>174.4</u>	<u>69.0</u>	<u>138.9</u>	<u>142.3</u>	<u>198.4</u>
<u>Consolidated public sector surplus or deficit (-)</u>	<u>-270.0</u>	<u>-264.7</u>	<u>-250.0</u>	<u>-274.4</u>	<u>-165.0</u>	<u>-95.7</u>	<u>-76.9</u>
Balance of nonconsolidated public sector	--	17.4	--	8.0	5.0	12.9	14.5
<u>Public sector surplus or deficit (-)</u>	<u>-270.0</u>	<u>-247.3</u>	<u>-250.0</u>	<u>-266.4</u>	<u>-160.0</u>	<u>-82.8</u>	<u>-62.4</u>
<u>Financing</u>							
External	270.0	138.7	250.0	91.4	160.0	27.9	125.5
National Bank 3/	--	108.6	--	175.0	--	54.9	-63.0
(Percent of GDP)							
Public sector revenue and grants	30.6	31.7	32.1	31.4	33.9	31.7	31.7
General government revenue	29.1	30.1	29.4	27.8	30.8	28.7	28.6
Operating balance of public enterprises	1.5	1.6	2.5	3.0	3.0	2.6	2.9
Public sector expenditure	36.6	37.7	37.7	37.4	37.1	33.7	33.3
Current expenditure of the general government	28.0	28.4	28.1	29.4	30.7	28.6	27.8
Capital expenditure	8.7	9.3	9.5	8.0	6.9	5.1	5.4
Public sector savings 2/	2.7	2.9	3.8	1.5	3.1	3.0	3.9
Surplus or deficit (-)	-6.0	-5.7	-5.5	-5.9	-3.5	-1.7	-1.2

Sources: Office of the Comptroller General; Ministry of Planning and Economic Policy; and Fund staff estimates.

1/ Includes net lending.

2/ Excludes grants, B 34 million of capital revenues in 1983, and B 14 million in program 1985; includes the balance of the nonconsolidated public sector.

3/ Includes net disbursements from Mexico and Venezuela under the San Jose Oil Agreement and net purchases from the Fund which are intermediated through the National Bank.

was to be facilitated by the completion of the La Fortuna hydroelectric project. A revenue package for the Central Government was introduced in 1985 which included widening the base for income taxes, eliminating the import duty exemption of the public sector, and increasing a number of indirect taxes and fees. In addition, the valuation of imports for the purpose of tariffs was changed from an f.o.b. to a c.i.f. basis, and several public sector assets were put up for sale. 1/ On the expenditure side, a general wage freeze for central government employees (except for medical personnel and teachers) was implemented and a new monitoring procedure of the Comptroller General's office over the operations of public sector entities was introduced.

The reduction of the overall deficit of the nonfinancial public sector in 1985 was larger than foreseen in the program, as the authorities curtailed capital expenditures in response to a significant shortfall in external credit disbursements. The deficit was reduced to the equivalent of 1.7 percent of GDP, well below the limit of 3.5 percent of GDP. However, the reduction in the public sector deficit was not sufficient to compensate fully for the shortfall in net external financing. As a result, the limit on net National Bank credit to the nonfinancial public sector applicable to December 31, 1985 was exceeded by about B 63 million. There was also a small excess with respect to the end-year limit on external debt with a maturity of less than one year.

Although public sector revenues and grants increased marginally in relation to GDP in 1985, they were below the level projected due to a lower yield of the revenue package mentioned earlier and to a decline in the operating balance of public enterprises. Owing to legal complications in the implementation of some of the measures of the central government revenue package, 2/ the yield of the package was only about two thirds of that expected. In addition, the Government was unable to dispose of the public sector assets identified for sale, and import duty collections were lower than expected. To some extent, these shortfalls in central government revenues were offset by larger-than-expected income tax and dividend payments from the oil pipeline company, Petroterminal de Panama (PTP). 3/ The operating surplus of the public enterprises taken as a group was 2.6 percent of GDP compared to

1/ For a more detailed discussion of the measures see EBS/85/152, June 17, 1985.

2/ In particular, the complications were related to making foreign companies operating in the former Canal Zone subject to Panama's income tax and to the elimination of the public sector's exoneration from paying import duties. This latter adjustment (which can be effectively seen as a reduction of expenditure) was to result from maintaining the originally budgeted levels of expenditure and transferring the import duty revenues to the Central Government.

3/ Petroterminal de Panama is a private company in which the Government of Panama has a 40 percent interest.

3.1 percent programmed and 3 percent the previous year; this shortfall reflected mainly larger than programmed purchases of fuel oil by the electricity company (IRHE) due to adverse weather conditions which limited its capacity to produce hydroelectric power.

Public sector expenditure declined by almost 4 percentage points of GDP in 1985 because of a decline in current expenditures of the general government and because of the cutback in investment mentioned earlier. Current expenditures of the general government were almost 1 percentage point of GDP lower than in the previous year and 2 percentage points of GDP lower than programmed. As a result, the program's public sector savings target of 3 percent of GDP, or twice the 1984 level, was achieved despite the shortfall in current revenue. The decline in current expenditures of the general government in relation to GDP was mostly associated with lower interest payments and a decrease in purchases of goods and services. Although the authorities were not successful in reducing public sector employment by as much as targeted in 1985, the general wage freeze for central government employees helped to maintain the wage bill of the Central Government in relation to GDP at the same level in 1985 as in 1984, and it was 0.6 percent of GDP lower than in the program.

Capital expenditure was reduced from 8 percent of GDP in 1984 to 5.1 percent of GDP in 1985; the program had envisaged capital expenditure of the order of 7 percent of GDP for 1985. IRHE and the telephone company (INTEL) postponed investments in the energy and communication sectors, and net lending by the mortgage and the agricultural banks was cut back somewhat from the projected level.

As part of the financial program, Panama completed negotiations in 1985 with both its commercial bank creditors and the Paris Club for the restructuring of amortization payments falling due in 1985-86. In addition, Panama negotiated a new credit from commercial banks of US\$60 million, of which US\$42 million was to have been disbursed in 1985. These disbursements from commercial banks, as well as a loan of US\$40 million from the U.S. AID Economic Support Fund, were conditional on progress made in negotiating a second structural adjustment loan (SAL II) with the World Bank. However, as no agreement was reached in the SAL II negotiations in 1985 these disbursements did not materialize. These shortfalls resulted in a shortage of counterpart funds for public sector investment, which in turn led to lower-than-projected disbursements of project-related credit. Overall, the shortfall in external financing to the public sector was about US\$120 million or the equivalent of 2.5 percent of GDP.

In spite of the cutback in public sector investment, economic activity in Panama was more robust in 1985 than originally projected. Real GDP is estimated to have grown by about 3 percent, compared with a projected increase of 0.4 percent. This growth reflected a recovery in the activity of the Colon Free Zone, an increase in activity of the oil pipeline company owing to a cold winter in the eastern United States,

and a higher level of electricity generation. The rate of inflation as measured by the consumer price index declined for the third consecutive year to slightly above 1 percent in 1985. The current account deficit of the balance of payments narrowed from 7.5 percent of GDP in 1984 to 5.4 percent in 1985, compared with a projected deficit of 6.1 percent of GDP, in reflection of an improvement in the trade balance and stronger net receipts of nonfactor services, which more than offset higher net outflows in the investment income account. Increased net outflows of private capital in 1985 may have reflected uncertainty about the Government's economic policies.

III. The 1986 Program

In discussing the framework of the program for 1986 with the authorities, the staff was mindful of the views expressed by Executive Directors at the time the stand-by arrangement was approved. The Executive Directors urged the authorities to strengthen tax administration to help achieve the revenue objectives envisaged in the program. Directors also emphasized the need to continue the efforts to improve the financial position and pricing policies of the public sector enterprises and agencies, and encouraged the authorities to reduce the deficit by restraining the growth of public sector current expenditures. As the level and structure of public sector capital expenditure were seen by the World Bank as generally in line with the priorities of Panama's development strategy, the Executive Directors observed that any further curtailment of spending for capital formation should be undertaken with caution. In order to achieve sustained economic growth, the authorities were also urged to implement the structural reforms in the industrial, agricultural, and labor areas which were being contemplated so as to redirect resources toward sectors with a comparative advantage.

The program for 1986, which is described in the attached letter from the Panamanian authorities, has as its main objectives a further reduction of the public sector deficit, a consequent reduction of the debt burden, the strengthening of the liquidity position of the National Bank, and an improvement in the allocation of resources in the economy. The improvement of resource allocation is to be aided through the implementation of a package of structural measures announced in early 1986 and supported by the second SAL from the World Bank.

1. Fiscal policy

Fiscal restraint remains the cornerstone of the adjustment effort. In order to consolidate the gains made last year, the program now calls for a reduction in the overall deficit of the nonfinancial public sector from 1.7 percent of GDP in 1985 to 1.2 percent of GDP in 1986, compared with the original target in the arrangement of 2.6 percent of GDP for 1986 (see Table 4). This is to result mainly from restraint in current expenditures. Public sector savings are programmed to increase from 3 percent of GDP in 1985 to almost 4 percent of GDP in

1986, while capital expenditure is to increase from 5.1 percent of GDP in 1985 to 5.4 percent in 1986.

Under the 1986 program, total government revenue is projected to be maintained at the same level in relation to GDP as in 1985. The impact of the measures taken in 1985 to increase the yield from taxes on foreign trade, to widen the tax base, and the increase in petroleum taxes implemented in midyear are projected to be offset by lower corporate income tax payments, mostly associated with lower income tax and dividend tax payments by PTP. An increase in indirect taxes on the domestic sale of petroleum products is to be in place by early June and is estimated to yield about B 20 million (0.4 percent of GDP), after taking account of the effects of the recent reductions in the domestic retail prices of petroleum products in the light of the decline in international oil prices. After these reductions the prices of most refined petroleum products continue to be higher than international prices, with the exception of the price of bunker fuel which was lowered to international levels to allow Panama to be competitive in the sale of this product. The authorities do not foresee any revenues arising from the sale of assets or loan transactions with regard to PTP this year. However, in the event that such a transaction takes place, any government proceeds arising from it will be excluded from the deposits of the nonfinancial public sector with the National Bank in determining net credit to the public sector; to the extent that the government proceeds are used to amortize external debt, the ceiling on external borrowing of the public sector will be adjusted downward for purposes of measuring observance of the performance criteria.

Overall public sector expenditure is projected to decline slightly in relation to GDP in 1986, owing to a reduction in current expenditure of almost 1 percent of GDP which more than offsets an increase in capital spending. The restraint in current expenditure reflects the wage freeze covering a large proportion of public sector employees of the Central Government that was imposed in 1985 and is being continued in 1986. In addition, the authorities plan to reduce the public sector labor force by about 2 percent this year, mainly by not filling vacancies arising from retirements or resignations starting April 1, 1986. In the circumstances of Panama, international competitiveness can be improved only by changes in productivity beyond those observed in Panama's trading partners, or through developments in wages. In this regard, the continuation of the wage freeze currently in effect in the public sector, in addition to its impact on the public finances, is expected to provide appropriate signals to the private sector of the economy.

As noted above, public sector investment is projected to increase slightly relative to GDP in 1986, reflecting to some extent the resumption of projects that were postponed last year. The public investment program continues to emphasize the development of basic infrastructure, with an increase in the share of projects with financing from multilateral agencies. The World Bank staff is concerned about the

difficulties of administering a program subject to such financing restraints, but feels that the 1986 program is generally in line with Panama's development strategy.

The attainment of the public sector targets will continue to require strict management of the public enterprises and agencies. The authorities intend to continue to strengthen the monitoring procedures of the *Comptroller General's Office over the operations of the public enterprises and agencies*. As part of the SAL II understandings with the World Bank, in 1986 a second sugar mill of the La Victoria public enterprise will be closed, and the state seed company and the state farm equipment company will cease commercial operations as public entities. Overall, the operating surplus of the public sector enterprises is projected to improve from 2.6 percent of GDP in 1985 to 2.9 percent of GDP in 1986. Also, among the government agencies, the activities of IMA, *the agricultural marketing agency*, have been significantly reduced and it no longer intervenes in the rice market.

Among the government agencies, the Social Security Agency will contribute to the improvement in the public sector finances as its administrative expenditures are to be reduced in 1986. The medium-term goal of the Government is to restore the actuarial soundness of the Agency, and with the technical assistance of the World Bank it is preparing a plan which would ensure the long-term financial viability of the Social Security Agency. The plan, which is to be implemented as part of the SAL II, envisages the elimination of early retirement, the gradual increase of the normal retirement age, and other reforms of the main retirement plan, as well as the reform of the pensions of 26 special work groups. The Government intends to implement some of the reforms, such as the elimination of early retirement and changes in the formula for the calculation of pension benefits under the main retirement program, by the end of 1986. The changes in the pension formula will aim at reducing the salary base and increasing the number of years for the calculation of initial pension benefits. The current average of the last three to five years of salary used in the pension calculation would be changed to an average of the last ten years. Other measures have already been put in place to improve the finances of the Social Security Agency: both the term of the bonds issued by the Government and the National Mortgage Bank to the Agency, and the interest rate paid on these bonds have been adjusted to make them more attractive financial instruments and thus to improve the Social Security Agency's investment portfolio.

The overall deficit of the public sector in 1986 will be financed by external credits, mostly from bilateral and multilateral sources. Net external financing is projected to amount to US\$125.5 million in 1986 and the program envisages a reduction in the net credit of the National Bank to the nonfinancial public sector of B 63 million, the amount of the excess over the ceiling at end-1985. Such a repayment to the National Bank will help to alleviate its tight liquidity situation, especially when account is taken of the effective limits that have been

imposed since December 1984 by foreign commercial banks on their lines of credit to the National Bank. However, relief for the National Bank will not come until late in the year. Because net disbursements of external financing are concentrated solely in the fourth quarter of 1986, the National Bank will need to provide credit to the public sector during the first nine months of the year in order to cover the cumulative deficit of the public sector plus the net external debt amortization. In fact, Panama will be amortizing about US\$8 million of external debt during the first nine months of the year.

2. External policies

The current account deficit of the balance of payments is projected to widen in 1986 to 6.1 percent of GDP from 5.4 percent in 1985 (Table 5), reflecting a 30 percent reduction in the charges for the transshipment of oil by PTP offset in part by improvements in the balances on trade and services.

The current account deficit in 1986 is expected to be financed about equally by public sector external borrowing and projected private flows. The net capital inflow to the nonfinancial public sector of about US\$125 million in 1986 reflects gross disbursements of US\$348 million and amortizations before rescheduling of US\$610 million; it includes disbursements of project-related loans of about US\$40 million from the IBRD, US\$70 million from the Inter-American Development Bank (IDB), and US\$25 million from U.S. AID. This inflow also includes projected drawings of US\$15 million from U.S. AID under the Economic Support Fund, of which US\$9 million would be available only after approval of the U.S. budget for the U.S. fiscal year beginning October 1, 1986. The program also envisages the placement of bonds in the Japanese market for a total of US\$25 million to be completed in the fourth quarter of 1986; this placement will partially offset US\$38 million of amortization of bonds in 1986.

The projected capital inflow for 1986 also includes a disbursement of US\$50 million under the SAL II from the World Bank and the full US\$60 million from the commercial banks' credit facility. On the basis of the latest understandings between the IBRD staff and the Panamanian authorities, the Bank staff is proposing a US\$80 million loan to be disbursed in two tranches. The Bank staff envisages a first disbursement of US\$50 million to be made this year immediately after approval of the loan, which is expected to take place some time in the last quarter, and the second one of US\$30 million will be made in 1987. All the disbursements from commercial banks are also expected to take place this year if Panama is in compliance with the Fund program and if the SAL II is approved by the World Bank and its first disbursement is made in 1986.

The program for 1986 includes restructuring amounting to US\$378 million from foreign commercial banks and US\$14.2 million from Paris Club creditors. In October of last year Panama signed a restructuring

Table 5. Panama: Summary Balance of Payments

(In millions of U.S. dollars)

	1982	1983	1984	1985		Proj. 1986
				Prog.	Est.	
<u>Current account</u>	<u>-405.4</u>	<u>-202.4</u>	<u>-259.4</u>	<u>-226.0</u>	<u>-176.3</u>	<u>-227.5</u>
Goods and services	-451.0	-246.8	-338.7	-274.0	-259.6	-306.5
Trade balance	-1,007.8	-926.9	-923.1	-869.0	-892.4	-880.6
Exports, f.o.b.	321.8	305.6	286.4	298.0	312.7	340.3
Petroleum trade	-242.5	-262.2	-217.1	-188.0	-200.7	-159.8
Imports, f.o.b.	-1,087.1	-970.3	-992.4	-979.0	-1,004.4	-1,061.1
Freight and Insurance	-53.4	114.2	59.0	...	90.9	12.7
Transportation	392.4	349.7	343.9	355.0	353.1	352.2
Travel	93.0	101.3	118.6	...	135.0	134.4
Investment income	-349.8	-324.2	-350.2	-452.0	-401.9	-421.0
Of which: Interest public						
debt	-343.9	-281.5	-325.0	-385.0	-328.6	-333.0
Government, n.i.e.	-12.0	-13.5	-8.1	...	-8.4	-9.3
Other services	486.5	452.6	421.2	692.0	464.3	505.1
Colon free zone	219.9	142.3	148.8	165.0	165.6	189.3
Rest of the world	266.6	310.2	272.4	527.0	298.7	315.8
<u>Unrequited transfers</u>	<u>45.6</u>	<u>44.3</u>	<u>79.3</u>	<u>48.0</u>	<u>83.3</u>	<u>79.0</u>
<u>Capital account</u>	<u>560.3</u>	<u>207.2</u>	<u>188.7</u>	<u>126.0</u>	<u>-75.7</u>	<u>227.5</u>
Official capital	510.2	302.1	214.2	160.0	34.0	125.5
Nonfinancial	435.8	143.2	98.3	184.0	39.1	196.8
Official banks	74.4	158.9	115.9	-24.0	-5.1	-71.3
Other official bank						
<u>transactions</u>	<u>0.4</u>	<u>-86.7</u>	<u>-12.5</u>	<u>--</u>	<u>134.5</u>	<u>--</u>
Private capital	49.7	-8.2	-13.0	-27.0	-244.2	102.0
Direct investment	0.8	54.9	37.3	12.0	66.1	71.3
Direct private borrowing	116.4	-151.9	-79.8	-69.0	-38.4	-32.5
Private banks net monetary						
movements	-67.5	88.8	29.5	30.0	-271.9	63.2
<u>Net errors and omissions</u>						
(including valuation						
adjustment)	-154.9	-4.8	70.7	93.0	251.9	--
<u>Memorandum item</u>						
Current account as a per-						
centage of GDP						
Before transfer payments	-10.5	-5.6	-7.5	-6.1	-5.4	-6.1
After transfer payments	-9.5	-4.6	-5.7	-5.0	-3.7	-4.5

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

agreement with foreign commercial banks covering US\$602 million of amortization payments falling due in 1985-86. 1/ Also, in September 1985 Panama negotiated with the Paris Club a 50 percent rescheduling of amortization payments of official loans and commercial credits guaranteed or insured by the governments of the creditor countries falling due in 1985-86 (about US\$19 million). 2/ By April 30, 1986 Panama had concluded all of the bilateral agreements as had been agreed with the Paris Club. Notwithstanding this debt relief, debt service after rescheduling in relation to exports of goods and nonfactor services is projected to increase from 30 percent in 1985 to about 33 percent in 1986 because of a scheduled increase in amortization payments to multilateral and bilateral creditors and the decline in PTP revenues from the transshipment of oil which affects nonfactor services.

The 1986 program envisages an increase of external debt (including Fund purchases) of 3.3 percent, with most of the net flows originating from bilateral and multilateral sources (Table 6). This compares with a rate of growth of 2.3 percent in 1985 when, as mentioned earlier, the disbursement of US\$42 million from the commercial banks' new credit facility was postponed to 1986. For 1985-86 as a whole the average annual rate of increase in the external debt is less than 3 percent, which may be compared with the average increase of slightly over 7 percent in 1983-84. While total external public debt is projected to rise by about US\$125 million in 1986 to a level of US\$3.9 billion (77 percent of GDP), the increase in commercial debt 3/ would be limited to US\$45.5 million (or 2 percent).

As part of its efforts to encourage a more efficient allocation of resources, the Government has completed its program started in 1983 of replacing import quotas by tariffs. Import quotas remain on only 16 items and price controls are being eliminated gradually for most items for which quotas have been replaced by tariffs. Tariff schedules are being unified and import duties will be gradually reduced over the next five years as a means of reducing effective protection. The new industrial incentives law passed in March will exempt certain firms from payment of duties on imported inputs for five years, after which they will pay a 3 percent minimum tariff; exporting firms are eligible for complete exemption under a drawback scheme. These reforms are also supported by the SAL II of the World Bank as explained below.

1/ The terms of the refinancing agreement are 12 years with 3 1/2 years grace, at a spread over LIBOR of 1 3/8 percent.

2/ The terms of the Paris Club rescheduling are 8 years, with 3 years grace.

3/ Commercial debt is defined as foreign borrowing excluding financing from bilateral and multilateral sources. It includes commercial bank lending, bonds, and suppliers' credits.

Table 6. Panama: Public Sector External Debt Indicators

	1982	1983	1984	Prel. 1985	Proj. 1986
(In millions of U.S. dollars)					
<u>Debt outstanding</u> (end of period)	3,197.6	3,488.2	3,686.7	3,769.9	3,895.4
Bilateral	464.2	511.4	537.0	539.9	509.0
Multilateral	526.1	771.3	954.3	1,050.5	1,161.4
Of which: IMF	83.9	192.7	271.1	311.3	316.7
Commercial banks	1,653.9	1,726.1	1,751.4	1,755.0	1,815.0
Other <u>1/</u>	553.4	479.4	444.0	424.5	410.0
<u>Disbursements</u>	817.9	509.9	475.1	215.0	348.2
<u>Debt service</u>	657.9	495.3	587.9	507.3	563.9
Amortizations <u>2/</u>	307.6	206.7	271.3	172.4	222.8
Interest payments	350.3	288.6	316.6	334.9	341.1
(In percent of GDP)					
<u>Debt indicators</u>					
External public debt	74.7	79.8	81.2	78.6	76.9
Multilateral and bilateral	23.1	29.3	32.8	33.1	33.0
Other	51.6	50.4	48.4	45.4	43.9
Interest payments	8.2	6.6	7.0	7.0	6.7
(In percent)					
<u>Debt service in rela-</u> <u>tion to:</u>					
Public sector receipts	49.6	35.2	40.4	32.2	33.8
Exports of goods and nonfactor services	37.7	29.2	36.0	29.6	32.8
<u>Effective interest rates</u> <u>on the total debt</u>	11.9	8.6	8.8	9.0	8.8

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

1/ Includes bonds placed domestically.

2/ After rescheduling.

Panama has no restrictions on payments and transfers for current and capital transactions. The authorities have expressed their commitment not to introduce any multiple currency practice or restriction to international payments, or to conclude any bilateral payments agreement with Fund members. Moreover, the Government does not intend to introduce restrictions on imports for balance of payments purposes.

3. Performance criteria

The program for 1986 includes the same performance criteria applied in 1985:

- a. Quarterly cumulative limits on the overall deficit of the nonfinancial public sector (Table 1 of the letter of intent).
- b. Quarterly cumulative limits on the net credit of the National Bank to the nonfinancial public sector (Table 2 of the letter of intent).
- c. Quarterly cumulative limits on the net external borrowing of the public sector with a subceiling on the net use of foreign commercial borrowing, and an end-of-year subceiling on the stock of debt with original maturity of less than one year (Table 3 of the letter of intent).
- d. The customary provisions relating to the exchange and trade system.

4. Relations with the World Bank

In addition to the policies to promote a more efficient resource allocation that were discussed above, the authorities intend to implement other legal and institutional changes that will address the structural problems of the Panamanian economy. These policy initiatives are to be supported by the SAL II of the World Bank. In March 1986 the Panamanian legislature approved three laws which introduced important changes in the areas of agricultural, industrial, and labor policies. As part of the measures undertaken for SAL II, the authorities have agreed to close several public enterprises which receive transfers from the Central Government and to reduce the public sector labor force by about 2 percent in 1986.

The new industrial incentives law provides for the reduction of the maximum nominal tariff applied to existing industries to 60 percent; nominal tariff protection currently varies from 25 percent to over 250 percent ad valorem. This action is to be effected over five years with the first reduction taking place on August 1, 1986. New industries will be subject to a maximum nominal tariff of 20 percent, except in the case of agroindustries which may receive a maximum nominal tariff protection of 30 percent. In the area of agricultural reforms, rice prices are to be determined without public intervention and the Government

intends to remove price controls for all agricultural products except tomatoes. The authorities also plan to reduce support prices for certain agricultural products toward international levels so as to create an incentive for export-oriented agriculture. These new agricultural and industrial policies are expected to encourage private investment in export-oriented industries as well as to reduce the burden on the budget. In the past, wage increases have tended to be relatively low, but the existing labor legislation had introduced rigidities which contributed to growing levels of unemployment. The newly approved changes to the Labor Code address this problem and include provisions to permit piecework, and to allow employers to pay bonuses and provide other incentives to increase productivity without being incorporated into the wage base. Other provisions in the labor area facilitate work at home, exempt small-scale industries from some of the more costly regulations of the Labor Code, and relieve export firms of certain overtime provisions. By addressing the nonwage costs of employment, these changes will reduce the rigidities in the labor market and help the economy absorb the increases in the labor force.

IV. Medium-Term Prospects

While Panama is implementing a further significant adjustment in 1986, the continued pursuit of sound financial policies in future years will be required to achieve satisfactory growth and a viable external position over the medium term. To quantify the medium-term outlook for Panama, the staff prepared an illustrative balance of payments and external debt scenario for 1987-91 (Table 7). The scenario assumes that the overall deficit of the nonfinancial public sector will average 2 percent of GDP a year, and that it will be financed entirely by borrowing from multilateral and bilateral sources. Such a policy stance is deemed to be consistent with GDP growth of about 3 percent a year on average, and an average rate of inflation, as measured by the GDP deflator, of 3 percent a year over the period.

Other assumptions of the medium-term projection are that the volume of nonpetroleum imports would grow slightly faster than real GDP, and that the volume of net petroleum imports would increase in line with real GDP. Nonpetroleum exports would grow by an average annual rate of 3.6 percent, or by about the same rate of economic growth anticipated for Panama's trading partners. These estimates have taken into consideration the assumptions for prices of commodities and manufactures contained in the latest World Economic Outlook exercise.

With regard to services, net receipts by PTP are projected to decline by 3.5 percent in 1987 owing to a lower level of oil transshipments, and then to remain unchanged through the rest of the period. Net service receipts from the Colon Free Zone are projected to grow by 8.5 percent a year. The projections include interest payments on commercial debt at a rate of 1.5 percentage points over LIBOR. The

Table 7. Panama: Medium-Term Scenario

	Prel. 1985	1986	1987	1988	Proj. 1989	1990	1991
(In millions of U.S. dollars)							
Current account	-176	-228	-217	-230	-245	-259	-273
Trade balance	-892	-881	-943	-1,027	-1,136	-1,241	-1,355
Exports	313	340	354	363	375	390	406
Imports (including net petroleum)	-1,205	-1,221	-1,297	-1,390	-1,511	-1,631	-1,761
Interest on public debt	-329	-333	-324	-324	-308	-300	-290
Other	1,045	987	1,050	1,121	1,199	1,282	1,372
Capital account	176	228	-242	-207	-83	128	150
Public sector	34	126	-351	-323	-207	-2	14
Of which: IMF	7	5	-54	-69	-49	-60	-38
Other 1/	142	102	109	116	124	130	136
Financing gap (public sector)	--	--	459	437	328	131	123
Public sector debt 2/	3,769.9	3,895.4	4,002.9	4,116.9	4,238.2	4,367.2	4,504.7
Bilateral and multilateral	1,577.7	1,657.7	1,765.2	1,879.2	2,000.5	2,129.5	2,267.0
Commercial 2/	2,192.2	2,237.7	2,237.7	2,237.7	2,237.7	2,237.7	2,237.7
Debt service							
Amortizations							
On debt outstanding end-1986							
Before 1985-86 rescheduling	406.6	610.2	667.7	611.5	455.1	249.7	174.8
After 1985-86 rescheduling	172.4	222.8	667.7	611.5	473.1	281.7	246.4
On debt contracted after 1986	--	--	--	--	6.5	20.7	31.2
Interest 3/	334.9	341.1	329.0	329.7	312.7	305.4	295.3
(In percent)							
Indicators							
Current account/GDP	-3.7	-4.5	-4.0	-4.0	-4.0	-4.0	-4.1
Total public sector debt/GDP	78.6	76.9	74.5	72.2	69.9	67.7	65.5
Debt service/exports of goods and nonfactor services							
Before rescheduling	43.2	55.5	54.9	49.1	38.1	26.7	21.8
After rescheduling 4/	29.6	32.9	54.9	49.1	39.0	28.1	24.9
Debt service/GDP							
Before rescheduling	15.5	18.8	18.5	16.5	12.8	8.9	7.3
After rescheduling	10.6	11.1	18.5	16.5	13.1	9.4	8.3
Effective interest rate on total external debt	9.0	8.9	8.3	8.1	7.5	7.1	6.7

Sources: World Bank; and Fund staff estimates.

1/ Includes private sector capital flows, errors, and omissions.

2/ Includes cumulative financing gap.

3/ Includes interest on internal bonds.

4/ Does not assume any rescheduling after 1986.

six-month LIBOR rate is assumed to average 7 percent over the period 1987-91. ^{1/} On the basis of the above assumptions, the current account deficit of the balance of payments would stabilize at 4 percent of GDP during 1987-91.

The medium-term scenario assumes that all new external borrowing by the public sector will be from multilateral and bilateral agencies at terms similar to those received in the recent past and that the net private sector capital inflow will grow in line with nominal GDP, an assumption which is consistent with the expected improvement in economic activity. The projection shows a financing gap equivalent to the amount of principal payments on debt of commercial nature, including commercial bank loans and bonds.

Under the circumstances depicted in the scenario, Panama's external public debt service ratio would increase from about 33 percent of exports of goods and nonfactor services in 1986 to over 50 percent in 1987-88, ^{2/} but would subsequently decline to 25 percent by 1991. The sharp increase in the debt service ratio in 1987-88 is associated with a peak in the amortizations of commercial debt. The scheduled amortization of the commercial debt in these two years is equivalent to about 25 percent of exports of goods and nonfactor services compared to 3 percent in 1986 (after rescheduling). The ratio of outstanding public sector debt to GDP would decline from 77 percent in 1986 to 65 percent in 1991 (on the assumption that credits are obtained to cover the financing gap). On the basis of the projections, the effective interest rate on total external debt would decline from 8.9 percent in 1986 to 6.7 percent in 1991, reflecting an improvement in the structure of the debt.

V. Staff Appraisal

While significant progress was made under the 1983-84 stand-by arrangement, the Panamanian authorities believed that further adjustment was necessary when that arrangement came to an end. Accordingly, in mid-1985 they adopted a program supported by a 21-month stand-by arrangement from the Fund. This program was designed to increase public sector savings and reduce the overall financing requirements of the nonfinancial public sector.

The staff welcomes the progress made in 1985 in the implementation of the program despite a significant shortfall in external financing.

^{1/} In the event that interest rates were to be 1 percentage point higher, interest payments would increase by an average of B 22 million a year (or the equivalent of 0.6 percent of GDP) over the period 1987-91.

^{2/} This debt service ratio takes into account the refinancing arrangement of 1983-84 and the restructuring arrangement of the 1985-86 public sector commercial debt.

That shortfall made necessary a larger reduction of the public sector deficit than had been programmed. The deficit in 1985 was, at 1.7 percent of GDP, only half the projected level of 3.5 percent, while public sector savings amounted to 3 percent of GDP, about the level that had been targeted. However, the additional adjustment made was not sufficient to offset fully the shortfall in external financing and the deficit in 1985 was thus financed in part by an unplanned increase in net credit from the National Bank. While the staff welcomes the large reduction in the overall fiscal deficit in 1985, it is concerned about the cutback in capital expenditures that was required.

The program for 1986 aims at limiting the public sector deficit to an amount that can be financed mostly from multilateral and bilateral credits as originally envisaged in the program, while allowing for the repayment to the National Bank of Panama of the credit used in 1985. The overall deficit of the nonfinancial public sector is to be reduced to 1.2 percent of GDP in 1986, compared with an original level of 2.6 percent of GDP in the economic program. The reduction in the deficit is to be achieved by maintaining the ratio of public sector revenue to GDP and by reducing current expenditure relative to GDP, while allowing for a modest recovery in public sector capital expenditure.

The removal of legal and administrative difficulties associated with some of the revenue measures introduced in 1985 should result in increases in the yield of these measures. The new policy concerning the petroleum sector in Panama is expected to result in an increase in revenues for the Central Government after allowing the transfer to the economy of some of the benefits of lower international petroleum prices. The moderate reduction in the domestic prices of petroleum products should help to reactivate the economy and improve Panama's competitiveness in the service sector.

The staff would urge the authorities to continue their efforts to improve tax administration as a means of strengthening revenue performance, so as to reduce the deficit and place Panama in a better position to cover the heavy debt servicing commitments in the years ahead. In addition, it will be important that the authorities be prepared to take additional measures if needed, to assure the achievement of the revenue targets.

The authorities intend to continue with a policy of tight expenditure control in 1986 to ensure that the growth of total outlays is kept below that of nominal GDP. Crucial to the achievement of this expenditure policy is the decision not to grant a general salary increase for a second year in a row and to achieve the proposed reduction in public sector employment in 1986. The staff shares fully the objectives of the expenditure policy and encourages the authorities to take all the necessary steps to achieve its successful implementation.

The staff notes that considerable efforts will have to be made to improve the overall financial position of the rest of the public sector. Progress has been made recently in the operations of the agricultural marketing agency and the electricity company, and further gains should be achieved in the operations of other public entities as the new monitoring procedures are applied more widely. The elimination of early retirement and the changes to the pension schemes of the Social Security Agency that are contemplated before the end of the year should contribute to an improvement in its finances in future years. Despite the planned changes, the staff would encourage the authorities to keep the finances of the Social Security Agency under close review and to take any additional measures that may be required to return this agency to a viable financial position over the medium term.

The World Bank staff believes that the investment projects being implemented in 1986 will contribute to continued economic growth, but has cautioned that further reductions in the public sector investment program would not be prudent. The staff welcomes the programmed increase in public sector savings that is supporting an increase in investment in 1986 and, if there should be a need to make further adjustments in the program, the staff would urge that it be done without affecting public investment.

Despite the reduction in the public sector deficit and the planned increase in the reliance on financing from multilateral and bilateral sources, Panama will continue to face a serious external debt management problem over the medium term. The medium-term projections indicate that, in the absence of further debt relief, the debt service burden would increase significantly during 1987-89; this outlook highlights the need to continue to implement a prudent external borrowing policy as part of the adjustment effort.

The program for 1986 envisages that there will be a net repayment to the National Bank of the full amount of credit extended to the public sector in 1985, thus maintaining the target of no net credit from the National Bank during the program period as a whole. Implementation of this policy decision will help to assure the needed strengthening of the liquidity position of the National Bank.

The authorities have recently undertaken major legislative reforms to modify the structure of incentives and thus to achieve an improvement in the allocation of resources. The staff welcomes the recent changes introduced by the authorities to reduce the level of effective protection, to improve the system of industrial and agricultural incentives, and to diminish rigidities in the labor market. These changes should enable Panama to shift resources to the areas in which it has a comparative advantage and facilitate economic growth and the expansion of employment over the medium term.

In summary, the authorities have made progress in recent years in correcting imbalances in the domestic economy, as shown particularly by

the reduction in the public sector overall deficit from 11 percent of GDP in 1982 to 1.7 percent of GDP in 1985. For 1986 the program envisages a further reduction in the public sector deficit in relation to GDP. The authorities are addressing the structural problems of the Panamanian economy, and in this regard they are being supported by a second SAL from the World Bank. The authorities are to be commended for their continued efforts to strengthen the public finances and improve resource allocation. The staff believes that the full implementation of the policies outlined above should result in a further improvement of Panama's economic situation and in the achievement of the main objectives of the stand-by arrangement.

VI. Proposed Decision

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

1. Panama has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Panama (EBS/85/152, Supp. 1) and paragraph 22 of the letter dated June 17, 1985 from the Minister of Planning and Economic Policy, the Minister of Finance and Treasury, and the General Manager of the National Bank of Panama, in order to review the progress made in implementing the program and to reach understandings on the policies and the performance criteria for the remaining period of the stand-by arrangement.
2. The letter, with attached tables, dated May 27, 1986 from the Minister of Planning and Economy, the Minister of Finance and Treasury, and the General Manager of the National Bank of Panama, shall be annexed to the stand-by arrangement for Panama, and the letter dated June 17, 1985 shall be read as modified and supplemented by the letter and attached tables dated May 27, 1986.
3. Panama will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Panama's currency in the

credit tranches beyond 25 percent of quota, or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota during any period in which the data at the end of the preceding quarter indicate that:

- (i) the cumulative limit on the deficit of nonfinancial public sector, referred to in paragraph 7 of the letter of May 27, 1986 and set forth in Table 1 thereof; or
- (ii) the ceiling on net credit of the National Bank to the nonfinancial public sector referred to in paragraph 13 of the letter of May 27, 1986 and set forth in Table 2 thereof; or
- (iii) any of the limits on external and commercial net borrowing by the public sector, or on end-year outstanding debt with a maturity of less than one year, referred to in paragraph 14 of the letter of May 27, 1986, and set forth in Table 3 thereof

is not observed.

4. The Fund finds that the review contemplated in Paragraph 4(b) of the stand-by arrangement has been completed.

Fund Relations with Panama
(As of April 30, 1986, unless otherwise indicated)

I. Membership Status

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

A. Financial Relations

II. General Department (General Resources Account)

- (a) Quota: SDR 102.2 million.
- (b) Total Fund holdings
of balboas: SDR 376.2 million or 368.1 percent
of quota.
- (c) Fund credit:

	<u>Amount</u>	<u>Percent of Quota</u>
<u>Total</u>	274.0	268.2
Credit tranches	54.4	53.4
Compensatory financing	58.9	57.6
Supplementary financing	22.9	22.4
Enlarged access	137.8	134.8

III. Stand-By Arrangements and Special Facilities

(a) Current stand-by arrangement:

- (i) Duration: From July 15, 1985 to March 31, 1987.
- (ii) Amount: SDR 90 million.
- (iii) Utilization: SDR 35 million.

(b) Stand-by arrangements during the last ten years:

- (i) Duration: June 15, 1983- December 31, 1984
- (ii) Amount: SDR 150 million
- (iii) Utilization: SDR 150 millions

- (i) Duration: April 28, 1982-April 27, 1983
- (ii) Amount: SDR 29.7 million
- (iii) Utilization: --

- (i) Duration: April 18, 1980-December 31, 1981
- (ii) Amount: SDR 90 million
- (iii) Utilization: 75.25 million

- (i) Duration: March 23, 1979-March 22, 1980
- (ii) Amount: SDR 90 million
- (iii) Utilization: --

(b) Stand-by arrangements during the last 10 years (continued):

(i) Duration: June 9, 1978-March 22, 1979
(ii) Amount: SDR 25 million
(iii) Utilization: --

(i) Duration: April 6, 1977-April 5, 1978
(ii) Amount: SDR 11.25 million
(iii) Utilization: --

(i) Duration: November 8, 1975-November 7, 1976
(ii) Amount: SDR 9.0 million
(iii) Utilization: --

(c) 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 6.14 million or 23.3 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 0-2, paragraph (b)(i). The currency of the United States (notes and coins) is legal tender in Panama.
- VI. Last Article IV Consultation: The 1985 consultation discussions were held in the period April 15-26, 1985 and were concluded by the Executive Board on July 15, 1985. Panama is on the standard 12-month cycle of consultations.
- VII. Technical Assistance: A Fiscal Affairs Department panel expert was assigned October 1982-December 1985 to provide assistance in the area of Customs Administration. A Central Banking Department panel expert was assigned in November 1983 to provide technical assistance to the National Banking Commission.

Panama: Selected Economic and Financial Indicators

	1982	1983	1984		1985		Prog. 1986
			Prog.	Actual	Prog.	Est.	
(Annual percent changes, unless otherwise specified)							
National income and prices							
GDP at constant prices	4.7	-1.5	2.0	-0.5	0.4	3.1	2.5
GDP deflator	5.4	3.8	4.0	4.3	1.5	2.5	3.0
Consumer price index	4.2	2.1	4.0	1.6	1.5	1.1	2.0
External sector on the basis of U.S. dollars							
Exports, f.o.b. non-oil	12.2	-5.0	7.9	-6.3	4.2	9.2	8.8
Imports, f.o.b.	5.4	-7.3	5.9	-1.9	-3.4	-0.4	1.3
Non-oil imports, f.o.b.	4.2	-10.7	7.1	2.3	-1.2	1.2	5.6
Public sector							
Revenue and grants	8.1	9.7	5.4	2.8	4.3	6.9	5.3
Of which: revenues <u>1/</u>	8.1	9.7	5.4	0.7	6.5	7.8	5.7
Total expenditure	24.7	-4.3	3.6	3.0	-0.1	-4.5	3.7
Money and credit							
National Bank net credit to public sector <u>2/</u>	17.1	50.8	42.4	54.3	-4.7	11.1	-24.3
Interest rates annual rate <u>3/</u>
(In percent of GDP)							
Public sector savings	1.3	2.9	3.8	1.5	3.1	3.0	3.9
Overall public sector deficit (-)	-10.8	-5.7	-5.5	-5.9	-3.5	-1.7	-1.2
Domestic financing <u>4/</u>	(0.7)	2.5	--	2.0	--	1.1	-1.2
Foreign financing	(10.1)	3.2	5.5	3.9	3.5	0.6	2.5
Gross domestic investment	27.7	21.4	24.0	17.7	18.7	16.9	17.7
Gross national savings	17.9	15.7	18.5	10.3	12.6	11.5	11.8
Current account deficit of balance of payments							
Before transfers	9.8	5.6	5.5	7.5	6.1	5.4	6.0
After transfers	8.9	4.6	...	5.7	5.0	3.7	4.5
External debt							
Exclusive of Fund credit	72.8	75.5	74.9	75.0	78.9	71.7	70.3
Total	74.7	79.9	80.8	81.0	85.0	78.2	76.6
(In percent of exports of goods and nonfactor services)							
Debt service before rescheduling	41.4	28.7	34.3	36.6	48.7	43.2	55.3
Interest payments	22.0	16.6	18.6	19.9	24.1	19.5	19.8
(In percent of public sector revenue)							
Debt service before rescheduling	48.9	35.2	39.8	41.9	49.0	48.7	59.2

1/ Includes capital revenues in 1983.

2/ Includes net drawings from the Fund and net disbursements from Venezuela and Mexico under the San Jose oil facility intermediated by the National Bank. In 1985 and 1986 there are net repayments under the San Jose facility.

3/ Freely fluctuating in line with international rates.

4/ National Bank credit to the public sector.

Panama: Summary of the Financial Program for 1986

1. Targets

a. Real GDP is projected to increase by 2.5 percent in 1986. The ratio of gross domestic investment to GDP is expected to increase from about 17 percent in 1985 to about 17.5 percent of GDP in 1986, mainly on the strength of higher investment in the private sector. Gross domestic savings are projected to increase moderately, principally on account of the behavior of the private sector.

b. The current account of the balance of payments (before transfers) is projected to widen by the equivalent of 0.7 percentage points of GDP, to 6.1 percent of GDP, mainly because of lower receipts from the transshipment of oil activities.

2. Assumptions

a. The rate of inflation, as measured by the GDP deflator, is estimated to increase slightly to 3 percent in 1986. Consumer prices are expected to increase by 2 percent in 1986.

b. Exports are projected to increase by almost 9 percent in 1986, in line with the projection for Panama's trading partners as given in the World Economic Outlook exercise. Non-oil imports are projected to increase by 5.6 percent. Export volumes are projected to increase at about 6 percent; the volume of non-oil imports will increase by 4.5 percent, mostly reflecting the expected recovery in investment.

c. Net foreign borrowing by the nonfinancial public sector, which was only US\$28 million in 1985, will amount to US\$125 million in 1986. Out of this total, only US\$46 million will be obtained from commercial sources, mainly commercial bank lending and bonds, and the rest from bilateral and multilateral sources. Debt with maturity of less than one year will decrease by US\$1.6 million during 1986.

d. The LIBOR rate is assumed to be 8.25 percent in 1986 and the effective interest rate on total foreign borrowing 8.9 percent.

3. Principal elements of the program

a. Public sector policies

(1) The public sector deficit is to be reduced from B 83 million (1.7 percent of GDP) in 1985 to B 62 million (1.2 percent of GDP) in 1986.

(2) The adjustment in 1986 is based on a package of revenue and expenditure measures. Revenue performance is to reflect the full year effect of the measures implemented in 1985, among which are the change in the import duty valuation base from f.o.b. to c.i.f., and an

increase in fees and indirect taxes. In addition, an increase in the rate of taxation of refined petroleum products is expected to generate B 20 million in the second half of the year.

(3) Current expenditure is projected to decrease by the equivalent of about 1 percentage point of GDP in 1986. The decrease reflects the lack of a general salary increase for the second year in a row, a projected reduction of public sector employment of about 2 percent, and the closure of several nonprofitable public entities.

(4) Public enterprises will continue to make significant adjustment to their finances. To this effect, the Azuero sugar mill will be closed at the end of the 1985-86 harvest, the state seed company ENASEMA will cease commercial operations and ENDEMA, the state-owned farm equipment company, will be closed at the end of the 1986 harvest. In addition, IMA will no longer intervene on the rice market.

In response to the adjustment in the public sector, public sector savings, which increased from 1.5 percent of GDP in 1984 to 3 percent in 1985, are projected to improve further to the equivalent of 3.9 percent of GDP in 1986.

(5) Capital expenditure by the public sector is projected to increase slightly to 5.4 percent of GDP. The investment program is to be reviewed by the World Bank during the preparation of the SAL II documentation.

b. National Bank of Panama

In order to preserve the liquidity of the National Bank, the program originally envisaged no access to credit by the nonfinancial public sector from the Bank over the program period. This target is to be maintained as the excess credit of B 63 million borrowed by the public sector in 1985 will be repaid entirely in 1986. However, the program allows for additional credit to be provided on a temporary basis during the year.

4. Structural adjustment policies

The financial program is accompanied by legal and institutional changes aimed at addressing the structural aspects of the economy, and improving resource allocation. The Government has completed the program of replacing quotas with tariffs as agreed with the Fund and the World Bank. Changes have been introduced to the labor code and to the legislation governing the industrial incentives and agricultural activities, to help foster private investment and to transfer resources to the export sector in line with Panama's comparative advantage. These efforts are to be supported by a second SAL from the World Bank.

Financial Relations of the World Bank Group with Panama

IBRD lending operations
as of December 1985

IBRD Disbursed Undisbursed
(In millions of U.S. dollars)

(Amount less cancellation)

<u>Total</u>	<u>408.29</u>	<u>164.89</u>
Power	166.49	89.48
Agriculture	39.22	10.67
Transportation	87.10	25.40
Industry ^{1/}	21.02	--
Urban development	15.34	19.66
SAL	60.20	--
Water supply and sewerage	15.59	18.01
Technical assistance	3.33	1.67

Principal payments 109.22

Debt outstanding, including
undisbursed 412.99

Commitments CY 1985 51.00

Disbursements CY 1985 26.26

IFC investments 9.50

Technical assistance:

IBRD regularly provides technical assistance in institution building and in project preparation and implementation under its loans. Accordingly, a Seventh Power Project approved in 1985 included provision for consultants to carry out studies on (i) two future medium-size hydroelectric projects and (ii) revaluation of the assets of the power company (IRHE).

Recent economic and sector
mission:

The last major economic mission visited Panama in March 1984. None is planned for the near future since substantial economic and sector work is being carried out in conjunction with the preparation and appraisal of a proposed second Structural Adjustment Loan planned for FY 1987.

Studies of the financial, public, and telecommunications sectors are also planned for FY 1987 in addition to the recently completed Transport Sector Review.

^{1/} US\$13.15 cancelled.

PANAMA - BASIC DATA

Area and population

Area	77,082 sq. kilometers
Population (est. mid-1986)	2.19 million
Annual rate of population increase (1980-84)	2.3 percent
Unemployment rate (1985)	11.8 percent

GDP (Est. 1985)

SDR 4,726 million
US\$4,798 million
B 4,798 million

GDP per capita (Est. 1985)

SDR 2,158.0

	1983	1984	Prel. 1985 (percent)	Proj. 1986
<u>Origin of real GDP</u>				
Agriculture and mining	10.4	10.5	10.4	10.5
Manufacturing	9.5	9.5	9.3	9.4
Construction	5.7	5.1	4.9	5.1
Commerce	12.8	13.0	12.7	12.7
Oil pipeline	5.6	4.0	4.2	4.1
Government services	12.9	13.4	13.6	13.0
Other	43.1	44.5	44.9	45.2

Ratios to GDP

Exports of goods and nonfactor services	38.8	35.9	35.7	33.8
Imports of goods and nonfactor services	38.8	37.3	34.4	33.2
Current account of the balance of payments	-4.6	-5.7	-3.7	-4.5
Central government revenues	20.3	20.2	21.0	20.8
Central government expenditures	25.5	25.9	23.0	22.4
Central government savings	-0.1	-1.4	0.7	0.8
Central government overall surplus or deficit (-)	-5.2	-5.7	-2.0	-1.6
External public and government-guaranteed debt (end of year) ^{1/}	73.6	81.2	78.6	76.9
Gross national savings	15.7	10.3	11.5	11.8
Gross domestic investment	21.4	17.7	16.9	17.7
Money ^{2/} and quasi-money (end of year)	44.6	47.4	46.4	47.0

Annual changes in selected economic indicators

Real GDP per capita	-3.7	-2.7	0.8	0.2
Real GDP	-1.5	-0.5	3.1	2.5
GDP at current prices	2.2	3.8	5.7	5.6
Domestic expenditure (at current prices)	-0.9	5.3	2.9	6.3
Investment	-21.1	-13.8	0.9	10.6
Consumption	6.5	10.5	3.3	5.4
GDP deflator	3.8	4.3	2.5	3.0
Consumer prices (annual averages)	2.1	1.6	1.1	2.0
Central government revenues ^{3/}	2.3	3.4	9.9	4.7
Central government expenditures ^{4/}	-3.3	10.0	-0.5	4.5
Money and quasi-money	1.0	8.3	5.1	7.0
Money ^{2/}	-2.4	4.8	7.8	5.5
Quasi-money	1.8	9.1	4.5	7.3
Net domestic bank assets ^{5/}	6.1	12.4	1.2	-1.4
Credit to public sector (net)	7.8	10.5	1.4	...
Credit to private sector	0.5	2.1	3.9	...
Merchandise exports (f.o.b., in U.S. dollars) ^{6/}	-5.0	-6.3	9.2	8.8
Merchandise imports (f.o.b., in U.S. dollars) ^{6/}	-10.7	2.3	1.2	5.6

Central government finances	1983	1984	Prel.	Proj.
			1985	1986
		(millions of balboas)		
Revenues <u>3/</u>	885.8	915.6	1,006.1	1,053.3
Expenditures <u>4/</u>	889.1	977.8	973.2	1,012.7
Current account surplus or deficit (-)	-3.3	-62.2	32.9	40.6
Overall surplus or deficit (-)	-227.8	-259.5	-97.0	-82.7
External financing (net)	98.5	64.6	2.8	...
Internal financing (net) <u>7/</u>	129.3	194.9	94.2	...
Balance of payments		(millions of U.S. dollars)		
Merchandise exports (f.o.b.)	305.6	286.4	312.7	340.3
Merchandise imports (f.o.b.) <u>8/</u>	-1,232.5	-1,209.5	-1,205.1	-1,220.9
Travel (net)	101.3	118.6	135.0	134.4
Investment income (net)	-324.2	-350.2	-401.9	-421.0
Other services and transfers (net)	947.4	895.3	983.0	939.7
Balance on current and transfer accounts	-202.4	-259.4	-176.3	-227.5
Official capital (net)	302.1	214.2	34.0	123.8
Private capital and errors and omissions (net)	-13.0	57.7	7.8	103.7
Other official bank transactions (net)	-86.7	-12.5	134.5	...
International reserve position		Dec. 31		
	1982	1983	1984	1985
		(millions of SDRs)		
National Bank (gross)	97.6	191.6	215.5	86.0
National Bank (net)	-40.1	-58.8	-128.6	-271.2

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/ Excludes crude oil and petroleum products trade.

7/ Includes credit from FIVEN, PEMEX, and the Fund intermediated through the National Bank.

8/ Includes net imports of crude oil and petroleum products.

Table 8. Panama: Central Government Operations

	1983		1984		1985		1986
	Prog.	Actual	Prog.	Actual	Prog.	Prel.	Prog.
(In millions of balboas)							
<u>Total revenue and grants</u>	895.8	885.8	911.3	915.6	1,003.3	1,006.1	1,053.3
<u>Current revenue</u>	895.8	885.8	902.3	885.6	1,003.3	986.1	1,038.3
<u>Tax revenue</u>	645.3	656.1	640.5	652.1	731.0	743.5	768.6
Income tax	286.3	302.6	289.0	281.6	315.3	353.5	323.6
Personal	...	116.2	240.0	116.4	125.0	118.4	134.3
Business ^{1/}	...	86.4	...	65.2	190.3	235.1	189.3
Other	27.2	26.5	23.0	27.0	34.0	34.3	37.0
<u>Taxes on foreign trade</u>	123.9	115.1	127.8	121.1	135.3	129.6	151.2
Imports	123.9	96.3	127.8	108.8	124.0	118.6	139.9
Exports	...	18.8	...	12.3	11.3	11.0	11.3
<u>Taxes on domestic transactions</u>	207.9	211.9	200.7	222.4	246.4	226.1	256.8
Value added	...	73.1	...	75.2	84.7	78.0	80.7
Petroleum products	...	68.7	...	60.8	75.7	72.3	90.8
Other	...	70.1	...	86.4	86.0	75.8	85.3
<u>Nontax revenue</u>	250.5	229.7	261.8	233.5	272.3	242.6	269.7
Panama Canal	60.4	59.7	...	60.0	62.0	66.5	65.5
Oil pipeline	11.0	12.2	...	9.7	11.6	11.8	20.5
Other services	149.3	127.2	...	136.0	144.7	135.6	143.3
Transfers from rest of public sector	29.8	30.6	...	27.8	54.0	30.7	40.4
<u>Grants</u>	--	--	9.0	30.0	--	20.0	15.0
<u>Current expenditure</u>	919.8	889.1	899.2	977.8	1,005.4	973.2	1,012.7
Wages and salaries	366.1	353.7	407.0	403.1	426.1	422.3	440.1
Goods and services	105.3	118.8	98.2	139.6	88.5	107.8	94.0
Pensions and transfers	141.5	141.1	120.9	148.7	156.1	161.6	177.7
Of which transfers to:							
Decentralized agencies	27.0	27.4	32.6	33.5	37.3	32.4	40.4
Public enterprises	5.9	6.7	3.8	0.6	3.4	1.0	3.2
Social Security Agency	40.9	40.9	47.0	48.8	57.0	56.6	73.5
Interest	289.1	263.2	267.0	281.1	330.8	278.6	296.0
Internal	26.8	32.3	...	42.7	59.1	29.6	36.5
External	262.3	230.9	...	238.4	271.7	249.0	259.5
Other	17.8	12.3	6.1	5.3	3.9	2.9	4.9
<u>Current balance</u>	-24.0	-3.3	12.1	-62.2	-2.1	32.9	40.6
<u>Capital expenditure</u>	170.0	224.5	191.9	197.3	140.4	129.9	123.3
Investment	130.5	182.0	162.8	166.6	124.7	124.2	119.4
Capital of transfers	39.5	42.5	29.1	30.7	15.7	5.7	3.9
<u>Overall surplus or deficit (-)</u>	-194.0	-227.8	-179.8	-259.5	-142.5	-97.0	-82.7
(Percent of GDP)							
Current revenue and grants	20.0	20.3	20.0	20.2	22.2	21.0	20.8
Current expenditure	20.5	20.3	19.8	22.5	22.3	20.3	20.0
Current account balance	-0.5	-0.1	0.3	-1.4	--	0.7	0.8
Capital expenditure	3.8	5.1	4.2	4.3	3.1	2.7	2.4
Overall surplus/deficit (-)	-4.3	-5.2	-4.0	-5.7	-3.2	-2.0	-1.6

Sources: Office of the Comptroller General; Ministry of Planning and Economic Policy; and Fund staff estimates.

^{1/} Includes Petroterminal de Panama (PTP).

Table 9. Panama: Operations of the Social Security Agency

(In millions of balboas)

	1983		1984		1985		1986
	Prog.	Actual	Prog.	Actual	Prog.	Prel.	Prog.
<u>Current revenue</u>	<u>349.7</u>	<u>331.6</u>	<u>358.0</u>	<u>312.4</u>	<u>328.5</u>	<u>336.8</u>	<u>365.8</u>
Contributions	259.4	249.8	292.5	256.5	262.8	275.3	289.6
Professional risk premium	19.5	17.9	23.8	17.6	20.5	17.6	19.1
Thirteenth month contribution	30.5	27.6	--	1.2	--	0.1	--
Investment income	17.9	15.1	12.3	15.2	18.9	13.4	18.8
Contribution to pension fund	12.2	13.1	17.4	13.7	14.9	12.3	19.0
Other	10.2	8.1	12.0	8.2	11.4	18.1	19.3
<u>Current expenditure</u>	<u>287.7</u>	<u>313.2</u>	<u>339.3</u>	<u>334.4</u>	<u>365.0</u>	<u>384.4</u>	<u>425.2</u>
Administration	19.0	20.4	17.3	21.7	23.0	23.0	16.4
Benefits and others	268.7	292.8	322.0	312.7	342.0	361.4	408.8
<u>Operating balance</u>	<u>62.0</u>	<u>18.4</u>	<u>18.7</u>	<u>-22.0</u>	<u>-36.5</u>	<u>-47.6</u>	<u>-50.4</u>
Transfers to Central Government	0.3	--	--	0.1	--	--	--
Transfers from Central Government <u>1/</u>	42.2	40.9	47.0	48.8	57.0	56.6	73.5
<u>Current balance</u>	<u>103.9</u>	<u>59.3</u>	<u>65.7</u>	<u>26.7</u>	<u>20.5</u>	<u>9.0</u>	<u>23.1</u>
<u>Capital expenditure</u>	<u>51.3</u>	<u>47.5</u>	<u>36.4</u>	<u>47.3</u>	<u>12.5</u>	<u>6.0</u>	<u>7.6</u>
Fixed investment	21.9	4.8	6.0	6.8	6.0	2.8	4.5
Net lending to private sector	1.4	14.9	3.5	11.8	--	3.2	--
Net lending to National Mortgage Bank	13.0	4.8	16.9	8.0	--	--	--
Housing program	15.0	23.0	10.0	20.7	6.5	--	3.1
<u>Overall surplus or deficit (-)</u>	<u>52.6</u>	<u>11.8</u>	<u>29.3</u>	<u>-20.6</u>	<u>8.0</u>	<u>3.0</u>	<u>6.5</u>

Sources: Social Security Administration; Ministry of Planning and Economic Policy; and Fund staff estimates.

1/ Includes employer contributions of the Central Government.

Table 10. Panama: Summary Operations of the Public Enterprises

(In millions of balboas)

	1983		1984		1985		1986
	Prog.	Actual	Prog.	Actual	Prog.	Prel.	Prog.
<u>Current revenue</u>	<u>476.1</u>	<u>501.1</u>	<u>519.7</u>	<u>497.3</u>	<u>484.9</u>	<u>482.0</u>	<u>505.0</u>
<u>Current expenditure</u>	<u>407.1</u>	<u>430.7</u>	<u>406.2</u>	<u>363.2</u>	<u>345.3</u>	<u>357.3</u>	<u>359.9</u>
Interest	82.9	64.7	71.6	59.5	83.2	74.2	68.3
Other	324.2	366.0	334.6	303.7	262.1	283.1	291.6
<u>Operating balance</u>	<u>69.0</u>	<u>70.4</u>	<u>113.5</u>	<u>134.1</u>	<u>139.6</u>	<u>124.7</u>	<u>145.1</u>
Transfer to Central Government	16.0	17.4	9.3	22.4	27.0	22.9	23.4
Transfer from Central Government	5.9	6.7	3.8	0.6	3.4	1.0	3.2
<u>Current account</u>	<u>58.9</u>	<u>59.7</u>	<u>108.0</u>	<u>112.3</u>	<u>116.0</u>	<u>102.8</u>	<u>124.9</u>
<u>Capital transfers</u>	<u>20.7</u>	<u>17.7</u>	<u>16.7</u>	<u>12.1</u>	<u>7.2</u>	<u>0.7</u>	<u>3.0</u>
<u>Capital spending</u>	<u>154.6</u>	<u>126.6</u>	<u>188.2</u>	<u>130.5</u>	<u>145.9</u>	<u>113.1</u>	<u>123.7</u>
<u>Fixed investment</u>	<u>154.6</u>	<u>126.6</u>	<u>188.2</u>	<u>130.5</u>	<u>145.9</u>	<u>113.1</u>	<u>123.7</u>
<u>Net lending</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>
<u>Overall surplus or deficit (-)</u>	<u>-75.0</u>	<u>-49.2</u>	<u>-63.5</u>	<u>-6.1</u>	<u>-22.7</u>	<u>-9.6</u>	<u>4.2</u>

Sources: Office of the Comptroller General; Ministry of Planning and Economic Policy; and Fund staff estimates.

Table 11. Panama: Summary Operations of the Decentralized Agencies

(In millions of balboas)

	1983		1984		1985		1986
	Prog.	Actual	Prog.	Actual	Prog.	Prel.	Prog.
<u>Current revenue</u>	<u>82.8</u>	<u>120.9</u>	<u>88.0</u>	<u>89.5</u>	<u>87.9</u>	<u>80.3</u>	<u>68.7</u>
<u>Current expenditure</u>	<u>123.1</u>	<u>115.7</u>	<u>123.0</u>	<u>101.2</u>	<u>111.2</u>	<u>106.3</u>	<u>88.1</u>
Interest	37.3	30.4	25.2	16.0	23.1	18.7	14.9
Other	85.8	85.3	97.8	85.2	88.1	87.6	73.2
<u>Operating balance</u>	<u>-40.3</u>	<u>5.2</u>	<u>-35.0</u>	<u>-11.7</u>	<u>-23.3</u>	<u>-26.0</u>	<u>-19.4</u>
Transfer to Central Government	6.0	5.8	--	4.5	0.5	1.7	1.7
Transfer from Central Government	27.0	27.4	32.6	30.4	37.3	32.4	40.4
<u>Current account</u>	<u>-19.3</u>	<u>26.8</u>	<u>-2.4</u>	<u>14.2</u>	<u>13.5</u>	<u>4.7</u>	<u>19.3</u>
Capital transfers	31.8	29.6	29.3	26.6	8.5	5.0	0.9
<u>Capital spending</u>	<u>66.1</u>	<u>55.9</u>	<u>62.9</u>	<u>29.0</u>	<u>29.8</u>	<u>1.8</u>	<u>25.1</u>
Fixed investment	50.0	45.1	11.4	15.0	2.1	--	0.7
Net lending	16.1	10.8	51.5	14.0	27.7	1.8	24.4
<u>Overall surplus or deficit (-)</u>	<u>-53.6</u>	<u>0.5</u>	<u>-36.0</u>	<u>11.8</u>	<u>-7.8</u>	<u>7.9</u>	<u>-4.9</u>

Sources: Office of the Comptroller General; Ministry of Planning and Economic Policy; and Fund staff estimates.

Table 12. Panama: Summary Operations of the Banking System

	1981	1982	1983	1984	Prel. 1985
(In millions of balboas; end of period)					
Net foreign assets	5,397.7	6,518.6	6,994.4	6,347.0	6,505.7
Of which: National Bank	-51.9	-44.2	-61.6	-126.1	-297.9
Overseas operations (net)	-6,003.6	-6,683.9	-7,183.3	-6,627.9	-6,642.1
Credit to nonresidents	18,125.1	19,093.9	15,921.3	14,338.5	14,347.8
Deposits from nonresidents	-23,891.6	-25,291.5	-22,635.1	-20,398.2	-20,570.9
Other foreign liabilities	-237.1	-486.3	-469.5	-568.2	-419.0
Net domestic assets	3,168.9	3,298.4	3,416.4	3,679.5	3,705.0
Public sector (net)	389.9	518.0	669.3	874.9	905.5
National Bank	182.5	213.7	322.3	497.3	552.3
Counterpart to foreign liabilities ^{1/}	198.3	260.9	408.1	500.2	526.2
Other	-15.8	-47.2	-85.8	-2.9	26.1
Other banks	207.4	304.3	347.0	377.6	353.2
Private sector	2,619.2	2,687.7	2,697.2	2,740.0	2,823.4
National Bank	284.2	338.2	342.1	340.5	326.0
Other banks	2,335.0	2,349.5	2,355.1	2,399.5	2,497.4
Unclassified assets (net)	279.2	239.1	49.9	64.6	-23.9
Long-term foreign liabilities	136.0	215.2	257.3	275.4	263.6
SDR allocation	30.7	29.0	27.6	25.9	28.9
Liabilities to domestic private sector	2,396.3	2,888.9	2,942.6	3,097.2	3,275.9
National Bank	118.4	143.1	168.5	199.9	198.9
Other banks	2,277.9	2,745.8	2,774.1	2,897.3	3,076.9
(In percent of GDP)					
Total liabilities	61.8	67.5	67.2	68.2	68.3
Net domestic credit	81.7	77.1	78.0	81.4	77.2
Public sector	10.1	12.1	15.3	19.3	18.9
Of which: National Bank	4.7	5.0	7.4	11.0	11.5
Private sector	67.5	62.8	61.6	60.3	58.8
(Annual changes as percent of liabilities to the domestic private sector at the beginning of the period)					
Total liabilities	16.9	20.6	1.9	5.3	5.8
Net domestic credit	22.9	5.4	4.1	8.9	0.8
Public sector	6.1	5.3	5.2	7.0	1.0
Private sector	19.9	2.9	0.3	1.5	2.7

Sources: National Bank of Panama; National Banking Commission; Savings Bank; and Fund staff estimates.

^{1/} Includes liabilities of the National Bank of Panama to the IMF, and to FIVEN and PEMEX under the San Jose Oil Agreement.

Panama City, Panama
May 27, 1986

Mr. Jacques de Larosiere
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. de Larosiere:

1. In a letter dated June 15, 1985, the Government of Panama requested a 21-month stand-by arrangement from the International Monetary Fund in support of a financial program covering the period through end-March 1987. The program aimed at consolidating the gains achieved under the previous 1983-84 program by continuing to strengthen public sector finances, reducing the debt service burden, and improving the efficiency of resource allocation so as to foster savings and investment, particularly in the private sector. Accordingly, the overall deficit of the nonfinancial public sector was programmed to decline from 6 percent of GDP in 1984 to 3.5 percent in 1985, and public sector savings were expected to improve by the equivalent of about 2 percentage points of GDP. The program aimed at financing the public sector's overall deficit from mostly bilateral and multilateral sources in order to ease the debt service burden over the medium term.

2. The Government of Panama feels that progress has been made in the implementation of the program, in circumstances of a significant shortfall in external financing from the level originally projected. The overall adjustment was stronger than envisaged in the program and took place mainly through a large cutback in investment expenditures. Public sector savings were somewhat below target, reflecting a smaller than expected yield of some of the revenue measures introduced last year. The overall deficit of the nonfinancial public sector was only B 83 million or 1.7 percent of GDP in 1985, compared with the projected 3.5 percent of GDP. The deficit was financed in part by an unprogrammed increase in net credit from the National Bank to the nonfinancial public sector.

3. The financial program for 1985 was designed to increase general government revenue by 3 percentage points to 30.8 percent of GDP while maintaining the operating surpluses of the public enterprises. To this end, the Government introduced a revenue package which included increases in a number of indirect taxes and fees, the elimination of the import duty exemption of the public sector, and measures aimed at widening the revenue base of the income tax. In addition, a change in the valuation of imports from an f.o.b. to a c.i.f. basis, and the sale of some public sector assets were also expected to increase general government revenues. Legal complications involving the implementation of some of these measures, a smaller-than-expected yield of some of the fee and

tax increases, and the inability to sell the public sector assets led to a shortfall in revenues which was to some extent compensated by higher-than-expected dividend payments to the Government by Petroterminal de Panama. While general government revenues fell short of the target by 2 percentage points of GDP, the outcome for the operating balances of the public enterprises as a whole was about as expected.

4. In the face of the revenue and external financing shortfalls, a more restrictive expenditure policy was implemented in 1985. Aided by a decline in international interest rates and lower-than-projected wage payments, current expenditures of the general government were reduced by almost half of a percentage point in relation to GDP. More importantly, capital expenditures of the public sector declined sharply from 8 percent of GDP in 1984 to 5.2 percent of GDP in 1985, a decline which reflects in part the completion of the La Fortuna hydroelectric project. Such a level of capital expenditure in relation to GDP is, however, too low for Panama's medium-term development needs.

5. In 1985 Panama concluded negotiations with both foreign commercial banks and the Paris Club for the refinancing of amortization payments falling due in 1985-86. In addition, Panama negotiated a new credit facility for US\$60 million from its foreign commercial bank creditors, arranged for these banks to maintain their lines of credit to the National Bank of Panama, and successfully concluded an external bond placement for US\$20 million. However, the disbursements under the commercial banks' new credit facility were contingent upon progress being made in negotiations for a second structural adjustment loan with the World Bank. Due to the delays in concluding these negotiations, Panama did not receive the two disbursements totaling US\$42 million that had been expected from commercial banks in 1985. Altogether the external public debt rose by US\$43 million to US\$3,754 million and declined in relation to GDP from 81 percent in 1984 to 78 percent in 1985.

6. In spite of the cutbacks in public sector investment in 1985, economic activity was stronger than originally anticipated, reflecting in large part a recovery in the Colon Free Zone, higher throughput of the oil pipeline and higher electricity production. The inflation rate, as measured by the change in the consumer price index, declined for the third consecutive year to an annual rate of slightly above 1 percent. The adjustment in the external sector was also stronger than projected as the current account deficit declined to 3.7 percent of GDP compared with a projected 5 percent of GDP.

7. In order to consolidate the gains made in 1985, Panama intends to continue its adjustment efforts and has designed a 1986 program that reflects a larger fiscal adjustment than originally envisaged. In the program approved by the Fund on July 15, 1985, the 1986 target for the overall deficit of the nonfinancial public sector was B 120 million, equivalent to 2.6 percent of GDP, to be financed mostly with multilateral and bilateral credits. In light of projected external financing, and because of the need to repay the National Bank of Panama of the

unanticipated use of B 62.8 million of credit in 1985, the overall public sector deficit in 1986 will need to be kept at a lower level of B 62 million, or equivalent to 1.2 percent of GDP. The overall public sector deficit will thus be financed mostly with multilateral and bilateral credits, as originally intended. Consistent with the overall fiscal target for 1986, cumulative quarterly limits on the overall deficit of the nonfinancial public sector have been set as described in the attached Table 1.

8. Recent progress in the negotiations for the above-mentioned second structural adjustment loan from the World Bank should make possible disbursements in 1986 under this loan and the new credit facility from commercial banks. As part of these negotiations, last month the legislature approved three laws regarding incentives to the agricultural and industrial sectors and reforms of the labor code. Thus, while the net financing needs of the public sector in 1986 will be mostly met by credits from bilateral and multilateral agencies, as mentioned above, the public sector will also have recourse to the US\$60 million credit negotiated with commercial banks last year. Negotiations are also well advanced for the placement of a ¥ 5 billion bond issue in the Japanese market.

9. The fiscal program for 1986 is based on a projection of general government revenue equivalent to 28.6 percent of GDP, the same ratio as in 1985. A projected decline in government revenues due to lower tax and dividend payments by Petroterminal de Panama is to be more than offset by an increase over the budgeted level of tax revenues from the oil refining operations via income taxes and specific duties applied to the sale of refined products, in order to capture a part of the surplus generated by the decline of the international oil prices. The new specific duties applied to the sale of refined products will be in place by June 1 prior to the presentation of the 1986 program to the Fund Executive Board. To the extent that there would be net proceeds to the Government in 1986 from either transactions in assets of Petroterminal de Panama or increases in the outstanding debt of Petroterminal de Panama from the level which existed at the end of 1985, the Government intends to use such resources to reduce further the nonfinancial public sector's debt to the National Bank or to make repayments to foreign creditors. Such resources, if any, would therefore not count as public sector revenues for the purposes of the program.

10. The program for 1986 envisages a cautious expenditure policy with overall expenditure rising by less than 4 percent, which is lower than the expected rate of growth of nominal GDP. Current expenditures of the General Government are projected to decline by 1 percentage point in relation to GDP reflecting efforts to restrict growth of the general government wage bill and purchases of goods and services. In addition the Government of Panama will prepare a plan by October 1, 1986, that would ensure the long-term financial viability of the Social Security Agency as part of the measures for the second structural adjustment loan from the World Bank. Among the measures envisaged by the plan is the

immediate implementation of the following legislative actions: (a) elimination of early retirement (ages 50/55) before the end of the year; (b) revision of the pension formula for workers who retire under the old age, disability, and survivors fund to make these pensions a function of the average salary of the last 10 years of work before the end of the year; and (c) application of the revised formula for calculating the pensions of the old age, disability, and survivors fund to the pensions of the 26 special work groups. This last measure is to be implemented during the first session in 1987 of the Panamanian legislature. Measures have already been put in place to improve the soundness of the Social Security Agency's investment portfolio, which combined with the dispositions described above, should help improve substantially the financial position of the agency in 1986 and strengthen its viability in future years. In addition, no increases in pension are to be granted in 1986 except to those persons receiving the minimum pension.

11. Public sector capital expenditure is projected to amount to 5.5 percent of GDP, a slight increase relative to the 1985 ratio with most of these investments having an important external finance component. The public investment program will emphasize the development of basic infrastructure such as communications, hydroelectric power, health and education. We feel that while the nation can afford only a modest improvement in investment as projected this year, it will be necessary to increase public sector investment in relation to GDP in future years so as to adequately meet the infrastructure needs of Panama.

12. With regard to the public sector enterprises, the Government will pursue a policy aimed at streamlining their operations and implementing adequate pricing policies to improve their operating surpluses and thus contribute to strengthening the public sector finances. In 1986 the operations of the Agricultural Marketing Board (IMA) have been curtailed, particularly those related to rice marketing operations and IMA is no longer intervening in the referred market. Owing to low world market prices for sugar and a reduced access to the U.S. market, the Azuero sugar mill will be closed at the end 1985-86 harvest and the overall level of subsidies to several other public enterprises will be either discontinued or reduced. The ending of the commercial operations of ENASEM, the state seed company, and sale of all seed inventories will be in effect immediately; the research and certification functions of the agency, including the IDB financed research project, will be transferred to IDIAP, the institute for agricultural research. ENDEMA, the state owned farm equipment company, will be closed after fulfilling its present contract for this year's harvest; it will not subscribe new contracts for the next agricultural year.

13. As described in paragraph 7, the 1986 program contemplates the repayment by the public sector to the National Bank of Panama of all of the excess credit extended in 1985 (B 63 million) in order to strengthen the Bank's liquidity. While targeting a net repayment for 1986 as a whole, the program allows for some net access by the public sector to

National Bank credit within the year in order to allow for the implementation of government programs prior to the expected disbursement of external credits late in 1986. At no time will such credit be allowed to exceed the ceilings specified in the attached Table 2.

14. The heavy debt service payments in the next few years remain a source of major concern. The Government of Panama intends to ease the debt service burden over the medium term by keeping the increase in foreign debt to reasonable levels and also by continuing to lower the share of debt from commercial sources. In line with this intention to reduce the debt service burden, net external borrowing of the public sector will not exceed US\$125 million in calendar year 1986, an increase of 3.4 percent over the outstanding level at end-1985, as indicated in the quarterly limits set forth in the attached Table 3. There will be limited recourse to external commercial credit by the public sector on a net basis during 1986, and quarterly sublimits on such credit have been established as indicated in Table 3. Moreover, short-term debt of the public sector will be reduced by US\$1.6 million in 1986 to the level which existed at the end of 1984.

15. The Government of Panama recognizes that financial adjustment must be accompanied by legal and institutional changes to address the structural problems of the Panamanian economy so as to promote a more efficient resource allocation. The completion of the program of replacing import quotas by tariffs was delayed in 1985 due to problems in designing a structural adjustment strategy. The Government now intends to complete this substitution by May 1, 1986 for all products which have import quotas except in the case of 16 agricultural products, and at the same time will eliminate any price controls applied to these product categories. The Government will also notify the Fund staff that these measures have been implemented prior to Executive Board consideration of the 1986 program. To induce a more efficient resource allocation the recently passed industrial law will reduce the maximum nominal tariff for existing industries to 60 percent. This is to be done over a 5-year period with the first adjustment being implemented on August 1, 1986. Under this industrial law, new industries will benefit from a nominal tariff protection of 20 percent at most, except for agroindustries, which may receive up to 30 percent. In the agricultural sector, price controls on all horticultural products except industrial tomatoes have been removed. Agricultural support prices exceeding international prices will be reduced by a significant margin and the price of rice will be determined without public intervention. The recently approved changes in the labor code permit piecework, and contain provisions to allow employers to pay bonuses and other incentives to productivity without incorporating them into the wage base, as they were previously required to do. Other provisions give more flexibility to the salary policies of export industries and small-scale enterprises. The Government feels that these measures will increase the productivity of the economy, help correct the erosion in competitiveness that has occurred in recent years, orient production toward exports, and reduce rigidities in the labor market, thus enabling the absorption of

increases in the labor force. These efforts at reforming the economy are to be supported by the above-mentioned second Structural Adjustment Loan from the World Bank to be disbursed in 1986-87.

16. Panama has no restrictions on payments and transfers for either international current or capital transactions. During the period of the stand-by arrangement, the Government of Panama does not intend to introduce any multiple currency practices, conclude any bilateral payment agreement with any Fund member, or impose any restrictions on payments or transfers for current international transactions, and furthermore, does not intend to introduce restrictions on imports for balance of payments purposes.

17. The Government of Panama believes that the policies described above are adequate to achieve the objectives of its program. During the remaining period of the stand-by arrangement the Government will periodically consult with the Fund, in accordance with the Fund's policies on such consultations, about the progress being made in the implementation of the program described above and any policy adaptations judged to be appropriate for the achievement of its objectives.

Sincerely,

Ricaurte Vasquez M.
Minister of Planning
and Economic Policy

Hector Alexander
Minister of Finance
and Treasury

Luis Alberto Arias
General Manager
National Bank of Panama

Table 1. Panama: Cumulative Limits on the Deficit of
the Nonfinancial Public Sector 1/

(In millions of balboas)

Period	Cumulative Limits
January 1-March 31, 1986 (Preliminary)	-13.7
January 1-June 30, 1986	25.9
January 1-September 30, 1986	40.6
January 1-December 31, 1986	62.5

1/ The deficit of the nonfinancial public sector will be defined as the sum of the net increase above their respective stocks as of December 31, 1985 in (1) the external debt of the nonfinancial public sector to foreign lenders (including debt with maturities of less than one year) and to the domestic banking system, including the Caja de Ahorros, but excluding the National Bank of Panama, as described in Table 3; and (2) the net credit extended by the National Bank of Panama to the nonfinancial public sector, as described in Table 2, but excluding transactions under the San Jose Oil Agreement, and with the Fund.

Table 2. Panama: Ceilings on Net Credit of the National Bank to the Nonfinancial Public Sector 1/

(In millions of balboas)

Period	Limit <u>2/</u>
Oustanding December 31, 1985 (actual)	552.2
January 1-March 31, 1986 (Preliminary)	1.3
January 1-June 30, 1986	36.1
January 1-September 30, 1986	48.8
January 1-December 31, 1986	-63.0

1/ Net credit to the nonfinancial public sector excludes deposits of the nonfinancial public sector corresponding to any net proceeds from transactions in assets or from increases in the debt outstanding as of December 31, 1985 of Petroterminal de Panama.

2/ The limit will be defined as the increase in net credit of the National Bank to the nonfinancial public sector above the stock outstanding as of December 31, 1985. The limit will be adjusted upward to the full extent of net purchases from the Fund, and of net disbursements on loans to Panama from Venezuela and Mexico under the San Jose Oil Agreement intermediated through the National Bank. The limits will be adjusted downward to the full extent of net repurchases from the Fund and net amortizations on loans under the San Jose Agreement.

Table 3. Panama: Cumulative Limits on External and Commercial Net Borrowing by the Public Sector

(In millions of U.S. dollars)

Period	Limits
<u>Total External Public Debt 1/2/</u>	
Outstanding December 31, 1985 (actual)	3,753.9
January 1-March 31, 1986 (Preliminary)	-15.0
January 1-June 30, 1986	-10.2
January 1-September 30, 1986	-8.2
January 1-December 31, 1986	125.5
<u>Total External Commercial Debt 2/3/</u>	
Outstanding December 31, 1985 (actual)	2,176.2
January 1-March 31, 1986 (Preliminary)	-6.5
January 1-June 30, 1986	-23.3
January 1-September 30, 1986	-9.7
January 1-December 31, 1986	45.5
<u>Outstanding Debt with Maturity of Less than One Year 2/</u>	
December 31, 1985 (actual)	37.7
December 31, 1986	36.1

1/ Net external public sector borrowing is defined as the sum of the net increase above their respective stocks on December 31, 1985 of: (1) the debts of the nonfinancial public sector (including debts with maturities of less than one year) to foreign lenders and to the domestic banking system exclusive of the National Bank of Panama; (2) public bonds, Treasury bills, and promissory notes held by the private sector; and (3) the medium- and long-term foreign liabilities of the National Bank of Panama, including purchases outstanding from the IMF, and including liabilities to Venezuela and Mexico under the San Jose Oil Agreement.

The limits will be increased by the difference between the ceiling on net credit to the nonfinancial public sector from the National Bank and the actual balances of such net credit, both according to the definitions in Table 2, when the latter is below its ceiling. The cumulative limits on external public debt will be adjusted downward by the amount of amortization payments made corresponding to any net proceeds to the nonfinancial public sector from transactions in assets or increases in the debt outstanding as of December 31, 1985 of Petroterminal de Panama.

2/ Excludes short-term debt of the National Bank of Panama.

3/ Excludes net disbursements from bilateral and multilateral international development agencies; otherwise defined as in (1) above.