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Report to Congressional Committees

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FOREIGN ASSISTANCE

U.S. Efforts to Spur Panama's Economy Through Cash Transfers

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National Security and
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The Honorable Robert C. Byrd
Chairman, Committee on Appropriations
United States Senate

The Honorable Claiborne Pell
Chairman, Committee on Foreign Relations
United States Senate

The Honorable William H. Natcher
Chairman, Committee on Appropriations
House of Representatives

The Honorable Lee H. Hamilton
Chairman, Committee on Foreign Affairs
House of Representatives

In January 1990, the executive branch advised the Congress that as a result of over 2 years of U.S.-imposed economic sanctions and the December 1989 military intervention, the new democracy in Panama might not survive without an immediate infusion of funds. The President proposed an economic recovery plan for Panama that included about $500 million in credit guarantees, export opportunities, and other incentives, and another $500 million in economic assistance.

In February 1990, the Congress provided $41 million for Panama as part of the Urgent Assistance for Democracy in Panama Act (P.L. 101-243), and in May 1990, another $420 million was provided as part of the Dire Emergency Supplemental Appropriations Act (P.L. 101-302). The latter act required the Agency for International Development (AID), in cooperation with Panama and nongovernmental organizations receiving assistance, to establish systems and controls to ensure that the assistance was used for its intended purposes. AID's goals were to (1) reestablish Panama's creditworthiness, (2) reduce unemployment, (3) enhance the integrity of the government by demonstrating its ability to deliver services, and (4) revitalize and stimulate growth of the Panamanian economy. The act also required us to report on whether (1) the funds, particularly cash transfers used for balance of payments and budget support, were effectively used and (2) any lessons could be learned from the assistance program.

The program to implement the Dire Emergency Supplemental Appropriations Act was developed to (1) quickly infuse cash into the Panamanian economy through a $114 million public sector infrastructure program and a $108 million private sector reactivation program, (2) provide a $130 million grant to help Panama quickly clear its arrears to international financial institutions, and (3) implement 23 long-term development projects at a cost of about $64 million. Another $4 million was for program administration costs. (See app. I.) The assistance program for Panama was extremely large—ranking first in fiscal year 1990 of all AID programs in per capita terms and being surpassed only by programs in Egypt and Israel in absolute terms.

In April 1991, we issued an interim report on the status of AID's assistance to Panama.[1] This report focuses on the cash grant programs implemented pursuant to the Dire Emergency Supplemental Appropriations Act. It does not assess the development projects funded under the act because most projects were just getting started at the time of our review and we have reported separately on two large projects that have been implemented.[2]

Results in Brief

AID documents do not provide an analytical basis showing how the executive branch justified the size of the total aid package for Panama or the size and composition of the component parts. AID officials and documents indicate that the size of the aid package was an interagency decision, and AID was tasked with devising ways to use the funds to jump start Panama's economy.

AID believes that the assistance program has been a success because the Panamanian economy has improved since the program began in mid-1990. We agree that a large infusion of cash into Panama's $5 billion economy may have had an impact. However, whether the U.S. cash grants jump started Panama's economy is questionable in view of the fact that over 60 percent of the assistance was not disbursed until 1992 or later, well after the economy was on its way to being restored to near pre-1987 levels. Furthermore, because AID did not target specific areas of need in the Panamanian economy and disbursed most of the private sector reactivation funds before economic reforms were instituted, the extent of the direct impact of AID's programs in aiding the Panamanian economy in a

[1] AID to Panama: Status of Emergency Assistance to Revitalize the Economy (GAO/NSIAD-91-168, Apr. 8, 1991).

[2] Foreign Assistance: Resettlement of Panama's Displaced Residents (GAO/NSIAD-91-63BR, Dec. 20, 1990) and Aid to Panama: Improving the Criminal Justice System (GAO/NSIAD-92-147, May 12, 1992).

broad-based manner, improving the standard of living of the majority, and reducing unemployment is unclear. Documents show that Panama's economy began to rebound rapidly once the political and economic burdens brought on by the Noriega regime were removed. AID acknowledged that Panama's economy was already improving before the cash grant funds were released.

Although the cash grant programs were implemented more slowly than anticipated, Panama's economy showed signs of an early recovery. Panama's gross domestic product grew by about 4.6 percent in 1990 and by 9.3 percent in 1991, restoring the economy to near pre-1987 levels.

Private Sector Reactivation

The $108 million for the private sector reactivation program, channeled through the Panamanian banking system, was released in three increments between September 1990 and August 1991. AID officials cited this as a successful policy-based program assistance effort; however, no separate economic policy reforms were sought or obtained from the Panamanian government in exchange for this assistance, and the assistance was disbursed before the policy reforms sought under other components of the program were implemented.

AID officials stated that the reactivation program resulted in increased lending by participating banks to their creditworthy customers by $416.1 million from June 1990 through March 1992, and that $215.4 million of the increased lending can be attributed directly to this program. Also, according to AID, this program resulted in the creation of nearly 23,500 jobs.

We agree that private sector lending may have increased as a result of AID's $108-million cash grant, and that a monetary stimulus of this magnitude may have had a positive impact on employment generation. However, it is important to note that bank deposits were increasing rapidly during this period, and AID documents do not demonstrate that some portion of the new lending AID attributes to its program would not have occurred without the program. An AID-sponsored evaluation team also questioned AID's claim that the $108-million private sector reactivation program stimulated additional lending beyond the amount of AID's input to the banking system.

In establishing this program, AID set no specific, measurable targets to indicate the success or failure of the program. For example, the goals of the Private Sector Reactivation Program were to increase lending and generate employment. However, no specific guidelines were established to ensure that maximum benefits were realized. Consequently, AID has no way of knowing whether the number of jobs it says were created represents success or failure, or whether the jobs represent long- or short-term employment.

The Panamanian banking system through which this U.S. assistance was channeled traditionally has served higher income segments of Panama's economy, and not small businesses or agriculture, which provide an estimated 80 percent of private sector employment in Panama. The Panamanian banks reported that at least some AID funds were lent to large, long-established Panamanian enterprises that, according to bank officials, would have received credit without the AID program.

The Public Sector Program

AID released the first $30 million of the $114-million public sector infrastructure program funds in October 1990 but did not release the second installment of $42 million until January 1992. According to AID, the final $42-million installment would be released on April 26, 1993. AID played a minimal role in maintaining accountability for these funds after their release to Panama and determining how the Panamanian government used the funds. The funds were commingled with Panamanian funds, impairing AID's ability to account for U.S. funds, and an independent certified public accounting firm reported that Panama's financial controls were weak.

AID officials stated that they did not participate in deciding which projects were financed because this was not important, and their hands-off management approach allowed the Panamanian government to gain experience in setting investment priorities and managing funds. Consequently, AID cannot be sure the funds were used for well-designed projects to address the problem areas previously identified by the agency. According to AID planning documents, if the agency participated in deciding how the funds were used, it would then be responsible for ensuring (1) that the funds were used for intended purposes and (2) proper accountability.

AID officials stated that this policy-based program was a success because the economic reforms it sought as a condition for disbursement were implemented. (The implementation of policy reforms was not a condition for the release of the first $30 million.) The Panamanian government enacted tax reform legislation, liberalized its trade program, implemented social security system reforms, and introduced a privatization program. We agree that these are important reforms; however, we noted that the third installment was not released before April 26, 1993, because Panama had not fully implemented all of the reforms set as a precondition for disbursement.

Clearing Panama's Arrears

The $130 million to help Panama clear its arrears to the international financial institutions was released in January 1992, 17 months later than anticipated. This delay occurred because the government of Panama did not adopt the economic reforms set by AID and the financial institutions as a condition for releasing the funds as early as expected. Consequently, Panama's access to resources from these institutions and any economic benefit to be derived from this assistance did not occur until 1992.

Lessons Learned

Although circumstances differ from country to country, lessons can be learned from the U.S. cash grant programs in Panama that may be applicable to other situations. The United States has a strong interest in helping countries like Panama strengthen their nascent democracies, and economic assistance often is important to this process. An early commitment of assistance may, for political or other reasons, be necessary. However, before large dollar commitments are made, a thorough economic assessment would help establish an analytical basis for determining both the total size and the composition of the assistance program. In the case of Panama, AID did not analytically justify either the size of the total aid package or the size and composition of the component parts.

The underlying reason the infusions of cash into the Panamanian economy did not occur as quickly as AID anticipated was that Panama was slow to meet the economic reform conditions set for the release of funds for the public sector and to clear arrears with international financial institutions. We believe that AID was correct in setting economic reform conditions and in withholding release of the funds until conditions were met. Furthermore, we believe that the private sector reactivation funds would have been more efficiently used if they too had been disbursed after economic reforms were implemented. Unless policies that create economic distortions and misallocations of resources are reformed, economic gains achieved through assistance programs cannot be sustained and the impact of U.S. assistance will be short lived.

In the case of Panama, some economists indicated that AID may have missed opportunities to ensure more efficient use of the private sector reactivation funds when it decided to release these funds before any economic policy reforms targeted toward private sector growth were adopted. According to economists we spoke with, reforms, such as (1) removing wage and price controls; (2) eliminating trade barriers that have insulated domestic producers from international competition; and (3) removing protection from government-sponsored monopolies that have driven up costs and prices, were necessary to maximize the use of U.S. assistance in sustaining Panama's economic growth. AID has acknowledged that although private sector lending increased as a result of its reactivation program, people and businesses who traditionally have had difficulty obtaining credit still face this barrier, unemployment remains unacceptably high, and unaddressed economic and policy reforms continue to reduce the potential impact of such increased lending on economic growth. A thorough analysis of a country's economy before assistance commitments are solidified would help identify such opportunities and form an analytical basis for assessing whether such reforms are achievable.

Recommendations

We have previously recommended that to ensure that AID's implementation of separate accounting of cash transfer funds is consistent with congressional intent, the AID Administrator (1) require recipients to maintain cash grant funds in separate accounts or (2) describe how accountability is to be maintained when the commingling of cash transfer funds with other foreign exchange cannot be avoided.[3] We are restating this recommendation, which was intended to ensure that cash grants are not subject to fraud, waste, and abuse, and that the funds are used for their intended purposes. In the case of Panama, this means that a separate account should have been established in the National Bank of Panama and controls exercised beyond the transfer of funds out of the Federal Reserve Bank of New York. We also recommend that the AID Administrator require that cash transfer Program Assistance Approval Documents, including those not directly linked with policy reform objectives such as the private sector reactivation program, contain (1) specific program objectives, (2) time frames or milestones for their accomplishment, and (3) expected impacts to facilitate measuring program success.

[3]Foreign Aid: Improving the Impact and Control of Economic Support Funds (GAO/NSIAD-88-182, June 29, 1988).

Agency Comments and Our Evaluation

AID disagreed with many statements, conclusions, and recommendations included in our draft report. AID believed that we (1) used inappropriate criteria in our evaluation; (2) overlooked the real impacts of the cash transfer programs; (3) lacked consistency in our treatment of conditionality; and (4) inappropriately encouraged AID to micromanage programs and impose directed credit as part of cash transfers. After thoroughly evaluating AID comments, we continue to believe that our evaluation was appropriate and that our observations and conclusions are consistently and accurately stated.

According to AID, we should have ascertained whether it followed its policies and guidance as they relate to cash transfers and not used any other criteria. However, ours was not a compliance review. Our bases for evaluating AID's administration of the cash transfer programs in Panama were whether (1) the funds were effectively used and (2) lessons could be learned from this program that could be applied elsewhere.

AID believed we were inconsistent in our discussion of economic policy conditionality and minimized the value of reforms required of and made by the Panamanian government. Also, AID asserted that we were critical of delayed disbursements on the one hand, but on the other hand suggested that the program should have been delayed further to allow for Panama to institute economic reforms. We believe our discussion of conditionality is consistent in that we state that AID assistance would have been more effective had the economic reforms been implemented before rather than after private sector reactivation program funds were disbursed. Furthermore, our report does not criticize AID for delaying disbursements for the public sector program or for helping Panama clear its arrears with the international financial institutions. The report simply states that Panama had not done its part to enable the funds to be released, and that AID was correct in its decision to delay disbursements. Our report does point out, however, that economic recovery was well underway before the AID funds were released.

AID acknowledged that it implemented a hands-off program, leaving many of the decisions to the government and the private sector in Panama because it did not want to micromanage these activities. We believe that it would have been appropriate for AID to have imposed controls, oversight, and guidance on such a large program, especially since AID recognized the inexperience of the government with its inherent administrative and financial shortcomings and the history of corruption and waste under the prior political regime. Failure to do so left U.S. funds subject to misdirection, waste, and abuse.

AID's comments have been reprinted in their entirety in appendix III along with our evaluation of them.

Scope and Methodology

To determine the effectiveness of AID's assistance program in Panama and what lessons could be learned for political use elsewhere, we interviewed officials and obtained pertinent documents at the U.S. Embassy in Panama; AID in Washington, D.C., and Panama; the Department of State; the United Nations; and the Panamanian government. We also discussed these matters with leading economists and political analysts in Panama and the United States.

Because the AID Inspector General was required under the Dire Emergency Supplemental Appropriations Act of 1990 to review the agency's compliance with internal controls over the economic support fund program for Panama, we did not review the controls for that program. However, we reviewed the Inspector General's September 1991 and March 1992 reports and incorporated their findings where appropriate. We conducted our review between August 1991 and August 1992 in accordance with generally accepted government auditing standards.

Appendix I provides information on the obligations and disbursement of funds for the three cash grant programs, as well as for the development projects and other expenses. Appendix II discusses the cash grant programs in more detail.

We are sending copies of this report to the Secretary of State, the Administrator of AID, and the Director of the Office of Management and Budget. We will also make copies available to others upon request.

This report was prepared under the direction of Harold J. Johnson, Director, International Affairs, who may be reached on (202) 512-4128 if you or your staff have any questions. Other major contributors to this report are listed in appendix IV.

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Abbreviations

AID	Agency for International Development

Status of Dire Emergency Assistance to Panama as of February 28, 1993

Dollars in thousands

Category of assistance	Obligated	Disbursed
Cash grant programs		
Payment of arrears	$130,000	$130,000
Public investment	113,850	71,850
Private sector reactivation	107,900	107,900
Subtotal	**351,750**	**309,750**
Development projects		
Labor union development (regional)	500	500[a]
Central American peace scholarships	5,450	2,886
Private sector scholarships	500	346
Panajuru local scholarships	500	284
Low-cost shelter	300	160
Rehabilitation of Chorrillo apartments	2,431	2,431
Immediate recovery program (housing)	7,255	6,692
Improving police services	13,200	13,200[a]
Financial management reform	4,500	805
Journalism strengthening	500	331
Civic education	240	189
AID electoral tribunal	840	840
Legislative development	700	0
Democratic initiatives	30	27
Natural resources management	10,000	85
Peace Corps	100	100
U.S. Information Service training	500	500
Improved administration of justice	6,900	1,247
Economic policy development	3,100	942
Tax administration improvement	1,600	695
Labor union development	138	138
Narcotics awareness	250	89
Latin American scholarships	4,360	686
Subtotal	**63,891**	**33,173**
Other expenses		
Project development and support	1,006	776
Operating expenses	2,279	2,255
Salaries	1,002	1,002
Subtotal	**4,287**	**4,033**
Total	**$419,931**	**$346,956**

[a]AID estimate.

Source: AID Panama.

AID's Cash Transfer Program

AID's three-part cash grant assistance program allotted (1) $130 million to help Panama pay off its arrears to international financial institutions, (2) $114 million to support Panama's public sector investment budget by funding infrastructure projects, and (3) $108 million to increase the amount of bank credit available to the private sector. This appendix discusses the execution and effectiveness of these cash grant programs.

Clearing Arrears to International Financial Institutions

By March 1990, largely as a result of more than a decade of corrupt leadership, economic management, and over 2 years of U.S.-imposed economic sanctions, Panama was $2.4 billion in arrears on its external debt payments, including $620 million to the International Monetary Fund, the International Bank for Reconstruction and Development (World Bank), and the Inter-American Development Bank. Panama had to clear its arrears to the international financial institutions before it could (1) reactivate more than $350 million for 18 suspended projects funded through loans from these institutions and gain access to further credit from them, (2) reschedule its bilateral official debt, and (3) begin negotiations with commercial banks on the outstanding debt owed them.

AID's Disbursement of $130 Million Contingent on Government of Panama Action

On July 3, 1990, the United States and Panama signed a grant agreement in which the United States was to contribute $130 million to the international, multidonor Panama Support Group that was formed to help Panama clear its arrears to the international financial institutions.[1] The U.S. contribution was equal to the amount of Panamanian funds frozen in the United States as a result of U.S.-imposed sanctions.

Before Panama could use the U.S. funds, AID required that it (1) set aside $130 million of its own funds as its contribution to clearing the arrears; (2) provide evidence that it had not accumulated additional arrears after March 31, 1990; (3) adopt a short-term, economic stabilization program that met the International Monetary Fund's requirements for a stand-by program;[2] and (4) secure other funding commitments that would be sufficient to clear the balance of arrears.

[1]The Panama Support Group consisted of the United States, Taiwan, and France.

[2]As part of this, the international financial institutions required that Panama institute three economic policy reforms in the areas of income tax, social security, and the privatization of state-owned enterprises. According to World Bank and AID officials, although in the grant agreement with AID did not explicitly condition disbursement on these reforms, U.S. policy was the driving factor of this requirement.

Meeting All Economic Conditions Not a Panamanian Priority

AID disbursed the $130 million on January 29, 1992, about 17 months later than the agency had anticipated. Program documents show that AID had initially anticipated that disbursement would occur by August 1990; however, Panama's legislature took longer than expected to enact the economic policy reforms that were prerequisites. AID informed us that the Panamanian legislature enacted the income tax and social security reforms on December 31, 1991.

When AID signed the grant agreement, it believed that the Panamanian government would be quick to enact all of the prerequisite economic reforms. However, officials from the World Bank and the Inter-American Development Bank told us that Panamanian government leaders did not actively promote the reforms and could not bring the different factions in the legislature together. They said that the reforms were not a Panamanian priority and that Panama's economic situation probably was not desperate enough to induce the legislature to enact reforms that were politically difficult to achieve. A prominent Panamanian economist also suggested that because the Panamanian government knew the assistance package had no time limit on its availability, the government may not have felt pressed to enact the reforms.

The Public Sector Assistance Program

AID and the government of Panama signed a $114-million cash grant agreement on July 3, 1990, that was to provide budget support for improving government services in agriculture, health, education, justice, natural resources, and other sectors. The grant was also expected to generate numerous short-term, private-sector jobs in fiscal years 1990 and 1991. AID documents do not provide an analytical basis to justify that $114 million—or some other amount—was needed for these purposes. However, the documents show that the Panamanian public sector investment budget had declined from $211 million in 1987 to $78 million in 1989. The cash grant was intended to make up for some of this shortfall in Panama's infrastructure improvement budget used for such things as roads, schools, and hospitals.

Funds were to be deposited into a government of Panama interest-bearing account in the Federal Reserve Bank of New York in three tranches of $30 million, $42 million, and $42 million. Disbursement of each tranche was contingent upon Panama's meeting certain conditions. Among other things, the government of Panama was required to show progress in
(1) enacting a medium-term economic reactivation program;
(2) implementing policy reform in the areas of public sector finance,

privatization, labor policy, and trade and commercial policy; (3) reaching an agreement with the U.S. government to exchange records on international currency transactions in connection with narcotics investigations and proceedings; and (4) signing the Mutual Legal Assistance Treaty with the United States.

The government of Panama could withdraw the disbursed funds (and any interest earned on them) once a month and deposit them into the Special Priority Investment Fund account in the National Bank of Panama, where the funds would be commingled with funds from the government of Panama. Panama based the amount of each monthly withdrawal on its projections of financing needs, and AID approval was required before the transaction took place.

In October 1990, AID disbursed the first tranche because the Panamanian government had satisfied the minimal conditions required by the grant agreement for this disbursement; Panama made its first withdrawal from its Federal Reserve Bank account in January 1991. Panama also met the conditions required for the disbursement of the second tranche, which AID paid in January 1992. AID had not disbursed the third tranche as of March 31, 1993, because Panama had not fully met the conditionality.

AID Did Not Have Reasonable Assurances That Panama Could Effectively Manage the U.S. Funds

Before signing the public sector grant agreement, AID knew that the Panamanian government's financial controls were weak. On May 1, 1990, an AID working group in Washington reviewed the AID mission's plan and recommended that the mission ensure itself that the government of Panama had appropriate financial accounting procedures in place before funds were transferred into the investment account. Accordingly, AID funded a review by an independent certified public accounting firm of the Panamanian government's financial controls.

The accounting firm informed AID that Panama's financial controls were weak and that the government lacked the ability to manage and control public sector funds. AID believed that Panama's ability to manage public funds could be improved by (1) creating an auditor general's office; (2) formulating a code of ethics for public officials; (3) separating the government's audit and financial functions; and (4) hiring an accounting firm to design a financial improvement project for areas such as accounting, budgeting, cash and debt management, and auditing.

Although AID disbursed the first $30 million for public sector assistance in October 1990, it did not have reasonable assurances that Panama could adequately manage these funds. In September 1991, an AID official told us that the government has made significant progress but still had an uncoordinated budgeting system, an inadequate financial reporting system, and an inadequate audit capability.

AID Opted for a Hands-Off Approach to Managing the Program

AID program documents state that Panama could determine which projects to fund without AID's participation in the decision-making process. AID had identified areas of most pressing need and assigned tentative funding levels to them during its initial program planning but did not require Panama to adopt these priorities and funding levels. Notwithstanding the questions about the government of Panama's ability to manage public funds, AID officials explained that their hands-off approach allowed the Panamanians to gain experience in setting investment priorities and managing funds.

An AID program official told us that because AID sought policy reform in exchange for the cash grant, it did not matter which projects Panama funded; what mattered was that the policy reforms were adopted before funds were made available. According to AID documents, AID decided not to participate in the decision-making process on the use of these funds or to track them further than the deposits into the special account in Panama. These documents indicate that if AID specified how the funds were to be spent, it would then be responsible for maintaining full accountability over the funds and ensuring that the funds were used for the purposes intended; the same accountability standards required for project activities.

The AID Regional Inspector General noted in a September 12, 1991, report that AID's general policy for cash grant programs was to track the end use of U.S. funds in order to prevent their abuse or diversion. Because AID chose to allow the funds for the Panama public sector to be commingled with funds from other sources in the Special Priority Investment Account, AID could not track the end use of the U.S. funds in the National Bank of Panama. The Regional Inspector General concluded that AID, therefore, would not be able to determine whether the funds had been used as intended.

Without participating with Panama in deciding how the funds would be used, AID could not be sure that the U.S. funds were used for well-designed projects to address the problem areas identified by the agency. According to AID, it relied on reports from the Panamanian government that funds were not used for purposes prohibited by the agreement. AID officials told us that they had planned to evaluate the investment budget after a substantial, but unspecified, amount of the grant had been disbursed. While this planned evaluation could have revealed information on what the program achieved, an evaluation after the fact would not (1) reveal discrepancies in actual versus planned spending until it was too late to take corrective action or (2) help to ensure that the government's spending was effective in meeting program goals.

The Private Sector Reactivation Program

AID considered the banking system in Panama, weakened by years of political, economic, and military crises, to be a major obstacle to rapid economic recovery. At the time AID program documents were being prepared in early 1990, (1) loans to the private sector were reported to have decreased by 27 percent from 1987 levels; (2) the Panamanian government maintained withdrawal restrictions on a small percentage of domestic, private sector deposits in Panamanian banks; and (3) the deposit base in all banks, both local and foreign-owned, had fallen from $41 billion to $14 billion. The U.S. Embassy in Panama attributed the bank problems largely to a loss of confidence in Panama as an international banking center.

Because withdrawal restrictions on term deposits in Panamanian banks were scheduled to be lifted on July 10, 1990, AID believed that the potential existed for massive withdrawals (a bank run), despite the fact that withdrawal restrictions applied to only a small percentage of overall bank deposits. To minimize this risk, bolster private sector lending, and generate economic growth, AID signed a $108-million private sector reactivation grant agreement with the government of Panama on July 24, 1990. AID documents state that the overriding priority for the recovery of the Panamanian economy was "judicious injection of additional external resources to revitalize private enterprise and bolster public sector investment, thus stimulating economic activity and generating employment." However, AID documents do not provide an analytical basis for showing that this goal could best be accomplished by providing funds for banks to increase their loan activity or that $108 million was the amount required to accomplish this purpose.

The Bank Run Did Not Occur

AID officials told us that in their opinion the $108-million grant enhanced the confidence of depositors and averted massive withdrawals; however, we found that data contained in AID documents indicated that the potential for massive withdrawals was remote. For example, these documents show that AID officials knew that massive withdrawals did not occur when the Panamanian government lifted withdrawal restrictions on demand deposits on January 1, 1989, and on savings deposits on April 25, 1990. Although deposits in savings accounts fell slightly in the weeks after restrictions on savings deposits were lifted, AID program documents noted that the liquidity of Panamanian banks did not drop, and in fact total deposits in the banking system were increasing.

Even though there was no bank run, AID still felt that banks needed support because (1) deposits had been frozen for a long time; (2) there could be rapid withdrawals, especially by foreigners; (3) the depressed economy made it difficult for banks to liquidate their assets rapidly; and (4) Panama did not have a central bank that could serve as a lender of last resort and provide liquidity.[3]

Our review of AID documents shows, however, that despite the absence of a central bank in Panama, general license banks in Panama are required to lend to other banks in Panama experiencing liquidity crises. This permits general license banks to perform the function that central banks often perform, that is, acting as a lender of last resort. Furthermore, (1) 24 percent of the frozen deposits were being used as collateral for new loans and were, therefore, not subject to immediate withdrawal; (2) the Panamanian government would have provided liquidity to state-owned banks; (3) foreign-owned banks were expected to be supported by their headquarters if a crisis had arisen, (4) the Panamanian banking system had \$2.6 billion in liquid assets, sufficient to cover the \$295 million in term deposits that (by AID's calculations) were available for withdrawal within 120 days; and (5) by the time the grant agreement was signed, private Panamanian deposits in the Panamanian banking system had increased by \$215 million (11 percent) over December 1989 levels. In addition, a study by the Panamanian National Banking Commission, completed before the grant agreement was signed, had concluded that there was a low probability that a systemic liquidity crisis would occur.

AID Directed All of the Funds to Increase Lending to the Private Sector

Since funds were not needed to avert a bank run, AID used the entire \$108 million to increase lending in the private sector by providing funds to commercial banks in Panama to make medium- and long-term loans to

[3]The Federal Reserve system's discount window serves as a lender of last resort in the United States by providing emergency loans to banks experiencing short-term liquidity crises.

creditworthy clients. The funds were disbursed through three deposits into a government of Panama account in the Federal Reserve Bank of New York.[4] The first deposit was conditioned on Panama's taking action on certain administrative requirements for implementing the program. AID disbursed the final two tranches as demand for funds dictated, but with no further conditions attached to the disbursements.

Commercial banks wishing to participate in the grant program were required to submit to the National Bank of Panama documentary evidence that they had made new medium- or long-term loans after July 24, 1990, the date of the grant agreement. Few restrictions were placed on how the loan proceeds could be used.[5] If the documentation was completed according to the requirements of the program, the National Bank of Panama would purchase an interest-bearing certificate of deposit from the commercial bank equal to 50 percent of the value of the new credit extended by the participating bank. The certificate was to be secured only by the good faith of the bank. The National Bank of Panama would then request a direct transfer of funds from the government of Panama's account at the Federal Reserve Bank of New York to a U.S. bank affiliated with the participating Panamanian bank, and ultimately to the participating commercial bank in Panama. The participating banks are to repay the certificates of deposit over a period not to exceed 5 years, based on the average maturity of the loans in the portfolio.[6]

Under the grant agreement, AID and the government of Panama were to decide by July 25, 1992, how to use the funds when certificates were redeemed. According to the AID Assistant Administrator for Latin America and the Caribbean, a decision has been made to use the funds generated from the repayments to help Panama repay its nonmilitary bilateral debt to the United States.

[4]The first tranche was disbursed in September 1990, the second in April 1991, and the third in August 1991.

[5]According to the grant agreement, loan proceeds could not be used to finance military, paramilitary, or police requirements of any kind; surveillance equipment; abortion equipment or services; luxury goods; gambling equipment; weather modification equipment; or any activity that would result in a significant loss of the tropical forest.

[6]For example, if the average maturity of the loans is 45 months (15-trimester periods) and 15 certificates are secured, 1 certificate is redeemed in each of the subsequent 15-trimester periods following the initial grant transaction.

AID Opted for a Hands-Off Approach to Managing the Program

During the early planning phase of the private sector reactivation program, before any agreements were signed, AID officials considered various ways of distributing the $108 million among Panama's economic sectors. AID identified various sectors (agriculture, construction, and industry) that were important to revitalizing the private sector, and it tentatively assigned how much of the grant money should be allocated to each sector. AID also considered a plan under which funds would be loaned to customers on the basis of criteria such as the economic efficiency of the proposed use of the funds, the potential for job creation, and economic policy considerations. However, by the time AID finalized the grant agreement with Panama, it had decided not to (1) specify how the money should be used, (2) participate with the National Bank of Panama in evaluating loan portfolios, (3) participate in decisions about which economic sectors should receive assistance, or (4) track the funds beyond their withdrawal from the Federal Reserve Bank of New York and their deposit into the accounts of participating banks in Panama.

AID officials told us that the grant was intended to encourage private, free-market lenders to make loans to improve the overall health of the economy, not to directly benefit specific sectors of the economy. Furthermore, AID officials said that it did not matter what loans were generated by U.S. grant funds because as far as they were concerned, the primary purpose of the funds was to increase lending regardless of what activities the loans supported.

Despite its laissez-faire approach to managing this program, the agency modified the grant agreement in February 1991 to encourage lending to small businesses. The modification allowed savings and loan associations (and other institutions) to make loans to small businesses and allowed banks to issue certificates of deposit for up to 80 percent of the value of the loan (rather than 50 percent) for loans to small businesses. In August 1992, an AID official informed us that only one loan, for about $150,000, was made to a small business as a result of this change in the grant agreement.

The Private Sector Reactivation Program's Impact on Panama's Economy Cannot Be Measured

AID officials believe the private section reactivation program was a success, citing as evidence an increase of $461.1 million in lending in Panama during the grant period and increases in Panama's gross domestic product, which by the end of 1991 had reached near pre-1987 levels. We agree that leading increased in Panama during the grant period and that Panama's economy rebounded to near pre-1987 levels; however, our review indicated that attempting to definitively link these events to AID's reactivation program is problematic at best.

The U.S. Embassy in Panama assessed Panama's economic performance 3 months after the first tranche had been disbursed and reported that the economy had recovered dramatically "largely on its own steam." The assessment did not link AID's cash grant program with the recovery. The assessment noted that (1) the banking system had benefitted from a substantial repatriation of funds and (2) domestic deposits had increased by $1.6 billion, or 50 percent. A July 1991 report by the American Chamber of Commerce in Panama also noted that foreign deposits had increased by 24 percent, total bank assets 19 percent, and total deposits 31 percent by the end of 1990. Furthermore, an AID-sponsored evaluation team, in its December 1992 report, questioned AID's claim that the reactivation program could be directly linked to new lending beyond the $108 million provided by the program itself.

It may never be possible to determine definitively the extent to which AID's private sector program contributed to subsequent improvements in Panama's economy. In most environments, a monetary stimulus will have at least short-term benefits. However, there is no way to determine whether the level of lending that occurred would have occurred without AID's assistance, or whether the U.S. funds were additive or merely substitutive to lending in Panama. According to the AID Regional Inspector General,

> There was no way to assess whether the participating banks would have made the loans in the absence of the program, nor was there a way to determine whether the funds received under the program resulted in increased lending for the specific types of activities the program was intended to support. No alternative mechanism was developed to show that eligible new lending would take place as a result of the program as opposed to simply reimbursing banks for old lending.[7]

Some economic development experts with whom we spoke questioned whether channeling money through the commercial banking system was the most effective way to reactivate the private sector and promote economic development. According to these experts, providing credit access to small- and medium-sized businesses is critical to the process of development and revitalization; however, commercial banks in developing countries are typically not interested in lending to such enterprises.

[7]Audit of the Panama Assistance Program Funded by Public Law 101-302 as of November 30, 1991, Regional Inspector General for Audit, Tegucigalpa, Honduras (Audit Report No. 1-525-92-006, Mar. 30, 1992).

They told us that AID's use of private banks as the vehicle for making more credit available substantially diminished the potential of reaching small- and medium-sized entrepreneurs. Banks focus on the creditworthiness of clients, and tend to make loans to those with sufficient collateral and a history of credit use. According to bank officials with whom we spoke, larger Panamanian corporations usually have had no trouble securing loans from banks, but commercial banks are usually unwilling to invest the time needed to make loans to smaller businesses. AID recognized this in its May 1991 5-year economic assistance strategy for Panama, in which it stated

> Micro and small businesses provide an estimated 80 percent of employment opportunities in Panama. Despite their importance to the economy, these businesses have the greatest difficulty in obtaining credit and technical assistance. For this reason, their potential to contribute even more toward Panama's economic growth is largely unrealized.

Private Sector Reactivation Program Not Linked to Policy Reforms

Many development experts in Washington and Panama told us that the economic stimulus provided by the private sector reactivation program would have had a greater effect over the long term if the underlying problems of the Panamanian economy were addressed before the aid was disbursed. Some analysts believe that AID should have conditioned the use of the private sector reactivation funds on the government's making basic changes to its economic policies, or not have released the funds until after the reforms were in place. AID documents prepared in connection with the development of the reactivation program discuss long-standing, unattended weaknesses in Panamanian economic policy that needed to be addressed because the failure to do so would weaken economic recovery. According to these documents, years of government mismanagement and intervention in sectors of Panama's economy had distorted wages and prices, contributed to the misallocation of resources from their most efficient uses, and resulted in higher costs for Panamanian businesses and consumers.

These problems discouraged foreign investors from investing in Panama. According to a leading Panamanian economist, Panama enacted legislation in 1991 designed to attract assembly plants to Panama, but firms have been reluctant to invest in Panama because various government policies reduce the expected return on investment. Officials at the U.S. Embassy said that Panama must address its labor problems and property rights issues before investors will seriously consider investing in Panama.

According to various experts and studies, the key long-term economic problems that Panama continues to face include (1) poverty and income disparity; (2) wage and price controls; (3) protection against imports; and (4) unregulated, government-sponsored monopolies. According to some estimates, the Panamanian population living in poverty ranges from 28 to 44 percent. Data indicate that a much wider gap in income distribution exists in Panama than in many developing countries. The median annual per capita income, by province, ranged from $252 to $917 in 1990. Recent studies have concluded that countries with greater inequalities in income distribution may have a slower rate of economic growth.[8] A recent World Bank report highlighted this relationship and presented data that show that, during the period 1965-89, Panama had one of the most widely skewed income distributions and one of the slowest economic growth rates of all the countries presented.

According to AID and Panamanian government documents, wages and prices are seriously distorted in Panama's agricultural and industrial sectors. In the agricultural sector alone, prices of more than 800 commodities were still controlled by the government of Panama at the time the private sector reactivation grant agreement was signed. Price controls have resulted in a misallocation of resources away from their most efficient uses. For example, milk price supports and ceilings on the price of meat have encouraged former cattle farmers to switch to dairy production, even though the country's climate is better suited to cattle raising than dairy production.

AID and Panamanian government documents show that the matrix of rules, regulations, and incentives created for agricultural markets have resulted in inefficiencies, monopolies, privileges, and a lack of competition. Trade barriers insulate domestic producers from international competition and allow them to charge higher prices than could be charged if they were forced to compete in the world market. High food costs affect the poor more than any other income group because food consumes a larger share of their income. Several economists told us that eliminating the protection on domestic agriculture would greatly reduce poverty in Panama. They cautioned, however, that a transition to free trade in agriculture would necessitate education programs for farmers to help them adjust to the demands of the international marketplace.

[8] T. Persson and G. Tabellini, "Is Inequality Harmful for Growth? Theory and Evidence," National Bureau of Economic Research Working Paper No. 3599 (Jan. 1991) and K. Murphy, A. Shleifer, and R. Vishney, "Income Distribution, Market Size, and Industrialization," Quarterly Journal of Economics, Vol. CIV (Aug. 1989).

Several economists with whom we spoke said that numerous unregulated, government-sponsored monopolies in Panama have driven up costs and prices. For example, a single transportation cooperative has the exclusive right to transport freight out of the Colon Free Zone. A prominent economist in Panama said that, as a result, the cost of land transportation for cargo in Panama is double what it would be in the United States. A single oil company has refining rights in Panama, and government-sponsored monopolies also exist for electricity, water, and the telephone system. No public utility commission regulates these monopolies because they are publicly owned utilities, and we are aware of no efforts to revise user fees even though economists in Panama told us that electricity costs in Panama were very high relative to other countries in the region.

Comments From the Agency for International Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEC 7 1992

U.S. Agency for International Development

Mr. Frank Conahan
Assistant Comptroller General
National Security and International Affairs Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

Thank you for sending for our review and comment your draft report on the cash grant programs implemented in Panama pursuant to the Dire Emergency Supplemental Appropriation Act (GAO code 472268). This letter and its enclosure constitute the Agency for International Development's official response, which we would like to see form part of the final report.

Panama's difficult political and economic situation in early 1990, in the aftermath of the U.S. economic sanctions and the Just Cause military action, fully justified the U.S. decision to direct the bulk of its assistance to Panama in the form of cash transfers. The country's economic activity had been paralyzed, the banking sector was shaky, and public finance and administration were in complete disarray. These problems could not have been addressed through project assistance alone.

See comment 1.

The GAO was tasked with considering whether the specific cash transfer programs implemented in Panama were well-conceived and well-executed. We disagree with many of the statements and conclusions of the report.

A.I.D. has three basic concerns with respect to the GAO's evaluation:

See comment 2.

First, cash transfers are not projects, and hence are subject to a different form of management and control.

The GAO looked for project-style management and control, did not find it, and then on that basis concluded that A.I.D. exercised inadequate program design and accountability. We believe that A.I.D. applied an extraordinary level of control and accountability to the cash transfers. This control was necessary because of the weakened state of Panama's public sector financial management that Noriega left behind. USAID/Panama complied fully with Agency policy in the design, execution and accountability of the programs.

See comments 2 and 3.

Second, we believe that the GAO did not identify the real impacts of the cash transfer assistance.

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This is also a result of the GAO's treating program assistance as project assistance. For example, the GAO believes the funds would have had a better return if A.I.D. had actively selected the projects in the public sector investment budget to finance, and had chosen which private sector companies to receive credit. A.I.D.'s world-wide experience implementing development programs has demonstrated, however, that micromanagement along the lines suggested by GAO considerably delays and reduces the impact of cash transfer programs.

Third, the GAO report is not internally consistent on the question of economic policy conditionality.

See comment 4.

The report does not clearly identify what reforms were needed, which reforms have been adopted by the Endara government, and what still needs to be done. The report criticizes delays in providing the assistance, argues that the program should have had heavier or different conditionality than it did (which would have introduced more delay), and faults A.I.D. for not directing credit into sectors where policy problems are the greatest (agriculture and industry). Directing credit as suggested by the GAO would have caused further delays in helping to restore growth to the Panamanian economy.

At this time, A.I.D. would also like to address the two recommendations contained in the report.

See comment 5.

First, the GAO recommends that cash grant funds be maintained in separate accounts, and that A.I.D. describe how accountability will be maintained when commingling of cash transfer funds with other foreign exchange cannot be avoided.

The Panama cash transfers, in accordance with existing Agency guidance, were deposited into separate accounts, and were maintained in those accounts until disbursed for the agreed-upon end uses. The extensive financial monitoring, control and accountability exercised in both programs is described in detail in the respective PAAD documents, and this information was reviewed and approved by A.I.D. during the program authorization process. The recommendation, therefore, does not provide for actions any different from those already taken for the programs in question.

Second, the GAO recommends that the A.I.D. Administrator require that cash transfer agreements contain (1) specific program objectives, (2) time frames or milestones for their accomplishment, and (3) expected impacts to facilitate measuring program success.

A.I.D. agrees that cash transfer programs should be based on sound analysis and should establish evaluation criteria. A.I.D. is working on strengthening its guidance on analysis and evaluation criteria for nonproject assistance.

See comment 6.

A.I.D. recommends that your staff compare its report with the independent evaluation commissioned by the Center for Development Information and Evaluation (CDIE) and conducted by Dr. Anne Krueger of Duke University, Dr. Jacques Polak of the International Monetary Fund, and Dr. John Newton of Nathan Associates, as regards methodology and issues. Their report applies a more appropriate technical approach to evaluating cash transfers, and its results differ markedly from the GAO conclusions. The authors endorse the design of the two Panama cash transfers, and note the important positive impacts which these programs have had on the Panamanian economy. CDIE will provide the GAO with a copy of this report when it is finalized.

The enclosure to this letter contains a line-by-line correction to what we believe are erroneous statements contained in your report. A.I.D. requests that this correction be included in full in the section of your report reserved for A.I.D.'s response. A.I.D. staff members both in Washington and in the Mission continue to be available to help clarify any of this information.

I am certain that you share our desire for an accurate and useful accounting of the cash transfer programs implemented in Panama. Please advise me of any ways I or my staff can be helpful in contributing to the suggested revisions of the report.

Sincerely,

John F. Owens

Richard Ames
Associate Administrator
Directorate for Finance and
Administration

encl.: A.I.D. line-by-line response to GAO draft report 472268

U.S. Agency for International Development
Line-by-Line Response
GAO Draft Report 472268
"Foreign Economic Assistance:
Impact on Panama's Economy Uncertain"

1. Report Title:

See comment 7.

The Agency does not believe that the impact of the two cash transfers in Panama is uncertain. Moreover, the A.I.D. Center for Development Information and Evaluation commissioned an independent evaluation of the program by Dr. Anne Krueger of Duke University, Dr. Jacques J. Polak of the International Monetary Fund, and Dr. John Newton of Nathan Associates. The authors of the report provide a clear and certain assessment of the impact of the cash transfers in question.

A.I.D. Comments on
"RESULTS IN BRIEF"

See comment 8.

2. "AID documents do not provide an analytical basis showing how the executive branch justified the size of the total aid package for Panama, or the size and composition of the component parts."

The size and composition of the A.I.D. program in Panama was the result of an interagency decision process and consultations with Congress that culminated in an NSD document signed by President Bush. This is why A.I.D. program documents, the primary source of information in the GAO report, did not provide the analysis. Participating agencies involved in considering program size and composition included the Department of State's Bureau of Inter-American Affairs and Bureau of Economic Affairs and the Treasury Department.

3. "AID did not target specific areas of need in the Panamanian economy. Consequently, the direct impact of AID's programs in aiding the Panamanian economy in general, improving the standard of living of the majority, and reducing unemployment is unclear."

See comment 9.

The above statement is at the heart of the GAO's fundamental objection to the Panama cash transfer programs. The GAO believes that the USG should have taken an activist role in selecting which public sector investment projects and which private sector activities should receive support associated with U.S.-funded cash transfers. An activist role as advocated by the GAO, however, runs contrary to the generally accepted norms of how cash transfer assistance should be designed to maximize benefit to the recipient economy.

See comment 10.

A.I.D. did target specific areas of need which interagency analysis had concluded were of highest priority. These were:

> (1) funding Panama's public sector investment program, which had been a casualty of the Noriega regime's larcenous public sector management and which had no access to international financial institution credits in the short term due to arrearages with international financial institution (IFI) creditors;
>
> (2) providing a safety net and injection of liquidity into Panama's banking sector, the cornerstone of Panama's modern economic sectors which had been the chief victim of the U.S. economic sanctions; and
>
> (3) providing a contribution to IFI arrears clearance, to help secure other bilateral donor contributions and ultimately reopen Panama's access to IFI credits.

See comment 11.

Contrary to the GAO's stated opinion, however, the provision of program grants for these three programs did not constitute dumping money indiscriminately into the Panamanian economy. In the case of the public sector investment program, the GAO appears to believe that because A.I.D. did not involve itself in selecting the actual projects to be funded, we lost an opportunity to tell the Government of Panama (GOP) that a road project in Colon was a better bet than a bridge in Chiriqui, and that fixing the airport should be left for later while repairing schools in Cocle should be undertaken immediately.

A.I.D. chose to leave these decisions to the Government of Panama because we had analyzed their public sector investment budgeting process closely during program design and had concluded that the Government's stated priorities for public investment in social and productive sectors were sound, and there was an adequate system to set priorities within the budget. The GAO did not include an evaluation of the public sector investment budget process as part of their analysis of the cash transfer. Hence, we question the basis for the GAO assertion that A.I.D. micromanagement would have produced a better program.

See comment 12.

Turning to the banking program, the GAO makes a similar charge--that A.I.D. should have intervened in telling banks which sectors, or even which borrowers to lend to. The GAO (Appendix II, p. 30-34) suggests that our program was less than fully effective because:

> (1) we did not dictate to banks that they extend more credit to microenterprises (which are not traditional clients of the banking sector we were trying to bolster);
>
> (2) we did not allocate specific proportions of loan funds for agriculture and industry (which the GAO analysts themselves note to be the two sectors most affected by bad economic policies); and

(3) by using commercial banks in the program, we precluded that at least some loans would be extended to borrowers whom the banks would judge to be uncreditworthy.

An active A.I.D. role in directing credit to specific borrowers or classes of borrowers runs contrary to the following characteristics of the program. First, the grant was given to the Government, which then deposited the funds with the private banks. The risks of any lending under the program by the banks were fully borne by the banks themselves. Second, the participating banks have staff experienced in loan analysis in the Panamanian context, while the A.I.D. mission does not. Third, the banks as participants in the private economy, are best placed to rapidly determine which sectors and subsectors are thriving, and which are not. Fourth, unlike financial markets in many developing countries, Panama's banking sector operates within a sound and market-oriented public policy framework.

In the circumstances described above, the maximum positive impact of the program is achieved with minimum bureaucratic intervention in the allocation of credit. In other words, A.I.D. designed the program to have maximum impact. Of course we cannot demonstrate that had we executed the program in some unspecified different manner thought to be better by the GAO, economic growth would have been more or less. Our responsibility was to set up the program based on the soundest economic and financial principles--knowledge derived from many years of experience around the world--which we did.

See comment 13.

4. "Further clouding the question of whether the U.S. cash grants "jump started" Panama's economy is the fact that over 60 percent of the assistance was not disbursed until 1992, after the economy was well on its way to being restored to near pre-1987 levels."

This statement presents a distorted picture. The GAO, in making its calculation, has separated out the cash transfers from other assistance provided early on through projects (such as the Immediate Recovery Project). Of the 60 percent of cash transfers not disbursed, about two-thirds ($130 million) represents the U.S. contribution to IFI arrears clearance. While earlier repayment of IFI arrears would have been helpful to the Panamanian economy, it is also true that repayment of IFI arrears is a flow of funds outside of Panama. We did not consider this portion of the funding to be part of a "jump start."

See comment 14.

5. "Estimates by private economists indicate that the unemployment rate dropped from as high as 30 percent at the beginning of 1990 to about 20 percent at the end of 1991. (Panamanian government data show that during this period the unemployment rate declined to 15.7 percent.)"

This statement is cited to show that the economy was well on the way to recovery by 1991, by noting that unemployment had dropped substantially. The data, as presented, are misleading. The 30 percent estimated unemployment refers to the dislocation of labor in the immediate aftermath of Just Cause and subsequent looting of private business establishments. This estimated rate was cut in half over the course of the year.

Private estimates of unemployment in Panama are of uncertain reliability as they are not based on large-scale systematic surveys, as are the government data. The most accurate picture of trends in unemployment are government data, which show that unemployment dropped slightly from 16.3 percent in mid 1989 to 15.7 percent in mid 1991.

A.I.D. Comments on
"PRIVATE SECTOR REACTIVATION"

See comment 15.

6. "AID officials cited [the private sector reactivation program] as a successful policy-based program assistance effort; however, no economic policy reforms were sought or obtained from the Panamanian government in exchange for this assistance."

The negotiation of the private sector reactivation program with the Government of Panama occurred simultaneously with the negotiation of the public sector cash transfer, which was conditioned on policy reform. Due to the need for timely support to the banking sector, it was decided to place all of the economic policy conditionality on the public sector program. This decision is explained in the PAAD for the Private Sector Reactivation Program. While there was linkage to policy conditionality discussions afforded by negotiation of the two cash transfers simultaneously, there was no economic policy conditionality attached specifically to the private sector reactivation program.

7. "We do not doubt that private sector lending increased. . . However, it is important to note that bank deposits were increasing rapidly during this period, and AID documents do not demonstrate that some portion of the new lending AID attributes to its program would not have occurred without the program."

See comment 16.

While bank deposits (most notably, short-term deposits) began to increase in 1990, this does not mean that banks were willing to make medium-term lending necessary for reactivation of private investment. In fact, Panamanian banks base decisions on medium-term lending on expectations about medium term-deposits. This is a reasonable strategy in light of their experience with the U.S. sanctions. When the U.S. applied economic sanctions in the late eighties, the commercial banks' short-term deposit base fled, leaving banks in a financially precarious situation due to their portfolios of longer-term loans.

A program which gave a secure, medium-term deposit base to the banking sector was exactly the appropriate stimulus to encourage medium-term lending. By contrast, increases in short-term deposits in any magnitude would not have provided banks with a secure basis for medium-term lending.

A.I.D. attributes $216 million in new lending to the program. Of this, $108 million represents the new lending directly underwritten by the A.I.D. grant, which was deposited by the GOP into the banking system. This amount would not have been lent to the private sector in the absence of the A.I.D. program, as Panamanian banks had no alternative source of medium-term deposited funds. The other $108 million in lending associated with the A.I.D. program is derived from the matching funds put up by the banking system.

In absence of the A.I.D. program, what would this other $108 million have been used for? In all likelihood, some would have been lent to the private sector in short-term loans, while some may have been invested abroad.

A.I.D. rejects the notion that somehow the program failed because some lending might have taken place in its absence. The purpose of the program was to stimulate more medium-term lending, and this objective was accomplished. Nor was A.I.D. planning remiss because we did not acknowledge and quantify that some medium-term lending would have taken place in absence of our program.

In the context of a badly shattered banking sector, and a reluctance to lend for private investment in Panama, the operating principle behind the Panama program was to generate as much private investment as possible with the money available. The indisputable fact remains - the U.S. funds allocated for the private sector reactivation program contributed directly at least $108 million in additional medium-term lending, and influenced banks to devote up to an additional $108 million of their own funds for the same objective.

8. "The goals of the Private Sector Reactivation Program were to increase lending and generate employment. However, no specific guidelines were established. . . Consequently it has no way of knowing whether the number of jobs it says were created represents success or failure."

See comment 17.

The purpose of the program, as stated in the PAAD, was to "provide immediate liquidity to the economy and to reactivate the banking system to permit an increase in credit to the private sector." There is no reference to a formal target for employment creation. The purpose stated in the program agreement also refers to an increase in lending, and not to employment. Certainly, the reactivation of the private sector was expected to contribute to a reduction in unemployment, but this was not a primary objective.

It is virtually impossible to count the number of jobs created under any cash transfer (or project, for that matter), as to be accurate, you must include both direct and indirect employment impact. This can generally only be done through use of a fairly detailed input-output table or perhaps, in certain cases, through an expensive survey. A very rough estimate might be made by looking at the historical ratio between capital investment and employment, and by making the assumption that this historical relationship prevails at the present time.

Just because employment creation is impossible to measure exactly does not mean that program design should be inattentive to employment creation. Maximization of direct and indirect creation of net new long-term jobs through a program to stimulate private investment depends on allowing those funds to flow to activities with the greatest overall rate of return. The Panama program directed toward the banking sector was designed just this way.

The GAO seems to suggest that USAID/Panama should have measured employment creation from the program via a headcount, and that reliable estimates of job creation should have been posited a priori to serve as guidelines to measure success. We believe that the GAO is incorrect in making this suggestion. An example illustrates our concern.

USAID/Panama attempted to quantify direct and indirect employment impact by asking firms receiving loans how many new employees it hired as a result of receiving the loan. The Mission reports that an estimated 9,500 direct jobs and 14,000 indirect jobs were created, based on information provided by borrowing firms. (The CDIE evaluators, using the proportion of employment to GDP as a rough yardstick, estimate that the program resulted in an increase in employment of 13,000.)

The estimates firms provided should be interpreted with care, as they understate the overall impact resulting from expanded productive capacity in the economy. If program funds facilitated the construction of an apartment complex, the USAID/Panama estimate would mostly include immediate employment in the construction industry. The employment impact of greater interest, however, is that for the useful life of the building, there are now jobs for interior designers, painters, plumbers, furniture manufacturers, light bulb salesmen, etc., that would not have otherwise existed. The loan recipient would have no way of knowing what this impact might be. The USAID/Panama estimate of employment creation provides insight into the positive impacts of the program, but was not offered as evidence that a program objective had been met.

9. "The Panamanian banking system through which this U.S. assistance was channelled, traditionally has served higher income segments of Panama's economy, and not small businesses or agriculture, which provide an estimated 80 percent of employment

in Panama. The Panamanian banks reported that at least some AID funds were lent to large, long-established Panamanian enterprises that, according to bank officials, would have received credit without the AID program."

The objective of the Private Sector Reactivation program was to bolster the financial stability of the Panamanian banking sector that had been severely damaged by U.S. sanctions during the late eighties, and to provide a deposit base that would underwrite a larger level of medium-term lending for investment. It was neither a purpose of the program, nor an unforeseen consequence, to give A.I.D. grant money to rich people, as the GAO appears to imply. The funds were given to the Government of Panama, which deposited them in the commercial banks, for lending at market rates to Panamanian business.

The program expanded the overall availability of credit. If some firms which received credit associated with the A.I.D. program would have gotten loans without the program, then our program freed up that credit for other borrowers.

The program's objective did not include creating lending windows for small businesses and small farmers in commercial banks. Certainly small business and small farmers benefitted from the program indirectly. Small businesses supply goods and services to large businesses, and small farmers grow food that is sold to urban consumers. Lending to the investment projects developed by the private sector with the highest rates of return creates business activity and jobs that produce benefits for other sectors of the economy. While providing credit to small business or agriculture may be a worthy objective of a development activity (e.g., the IDB has in the past been active in agricultural credit in Panama), it was not the objective of the program in question.

Small business and agriculture account for 80 percent of employment in the Panamanian private sector, not in the economy at large.

A.I.D. Comments on
"THE PUBLIC SECTOR PROGRAM"

See comment 18.

10. "AID played a minimal role in maintaining accountability for these funds after their release to Panama, and no role in determining how the Panamanian government used the funds."

The two cash transfer programs implemented by USAID/Panama were designed under the normal A.I.D. review and approval process, and complied completely with existing policy guidance for cash transfers. As provided for in existing policy guidance, accountability for general budget support is not undertaken at the level of individual public sector investment projects. Thus, the report has created a false issue.

When compared to existing guidelines, A.I.D. accountability was not minimal, but in fact went far beyond the normal accountability applied to a cash transfer program. The following elements of accountability were built in the public sector budget support program.

a. A.I.D. reviewed the public sector investment budget planning process, and public sector financial management as part of program design. This process included study of the documents provided by line Ministries to the Ministry of Planning, as investment projects are put into the budget, reviewing the level of analysis undertaken in the design of investment projects, reviewing the flow of funds out of the Government's revolving account into the implementing agencies, and similar issues. During this review, we identified areas of vulnerability, and built appropriate controls into the program.

b. The program itself provided for several levels of control. Disbursements from the U.S. Federal Reserve separate account into the Panamanian Special Priority Investment Fund (SPIF) were subject to concurrent audit by the A.I.D. Regional Inspector General. Program funds were used to contract a private audit firm to follow flows of funds from the SPIF into the line ministries (more on this audit later). In addition, an impact evaluation was provided for as part of the program to look at the effectiveness of public sector investment spending.

The GAO emphasizes that accountability for the A.I.D. funds could not be maintained because they were commingled with Panamanian funds in the SPIF. This assertion sidesteps the fact that we exercised financial controls and audit rights over both the Panamanian and the U.S. funds contained in the SPIF, which represents an extraordinary level of control. The U.S. has rarely taken on the responsibility for the financial integrity not only of its own funds, but also those of the recipient government. Due to the critical nature of this program, we felt this was an appropriate role.

See comment 19.

c. We also reviewed extensive information on Panama's execution of the SPIF portion of the public sector investment program. We received monthly information from the Controller General's Office on such details as number of contracts let, and amounts of funds disbursed by each Ministry, and produced a monthly report of this information. We reviewed published documents that indicated which projects were financed through the SPIF, and followed up with the GOP when we had questions.

As regards A.I.D. involvement in selecting projects, we believed that the GOP had better information than we did about which projects were priority. Our involvement was limited to jointly selecting the priority sectors, and disseminating a negative list of activities for which SPIF funds could not be used. While we were intentionally not involved in selecting specific projects, it is incorrect to categorize our role as "no role."

11. "The funds were commingled with Panamanian funds and funds from other donors, impairing AID's ability to account for U.S. funds. . ."

See comment 20.

The U.S. cash transfer grant helped fund the establishment and operation of an account to finance high priority investment activities (the SPIF). The deposit of funds into the SPIF account constituted the end use of the U.S. grant under the program, and Agency policy on cash transfers does not require that funds be tracked beyond this point. Thus, this is also a false issue.

Going beyond existing cash transfer requirements, the USAID/Panama program provided for monitoring and audit of the SPIF funds, both U.S. and Panamanian. This aspect of program design was reviewed and approved at the time of Agency authorization of the program.

See comment 21.

As a factual correction, the SPIF contained funds from the U.S. grant and from the Government of Panama. While the fund was constituted to receive other donor funding, the delays in restarting other donor activities resulted in no contributions from other donors to date being deposited. The bank account statements for the SPIF showing deposits are part of the program's official files, and were made available to the GAO.

12. "An independent certified public accounting firm reported that Panama's financial controls were weak. The firm reported that it could not complete its audit because records contained discrepancies and the Panamanian government was slow in providing necessary data."

That the Government of Panama's financial controls were weak at the time the program was initiated is a well-known fact. It is clear that public sector financial management under the Noriega regime amounted to little more than officially sanctioned larceny. A.I.D. financed the audit contract with a private accounting firm precisely in order to assure accountability in the period during which the post-Noriega Government of Panama strengthened its system of financial controls.

The above characterization of the audit of the program is misleading. The Government of Panama, using program funds, entered into a host country contract with Price Waterhouse to audit the use of funds under the SPIF. The contract made history because it was the first time a private accounting firm was used to audit the public sector budget.

The auditors reported that public sector financial management of the SPIF was generally sound and honest. The main problem was that some of the Ministries' financial records were not computerized, especially for decentralized programs implemented outside of the capital city. For these programs, the auditors found it difficult to compile the data needed to complete the audit. After an initial period when the various government agencies using SPIF funds became accustomed to the idea of a private audit firm examining their records, most agencies began cooperating with the audit and providing data as quickly as they could. The audit found that financial procedures were being followed, documentation was in order, and contracting processes were competitive and by the rules. Only two cases where money could not be accounted for, both small, have been discovered to date and in both cases the amounts involved were promptly redeposited into the SPIF.

13. "AID officials stated that they did not participate in deciding which projects were financed because this was not important, and their hands-off management approach allowed the Panamanian government to gain experience in setting investment priorities and managing funds. Consequently, AID cannot be sure the funds were used for well-designed projects to address the problem areas identified by the Agency."

See comment 19.

Our support was to the highest priority activities of the GOP public sector investment program. We disagree with the notion that we should have chosen individual activities to support. A public sector investment program typically consists of a multitude of projects, some newly starting, some almost completed. The projects are geographically scattered, under the supervision of numerous agencies, and operate in a variety of sectors.

See comments 1 and 2.

The GAO incorrectly believes that we should have reviewed the list of projects in the investment budget and picked the best for our support. A.I.D.'s approach fully complied with Agency guidance for general budget support. A.I.D. allowed the GOP, which has detailed knowledge of its investment program, to decide which projects were highest priority. We participated by negotiating mutually agreed upon sectors, and by providing a negative list of activities with which our funds should not be associated.

14. "According to AID planning documents, if the Agency participated in deciding how the funds were used, it would then be responsible for ensuring (1) that the funds were used for intended purposes and (2) proper accountability."

See comments 1 and 2.

In the program as designed, USAID/Panama was clearly responsible for ensuring that the funds were used for their intended purposes, and the Mission undertook the necessary steps to ensure accountability.

The issue to which the GAO is referring is the dilemma of applying normal A.I.D. project accountability norms to budget support, when the budget support is given in appropriated dollars rather than in local currency as is the usual case. (This dilemma comes about because Panama uses the dollar as its currency.) USAID/Panama sought legal advice at the time the program was designed, which indicated that if U.S. appropriated dollars were provided directly to specific, identifiable projects of the Government of Panama budget, all of the usual rules (e.g., contracting, personnel, etc.) applied by A.I.D. to its own projects would have to be enforced. At the same time, since the projects are part of the public sector budget, the GOP would have applied its own rules to design, contracting, and so on. Hence, our best advice at the time told us that there was no feasible way to directly finance individual projects of the investment budget.

The approach we chose, to contribute to the SPIF, then apply our norms of cash transfer accountability to all of the SPIF funds--U.S. and Panamanian--was a way to avoid the dilemma caused by Panama's use of the dollar as its currency, while still maintaining adequate financial accountability. The only other feasible approach would have been to design and implement a new set of projects from scratch-- similar to establishing a DA project portfolio-- which would have caused at least a year's delay in execution.

We request that the GAO, if it believes this issue is worthy of mention in its report, might explain the dilemma in full. If the GAO interpretation of the rules that would apply when appropriated dollars are used for budget support differs from A.I.D.'s, then the GAO should explain where it disagrees with our interpretation. Discussing this complicated issue in a vague way leads readers to perhaps erroneously conclude that A.I.D. designed the program the way it did out of laziness. That is simply untrue.

See comment 22.

15. "The implementation of policy reforms was not a condition for the release of the first $30 million."

This statement is incorrect. The design of an acceptable reform program and implementation of some early actions were conditions for the first tranche disbursement.

16. "Many distortions remain in Panama's economy which, according to leading economists in Panama, should have been addressed as part of the overall AID assistance package."

See comment 23.

The Panamanian economy in 1990 represented one of the most distorted policy environments in the region. Strong action was needed to correct policy problems in nearly every sector of the economy.

Action on all fronts would have exceeded the administrative capacity of the Government, as well as the political tolerance of the society. Hence, the construction of the policy program required compromise in narrowing the list of reforms to one that was substantive, yet doable. It is not surprising that any economist involved in the process would see areas where additional reforms were needed, but priorities for action had to be made in order to have a program that could be implemented.

A.I.D. Comments on
"LESSONS LEARNED"

17. "Some economists indicated that AID may have missed opportunities to ensure more efficient use of the private sector reactivation funds when it decided to release these funds before any ... economic policy reforms were adopted. According to economists we spoke with, reforms such as (1) removing wage and price controls, (2) eliminating trade barriers, (3) removing protection from government-sponsored monopolies, and (4) removal of other distortions, were necessary to effectively use the AID assistance."

See comment 24.

The question being asked, but not clearly stated in the GAO report, is whether the impact of private sector investment supported by the A.I.D. program was diminished because the program was initiated prior to the adoption by the GOP of all of its policy reforms. Were there investment activities that might have made financial sense under the old, weak policy framework, but which would be inappropriate given the country's new economic policy direction?

See comment 6.

The answer is no. At the time the first tranche of assistance was released, the GOP had already publicly announced the broad outlines of its economic reform program, including measures in all of the areas listed in the GAO report and cited above. At the same time, it was common knowledge that Panama was seeking agreement on adjustment programs with the World Bank and IDB, to correct economic policy distortions. For this reason, it is certain that any investor would look at the future direction of policy in determining the profitability of a given investment idea.

In fact, the pattern of lending observed under the program was oriented more heavily, especially in the beginning, to sectors exhibiting a relatively less distorted policy environment, as potential investors in sectors expecting more extensive reforms chose to wait and see what the specific reforms would be. Examples of sectors less constrained by policy problems were housing and other construction (where the GOP moved quickly to lower high tariffs on imported inputs) and commerce. So the effectiveness of the private sector reactivation program was not harmed by initiating the program prior to implementation of Panama's economic reform program.

This "lesson learned" offered by the GAO is inconsistent with its suggestion that loans under the private sector reactivation program should have been directed by A.I.D. into agriculture and manufacturing, the sectors with the most distorted policy environments.

18. "A thorough analysis of a country's economy before assistance commitments are solidified would help identify such opportunities and form an analytical basis for assessing whether such reforms are achievable."

See comment 25.

A.I.D. conducted a thorough analysis of the economic policy environment prior to obligating its assistance. In fact, the basis of A.I.D.'s analysis, an extensive series of reports produced with A.I.D.'s funding during the eighties (whose recommendations were not adopted by the Noriega regime), was used by the GOP in developing the outlines of its economic program. After Just Cause, A.I.D. brought numerous economists to Panama to review the state of the economy, and contracted a senior economic advisor to work in the Ministry of Planning on the Government's economic program. A.I.D. coordinated closely with staff of the World Bank and International Monetary Fund, who were also engaged in analyzing the economy.

In the context of a country whose economy faces serious long-term structural policy problems, compounded by the impact of two years of U.S. economic sanctions and an invasion, the level of serious analytical work achieved in the few months following Just Cause was notable.

A.I.D. Comments on
"RECOMMENDATIONS"

See comment 20.

19. "We are restating [the] recommendation [that cash grant funds be maintained in separate accounts, and that AID describe how accountability will be maintained when commingling of cash transfer funds with other foreign exchange cannot be avoided.]"

A.I.D. fully complied with Agency requirements regarding deposit of cash transfer funds into a separate, noncommingled account. The PAADs for the Panama cash transfers provide extensive detail on how accountability would be maintained.

20. "We also recommend that the AID Administrator require that cash transfer agreements contain (1) specific program objectives, (2) time frames or milestones for their accomplishment, and (3) expected impacts to facilitate measuring program success."

See comment 26.

A.I.D. agrees that cash transfer programs should be based on sound analysis and establish evaluation criteria. A.I.D. is working on strengthening its guidance on analysis and evaluation criteria for nonproject assistance. The place for citing evaluation criteria and expected impacts on economies is the PAAD, not the program agreement.

A.I.D. Comments on
"APPENDIX II"

See comment 26.

Page 18: A.I.D.'s assistance to clearance of Panama's IFI arrears was not specifically conditioned on Panama's compliance with IFI policy conditionality relating to income tax, social security and privatization reform laws. This legislation constituted part of the prior actions for the first tranche disbursements of the IDB and World Bank. Since the first tranche disbursements of these two institutions were to be used to repay the Treasury bridge loan, the arrears clearance process could not go forward without them.

See comment 26.

Page 21: A.I.D. had not yet disbursed the final tranche of the Public Sector cash transfer as of November 1992, as the conditionality had not yet been fully met.

Page 22: The recommendations for public sector financial management reform cited by the GAO are areas that cannot be addressed overnight, as they require legislative action, institutional change, and staff training. All of the identified areas of weakness are in the process of being corrected, and to date, much progress has been made with assistance from the Mission's Financial Management Project.

In the interim period while financial management reforms were being implemented, USAID/Panama assured accountability for its funds through audit, tracking and reporting requirements that go well beyond those usually instituted for a cash transfer.

See comment 26.

Page 24: A tracking and audit mechanism was built into the grant agreement.

See comment 27.

Page 24: An impact evaluation is different from an audit, and would not serve the purpose of identifying discrepancies between actual and planned investment spending. An impact evaluation of public sector investment was planned for a point in time when investment activities were sufficiently far along to analyze their impact. Analysis of a half-built bridge would not be very useful in determining impact on the community or economy. We disagree with the GAO opinion that impact evaluations before investment projects were complete might provide useful information to A.I.D. or the Government.

See comment 28.

Page 26: The GAO has confused the two subprograms under the Private Sector Reactivation Program. The subprogram intended to assist the banking sector in case of a run provided temporary liquidity support to qualifying banks. The medium-term lending program was a separate subprogram with different objectives. This is why A.I.D. documents do not analyze why a medium-term lending program would accomplish the objective of avoiding a run on the banks.

See comment 6.

Page 26: Regarding the likelihood of a run on the Panamanian banking system, the "unfreezing" of time deposits was viewed as the action most likely to trigger a run, as a high proportion of these deposits were held by foreign depositors. The earlier "unfreezings" of demand and savings deposits were not believed to be as vulnerable. This explanation is provided in A.I.D. documentation.

See comment 6.

Page 27: The GAO's analysis does not factor in the confidence created within the banking system by the public knowledge that the U.S. planned to finance a bank safety net. It is easy to say two years later that no run occurred, hence the belief that there was a likelihood of a run was misplaced. At the time, however, there was a great deal of nervousness about the shakiness of the banking sector.

The factors cited by the GAO as evidence that a run would not have occurred are not relevant arguments. If a run on the banks had taken place, it would have started with one or two of the weakest banks closing their doors to withdrawals, followed by a domino effect of massive withdrawals on the system. Hence, looking at average or global statistics on the sector does not say much. A.I.D. analysis looked instead at the financial picture of individual banks, and we concluded that there were a handful of nearly insolvent banks, the collapse of which could have resulted in a run.

See comments 1, 2, and 6.

Page 30: A.I.D.'s decision not to dictate which sectors should receive credit, which borrowers should receive loans, and what loans should be used for, was sound, sensible and fully consistent with A.I.D. policy. It recognized that commercial banks, which bore 100 percent of the risk of nonrepayment, were best qualified to make such decisions.

See comment 26.

Page 31: Tracking the funds into the individual loans made by commercial banks would not have been appropriate given the program design. The U.S. grant was given to the Government of Panama, and was deposited in C.D.'s. The C.D. deposits were conditioned on the banks' presentation of a loan portfolio meeting certain criteria. For the purposes of knowing where the funds were, however, they were always invested in the C.D.s owned by the Government.

See comment 26.

Page 32: The U.S. Embassy reported that Panama's economy, not the banking system, had rebounded largely on its own terms. The Embassy reported that total liabilities of the banking system increased by $3.1 billion, but banks generally strengthened foreign liquidity positions at the expense of domestic credit expansion. Firms used mainly their own funds, supplier credit and modest short-term credit lines from foreign banks to rebuild inventories. This is why the Private Sector Reactivation Program proved useful--it boosted banks' capacity for medium-term lending which was lacking during early 1990.

See comment 6.

Page 33: The GAO characterizes the cash transfers as "a monetary stimulus." The GAO further states that "in most environments, a monetary stimulus will have at least short term benefits." The use of the term "monetary stimulus" is misplaced, as is the suggestion that the program as designed is equivalent to an expansion of the money supply that might produce some short-term benefit, but which may not have any long-term impact.

The two cash transfers allowed the private and public sectors to sustain a level of investment that would have been impossible in their absence. The resulting net increase in the capital stock will raise future growth rates over what they would have been for the life of the new capital.

See comment 6.

Page 34: The notion that in the absence of the A.I.D. program, the same loans would still have been made is wrong. Where would the money have come from? There is no reason to believe that Panamanian or foreign savers would have acted differently in absence of our program, so deposits would not have been otherwise bigger. Most of the banks participating in the program were Panamanian, and had no access to foreign sources of credit. Because Panama uses the U.S. dollar as its currency, there is no central bank that can create money for credit. Hence, absent the A.I.D. program, there was no alternative source of medium-term deposited funds that Panamanian banks could have tapped.

See comment 6.

See comment 29.

Page 35: The GAO's opinion that the Private Sector Reactivation Program funds would have been better spent in a microenterprise and small business directed credit program fails to recognize that the chief objective of the program was to help restore health to Panama's banking sector, which had been badly damaged by the political crisis and U.S. sanctions. The question of which type of program would have greater impact on output, employment, and incomes is academic. One comment may be made, however. Establishing and running a small and microbusiness lending program would have expended a great deal of funds in administration and overhead, leading to, all else equal, a lower level of funding available for investment than in the program as designed with the commercial banks.

See comments 1, 2, and 6.

Pages 36-39: It is misleading to cite all of Panama's economic policy weaknesses that prevailed in 1990 and then state that these were not addressed by the conditionality of the Private Sector Reactivation Program. All of these issues have been addressed in Panama's economic program, supported by A.I.D. and the IFI's. Information on Panama's progress in establishing safety net programs to reduce poverty (like the FES), eliminating domestic price controls (there are no wage controls, except the minimum wage), lowering tariffs and eliminating quotas, and privatization was provided to the GAO.

Pages 36-39 and elsewhere: There are many errors in the GAO's description of Panama's economic policy environment, and correcting them all would take a great deal of space. Below are a few of the GAO's incorrect statements.

See comment 30.

o The reason why no public utility commission regulates the rates charged by Panama's public sector monopolies in telecommunications, electric power, water and sewerage is that these utilities are owned and operated by the public sector. Regulatory commissions are used to regulate rates in private utilities, or public autonomous utilities. The GAO is misstating the concern that Panama's privatization efforts be accompanied by establishment of regulatory frameworks.

See comment 31.

o Quotas and specific tariffs will be eliminated under the World Bank program, while tariffs will be reduced to a maximum of 40 percent for industry and 50 percent for agriculture. The first round of these reductions has already taken place.

See comment 26.

o Agriculture has not been exempted from the reform program. The program lowers tariffs on agricultural commodities, eliminates domestic price controls, and nontariff barriers such as quotas.

See comment 26.

o There are no policy distortions in Panama that serve to keep internal prices at a level of 800 percent of world prices. The GAO seems to be making reference to the specific duties that prevailed prior to initiation of Panama's economic reform program that, for a few commodities, resulted in a level of protection whose ad valorem equivalent tariff was as high as 800 percent. The result of these trade barriers was that the products in question were not imported. The domestic prices of these products, while higher than they might have been in an open trade environment, never approached eight times the world price.

The following are GAO's comments on the Agency for International Development's letter dated December 7, 1992.

GAO's Comments

1. Our mandate was to determine whether U.S. assistance funds provided to Panama were effectively used and what lessons could be learned from the U.S. experience in Panama. We did not limit our review to an examination of whether or not AID followed its own policy and guidelines in program design and implementation. This point is important because AID consistently throughout its comments challenges the basis for our observations and conclusions by implying that if it followed its own policy and guidance we should have no questions about the implementation and impact of the program. We did not use AID's policy and guidance as our only criteria. Our review included looking at program design, monitoring techniques, goal setting, and results determination within the context of the economic, political, and social environment existing in Panama at the time the assistance was initially promised and during implementation. We would also note that the AID Inspector General reviewed the agency's compliance with existing laws and regulations on this program and identified a number of problems concerning the adequacy of AID management controls.

2. While differences exist between project management and cash transfer program management, the issue is whether AID provided sufficient attention to how the government of Panama and the Panamanian private sector ultimately used U.S. assistance and whether maximum benefit to Panama was achieved. At issue is whether AID had reasonable levels of control and monitoring capability regardless of the type of assistance being provided. Notwithstanding the distinction between projects and programs, and AID's interpretation of what its control and accountability requirements are, our review and that of the AID Inspector General indicated that AID did not have reasonable assurance as to how U.S. funds were being spent because it did not adequately monitor or account for these funds. The results of two AID Inspector General's reports—one issued in September 1991 and the other in March 1992—call into question AID's contention that it had applied an extraordinary level of control and accountability to the cash transfer programs.

3. Our position throughout the report is that AID could have taken steps to better maximize potential benefits of the assistance without micromanagement. It is generally recognized that a direct causal relationship between assistance and improvements in the growth rate of

the recipient country's economy is difficult to establish. However, determining the impact of this U.S. assistance to Panama was further complicated by the fact that after 22 months, AID had disbursed only 30 percent of the assistance, yet Panama's gross domestic product increased 6.4 percent in 1990 and 9.3 percent in 1991.

AID comments misrepresent the content of our report. For example, we never called for AID to choose individual companies to receive credit under the private sector reactivation program, as AID asserts. We did point out that the private sector reactivation program funds were disbursed before needed reforms were implemented, and without targeting specific areas of need in the Panamanian economy. We also pointed out that AID, in its own documents, recognized the need to target assistance to small businesses, since, according to AID, they provide for 80 percent of private sector employment opportunities in Panama. We also cited AID sources on the difficulties small businesses have in obtaining credit, and the resulting lost potential for growth in Panama.

4. Needed reforms were well documented in AID's own program documents. Most of them were developed with the help of the international financial institutions, and we do not dispute them. We agree that we did not spell out in detail the specific reforms that were considered needed. However, we do discuss the reforms for the various sectors and where AID acknowledged the required reforms were implemented by sector. We do not believe further discussion is needed.

We did not criticize AID for failing to disburse funds more quickly, as AID asserts. Rather, we related the speed of disbursement to the actions by the government of Panama in satisfying AID requirements for reform. The delays were reported as a factor that reduced the potential impact assistance had on jump starting the Panamanian economy.

Further, Panama's unwillingness to promptly accept reforms may be related to how Panama viewed its need for quick infusions of cash. If the government of Panama was not able to take quick action to make legislative changes to satisfy the conditions set for disbursing assistance, then perhaps, as some economists noted, the situation in Panama was not as dire as had been described by U.S. executive branch officials in justifying to Congress the size of the assistance package.

A contrasting situation existed with regard to AID's cash transfer program in Nicaragua. The economic situation there was more severe and the need for cash assistance so great that major economic reforms were effected by the Chamorro government very quickly.

5. We reported that AID maintained funds in separate accounts in the Federal Reserve Bank of New York. However, our concern related to the commingling of U.S. and Panamanian funds in the National Bank of Panama, which precluded accountability for U.S. funds. This action is inconsistent with AID's contention that it imposed extraordinary measures of control and accountability over U.S. funds. AID's point that it followed its procedures while the funds were in the Federal Reserve Bank has no bearing on the fact that once the funds were released in tranches to Panama, AID lost control. The fact that AID procedures do not impose any further accountability for the funds raises considerable question.

6. The evaluation team retained by AID agreed with many of our points in it analysis of the aid program for Panama. For example, the evaluation team agreed with us that the chances for a run on the banking system were minimal. They stated that "The fact that deposits increased—by $230 million in the first half of 1990—before the freeze on time deposits was lifted, was strong evidence that confidence in the banking system had returned and that the unfreezing of deposits in early July would not entail any serious risk of a run on the banks. This judgement was confirmed by a careful study that the Comision Nacional Bancaria (CNB) made in April 1990. It concluded that by that time the banks did have enough liquidity to meet any demands for withdrawals that might occur as time deposits were unfrozen." In addition, the evaluation team pointed out, as we did, that U.S. funds were not available at the time that term deposits were unfrozen. The evaluation team also agreed with us that more flexibility in administering the program would have been helpful. The evaluation team pointed to the importance of the "political success" of the aid program as a reason for disbursing funds quickly but noted that there would be a difference between the recovery induced growth rates and the "sustainable growth path."

The evaluation team also agrees with us that measuring the impact of the private sector reactivation program is difficult. Further, the evaluation team takes issue with AID's claim that the $108-million program stimulated an additional $108 million in lending. They point out that a foreign assistance program can have leverage if it induces the recipient to do what the recipient, in the absence of such assistance, would not. The team stated that this did not occur with the private sector reactivation program. The evaluation team points out that AID's provision requiring private sector reactivation program funds to be used for medium term loans was not supported. They questioned why longer term loans were not allowed to qualify for program funds.

We agree with the evaluation team's warnings against directed credit, but contrary to AID's assertion, our report does not call for directed credit. We point out that many in Panama lacked access to credit and that AID recognized this in its 1991 5-year economic assistance strategy for Panama. This planning document stated that because those in small business have the greatest difficulty in obtaining credit and technical assistance, "their potential to contribute even more toward Panama's economic growth is largely unrealized." This led us to suggest that the private sector reactivation program should have included a provision to make credit more accessible to small business, but this falls far short of advocating that AID direct credit to specific activities or enterprises.

We disagree with some conclusions reached by the evaluation team, and it offered no support for other conclusions. For example, the evaluation team said that conditionality was not necessary for the private sector reactivation program, since "U.S. interests in economic reform were sufficiently safeguarded by the conditionality attached to the use of the portion of aid devoted to public investment." While the team emphasized the leverage effects of conditionality, our point was simply that the long term impact of the aid program would have been larger if the release of the private sector reactivation program funds were disbursed after (rather than before) fundamental reforms were implemented. The evaluation team also endorsed AID's decision to channel assistance through the banking sector and to allow banks to use the money essentially as they saw fit on the basis that to pressure banks to actively pursue other aims in their use of AID money—such as the promotion of small business—would cause "the primary aim of giving a strong push to economic recovery" to suffer. The team's report offered no evidence to support this conclusion.

We encountered a few groups in Panama that addressed both the needs of the small borrower and the legitimate concerns of the lender. For example, many bankers told us that the cost of investigating small loan applications was too high relative to the expected return. One group in Panama, supported in part by a $5-million donation from AID out of an earlier appropriation, performed evaluations of small business loan applications and made lending recommendations to banks. The administrator of the program said that many worthy applicants had been turned away due to a lack of funds. If such a program performs a function that bankers were unwilling to fulfill, it is more likely to survive after the government sponsorship is removed, benefiting both bankers and small borrowers.

The evaluation team cites Panama's relatively high per capita income as a factor that put it "outside the normal scope for high-intensity A.I.D. assistance." We disagree with this judgment for two reasons. First, the income distribution in Panama is among the most highly skewed in the region. Thus, using per-capita income statistics to illustrate Panama's prosperity can be deceiving. Second, with such large amounts of U.S. funds at stake, and with Panama unlikely to receive similar amounts in the future, it was particularly important to ensure that U.S. funds were used in such a way to achieve the greatest benefit.

The points of disagreement between the evaluation team and us result from a different focus adopted by the evaluation team. Our approach to evaluating the aid program was to look at whether U.S. funds were used in the most effective manner possible. In contrast, the report of the AID evaluation team focused primarily on whether AID administered the program as planned. Nevertheless, it reached conclusions that went beyond the scope of the team's work. The team offers little or no support or explanation for some of its broad conclusions, and many of the issues raised in its "statement of work" were not addressed in the text.

7. The inability of economists to accurately establish cause and effect relationships between foreign assistance and economic growth is widely accepted. While AID may choose to characterize the evaluation team's estimate as "a clear and certain assessment," the team's study concludes that the team's estimate will be "at best ... only a very rough one." Also see discussion in GAO comment 6.

8. Our report points out that an interagency process was involved. However, that does not explain why we could find no one to provide some justification for such a large program, or a rationale for the size of the component parts. Contrary to AID's contention, we did not limit our inquiry on this matter to AID program documents. We sought documents and testimonial evidence to support the decision from a wide variety of sources. We were unable to obtain any documentation that provided a clear rationale or justification for the overall size of the program or the size of its component parts.

9. AID is correct that we believe it should have taken a more active role in managing the cash transfer programs—they involved hundreds of millions of U.S. dollars. Because it was to be such a large amount of assistance and AID's program documents and the results of independent audit reports clearly indicated Panama's shortfalls in terms of control and accountability, we believe AID's generally accepted norms of giving the country the funds without further control was not appropriate in this case. Indeed, on page one of its comments, AID characterized Panama's public finance and administration as being in "complete disarray."

10. While AID advised us that it had in fact reviewed the investment needs as provided by the government of Panama and had identified areas of most pressing need and assigned tentative funding levels for each area, such determinations were not included in AID's program documents or grant agreement. Moreover, AID officials told us that AID chose to adopt a hands-off approach in managing this $114-million grant to allow the government of Panama to gain experience in setting investment priories and managing funds.

11. We did not characterize the cash transfer programs as indiscriminately dumping money on the economy, as AID has asserted. However, given the state of the Panamanian public sector at the time, we do not believe AID's approach to allowing the government of Panama to learn how to administer funds through trial and error without U.S. guidance was appropriate. Although AID program documents cite the potential for waste, fraud and abuse that existed, AID officials in Panama told us they did not know what projects were being funded.

AID's assertion that we did not look into the public sector investment budget process as part of our analysis is incorrect. Through our evaluation of the budget process we learned that the government of Panama had advised AID that it would need over 3 times the $114 million AID was proposing for 2 years to meet the infrastructure needs for the first year alone. Within this context, it is clear that Panama wanted to make needed infrastructure improvements that were beyond AID's ability to fund. This fact seems to add to the necessity that AID be involved in helping to prioritize the projects for U.S. funding.

12. There was wide agreement among the many economic and development experts that we interviewed in Panama and the United States that the lesson to be learned from the Panama situation was that the private sector reactivation program would have had a larger long-term

impact if it had been implemented after, rather than before, reforms were implemented. The reason most often given for this conclusion was that in a pre-reform environment the private sector is likely to direct the funds where they generate the highest private rather than social return. They believe that in a post-reform environment, domestic prices more accurately reflect world market conditions and loans granted are more likely to be based on their long-term viability rather than distortions in the domestic market in the country.

AID has misrepresented or overdramatized what our report says. We did not indicate that AID should dictate to banks what loans to make. We did not call for specific funding proportions for specific sectors of the economy. We did not say that AID should insist that loans be given to uncreditworthy borrowers. However, we did point out that early AID planning documents acknowledge that small businesses often have problems getting access to credit. AID's 5-year plan stated that: "Micro and small businesses provide an estimated 80 percent of employment opportunities in Panama. Despite their importance to the economy, these businesses have the greatest difficulty in obtaining credit and technical assistance. For this reason, their potential to contribute even more toward Panama's economic growth is largely unrealized." We also reported that AID appeared to recognize the need for change when, in February 1991, it modified the grant agreement to encourage lending to small businesses. However, only one loan resulted from this change; a strong indication that the established banking sector was not the best means to channel funds to these enterprises.

There are many reasons why it is difficult for some businesses to get loans in Panama. Some of the reasons are entirely justifiable; some are not. The solution is not to mandate that banks lend a specific proportion of their loans to those in certain sectors. However, ignoring the problems of all those who are denied credit is not the preferred solution either. If those in small business are having trouble getting loans, then perhaps the solution is a program that attempts to alleviate the main causes of their inability to secure funds.

AID mistakenly claims that Panama's banking sector operated within a sound and market-oriented public policy framework. We found that the many policy distortions in place caused much of the Panamanian economy to be far from market oriented. Indeed, the reforms sponsored by AID and the international financial institutions were designed to remedy many of these market distortions. If the Panamanian economy was sound at the time of the AID program, there would have been no need for such reforms.

We question AID's assertion that the maximum positive impact of the program was achieved with minimum bureaucratic intervention in the allocation of credit. At the time of the disbursal of the private sector reactivation program funds, the income distribution in Panama was highly skewed and has remained that way. The many distortions in the economy kept away needed foreign investment, and even after the program funds were disbursed, the unemployment rate in Panama dropped only modestly. This draws into serious question whether the private sector in Panama was best equipped to solve the economic and political problems of the country when the incentive was simply to maximize profits.

13. We were charged with evaluating the effectiveness of the cash transfer assistance, not the effectiveness of previously provided assistance. AID asserts that it did not consider funding for clearing arrears with the international financial institutions as part of U.S. efforts to jump start the economy. This assertion is not consistent with how the executive branch justified this program to the Congress, and it ignores the fact that such funding would allow Panama to more rapidly be eligible for new loans from the international community.

14. Regarding the unemployment controversy, we used the unemployment numbers that AID used in its documents. However, we acknowledged in the draft report that these figures were unofficial and not necessarily reliable. We believe that AID's point is well taken and we have deleted this statement from the report to avoid misleading conclusions.

15. AID's position that conditionality for the private sector funds was ruled out by the need for "timely support of the banking sector" lacks substance. Funds could have been made available in the unlikely event of a bank panic, while the use of such funds for medium-term lending was withheld until the reforms were passed.

16. It is difficult to determine how much of the increased lending can be attributed to the program that would not have occurred without it, or whether the economic impact of the increased medium-term lending had a major effect on economic recovery. However, the evaluation team retained by AID disagreed with AID's claim that the $108-million private sector reactivation program resulted in a $216-million increase in investment.

They claimed the impact was an increase in investment of $108 million, not $216 million.

While the type of maturity matching described in AID's comments is often sought, bankers in Panama told us that the more common practice in Panama was to continually roll over short-term deposits. That is, while many of the deposits in Panama are short-term, depositors often redeposit them as they mature.

We were advised by bank officials that the creditworthy customers who borrowed funds from this program probably would have gotten loans anyway, but the terms would have been shorter and the rates a bit higher. In fact, we did not see evidence that many of the beneficiary banks were even advertising a rate for medium term deposits. Additionally, while maturity matching is a responsible way to guard against interest rate risk, AID's defense of the program based on this concept is flawed. The certificates of deposit used to secure U.S. funds with the banks were on deposit for 5 years, yet because the funds were repaid in quarterly installments, the average maturity of each certificate was only 2.5 years. If the maturity matching principle had been followed, no loan would have been made that was longer than 2.5 years. Yet, over 25 percent of the loans were for mortgages whose average maturity was 10 years.

17. We agree that measuring the impact of the program is difficult, but we find it somewhat puzzling that AID reported job creation estimates as a measure of the program's success while at the same time saying the purpose of the program was to increase lending, not to increase employment. Our point is that if AID wants to use increased employment as a performance indicator now, it should have established some job related goals, criteria and benchmarks to judge the effectiveness of the program. Furthermore, despite AID's assertion that employment generation was not a stated goal in its program authorization document, the fact remains that the program was justified to the Congress on that basis.

18. AID's statements have been disproven by several sources. AID's Inspector General pointed out the problems in terms of control and accountability. AID mission officials acknowledged that they did not know what the funds were being used for, and AID officials told us they never intended to closely follow how U.S. funds were spent. Despite this, AID now asserts that it exercised an extraordinary level of control over funds and had audit rights over both the Panamanian funds and U.S. funds in the Special Priority Investment Fund account. Nonetheless, AID's controller in

Panama could not match information provided by the government of Panama with that of the independent auditor. AID's Inspector General criticized AID for its inability to monitor and account for U.S. funds. Furthermore, the completion of an audit after the fact does not seem to us to be the best way to guarantee that the U.S. funded programs are designed for maximum effectiveness and efficiency.

19. AID comments are internally inconsistent. Here AID asserts involvement in selecting priority sectors and disseminating a list of activities that funds could not be used for. However, elsewhere AID asserts that its policy does not call for funds to be tracked beyond the transfer to Panama. Further, the "negative list" referred to by AID is largely a boilerplate statement normally contained in grant agreements which includes such things as prohibitions on funding abortions. Despite AID's comments on this report, AID officials in Panama told us that they did not know specifically what projects were being funded through this account at the time initial funding occurred.

20. We do not criticize AID for violating its regulations or policy, but rather question whether AID's responsibility to control and account for U.S. funds should be limited to existing policy. That is, AID should be sufficiently flexible to implement extra controls when circumstance suggest this might be necessary, even if its policy does not require it to do so. Also see GAO comment 1.

21. Reference to other donors deleted.

22. There was no requirement for actual implementation of any economic policy reforms prior to disbursement. All the government of Panama had to do in this regard was submit letters of intent or plans relating to how it intended to deal with policy reform.

23. We asked for, but AID officials in Washington and Panama did not provide, documentation to show how the policy reform requirements were decided or prioritized. We are unaware that such data exists. In addition, they provided no indication of what compromises were made in deciding reforms were considered doable.

24. AID has repeatedly stressed the importance of the reforms for economic growth. Therefore, it would logically follow that the potential for achieving a higher rate of growth over time is higher when the reforms are implemented than when they are not. AID agreed that Panama must

diversify its economy by eliminating protectionist trade policies in order to achieve a higher rate of sustained growth. The potential for the program to reach important sectors of the economy, like manufacturing and agriculture, was hampered by the distortions. We believe that the entire set of sectors should be viewed as a whole rather than as one sector versus another. The fact that resources flow to less distorted sectors of an economy does not imply that the resources would not have a higher value in another sector in an undistorted economy.

25. AID had not had a presence in Panama since 1987. According to AID mission personnel, the AID mission director, the project officer, and two AID economists—not numerous economists—designed the program. They acknowledged that not all relevant bureaus and offices within AID were consulted during program development. This was corroborated by an official of AID's Bureau of Private Enterprise who stated that the Bureau had not been consulted on the private sector reactivation project even though they had a level of expertise in that area.

26. The report has been modified to incorporate this comment.

27. AID's use of the analogy of the evaluation of the impact of a half built bridge is contradictory to its prior comments that cash transfers are not projects. AID's decision to defer any evaluation of the program's impact until after most of the money had been spent precludes a basis for mid-course corrections or adjustments that could enhance results.

28. We realize there were two subprograms in the private sector reactivation program; our concern remains that AID had no analytical justification for the size or design of either component.

29. Simply stating that establishing and running a small business lending program leads to more administrative costs and overhead is not a sufficient basis for concluding that such a program should be ignored. Even if the administrative and overhead costs are higher when a small business lending program is in place (although AID did not present data showing this was the case), a proper analysis of the alternative lending programs would have to consider the differential benefits offered by each program. For example, it may be that small business lending programs reach a different clientele than a program like the Private Sector Reactivation Program. The benefits of serving the different clientele would then have to be compared with the cost of providing the service. Minimizing overhead and administrative costs, without considering other

development goals, does not seem to be a sufficient basis for such a policy determination. We believe AID should have reasonable assurances that U.S. funds were being properly spent. Reasonable means that the costs would not be dispositionately high compared to the potential benefits.

30. We have modified the report to reflect AID's comments on public sector ownership of utilities in Panama. However, electricity costs are extremely high in Panama relative to neighboring countries, and according to economists we spoke with, are a significant factor in keeping out needed foreign investment. Furthermore, the burden of high utility cost often weighs more heavily on the poor that the rest of the population. It is common elsewhere in the world to establish regulatory commissions when a public utility is privatized. This is because public utilities are often natural monopolies. If utilities are to be privatized in Panama, the establishment of public utility commissions should be considered as an important part of the privatization process to ensure that the benefits accrue to the consumers.

31. Although many quotas and tariffs were to be eliminated as part of the reform process, those quotas and tariffs were in place during the time that the private sector reactivation program was initiated.

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