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September 11, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Panama - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Panama, which will be brought to the agenda for discussion on a date to be announced.

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

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INTERNATIONAL MONETARY FUND

PANAMA

Staff Report for the 1986 Article IV Consultation

Prepared by the Western Hemisphere Department

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

Approved by S. T. Beza and W. A. Beveridge

September 10, 1986

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I. Introduction

The 1986 Article IV consultation discussions with Panama were held in Panama City during the period July 8-21, 1986. ^{1/} The Panamanian representatives in the discussions included the Minister of Planning and Economic Policy, the Minister of Finance and Treasury, the Minister of Commerce and Industry, the Comptroller General, the General Manager of the National Bank, the Director of the Budget, and other senior officials of the Government, the National Bank, and various public enterprises and agencies. Mr. Hernando Arias, Alternate Executive Director for Panama, participated in the discussions. ^{2/}

The last Article IV consultation with Panama was concluded by the Executive Board on July 15, 1985 (EBM/85/107). On that occasion, the Executive Board also approved a stand-by arrangement for Panama (EBS/85/152, 6/17/85) for the period through March 31, 1987 in the amount equivalent to SDR 90 million. Panama made three purchases in 1985 for the equivalent of SDR 35 million, but purchases of SDR 11 million each scheduled to be made in February and May 1986 were not made because of the nonobservance of performance criteria as of December 31, 1985 and because of delays in completing the review scheduled to establish the performance criteria for 1986.

The review was completed on July 2, 1986 (EBM/86/108), when the Executive Board established performance criteria for 1986. Following completion of the review, Panama made a purchase of SDR 22 million in mid-July equivalent to the two purchases of SDR 11 million each that had not been made earlier in the year. After making a scheduled purchase at the end of August 1986, Panama has now made all scheduled purchases to date under the stand-by arrangement (Table 1). As of August 31, 1986, Panama's total outstanding purchases stood at SDR 295.1 million (288.7 percent of quota). Further information on Panama's relations with the Fund is given in Appendix I.

II. Performance Under the Stand-By Arrangement in 1985

In light of the continued heavy debt service burden, the authorities formulated an adjustment program for 1985-86 aimed at consolidating the progress made in strengthening the public finances during 1983-84; this program is being supported by the stand-by arrangement approved on July 15, 1985. The program originally envisaged 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.

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

^{2/} The staff mission consisted of Messrs. Pérez (Head), Fritz-Krockow, and Roncesvalles, Ms. Suss and Ms. de Lucio (Secretary) (all WHD).

Table 1. Panama: Projected Transactions During 1986-87

	Outstanding December 31, 1985	Transactions During 1986				Transactions During 1987
		Jan.- Mar. <u>1/</u>	Apr.- June <u>1/</u>	July- Sept. <u>1/</u>	Oct.- Dec.	Jan.-Mar.
<u>(In millions of SDRs)</u>						
<u>Transactions under tranche</u> <u>policies (net) 2/</u>		-9.4	-3.6	24.0	9.1	2.8
Purchases		--	--	33.0	11.0	11.0
Ordinary resources		--	--	16.5	5.5	5.5
Enlarged access resources		--	--	16.5	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) 3/</u>		--	--	-7.4	-7.4	-7.4
Purchases		--	--	--	--	--
Repurchases		--	--	-7.4	-7.4	-7.4
<u>Total Fund credit outstanding</u> <u>(end of period)</u>	283.4	274.0	270.4	287.0	288.7	284.1
Under tranche policies <u>2/</u>	224.5	215.1	211.5	235.5	244.6	247.4
Special facilities <u>3/</u>	58.9	58.9	58.9	51.5	44.1	36.7
<u>(As percent of quota)</u>						
<u>Total Fund credit outstanding</u> <u>(end of period)</u>	277.3	268.1	264.5	280.8	282.5	278.0
Under tranche policies <u>2/</u>	219.7	210.5	206.9	230.4	239.3	242.1
Special facilities <u>3/</u>	57.6	57.6	57.6	50.4	43.2	35.9

Source: Fund staff estimates.

1/ Actual figures.

2/ Ordinary and enlarged access resources.

3/ Compensatory financing facility.

This objective was to be achieved through measures to strengthen revenue, to reduce the rate of growth of current outlays, and to scale down investment expenditures. 1/ The overall public sector deficit was to be fully financed from external sources and there was to be no recourse to National Bank credit. 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 both 1985 and 1986. 2/

Panama's performance in 1985 under the current stand-by arrangement was mixed. The overall deficit of the nonfinancial public sector was reduced to the equivalent of 1.7 percent of GDP, well below the program limit of 3.5 percent of GDP, because current expenditures of the general government were lower than had been projected (associated mostly with lower interest payments) and the implementation of the investment program was slowed by a significant shortfall in external credit disbursements. However, the reduction in the public sector deficit was not sufficient to compensate fully for the external financing shortfall and, as a result, the use of net credit from the National Bank was higher than had been planned. The shortfall in external financing arose in large part from the failure to conclude negotiations for a second structural adjustment loan from the World Bank (SAL II). Disbursements of US\$42 million in new credits from the commercial banks and US\$40 million from the U.S. AID Economic Support Fund were conditional on progress made in negotiating SAL II, and as no agreement was reached between the Panamanian authorities and the World Bank, these disbursements did not materialize.

After declining by a cumulative 2 percent in the period 1983-84, real GDP grew by about 3 percent in 1985 as activity in the Colon Free Zone recovered, and the volume of crude oil carried through the pipeline of Petroterminal de Panama (PTP) increased owing to a cold winter in the eastern United States. The rate of inflation, as measured by the consumer price index, declined for the fourth consecutive year to about 1.1 percent in 1985 (Table 2). The current account deficit of the balance of payments (before transfers) narrowed from 7.5 percent of GDP in 1984 to 6.7 percent of GDP in 1985 as an increase in net receipts of nonfactor services more than offset a deterioration in the merchandise trade balance and higher net outflows of investment income.

1/ For a more detailed description, see EBS/85/114, pp. 4-9.

2/ 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 medium of exchange.

Table 2. Panama: National Accounts and Prices

	1982	1983	1984	Prel. 1985	1986 Prog.1/ Proj.2/	
(Annual percentage change, unless otherwise specified)						
GDP at current prices	10.3	2.2	3.8	5.7	5.6	6.0
GDP at constant prices	4.7	-1.5	-0.5	3.1	2.5	2.9
GDP deflator	5.4	3.8	4.3	2.5	3.0	3.0
Consumer price index (period average)	4.2	2.1	1.6	1.1	2.0	1.2
Wholesale price index (period average)	2.3	-3.8	1.0	-0.4	...	-0.5
Average monthly wages	1.4	1.3	1.5	...	...	...
Unemployment rate (as a percent of labor force)	8.4	9.7	9.9	11.8	...	13.4
(In percent of GDP)						
<u>Total domestic demand</u>	<u>103.1</u>	<u>100.3</u>	<u>101.6</u>	<u>100.0</u>	<u>99.4</u>	<u>98.7</u>
<u>Domestic consumption</u>	<u>75.5</u>	<u>78.9</u>	<u>83.9</u>	<u>82.8</u>	<u>81.6</u>	<u>81.2</u>
<u>Gross domestic invest- ment</u>	<u>27.7</u>	<u>21.4</u>	<u>17.7</u>	<u>17.1</u>	<u>17.7</u>	<u>17.5</u>
Public sector	9.5	8.3	7.2	5.0	4.9	4.8
Private sector	18.2	13.1	10.5	12.1	12.8	12.7
<u>Gross national savings</u>	<u>17.1</u>	<u>15.7</u>	<u>10.4</u>	<u>10.4</u>	<u>11.8</u>	<u>12.5</u>
Public sector	1.3	2.9	2.2	3.4	4.3	4.0
Private sector <u>3/</u>	15.9	12.8	8.2	7.0	7.5	8.5
<u>Foreign savings</u>	<u>10.6</u>	<u>5.7</u>	<u>7.3</u>	<u>6.7</u>	<u>5.9</u>	<u>5.0</u>

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

1/ As described in EBS/86/114, May 28, 1986.

2/ Staff revised projection.

3/ Includes foreign grants.

III. The 1986 Economic Program and Developments During the Year

The 1986 program, which was presented in the review of the stand-by arrangement concluded on July 2, 1986, aimed at a further reduction of the public sector deficit, and at a strengthening of the liquidity position of the National Bank. In light of the fiscal outcome in 1985 and the external financing prospects, the target for the overall public sector deficit in 1986 was reduced from the 2.6 percent of GDP (envisaged when the stand-by arrangement was approved) to the equivalent of 1.2 percent of GDP. This deficit was to be completely financed by external credits, mostly from bilateral and multilateral resources, with only limited recourse to commercial credits on a net basis.^{1/} An improvement in resource allocation was sought through the implementation of a package of structural measures announced in early 1986 and supported by SAL II.

When the authorities developed their financial program for 1986, net external financing to the nonfinancial public sector was projected to be US\$125 million for the year, including a disbursement of US\$50 million under SAL II from the World Bank and US\$15 million under the U.S. AID Economic Support Fund. The financing package for 1986 also included a rescheduling of US\$354 million in amortization payments to foreign commercial banks falling due in 1986 and the full disbursement of the US\$60 million from the commercial banks' credit facility, including the US\$42 million which was to have been disbursed in 1985. The program also envisaged a private placement of bonds in the Japanese market for approximately US\$25 million; this placement was to offset in part US\$38 million of amortization of bonds in 1986.

Moreover, the nonfinancial public sector was to make a net repayment of B 63 million to the National Bank to strengthen its liquidity (corresponding to the amount of the excess over the ceiling at end-1985). However, the net repayment to the National Bank is not to be made until the last quarter of 1986 when net disbursements of external financing were to take place; the National Bank was to provide credit for the public sector during the first nine months of the year to cover the cumulative deficit of the public sector plus net external debt amortization.

The 1986 fiscal targets had been based on the assumption that output would expand at a rate of 2.5 percent, with the GDP deflator rising by 3 percent. Public sector revenue, including the operating surpluses of the public enterprises, was to be maintained at the same level in relation to GDP as in 1985. The full year impact of the revenue measures taken in 1985 to increase the yield from taxes on foreign

^{1/} For purposes of the stand-by arrangement, all credits from commercial banks, whether local or foreign, are treated as external credits.

trade, and to widen the tax base, and the increase in petroleum taxes implemented in June 1986 were expected to contribute to the revenue performance.

Total public sector expenditure in 1986 was projected to decline slightly relative to GDP, as a reduction in current expenditure would more than offset a projected increase in capital spending. The restraint in current expenditure would reflect the continuation of a wage freeze covering a large proportion of central government employees and a 2 percent reduction of the public sector labor force. Overall, public sector savings were targeted to increase to almost 4 percent of GDP from 3 percent of GDP in 1985. ^{1/}

Panama's performance under the stand-by arrangement has been satisfactory so far in 1986. The ceiling on National Bank credit to the nonfinancial public sector was observed with a modest margin on June 30, 1986 in spite of the delay in Panama's drawings from the Fund referred to earlier. ^{2/} The nonfinancial public sector registered a surplus of B 2.4 million in the first semester of 1986, compared with a targeted deficit of B 25.9 million. The limit on total external borrowing of the public sector and the sublimit on commercial borrowing were met with large margins (Table 3).

According to the latest estimates, real GDP is expected to grow by about 3 percent in 1986, compared with the program projection of 2.5 percent, with the GDP deflator rising by 3 percent as projected. Activity in the Colon Free Zone, the Panama Canal, and the commercial sector has been more buoyant than had been projected, while agricultural and manufacturing production has been weaker.

IV. Summary of Policy Discussions

At the time of the review of the stand-by arrangement, Executive Directors welcomed the progress that had been made in strengthening the finances of the public sector and emphasized the need to focus on expenditure control in the future to achieve the fiscal goals of the program. In the view of Executive Directors, expenditure control efforts should concentrate particularly on current expenditure as a further curtailment of investment expenditure could have negative consequences for the country's growth prospects. Executive Directors also welcomed the recent improvements in tax administration, and noted that tax reform might be desirable to strengthen incentives for the private sector. Executive Directors commended the authorities on their structural reforms in the industrial, agricultural, and labor areas, which in their

^{1/} For a more detailed description of the 1986 program, see EBS/86/114, pp. 9-12.

^{2/} No performance criteria were established for March 31, 1986 because of the delays in completing the review.

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

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

	1985	1986 1/			
	Dec.	Mar. 2/	June	Sept.	Dec.
<hr/>					
<u>Deficit of nonfinancial</u>					
<u>public sector</u>					
Cumulative limit	160.0	-13.7	25.9	40.6	62.5
Actual	-80.0	-13.7 3/	-2.4 3/	...	...
Margin (excess -)	80.0	--	28.3	...	...
<u>Net credit from BNP to the</u>					
<u>nonfinancial public sector</u>					
Limit 4/	--	1.3	36.1	48.8	-63.0
Adjusted limit	-7.9	-15.7	18.9	...	...
Actual	54.9	-15.7	18.5	...	...
Margin (excess -)	-62.8	--	0.4	...	...
<u>Net external borrowing of the</u>					
<u>total public sector</u>					
Cumulative limit 5/	160.0	-15.0	-10.2	-8.2	125.5
Adjusted limit	153.8	-15.0	-23.3	...	...
Actual	12.6	-15.0	-53.2	...	...
Margin (excess -)	141.2	--	29.9	...	...
<u>Net commercial borrowing</u>					
<u>of the public sector</u>					
Cumulative limit	32.0	-6.5	-36.8	-9.7	45.5
Actual	-41.1	-6.5	-47.0	...	...
Margin (excess -)	73.4	--	10.2	...	...
<u>Outstanding commercial debt with</u>					
<u>maturity of less than one year</u>					
Cumulative limit	40.2				40.2
Actual	41.8				...
Margin (excess -)	-1.6				...

Sources: Central Statistical Office; National Bank of Panama.

1/ Limits are cumulative from January 1, 1986.

2/ Indicative ceilings.

3/ The overall financial operations of the nonfinancial public sector registered a surplus.

4/ Limit to be 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.

5/ Limit to be adjusted to the full extent of any net short-term debt flows of the National Bank; also adjusted upward by any margin on the limit for National Bank credit to the nonfinancial public sector.

view would help improve resource allocation and raise productivity. In addition, Executive Directors noted that Panama will only return to a sustainable external position in the medium term, and that the restructuring of Panama's commercial debt as well as some net new commercial bank financing may be needed in the next few years to support Panama's adjustment effort.

1. Fiscal policies

The Panamanian authorities were satisfied with the fiscal performance of the first half of 1986. The authorities attributed the achievement of a small overall surplus by the public sector to a better-than-projected revenue performance and the implementation of a cautious expenditure policy, and they were confident that the fiscal targets of the program for the year as a whole would be met (Table 4). The authorities planned to continue to monitor expenditures closely, particularly in light of developments regarding the disbursements of external credits.

Public sector revenue in the first half of 1986 was 2 percent higher than projected at the time of the review, and almost 20 percent higher than in the same period of 1985. The strong revenue performance was explained by the effect of the revenue package introduced in 1985 and by improved economic conditions. Public sector revenue and grants in 1986 as a whole are expected to be roughly in line with the program projection. 1/

Income tax receipts for the first half of the year were about 11 percent higher than had been projected, as the recovery in 1985 2/ had been stronger than had been anticipated and additional efforts were made to collect income tax arrears. For the year as a whole, income tax collections are now expected to be about 5 percent higher than projected. Import tax collections are expected to be about 8 percent lower than envisaged, however, partly because of delays in such collections associated with classification problems following the introduction of the Brussels nomenclature in 1985; at the same time, it should be noted that the difficulties encountered last year in implementing the legislation that eliminated the public sector's exoneration of import duties have been overcome. Collections of the value-added tax (ITBM) also have been adversely affected by the problems that have arisen in the classification of imports under the newly introduced Brussels nomenclature. A task force is now working to improve the collection and verification of the ITBM, and the authorities expect positive results from these efforts starting in the second half of this year.

1/ In addition, the authorities estimate that Panama may receive as much as US\$18 million in 1986 from the surpluses in the operations of the Panama Canal in previous years. This amount is not included in the projection of public sector revenue for 1986 in Table 4.

2/ In March-April, 1986 the final income tax payments of 1985 were made.

Table 4. Panama: Operations of the Nonfinancial Public Sector

	1983	1984	1985		1986	
			Prog. 1/	Actual	Prog. 2/	Proj.
(In millions of balboas)						
<u>Revenue and grants of consolidated public sector</u>	<u>1,385.5</u>	<u>1,424.6</u>	<u>1,531.8</u>	<u>1,523.3</u>	<u>1,607.8</u>	<u>1,604.2</u>
General government	1,315.1	1,260.5	1,392.2	1,378.6	1,447.7	1,444.3
Central Government	862.6	858.6	975.8	961.5	1,013.2	1,010.9
Social Security Agency	331.6	312.4	328.5	336.8	365.8	361.6
Decentralized agencies	120.9	89.5	87.9	80.3	68.7	71.8
Operating balance of public enterprises	70.4	134.1	139.6	124.7	145.1	144.9
Grants	--	30.0	--	20.0	15.0	15.0
<u>Expenditure of consolidated public sector</u>	<u>1,650.2</u>	<u>1,699.0</u>	<u>1,696.8</u>	<u>1,616.2</u>	<u>1,684.7</u>	<u>1,674.7</u>
<u>Current expenditure of general government</u>	<u>1,243.0</u>	<u>1,333.6</u>	<u>1,383.9</u>	<u>1,373.9</u>	<u>1,408.9</u>	<u>1,407.1</u>
Central Government	814.1	898.0	907.7	883.2	895.6	895.0
Social Security Agency	313.2	334.4	365.0	384.4	425.2	422.8
Decentralized agencies	115.7	101.2	111.2	106.3	88.1	89.3
<u>Capital expenditure 3/</u>	<u>407.2</u>	<u>365.4</u>	<u>312.9</u>	<u>242.3</u>	<u>275.8</u>	<u>267.3</u>
<u>Public sector savings 4/</u>	<u>125.9</u>	<u>69.0</u>	<u>138.9</u>	<u>142.3</u>	<u>198.4</u>	<u>196.6</u>
<u>Consolidated public sector surplus or deficit (-)</u>	<u>-264.7</u>	<u>-274.4</u>	<u>-165.0</u>	<u>-92.9</u>	<u>-76.9</u>	<u>-70.2</u>
Balance of nonconsolidated public sector	17.4	8.0	5.0	12.9	14.5	14.5
<u>Public sector surplus or deficit (-)</u>	<u>-247.3</u>	<u>-266.4</u>	<u>-160.0</u>	<u>-80.0</u>	<u>-62.4</u>	<u>-55.7</u>
<u>Financing</u>						
External	138.7	91.4	160.0	25.1	125.5	118.7
National Bank 5/	108.6	175.0	--	54.9	-63.0	-63.0
(Percent of GDP)						
Public sector revenue and grants	31.7	31.4	33.9	31.7	31.7	31.5
General government revenue	30.1	27.8	30.8	28.6	28.6	28.4
Operating balance of public enterprises	1.6	3.0	3.0	2.6	2.9	2.9
Public sector expenditure	37.7	37.4	37.1	33.7	33.3	32.9
Current expenditure of the general government	28.4	29.4	30.7	28.6	27.8	27.7
Capital expenditure	9.3	8.0	6.9	5.1	5.4	5.3
Public sector savings 4/	2.9	1.5	3.1	3.0	3.9	3.9
Surplus or deficit (-)	-5.7	-5.9	-3.5	-1.7	-1.2	-1.1

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

1/ As described in EBS/85/152, June 17, 1985.

2/ As described in EBS/86/114, May 28, 1986.

3/ Includes net lending.

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

5/ 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.

In general, the authorities are seeking to strengthen the administration of taxes through improved methods of verification and collection, but they are facing a shortage of skilled personnel. Although they are addressing this problem, in part through technical assistance from abroad in various areas, it may be several years before the full benefits of these efforts become apparent. The staff agreed that improvements in tax administration were an important component of the adjustment effort, particularly since it was not advisable to raise tax rates because of the effects on incentives to private sector activity.

Total public sector spending for 1986 is now projected to be marginally lower than envisaged at the time of the review, owing mainly to lower interest and investment outlays. Current expenditure of the public sector is projected to be in line with the program; the wage freeze covering a large proportion of central government employees is being implemented successfully and the authorities expected to be able to reach the goal of reducing public sector employment by 2 percent in 1986. Although investment spending had been restricted during the first part of the year, the authorities were confident that they would be able to accelerate the rate of implementation of the investment budget in the second half as disbursements of external credits were resumed in July. For the year as a whole, total public sector investment is expected to be close to the targeted level, although there would probably be a shortfall in the investment of the Central Government and the electricity company (IRHE).

Revised estimates by the mission showed that the surplus of the Social Security Agency in 1986 would be marginally smaller than projected, owing to a revenue shortfall of about B 7 million (0.1 percent of GDP) stemming from a work stoppage in April. Expenditure also is projected to be less than envisaged earlier, in reflection of efforts to reduce employment on a net basis and to improve procurement methods. During the first half of 1986, job positions have been reduced by the equivalent of 1.1 percent of employment as of the end of September 1985. Also, administrative measures are being taken to curb expenditures on medicines and medical supplies. These measures are part of the package agreed with the World Bank for the SAL II program.

Although the financial performance of the Social Security Agency appeared to be roughly on track, considerable efforts are still needed to implement the reforms of the pension programs of the Social Security Agency envisaged for 1986. In accordance with the commitments of the authorities to the Fund and the World Bank, a draft law is to be approved by the Cabinet by October 1, 1986 to reform the main pension system of the Social Security Agency. Early retirement is to be eliminated and the formula for calculating pensions is to be modified with a view to reducing pension levels. These steps are necessary to restore the actuarial soundness of the Agency. The authorities noted that significant progress had been made on the technical work necessary for implementing the reform, but that some details still needed to be worked

out and agreed to with the World Bank staff. Despite the closeness of the October 1 deadline, the authorities were of the view that they would be able to complete the work on schedule.

In addition to the reform of the main pension program, a reform of the pension systems of 26 work groups, including the military and teachers, is to be implemented by March 1987. The authorities reported that work on these reforms was proceeding satisfactorily. The staff highlighted the importance of regularizing pension benefits for these groups and also of controlling the growth in expenditure of these pension funds in future years, given the continued need to maintain a restrained fiscal policy stance.

The authorities were satisfied with the progress that had been made in strengthening the monitoring procedures of the Comptroller General's Office over the operations of the public enterprises and agencies. The most important enterprises and agencies already were being monitored by the procedures introduced in 1985. Overall, the operating balances of the public enterprises and agencies in 1986 are projected to be roughly in line with the projections included in the review of the program.

As part of their efforts to streamline the operations of the enterprises and agencies, the authorities closed a second sugar mill of the La Victoria public enterprise on July 31, 1986 and are actively negotiating the sale of this mill as well as that of an airline company, a hotel, and a tractor services company. The Government has announced that the role of the agricultural marketing agency, IMA, will be limited to warehousing, providing price and market information, setting standards, and intervening in the markets only in times of national emergency. Prior to 1986, IMA supported the domestic prices of various agricultural products through subsidized buffer stock operations.

2. Financial system ^{1/}

The growth in the net domestic credit of the banking system slowed down from an annual rate of about 6 percent of liabilities to the private sector during 1983-84--which mostly reflected an increase in credit to the public sector--to less than 1 percent in 1985 (Table 5). While credit to the private sector grew by 3 percent in 1985, about twice as fast as in the previous year, the rate of growth of credit to the public sector declined in reflection of the reduction in the overall fiscal deficit. Net credit to the public sector in 1985 came entirely from the National Bank, and was funded mainly with the Bank's own resources, in contrast with the experience of 1983-84 when National Bank credit to the public sector was covered by increased external liabilities (to the

^{1/} Domestic interest rates are market determined in Panama and move in line with Eurocurrency and U.S. interest rates.

Table 5. Panama: Summary Operations of the Banking System

	1982	1983	1984	1985	Proj. 1986
(In millions of balboas; end of period)					
Net foreign assets	6,518.6	6,994.4	6,347.0	6,505.6	7,290.1
Of which: National Bank	-44.2	-61.6	-126.1	-297.8	-269.9
Overseas operations (net)	-6,693.3	-7,202.1	-6,627.9	-6,642.3	-7,610.2
Credit to nonresidents	19,093.9	15,921.3	14,338.5	14,347.8	14,400.0
Deposits from nonresidents	-25,300.9	-22,653.9	-20,398.2	-20,571.0	-21,610.2
Other foreign liabilities	-486.3	-469.5	-568.2	-419.1	-400.0
Net domestic assets	3,308.1	3,435.3	3,679.4	3,702.9	3,916.1
Public sector (net)	518.0	669.3	874.9	904.4	841.3
National Bank	213.7	322.3	497.3	552.2	489.2
Counterpart to foreign liabilities ^{1/}	260.9	408.1	500.2	526.2	466.4
Other	-47.2	-85.8	-2.9	26.0	22.8
Other banks	304.3	347.0	377.6	352.2	352.1
Private sector	2,687.7	2,697.2	2,740.1	2,824.4	2,960.9
National Bank	338.2	342.1	340.5	326.0	313.0
Other banks	2,349.5	2,355.1	2,399.6	2,498.4	2,647.9
Unclassified assets (net)	102.4	68.8	64.4	-25.9	113.9
Long-term foreign liabilities	215.5	257.5	275.5	261.4	184.6
SDR allocation	29.0	27.5	25.9	28.9	30.1
Liabilities to domestic private sector	2,888.9	2,942.6	3,097.2	3,275.9	3,381.3
National Bank	143.1	168.5	199.9	198.9	218.1
Other banks	2,745.8	2,774.1	2,897.3	3,077.0	3,163.2
(In percent of GDP)					
Total liabilities	67.5	67.3	68.2	68.3	66.5
Net domestic credit	77.3	78.5	81.0	77.2	77.0
Public sector	12.1	15.3	19.3	18.8	16.5
Of which: National Bank	5.0	7.4	11.0	11.5	9.6
Private sector	62.8	61.7	60.3	58.9	58.2
(Annual changes as percent of liabilities to the domestic private sector at the beginning of the period)					
Total liabilities	20.6	1.9	5.3	5.8	3.2
Net domestic credit	5.5	4.4	8.3	0.8	6.5
Public sector	5.3	5.2	7.0	1.0	-1.9
Private sector	2.9	0.3	1.5	2.7	4.2

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.

Fund, the Investment Fund of Venezuela, and Petroleos Mexicanos). Partly as a result of the reduced liquidity position of the National Bank, 1/ its credit to the private sector in 1985 declined slightly.

The authorities noted that the 1986 program called for a net repayment by the nonfinancial public sector to the National Bank of the amount of the excess over the ceiling on National Bank credit to the nonfinancial public sector at end-1985 (B 63 million). Such a repayment would contribute to the strengthening of the liquidity of the Bank. Under the program, banking system credit to the public sector would decline by almost 2 percent in 1986, while credit to the private sector would increase by more than 4 percent.

3. External policies

The latest estimates indicate that the current account deficit of the balance of payments will narrow from 6.7 percent of GDP in 1985 to 5 percent of GDP in 1986 (Table 6). The revised projection for 1986 may be compared with the original program target of 6.1 percent of GDP, and reflects stronger nonfactor services receipts. In the revised balance of payments projection for 1986, the current account deficit is financed in approximately equal parts by public sector borrowing and private capital flows.

It may be recalled that a key objective of the 1986 financial program is to limit the amount of external borrowing of the nonfinancial public sector and to improve the maturity structure of the public sector external debt. Although debt contracted on commercial terms is expected to increase by US\$45 million on a net basis during 1986, its share in total external debt is expected to remain unchanged at about 58 percent, while total external debt as a percent of GDP is expected to decline by some 2 percentage points to 76 percent at the end of 1986 (Table 7). Debt service (after rescheduling) in relation to exports of goods and nonfactor services is projected to stay at about 31 percent in 1986, unchanged from a year earlier; the rescheduling of amortization payments to commercial banks in 1985-86 reduced this ratio by 20 percentage points in 1986 from what it would have been without the rescheduling.

The authorities are concerned about the external debt situation over the *medium term*. Amortization payments to foreign and domestic commercial banks peak in the period 1987-91, with some US\$1.4 billion falling due. The authorities indicated that they are given consideration to negotiating a multi-year rescheduling arrangement with commercial banks, which would allow the present administration to formulate

1/ For purposes of fulfilling its obligations as a commercial bank and its clearing obligations in the banking system, the National Bank considers as its liquidity position the liquid assets it holds in other commercial banks plus the unutilized portion of the lines of credit from foreign commercial banks.

Table 6. Panama: Summary Balance of Payments

(In millions of U.S. dollars)

	1982	1983	1984	Est. 1985	1986 Prog. 1/	Proj.
<u>Current account</u>	<u>-405.4</u>	<u>-202.5</u>	<u>-259.4</u>	<u>-240.4</u>	<u>-227.5</u>	<u>-174.9</u>
Goods and services	-451.0	-246.8	-338.7	-323.6	-306.5	-253.9
Trade balance	-1,007.8	-926.9	-923.1	-929.3	-880.6	-892.2
Exports, f.o.b.	321.8	305.6	286.4	310.9	340.3	332.9
Petroleum trade	-242.5	-262.2	-217.1	-171.9	-159.8	-91.7
Imports, f.o.b.	-1,087.1	-970.3	-992.4	-1,068.3	-1,061.1	-1,133.4
Freight and Insurance	-53.4	114.2	59.0	83.0	12.7	48.9
Transportation	392.4	349.7	343.9	353.1	352.2	383.1
Travel	93.0	101.3	118.6	135.0	134.4	141.7
Investment income	-349.8	-324.2	-350.2	-426.6	-41.0	-435.2
Of which: interest public						
debt	-343.9	-281.5	-325.0	-328.6	-333.0	-335.3
Government, n.i.e.	-12.0	-13.5	-8.1	-8.4	-9.3	-9.3
Other services	486.5	452.6	421.2	469.7	505.1	509.1
Colon Free Zone	219.9	142.3	148.8	170.9	189.3	193.3
Rest of the world	266.6	310.2	272.4	298.7	315.9	315.8
<u>Unrequited transfers</u>	<u>45.6</u>	<u>44.3</u>	<u>79.3</u>	<u>83.3</u>	<u>79.0</u>	<u>79.0</u>
<u>Capital account</u>	<u>560.3</u>	<u>207.2</u>	<u>188.7</u>	<u>33.2</u>	<u>227.5</u>	<u>173.7</u>
Official capital	510.2	302.1	214.2	38.8	125.5	126.7
Nonfinancial	435.8	143.2	98.3	34.9	196.8	195.8
Official banks	74.4	158.9	115.9	3.9	-71.3	-69.1
Other official bank						
<u>transactions</u>	<u>0.4</u>	<u>-86.7</u>	<u>-12.5</u>	<u>134.5</u>	<u>--</u>	<u>-48.3</u>
Private capital	49.7	-8.2	-13.0	-140.1	102.0	95.3
Direct investment	0.8	54.9	37.3	90.6	71.3	76.5
Direct private borrowing	116.4	-151.9	-79.8	-8.4	-32.5	-153.0
Private banks net monetary						
movements	67.5	88.8	29.5	-223.3	63.2	171.8
<u>Net errors and omissions</u>						
(including valuation						
adjustment)	<u>-154.9</u>	<u>-4.8</u>	<u>70.7</u>	<u>207.1</u>	<u>--</u>	<u>1.2</u>
<u>Memorandum item</u>						
Current account as a per-						
centage of GDP						
Before transfer payments	-10.5	-5.6	-7.5	-6.7	-6.1	-5.0
After transfer payments	-9.5	-4.6	-5.7	-5.0	-4.5	-3.4

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

1/ As described in EBS/86/114, May 28, 1986.

Table 7. Panama: Public Sector External Debt Indicators

	1982	1983	1984	Prel. 1985	Proj. 1986
<u>(In millions of U.S. dollars)</u>					
<u>Debt outstanding</u> <u>(end of period)</u>	<u>3,197.6</u>	<u>3,488.2</u>	<u>3,686.7</u>	<u>3,767.1</u>	<u>3,885.8</u>
Bilateral	464.2	507.6	533.2	534.4	494.5
Multilateral	526.1	773.3	944.3	1,043.3	1,156.4
Of which: IMF	83.9	192.7	271.1	311.3	318.9
Commercial banks	1,653.9	1,726.1	1,751.4	1,754.6	1,814.6
Other <u>1/</u>	553.4	481.2	457.8	434.8	420.3
<u>Disbursements</u>	<u>817.9</u>	<u>509.9</u>	<u>475.1</u>	<u>218.0</u>	<u>347.3</u>
<u>Debt service</u>	<u>657.9</u>	<u>495.3</u>	<u>587.9</u>	<u>522.3</u>	<u>569.2</u>
Amortizations <u>2/</u>	307.6	206.7	271.3	187.4	228.6
Interest payments	350.3	288.6	316.6	334.9	340.6
<u>(In percent of GDP)</u>					
<u>Debt indicators</u>					
External public debt	74.7	79.8	81.2	78.5	76.4
Multilateral and bilateral	23.1	29.3	32.5	32.9	32.5
Other	51.6	50.4	48.7	45.6	43.9
Interest payments	8.2	6.6	7.0	7.0	6.7
<u>(In percent)</u>					
<u>Debt service in rela-</u> <u>tion to:</u>					
Public sector receipts	52.0	34.2	39.6	32.7	34.0
Exports of goods and nonfactor services	35.2	29.2	34.7	30.9	31.1
<u>Effective interest rates</u> <u>on the total debt</u>	<u>11.9</u>	<u>8.6</u>	<u>8.8</u>	<u>9.0</u>	<u>8.9</u>

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

1/ Includes bonds placed domestically.

2/ After rescheduling.

its financial policies on a firmer basis for the remaining three years of its term in office. The authorities have not yet determined whether they will need new credits from the banks in 1987 and hope to deal with this issue separately from the debt restructuring. The staff concurred with the authorities on the desirability of a multi-year restructuring arrangement with commercial banks; the staff stressed the importance of maintaining a cautious fiscal policy stance over the medium term given the relatively heavy debt service burden that Panama would face even if its commercial debt were restructured.

4. Structural adjustment policies

As noted earlier, Panama's economic program encompasses structural adjustment measures in the context of SAL II. In addition to measures to reduce the size of the public sector through the sale of public enterprises, the reduction of the labor force in the public sector and the reform of the social security system discussed earlier, SAL II includes reforms in industrial, agricultural, and labor policies. In March 1986 the Panamanian legislature approved three laws which introduced important changes in these three areas.

a. Industry

While the unweighted average level of tariffs in Panama was estimated to be 30 percent at the beginning of 1986, there was a large variation in tariff protection. Nominal tariff protection ranged from 0 percent to 385 percent, with an even broader range of effective protection. Ten out of 19 major import categories had maximum tariff levels in excess of 100 percent. Under the new Industrial Incentives Law passed in March 1986, the maximum nominal tariff for industries already in place is to be reduced to 60 percent (for a limited number of cases, the maximum tariff rates would be 90 percent). This action is to be effected over five years by reducing the tariffs each year by one fifth of the difference between the rate that existed in mid-1986 and the 60 percent target rate. The first reductions were implemented in August 1986. Tariffs on newly produced goods are not to exceed 20 percent, except that in agroindustries they may reach as high as 30 percent.

The system of special contracts, (Contratos con la Nacion), that provided fiscal and other incentives to industrial firms has been discontinued, and a national industrial register has been instituted. Registered firms receive certain tax incentives, and are granted exemptions on import duties on raw materials until 1990; after 1990 all firms will pay at least a 3 percent minimum import tax. All firms are subject to a 3 percent import duty on imports of capital goods. Firms with current Contratos con la Nacion can give them up and become part of the national industrial register to receive the new benefits.

Panama also has made progress in reducing nontariff barriers in 1986. As part of its efforts to encourage a more efficient allocation of resources, the Government announced the removal of quotas on 19 products in April and another 50 in June, leaving only 20 products subject to import quotas. The remaining quotas are concentrated in agricultural products. As quotas were removed, so were price controls on the corresponding products. Panama has been following a policy of reducing the scope of price controls since 1976, when about 150 product categories were subject to price controls. Controls over the prices on a significant number of items were lifted from 1976 to 1985, and at the end of 1985 59 product categories were subject to controls. In June 1986 price controls were removed on 25 product categories, leaving 34 product categories (mainly manufactured products) subject to price controls. Of the items that remain subject to price controls, only edible oil is included in the basket of goods used to calculate the consumer price index.

b. Agriculture

The March 1986 agricultural law eliminated the emphasis on achieving self-sufficiency in food production that had been the focus of the previous agricultural law. The new agricultural strategy aims at exposing the domestic market to international competition by gradually lowering tariff protection. In an important step in this area, rice prices are to be determined without public price intervention, and the activities of IMA are being reduced as noted above. In addition, the price support system for agricultural products, except for tomatoes, was removed effective August 1, 1986, and export quotas will no longer be imposed on beef. The authorities also replaced quotas and prohibitions on agricultural imports by tariffs as agreed in the policy package with the World Bank.

c. Labor

Over the years labor legislation had introduced rigidities in the labor market which contributed to growing unemployment. The recently approved changes to the Labor Code address this issue, in part by including provisions to allow piecework and to permit employers to pay bonuses and other incentives for increases in productivity without incorporating them into the wage base. ^{1/} Other provisions facilitate work in the home, exempt small-scale industries from some of the more costly regulations of the Labor Code, and exempt export firms from certain overtime provisions. However, the regulations regarding dismissal costs in medium and large firms, which had been identified as an important deterrent to hiring, have not been modified significantly to date.

^{1/} In the financial setting of Panama, international competitiveness can be influenced only through changes in unit labor costs. During the period 1981-85, Panama's real effective exchange rate has remained virtually unchanged.

V. Medium-Term Prospects

The Panamanian authorities have indicated their intention to pursue economic policies after the period of the current arrangement, that would be consistent with the achievement of satisfactory growth and a viable external position over the medium term. On that basis, the staff prepared an illustrative balance of payments and external debt scenario for 1987-91 (Table 8). The scenario assumes that the overall deficit of the nonfinancial public sector will average 2 percent of GDP a year. It is also assumed that real GDP will grow by 3 percent a year on average and that the average rate of inflation, as measured by the GDP deflator, will average 3 percent a year.

Other assumptions underlying the medium-term projection are that the value of nonpetroleum imports will grow slightly faster than nominal GDP as the severity of the external financing constraint eases, while the volume of net petroleum imports would increase slightly less than real GDP. Following an increase of 9 percent projected for 1987 when banana production is expected to rebound from the strike-depressed level of 1986, the volume of nonpetroleum exports, which in addition to bananas consist of other traditional primary products such as sugar and coffee, as well as shrimp and some manufactured products, is projected to grow on average in 1988-91 somewhat more slowly than output in Panama's trading partners (2.2 percent). The value of nonpetroleum exports is projected to grow on average by about 5.5 percent a year, taking into consideration the assumptions for prices of commodities and manufactures contained in the latest World Economic Outlook.

The projections for services, which account for the bulk of current account receipts, are strongly influenced by developments in the operations of the PTP, Canal, and the Colon Free Zone. The net receipts of PTP are projected to decline by 6 percent in 1987 owing to a lower level of oil transshipments, and then to increase by about 2 percent a year in the period 1988-91 in reflection of increases in PTP's net investment income. Net receipts from the Canal are expected to increase on average by 2 percent a year during 1987-91; tonnage fees are assumed to be unchanged. Net receipts from the Colon Free Zone are projected to grow in line with nominal GDP. The projections include interest payments on commercial debt at a rate of 1.5 percentage points over LIBOR. The six-month LIBOR 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 decline from 3.4 percent of GDP in 1987 to 2.8 percent of GDP by 1991.

The medium-term scenario assumes that all new external borrowing by the public sector will be from multilateral and bilateral agencies at

^{1/} In the event that interest rates were to be 1 percentage point lower, interest payments would decrease by an average of B 22 million a year (or the equivalent of 0.4 percent of GDP) over the period 1987-91.

Table 8. Panama: Medium-Term Scenario

	1984	Est. 1985	1986	1987	1988	Proj. 1989	1990	1991
(In millions of U.S. dollars)								
<u>Current account</u>	-259	-240	-174	-181	-193	-192	-195	-196
Trade balance	-923	-929	-892	-953	-1,018	-1,099	-1,179	-1,265
Exports	286	311	333	362	377	395	415	439
Imports (including net petroleum)	-1,209	-1,240	-1,225	-1,315	-1,395	-1,494	-1,594	-1,704
Interest on public debt	-325	-329	-335	-316	-313	-295	-288	-277
Other	989	1,018	1,053	1,087	1,137	1,202	1,272	1,346
<u>Capital account</u>	259	240	174	-272	-234	-121	79	87
Public sector	214	39	127	-345	-313	-192	13	29
Of which: IMF	98	6	8	-54	-69	-49	-60	-38
Official bank	-13	135	-48	-18	-18	-26	-32	-39
Private capital <u>1/</u>	58	66	96	91	97	96	96	98
<u>Financing gap (public sector)</u>	--	--	--	453	427	313	116	108
Public sector debt	3,767.1	3,885.8	3,993.7	4,108.3	4,230.0	4,359.3	4,497.2	
Bilateral and multilateral	1,577.7	1,650.9	1,758.8	1,873.4	1,995.1	2,124.4	2,262.3	
Commercial	2,189.4	2,234.9	1,781.7	1,354.5	1,041.3	925.3	817.1	
Cumulative financing gap	--	--	453.2	880.4	1,193.6	1,309.6	1,417.8	
<u>Debt service</u>								
Amortizations								
On debt outstanding end-1986								
Before rescheduling		406.6	592.5	667.7	611.5	460.7	273.7	198.9
After rescheduling		172.4	222.8	667.7	611.5	479.6	309.5	274.2
On debt contracted after 1986		--	--	--	--	--	--	15.2
Interest <u>2/</u>		334.9	340.6	319.9	316.8	299.4	291.8	280.9
(In percent)								
<u>Indicators</u>								
Current account/GDP	-5.0	-3.4	-3.4	-3.4	-3.2	-3.0	-2.8	
Total public sector debt/GDP <u>3/</u>	78.5	76.4	74.0	71.7	69.5	67.4	65.2	
Debt service/exports of goods and nonfactor services								
Before rescheduling	41.3	51.0	52.1	47.3	37.1	26.5	22.1	
After rescheduling <u>4/</u>	28.3	30.8	52.1	47.3	38.1	28.1	25.5	
Debt service/GDP								
Before rescheduling	15.5	18.3	18.3	16.2	12.5	8.7	7.2	
After rescheduling <u>4/</u>	10.6	11.1	18.3	16.2	12.8	9.3	8.3	
Effective interest rate on total external debt	9.0	8.9	8.1	7.8	7.2	6.8	6.3	

Sources: World Bank; and Fund staff estimates.

1/ Includes errors and omissions.

2/ Includes interest on internal bonds.

3/ Under the assumption that principal payments on commercial debt are rolled over.

4/ Does not assume any rescheduling after 1986.

terms similar to those received in the recent past, while net private sector capital inflows are projected to decline in relation to GDP from the relatively high ratio expected for 1986 to the ratio that prevailed in 1985. The projection points to financing gaps over the medium term equivalent to the amount of principal repayments on commercial debt, including commercial bank loans and bonds; the financing gap averages US\$440 million in 1987 and 1988, declines to US\$310 million in 1989, and to US\$110 million in 1990 and 1991. ^{1/}

These projections underscore the difficult situation that Panama faces during the period 1987-91--notwithstanding a significant adjustment in the external current account--unless it can negotiate a restructuring of the maturities of its commercial debt. Under the assumption that maturities on commercial debt after 1986 would be rolled over or refinanced, the debt service ratio would be made more manageable for Panama. On this basis, the ratio of outstanding public sector debt to GDP nevertheless would decline from 76 percent in 1986 to 65 percent in 1991. At the same time, the share of commercial debt in total outstanding debt would fall from 57 percent in 1986 to 50 percent in 1991. Also, the effective interest rate on total external debt would decline from 8.9 percent in 1986 to 6.3 percent in 1991, reflecting an improvement in the structure of the debt.

VI. Staff Appraisal

Following the successful implementation of the economic program in 1983-84, the Government of Panama adopted a new economic program in mid-1985 which was aimed at consolidating the gains made in the preceding 2 years and was supported by a 21-month stand-by arrangement from the Fund. This program was designed to reduce the overall financing requirement of the nonfinancial public sector and to strengthen the liquidity position of the National Bank.

The overall deficit of the nonfinancial public sector in 1985 was reduced to 1.7 percent of GDP, about one half the programmed level, because of lower than expected current expenditures and a curtailment in investment spending associated with a shortfall in external financing. However, the reduction in the fiscal deficit was not sufficient to

^{1/} Under the assumption that Panama would be able to make the principal repayments on debt of a commercial nature, the external public debt service ratio would increase from 31 percent of exports of goods and nonfactor services in 1986 to an average of 50 percent in 1987-88, but would subsequently decline to 25 percent by 1991 (taking into account the effect of the 1985-86 restructuring agreement). The increase in the debt service ratio in 1987-88 is, thus, associated with a peak in the amortization of commercial debt in these years (equivalent to about 23 percent of exports of goods and nonfactor services).

offset in full the shortfall in external financing and, thus, there was an unplanned increase in net credit from the National Bank to the non-financial public sector.

In the first quarter of 1986, the authorities made progress in implementing a number of structural adjustment measures that also served as a basis for the external financing package for 1986. The conclusion of a financing package and the continuation of a cautious fiscal policy permitted the completion of the review of the stand-by arrangement that established performance criteria for 1986. Performance under the program in the first half of the year was good. The public sector registered a small surplus instead of the modest deficit that had been projected, and the ceiling on National Bank credit to the public sector was observed despite delays in the disbursements of some external credits. Also, the limits on external borrowing by the public sector were observed with large margins.

The fiscal measures that the authorities have taken provide reasonable assurances that the public sector deficit in 1986 as a whole will be consistent with the limits on public sector external borrowing, while at the same time permitting net repayments to the National Bank as provided for in the program. Also, public sector savings are expected to be in line with the program's indicative target. On the revenue side, achievement of the program's objectives is being helped by removal of the legal and administrative difficulties associated with the implementation of some of the revenue measures introduced in 1985, and by continuing efforts to improve tax administration. Measures on the expenditure side include efforts to reduce public sector employment and a general wage freeze for most employees of the Central Government. Moreover, the authorities have strengthened the monitoring of the operations of public sector enterprises and agencies.

Owing to delays in disbursements of external credits in the first half of 1986, public sector investment spending is expected to be somewhat lower than projected, and a special effort would be required to attain the level envisaged for the year as a whole. Within the strategy of overall expenditure restraint, the staff would urge the authorities to avoid further slippages in the execution of the investment program in order to strengthen the country's growth prospects. If there should be a need to implement additional expenditure cuts, it would be desirable to focus on current outlays.

The staff welcomes the administrative actions taken recently to reduce operating costs by the Social Security Agency. The staff would note the importance of the timely implementation of the reforms of the main retirement program and of the special work groups that are to be carried out by March 1987 for restoring the actuarial soundness of the Social Security Agency. These actions would make an important contribution to the lasting strengthening of the public finances.

The contemplated repayment this year by the public sector to the National Bank of the full amount of credit extended in 1985 is important to assure the needed strengthening of the liquidity position of the National Bank. The staff would urge the authorities to continue to make every effort to attain this objective.

Despite the reduction in the public sector deficit and the improvement in the structure of the external debt in recent years, Panama continues to face a serious debt servicing problem and it appears that returning to a sustainable external position will take a number of years. Even with appropriate financial policies, the debt service burden is expected to increase in 1987-89, and Panama would benefit greatly from a restructuring agreement with commercial banks covering amortization payments falling due in the next few years.

In the context of a structural adjustment loan from the World Bank, the authorities recently have undertaken major reforms--in some cases involving legislative actions--with the aim of improving incentives for investment in the industrial and agricultural sectors and resource allocation in general. The staff welcomes, in particular, the replacement of import quotas by tariffs, the reduction of import tariffs, the elimination of price controls on many items, and the reform of the Labor Code. However, the staff would note that the level of import tariffs would remain high and the number of items subject to price controls would still be considerable even after the implementation of the announced reforms; an acceleration in trade and price liberalization would bring further benefits in terms of the efficiency with which resources are used. The staff would encourage the authorities to complete the calendar of structural policy measures contemplated in SAL II; delays in the implementation of these measures would have a detrimental effect on the productivity of the economy and could affect adversely the external financing available for this year.

In summary, the authorities have made significant progress in recent years in correcting imbalances in the economy and the program for 1986, which represents a continuation of this effort, is on track. The authorities are complementing the financial adjustment program with structural reforms which should enhance Panama's ability to achieve sustainable economic growth over the medium run.

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

Fund Relations with Panama
(As of August 31, 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 397.3 million or 388.7 percent
of quota.
- (c) Fund credit:

	<u>Amount in SDRs</u>	<u>Percent of Quota</u>
<u>Total</u>	<u>295.1</u>	<u>288.7</u>
Credit tranches	63.7	62.3
Compensatory financing	58.9	57.6
Supplementary financing	18.2	17.8
Enlarged access	154.3	151.0

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 68 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 million

- (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: SDR 75.25 million

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

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

- (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 4.69 million or 17.8 percent of net cumulative allocation.

B. Nonfinancial Relations

- V. Exchange Rate: The exchange value of the Panamanian balboa is pegged 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. Fund Missions: 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. The review of the 1985-86 stand-by arrangement was concluded by the Executive Board on July 2, 1986.

- VII. Technical Assistance: A Fiscal Affairs Department panel expert was assigned from October 1982 to December 1985 to provide assistance in the area of Customs Administration. A Central Banking Department panel expert has been assigned since November 1983 to provide technical assistance to the National Banking Commission.

Panama: Selected Economic and Financial Indicators

	1982	1983	1984	1985		1986	
				Prog.	Est.	Prog.	Proj.
(Annual percent changes, unless otherwise specified)							
National income and prices							
GDP at constant prices	4.7	-1.5	-0.5	0.4	3.1	2.5	2.9
GDP deflator	5.4	3.8	4.3	1.5	2.5	3.0	3.0
Consumer price index	4.2	2.1	1.6	1.5	1.1	2.0	1.2
External sector on the basis of U.S. dollars							
Exports, f.o.b. non-oil	12.2	-5.0	-6.4	4.1	8.6	8.8	7.1
Imports, f.o.b.	5.4	-7.3	-1.9	-3.5	2.5	1.3	-1.2
Non-oil imports, f.o.b.	4.2	-10.7	2.3	-1.4	7.7	5.6	6.1
Public sector							
Revenue and grants	8.1	9.7	2.8	7.5	6.9	5.6	5.3
Of which: revenues <u>1/</u>	8.1	9.7	0.7	9.8	7.8	6.0	5.7
Total expenditure	24.7	-4.3	3.0	-0.1	-4.9	4.2	3.6
Money and credit							
National Bank net credit to public sector <u>2/</u>	17.1	50.8	54.3	-4.7	11.1	-24.3	-11.4
Interest rates annual rate <u>3/</u>	...	...	...	...	...	...	...
(In percent of GDP)							
Public sector savings	1.3	2.9	1.5	3.1	3.0	3.9	3.9
Overall public sector deficit (-)	-10.8	-5.7	-5.9	-3.5	-1.7	-1.2	-1.1
Domestic financing <u>4/</u>	(0.7)	2.5	2.0	--	1.1	-1.2	-1.2
Foreign financing	(10.1)	3.2	3.9	3.5	0.6	2.5	2.3
Gross domestic investment	27.7	21.4	17.7	18.7	17.1	17.7	17.5
Gross national savings	17.9	15.7	10.4	12.6	10.5	11.8	12.5
Current account deficit of balance of payments							
Before transfers	9.8	5.6	7.5	6.1	5.4	6.1	5.0
After transfers	8.9	4.6	5.7	5.0	3.7	4.5	3.4
External debt							
Exclusive of Fund credit	72.8	75.5	75.2	78.9	72.0	70.3	70.1
Total	74.7	79.9	81.2	85.0	78.5	76.6	76.4
(In percent of exports of goods and nonfactor services)							
Debt service							
before rescheduling	37.2	27.9	34.4	48.7	41.9	55.3	51.0
Interest payments	19.8	16.3	18.5	24.1	19.8	18.7	18.6
(In percent of public sector revenue)							
Debt service before rescheduling	52.0	34.2	39.6	49.0	47.7	59.2	55.9

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--Statistical Issues

1. Outstanding statistical issues

Panama's economic statistics are generally adequate and timely. Statistical information is adequate and up-to-date for national accounts, prices, public sector finances, monetary accounts, and the balance of payments. Some delays exist with regard to information on the monetary accounts and no information is available on international banking for the international banking statistics project.

a. Government finance

The 1985 GFS Yearbook includes data for the consolidated Central Government and for local governments through 1982 only. Some updating is required for the data on financing and debt as well as for the major analytical aggregates.

b. International banking statistics

Panama has provided only a highly preliminary detailed geographic analysis of the external positions of deposit banks for use in the Fund's international banking statistics, and is not currently collecting data from the banks. A staff member visited Panama in 1985 in order to discuss with the authorities the IBS project and resolve any issues that prevented the country from sending the requested data. These and other recent discussions with the authorities, however, have not yet led to Panama's participation in the IBS project.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Panama in the August 1986 issue of IFS. During the past year the data have generally been provided on a timely basis.

Status of IFS Data

		<u>Latest Data in August 1986 IFS</u>
Real Sector	- National Accounts	1984
	- Prices: WPI	Q4 1985
	CPI	March 1986
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	October 1985
	- Financing	October 1985
	- Debt	January 1986
Monetary Accounts	- National Bank	December 1985
	- Deposit Money Banks	December 1985
	- Other Financial Institutions	December 1985
Interest Rates	- Discount Rate	n.a.
	- Bank Lending/Deposit Rate	n.a.
	- Bond Yields	n.a.
External Sector	- Merchandise Trade:	
	Export Value	December 1985
	Unit Value of Exports	December 1985
	- Balance of Payments	1985
	- International Reserves	December 1985
	- Exchange Rates	June 1986

Financial Relations of the World Bank Group with Panama

IBRD lending operations
as of June 30, 1986

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

(Amount less cancellation)

<u>Total</u>	<u>417.9</u>	<u>154.8</u>
Power	172.4	83.6
Agriculture	39.2	16.4
Transportation	89.6	22.9
Industry	21.0	--
Urban development	20.8	14.2
SAL	60.2	--
Water supply and sewerage	17.2	16.4
Technical assistance	3.8	1.2

Principal payments 122.5 1/

Debt outstanding, including
undisbursed 450.2

Commitments CY 1985 51.0

Disbursements CY 1985 26.3

IFC investments 16.1

Technical assistance:

IBRD regularly provides technical assistance in institution building and in project preparation and implementation under its loans, while SAL I was accompanied by a technical assistance project which included a number of policy oriented studies. Various studies of public sector management are also planned for FY 1987.

Recent economic and sector
mission:

The last major economic mission visited Panama in March 1984. None is planned for FY 1987 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.

1/ Including repaid to third parties.

Table 9. Panama: Central Government Operations

	1983	1984	1985		1986	
			Prog.	Prel.	Prog.	Proj.
(In millions of balboas)						
<u>Total revenue and grants</u>	<u>885.8</u>	<u>915.6</u>	<u>1,003.3</u>	<u>1,006.1</u>	<u>1,053.3</u>	<u>1,051.0</u>
<u>Current revenue</u>	<u>885.8</u>	<u>885.6</u>	<u>1,003.3</u>	<u>986.1</u>	<u>1,038.3</u>	<u>1,036.0</u>
Tax revenue	656.1	652.1	731.0	743.5	768.6	776.4
Income tax	302.6	281.6	315.3	353.5	323.6	339.0
Personal	116.2	116.4	125.0	118.4	134.3	140.5
Business ^{1/}	86.4	65.2	190.3	235.1	189.3	198.5
Other	26.5	27.0	34.0	34.3	37.0	38.0
Taxes on foreign trade	115.1	121.1	135.3	129.6	151.2	138.0
Imports	96.3	108.8	124.0	118.6	139.9	128.0
Exports	18.8	12.3	11.3	11.0	11.3	10.0
Taxes on domestic transactions	211.9	222.4	246.4	226.1	256.8	261.4
Value added	73.1	75.2	84.7	78.0	80.7	81.7
Petroleum products	68.7	60.8	75.7	72.3	90.8	91.0
Other	70.1	86.4	86.0	75.8	85.3	88.7
Nontax revenue	229.7	233.5	272.3	242.6	269.7	259.6
Panama Canal	59.7	60.0	62.0	66.5	65.5	65.5
Oil pipeline	12.2	9.7	11.6	11.8	20.5	20.5
Other services	127.2	136.0	144.7	135.6	143.3	143.6
Transfers from rest of public sector	30.6	27.8	54.0	30.7	40.4	30.0
<u>Grants</u>	<u>--</u>	<u>30.0</u>	<u>--</u>	<u>20.0</u>	<u>15.0</u>	<u>15.0</u>
<u>Current expenditure</u>	<u>889.1</u>	<u>977.8</u>	<u>1,005.4</u>	<u>973.2</u>	<u>1,012.7</u>	<u>1,012.1</u>
Wages and salaries	353.7	403.1	426.1	422.3	440.1	440.7
Goods and services	118.8	139.6	88.5	107.8	94.0	98.0
Pensions and transfers	141.1	148.7	156.1	161.6	177.7	182.4
Of which transfers to:						
Decentralized agencies	27.4	33.5	37.3	32.4	40.4	40.4
Public enterprises	6.7	0.6	3.4	1.0	3.2	3.2
Social Security Agency	40.9	48.8	57.0	56.6	73.5	73.5
Interest	263.2	281.1	330.8	278.6	296.0	286.0
Internal	32.3	42.7	59.1	29.6	36.5	28.0
External	230.9	238.4	271.7	249.0	259.5	245.0
Other	12.3	5.3	3.9	2.9	4.9	5.0
<u>Current balance</u>	<u>-3.3</u>	<u>-62.2</u>	<u>-2.1</u>	<u>32.9</u>	<u>40.6</u>	<u>38.9</u>
<u>Capital expenditure</u>	<u>224.5</u>	<u>197.3</u>	<u>140.4</u>	<u>129.9</u>	<u>123.3</u>	<u>119.9</u>
Investment	182.0	166.6	124.7	124.2	119.4	116.0
Capital of transfers	42.5	30.7	15.7	5.7	3.9	3.9
<u>Overall surplus or deficit (-)</u>	<u>-227.8</u>	<u>-259.5</u>	<u>-142.5</u>	<u>-97.0</u>	<u>-82.7</u>	<u>-81.0</u>
(Percent of GDP)						
Current revenue and grants	20.3	20.2	22.2	21.0	20.8	20.7
Current expenditure	20.3	22.5	22.3	20.3	20.0	19.9
Current account balance	-0.1	-1.4	--	0.7	0.8	0.8
Capital expenditure	5.1	4.3	3.1	2.7	2.4	2.4
Overall surplus/deficit (-)	-5.2	-5.7	-3.2	-2.0	-1.6	-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 10. Panama: Operations of the Social Security Agency

(In millions of balboas)

	1983	1984	1985		1986	
			Prog.	Prel.	Prog.	Proj.
<u>Current revenue</u>	<u>331.6</u>	<u>312.4</u>	<u>328.5</u>	<u>336.8</u>	<u>365.8</u>	<u>361.6</u>
Contributions	249.8	256.5	262.8	275.3	289.6	285.9
Professional risk premium	17.9	17.6	20.5	17.6	19.1	18.5
Thirteenth month contribution	27.6	1.2	--	0.1	--	--
Investment income	15.1	15.2	18.9	13.4	18.8	18.9
Contribution to pension fund	13.1	13.7	14.9	12.3	19.0	18.4
Other	8.1	8.2	11.4	18.1	19.3	19.9
<u>Current expenditure</u>	<u>313.2</u>	<u>334.4</u>	<u>365.0</u>	<u>384.4</u>	<u>425.2</u>	<u>422.8</u>
Administration	20.4	21.7	23.0	23.0	16.4	18.4
Benefits and others	292.8	312.7	342.0	361.4	408.8	404.4
<u>Operating balance</u>	<u>18.4</u>	<u>-22.0</u>	<u>-36.5</u>	<u>-47.6</u>	<u>-59.4</u>	<u>-61.2</u>
Transfers to Central Government	--	0.1	--	--	--	--
Transfers from Central Government ^{1/}	40.9	48.8	57.0	56.6	73.5	73.5
<u>Current balance</u>	<u>59.3</u>	<u>26.7</u>	<u>20.5</u>	<u>9.0</u>	<u>14.1</u>	<u>12.3</u>
<u>Capital expenditure</u>	<u>47.5</u>	<u>47.3</u>	<u>12.5</u>	<u>6.0</u>	<u>7.6</u>	<u>7.8</u>
Fixed investment	4.8	6.8	6.0	2.8	4.5	5.7
Net lending to private sector	14.9	11.8	--	3.2	--	--
Net lending to National Mortgage Bank	4.8	8.0	--	--	--	--
Housing program	23.0	20.7	6.5	--	3.1	2.1
<u>Overall surplus or deficit (-)</u>	<u>11.8</u>	<u>-20.6</u>	<u>8.0</u>	<u>3.0</u>	<u>6.5</u>	<u>4.5</u>

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

^{1/} Includes employer contributions of the Central Government.

Table 11. Panama: Summary Operations of the Public Enterprises

(In millions of balboas)

	1983	1984	1985		1986	
			Prog.	Prel.	Prog.	Proj.
<u>Current revenue</u>	<u>501.1</u>	<u>497.3</u>	<u>484.9</u>	<u>482.0</u>	<u>505.0</u>	<u>501.9</u>
<u>Current expenditure</u>	<u>430.7</u>	<u>363.2</u>	<u>345.3</u>	<u>357.3</u>	<u>359.9</u>	<u>357.0</u>
Interest	64.7	59.5	83.2	74.2	68.3	68.3
Other	366.0	303.7	262.1	283.1	291.6	288.7
<u>Operating balance</u>	<u>70.4</u>	<u>134.1</u>	<u>139.6</u>	<u>124.7</u>	<u>145.1</u>	<u>144.9</u>
Transfer to Central Government	17.4	22.4	27.0	22.9	23.4	23.4
Transfer from Central Government	6.7	0.6	3.4	1.0	3.2	3.2
<u>Current account</u>	<u>59.7</u>	<u>112.3</u>	<u>116.0</u>	<u>102.8</u>	<u>124.9</u>	<u>124.7</u>
Capital transfers	17.7	12.1	7.2	0.7	3.0	3.0
<u>Capital spending</u>	<u>126.6</u>	<u>130.5</u>	<u>145.9</u>	<u>110.6</u>	<u>123.7</u>	<u>119.8</u>
Fixed investment	126.6	130.5	145.9	110.6	123.7	119.8
Net lending	--	--	--	--	--	--
<u>Overall surplus or deficit (-)</u>	<u>-49.2</u>	<u>-6.1</u>	<u>-22.7</u>	<u>-7.2</u>	<u>4.2</u>	<u>7.9</u>

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

Table 12. Panama: Summary Operations of the Decentralized Agencies

(In millions of balboas)

	1983	1984	1985		1986	
			Prog.	Prel.	Prog.	Proj.
<u>Current revenue</u>	<u>120.9</u>	<u>89.5</u>	<u>87.9</u>	<u>80.3</u>	<u>68.7</u>	<u>71.8</u>
<u>Current expenditure</u>	<u>115.7</u>	<u>101.2</u>	<u>111.2</u>	<u>106.3</u>	<u>88.1</u>	<u>89.3</u>
Interest	30.4	16.0	23.1	18.7	14.9	15.1
Other	85.3	85.2	88.1	87.6	73.2	74.2
<u>Operating balance</u>	<u>5.2</u>	<u>-11.7</u>	<u>-23.3</u>	<u>-26.0</u>	<u>-19.4</u>	<u>-17.5</u>
Transfer to Central Government	5.8	4.5	0.5	1.7	1.7	1.7
Transfer from Central Government	27.4	30.4	37.3	32.4	40.4	40.4
<u>Current account</u>	<u>26.8</u>	<u>14.2</u>	<u>13.5</u>	<u>4.7</u>	<u>19.3</u>	<u>21.2</u>
Capital transfers	29.6	26.6	8.5	5.0	0.9	0.9
<u>Capital spending</u>	<u>55.9</u>	<u>29.0</u>	<u>29.8</u>	<u>1.4</u>	<u>25.1</u>	<u>23.7</u>
Fixed investment	45.1	15.0	2.1	--	0.7	0.7
Net lending	10.8	14.0	27.7	1.4	24.4	23.0
<u>Overall surplus or deficit (-)</u>	<u>0.5</u>	<u>11.8</u>	<u>-7.8</u>	<u>8.3</u>	<u>-4.9</u>	<u>-1.6</u>

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

