STOCK MARKETS AND DEVELOPMENT: A CASE STUDY OF PANAMA

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presented by

Nicholas John De Grazia

has been accepted towards fulfillment
of the requirements for

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Milton Taylor
Major professor

Date Oct. 25, 1974.

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ABSTRACT

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By

Nicholas John DeGrazia

This dissertation tests the hypothesis that Panama should adopt an organized stock market at its present stage of economic development because: (1) there is a need for equity-financed capital on the part of Panamanian business firms; (2) there are many financial institutions willing and able to act as financial intermediaries; (3) there is an ever-increasing supply of savings that can be expected to flow into business firms through the sale of stock; and (4) a stock market will promote economic development by increasing the capacity to produce goods and services.

A model is presented which assumes that the demand for and supply of equity-financed capital is dependent upon factors internal and external to the business firm. The external factors that affect both the demand and supply side include the types of existing financial institutions, the structure of existing capital markets and the regulatory framework in Panama. The external factors that affect the

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Data on the external and internal factors were collected while the author resided in Panama for seven months within the period 1971-1973. The data include (1) an analysis of the financial statements from 255 companies doing business in Panama between 1969 and 1971; (2) the results of fifty questionnaires used to determine the sources and uses of capital funds; and (3) a discussion of banking laws, tax laws, laws of incorporation and laws governing the sale of securities in Panama.

The dissertation concludes that Panama should not establish a stock market at its present stage of economic development for a number of reasons. First, the business sector in Panama is characterized by a relatively large number of commercial and service-oriented enterprises. These firms need capital funds primarily to finance inventories and accounts receivable. Such capital requirements are unpredictable, occur frequently and tend to be better satisfied by a source of short-term capital funds such as

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an overdraft mechanism. Although the companies surveyed were able to raise funds through the sale of stock, they chose not to do so.

Second, although there are many financial institutions in Panama capable of buying corporate securities, they are generally unwilling to do so. Banks operate in Panama because it is relatively profitable to undertake business there. Liberal tax laws, the U.S. dollar standard, and the absence of exchange controls and a central bank are conducive to profitable banking activity. Third, although the level of savings in Panama is growing rapidly in terms of bank deposits, most of the deposits are from foreign sources. The largest proportion of domestic savings is derived from corporations in Panama, not from individual households. Fourth, stock markets cannot be expected to promote economic development in Panama. Such markets may not appreciably affect the problems of poverty, unemployment or the distribution of income in a positive way.

Stock markets could stimulate economic growth by providing long-term capital for investments if there existed a strong demand for equity-financed capital or if the process of industrialization was well established. The data presented indicate, however, that neither condition exists in Panama at the present time.

STOCK MARKETS AND DEVELOPMENT: A

CASE STUDY OF PANAMA

By

Nicholas John DeGrazia

A DISSERTATION

Submitted to
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in partial fulfillment of the requirements
for the degree of

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Department of Economics

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INTRODUCTION

This dissertation presents an analysis of the role of an organized stock market in the economic and financial development of the Republic of Panama.[1] The purpose of the dissertation is to determine if the establishment of an organized stock market could enhance the economic and financial development of Panama. The hypothesis to be tested is that Panama should adopt an organized stock market at its present stage of economic development because: (1) there is a need for equity-financed capital on the part of Panamanian business firms; (2) there are many financial institutions willing and able to act as financial intermediaries; (3) there is an ever-increasing supply of savings that can be expected to flow into business firms through the sale of stock; and (4) a stock market will promote economic development by increasing the capacity to produce goods and services.[2]

To test this hypothesis, a number of related issues will be discussed. Chapter I presents the theoretical foundation upon which the analysis is based. This consists of an identification of the processes by which business firms finance their capital expenditures as stated in the Gurley and Shaw theory of finance.[3] This theory places emphasis upon the role of financial institutions, such as commercial banks, in the financing of capital expenditures. In contrast to the Gurley-Shaw theory, this dissertation emphasizes the role of an organized stock market in the financing of capital expenditures and how this can affect economic and financial development. A model is presented which assumes that the need for a stock market is dependent upon the demand for and supply of equity-financed capital. The model also assumes that the demand for and supply of equity-financed capital is dependent upon factors internal and external to the business firm.

Chapter II describes the economic and political characteristics of the Republic of Panama. Since change does not occur in a vacuum, a description of the economic and political characteristics of the economy is necessary. In a socialistic environment, for example, a stock market is not a feasible method of raising long-term capital funds because the private ownership and exchange of financial assets does not exist.

In Chapter III, the external factors that affect the demand for and supply of equity-financed capital are analyzed. The external factors that affect both the demand and supply side include the types of existing financial institutions, the structure of existing capital markets, and the regulatory framework in Panama. The external factors that affect the supply side include the volume of savings, the pro

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The internal factors that affect the demand for and supply of equity-financed capital are analyzed in Chapter IV. Internal factors that primarily affect the demand side are the types of business firms in the economy and their capital needs. The only internal factor that affects both the demand and supply side is the financial position of the business firms.

Chapter V discusses organized stock markets in other Latin American countries and how they relate to the process of economic growth.

Chapter VI presents the conclusions of the dissertation. It will be shown that Panama should not adopt an organized stock market because: (1) a need for equity-financed capital by Panamanian business firms does not exist; (2) financial institutions such as commercial banks are generally unwilling to purchase the common or preferred stock of local businesses; (3) it is unlikely that a significant supply of savings will flow into an organized stock market; and (4) an organized stock market will not enhance the economic development of Panama.

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FOOTNOTES--INTRODUCTION

[1]Economic development can be defined as economic growth which is accompanied by a more equal distribution of income, a reduction in poverty, and/or a reduction in unemployment. For a discussion of the distinction between economic growth and economic development, see Dudley Seers, "What Are We Trying To Measure," The Journal of Development Studies, Special Issue on Development Indicators, VIII, No. 3 (1972), p. 21. Financial development can be defined as an expansion of the number and types of financial institutions and financial assets in an economy.

[2]Equity-financed capital funds refer to funds obtained through the sale of common or preferred stock such that the stockholder owns a share of the business.

[3]John G. Gurley and Edward S. Shaw, Money in a Theory of Finance (Washington, D.C.: Brookings Institution, 1960).

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CHAPTER I

FINANCE AND THE ROLE OF CAPITAL MARKETS IN ECONOMIC DEVELOPMENT

The Gurley and Shaw Theory of Finance

John G. Gurley and Edward S. Shaw developed a theory of finance that examined the saving-investment process and methods by which investments are financed in a developing economy.[1] According to the Gurley-Shaw model, business firms can finance their investments or capital expenditures through three processes: self-finance, direct finance, and indirect finance.[2] Under self-finance, firms finance their investments out of retained earnings and depreciation, that is, out of corporate savings.

Under the direct finance process, deficit spending units borrow capital funds directly from surplus spending units. A deficit spending unit is a business enterprise whose demand for spendable funds exceeds its savings from income, thus the enterprise demands loanable funds. A surplus spending unit is an individual saver whose income exceeds his expenditures, thus the saver supplies loanable funds. In the process of direct finance, the deficit spending unit issues a primary security to a surplus spending unit in exchange

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exchange for cash. These primary securities include all debt and stock issues of deficit spending units such as common or preferred stock, bonds, mortgages, promissory notes and debentures. The surplus spending unit holds the primary security in anticipation of a rate of return while the deficit spending unit uses the cash to purchase assets or to reduce liabilities.

Under the indirect finance process, a deficit spending unit borrows from a monetary or non-monetary financial institution which, in turn, issues indirect financial assets to surplus spending units. Financial institutions of this type include commercial banks, savings and loan associations, mutual funds, life insurance companies, credit unions, finance companies and investment banks. These financial institutions accept money from surplus spending units and issue indirect financial assets which include savings accounts, mutual fund shares and other equities. Thus, under indirect financing, the surplus spending unit acquires a claim on the financial institution rather than, as in the case of direct financing, on the deficit spending unit.

The Need For Capital Markets

As the capital requirements of a firm go beyond the limits of self-finance, the need for capital markets arises. Capital markets--or securities markets as they are usually referred to--can be defined as those places where buyers

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and sellers of primary securities negotiate financial transactions. Such markets provide the mechanism by which primary securities can be exchanged for money. Thus, capital markets provide the business firm with another source of capital funds. The business firm can raise these funds by issuing capital stock or debt, either directly or indirectly to surplus spending units.

It should be noted, however, that the existence of a securities market does not imply the existence of a corporate stock market. A corporate stock market is a specific form of securities market where only shares of common or preferred stock are purchased or traded. By definition, a securities market exists at the moment a business firm acquires capital funds, either directly or indirectly, from surplus spending units. Such funds, however, may not be derived from the sale of common or preferred stock. In effect, all corporate stock markets are securities markets, but not all securities markets include a corporate stock market.

As security markets are developed in a growing economy to supply the capital requirements of business firms, corporate stock markets may or may not be established. According to the Gurley and Shaw theory, the decision to establish a corporate stock market is dependent upon the type of financial institutions already functioning in the economy as well as on the existing demand to increase

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various types of primary securities. If financial institutions are willing and able to act as financial intermediaries in the indirect financing process or as final purchasers of primary securities in the direct financing process, then the establishment of a stock market may be feasible and practical.[3] If the demand for capital funds has surpassed that amount provided by existing primary securities, the creation of a stock market may, theoretically, serve a number of useful functions.

Theoretical Functions of a Corporate Stock Market

Gurley and Shaw maintain that all securities markets have a distributive and allocative function. The distributive function is to disseminate information to savers and investors. The markets telegraph information to investors regarding the asset preferences of savers and make known the primary security issues of investors to savers. The allocative function is to increase the quantity of capital funds available to businesses which seek tangible assets by channeling money from savers to investors. In the long run, these markets provide flexibility in the financing of capital needs and permit a more intensive mobilization of domestic savings than may be provided by financial institutions alone.

Stock markets, as securities markets, can perform an allocative and distributive function if there is an appropri

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appropriate supply of and demand for equity-financed capital funds. Savers must be willing and able to divert their savings into shares of common or preferred stock, and investors must be willing and able to acquire capital funds through the sale of such stock. If such a willingness exists on the part of both savers and investors, stock markets can be expected to: (1) increase the supply of capital funds available to businesses for the acquisition of productive assets such as new equipment; (2) direct the flow of new savings, domestic and foreign, toward businesses with a productive use for the funds; (3) effectively increase the working capital of business enterprises; (4) generate a competitive rate of return on the shares purchased; (5) provide liquidity for the shares of stock exchanged amongst savers.

According to the Gurley and Shaw theory, if the need for capital funds goes beyond the limits of the self-finance process and securities markets do not arise, the economy may stagnate. In a stagnant economy, the production or importation of capital goods, such as machinery, is needed only to replenish the stock of capital as it wears out. Under such circumstances, depreciation allowances and retained earnings will provide the necessary capital funds. In a developing economy, however, positive net capital formation must occur such that net additions are made to the stock of capital. Direct and indirect financing through securities markets

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Restatement of the Gurley and Shaw Theory of Finance

In contrast to the Gurley and Shaw theory, the demand for an organized stock market may be dependent upon factors other than the existing or planned financial institutions in the economy. This dissertation proposes a model whereby the decision to establish a stock market within a developing economy is dependent upon the demand for equity-financed capital by business firms, the demand for an alternative form of savings by surplus spending units, and the available supply of equity-financed capital. The demand for equity-financed capital refers to the demand for capital funds derived exclusively from the sale of stock. The available supply of equity-financed capital refers to savings that can be expected to flow into an organized, corporate stock market.

It is further proposed that the demand for and supply of equity-financed capital is dependent upon factors which are internal and external to the business firm. The external factors that affect both the demand for and supply of equity-financed capital are the types of existing financial institutions, the structure of existing capital markets, and the regulatory framework. The external factors that only affect the supply of equity-financed capital are the volume of savings, the propensity to save, and the rates of return on alternative forms of savings.

The rationale for including the proposed external factors in the model can be given in terms of the financial community's ability to meet the capital requirements of the business community. If there is a sufficient number of financial institutions--such as commercial banks and savings and loan associations--that are able to meet the capital requirements of the business community with loans or other debt instruments, there would be no need for equity-financed capital. If the processes of indirect and direct financing through existing capital markets are meeting the capital needs of businesses, there would be no need for a corporate stock market. Likewise, if no regulatory framework exists to protect the rights of stockholders, the ability to raise funds through the sale of stock will be limited.

The volume of savings, the propensity to save, and the rate of return on savings affect the supply of equity-financed capital for a number of reasons. If the volume of savings and/or the propensity to save is low for the economy, all forms of direct and indirect financing techniques will be ineffective in satisfying the demand for capital. Such a situation would hinder the successful operations of a stock market since savings would not be available for the purchase of stock. Likewise, if savers are receiving rates of return on savings deposits or foreign securities that are greater than the current or expected rate of return on domestic shares of stock, it is unlikely that they will be willing to buy the domestic shares.

The internal factors that primarily affect the demand for equity-financed capital are the types of business firms in the economy and their capital needs. The only internal factor that affects the demand for and supply of equity-financed capital is the financial status of the business firm.

The rationale for including the proposed internal factors can be given in terms of the profitability of buying or selling corporate stock. If the business firm is not excessively leveraged, it may be more profitable to acquire more capital debt than to issue corporate stock.[4] If the nature of the business firm's operations requires a short-term, frequently occurring demand for capital funds, the sale of common or preferred shares of stock may not be the most expeditious solution. Corporate stock issues generally require several months of preparation due to legal requirements.

The analysis of the internal and external factors will proceed under three assumptions. First, the saving-investment process is assumed to be present to the extent that there are clearly defined savers and investors in the economy. Second, a business community exists with a demand for capital funds that goes beyond the limits of self-financing techniques. Third, the economy is growing as measured by a rising gross domestic product in real terms. Each of these assumptions will be considered in Chapter II.

FOOTNOTES--CHAPTER I

[1]John G. Gurley and Edward S. Shaw, "Financial Aspects of Economic Development," American Economic Review, XLV (September, 1965).

[2]Ibid., p. 518.

[3]John G. Gurley and Edward S. Shaw, Money In A Theory of Finance (Washington, D.C.: Brookings Institutions, 1960), p. 123.

[4]An excessively leveraged firm would have too much outstanding debt relative to its equity. The equity of the firm includes retained earnings and the value of outstanding shares of stock, if any. A discussion of the profitability of acquiring debt versus a stock issue will be presented in Chapter IV.

CHAPTER II

ECONOMIC AND POLITICAL CHARACTERISTICS OF PANAMA

Introduction

The role of a stock market in a developing country is largely dependent upon the country's stage of economic and financial development. In a barter economy, for example, or in an economy with little savings, a market designed to transfer funds among savers and investors would serve no useful function. If there is a growing money economy, however, and the saving-investment process has been established, a stock market may further economic development for reasons presented in Chapter I. Thus, before the factors that affect the demand for a stock market are analyzed, the stage of economic and financial development in Panama should be considered.

This Chapter discusses the major economic and political characteristics of the Republic of Panama in order to determine its stage of economic and financial development. Emphasis is placed upon those characteristics that are: (1) necessary for the testing of the hypothesis as stated in the Introduction; and (2) representative of the economic strengths and problems in Panama.

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Economic Growth and Inflation

The gross domestic product of the Republic of Panama (in constant 1960 balboas) increased at an average annual rate of 7.9 percent between 1960 and 1971.[1] As indicated in Table 2.1, this growth rate is greater than the average annual rate for 18 Latin American republics and the average annual rate for the Central American Economic Community Countries for the same period by approximately 2.5 percent.

The economic growth in Panama is primarily traceable to increases in investment by the public and private sectors. In the periods 1960-65 and 1965-70, private investment increased at rates of 9.8 percent and 15.3 percent respectively while public investment increased at rates of 14.8 percent and 21.0 percent.[2] Total investment as a percentage of GDP increased from 16.3 percent in 1965 to 27.1 percent in 1970. Most of this investment by the public and private sectors has been in urban infrastructure and in new residential and non-residential construction. Investments of the private sector, as indicated in the data of Table 2.2, accounted for 76.4 percent of the increase in gross fixed capital formation during the period 1960-71. Of the total increase in gross fixed capital formation during this period, 58.8 percent was due to various types of construction and 41.2 percent was due to the purchase of capital goods. The private sectors contributions to this increase was somewhat evenly divided between construction (38.4 percent) and capital goods (37.9 percent).

TABLE 2.1.--Average Annual Growth Rates of GNP of 18 Latin American Countries, 1960-1971.

	GNP Growth Rate (%)	Per Capita GNP Growth Rate (%)	Per Capita GNP 1971 (US $)
Total			
18 Republics[1]	5.6	2.6	530
CAEC[2]	5.5	2.2	355
Argentina	4.0	2.5	1,068
Bolovia	5.1	2.7	203
Brazil	6.5	3.5	394
Chile	4.8	2.7	854
Colombia	5.1	1.9	320
Costa Rica	6.3	2.9	539
Dominican Republic	3.8	1.0	356
Ecuador	5.2	1.7	267
El Salvador	5.5	2.0	294
Guatemala	5.2	2.1	354
Honduras	4.3	0.9	255
Mexico	6.8	3.3	670
Nicaragua	6.4	3.2	440
Panama	7.9	4.8	739
Paraguay	4.5	1.4	246
Peru	5.0	1.9	446
Uraguay	1.4	0.1	833
Venezuela	5.9	2.3	931

[1]Excludes Haiti.

[2]Central American Economic Community Countries (CAEC).

Sources: Latin American Economic Growth Trends prepared by the Office of Statistics and Reports, Bureau for Program and Policy Coordination--June, 1972. Gross National Product: Growth Rates and Trend Data by Region and Country, Office of Statistics and Reports, Bureau for Program and Policy Coordination, May 10, 1972.

TABLE 2.2.--Sectoral Distribution of Gross Fixed Capital Formation. (Millions of 1960 Balboas)

	1960	1965	1970	1971	% of the Increase 1960-1971 Occurring in this Sector	
Total	61.4	97.1	221.9	254.7		
Public	12.0	21.7	59.0	57.7		23.6
Private	49.4	75.4	162.9	197.0		76.4
1. Construction	38.9	51.3	112.5	152.6	58.8	
Public	11.0	20.2	39.8	50.4		20.4
Private	27.9	31.1	72.7	102.2		38.4
Residential	14.9	20.2	46.4	59.5	23.1	
Public	1.6	2.1	4.9	7.8		3.2
Private	13.3	18.1	41.5	51.7		19.9
Non-Residential Building	17.7	18.2	39.3	61.5	22.7	
Public	3.5	5.7	9.3	12.6		4.7
Private	14.2	12.5	30.0	48.9		18.0
Other Construction	6.3	12.9	26.8	31.6	13.0	
Public	5.9	12.4	25.6	30.0		12.5
Private	0.4	0.5	1.2	1.6		0.6
2. Capital Goods	22.5	45.8	109.4	102.1	41.2	
Public	1.0	1.5	19.2	7.3		3.3
Private	21.5	44.3	90.2	94.8		37.9
Transport & Communications	8.8	15.3	45.7	39.3	15.8	
Public	0.1	0.3	4.3	1.5		0.7
Private	8.7	15.0	41.4	37.8		15.1
Machinery, etc.	13.7	30.5	63.7	62.8	25.4	
Public	0.9	1.2	14.9	5.8		2.5
Private	12.8	29.3	48.8	57.0		22.9

Sources: Dirección de Estadística y Censos, *Ingreso Nacional, 1960-1968*, pp. 42 and 43; *Información Estadística para la Conferencia Anual de la Asociación Panameña de Ejecutivos de Empresas, CADE-1973*, p. 20.

During the period 1960-72, the gross domestic product increased from B/415.8 million to B/1.04 billion (in 1960 balboas) or an increase of 151 percent. Three economic sectors accounted for almost one-half of this increase. The manufacturing sector accounted for 19.5 percent, wholesale and retail trade for 14.5 percent, and agriculture for 13.1 percent.[3] For the same period, the average annual growth rates for these sectors were 10.3 percent, 8.2 percent and 5.3 percent respectively.

Between 1968 and 1972, however, other sectors began to account for more than one-half of the growth in gross domestic product. Construction, finance and insurance, public utilities, and transportation and communication sectors showed the highest average annual growth rates during this period. The finance and insurance sector, for example, grew at an average annual rate of 20.7 percent between 1968 and 1972 while the public utilities sector grew at an average annual rate of 16.1 percent. The manufacturing sector, however, showed an average annual growth rate of 6.7 percent during the same period. Prior to 1972, these relatively high growth rates occurred in the absence of inflation. As indicated in Table 2.3, the consumer price index increased slowly between 1967 and 1972, with the exception of 1970. In 1972, however, the consumer price index increased by 5.5 percent to an index value of 120.2. In the same year,

TABLE 2.3.--Price Indices, 1967-1972.

Consumers' Price Index[a]	1967	1968	1969	1970	1971	1972 1st Qtr.	1972 2nd Qtr.	1972 3rd Qtr.	1972 4th Qtr.	Total 1972
(1962=100)										
All items	104.0	106.7	108.6	111.9	113.9	117.1	120.3	121.3	122.1	120.2
		(1.6)	(1.8)	(3.0)	(1.8)	(2.4)	(2.7)	(0.8)	(0.7)	(5.5)
Food & Beverages	107.2	110.5	112.8	116.1	118.9	121.2	125.1	126.3	125.1	124.4
		(3.1)	(2.1)	(2.9)	(2.4)	(1.2)	(3.2)	(1.0)	(-1.0)	(4.6)
Housing	104.0	105.1	106.0	105.9	107.8	109.3	112.4	113.1	113.5	112.1
		(1.1)	(0.9)	(-0.1)	(1.8)	(0.6)	(2.8)	(0.6)	(0.4)	(0.4)
Miscellaneous	103.6	103.9	106.6	113.2	114.2	119.6	123.3	123.8	127.8	123.6
		(0.3)	(2.6)	(6.2)	(0.9)	(5.2)	(3.1)	(0.4)	(3.2)	(8.2)
(1961=100)										
All items	105.2	107.0	108.7	112.0	118.0	126.2	128.4	128.9	129.0	128.1
		(1.7)	(1.6)	(3.0)	(5.4)	(4.0)	(1.7)	(0.4)	(0.1)	(8.6)
Imports	106.7	108.2	110.2	115.3	121.6	128.8	129.3	130.0	131.0	129.8
		(1.4)	(1.8)	(4.6)	(5.5)	(2.9)	(0.4)	(0.5)	(0.8)	(6.7)
Industrial	102.4	103.8	105.1	106.9	112.9	124.0	127.3	127.9	126.1	126.3
		(1.4)	(1.3)	(1.7)	(5.6)	(6.5)	(2.7)	(0.5)	(-1.4)	(11.9)
Agricultural	109.4	113.7	115.2	119.2	124.2	126.1	129.6	129.5	132.8	129.5
		(3.9)	(1.3)	(3.5)	(4.2)	(0.1)	(2.8)	(-0.1)	(2.5)	(4.3)

[a]Low and medium income families in Panama City.

Source: Dirección de Estadística y Censo, Estadística Panameña, Serie G, 1973.

the wholesale price index increased by 8.6 percent to an index value of 128.1.

The adequacy of the consumer price index as a measure of price changes throughout the country may be questioned. The index only measures price changes on goods and services consumed by low and medium income families living in Panama City. According to the 1970 census, approximately 387,000 people lived in Panama City or roughly 27 percent of the population. Thus, the index reflects the price changes of those goods and services consumed by less than 27 percent of the population.

While it is difficult to quantify their impact, several factors exogenous and endogenous to the Panamanian economy contributed to the price movements between 1967 and 1972. Among the endogenous factors were the introduction of new indirect taxes and a new labor code. The price index for transportation rose by 15 percent during the first half of 1972 due to the increase in gasoline taxes, and the alcoholic beverage index rose by 10.9 percent because of the higher production taxes and import duties. The new labor code established in 1970 increased labor costs by raising the minimum wage and designating a compulsory "13th month" bonus for all employees.

Among exogenous factors which affected price movements between 1967 and 1972 were currency realignments instituted in the Smithsonian Agreement of December, 1971, substantial increases in commodity prices throughout 1972, and Panama's continued reliance upon imported goods. According to the International Monetary Fund, export prices of the industrialized countries rose 9.2 percent between the second quarter of 1971 and the second quarter of 1972.[4] Panama's reliance on imports is partially reflected in the fact that 200 of the 328 items surveyed for the wholesale price index are imported.[5] In addition, the ratio of imports to gross domestic product ranged from 42 to 45 percent during the period 1967-72.[6]

At the 1972 meeting of Panamanian business executives, the Minister of Planning and Economic Policy stated that Panama could no longer hope to insulate itself from world inflationary pressures. The Minister indicated that a 7-8 percent annual rise in prices could be expected in the middle 1970's.[7]

Balance of Payments

Panama has never been a major exporting country. Since 1960, exports comprised less than 12 percent of the annual gross domestic product. Although imports are usually much larger than exports, the trade deficit is offset to a large extent by income received from the sale of goods and services to the Canal Zone and tourists as well as the inflow of capital funds from foreign sources.

Table 2.4 provides a listing of the type and value of exports shipped from Panama and the balance of payments

TABLE 2.4.--Balance of Payments, 1960-1971. (In Millions of Current Balboas)

	1960	1966	1967	1968	1969	1970	1971
Trade Balance	- 69.2	-114.2	-123.1	-128.4	-152.5	-200.6	-223.4
Exports	38.8	103.3	109.2	117.5	132.5	130.4	136.4
Bananas	18.2	44.7	49.5	57.6	63.4	61.8	62.9
Petroleum	--	25.9	22.9	18.8	24.0	21.5	25.1
Shrimp	5.0	9.0	9.2	9.7	9.7	10.2	12.0
Sugar	0.4	1.6	3.9	4.6	5.4	5.0	6.3
Other	15.2	22.1	23.7	26.8	30.0	31.9	30.1
Imports (F. O. B.)	108.0	217.5	232.3	245.9	285.0	331.0	359.8
Services, Net	40.9	83.0	95.2	113.1	122.6	134.8	144.7
Exports	89.3	161.1	189.9	210.4	233.5	266.0	301.8
Canal Zone	52.1	84.5	100.0	112.5	122.0	122.5	126.6
Other Countries	37.2	76.6	89.9	97.9	111.5	143.5	175.2
Imports	48.4	78.1	94.7	97.3	110.9	131.2	157.1
Canal Zone	3.1	2.0	2.1	2.2	2.2	2.3	2.3
Other countries	45.3	76.1	92.6	95.1	108.7	128.9	154.8
Deficit on Current Account	- 28.3	- 31.2	- 27.9	- 15.3	- 29.9	65.8	- 78.7
Unilateral Transfers	0.9	1.9	1.8	0.3	1.2	3.7	3.7
Canal Zone	2.9	4.3	4.5	5.5	6.1	7.3	8.7
Other Countries	- 2.0	- 2.4	- 2.7	- 5.2	- 4.9	- 3.6	- 5.0
Total Current Account & Transfers	- 27.4	- 29.3	- 26.1	- 15.0	- 28.7	- 62.1	- 75.0

TABLE 2.4.--Continued.

	1960	1966	1967	1968	1969	1970	1971
Capital Flows, Net	28.0	25.2	30.3	16.3	62.6	127.5	83.7
Non-Monetary Institutions, Net	21.5	22.3	15.8	11.2	51.8	70.4	51.4
1. Private, Net	16.1	17.6	13.4	13.1	17.9	35.3	17.9
Long-term, Net	17.1	20.4	11.7	18.7	24.5	39.7	24.3
Short-term, Net	- 1.0	- 2.8	1.7	- 5.6	- 6.6	- 4.4	- 6.4
2. Government, Net	5.4	4.7	2.4	- 1.9	33.9	35.1	33.5
Long-term, Net	6.9	5.4	2.4	- 1.0	34.5	34.8	31.8
Short-term, Net	- 1.5	- 0.7	--	- 0.9	- 0.6	0.3	1.7
Monetary Institutions, Net	6.5	2.9	14.5	5.1	10.8	57.1	32.3
1. Net Increases in Foreign Assets (-)	5.5	- 40.9	16.4	- 17.6	- 94.8	-128.2	-181.9
2. Net Increase in Foreign Liabilities	1.0	43.8	- 1.9	22.7	105.6	185.3	214.2
Net Errors and Omissions	- 0.6	4.1	- 4.2	- 1.3	- 33.9	- 65.4	- 8.7

Source: Dirección de Estadística y Censos, Panama en Cifras 1967-1971, Nov., 1972, pp. 114-116.

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figures for selected years between 1960 and 1971. Most of the exports have been derived from the agricultural sector. With imports of large quantities and varieties of goods, it is evident that the commercial and manufacturing sectors primarily service a local market. Table 2.4 also shows the sharp increase in capital flows to non-monetary and monetary institutions following a change in political leadership in 1968. At that time, Brigadier General Omar Torrijos assumed control of the Republic of Panama through a bloodless coup d'etat.

The deficit on merchandise account has expanded rapidly since 1960 and grew considerably in 1971, as shown in Table 2.4.[8] Services exported to the Canal Zone and to other countries, on the other hand, have exceeded the import of services since 1960. But by 1970, the rest of the world has replaced the Canal Zone as a major source of earnings from services rendered. This resulted in a deficit on current account substantially less than the merchandise trade deficit. The merchandise trade deficit was B/223.4 million in 1971, for example, while the deficit on current account was only B/78.7 million in 1971. In absolute terms, however, the deficit on current account has risen significantly from the 1968 low of B/15.3 million to B/75.0 million in 1971.

Net capital flows have exceeded the current account deficits since 1967 and have been derived from several

sources. The net increase in foreign liabilities of financial institutions, both monetary and non-monetary, was substantial between 1968 and 1971--a reflection of the development of an international financial center in Panama. The net increase in foreign liabilities rose from B/1.0 million in 1960 to B/214.2 million in 1971. Long-term capital flows to the government were an important source of funds as were long-term private flows of capital to non-monetary institutions. Most of the long-term capital flows were in the form of sales from government bonds and foreign aid.

Money and Banking

The balboa is the unit of currency in Panama and is at par with the U. S. dollar. There are no paper balboas, however; only coins that correspond exactly in size and weight to U. S. coins. The U. S. dollar is the only paper currency in circulation. As a result, the Republic of Panama is actually on a dollar standard.

Ownership of gold is legal, and both Panamanian coins and U. S. dollars can be freely exchanged into gold. Since there are no foreign exchange controls, there are no black market activities. Without paper balboas, the government cannot increase the money supply by artificial means such as by printing new money.[9] This has been one of the reasons for the relative price stability prior to 1972. Panama is one of five countries in the world without government control over the amount of money in circulation.

In fact, the total amount of money in circulation is not known because of the substantial private holdings of U. S. coins and currency.

The banking community in Panama has grown rapidly in recent years. In fact, Panama is in the midst of a "banking boom." In 1965, there were six commercial banks operating in Panama with assets of approximately B/240 million. In June, 1973, there were 51 commercial banks representing 13 foreign nations with assets of over B/1.6 billion.[10] Between 1966 and 1972, deposits in the banking system increased by 500 percent while loans outstanding increased by 470 percent. Levels of deposits and loans outstanding attributable to residents and non-residents during this period are summarized in Table 2.5. During the same period, deposits from residents increased by 213 percent while deposits from non-residents increased by 929 percent. Loans outstanding to residents increased 291 percent and loans outstanding to non-residents increased by 1,234 percent for the same period. Annual growth rates of deposits and loans outstanding between 1966 and 1972 are presented in Table 2.6. As indicated in the growth rates, there was a significant increase in the flow of funds to and from Panama during this period. Furthermore, a sizeable portion of the deposits from non-residents remained in Panama in the form of loans to residents.

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TABLE 2.5.--Deposits and Loans Outstanding for Banking System, 1966-1972.

	1966	1967	1968	1969	1970	1971	1972
Deposits	269.0	298.9	341.3	473.7	714.6	975.4	1612.9
Residents	161.3	193.8	216.6	239.4	303.7	373.2	504.5
Non-Residents	107.7	105.1	124.7	234.3	410.9	602.2	1108.4
Loans Outstanding	240.8	263.2	302.7	433.9	665.2	938.3	1372.4
Residents	195.2	233.2	261.4	331.6	419.8	562.9	764.2
Non-Residents	45.6	30.0	41.3	102.3	245.4	375.4	608.2

Source: National Banking Commission of Panama, Statistical Bulletin, May, 1973.

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TABLE 2.6.--Growth Rates of Deposits and Loans Outstanding for Banking System, 1966-1972. (Growth Rates in Percentages)

	Average Annual Rate of Growth		Annual Percent Change					
	1966-1972	1968-1972	1966-1967	1967-1968	1968-1969	1969-1970	1970-1971	1971-1972
Deposits	35.	48.	11.1	14.2	38.8	50.9	36.5	65.3
Residents	21.	24.	20.1	11.8	10.5	26.9	22.9	35.2
Non-Residents	47.	70.	-2.4	18.6	87.9	75.4	46.6	84.0
Loans Outstanding	34.	46.	9.3	15.0	43.3	53.3	41.1	46.3
Residents	26.	31.	19.5	12.1	26.9	26.6	34.1	35.8
Non-Residents	50.	100.	-34.2	37.7	147.7	139.9	53.0	62.0

Source: National Banking Commission of Panama, Statistical Bulletin, May, 1973.

A better index of the flow of funds may be that of loans granted, as shown in Table 2.7. Since 1966, the greatest percentage of loans to residents has been to commercial enterprises. In Table 2.8 are listed the annual growth rates of loans to residents and non-residents. Between 1968 and 1972, loans to residents in the field of housing grew the fastest, with agriculture, livestock, commerce and industry growing at lower rates. A comparison between Table 2.6 and Table 2.8 indicates that the data on loans granted rose more rapidly than loans outstanding between 1966 and 1972. This indicates that there was an increase in the rate of loan turnover.

The deposit and loan activity clearly indicate that the saving-investment process is established in Panama. Savings, as measured by deposits in the banking system, have grown rapidly since 1966 as well as investment, as measured by loans granted. The data may, however, overstate the magnitude and intensity of the saving-investment process. Since 1970, more than 50 percent of the deposits have been attributable to non-residents. During the same period, more loans were granted to non-residents. Furthermore, there is no guarantee that the loans to residents were for the purchase of productive capital goods. Hence, the saving-investment process is present in Panama, although it may not be as extensive as the overall growth in deposit and loan activity would seem to indicate.

TABLE 2.7.--Loans Granted by Banking System, 1966-1972.
(In Millions of Balboas)

	1966	1967	1968	1969	1970	1971	1972
Total Loans Granted	287.7	329.1	368.8	565.5	941.6	1511.0	2232.8
To Residents	240.6	309.3	327.8	425.0	549.6	864.2	1004.7
Agriculture	2.9	9.9	8.1	9.4	16.0	23.4	30.6
Livestock, Fishing & Forestry	10.1	12.0	15.7	18.3	20.3	35.1	45.5
Commerce	155.0	193.7	209.2	246.8	380.3	513.1	627.3
Housing	13.3	11.0	11.1	18.0	18.6	48.3	55.8
Industry	22.5	27.8	33.0	36.8	35.5	88.1	89.3
Other Construction	5.2	7.3	12.4	13.8	17.6	23.6	25.9
Personal	30.3	44.2	30.3	51.5	54.1	82.6	102.4
Other	1.3	3.4	8.0	30.4	7.2	50.0	27.9
To Non-Residents	47.1	19.8	41.0	140.5	392.0	646.8	1228.1

Source: National Banking Commission of Panama, Statistical Bulletin, May, 1973.

TABLE 2.8.--Growth Rates of Loans Granted by Banking System, 1966-1972.
(Growth Rates in Percentages)

	1966-1972	1968-1972	1966-1967	1967-1968	1968-1969	1969-1970	1970-1971	1971-1972
Total Loans Granted	41.	57.	14.4	12.1	53.3	66.5	60.5	47.8
To Residents	27.	32.	28.6	6.0	29.7	29.3	57.2	16.2
Agriculture	48.	39.	241.4	-8.2	16.0	70.2	46.2	30.8
Livestock, Fishing & Forestry	29.	30.	18.8	30.8	16.6	10.9	72.9	29.6
Commerce	26.	32.	25.0	8.0	18.0	54.1	34.9	22.2
Industry	26.	29.	23.6	18.7	11.5	-3.5	148.2	1.4
Housing	27.	50.	-17.3	0.9	62.2	3.3	159.7	15.5
Other Construction	31.	20.	40.4	69.9	11.3	27.5	34.1	9.7
Personal	22.	35.	45.9	-31.4	70.0	5.0	52.7	24.0
Other	70.	36.	161.5	135.3	280.0	-76.3	594.4	-44.2
To Non-Residents	60.	80.	-58.0	107.1	242.7	179.0	65.0	89.9

Source: National Banking Commission of Panama, Statistical Bulletin, May, 1973.

The increase in the number of commercial banks and banking activity in Panama is due to several reasons. First, the tax laws pertaining to taxable income are very liberal. The income tax is only levied upon net income derived from operations within the territory of the Republic of Panama. Interest from a loan granted to a non-resident, therefore, is not subject to Panamanian income taxes. This tax saving allows the commercial banks to offer attractive rates on deposits and loans. Second, there are no exchange controls or controls over the money supply that may affect interest rates. Third, the dollar standard provides relative economic stability. Fourth, numbered bank accounts are legal.

Manufacturing and Commerce

Between 1960 and 1972, the manufacturing sector accounted for 19.5 percent of the total increase in gross domestic product, the highest of any sector. This percentage decreased to 12.0 percent, however, for the period 1968-1972. Although their sizes vary, most manufacturing enterprises are relatively small compared to similar enterprises in an industrialized economy. In 1969 there were 2,070 manufacturing enterprises registered with the Ministry of Commerce and Industry. Of these, only eight had a paid-in capital of B/1.0 million or more and only one enterprise had more than 1,000 employees.[11]

In most cases, a few manufacturing enterprises dominate each type of industry, especially in those industries where a heavy initial investment is required. This oligopolistic tendency is further strengthened in that (1) the manufacturers primarily service small local markets and (2) Panama is in the early stage of industrialization. The existence of oligopolies is particularly evident in such industries as beer, edible oil, tobacco, plywood, clay and petroleum products. As of 1972, for example, there were two breweries and two tobacco producers. Table 2.9 provides data on the gross value of industrial production as classified by type of activity. According to these data, those industries with a higher gross value of industrial production are also the industries with oligopolistic tendencies.

Most Panamanian manufacturing enterprises are owned by individual entrepreneurs. Among those enterprises owned by shareholders, the exact number of shareholders per company is not easily determined. Business enterprises are not required by law to report the number of shareholders in their financial statements. It is known, however, that Cemento Panamá, S. A. had approximately 1100 stockholders and that Cervecería Nacional, S. A. had about 2000 stockholders as of 1972.[12] According to the National Securities Commission of Panama, these two companies had the widest distribution of stock of all Panamanian companies.

TABLE 2.9.--Gross Value of Industrial Production at Market Prices by Type of Activity, for Selected Years.
(In Millions of Balboas)

	1960	1965	1969	1970	1971
Foodstuffs	16.9	29.1	39.4	42.0	45.9
Beverages	8.4	13.0	17.1	18.0	16.3
Tobacco	2.6	3.3	3.8	3.9	4.1
Clothing & Shoes	5.4	6.5	10.3	8.9	10.6
Lumber Products	1.6	2.4	3.1	2.6	3.4
Furniture and Fixtures	2.7	4.6	8.5	9.1	10.5
Paper & Paper Products	0.8	3.8	6.3	7.2	7.6
Printing	3.6	6.0	12.9	10.9	8.4
Rubber Products	0.2	0.2	0.3	0.3	0.4
Chemicals	1.9	3.3	4.3	3.5	3.8
Leather Products	0.6	0.5	0.5	0.5	0.4
Petroleum Products	0.0	4.5	8.4	10.0	10.0
Mineral Products (except Petroleum)	5.2	7.8	11.4	13.4	14.7
Basic Metal Industry (Metal Products except Machinery & Transport Equipment)	2.0	8.6	13.5	16.7	20.2
Other	2.5	4.3	5.8	6.3	6.8
TOTAL	54.5	98.1	146.0	153.6	166.5

Source: Consejo Nacional de la Empresa Privada, "Visión De La Economica Panameña: 1971-1972," prepared by Investigación y Desarollo, S. A., 1972, p. 37.

In 1957 an investment incentive law was passed with the intention of attracting capital funds to various industries.[13] Concessions, exemptions, and tariff protection from imports were granted by the government of Panama to eligible companies for periods up to 25 years. Most national and foreign enterprises that contributed to the welfare, economic advancement or development of Panama were eligible to receive the concessions. By the end of 1970, approximately 250 companies had taken advantage of the investment incentive law.[14]

In 1971 a new incentive law, Cabinet Decree No. 413, classified all companies into two categories: those companies producing mainly for export and those producing chiefly for the domestic market. Different benefits are given to the two categories, with the greater benefits accorded to the export-oriented companies. A business firm producing for the domestic market receives a 50 percent income tax exemption if its profits are reinvested, receives a 100 percent exemption from import duties for machinery, equipment and parts, and receives partial exemption of duties on raw materials and containers not made locally. A 125 percent depreciation allowance on machinery and equipment is also granted under the law as well as an additional income tax exemption of 10 percent of salaries paid and 50 percent of the cost of utilities if the business firm's plant is located outside of the metropolitan area

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surrounding Panama City. A firm which produces for the export market receives total exemption from income, export, and sales taxes and import duties on machinery, equipment, parts, raw materials, containers, fuels, and lubricants.

Commercial activities comprise the bulk of non-financial business activities in Panama. In 1968, there were approximately 12,000 commercial establishments ranging from flower shops to wholesalers of agricultural products. Approximately 1,650 of these 12,000 establishments were wholesale businesses. All commercial activities can be conducted under one of three different types of business organization: proprietorships, partnerships or corporations. Approximately 10,000 of the 12,000 commercial establishments were individually owned in 1968.[15] Virtually all of the remaining establishments were incorporated. At the retail level, individual ownership is most common with business being conducted with the help of family members. Because of the ease of establishing a corporation and the limited liability associated with it, there are few partnerships in the commercial sector. The commercial sector is also characterized by a number of foreign-based companies or paper companies. These are commercial enterprises that can operate in one of three ways: (1) a foreign firm establishes an office in Panama for the purpose of negotiating foreign sales; (2) a foreign firm does not set up an office, but operates through agents that handle sales accounts of several base companies; or (3) a foreign firm organizes in Panama and operates through a lawyer.[16] Paper companies benefit Panama through the monies they expend for certain fees, clerical help, legal services, and office space rentals; through deposits they place in local banks which, in turn, can be loaned to local Panamanian businesses; and through "corporate tourism" they provide in the form of resident managers, visiting businessmen and consultants. The rather cosmopolitan aura of Panama indicates that the latter of these benefits may be the most important in terms of the cash flow provided by the paper companies.

The greatest single concentration of commercial and distributive activity lies in the Free Trade Zone located just outside of the city of Colon. It is a physically segregated area of approximately 100 acres where foreign merchandise may be landed without levy of custom law or duties. Established by Executive Decree No. 18 in 1948, the Free Trade Zone began operations in 1953. Since then it has functioned as an autonomous agency of the government of Panama and has been administered by a board of directors and a managerial staff. By 1970, the Free Trade Zone accommodated over 600 companies and employed over 2,500 persons.[17] In recent years, the Free Trade Zone has contributed about B/30 million annually to the Panamanian economy in the form of salaries, taxes, and fees although this cash flow is partially offset by imports from the Free Zone. Table 2.10 summarizes the extent of imports, exports, and re-exports in the Free Trade Zone. Re-exported goods are those imported goods that are exported to a foreign country.

Paper companies and commercial enterprises in the Free Trade Zone flourish in Panama primarily because of liberal tax benefits. Paper companies with an office and employees do not pay any income tax in Panama if the office merely directs purchases and sales where the merchandise never physically enters Panama. A Panamanian corporation, with dividends from foreign corporations as its only income, is not subject to income tax. The corporation may, in turn, pay out such dividends to its stockholders free of Panamanian income taxes. Many companies operating in the Free Trade Zone have signed a contract with the Panamanian government which protects these companies against increases in income taxes. Generally, these contracts entitle the company to a 90 percent discount on taxes payable on profits earned on export and re-export sales. Taxes that are paid are based upon tax rates established in 1954.

Liberal incorporation laws have also stimulated the creation of paper companies and free zone companies. The

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TABLE 2.10.--Value of Imports, Exports, and Re-Exports from the Free Trade Zone, 1967-1971.
(F. O. B. in B/1000's)

	1967	1968	1969	1970	1971
Exports to Panama	26,645	27,023	33,141	40,524	46,359
Imports to Free Zone	120,287	130,438	153,686	191,206	217,668
Re-Exported Goods	185,885	188,768	214,110	249,440	255,732

Source: Panama en Cifras, 1967-1971, Dirección de Estadística y Censos, Contraloría General, 1972.

process of incorporation is governed by the Articles of Cabinet Decree No. 32 which has not been substantially changed since 1927.[18] At least two persons are required for incorporation, but there are no limitations as to the number, domicile, or nationality of board members and their meeting place. There is no minimum capital requirement and no limit on the life of the company.

Economic Benefits of the Canal Zone

There are three major economic benefits that accrue to Panama because of the Canal and the Canal Zone.[19] First, there are wages and salaries paid to Panamanian citizens who work in the Canal Zone. Second, there are monies spent by Canal Zone residents and contractors for goods and services sold in Panama as well as Panamanian goods sold in the Canal Zone. Third, the U. S. government currently pays B/1.93 million to Panama each year in accordance with the treaty signed in 1903. Estimated gross payments and income flows to the Republic of Panama from the Canal and the residents of the Canal Zone are presented in Table 2.11. Wages and salaries paid to Panamanians and expenditures by Canal Zone residents on Panamanian goods and services are the largest sources of income. Measured in current balboas, the total income flow equalled 17 percent of the gross domestic product in 1968 and 15 percent in 1971. In fact, the total flow of income from the Canal Zone as a

TABLE 2.11.--Estimated Gross Payments and Income Flow to the Republic of Panama from the Canal Zone, 1967-1972.
(In Thousands of Current Balboas)

	1967	1968	1969	1970	1971	1972
1. Gross wages and salaries paid to Panamanian residents employed in canal zone	58,761	65,109	71,134	74,983	78,735	81,418
2. Retirement and disability payments	4,479	5,508	6,142	7,303	8,692	9,608
3. Direct purchase in Panama by U.S. Agencies	19,402	21,090	23,776	24,527	23,485	26,125
Goods	13,868	16,235	17,357	16,887	18,271	20,784
Services	5,534	4,855	6,419	7,640	5,214	5,341
4. Purchase of goods in Panama by Private organizations operating in canal zone	11,342	10,000	10,004	8,576	8,554	8,273
Petrol	6,542	500	4,900	3,576	3,054	2,273
Others	4,800	500	5,104	5,000	5,500	6,000
5. Contractors purchases in Panama of goods and services for canal zone projects	8,272	11,704	12,324	6,926	8,130	7,359
6. Expenditures by residents of canal zone	30,744	33,885	35,796	37,291	38,566	39,108
Sub-Total	133,000	147,296	159,176	159,606	166,162	171,891
Annuity	1930	1930	1930	1930	1930	1930
	134,930	149,226	161,106	161,536	173,821	168,092

Source: Economics Section, United States Embassy, Republic of Panama, 1973.

percentage of gross domestic product has steadily declined since 1968.

Although the Canal is Panama's principal resource, it only partially affects the saving-investment process in Panama. As a source of income, the expenditures of the Canal Zone provide savings to Panamanian residents that may become a source of capital funds. The demand for capital funds in the Canal Zone, however, is completely satisfied by the U. S. government. The Canal Zone, therefore, may supply equity-financed capital by generating an income flow to Panama, but the Zone will not have a demand for equity-financed capital from Panama. Hence, the presence of the Canal Zone does not directly affect the decisions to establish an organized stock market in Panama.

Poverty and the Distribution of Income

Although the growth rates in Panama have been high by Latin American standards, the benefits of growth have not been equally distributed among individuals or regions in Panama. The unequal distribution of income remains as one of Panama's most severe economic problems. According to a study made by Charles McLure, Jr., approximately 75 percent of all Panamanian employees received less than B/2,000. per year and in total accounted for a little less than 45 percent of all labor income in 1969.[20] Only about 10 percent of the employees earned over B/300. per month, but

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but in total they received about one-third of all labor income. According to McLure, the reasons for the unequal distribution of labor income were straightforward.[21] Agriculture and domestic services accounted for 43,000 of the 73,000 persons who received labor income of less than B/1,000. per year in 1969. At the same time, a small number of highly paid persons in selected activities such as manufacturing, commerce, and services earned salaries considerably higher than the average.

The McLure study also presented estimates of the distribution of non-labor income, i.e. income from a source other than wages, such as salary. Three-fourths of the recipients of non-labor income with the lowest incomes received less than 20 percent of non-labor income. The 4 percent with the highest incomes were estimated to receive 40-55 percent of all non-labor income. The unequal distribution of non-labor income can be attributable to the diversity amongst occupations. Those who received non-labor income included approximately 80,000 farm operators at or near the subsistence level, almost 14,000 self-employed persons in domestic services, a large number of persons employed in minor commerce of their own, the wealthy owners of farms and other businesses, and highly paid professional people.[22]

The estimates of the distribution of labor and non-labor income led McLure to conclude that "the poorest two-thirds of income recipients in the country receive just under or just over one-fourth of all income. . . ."[23] The richest 10 percent received about 45 percent of all income in 1969.[24] These results are not significantly different from the distribution of income in other Latin American countries as indicated in Table 2.12.

According to McLure, the reasons for the unequal distribution of income, in general, are twofold.[25] First, a considerable portion of the labor force has engaged in low-income occupations such as agricultural employment, domestic services, minor commerce, and the operation of small farms. Second, many industries have enjoyed a monopoly position due to the smallness of the national markets and the liberal use of tariffs and quotas that protect local industries from foreign competition.

In 1972, a second study of income distribution in Panama was made by G. S. Sahota.[26] Whereas the McLure study made estimates at the national level, the Sahota study estimated the distribution of income at the province level and for the rural and urban sectors. Sahota's estimates of the distribution of income are given in Table 2.13. As this table indicates, the income accruing to the highest 10 percent of income recipients for all provinces is slightly higher than the McLure estimate.

Poverty in Panama is another economic problem, although the poor are not as impoverished as the poor in

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TABLE 2.12.--Patterns of Income Distribution in Latin America.

	Nation	Year	Percentage of Income Received by Top 10% of Income Recipients
1.	Mexico	1950	49.0
2.	Mexico	1957	46.7
3.	Mexico	1957	45.0
4.	El Salvador	1946	43.6
5.	Guatemala	1947-48	43.8
6.	Puerto Rico	1953	32.9
7.	Puerto Rico	1946-47	40.8
8.	Argentina	1959	35.8
9.	Chile	1960	37.5
10.	Ecuador	1957	30.0
11.	Venezuela	1957	45.0
12.	Colombia	1953	48.4
13.	Colombia	1964	52.0
14.	Panama	1969	44.6

Source: Charles E. McLure, Jr., "Distribution of Income and Tax Incidence in Panama, 1969," USAID/Panama, 1971.

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TABLE 2.13.--Summary Statistics of Income Distribution in Panama, 1970.

Province	Percentage of Income Received by Top 10% of Families	Percentage of Income Received by Bottom 1/3rd of Families
Bocas del Toro	43.25	9.824
Cocle	53.72	4.362
Colon	35.43	7.379
Chiriqui	56.06	4.524
Darien	45.29	6.914
Herrera	52.32	5.669
Los Santos	50.41	5.403
Panama	45.06	7.052
Veraguas	58.33	6.186
TOTAL	47.76	5.775
TOTAL URBAN	41.42	8.555
TOTAL RURAL	51.84	5.295

Source: Gian S. Sahota, "Public Expenditure and Income Distribution in Panama," prepared for the Agency for International Development, 1972, Table 2, p. 108.

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other countries, such as India.[27] The per capita annual income of the bottom half of the population was about B/200. in 1973 while that of the top 10 percent was about 15 to 20 times this figure. According to the Ministry of Health, a nutritionally adequate diet costs approximately B/.50 per person per day. Thus, a person must earn about B/185. a year to obtain this diet. If it is assumed that the poor are unable to set aside more than 70 percent of their income for food without depriving themselves of other necessities, a person must receive at least B/260. a year to afford the minimum diet.[28] Thus, the data suggest that about 50 percent of the population cannot afford the minimum diet.

Employment and the New Labor Code

The relatively high rate of economic growth in Panama has been coupled with a rapid expansion in the employed labor force. The size of the employed labor force grew from 300,000 workers in 1960 to 435,000 workers in 1971. The number of persons employed increased at a compounded rate of 3.4 percent per annum between 1960 and 1971 while the labor supply increased at a rate of 3.3 percent per annum. As a result, it has been difficult to reduce the unemployment rate during this period in spite of the rising level of employment. In 1971, 7.6 percent of the labor force was unemployed.

Levels of employment for the various sectors and indices of labor mobility are provided in Table 2.14. Between 1968 and 1971, employment in the agricultural sector decreased by 4.4 percent. Surprisingly, the manufacturing sector also showed a decline in employment by 7.7 percent during the same period--a time when manufacturing output was expanding.[29] Of the total increase in employment during this period, 70.5 percent occurred in the services sector, with 47.0 percent of this accounted for by government employment. The data suggest, therefore, that a portion of the work force has shifted out of the agricultural and manufacturing sectors and into the services sector.

The increase of employment in the services sector is typical for a developing economy where this sector plays the role of a residual employer. Many of the participants in such a sector are in occupations providing part-time or casual jobs of low wages and productivity. This tends to be the case in Panama: in the metropolitan area of Panama City, employees in service activities in 1971, including domestic servants, had an average weekly salary of B/24.10 compared to an overall average salary for the metropolitan area of B/33.33.[30]

In 1972, a new labor code was instituted by the Panamanian government that gave workers greater job security and benefits. The code requires that 90 percent of ordinary workers be Panamanians and that foreign specialized,

TABLE 2.14.--Employment by Sectors, 1968-1971.

TABLE 2.14.--Employment by Sectors, 1968-1971.

	1968	1969	1970	1971	Growth Rate Per Annum	Sector's Share in Overall Employment Increase
Agriculture, fishing, hunting, and forestry	157,800	157,400	158,200	150,800	-1.5	- 22.2
Non-Agricultural Activities	246,300	262,900	274,700	284,800	5.0	122.2
Mining	600	400	500	600	0	0
Manufacturing	45,600	41,500	42,600	42,100	-2.6	- 11.1
Non-durable goods	35,800	31,600	32,700	32,000	-3.7	- 12.1
Durable goods	9,800	9,900	9,900	10,100	1.0	1.0
Electricity, gas and water	3,400	3,400	4,200	4,900	13.0	4.8
Construction	19,300	20,300	23,500	26,100	10.6	21.6
Trade, hotels and restaurants	51,700	58,300	61,600	59,200	4.6	23.8
Transport, storage and communications	14,700	15,900	16,300	18,000	7.0	10.5
Services	88,100	100,800	103,600	110,300	7.8	70.5
Governmental	36,200	41,000	45,100	51,000	12.1	47.0
Private	51,900	59,800	58,500	59,300	4.5	23.5
Personal	49,600	57,000	55,600	55,100	3.6	17.5
Others	2,300	2,800	2,900	4,200	22.0	6.0
Canal Zone	22,900	22,300	22,400	23,600	1.0	2.2
TOTAL	404,100	420,300	432,900	435,600	2.5	100.0
% Increase		4.0	3.0	0.6		

<u>Source</u>: Dirección de Estadística y Censos, <u>Estadísticas del Trabajo Año</u>, 1971.

technical and managerial employees can comprise only 15 percent of the total work force.[31] The labor code includes a mandatory "thirteenth month" annual wage bonus, limits the number of extra hours of work and requires 150 percent of the hourly wage for overtime pay. Also, workers can only be dismissed "for cause" which the employer must justify to the Ministry of Labor. If the employer cannot sustain the dismissal, the employee must be given a penalty compensation.

Although the labor code provides benefits for employed workers it may also provide an incentive not to hire additional workers. Under the code it is very difficult to dismiss an employee once he or she is hired. In the case of an economic slowdown, business firms--unable to reduce their work force--could suffer a loss of profits sufficient to close their plants. Because of the inability to vary the size of the work force in response to cyclical changes in the economy, businesses may be reluctant to hire additional workers when output expands. Such a situation would result in a more intensive use of existing workers and an increase in unemployment as additions to the labor force seek work.

Current Political Environment

Cabinet Decree No. 280, published in 1971, provided the election of an assembly of representatives from the 505 townships (corregimiéntos) in Panama. The assembly was to be composed of one representative and one alternate from each township. In order to be nominated, a candidate had to be Panamanian by birth, over 21 years of age, in full enjoyment of his civil rights, and a resident of his municipality at least 12 months prior to the election.[32] In August, 1972, the elections were held and the 505 delegates were elected.

In October, 1972, this new assembly of representatives approved a new constitution and elected the former president and vice-president of the provisional junta government as the official president and vice-president of the Republic. The assembly also vested extraordinary executive powers, formerly reserved for the president, to Brigadier General Omar Torrijos for a six-year period. These powers, in effect, made Torrijos the head of the government with authority to approve contracts and agreements, appoint cabinet ministers, and conduct foreign affairs.

The Assembly of Representatives is the new legislative branch of the government which conducts a 30-day session each year. When the Assembly is not in session, a legislative council performs the legislative functions. The council is composed of General Torrijos, the president, the vice-president, the members of the cabinet, eight members of the Assembly, and the president of the Assembly.

The most recent political development with economic ramifications is the re-opening of negotiations to revise the Panama Canal Treaty entered into by the Republic of Panama and the United States in 1904. In effect, the treaty gave in perpetuity "all the rights, powers and authority . . . which the United States would possess and exercise if it were the sovereign . . . to the entire exclusion of the exercise by the Republic of Panama of any such sovereign rights, powers, and authority."[33] At the present time, the government of Panama is specifically seeking to (1) end the sole control of the United States over the Canal and any new canal that may be built; (2) increase the annuity from B/1.93 million per annum to a much larger amount; (3) reduce the number of U. S. forces stationed in the Canal Zone; (4) acquire Panamanian jurisdiction over courts and jails in the Zone; (5) re-acquire lands and water in the Zone not required for the operation or defense of the Canal; and (6) place some of the commercial activities of the Zone now controlled by U. S. concessionaries in the hands of Panamanian business-men.

The outcome of the treaty negotiations will undoubtedly affect the reputation and political future of General Torrijos. On numerous occasions, Torrijos has promised the people that the United States will grant the demands of the Panamanian government and relinquish control ove

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over the Canal. Should these promises not be fulfilled, Torrijos would certainly lose the confidence of his supporters.

Torrijos is a new type of political leader in Panama. Prior to 1968, the rulers of the country tended to be drawn from wealthy families--the oligarchy as it is called--who made fortunes in sugar and other commodities. Torrijos, on the other hand, is a man of humble origins who worked his way up to the position of colonel in the National Guard before his takeover in 1968. Among his supporters are farmers, laborers, and Marxist-oriented student organizations. The opponents of Torrijos are the businessmen, clergy, and others that are critical of a military-backed government.

The businessmen are particularly critical of government programs that threaten the capitalistic environment in Panama. The new labor code as well as recent laws aimed at controlling rents, providing incentives for low-income housing construction and imposing a greater measure of supervision over the real estate market are examples of such threats. Business entrepreneurs view the actions as the first steps toward nationalization.

Although the current political environment appears to be stable, the outcome of the treaty negotiations will affect this stability as well as the economic conditions in Panama. If Torrijos' promises to Panamanians are fulfilled, more programs and laws with social benefits for low-income groups may be expected. If the United States, however, refuses to relinquish its sovereign control over the Canal, Torrijos' political position could be seriously weakened.

Summary

The Republic of Panama has a number of noteworthy economic and political characteristics that describe its present stage of economic development. The economic growth rate has been relatively high since 1960 due to significant increases in private and public investment. Although this rapid growth rate apparently occurred in the absence of inflation, there is some doubt about the accuracy of the price indices. The merchandise trade deficit has been substantial in recent years, although it has been partially offset by the export of services to the Canal Zone and foreign countries as well as the capital inflows from foreign sources. The banking community is relatively large and has grown rapidly due to the lack of exchange controls, liberal tax laws, the absence of a central bank, and the dollar standard. In the corporate sector there are a relatively small number of manufacturing firms and many commercial and service-oriented enterprises. Although the labor force is growing, the rate of unemployment has steadily increased since 1969. At the same time, there are many poverty-stricken people in Panama and the distribution of income is as unequal as in most Latin American countries. In recent years, the Canal Zone has remained an important source of income for Panama, but it has also become the source of political turmoil.

These characteristics seem to indicate that (1) the saving-investment process is firmly established in Panama as evidenced by the deposit and loan activity in the banking community; (2) there exists a highly capitalistic business sector with a demand for capital that goes beyond the limits of internal finance, as evidenced by the volume of loans to the corporate sector; (3) the economic strengths of Panama can be found in liberal tax laws, the absence of monetary controls, the dollar standard, the activities of the Free Trade Zone, and a relatively stable government; and (4) the economic and political problems of Panama center upon poverty, unemployment, the distribution of income, and uncertainties over the Panama Canal Treaty.[34]

FOOTNOTES--CHAPTER II

[1]Delbert A. Fitchett, "Macroeconomic Indicators" (unpublished report, USAID Mission to Panama, 1973), p. 1. Also note that one balboa is equal to one U. S. dollar. In fact, U. S. currency is the only currency in circulation in Panama. U. S. and Panamanian coins are used interchangeably.

[2]*Ibid.*, Table A.1, p. 2.

[3]*Ibid.*, Table A.2, p. 3.

[4]International Monetary Fund, *International Financial Statistics*, Vol. XXVI, No. 4, April, 1973, p. 32.

[5]U. S. Department of Commerce, *Foreign Economic Trends*, May 10, 1973, p. 5.

[6]Dirección de Estadística y Censos, Panama en Cífras, 1967-1971, November, 1972, pp. 209-217.

[7]U. S. Department of Commerce, *Foreign Economic Trends*, May 10, 1973, p. 6.

[8]The very large figures for error and omissions for 1969 and 1970 are reportedly due to government imports of equipment which were not recorded in normal import registration channels. Thus, the trade and current account deficits of 1969 and 1970 are considerably understated.

[9]The money supply includes currency, coins, and demand deposits. Changes in the money supply are completely dependent upon deposits and withdrawals made by residents and non-residents of Panama.

[10]National Banking Commission of Panama, *Statistical Bulletin*, May, 1973.

[11]Thomas E. Weil, *et al.*, *Area Handbook for Panama* (Washington, D.C.: U. S. Government Printing Office, 1972), p. 292.

[12]Both of these companies were among the 50 largest in 1971 in terms of total net sales. Ceménto Panama, S. A.

reported net sales of approximately B/6.5 million while Cervecería Nacional, S. A., reported B/13.4 million.

[13]Law 25 (February 7, 1957).

[14]Thomas E. Weil, Handbook, p. 287.

[15]Ibid., p. 338.

[16]Milton Taylor, "Tax Incentives for Development: Panama's Experience" (unpublished report, Agency for International Development, Panama, 1969).

[17]Thomas E. Weil, Handbook, p. 329.

[18]Law 32 (February 26, 1927).

[19]The Canal Zone is an area approximately 50 miles long and 10 miles wide that surrounds the Panama Canal. According to a treaty signed in 1904, the United States has complete sovereign control over all activities in the Canal Zone. Numerous military personnel and employees of the Panama Canal Company reside in the Zone with their families.

[20]Charles E. McLure, Jr., "The Distribution of Income and Tax Incidence in Panama, 1969" (unpublished report, USAID Mission to Panama, 1969), p. 37.

[21]Charles E. McLure, Jr., "The Distribution of Income and Tax Incidence in Panama, 1969: Summary and Conclusions" (unpublished report, USAID Mission to Panama, 1969), p. 1.

[22]Ibid., p. 3.

[23]Ibid., pp. 5-6.

[24]Ibid.

[25]Ibid.

[26]Gian S. Sahota, "Public Expenditure and Income Distribution in Panama" (unpublished report, USAID Mission to Panama, 1972).

[27]Virtually no research has been done on the issue of poverty in Panama. For some insights into the problem, see Arun Shourie, "Ways of Helping the Poor of Panama: Some First Impressions" (unpublished report, government of Panama, 1973).

[28]*Ibid*., p. 3.

[29]In contrast, some authors emphasize the importance of a labor-intensive production process. For example, see Gustav F. Papenek, *Review of Economic Development in South Asia*, by E. A. G. Robinson & Michael Kidron, eds., in the *Economic Development and Cultural Change*, January, 1974, p. 353.

[30]Dirección de Estadística y Censos, *Información Estadística para la Conferéncia Anual de la Asociación Panameña de Ejecutivas de Empresa Panamá* (Panama, 1973), p. 34.

[31]United States Department of State, "The Climate for Investment Abroad" (unpublished report, Washington, D.C., 1973).

[32]United States Embassy, Republic of Panama, interview held with the political officer, August, 1973. Also see United States Department of State, *Background Notes: Panama* (Bureau of Public Affairs, 1973).

[33]*Panama Canal Treaty*, 1904, p. 1.

[34]The saving-investment process refers to the transfer of money from savers to investors. Either savers deposit money in a financial institution which, in turn, is loaned to a business firm in need of capital funds; or savers loan the money directly to the business firm in exchange for a bond or promissory note.

A capitalistic business sector refers to a number of business firms where the means of production and distribution are privately owned and operated for profit. The term also suggests that there is a high concentration of wealth among a few large business firms.

CHAPTER III

EXTERNAL FACTORS AFFECTING THE SUPPLY OF AND DEMAND FOR EQUITY-FINANCED CAPITAL

Introduction

It has been proposed in Chapter I that the demand for and supply of equity-financed capital are dependent upon factors external and internal to the business firm. This Chapter discusses the external factors within the context of the Panamanian economy.

The first external factor to be considered is the existing structure of capital markets in Panama. Before the characteristics of these markets can be discussed, however, it will be useful to distinguish between primary and secondary capital markets as well as organized and unorganized stock markets in general. Such a clarification will enhance the discussion of specific capital markets in Panama.

Primary and Secondary Capital Markets

In primary capital markets, business firms issue primary securities to obtain capital funds. These funds flow directly or indirectly from the purchaser of the securities to the business firm. In the case of direct financing, the capital funds flow directly from the surplus-spending unit to the deficit-spending unit. In the case of indirect financing, the capital funds flow indirectly from the surplus-spending unit to the deficit-spending unit through a financial institution. Since primary securities include all liabilities and outstanding equities of non-financial spending units, both capital debt and capital stock are exchanged for capital funds in a primary capital market.[1] Capital debt refers to all liabilities of the business firm with maturities of more than one year such as bonds and long-term promissory notes.[2] Capital stock refers to shares of common or preferred stock. It has no maturity date, contains no fixed interest obligations, but represents ownership in the business.

Both capital debt and capital stock can be sold through a private placement of the primary securities or through an underwriting market. The private placement market and the underwriting market are sub-markets of a primary capital market. In a private placement market, the capital debt or capital stock is placed with one or more surplus spending units such as friends, employees, or financial institutions. While capital stock can be sold in this manner, a private placement market is generally used for the issuance of capital debt.[3] Secured and unsecured promissory notes and bonds, for example, can be sold to commercial banks, life insurance companies, or investment companies. Usually there are no rules or regulations governing the activities of such private placements, nor are public records kept of the transactions.

In an underwriting market, new capital debts and capital-stock issues are placed with one or more groups of investment bankers or brokerage houses for further public sale and distribution.[4] The underwriter bears the risk of financial loss and, in return, receives a commission or premium for its risks. The premium charged by the underwriter is called a spread. A spread is equal to the difference between the selling price of the security to the public (the public offering price) and the proceeds per share going to the business firm that issued the security. If, for example, the public offering price of a new stock is $10.00 per share and the proceeds going to the business firm are $9.15 per share, the spread is $0.85 or 8.5 percent.

In a primary stock market, only shares of common or preferred stock are issued by deficit-spending units. The shares are usually sold through an underwriting market where the price per share is determined jointly by the underwriter and the business firm. Once the price per share and the spread are determined, the shares are offered to the surplus-spending units.

A secondary capital market is one in which surplus-spending units exchange capital funds and securities without directly affecting the inflow of capital to the business firm.[5] Capital funds, therefore, only flow to the business firm in primary capital markets where the securities are sold for the first time. The securities enter the secondary market when they are sold for the second time. The securities remain outstanding in the secondary capital market until the business firm that issued the securities repurchases them.

The secondary market is a valuation facility for the business firm, providing a guide for future capital stock and capital debt financing. At any given time, the market supply of capital funds is equal to the amount of money being offered by surplus-spending units in the secondary market.[6] The market supply of securities is equal to the value of the capital debt and capital stock offered for sale by deficit-spending units or other surplus-spending units. In a secondary capital market, individuals either offer money and demand securities in return or offer securities and demand money.

Shares of common or preferred stock previously issued in a primary stock market are traded by individuals and institutions in a secondary stock market. These institutions can be monetary, such as commercial banks, or non-monetary, such as mutual funds and life insurance companies. The market value or price per share of the stock is a function of several economic and political c

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variables, one of which is the ratio of the supply of capital funds to the supply of securities. The supply of capital funds offered by the surplus-spending units is, in effect, a measure of the demand for capital stock. When the ratio increases, the supply of capital funds has increased relative to the supply of securities; the demand for securities is greater than the supply, and the prices per share of capital stock tend to rise. The converse is also true. In some secondary stock markets such as those in the United States, the fluctuations in stock prices are increasingly more responsive to changes in both non-economic factors and economic factors other than the ratio just described. Changes in the political environment, wars, and international monetary changes, for example, can affect stock prices.

Organized and Non-Organized Stock Markets

An organized stock market is generally referred to as a stock exchange.[7] It possesses all of the characteristics of a business organization with charters, by-laws, governing bodies, rules, regulations, and a physical facility for carrying on operations. This facility is generally located in or near the financial district, and the shares of capital stock listed there are traded by individuals who are referred to as members of the exchange. These members can buy and sell on their own account or act as representatives of brokerage firms which buy and sell on behalf of their clients. The members are prime risk-takers when they buy on their own account, and, in effect, generate liquidity for the securities listed on the exchange. Thus, the prices of the securities are determined by the transactions of the members on the floor of the exchange.

Generally, the probability of a given business firm being accepted on a given stock exchange is a function of the firm's age, quantity of assets, profits, dividends, national interest in the company, position in its industry, and the growth trends of the relevant industry itself.[8] For acceptance on an exchange, a firm must submit its papers of incorporation, financial statements, and other documents to the commission regulating the activities of the exchange, as well as pay a listing fee.

The advantages to the firm of listing its capital stock on an exchange--and, in fact, the advantages of having an exchange in the first place--can be traced to the structure and operations of an exchange.[9] First, the trading process that occurs on the floor of the exchange enables changes in the supply and demand for capital funds to be quickly and accurately reflected in the prices of the securities. Thus, if a firm develops a new product, announces higher earnings, or announces a new management, the fact is generally reflected in the resulting price of the security. Second, the exchange has a built-in system of checks and balances that permit maximum freedom in trading and prevents extreme price fluctuations. Third, the transactions and services of the members are designed to allow for participation by small and large investors, making it more difficult for either to manipulate the market. Fourth, the listed securities generally appear daily in newspapers and other media so businessmen can keep a close watch on investor's evaluation of their business. This also provides free advertising. Fifth, many investors will only buy listed securities because of their higher liquidity. Finally, many public and private research projects draw on the data of listed companies because of its availability. This calls public attention to the firm and the products and services it offers.

There are, however, advantages of not listing on an exchange. There are no listing charges and no public disclosure of financial statements or related reports that may injure the firm's ability to raise capital. Small and medium-sized firms also believe that they can get more attention and service from local over-the-counter dealers rather than brokers working on the exchanges.

Unorganized stock markets are referred to as over-the-counter markets. These are not centralized in one place, like a stock exchange, but exist in the office of any securities dealer. The dealer or stockbroker buys and sells capital stock for either his own account or that of his clients. The operations of these markets are very informal, and, in effect, the individual brokers "create" the market by bringing buyers and sellers together. The prices of the securities traded are a function of the supply of and demand for capital funds and the volume of securities outstanding. Generally, however, rather than having a single price for the security, there is a bid and asked price. The bid price equals the per share price in the local currency that a broker is willing to pay a seller and the asked price is that which a broker is willing to accept for the shares.

Capital Markets in Panama

There were no organized stock markets operating in Panama as recently as 1973. There has been an over-the-counter market or unorganized, secondary stock market that has operated on a limited scale. This market is serviced primarily by two stockbrokers who "create" markets in approximately 75 stocks of Panamanian firms. The Panamanian newspapers carry a list of approximately 60 of these stocks with a quoted market price. This price represents the price paid per share for the most recent trade of 100 or more shares. The prices range from B/.50 to B/100 per share.

There is no regular or daily trading activity in the secondary stock market. When an individual wants to sell a stock, he calls a broker who tries to find a buyer willing to buy the stock at a stated price. Brokers usually receive a 2.5 to 6 percent commission per trade and generally conduct other business matters such as real estate sales or financial loans to supplement their activities in this secondary market.[10]

Although active trading in common or preferred stock is not present in Panama today, many businessmen between 1945 and 1955 sold "shares" or partial ownership in their companies to other businessmen, bankers and political leaders in Panama. No formal stock certificates were issued and very few records were kept, but a transaction occurred between a seller of equity ownership and a seller of capital funds.

According to stockbrokers in Panama, most of these transactions were consummated at the bar of the International Hotel in downtown Panama.[11] An individual seeking to buy and operate a fleet of shrimp boats, for example, would seek capital funds from businessmen and bankers who often lunched at the hotel. Capital funds would be received in exchange for a "share" in the potential profits of the new business. It was also commonplace for businessmen to exchange their "shares" of various enterprises among one another. In 1952, the market place moved from the International Hotel to the El Panama Hotel, and the exchange of capital funds for equity ownership in Panamanian firms flourished at a pace sufficient to support nine stockbrokers.

Beginning in 1955, however, there was a series of political eruptions that shook the confidence of many savers and resulted in a series of capital flights that significantly reduced the volume of stock trading. The Cuban Revolution in 1959, the invasion of Panama by Cuban mercenaries in 1960, the riot in 1964, and the capital flight of 1968 were instrumental in reducing the number of active brokers from nine to two. Confidence in the value of Panamanian stock also has been affected by some alleged failures of the government to carry out its agreements with local business firms.[12]

No data exists on the past or present volume of stock trading in Panama. Since many firms sold shares directly to individuals in bearer form, and since those sold through a broker were not a matter of public record, it is impossible to trace the total quantities involved. Even the audited financial statements submitted by firms with their tax returns provide no data. Neither local accounting standards nor the Panamian Internal Revenue Service require that a firm reveal the details of its equity position. The number of authorized shares, paid-in capital, number of shares outstanding, par value, and whether or not the stock is in bearer or nominal form may or may not be reported.

Panamanian savers also invested in mutual funds in Panama during the 1960's. Fund of Funds, Investment Overseas Services (I.O.S.), the United States Investment Fund (U.S.I.F.), and shares of the U. S. Investment Bank were sold through brokers.[13] Unfortunately, many Panamanians lost great sums of money by purchasing these shares when stock prices were very high and attempting to sell the shares when prices fell toward the end of the 1960's. The most well-remembered of the mutual fund fiascos, the "Gramco Affair," involved U.S.I.F. This fund had a major financial interest in a real estate trust, called Gramco, that operated out of the Bahamas. The trust or holding company did not own parcels of real estate, but held options to buy properties, in addition to second and third mortgages where the interest portion of the mortgage payment was low. As a result, the trust and mutual fund had very little liquidity. By the end of the 1960's, the fund lacked the necessary liquidity to maintain its investments. The price of its shares went to zero, and trading in U.S.I.F. shares by 1970 ceased. According to one broker who sold U.S.I.F. shares in Panama, the fund sold B/18 million worth of shares to Panamanians.[14]

In June, 1972, representatives of U.S.I.F. returned to establish a market in U.S.I.F. shares in Panama. According to the advisory board of the real estate trust, a massive reorganization took place in 1971 that placed the

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fund on firm financial ground.[15] Two markets had been established to generate liquidity for the 350 million shares outstanding, one in Luxembourg and one in Belgium. By June, 1972, the shares were trading at a price of $3.00-3.25 per share, a vast improvement over the price of zero in 1970. Under the reorganization, shares could be purchased in registered or bearer form (international depository receipts). The management of U.S.I.F. encouraged the purchase of shares in bearer form to insure maximum liquidity and to avoid income and capital gains taxes. As an extra incentive, U.S.I.F. agreed to pay all commissions involved in the purchase of shares in bearer form between June, 1972 and approximately November, 1972.

With respect to primary capital markets, a unique situation has developed in Panama in recent years. A primary stock market is virtually non-existent. There is, however, an extremely active primary capital debt market. As of 1972, firms could obtain loans from local banks for up to seven years at interest rates of 9.5 to 12 percent, depending upon the bank, customer, amount of the loan, and maturity date. Generally, the lower interest rates were obtainable from foreign banks with sizeable "offshore" operations. Virtually no bank in Panama would sign a loan agreement for more than seven years, although the renewal of loans was quite common. There is no accurate data on the amount of capital debt that is "rolled over," but it appears to be a common practice. Desarrollo Industrial, S. A., a development institution created by the Agency for International Development, offered loans at 9 percent for up to ten years, but the supply of funds was limited as of 1972.[16]

Probably the most common method of acquiring short-term capital debt, at the present time, is through the use of an overdraft or sobregiro mechanism. Panama is clearly the "land of the overdraft account" in that approximately thirty banks offer this device as a source of debt-financed capital.[17] After a firm has established a line of credit with a bank and signed an agreement stipulating the terms of the overdraft, it can draw checks on its demand deposit account in excess of the amount deposited. The bank will automatically deposit funds to cover the amount of the overdraft up to the line of credit.[18] Some banks deposit an amount equal to the amount of the overdraft, while others will deposit 10 percent of the line of credit or some multiple of 10 percent sufficient to cover the overdraft. If a firm has a line of credit of $100,000, for example, and overdraws its account by $12,000, the bank will deposit either $12,000 or $20,000 into the demand account depending upon bank policy. The latter amount would force the firm to borrow more funds than it needs. The interest rates on such overdrafts are presently 8.5-10 percent.

The *sobregiro* is a convenient method of acquiring capital funds, particularly if the demand for such funds is frequent and unpredictable as to timing and magnitude. The exact number and value of outstanding overdrafts is not available; however, conversations with a number of bankers leads one to believe that every firm that borrows money from a bank in Panama at least twice a year has an overdraft account.[19]

Another primary capital debt market in Panama is the government bond market. Government bonds are acquired by state agencies, particularly the *Caja de Seguro* Social, and by the public. As of December 31, 1971, the *Caja de Seguro* Social held B/65.2 million in government bonds while B/57.4 million were held by the public.[20]

According to a 1956 cabinet decree, all insurance companies must invest a portion of their reserves in government bonds. In 1970, the 14 national insurance companies held $5,251,265 in bonds, representing a 110 percent increase over those held in 1966.[21] Foreign insurance companies held $4,318,463 in 1970 which also represented a 100 percent increase over 1966.[22] In 1970, the 25 largest banks operating in Panama accounted for $5,056,000 in government bonds, which rose to $8,421,000 in 1971.[23] The bonds pay 6 percent and have a twenty-year period to maturity. Occasionally the bonds are traded in an over-the-counter market where discounts have been as high as 30 percent.

Monetary Financial Institutions

The second external factor that can affect the supply of and demand for equity-financed capital is the type and number of financial institutions. The dominant monetary financial institutions in Panama which provide the principal financial assets to savers are commercial banks. During the 1960's, the number of these financial institutions increased dramatically. In 1962, for example, there were only six commercial banks in Panama with a total of fourteen offices. As of June, 1973, there were 51 commercial banks with a total of 168 offices.[24] Between December, 1972, and June, 1973, the number of banks licensed to conduct business in Panama increased by eleven. The allocation of banks by nationality is given in Table 3.1.

There are a number of reasons for the presence of so many international commercial banks in Panama. First, there are no exchange controls given by the government. Second, since 1968 the government has shown stability and a desire to attract foreign investment and tourism. Third, the tax laws are conducive to the generation of tax-free income from foreign sources by financial institutions operating in Panama. The income tax laws are based upon the source of income and not the residence of the income recipient. Only income derived from sources within the Republic of Panama is subject to Panamanian income tax rates. Fourth, there is no central bank in Panama. Neither the

TABLE 3.1.--Banks Operating in Panama Classified by Nationality, 1973.

Country	Number of Banks
Panama	15
United States	10
Colombia	6
Switzerland	4
France	4
Spain	2
West Germany	2
Holland	1
Great Britain	1
Luxembourg	1
South Korea	1
Brazil	1
Japan	1
Hong Kong	1
Canada	1
	51

Source: Comisión Bancária Nacional, República de Panamá, 1973.

government nor its agencies make any attempt to control the size of the money supply or to establish borrowing rates amongst the banks. Harry Johnson has argued that a central bank carries the threat of monetary mismanagement that can result in exchange and payment restrictions and devaluation.[25] Thus Johnson has viewed the absence of a central bank to be more of an advantage than a disadvantage:

> Monetary history is full of cases of governments hungry for money that they wanted to spend on projects they considered desirable, obtaining money not by taxes but by pressing their central bank to buy more government debt than was prudent from the point of view of defending the stability of the currency. As a result, the central bank runs its international reserves and liquidity position dangerously low and the government is driven into exchange and trade controls . . . and currency devaluation. . . . For countries short of domestic savings and dependent on foreign capital for economic development, this highly probably long-run effect is a costly price to pay for capturing the returns on the investment of the real resources represented by the domestic money supply.[26]

The fifth reason for the "banking boom" in Panama is liberal banking laws. On July 2, 1970, Cabinet Decree Number 238 was issued which created the National Banking Commission of Panama. The Commission was established to insure the soundness and efficiency of the banking system and to promote favorable conditions in developing Panama as an international banking center. The banking laws only affect the operations of banks within the Republic and pertain to the general areas of licensing, paid-in capital, contingency credits, legal reserves and liquidity.

Except for Banco Nacional, the official bank of Panama, every banking entity in Panama must have one of three licenses issued by the National Banking Commission. A Class I license is issued to banks organized under foreign legislation and in accordance with Panamanian legislation that operates within and outside of Panama. A Class II license is issued to those banks organized in accordance with Panamanian legislation that operate exclusively outside of Panama. A Class III license is issued to those banks organized in accordance with foreign legislation that only have representative offices in Panama.

Commercial banks that operate in Panama must have a paid-in capital of at least B/1 million. These banks must also have at least B/250,000 in assets deposited in Panama, primarily in the form of government bonds, which are free from all obligations so as to act as a deposit of guarantee. If at least 75 percent of the bank's capital is owned by Panamanian citizens or foreigners who have continuously resided in Panama for at least five years, banking operations may start with a paid-in capital of B/250,000 with ten years to increase the amount to the minimum B/1,000,000.

In order to maintain its license, a bank must be the beneficiary of a contingency credit granted by a foreign bank or its head office outside of Panama in an amount not less than 10 percent of the total value of its productive assets. In addition, every bank must maintain a legal reserve consisting of cash assets of not less than 5 percent and not more than 25 percent of the total amount of local deposits. Although the exact rate is set by the National Banking Commission, at least 30 percent of the reserve must be money of legal tender in Panama.

Every bank operating in Panama must also maintain a minimum balance of liquid assets equivalent to 35 percent of the gross total of its deposits, except for mortgage banks that have a rate of 12 percent. Deposits received from a bank's head office, branch, subsidiary or affiliate are not subject to the liquidity requirements.

There are no restrictions on either interest paid by banks on foreign deposits or on local time deposits. Hence, it is not uncommon to find foreign depositors earning 9-10 percent on their time deposits. In fact, the commercial banks have become a haven for foreign capital because of higher interest rates being paid on deposits and numbered bank accounts that provide secrecy for their owners. A number of foreign banks also transfer a portion of their assets to their branches in Panama for relending to other Latin American customers. Except for the liquidity requirement that includes foreign deposits, there are no restrictions on the "off-shore" operations of banks operating in Panama.

The National Bank of Panama is one of two government-owned banks. The oldest bank in the country, it began as a mortgage loan bank and was changed to a commercial or full-service bank in 1956.[27] In 1969 it acquired the Bank of Popular Credit, another government institution, which was created in 1962 to make small loans to low-income workers. The National Bank of Panama is the official depository and fiscal agent of the central government, provinces, municipalities, and autonomous agencies. In 1971 it was still the largest bank in Panama with about 16 percent of the total banking system assets.

The other government-owned bank is the Savings Bank, established in 1934. The savings of its depositors are used for granting loans on real estate and other tangibles with an open market value. It has made a significant contribution to the economy by approving over B/100 million in loans as of 1970.

Between 1965 and 1971, the banking system rapidly enhanced its financial position. Table 3.2 and Table 3.3 contain the balance sheet data of all banks in the banking system. These data include the assets and liabilities of the government-owned banks as well as the private banks.

According to the data of Table 3.2, the highest proportion of the total assets in the banking system is in the form of local and foreign loans. As a percentage of total loans, foreign loans have significantly increased

TABLE 3.2.--Classification of Assets of Banking System in Panama, 1965-1971.
(In Millions of Balboas)

Assets	1965	1966	1967	1968	1969	1970	1971
Liquid Assets	44.0	53.8	59.7	68.8	89.3	103.1	135.5
Loans	184.3	240.8	263.2	302.7	433.9	665.2	938.3
Local	170.7	195.2	233.2	261.4	331.6	419.8	562.9
Foreign	13.6	45.6	30.0	41.3	102.3	245.4	375.4
Securities	2.4	3.1	5.0	6.8	8.6	10.5	11.9
Government	1.2	1.6	3.5	2.8	3.6	6.5	7.9
Foreign	0.3	0.3	0.0	2.1	2.6	1.3	0.8
Other	0.9	1.2	1.5	1.9	2.4	2.7	3.2
Other Assets	17.1	30.7	17.2	15.3	21.1	37.3	45.8
Total Assets	247.8	328.4	345.1	393.6	561.9	816.1	1131.5
(Percentages)							
Local Loans / Total Loans	92.6	81.1	88.6	86.4	76.4	63.1	60.0
Foreign Loans / Total Loans	7.4	18.9	11.4	13.6	23.6	36.9	40.0
	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Comisión Bancária Nacional, República de Panamá, 1973.

TABLE 3.3.--Classification of Liabilities of Banking System in Panama: 1965-1971.
(In Millions of Balboas)

Liabilities	1965	1966	1967	1968	1969	1970	1971
Domestic Deposits	136.2	161.3	193.8	216.6	239.4	303.7	373.2
Time	83.8	102.8	126.6	138.8	153.4	200.6	264.8
Demand	50.9	57.2	65.0	75.0	83.2	99.1	103.8
Other	1.5	1.3	2.2	2.8	2.8	4.0	4.6
Foreigh Deposits	71.5	107.7	105.1	124.7	234.3	410.9	602.2
Time	30.2	48.2	49.9	73.9	150.2	194.4	544.8
Demand	41.0	57.4	51.4	46.6	83.0	212.9	53.1
Other	0.3	2.1	3.8	4.2	1.1	3.6	4.2
Obligations	1.1	2.7	4.9	9.4	28.4	24.7	45.5
Internal	0	0	0	1.3	5.6	2.4	1.8
External	1.1	2.7	4.9	8.1	22.8	22.3	43.7
Other Liabilities	20.1	36.1	21.1	21.7	30.2	42.6	45.4
Capital and Reserves	18.9	20.6	20.2	21.2	29.6	34.2	65.2
Total Liabilities	247.8	328.4	345.1	393.6	561.9	816.1	1131.5
				(Percentages)			
Domestic Deposits / Total Deposits	.656	.600	.648	.635	.505	.425	.383
Foreign Deposits / Total Deposits	.344	.400	.352	.365	.495	.575	.617
	1.000	1.000	1.000	1.000	1.000	1.000	1.000

Source: Comisión Bancária Nacional, República de Panamá, 1973.

relative to local loans between 1965 and 1971. This shift is a manifestation of the agressiveness and scope of the Panamanian banking community.

The international character of the banking system is further reflected on the liability side of the balance sheet as shown in Table 3.3. In 1965, local deposits as a percentage of total deposits exceeded that of foreign deposits. In 1970, a shift occurred such that foreign deposits became a larger percentage of total deposits.

Panama's role as an international banking center can further be seen by the inflow of foreign funds to the banking system relative to the total banking assets invested or loaned outside of Panama. In 1971, foreign deposits and obligations totalled B/647.7 million while loans and investments by Panamanian banks outside of Panama totalled B/376.2 million. Foreign loans and investments, therefore, represented 58 percent of foreign deposits and obligations. This reflects the international intermediary function of the Panamanian banking system and suggests that a considerable portion of foreign deposits remain available in Panama for financing local economic development.

Commercial Banks and the Indirect Financing Process

Since 1965, the monetary financial institutions have played a nominal role in the indirect financing process except in the issuance of capital debt. As indicated in Table 2.10 of Chapter II, the number of residential and non-residential loans granted has been increasing dramatically since 1965, with most of the local loans going to the commercial sector. Hence, banks or monetary financial institutions have engaged in the process of indirect financing in Panama. Firms have issued capital debt to banks in exchange for a promissory note or overdraft account. The banks, in turn, have offered indirect securities in the form of demand and savings accounts.

Yet, banks have not purchased primary securities in the form of corporate stock or bonds from local enterprises to any appreciable extent since 1965. As indicated in Table 3.2, the proportion of total assets in the banking system attributable to primary securities has been less than 2 percent since 1965. Although it is not specified, most of the securities held by the banks are government bonds. The banks hold very few securities from local private firms. The apparent reason for this behavior has been the higher rate of return on loans to residents and non-residents relative to the return on local securities. A portfolio of 39 Panamanian firms currently paying a dividend showed an after-tax dividend yield of 5.8 percent for 1971.[28] At the same time, commercial banks were issuing loans with interest rates of 9.5 to 12.5 percent. Furthermore, if the loan was made to a non-resident, the interest received was not taxable.

Although there are no laws to prevent it, few banks have assumed the role of investment bankers. Banco Fiduciário is the only bank with an active trust department that has attempted to advance the bank's role in the process of indirect financing. Due to the relative unprofitability of local capital stock and bonds, most banks have allocated their funds in the form of loans. An exception to this behavior, however, occurred in 1973 when the Coronado Beach Golf Club, Inc. issued five-year debentures totalling B/1,300,000. First National City Bank of New York, Banco Continentál de Panamá, S. A., Banco de Colombia, S. A., and the Chase Manhattan Bank purchased the entire issue. The interest on the debentures was payable quarterly at a rate of ½ of 1 percent over the London Interbank rate for a $100,000 certificate of deposit at 90 days with a minimum rate of 9.5 percent and maximum rate of 12 percent.

Non-Monetary Financial Institutions

Although commercial banks dominate the financial community, there are non-monetary financial institutions that also facilitate the savings-investment process. These institutions include finance companies, insurance companies, savings and loan associations, capitalization companies and credit cooperatives.

In 1970 there were 24 finance companies with total assets of B/36 million.[29] Thirteen of these were commercial credit companies, mainly financing automobiles and home appliances; four were home loan savings and loan associations; five were in the business of granting small personal loans; and two were industrial development institutions.

The most important non-monetary financial institution in Panama as of 1973 was Desarrollo Industrial, S. A., commonly referred to as DISA. It was created in 1963 by the United States Agency for International Development. By 1971, it was privately and totally owned by 281 Panamanian stockholders with an authorized capital of B/14 million. DISA has granted medium and long-term loans for up to 15 years at an interest rate of up to 9 percent. The loans are usually for equipment and buildings for new industries that are designed to increase employment, increase exports, utilize national raw materials, or engage in import substitution. As of 1970, DISA had approved 152 loans for a total of B/12 million.

In 1970, there were also 14 national and 14 foreign insurance companies operating in Panama with assets of B/51.2 million.[30] Most of the investments of the insurance companies were in government bonds, with some funds being spent on the capital stock of local business firms and real estate. The Social Security Fund--a unique type of insurance company--is authorized to use funds accumulated from its insured members to purchase government bonds and to make loans to industry and housing.

In 1954 the National Council of Cooperatives was established to promote agricultural and credit cooperatives.[31] By 1970 there were nearly 200 functioning cooperatives with over 22,000 members. One hundred and fifteen of these cooperatives were credit cooperatives located mainly in urban areas. Seventy-five of these belong to the Federación de Cooperatívas de Crédito, which was given a B/2 million loan in 1971 from USAID for relending to members.

Finally, there are two capitalization companies in Panama. One was established by the Banco de Colombia with the International Insurance Company of Panama; the other was established by Seguros Bolívar, the largest insurance company in Panama. Capitalization companies are financial institutions that collect savings from the public and issue an insurance policy to the depositor. The policy is issued for an amount such that the premiums are equal to the total amount the depositor pledged to save over a period of time. These amounts vary from B/1,000 to B/500,000 and the period involved varies from 12 to 208 months. Once a month, a drawing is held based upon the National Lottery and the certificate whose number corresponds to the last three digits of the first prize lottery number wins for the holder of the account the amount he pledged to save.

These capitalization companies are controlled by the Panamanian government and regulated by the laws governing insurance companies. This means that a portion of the funds deposited in the companies must be invested in the Republic such as bonds or real estate.

Non-Monetary Financial Institutions and Indirect Financing Techniques

The non-monetary financial institutions also have played a role in the indirect financing process by purchasing primary securities of the Panamanian government and local business enterprises. Insurance companies, credit unions, and finance companies have all purchased the capital stock and/or capital debt of local entities. The data of Table 3.4 summarize the type of investments that the 28 insurance companies held in 1970. It is evident, particularly in the case of the foreign insurance companies, that there has been a preference to invest in government bonds rather than corporate stock or bonds. In some cases, however, the rate of return on corporate stock was higher than the return on the government bonds.

Desarrollo Industrial, S. A., has also acted as a financial intermediary by purchasing the primary securities of other Panamanian firms as well as by issuing its own stock. Table 3.5 contains the portfolio of DISA for the years 1970 and 1971. However, these investments represented less than 3 percent of the total assets for both years. During the same years, DISA had 201,184 shares of its 400,000 authorized shares in circulation with a nominal value of B/2,011,840.[32] Since 1968, DISA has paid a dividend ranging from B/0.50 to B/1.45 per share.[33]

TABLE 3.4.--Types of Investments and Rates of Return on Investments Held by National and Foreign Insurance Companies, 1970.

National Firms	Type of Investment		Rate of Return on Investments	
	Govt. Bonds	Corp. Stock	Govt. Bonds	Corp. Stock
1	200,000	--	.094	--
2	200,000	--	.075	--
3	160,000	--	.069	--
4	347,000	--	.077	--
5	54,000	--	.045	--
6	1,185,000	2,179,000	.074	.069
7	680,000	186,000	.069	.118
8	443,000	1,214,000	.057	.081
9	317,000	785,000	.075	.027
10	427,000	528,000	.070	.092
11	95,000	--	.107	--
12	525,000	343,000	.070	.058
13	455,000	2,366,000	.072	.006
14	162,000	200,000	.068	.006
Foreign Firms				
1	138,000	--	.075	--
2	451,000	--	.075	--
3	221,000	450,000	.108	--
4	400,000	--	--	--
5	170,000	--	.073	--
6	200,000	--	.045	--
7	576,000	--	.048	--
8	300,000	--	.060	--
9	153,000	--	.077	--
10	613,000	--	.057	--
11	475,000	172,000	.077	.144
12	360,000	--	.053	--
13	--	--	--	--
14	261,000	--	.060	--

Source: Sr. Fernando C. Ruiz C., Superintendent of Insurance, Republic of Panama, 1972.

TABLE 3.5.--Investment Portfolio of Desarrollo Industrial, S. A. Registered at the Cost of Acquisition, 1970-1971.

Investments	1971	1970
Fundición Centroamericana, S.A.	14,000	14,000
Conservas Panameñas Selectas, S.A.	25,000	25,000
Latas Panama, S.A.	25,000	25,000
Industria Panameña de Papel, S.A.	153,300	153,300
Concreto, S.A.	25,063	25,063
Finanzas, Contraduria y Cobranzas, S.A.	913	913
Tubos Miraflores, S.A.	4,020	4,020
Molino Panameño de Papel, S.A.	20,000	20,000
Editora Intercontinentál, S.A.	--	20,000
Capitales Panameños, S.A.	14,929	11,406
Distribuidóra de Papel, S.A.	22,000	21,900
Bonos Puentes de la Provincia de Colon--1967-87 at 6%	225	600
Bonos para Caminos Llanos de Cocle--1968-88 at 6%	3,750	5,250
Bonos de Establecimientos de Salud Publica--1968-88 at 6%	214	214
Bonos para Construcciońes Nacionales--1968-88 at 6%	3,599	3,929
	B/312,013	B/330,595

Source: Annual Report, DISA, 1971.

Credit unions operating in Panama have also acted as financial intermediaries by purchasing the primary securities of local firms and offering their own credit union shares as indirect financial securities. As of 1972, however, the Federación de Cooperativas de Crédito de Panama which includes 75 credit unions, only reported investments totalling B/11,550. None of these investments were in the form of capital stock or capital debt of local firms.

Panama as a Regional Financial Center

Due to the activities of the various financial institutions operating in Panama, the country has developed into a regional financial center designed to service the financial needs of enterprises within Panama and the countries surrounding it. Panama has attracted these foreign financial institutions by virtue of its location and legal advantages rather than national size, international power, or the competence of national banks in international financial business.[34]

Although the financial center is largely financed by foreign capital and directed by foreigners, there are a number of potential benefits derived from its presence.[35] First, there are taxes collectable by the central and local governments on the profits of the financial institutions and on the incomes of the foreign employees of these institutions. Since the capital and skilled people employed in the financial center would not be in Panama otherwise (and therefore would not be subject to taxes), and since these inputs do not replace domestic capital and skills, the ability of the government to tax the financial institutions represents a net gain in taxable capacity. Second, the sources of employment for the local population can be expanded in two ways. One is the employment provided to construction workers in the process of building new office buildings or reconditioning old ones. This includes the construction of new apartment buildings and other forms of housing for the incoming foreign employees. The other source of employment is in the financial sector. This source includes skilled and unskilled positions ranging from janitors and drivers to accountants and executives.

A third potential benefit derived from the financial center derives from improved welfare effects among Panamian citizens as capitalists or potential capitalists. Improved welfare effects include: the capital gains received by urban landowners from selling land for offices and apartment buildings; the provision of safer and higher-yielding outlets for savings through the process of financial intermediation; and the provision of capital funds to local enterpreneurs on more attractive terms through financial intermediary activities.

An empirical investigation of the quantitative importance of these potential benefits led Johnson to conclude that "there is little impressive quantitative support to the view that the growth of the financial center is a powerful lever for promoting Panamanian economic development. To a degree, Panama receives all of the potential benefits of a financial center, but not to the degree of being a major impetus in the process of economic growth and development."[36] The data of Table 3.6 shows that Panama is rapidly approaching the stature of other regional financial centers of the world. As the assets, deposits, and number of financial institutions increase, the pecuniary benefits for Panama will also increase.

Regulatory Framework

The third external factor that can affect the demand for and supply of equity-financed capital is the regulatory framework, i.e. the government agencies and laws that regulate the exchange of securities. Regarding the regulatory framework in Panama, Cabinet Decree Number 247 passed on July 16, 1970, created the National Securities Commission of Panama. This commission primarily was created to supervise the registration, issue, sale, and transfer of capital stock within Panama. Specifically, it was designed to encourage firms operating in Panama, or seeking to operate in Panama, to register their securities with the National Securities Commission (NSC).[37] In the event that a saver wanted to

TABLE 3.6.--International Financial Centers, 1973.
(In Billions of Dollars)

Financial Center	Banks	Assets	Deposits
Nassau	333	$ 12	$ 2.2
Luxembourg	51	11	N.A.
Singapore	43	2.4	1.4
Grand Cayman	95	N.A.	25
Hong Kong	74	7.9	4.8
Panama	51	1.9	1.6

Source: Chase Manhattan Bank, Republic of Panama, 1973.

buy shares of stock in a Panamanian firm, the saver would check with the NSC as to the financial status of the companies selling capital stock. The shares could then be sold through a licensed broker and the trade registered by the NSC.

The National Securities Commission operates within the Ministry of Commerce and Industry and has the authorization to verify the truthfulness of information provided by corporations that register with NSC; to authorize or suspend the sale of securities as established by Cabinet Decree 247; to issue licenses to stockbrokers and mutual fund salesmen (as well as revoke such licenses); to regulate the sale of mutual fund shares, domestic or foreign, within the Republic; and examine the financial statements of the companies registered with the NSC at least once a year.[38] The National Securities Commission is solely responsible for reporting any changes in price of those stocks listed in the local newspapers. As of June, 1972, stockbrokers must submit a form similar to those used in the United States to the National Securities Commission for each trade.

According to Cabinet Decree Number 247, every corporation seeking to offer shares of capital stock to the public must submit an application to the NSC for approval before issuing the stock. This application must include, among other things, the names of the officers of the company, the quantity, value, and price of the stock to be offered, and complete financial statements that are no more than four months old at the time of application.

Cabinet Decree Number 247 also regulates the activities of stockbrokers.[39] Each must have a license to conduct business issued by the NSC, be a Panamanian citizen, and maintain with the National Government a security bond of $1,000. Each stockbroker must also pass a written examination to determine the individual's basic knowledge about securities, mutual funds, current legal provision and stock exchange operations. Cabinet Decree Number 247 also includes articles that define the rights afforded to minority stockholders.[40] Beyond the fact that they can vote at shareholder meetings on issues brought before the groups of shareholders, and that they can contest matters pertaining to the operation of the company by requesting a hearing before a judge, the minority shareholders have little power. There are no specific provisions for proxy votes, the right of shareholders to inspect the company's records, the preemptive right to subscribe to new issues, or the right to sue the directors of the company.

Under the general provision of Cabinet Decree Number 247, capital gains realized from the sale of stock issued by companies with at least 25 percent of their assets invested in Panama--are not considered as part of taxable income. The interest paid on bonds, financial or mortgage certificates, or other debentures with maturity dates in

excess of three years, are subject to a 5 percent withholding tax on the interest received per year. Once this tax is paid, however, the recipient of the interest need not declare the interest received as part of his taxable income.

Cabinet Decree Number 248 specifically regulates the sale of mutual fund shares by national and foreign mutual funds.[41] National mutual funds must have a paid-in capital of at least B/2,000,000 and a security bond of at least B/50,000 which can be in the form of local bank deposits or government bonds. Foreign mutual funds must have a paid-in capital of at least B/5,000,000 and a security bond of at least B/250,000. Both of these financial requirements must be met before any shares of the mutual fund can be sold. In addition, all mutual funds are required to invest in Panama. Both national and foreign funds must invest at least 25 percent of all mutual fund sales in Panama. This investment can be in the form of stock in national companies, government bonds, real estate, or mortgages. Up to one-third of the investment can be in a time deposit with the Caja de Ahorros in Panama.

Since 1970, the National Securities Commission has spent much of its time encouraging national companies to register their securities and developing amendments to the existing securities laws. The intent of the Commission has been to generate an environment conducive to open

trading of stocks and bonds. The full disclosure of financial statements and intended uses of capital funds is a major step in reducing obstacles to the successful implementation of an organized stock market. As of early 1973, however, only fifteen companies had registered their capital stock with the Commission. Most business firms did not register their stock because they did not want to share ownership in the business.

Estimates of Savings in Panama

The fourth external factor that primarily affects the supply of equity-financed capital is the amount of savings in the economy. Most of the data employed in studies of savings behavior in developing countries are derived from national product data at market prices. Apart from gross domestic savings, no completely consistent cross-country information exists for the major components of savings among the developing countries. Most estimates of gross domestic savings are derived as a residual following a process of deducting the current account deficit from gross capital formation.[42] Gross private savings is derived by subtracting from gross domestic saving, government saving or government revenue minus current government expenditures. As a residual, the validity of the savings figure is totally dependent upon the validity of other figures such as gross capital formation. Unfortunately, there is no way to determine the accuracy of these figures.

Table 3.7 provides the derivations of the savings estimates for Panama between 1967 and 1971. Except for 1970, gross private savings (which includes savings from households and corporations), increased steadily between 1967 and 1971. Gross private savings as a percentage of GDP have remained relatively stable since 1967 at an average level of 18 to 19 percent.

Table 3.8 contains data on the gross domestic capital formation and savings by percentage shares for 19 Latin American countries during the period 1964-68.[43] As can be observed, Panama's corporate sector has accounted for the bulk of the savings in the country while the household sector has on the average dissaved over the period 1964-68.

Alternatives Available to Savers

In Table 3.9 are listed the alternatives available to local and foreign savers. In comparing after-tax risk and rate-of-return on capital stock with other available alternatives in Panama, it appears that capital stock has provided the most risk with a competitive to less than competitive rate of return relative to other alternatives.

As indicated in Table 3.9, the pre-tax and after-tax dividend yields of a sample of common stocks in 1970 were 6.4 percent and 5.8 percent respectively. Of the alternatives available to Panamanians, capital stock is the only form whose yield is subject to withholding or income tax. At the same time, interest rates on bank time

TABLE 3.7.--Gross Domestic Capital Formation and Savings 1967-1971.
(Millions of 1960 Balboas)

	1967	1968	1969	1970	1971
Gross Capital Formation	158.5	179.5	205.5	242.2	276.5
Current Account Deficit[a]	-26.1	-15.0	-33.4	-78.2	-79.1
Gross Domestic Saving	132.4	164.5	172.1	164.0	197.4
Government Saving[b]	- .8	- 6.7	- 4.8	-15.8	- 6.4
Gross Private Saving	131.6	157.8	167.3	148.2	191.0
Gross Private Saving As % of GDP	.182	.205	.200	.166	.196

[a]Includes unilateral transfers between the Canal Zone and other countries.

[b]Uses ordinary revenues and expenditures.

Source: Panamá En Cifras, November, 1972, and; América En Cifras, Organization of American States, Book No. 4, 1972.

TABLE 3.8.--Capital Formation and Saving, 19 Latin American Countries, 1964-68.

	Gross Domestic Capital Formation Percent Share				Saving			
						Percent Share of		
	GNP	Depre-ciation	Saving	Internat. Deficit	% of National Income	General Govern-ment	Corpo-rations	House Holds
Argentina	18.2	--	--	--	--	--	--	--
Bolivia	16.7	34.0	41.2	24.8	7.8	3.6	65.6	30.8
Brazil	16.2	29.4	70.0	0.6	14.6	13.8	86.2	
Chile	17.0	56.0	32.8	11.2	7.0	104.0	62.4	-66.4
Colombia	19.7	44.0	42.8	13.2	9.8	54.4	32.0	13.6
Costa Rica	23.5	25.0	44.0	31.0	12.2	12.6	87.4	
Ecuador[a]	13.9	36.2	51.6	12.2	8.4	75.6	24.4	
Guatemala	13.2	75.0		25.0	5.8[b]	33.5[b]	66.5[c]	
Guyana[a]	23.3	26.0	48.4	25.6	12.4	0.2	5.2	94.6
Honduras	17.3	25.2	50.6	24.2	10.0	9.0	33.6	57.4
Jamaica	23.7	31.4	42.6	26.0	11.6	16.5[b]	58.2[b]	25.3[b]
Nicaragua	20.5	19.8	52.4	27.8	12.0	24.4	65.6	0.0
Panama	20.7	43.4	39.2	17.4	9.6	53.6	109.2	-62.8
Paraguay	15.2	45.0	28.2	26.8	4.8	65.2	34.8	
Peru[a]	20.0	87.0		13.0	13.8[c]	0.5[c]	67.0[c]	32.5[c]
Trinidad	23.7	37.0	40.0	23.0	10.8	27.2	72.8	
Uruguay	12.0	30.0	80.8	-10.8	10.6	5.0	95.0	
Venezuela	23.4	41.6	57.8	0.6	16.0	59.0	13.6	27.4

[a]1963-67. [b]1964-67. [c]1964-66.

Source: United Nations, Yearbook of National Accounts Statistics, 1969, Vol. II, Tables 2 and 8.

TABLE 3.9.--Summary of Principal Local Financial Investments Available to Panamanian Savers, 1972.

	Pre Tax Effective Yield	Tax on Yield	After Tax Yield	Special Characteristics
BANK DEPOSITS				
Savings Deposits (under B/14,000)	.045	Tax Exempt	.045	Minimal Risk Many Bank Branches- Very convenient
Time Deposits (over B/14,000 and over 31 days maturity)	.060 - .080	Tax Exempt		Minimal Risk Many Bank Branches- Very convenient--rates competitive with other money centers
MORTGAGE DEPOSITS	.055	Tax Exempt	.055	Minimal Risk
SAVINGS AND LOAN				
Savings Deposits	.055	Tax	.055	Minimal Risk-Saver can get higher rate if he chooses longer term deposit.
Fixed Term	.060	Exempt	.060	
Fixed Term	.070		.070	
GOVERNMENT BONDS	(.060 nominal) .070 - .080	Tax Exempt	.070-.080	Some Risk--Bonds sell at a discount in over-the-counter market
COMMON STOCK[a]	.064 (dividend yield)	10 percent dividend withholding	.058	High degree of risk. Lack of organized market. Market in downtrend at present.

[a]Based upon a portfolio of thirty-nine common stocks utilizing prices and earnings per share as quoted on November 29, 1972.

Source: Peter Treadway, Capital Markets Program, Organization of American States, Washington, D.C., 1973.

deposits of over B/14,000 fluctuate freely according to changes in the market supply and demand. Since Panamanian savers can place funds abroad without restriction, local interest rates must always be competitive with rates obtainable in international money centers. In 1972, bank time deposits of over B/14,000 with maturity periods in excess of thirty-one days averaged 6.8 percent.

For the small saver, ordinary bank savings accounts paid 4.5 percent while mortgage banks and savings and loan associations paid 5.5 percent in 1972. Savers also could purchase government bonds in the discount market with yields of 7 to 8 percent. The risk on these types of savings is minimal; banking facilities are well developed, and branch offices exist throughout the country.

The total return on capital stock is the dividend yield plus any capital gains or losses. In general, it would not be correct to equate the dividend yield with the return on capital stock. Panamanian savers who purchase shares of stock, however, purchase for the long-run and only seem to be concerned with the dividend yield. In view of this assumption, the above use of dividend yield as a basis for comparison with other financial assets has some justification.

Summary

Capital debt issued in primary markets appears to be the most prominent type of capital funds in Panama.

Secondary stock markets are not active and do not represent a major source of capital funds. Primary stock markets are virtually non-existent. There are many monetary and non-monetary financial institutions capable of supplying equity-financed capital to businesses through the indirect financing process. Most of these financial institutions, however, do not supply equity-financed capital because the rates of return on financial assets, such as loans and savings deposits, are higher than the return on common stock. A regulatory framework has been established in the form of the National Securities Commission of Panama. The Commission was primarily organized to supervise the issuance and transfer of capital stock. Between 1970 and 1972, however, few companies had registered their outstanding shares of stock with the Commission.

Panama has developed into a regional financial center that serves the financial needs of foreign and domestic enterprises. Although the center primarily acts as a haven for foreign capital, it does provide a number of economic benefits to Panama such as tax revenue. Gross private domestic saving steadily increased between 1967 and 1971. The negative saving of households was offset by the positive saving of companies and the government. The greater proportion of savings in banks, however, came from foreign depositors.

FOOTNOTES--CHAPTER III

[1]For a detailed discussion of primary and secondary capital markets, see Louis K. Brandt, Business Finance: A Management Approach (Englewoods Cliffs, N.J.: Prentice-Hall, Inc., 1965), Chapter 20.

[2]Ibid., p. 412.

[3]Ibid., p. 420.

[4]Ibid., p. 422. It is interesting to note that most brokerage firms consider themselves as investment banks. The major difference is that a brokerage firm acts as an underwriter and as a dealer in securities. It can buy and sell securities for customers and its own account. An investment bank, however, only acts as an underwriter.

[5]Louis K. Brandt, Business Finance, p. 413.

[6]Although the supply of capital funds is equal to the amount of money being offered by surplus-spending units, the decision to supply capital funds is dependent upon the yield or rate of return on the securities.

[7]Louis K. Brandt, Business Finance, p. 414.

[8]Ibid., p. 416.

[9]Ibid., p. 417.

[10]Joseph Nacchio, in a private interview held in Panama City, Republic of Panama, July, 1972.

[11]Joseph Nacchio and Monty Motta, in private interviews held in Panama City, Republic of Panama, July, 1972.

[12]One case, in particular, dealt with an American who began a travel agency in Panama City. After establishing the agency, the American sought to import air-conditioned buses in order to conduct tours around the country. With the government's sanction, the buses were shipped to Panama. Later, Panamanian cab drivers lodged a complaint with the government that the buses were taking a significant portion of business away from them. The

government, in turn, forbade the use of the buses by the travel agency. After attempts to settle the issue failed, the American closed his agency and returned to the United States. The buses, however, remained in Panama.

[13]James Reid, in a private interview held in Panama City, Republic of Panama, August, 1972.

[14]Monty Motta, in a private interview held in Panama City, Republic of Panama, August, 1972.

[15]Meeting with representatives of U.S.I.F., Panama City, Panama, June, 1972.

[16]Ricardo Lay, in a personal interview held in Panama City, Republic of Panama, June, 1972.

[17]Welton Hewitt, in a personal interview held in Panama City, Republic of Panama, July, 1972.

[18]As mentioned earlier, Panama does not have a central bank. Bank deposits, therefore, are equal to deposits made by residents and non-residents. As shown in Chapter II, most deposits are made by non-residents.

[19]Ibid.

[20]Peter Treadway, "An Economic Analysis of the Feasibility of Creating an Underwriting Market-Making Fund in Panama" (unpublished report, Organization of American States, Washington, D.C., June, 1973). The public includes institutions as well as individuals in Panama.

[21]Superintendent of Insurance, Ministry of Commerce and Industry (unpublished material, Republic of Panama, 1973).

[22]Ibid.

[23]Jose Chong-Hon, Peat, Marwick, Mitchell and Co. (unpublished report, Republic of Panama, May, 1972).

[24]National Banking Commission, Statistical Bulletin (Panama: National Banking Commission, 1973).

[25]Harry G. Johnson, "The Panamanian Monetary System," Euromoney, January, 1972, p. 48.

[26]Ibid., p. 50.

[27]Thomas E. Weil, Handbook, p. 263.

[28]Peter Treadway, "An Economic Analysis," p. 18.

[29]Thomas E. Weil, Handbook, p. 265.

[30]Superintendent of Insurance, Ministry of Commerce and Industry (unpublished material, Republic of Panama, 1973).

[31]Thomas E. Weil, Handbook, p. 266.

[32]Desarrollo Industrial, S. A., Annual Report, 1971, p. 17.

[33]*Ibid.*, p. 24.

[34]Harry G. Johnson, "Panama as a Regional Financial Center" (unpublished report, USAID Mission, Panama, August, 1972), p. 2.

[35]*Ibid.*, p. 6.

[36]*Ibid.*, p. 42.

[37]Cabinet Decree Number 247, Ministry of Commerce and Industry, Republic of Panama (1970), p. 5.

[38]*Ibid.*, p. 6-7.

[39]*Ibid.*, p. 10.

[40]*Ibid.*, p. 16.

[41]*Ibid.*, p. 34.

[42]Raymond Mikesell and James Zinser, "The Nature of the Savings Function in Developing Countries: A Survey of the Theoretical and Empirical Literature," Journal of Economic Literature, XI, March, 1973.

[43]For a lucid discussion of the mobilization of financial resources in Latin America, see Raymond W. Goldsmith, "The Mobilization of Domestic Resources for Economic Growth Through the Financial System," printed in The Mobilization of Internal Financial Resources in Latin America, Inter-American Development Bank, 1972.

CHAPTER IV

INTERNAL FACTORS AFFECTING THE SUPPLY OF AND DEMAND FOR EQUITY-FINANCED CAPITAL

Introduction

The supply of and demand for equity-financed capital is dependent upon factors internal to the business enterprise as well as upon external ones. The internal factors that primarily affect the demand side are the types of business firms in the economy and their capital needs. The only internal factor that affects both the demand and supply side is the financial characteristics of the business firm.

The ability of the business firm to attract equity-financed capital funds is largely dependent upon the firm's profitability, debt to equity position, dividend rate, and ability to support interest charges.[1] A low dividend rate in the absence of rising stock prices, for example, may provide a less than competitive rate of return to savers; thus, common stock becomes an unattractive source of capital funds. A large debt to equity position, however, may suggest that the business firm cannot afford more capital debt and should use equity-financed capital to satisfy capital needs.

This chapter discusses the internal factors that affect the supply of and demand for equity-financed capital. Financial data collected from business firms operating in Panama are presented as well as a cross-sectional analysis of the types of business enterprises established there.

Sources of Financial Data

In order to determine the financial characteristics of Panamanian business firms, balance sheet and income statement data were collected from two sources. First, financial data were obtained from the 100 largest non-financial business firms classified by net taxable income for 1970. These data included net sales, total assets, net income before and after taxes, retained earnings, paid-in capital and dividends paid. The second source was a random sample of 155 non-financial firms selected from those firms reporting a net taxable income greater than B/15,000 but less than the net taxable income of the 100th largest firm for 1970.[2] Data collected from this sample were the same as those of the first sample with two additions: depreciation expense for the year, and the interest paid.[3] Although the first sample is cross-sectional data for the year 1970, the second sample is a time series for the years 1969, 1970, and 1971.

As indicated in Table 4.1, approximately 5,400 business firms filed a corporate income tax form in 1970

TABLE 4.1.--Classification of Business Firms According to Net Taxable Income, 1970.

Net Taxable Income (Balboas)			No. of Firms
Less than zero			825
.00			1204
.01	-	15,000	2240
15,000.01	-	30,000	484
30,000.01	-	100,000	487
100,000.01	-	500,000	144
500,000.01	-	and up[a]	13
		TOTAL	5397

[a]The highest net taxable income figure for any firm in 1970 was B/4,388,123.

Source: Ministry of Finance, Republic of Panama, 1972.

with 1,128 of these firms reporting a net taxable income greater than B/15,000 for 1970. This means that the combined sample of 255 firms accounted for 23 percent of those firms above the B/15,000 mark and approximately 5 percent of all non-financial firms filing a corporate tax form in 1970. The industrial classification of the two samples given in Table 4.2 indicates that the samples were dominated by commercial enterprises.

The balance sheet and income statement data were collected from the corporate tax returns filed with the Ministry of Finance. All business firms are required to fill out a standard tax form and insert a copy of their balance sheet and income statement. Most firms, however, only complete parts of the standard tax form and use several different forms to report the information usually found in financial statements. As a result, some firms present their financial status using very detailed accounting methods while others use very general methods and may include several different accounts under one general heading. For example, a firm may give a total amount for deductible expenses and not itemize each expense; or a single figure may be given for the amount of paid-in capital with no specification of the number of authorized shares, par value, or number of shares outstanding. Some firms fail to include any financial statements with their tax returns. As a result of these tendencies, tax return data may not

TABLE 4.2.--Industrial Classification of Sample Data.

Type of Business Firm	No. of Firms	Percentage
(Sample of 100 largest firms)		
Industrial	34	34.0
Commercial	63	63.0
Utility	1	1.0
Construction	1	1.0
Transportation	1	1.0
TOTAL	100	100.0
(Random Sample of 155 firms)		
Industrial	21	13.6
Commercial	125	80.6
Utility	1	0.6
Construction	5	3.2
Transportation	3	1.9
TOTAL	155	99.9

Source: Ministry of Finance, Republic of Panama, 1972.

be the most accurate source of financial data. Audited financial statements that follow standardized accounting principles would be a more accurate source. Corporate tax returns are, however, the only source of information regarding the financial characteristics of business firms in Panama. The financial data from the 255 firms sampled here are presented in Appendices A and B.

As an additional source of information, a questionnaire was developed to determine the extent of equity ownership in Panama as well as the sources and uses of capital funds by Panamanian businesses. Graduate students from the University of Panama used the questionnaire to interview 50 executives from a random sample of 50 non-financial firms that reported a net taxable income of B/15,000 or more in 1970. The questionnaire and results of the interviews are presented in Appendices C and D.

Financial and Statistical Measures

After the data were collected, a number of financial ratios were computed for each of the 255 firms. The ratios used to measure profitability for the firms were: the rate of return on capital before and after taxes, the rate of return on net sales after taxes, the rate of return on equity after taxes, and the ratio of net sales to total assets. The ratios used to measure the extent of insolvency risks were: the ratio of total debt to total equity, the ratio of total debt to total assets, and the ratio of retained earnings to equity. In addition, the ratio of dividends paid to profits after tax and the times-interest earned ratio were computed for the random sample of 155 firms.[4]

Three statistics were used to measure the central tendency of the financial ratios: the unweighted arithmetic mean, a weighted mean, and the median. Since all of the distributions analyzed were skewed to the right, the unweighted mean represents a biased average due to the extreme values in the upper portions of the distributions. The weighted mean represents a more unbiased measure of central tendency since it accounts for differences in firm size.[5] The median is also a more unbiased measure because it reduces the influence of extreme values.

Even though the unweighted mean is biased because of the positive skewness, it does serve a useful function. If the weighted mean tends to be greater than the unweighted mean, this indicates that higher weights are associated with higher values of the ratio and vice versa. Therefore, if the weighted average of a debt to equity ratio were less than the unweighted average, firms with smaller equity positions would be associated with larger debt to equity ratios and firms with larger equity positions would be associated with smaller debt to equity ratios. If equity is used as a measure of firm size, it can be said that smaller firms have greater leverage than larger firms.

The statistical values of the financial ratios described above for the two samples are presented in Table 4.3 and Table 4.4. Since the unweighted mean is a biased statistic and since no single statistic can completely describe the financial status of the companies surveyed, the analysis of the financial ratios is based upon the weighted means and medians. The standard deviations around the arithmetic means are given in Appendix A. The size of the standard deviations indicates a relatively high degree of dispersion around the means.

Analysis of Financial Ratios

The risk of insolvency, defined as the probability that a firm will have an insufficient quantity of funds to meet future financial obligations, can be measured by the size of the debt to equity ratio.[6] As the ratio increases, the risks of insolvency also increase indicating that the firm is acquiring more debt relative to its equity. Although there are no exact guidelines for interpreting this ratio, generally a ratio of 1:1 to 2:1 is indicative of moderate insolvency risks while a ratio greater than 3:1 is indicative of high insolvency risks.[7] These guidelines vary, however, from industry to industry. Business firms with a capital intensive production process, for example, will tend to have a higher debt to equity ratio than a service-oriented business.

According to these guidelines, business firms included in the survey indicated low to moderate insolvency

TABLE 4.3.--Averages of Financial Data from Sample of 100 Largest Non-Financial Firms, 1970.

	X[a]	Xw[a]	Md[c]
1. Debt-Equity Ratio	1.228	1.256	0.70
2. Total Debt to Total Assets	0.551	0.557	0.412
3. Return on Capital Before Taxes	0.208	0.097	0.190
4. Return on Capital After Taxes	0.134	0.068	0.102
5. Return on Equity After Taxes	0.251	0.132	0.178
6. Return on Net Sales After Taxes	0.115	0.066	0.085
7. Net Sales to Total Assets	1.588	0.880	1.316
8. Dividends Paid to Profits After Taxes	0.770	0.634	0.383
9. Ratio of Retained Earnings To Equity	0.532	0.533	0.550

[a]Unweighted arithmetic mean.

[b]Weighted arithmetic mean where weights are the denominator of the ratio.

[c]Median.

TABLE 4.4.--Averages of Financial Data Collected from Random Sample of 155 Non-Financial Firms, 1969-1971.

	1969	1970	1971
		X^a	
1. Debt-Equity Ratio	1.350	1.533	1.774
2. Return on Equity Before Taxes	.352	.353	.258
3. Return on Capital After Taxes	.197	.162	.161
4. Return on Equity After Taxes	.260	.277	.208
5. Return on Net Sales After Taxes	.170	.158	.112
6. Net Sales to Total Assets	1.898	1.515	1.645
7. Dividends Paid to Profit After Taxes	.225	.400	.081
8. Ratio of Retained Earnings to Equity	.524	.553	.559
9. Times Interest Earned Ratio	53.407	27.571	21.198
		Xw^b	
1. Debt-Equity Ratio	1.158	1.267	1.620
2. Return on Capital Before Taxes	.087	.072	.062
3. Return on Capital After Taxes	.072	.058	.048
4. Return on Equity After Taxes	.154	.151	.125
5. Return on Net Sales After Taxes	.072	.068	.048
6. Net Sales to Total Assets	.228	.435	.465
7. Dividends Paid to Profit After Taxes	.228	.435	.465
8. Total Debt to Total Assets	.537	.559	.618
9. Ratio of Retained Earnings to Equity	.451	.503	.498
		Md^c	
1. Debt-Equity Ratio	.739	.756	.792
2. Return on Equity Before Taxes	.233	.211	.182
3. Return on Capital After Taxes	.095	.093	.087
4. Return on Equity After Taxes	.197	.174	.151
5. Return on Net Sales After Taxes	.103	.100	.075
6. Net Sales to Total Assets	1.178	1.074	1.089
7. Dividends Paid to Profit After Taxes	0	0	0
8. Ratio of Retained Earnings to Equity	.558	.604	.610
9. Times Interest Earned Ratio	10.481	8.486	6.058

[a]Unweighted arithmetic mean.

[b]Weighted arithmetic mean where weights equal the denominator of the ratio.

[c]Median.

risks for the years studied. For the sample of 100 firms, the ratio of total debt to equity indicated a weighted mean of 1.256 with a median of 0.700 for 1970. The sample of 155 firms showed weighted means of 1.158, 1.267, and 1.620 for the years 1969, 1970, and 1971.

Two points are of interest with respect to these ratios. First, the weighted mean for the sample of 100 firms is approximately equal to its unweighted mean, while the weighted means for the sample of 155 firms are lower than the unweighted means. Thus, in the sample of 155 firms, firms with higher equity positions are associated with lower debt to equity ratios and vice versa. If equity is used as a measure of firm size, this relationship between the means indicates that smaller firms in the random sample tend to be more leveraged than larger firms. Second, the weighted mean and median of the debt to equity ratio have steadily increased over the period 1969-1971. The weighted mean increased at a rate of 16 percent per year while the median increased at approximately 4 percent per year. In addition, the average amount of stockholder equity steadily increased as given by the unweighted mean and median values in Appendix B. These variations indicate that, on the average, the amount of debt held by firms increased faster than the amount of equity during the period 1969-1971.

In comparison to selected developed countries, Panamanian businesses appear to have been moderately or even under leveraged. The ratio of total debt to total assets for seven developed countries is provided in Table 4.5.[8] In 1969 and 1970, this ratio ranged from 0.516 to 0.853 for those countries surveyed. The ratio of total debt to total assets for the 100 largest firms in Panama showed a weighted mean of 0.557 for 1970. The random sample of 155 firms revealed a weighted mean of 0.537 and 0.559 for 1969 and 1970 respectively. The ratio of total debt to total assets for Denmark, Finland, Italy, Japan, and Sweden were significantly higher than that of Panama for the same period. This observation is somewhat surprising in view of the weak capital stock market and strong banking system in Panama. With such an arrangement, one would expect to find the Panamanian firms in a more leveraged position.[9]

A study undertaken by Investigación Desarollo, S. A. (INDESA), a consulting firm located in Panama, also measured the extent of financial leverage among Panamanian firms.[10] Based upon a sample of 25 non-financial firms, INDESA computed a value of 0.446 and 0.455 for the ratio of total debt to total assets in 1969 and 1970 respectively. Computed for commercial firms only, the ratios were 0.695 and 0.716 for 1969 and 1970 respectively.

The average interest expense on the debt rapidly increased during the period 1969-1971, while the ability of the firms to support the interest expenses decreased.

TABLE 4.5.--Total Debt/Total Asset Ratios for Non-Financial Firms from Selected Countries.

	1969	1970
Denmark		
All Non-Financial Sectors	0.660	0.665
Manufacturing Industries	0.637	0.649
Finland	0.733	0.748
Italy	0.715	0.749
Japan		
All Industries	NA	0.853
Manufacturing	NA	0.818
Sweden	0.717	NA
United Kingdom		
Quoted	0.514	0.533
Non-Quoted	0.610	0.579
United States	0.516	0.517

Source: OECD Financial Statistics, 1972.

The unweighted mean interest expense for the sample of 155 firms increased from B/6,262 in 1969 to B/11,345 in 1971, an increase of 81 percent. The times-interest-earned ratio, which measures the ability of the firm to support its interest charges, declined during the same period. The unweighted mean of this ratio declined from 53.4 in 1969 to 21.2 in 1971, while the median value declined from 10.5 in 1969 to 6.1 in 1971. In absolute terms, the business firms surveyed tended to be able to support the interest charges on the average, although this ability decreased significantly between 1969 and 1971.

The profitability rates of the firms surveyed were measured by three financial ratios: the rate of return on capital or total assets, the rate of return on equity, and the rate of return on net sales. These measures were computed by dividing net income before and after taxes by total assets, equity, or net sales. As indicated in Tables 4.3 and 4.4, the weighted means and medians for both samples revealed after-tax profit rates ranging from 6 percent to 20 percent depending upon the measure used and the time period investigated.

Between 1969 and 1971, however, the rates of return on capital, equity and sales decreased on the average. The decline can be attributable to a decrease in demand in the wholesale and retail trade sector, higher prices on imported goods that were not shifted forward in the form of higher domestic prices, and the rise in interest charges during the 1969-70 period.

In the sample of 155 firms, the weighted means of rates of return on capital, equity and sales, were significantly less than the unweighted means. In fact, in most cases the weighted means were less than the medians. This indicates that there were more smaller firms in the sample with higher rates of profitability than larger firms with higher rates of profitability. On the average, the smaller firms were more profitable than the larger firms in the random sample of 155 firms. In terms of the range and median values of the net taxable income of these firms for the period 1969-71, it appears that firms with a net taxable income between B/10,000 and B/35,000 had higher profit rates than those firms with a net taxable income greater than B/35,000 but less than B/200,000. This indication, coupled with the earlier inference that smaller firms in the sample of 155 firms were more leveraged (i.e., higher debt to equity ratios), leads to the conclusion that leverage tended to be profitable in Panama for firms in the B/10,000 to B/35,000 class between 1969 and 1971.

Panamanian business firms also generated higher rates of return on equity during 1969 and 1970 than some developed countries. Average rates of return on equity after taxes for non-financial firms in selected developed countries are provided in Table 4.6.[11] The random sample

TABLE 4.6.--Average Rate of Return on Equity After Taxes for Non-Financial Firms in Selected Countries.

	1969	1970
Finland	0.085	0.076
Japan		
All Industries	NA	0.168
Manufacturing	NA	0.166
Sweden	0.080	NA
United Kingdom		
Quoted	0.089	0.088
Non-Quoted	0.091	0.097
United States	0.065	0.050

Source: OECD Financial Statistics, 1972.

of 155 non-financial firms showed a weighted mean of 0.154 and 0.151 for the after-tax return on equity in 1969 and 1970 respectively. The sample of the 100 largest non-financial firms showed an after-tax return on equity of 0.132 for 1970. Based upon the countries considered in Table 4.6, only Japan reported higher rates of return on equity after taxes in 1970.

In further comparison, Fortune Magazine's 500 largest industrial firms showed a median of 0.046 for the return on sales after taxes in 1969. The industry median for the return on capital after taxes equalled 0.113. In 1970, the "Fortune 500" companies indicated an industry median for the return on sales after taxes of 0.039. The industry median return on equity after taxes was 0.095. The industry medians for the return on sales and the return on equity after taxes were 0.038 and 0.091 respectively in 1971.

The relatively high profitability rates for Panamanian firms are indicative of a significant capacity for the self-financing of capital needs. Moreover, since the weighted means were uniformly lower than the unweighted means in both samples, it appears that the relatively smaller firms had a greater capacity for self-financing during the period 1969-1971 than larger firms.

The dividend payout ratio, defined as the ratio of dividends paid to net profit after taxes, indicated some interesting trends. In the sample of 100 firms, the weighted mean of the payout ratio was large in absolute terms (63.4 percent), less than the unweighted mean and greater than the median. The large absolute value reflects the presence of a number of U. S. subsidiaries that pay large dividends to other foreign subsidiaries or the parent company as a low-cost source of capital funds. When the subsidiary in Panama needs capital funds, it may receive a dividend payment from the parent company or another subsidiary. Besides certain tax advantages, this arrangement reduces reliance upon local capital markets for capital funds.[12] The fact that the unweighted mean payout ratio is greater than the weighted mean reflects the presence of many large firms that pay no dividends at all.[13]

In the sample of 155 firms, the weighted means for the three dividend payout ratios were higher than the unweighted means and medians. This reflects the fact that many of the firms in this sample paid no dividends between 1969 and 1971, and those that did were the larger firms in the sample.[14]

The dividend payout behavior expressed in the two samples is not unusual when one considers the personal and corporate marginal tax rates presently effective in Panama, as well as the fact that many Panamanian firms are not publicly owned. If a privately held firm has a net taxable income of B/40,000 or less, the owner has no tax advantage in terms of paying himself a higher salary or paying himself a dividend out of higher net profits. The personal and corporate marginal tax rates are approximately the same at income levels below B/40,000. The owner may just as well keep the income subject to personal income tax equal to the amount subject to corporate income tax. After B/ 40,000 of corporate taxable income, it is more advantageous for the owner to pay himself a salary of no more than B/ 40,000 and take the remainder in the form of dividends.

Since the firm pays a 10 percent withholding tax on 40 percent of the net taxable income whether dividends are paid or not, it is advantageous for the owner to take additional earnings from the firm in the amount of at least 40 percent of taxable income. When net taxable income reaches B/40,000, the personal marginal tax rate becomes greater than the corporate marginal tax rate and it is more profitable for the owner to take additional profits through a dividend payment rather than a higher salary. It should be noted that once the 10 percent withholding tax is paid by the firm, the dividend recipient need not declare the dividend as part of personal income.

Results of Questionnaire

The questionnaire presented in Appendix C was used to interview 50 executives from a random sample of 50 non-financial firms that reported a net taxable income of

B/15,000 or more in 1970. More than 25 of the 50 business firms surveyed were commercial enterprises. Since this type of enterprise is most characteristic of businesses in Panama, the random sample of 50 non-financial firms tends to be a representative sample. The completed questionnaires revealed some interesting characteristics regarding capital financing behavior in Panama. First, 23 of the 50 firms surveyed were privately owned, while 21 were publicly owned where the majority of the stockholders were not employees of the company or relatives of management. The remaining 12 firms were publicly owned where the majority of the stockholders were not employees of the company or relatives of management. Second, 12 of the firms issued securities at least once in the past two years. Of these, 11 firms issued common stock and 6 of the 11 sold the stock to the directors, executives, or employees of the company. The remaining 1 firm issued bonds. Third, 41 firms expressed a preference to obtain external sources of capital by borrowing from financial institutions. Only 9 firms expressed a preference for the issuance of stock as a source of external capital funds. Fourth, 37 firms had 50 stockholders or less; 33 had less than 26 stockholders. Fifth, of those 26 firms that obtained additional capital funds for their operations in 1970 and 1971, 6 firms financed the capital expenditures through short-term borrowing, 6 through long-term borrowing (maturity date in excess of one year), 3 through the issuance of new stock, 5 through retained earnings, and 6 through a combination of borrowing, retained earnings, and new stock issues. Sixth, of those 26 firms that obtained additional capital funds for their operations in 1970 and 1971, 5 used the funds for the expansion of plant and facilities, 8 for an increase in inventories, 4 for financing accounts receivable, 3 for something else, and 6 for a combination of the above uses. Seventh, 44 of the respondents said that all of their capital needs within the past two years were adequately supplied by the financial institutions in Panama.

An Explanation of Financing Behavior

A possible explanation and justification for the apparent preference of debt and retained earnings over equity capital can be found in a study by Gordon Donaldson of 20 U. S. business firms which indicated the following attitudes towards non-debt sources of capital funds:[15]

1. Management strongly favored internal generation as a source of new funds even to the exclusion of external sources except for occasional "bulges" in the need for funds.

2. Management considered the internal generation of funds to be in the best interest of the existing stockholders, (i.e., if new stock was issued there would be an immediate decrease in earnings per share, cash dividends per share, market prices, and the price-earnings ratio).

3. The advantage of using funds already within full control of management, available without delay, uncertainty, negotiation, interference, publicity, explanation, or apparent cost to the shareholder, is important to management.

The Donaldson study concluded that if management gives such priority to retained earnings as a source of funds, it may be that the potential gains of borrowing only become realized when internally generated funds prove inadequate to meet the need for capital funds.

On the matter of debt capital, there are also incentives that may account for the financing behavior of Panamanian firms. These incentives include.[16]

1. The use of debt relieves the current market of the direct threat of dilution due to more shares being traded.

2. Debt is normally a cheaper source of funds than retained earnings or new equity issues due to the tax shield of the interest charge.

3. There may be an uncontrollable peaking of mandatory expenditures which, when combined with other mandatory cash outflows, may at some point in time exceed internal resources.

4. The limited duration of the contractual arrangement and the relative ease of terminating the contract if and when means to do so become available is attractive.

5. Compared to arranging a new stock issue, the arrangement of a loan is significantly less bothersome and time consuming.

6. The maintenance of corporate privacy may have a high priority (i.e., no new stockholders).

7. If the purchasing power of the dollar is expected to deteriorate due to inflation, it is better to finance on the basis of fixed dollar commitments.

8. The firm may be conditioned to debt financing, have established channels of communication, and, therefore, seek to follow a familiar pattern.

9. There may exist a sizeable and aggressive financial community.

All of these incentives are present in Panama to some extent. Many business firms are privately owned and have well-established banking connections. The recent inflationary pressure favors the financing of capital expenditures on the basis of fixed dollar commitments. The overdraft accounts offered by most of the 52 banks provide a flexible and easily arranged source of capital funds that is required to finance inventories and accounts receivable.

A Note on Insolvency Risks

Bankers in Panama City assert that many firms in Panama have debt-heavy financial structures and are running high insolvency risks. They further assert that an increase in these risks indicates an ever-increasing demand for equity-financed capital. The results presented in this paper clearly indicate that the first assertion is incorrect. The combined sample of 255 firms indicated low to moderate insolvency risks both in absolute terms and in comparison to other countries. With respect to the second assertion, Orson Hart has observed that the economic functions of securities markets are two-fold.[17] First, these markets facilitate the exchange of outstanding securities and, second, they provide a structure to enable private firms and government to raise capital. But, according to Hart, the raising of capital has never been a major function of stock markets. Corporate enterprises have raised most of their capital through retained earnings and other sources outside the framework of the marketplace. Hart further contends that these sources of capital will not sustain the needs of American business much longer as manifested by the rising debt ratios of U. S. corporations. In 1950, long-term debt constituted 11 percent of the capital structure of manufacturing corporations as defined by the Federal Trade Commission. In 1960, the ratio was 16 percent and in 1971, 25 percent. New stock issues have increased to more than $13 billion in 1971 compared with an average of less than $2 billion per year during the 1960's. Thus, Hart assumes that an inevitable demand for equity-financed capital is dependent upon changes in the debt positions or solvency risks of the firms. According to Hart, an increase in the debt-equity ratio indicates a demand for equity-financed capital.

This relationship may not hold true for Panama in spite of the rising debt-equity ratios between 1969 and 1971 because of the extensive use of the overdraft system. The overdraft mechanism allows firms to acquire funds by drawing on their demand deposits in excess of the amount deposited by the firms. The bank places money into the firms' demand deposit account up to a negotiable limit and charges interest on the monies extended. The result is similar to equity-financing in the sense that there are no fixed maturity dates. Although the amount of the overdraft may be recalled by the bank at any time, such incidents were not observed during the period of analysis. Hence, the insolvency risks may not be as great as the debt-equity ratios may suggest.[18]

Types of Business Enterprises and Capital Needs

The internal factors that primarily affect the demand for equity-financed capital are the types of business enterprises. Capital intensive industries that have a demand for new machinery or an expansion of plant facilities requiring a substantial sum of money would require some form of long-term financing; that is, the firm would need capital funds with a 15-20 year maturity date or no maturity date at all.[19] In this case, a bond or stock issue might best satisfy the capital needs because of the long-term maturity date of a bond issue or the absence of a maturity date in the case of a stock issue. On the other hand, a commercial or service-oriented firm that needs capital funds primarily to replenish or expand inventories on short notice would require a source of funds that is quickly and easily obtainable.[20] In this case, a short-term loan from a financial institution or an overdraft mechanism would better satisfy the capital need.

In order to determine the capital needs of businesses, it is necessary to approximate the number and types of enterprises in Panama. Table 4.7 lists the number of licenses issued by the Ministry of Commerce and Industry and the declared amount of paid-in capital classified by type of economic activity. According to Law Number 24, established in 1941, all businesses except those that deal exclusively with the buying and selling of animals or products from Panama and by Panamanians, must have a license to operate in Panama. Since approximately 90 percent of all businesses only have one license per business, the registry of licenses can serve as an approximation of the number of different enterprises in Panama as of 1970. As indicated by the data of Table 4.7, 88.7 percent of the licenses issued as of 1970 were in the commercial and service-oriented fields.

TABLE 4.7.--Number of Licenses Issued in Panama and the Amount of Declared Capital by Type of Economic Activity, 1970.

Type of Activity	No. of Licenses	Percent	Declared Capital	Percent
Agriculture, Fishing Hunting	64	0.3	25,311,898	6.4
Mining	35	0.1	3,140,500	0.8
Manufacturing	1,984	9.5	88,417,086	22.4
Public Utilities	12	0.1	32,858,345	8.3
Construction	265	1.3	10,314,465	2.6
Commercial Trade	16,299	78.0	132,683,763	33.6
Transportation, Warehousing, Communication	433	2.1	17,975,562	4.5
Finance, Insurance, Loan Companies	650	3.1	76,502,170	19.3
Community Services	1,151	5.5	8,329,025	2.1
TOTAL	20,893	100.0	395,532,814	100.0

Source: Dirección de Estadística y Censo, Series "F.1" No. 1, 1970, p. 56.

Additional characteristics of manufacturing, commercial and service enterprises that employed five or more employees as of 1971 are contained in Table 4.8. The commercial and service sectors are larger than the manufacturing sector in terms of gross sales, employment, wages and salaries paid, and the number of establishments. In 1971, there were three establishments in the commercial or service sector for every one establishment in the manufacturing sector. Commercial and service-oriented enterprises primarily need capital funds to finance inventories and accounts receivable. The size and timing of such capital demands are unpredictable and occur frequently since they are affected by price fluctuations on international markets and changes in supply factors abroad. This sporadic demand for capital funds is best satisfied by a short-term, capital-financing arrangement such as an overdraft mechanism.

Summary

An examination of the internal factors that affect the capital financing process used by Panamanian business firms leads to a number of relevant facts for the purpose of this study. First, data drawn from the sample of 255 non-financial firms indicated comparatively high profitability rates and low insolvency risks during the period 1969-1971. The fact that the debt-to-equity ratios were

TABLE 4.8.--Characteristics of Manufacturing, Commercial, and Service Establishments with Five or More Employees, 1971.

Characteristics	Total
Manufacturing	
Number of Establishments	698
Persons Employed	25,179
Wages and Salaries	51,891,326
Value of Gross Sales	424,039,844
Commercial (Wholesale Only)	
Number of Establishments	504
Persons Employed	9,282
Wages and Salaries	24,354,083
Value of Gross Sales	412,122,896
Commercial (Retail Only)	
Number of Establishments	1,016
Persons Employed	14,481
Wages and Salaries	27,745,153
Value of Gross Sales	326,100,135
Service	
Number of Establishments	744
Persons Employed	10,364
Wages and Salaries	16,561,684
Value of Gross Sales	73,916,229

Source: Dirección de Estadística y Censo, Boletín No. 491, 26 de Diciémbre de 1972.

low to moderate, coupled with the fact that many loans were granted to local firms between 1969 and 1971, indicates that business firms were able to acquire additional debt without jeopardizing their financial position. On the average, the insolvency risks increased between 1969 and 1971, indicating a rise in the acquisition of debt relative to equity. Even though the average amount of equity per firm increased between 1969 and 1971, the average debt-to-equity ratio increased faster.

Second, during the period of analysis, there was a stated preference for the issuance of capital debt to finance capital needs rather than the issuance of capital stock. Equity ownership is not widespread among the public, and the firms interviewed seemed to prefer it that way. The acquired capital funds were primarily used to purchase inventories and to finance accounts receivables. Only a few firms were unable to supply a capital need satisfactorily with the existing financial institutions in Panama.

Third, the business sector in Panama is characterized by a relatively large number of commercial and service-oriented enterprises. By their nature, these firms need capital funds primarily to finance inventories and accounts receivable. Such capital needs are unpredictable and occur frequently since they are affected by price fluctuations on international markets and changes in supply factors abroad. This sporadic demand for capital is better satisfied by a source of short-term capital funds such as that provided by an overdraft mechanism rather than by the issuance of capital stock.

FOOTNOTES--CHAPTER IV

[1]This functional relationship assumes that the rate of return to a surplus spending unit is related to the cost of capital to the firm. As the cost of capital rises, the ability of the firm to offer attractive rates of return via dividends or interest payments may decrease. As Modigliani and Miller have shown, in light of a progressive corporate tax structure, the debt-equity ratio does effect the cost of capital. See Franco Modigliani and Merton Miller, "The Cost of Capital, Corporate Finance and the Theory of Investment," American Economic Review, June, 1958, pp. 261-297.

[2]The B/15,000 figure was chosen somewhat arbitrarily. The intent was to concentrate on those firms most likely to have a demand for equity-financed capital. It could be argued that a firm with a low net taxable income may not be in a financial position to "go public."

[3]The financial data for the two samples were collected at different times. At the time the depreciation and interest expenses were collected for the sample of 155 firms, there was insufficient time to gather the same information for the sample of 100 firms. In effect, the changes in the interest expenses over time, as indicated by the sample of 155 firms, is more meaningful than the cross-sectional counterpart.

[4]The times-interest-earned ratio is equal to gross earnings before interest charges and taxes divided by interest charges. The ratio is valuable to bond investors as a measure of the safety factor involved in any investment calling for the payment of a fixed sum quarterly, semi-annually, or annually. A company should earn its interest charges a minimum of three or four times if its bonds are to be considered safe. A common stock investor should hesitate to purchase shares of a company with a low ratio of times-interest earned since a low ratio is an indication of financial trouble.

[5]Theoretically speaking, all arithmetic means are weighted means. If no specific weights are given to each and every value in the series, each value is assigned an equal weight of one. In averaging percentages or ratios, it is necessary to assign proper specific weights to the

values in the calculation of the mean in order to obtain an unbiased result. Consider, for example, the calculation of the mean of 50 debt to equity ratios for 50 different companies. If you summed the 50 ratios and divided by 50, you would obtain the average amount of debt to equity per firm. This calculation assumes that all 50 companies are of equal size with respect to the size of their equity since a weight of one was applied to each ratio in the calculation of the mean. To account for the differences in size as measured by the amount of equity, each ratio should be weighted by multiplying the ratio by the amount of equity. The summation of these products divided by the summation of the weights (size of equity) would equal the weighted mean or average amount of debt per unit of equity for all 50 firms. Mathematically, the weighted mean would equal the total amount of debt for the 50 companies divided by the total amount of equity for the 50 companies. In general, the weighted mean of a series of ratios where each ratio equals A/B is equal to $\Sigma A/\Sigma B$. The values of B, in effect, are the weights.

[6]The debt-equity ratio was computed by using both long-term and short-term debt. Long-term debt refers to an obligation with a maturity date that is longer than one year from the date of issue. Equity refers to the stockholder's total worth in the business. It includes the value of capital stock, if any, and retained earnings.

[7]These general guidelines were made known through conversations with managers from Peat, Marwick, Mitchell, Inc., a CPA firm. For a general discussion of the subject, see Gordon Donaldson, Corporate Debt Capacity, Richard D. Irwin, Inc., 1971, pp. 8, 142.

[8]The relationship between the debt-equity ratio and the debt-asset ratio can be easily derived as follows:

Let D=total debt E=total equity A=total assets

Then,

$$D=D/E\ (A-D) \text{ where } E=A-D$$

Also,

$$D/A=D/E-(D\times D/E\times A)$$

And,

$$D/A + D\times D/E\times A = D/E$$

And,

$$D/A \times (1+D/E) = D/E$$

Therefore,

$$D/A = (D/E)/1+D/E$$

[9]One explanation for this observation is that although the total debt of many firms is high in absolute terms, the

amount of retained earnings are sufficiently high to offset the large debt position.

[10]The title and date of publication of this source are unknown at this time. The author obtained this information from one of the consultants at INDESA.

[11]Such comparisons for other developing countries are not available due to the sparcity of research in this area. At the present time, however, the Organization of American States is sponsoring research identical to that contained in this thesis. Differences in tax rates between Panama and some developed countries account for part of the differences among rates of return on equity.

[12]Dividends are only taxed once at a rate of 10 percent.

[13]Net profits after taxes ranged from B/100,000 to B/2 million in this sample. Therefore, the smaller firms that did pay a dividend in this sample were in the B/100,000-B/130,000 range. The dividend ratios in both samples suggest that business firms with net profit after taxes between B/70,000 and B/140,000 had the higher dividend payout ratios.

[15]Gordon Donaldson, <u>Corporate Debt</u>, pp. 68-80.

[16]<u>Ibid</u>.

[17]Dr. Orson H. Hart, Vice President and Director of Economic Studies of the New York Life Insurance Company. These comments were made in response to the Second Buttonwood Lecture given by Professor Sidney M. Robbins, entitled "Some Reflections on the Central Market," sponsored by the Graduate School of Business, Columbia University and the New York Stock Exchange, Inc., 1972.

[18]The exact number of firms that have an overdraft account as well as the sizes of such accounts are not known in Panama. Conversations with officers of four of the large banks indicates that most firms with gross sales in excess of B/50,000 per year have an overdraft account. It is a very common source of capital funds.

[19]Such was the case of the development of the railroads in the United States where capital financing often included a combination of common stock, debentures, secured bonds, and income bonds.

[20]For a discussion on the cost and complexities associated with issues of capital stock and capital debt, see Louis K. Brandt, Business Finance: A Management Approach (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1965), pp. 411-439.

CHAPTER V

ORGANIZED STOCK MARKETS AND ECONOMIC GROWTH

Introduction

From the analysis of the external factors that affect the demand for and supply of equity-financed capital, it is evident that capital markets in Panama have enhanced economic growth by mobilizing financial resources and channeling them to investors. As stated earlier, deposits in the banking system increased by 500 percent while loans outstanding increased by 470 percent between 1966 and 1972. While it is true that more than 50 percent of the deposits have been attributable to non-residents, deposits from residents increased by 213 percent during the period from 1966 to 1972. During the same period, loans granted to residents increased by 318 percent. Although the banking community has furthered the economic growth of Panama, it is not evident at this point that an organized stock market will further mobilize capital funds for economic growth.

This chapter discusses the possibility that organized stock markets will increase the mobilization of domestic resources for economic growth of a developing country. The discussion is based upon the experiences of other Latin American countries, such as Mexico, Colombia, and Brazil.

Although the economic and political characteristics of Panama are rather atypical, a brief discussion of the economic contributions and problems of stock markets in other Latin American countries will be useful in considering the possible role of a stock market in Panama. This chapter will also identify the elements that constitute a "successful" stock market, i.e. one that will increase the mobilization of domestic resources for economic growth beyond those provided by the banking system.

A Mistaken Historical Analogy

Raymond W. Goldsmith has questioned whether Latin American countries should place emphasis on direct financing techniques, particularly the sale of government and private securities to large numbers of savers which characterized the financial development of Europe and North America in the early 1900's, or on indirect financing through financial institutions.[1] In Europe and North America, massive sales of stocks and bonds were made to private investors. The sale of securities to individuals was considerably in excess of individuals' savings through other financial institutions. These securities were essentially of three types: (1) long-term government bonds, (2) long-term bonds of mortgage banks and similar real estate credit organizations, and (3) long-term bonds and stocks of railroad corporations and industrial enterprises.[2]

The factors that made the sale of these stocks and bonds to private investors crucial in the mobilization of resources for economic growth were the following:

1. Political stability prevailed and the decision to save was not materially influenced by considerations of substantial changes in a country's political or economic system.

2. The money illusion prevailed making it doubtful that savers were influenced by expected differences between nominal and real yields on securities.[3]

3. At that time, savers were more interested in income stability rather than in fluctuations of market prices. As a result, savers were willing to buy long-term bonds where the liquidity of their holdings was based upon open-market sales rather than upon redemption by the issuers.

4. Savers, at least in the financially secure countries, had complete confidence in the credit of their own governments and in that of large mortgage banks and private corporations.

5. The interest rates offered to bond-holders corresponded to market rates both for government and private issuers.[4]

6. There existed a large <u>rentier</u> class willing and able to invest a substantial portion of its savings in long-term, fixed income securities.

7. Railroads, the most important non-government issuers of marketable securities, were relatively uniform and simple in their financial structure, their operations and prospects, and usually started out as sizeable publicly-owned corporations.[5]

In the light of these factors, it should be evident that the economic and political environment of Panama is not as it was in Europe or North America prior to World War I. The capital flights that occurred in Panama in 1964 and 1968 were manifestations of the effect of potential changes in the economic and political system on the decisions of savers in Panama. According to Goldsmith, the money illusion cannot still be held in most Latin American countries, and its disappearance will likely affect long-term, fixed income securities unfavorable in the future. Although it is probably true that Panamanian savers are interested in income stability, there tends to be a reluctance to commit funds to long-term investments. Political uncertainties and the absence of liquidity generate a cautious attitude among savers.

As indicated earlier, interest rates on government securities have not corresponded to rates obtainable on other financial assets. As a result, government securities have had to be placed with government agencies, foreign sources, or private financial institutions in Panama which were forced by government regulations to purchase the securities. Goldsmith has observed that the liquidity preferences of private investors have been extremely high in Latin America. Investors have preferred short-term and fixed income securities or assets that could be redeemed for cash on short notice. Such a tendency does not favor the establishment of a bond or stock market with little or no liquidity.[6]

Characteristics of Latin American Stock Markets

In contrast to Goldsmith's views, many Latin American countries have organized stock markets or stock exchanges as a supplement to existing capital markets. In Chile, Colombia, and Venezuela, there are two stock exchanges, while there are three in Mexico, four in Argentina, and 21 in Brazil.[7] Generally speaking, the exchanges in the capital cities are the most important except in Brazil, where the exchanges of Rio de Janiero and Sao Paulo are the largest in the country. Although several of the Latin American stock exchanges have been in existence for many years, the volume of operations registered with these institutions is relatively small.[8]

Table 5.1 gives indicators of stock exchange activity in eight Latin American countries for 1962. In general, these are the Latin American countries in which capital markets are relatively more developed. In the remaining countries, either no stock exchanges have been established,

TABLE 5.1.--Indicators of Stock Exchange Activity in Eight Latin American Countries, 1962.

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Uruguay	Venezuela
1. Number of stock exchanges	3	21	2	2	3	1	1	1
2. Number of registered companies								
(a) Total	552		372	107	350	115	--	91
(b) Industrial	351		150	63	138	20	--	30
3. Relative importance of volume of transactions (percentages)								
(a) Ratio between total transactions and gross domestic product . .	1.5	1.2	0.8	1.1	10.9	0.7	1.3	1.1
(b) Ratio between transaction in shares and gross domestic product	1.4	0.4	0.7	0.6	0.1	0.4	0.1	0.1
(c) Ratio between transaction in industrial shares and the industrial product		0.9	1.9	2.6	0.2	0.1		0.3
4. Ratio between transactions in industrial shares and total transactions (percentages)	30	15[a]	35	40	0.5[b]	10	6.5	6

[a]In 1960 the corresponding ratio was 50 percent.

[b]In 1961 the corresponding ratio was 6.3 percent.

Source: Economic Commission for Latin America, The Process of Industrial Development in Latin America (New York: United Nations, 1966), Table 39, p. 204.

such as Panama, or the established stock exchanges are not very active.[9] The data contained in Table 5.1 indicate a general lack of development thus far of stock markets in Latin America. In fact, it is clear that relatively few companies are registered on the stock exchanges, and that the stock exchange operations are small as measured by the ratio of total transactions to gross domestic product. Except for Mexico, this ratio was less than 2 percent for the countries surveyed in 1962, whereas the ratio in the United States and Japan were over 11 percent and 20 percent respectively in 1962. Furthermore, the small scale of stock markets in Latin America does not reflect an initial stage of development of such markets.[10] On the contrary, some stock markets are well-established and in some cases achieved higher volumes of transactions in earlier periods. The stock exchanges in Buenos Aires and Rio de Janeiro, for example, began operating in 1854 and 1876 respectively.[11]

The supply of negotiable securities on Latin American exchanges has been relatively limited due to the type of business enterprises operating in these countries. Large-scale production units are relatively scarce in Latin America. Conversely, medium-size and small businesses are comparatively important in a developing country's productive structure. These businesses are usually family-owned or controlled by a small group and finance their capital needs almost exclusively with retained earnings, depreciation, bank loans or suppliers' credit.[12]

Family ownership or closed control is not limited to small and medium-size businesses; it is also common in large enterprises as well. In fact, most privately-owned companies in Latin America have a negative attitude toward the distribution of ownership to the public. In addition to the reasons given in Chapter IV, "closed companies" are opposed to a large distribution of net profits in the form of dividends which could adversely affect capital expansion programs.

The advance of economic development in some Latin American countries, such as Mexico, has, however, created favorable conditions for the wider distribution of ownership in many companies.[13] Economic growth, particularly in the industrial sector, has led companies to seek equity-financed capital when internal funds and bank credit have proved inadequate to finance an accelerated rate of expansion. This tendency is, however, still of negligible importance in the Latin American context. There remains a very limited number of widely-distributed securities that are regularly traded.

Although there are many shares of stock quoted on the Latin American exchange, this does not constitute a measure of the number and variety of securities that are actually traded.[14] On the Buenos Aires exchange, for example, only 30 out of more than 500 listed companies have a relatively large number of stockholders and shares outstanding such that trading activity will not seriously affect the quoted prices. In Brazil, all corporations are required to list their securities on an exchange, and accordingly, there are approximately 8,000 issues listed on the exchanges in Rio and Saõ Paulo. Trading is concentrated, however, in about 40 of these issues. Over 400 issues are listed on the exchange in Mexico City, but less than 60 are regularly traded. On the stock exchange in Bogotá, nearly 75 percent of the total trading is done in 12 issues. Out of over 100 issues of stock listed on the Lima exchange, only a third have been traded occasionally in recent years, and in 1967 nearly 90 percent of total trading in shares was concentrated in three issues. The situation in Venezuela is similar; only 40 issues out of nearly 100 listed on the exchanges in Caracas and the State of Miranda have shown any turnover, and the three most active issues account for over 40 percent of total trading activity.

The behavior of stock price indices on most Latin American exchanges, deflated by the cost of living index, is discouraging to savers. Table 5.2 indicates the movements of share price indices for selected Latin American countries between 1959 and 1967. Only Mexico and Venezuela showed a comparatively stable behavior, and in some cases, stock prices rose faster than the cost-of-living index. In the

TABLE 5.2.--Price Indexes of Shares Listed on Various Latin American Stock Exchanges, 1959-1967. (1959=100)

Year	Argentina (Buenos Aires)		Brazil (Rio & Saõ Paulo)		Colombia (Bogotá)		Mexico (Mexico City)		Peru (Lima)		Venezuela (Caracas, State of Miranda)	
	Share Price Index	Real Price Index[a]	Share Price Index[b]	Real Price Index[a]	Share Price Index	Real Price Index[a]	Share Price Index	Real Price Index[a]	Share Price Index	Real Price Index[a]	Share Price Index[c]	Real Price Index[a]
1959	100	100	100	100	100	100	100	100	100	100	100	100
1960	96	77	192	142	98	93	101	96	100	92	75	72
1961	94	66	231	122	96	84	95	90	96	83	71	70
1962	45	25	344	199	97	83	90	83	89	72	70	69
1963	39	17	721	144	100	65	93	85	84	64	81	80
1964	44	16	765	82	113	62	104	94	84	58	97	95
1965	33	9	940	62	103	55	116	101	83	49	93	89
1966	24	5	1130	51	95	42	110	92	82	44	79	76
1967	31	5	1339	47	101	42	110	89	80	39	--	--

[a]Obtained by deflating the share price index by the cost of living index.

[b]Quotation index of the 22 securities with the largest turnover on the exchanges of Rio and Saõ Paulo, adjusted by stock dividends.

[c]Price index of the 14 most representative stocks.

Source: Antonín Basch and Milic Kybal, Capital Markets in Latin America: A General Survey and Six Country Studies (New York: Praeger Publishers, 1971), Table 3.6, p. 79.

other countries, however, the real index of share prices declined sharply in the period from 1959 to 1967. In Brazil, stock prices showed an increase in real terms from 1959 to 1963, but then dropped sharply until 1967.

The behavior of stock prices is important to the development of an efficient secondary market.[15] Frequent short-run fluctuations can create mistrust and a lack of confidence in securities as an instrument of savings. Ideally, the development of a sound and active secondary market requires some fluctuations of prices over the short run in response to changing economic conditions, with a moderate and sustained upward trend over the long term. Reasonable price stability is one of the chief factors in attracting savers and investors to stock markets. Unfortunately, the price fluctuations on some Latin American stock exchanges in recent years have not been conducive to the purchase of securities by the public. Inflation, political instability, and fraudulent stock manipulations are mostly responsible for this price behavior on Latin American exchanges. Finally, it should be noted that all of the characteristics of Latin American stock exchanges discussed here operate jointly to determine the degree of liquidity in the securities markets. As stated earlier, the principal feature of a stock exchange is the operation of a secondary market that facilitates the mobilization of resources among individuals and institutional investors.

The secondary market must provide the assurance that long-term securities can be easily and quickly converted into cash. Latin American exchanges perform this function to a limited degree for only a few stock issues. Obviously, the liquidity in the secondary markets is directly related to the demand for and supply of equity-financed capital. There exists what might be called a "vicious circle of inadequate liquidity." The supply of equity-financed capital is small, among other reasons, because the number of securities offered is small; however, the demand for equity-financed capital is small partly because of the small number of savers willing and able to buy securities. In other terms, the supply of negotiable securities is small because there is a weak demand for them; but the demand is weak because there are so few securities offered in the market.

In summary, most of the stock exchanges in Latin America have the following characteristics:

1. The volume of transactions has been low for most of the exchanges as measured by the ratio of total transactions to gross domestic product.

2. Fixed-income securities such as bonds are traded rather than shares of stock.

3. The supply of negotiable securities or the number of businesses willing to sell their stock has been relatively small.

4. The number of securities actually traded on a regular basis is, in most cases, much smaller than the number of securities listed on the exchange.[16]

5. Stock price index movements have been unstable and susceptible to inflationary pressures. In real terms, stock price indices have fallen on the average since 1959.

6. Inadequate liquidity exists for many of the secondary markets.

Elements of a Successful Stock Market

The characteristics of Latin American stock exchanges and the analysis of factors affecting the supply of and demand for equity-financed capital in Panama suggest that a successful stock market requires a number of basic elements.[17] First, a stock market requires a large number of firms with a demand for long-term capital that is greater than that provided by existing financial institutions such as commercial banks. In general, only industrial firms and public utilities will encounter such capital demands as they expand the size of their plant and equipment. Second, these industrial firms must be willing to share ownership and some decision-making power that previously resided with a small group. Third, the firms should be profitable enough to offer an attractive rate of return to savers in the form of dividend payments and a rising stock price in the long-run. Fourth, the number of savers must be large, so as to provide the funds required by investors and to prevent a concentration of ownership in the industrial firms. A high concentration of ownership by a few savers can lead to monopoly power in commodity markets and price manipulation in the stock markets. Fifth, savers must understand the principles behind the buying and selling of securities. Savers should understand, for example, how stock prices fluctuate in response to changes in economic variables such as political stability. Sixth, there must be liquidity in the secondary market. Savers must be able to sell their shares whenever they desire. To provide liquidity, traders and/or market-making institutions should be present in the marketplace. Traders are individuals who buy and sell securities regularly. They buy or sell securities on the basis of speculation where the current market price of the security does not accurately reflect the future profitability of the company. A market-making financial institution such as a development bank may also provide liquidity by explicitly guaranteeing that the redemption of securities will be possible on reasonable terms in the event of a crisis. Lastly, a successful stock market requires a regulatory framework that will prevent fraudulent dealings, protect the rights of minority stockholders and establish standards for the reporting of financial data by the business firms issuing stock.

Guidelines for Economic Growth and Development

Orthodox growth theory argues that capital markets are necessary for prolonged economic growth. As the capital requirements of a business firm go beyond the limits of self-finance, capital markets are needed to provide additional funds to the firm so that it can expand the size of its operation. These additional funds could be acquired by issuing capital stock or debt, i.e. by selling shares of stock to the public or borrowing from a bank. According to growth theory, these additional funds will be used to purchase new capital goods which increases the capacity to produce goods and services.[18]

While it is true that the capital requirements of firms may go beyond the limits of self-finance during the process of economic growth, it is not necessarily true that stock markets are the best means of supplying the additional capital funds. As this dissertation has suggested, when the business sector is characterized by commercial and service-oriented enterprises, the demand for capital funds may be better satisfied with short-term capital debt rather than long-term equity-financed capital. On the other hand, if the business sector is characterized by a growing number of industrial or manufacturing firms with a demand for equity-financed capital, then stock markets can be expected to enhance the mobilization of financial resources.

If the economic goals of an economy include the reduction of poverty and the unequal distribution of income, it is doubtful that stock markets will positively affect such goals. The poverty-stricken members of the economy would be virtually unable to purchase securities and, hence, any benefits provided by a stock market would not accrue to them. Even if large numbers of individuals from all income levels were buying and selling stock, it is unlikely that the profits of such activities would automatically flow from the upper-income groups to the lower-income groups. More than likely, the trading activity would be concentrated among the wealthy, and income would only be redistributed within that group of individuals. This would be particularly true in Panama where virtually all of the savings are accounted for by business firms and foreign depositors. Hence, stock markets cannot be expected materially to affect the problem of income and wealth inequality, and unless an industrial base is established, these markets may not effectively mobilize resources for economic growth. In terms of guidelines for economic growth, capital debt markets should be established when the demand for capital funds goes beyond the limits of self-finance. Stock markets should only be established when the process of industrialization has reached a stage where the demand for equity-financed capital is quite evident and the risk of business failure is minimal. In the early stages of industrialization, the risk of business failure may be high. As a result, businessmen may prefer equity-financed capital to debt capital, since there is no financial obligation associated with the former source of capital funds. But if the risk of failure is high, savers will be most reluctant to supply the capital funds. Therefore, stock markets may not effectively supply the required funds.

FOOTNOTES--CHAPTER V

[1]Raymond W. Goldsmith, "The Mobilization of Domestic Resources for Economic Growth Through the Financial System," in The Mobilization of Internal Financial Resources in Latin America, Inter-American Development Bank (Lima: Inter-American Development Bank, 1971), p. 3.

[2]*Ibid*., p. 18.

[3]A money illusion occurs if a doubling of all prices and wages leads to an increase in consumption, even though real income remains unchanged. The money illusion implies that consumers and savers change their consumption and saving patterns in response to changes in nominal income rather than real income.

[4]In macroeconomic theory, the market rate of interest is the interest rate at which the real and money interest rates are equal. The money interest rate is defined as that rate that equates the demand for money and the supply of money, while the real interest rate equates intended saving and investment. Thus, interest rates offered to bondholders were "equilibrium" rates for both government and private issuers. The demand and supply factors just balanced at the rates offered to bondholders.

[5]Goldsmith, "Mobilization of Domestic Resources," p. 18. An eight factor may be that Anglo-Saxon commercial law was favorable to the development of securities markets. Spanish law, however, was derived from Napoleonic law which was not as favorable to such markets.

[6]*Ibid*., p. 19.

[7]Antonin Basch and Milic Kybal, *Capital Markets in Latin America: A General Survey and Six Country Studies* (New York: Praeger Publishers, 1971), p. 66.

[8]*Ibid*.

[9]Economic Commission for Latin America, *The Process of Industrial Development in Latin America* (New York: United Nations, 1966), p. 205.

[10] Ibid.

[11] Ibid., p. 210.

[12] Antonin Basch and Milic Kybal, Capital Markets, p. 73.

[13] Ibid., p. 75.

[14] Ibid.

[15] Ibid., p. 77.

[16] On the New York Stock Exchange, virtually all listed securities are traded on a daily basis. On the over-the-counter markets, there is a low number of securities that are not traded on a daily basis.

[17] A successful stock market can be defined as one that: (1) continually mobilizes capital funds for economic growth and chanels them to businesses in need of funds; and (2) provides liquidity in a secondary market.

[18] Charles P. Kindleberger, Economic Development (New York: McGraw-Hill Book Company, Inc., 1958), p. 42.

CHAPTER VI

SUMMARY AND CONCLUSIONS

The purpose of this study has been to inquire into whether the establishment of an organized stock market would enhance the economic and financial development of Panama. It was hypothesized that Panama should establish an organized stock market at its present stage of economic development because : (1) there is a need for equity-financed capital on the part of Panamanian business firms; (2) there are many financial institutions willing and able to act as financial intermediaries; (3) there is an ever-increasing supply of savings that can be expected to flow into business firms through the sale of stock; and (4) a stock market will promote economic development by increasing the capacity to produce goods and services. Given the evidence presented here, this hypothesis must be rejected for a number of reasons.

First, only a few Panamanian businesses have a demand for equity-financed capital. The business sector in Panama is characterized by a relatively large number of commercial and service-oriented enterprises. These firms need capital funds primarily to finance inventories and accounts receivable. These capital needs are unpredictable and occur frequently since they are affected by price fluctuations on international markets and changes in supply factors abroad. This sporadic demand for capital is better satisfied by a source of short-term capital funds such as that provided by an overdraft mechanism rather than by the issuance of capital stock. The financial data collected from 255 business firms indicated that the firms were able to raise capital through the issuance of stock, but were unwilling to do so. The businesses seem to prefer debt capital since it better suits their capital needs, is easily obtainable, and does not entail the sharing of ownership.

Second, although there are many financial institutions in Panama capable of buying corporate securities, they are generally unwilling to do so. The many commercial banks in Panama are not operating to enhance the economic development of Panama by buying the securities of Panamanian businesses. Banks operate in Panama because it is relatively profitable to undertake business there. The liberal tax laws, the U. S. dollar standard, and the absence of exchange controls and a central bank are conducive to profitable banking activity. In the past, neither commercial banks nor non-monetary financial institutions have purchased primary securities from local enterprises to any appreciable extent. The reasons for this are: (1) very few local enterprises have offered securities for sale, and (2) the rate of return on those securities that were offered was low relative to other forms of savings.

Third, although the level of savings in Panama is growing rapidly in terms of bank deposits, most of the deposits are from foreign sources. Also, the largest proportion of domestic savings is derived from corporations in Panama, not from individuals. With such a distribution of savings, it is unlikely that the supply of savings would be channeled into corporate securities as it was in Europe and North America prior to World War I. In addition, the rate of return on alternative forms of savings have been historically higher than the return on corporate securities.

Fourth, stock markets cannot be expected to promote economic development in Panama. As discussed earlier, such markets may not appreciably affect the problems of poverty, unemployment or the distribution of income in a positive way.

Stock markets could stimulate economic growth by providing long-term capital for investments if there existed a strong demand for equity-financed capital or if the process of industrialization was well established. The data presented in this study, however, indicate that a strong demand for equity-financed capital does not exist for most Panamanian businesses and the economy has not become industrialized. Furthermore, the analysis of Panama's economic characteristics suggests that it may not be prudent to pursue the course of industrialization. A relatively small labor force, higher wages than other Latin American countries, the lack of abundant natural resources, the limited domestic market, and the existing labor code are not conducive to the establishment of industrial firms. Panama's real comparative advantages are the liberal tax and corporate laws, the absence of exchange controls and a central bank, the fact that the U. S. dollar is the standard currency, and its geographic position. The economic problems are centered around poverty, inflation, unemployment, and an unequal distribution of income and wealth. Stock markets cannot be expected to either enhance the comparative advantages of Panama or to solve its basic economic problems.

APPENDICES

APPENDIX A

TABLE A.1.--Descriptive Statistical Summary of Financial Data from 100 Largest Non-Financial Firms, 1970.

	Number of Observations	Unweighted Mean	Minimum Value	Maximum Value	Standard Deviation	Standard Error of Mean	Median
Net Taxable Income	100	B/ 368,925	B/148,495	B/ 4,338,123	B/ 500,988	B/ 50,098	B/ 215,574
Total Net Sales	89	B/3,644,427	B/240,875	B/23,061,900	B/4,372,583	B/ 463,493	B/2,080,244
Total Assets	88	B/4,201,321	B/205,734	B/68,510,550	B/9,559,356	B/1,049,276	B/1,663,277
Total Net Fixed Assets	88	B/2,026,271	B/ 0	B/60,317,000	B/7,326,593	B/ 804,198	B/ 348,000
Ratio of Net Fixed Assets to Total Assets	88	.352	0	.900	.239	.026	.310
Paid-In Capital	90	B/ 870,279	B/ 0	B/16,447,616	B/2,006,405	B/ 211,494	B/ 209,681
Retained Earnings	90	B/ 958,227	B/(40,104)	B/15,416,520	B/2,175,424	B/ 229,310	B/ 373,769
Stockholder Equity	90	B/1,798,303	B/ 0	B/27,497,233	B/3,693,138	B/ 389,291	B/ 742,859
Ratio of Retained Earnings to Equity	90	.532	0	1	.336	.035	.55
Total Debt	88	B/2,303,814	B/ 31,613	B/42,291,080	B/6,319,051	B/ 673,613	B/ 720,871
Ratio of Debt to Equity	88	1.228	0	5.7	1.345	.143	.70
Rate of Return on Capital Before Taxes	88	.208	.010	.920	.165	.018	.19
Net Profit After Tax	91	B/ 234,008	B/ 52,048	B/ 2,213,561	B/ 281,488	B/ 29,508	B/ 149,462
Rate of Return on Capital After Taxes	88	.134	.008	.762	.118	.012	.102
Rate of Return on Equity After Tax	89	.251	0	1.272	.226	.024	.178
Rate of Return on Net Sales After Taxes	89	.115	.005	.755	.120	.013	.085
Dividends Paid	89	B/ 161,216	B/ 0	B/ 2,150,000	B/ 340,934	B/ 36,139	B/ 56,351
Ratio of Dividends Paid After Tax Profit	89	.770	0	19.58	2.213	.234	.383
Ratio of Net Sales to Total Assets	88	1.588	.001	9.015	1.398	.153	1.316

APPENDIX B

TABLE B.1.--Descriptive Statistical Summary of Financial Data from 155 Randomly-Selected Non-Financial Firms, 1969-1971.

	Number of Observations	Unweighted Mean	Minimum Value	Maximum Value	Standard Deviation	Standard Error of Mean	Median
Total Net Sales							
1969	142	B/438,020	B/ 0	B/ 3,715,423	B/ 569,761	B/47,813.27	B/212,637
1970	143	B/494,446	B/ 0	B/ 4,287,232	B/ 638,143	B/53,364.21	B/259,266
1971	121	B/621,054	B/ 32	B/ 4,362,240	B/ 736,408	B/66,946.21	B/328,534
Net Profit Before Tax							
1969	144	B/ 37,839	B/ (142)	B/ 170,383	B/ 29,285.88	B/ 2,440.49	B/ 26,998
1970	148	B/ 41.430	B/ (11,629)	B/ 203,782	B/ 31,323.71	B/ 2,574.79	B/ 33,932
1971	122	B/ 39,731	B/(113,607)	B/ 178,341	B/ 42,968.82	B/ 3,890.22	B/ 34,376
Total Assets							
1969	135	B/444,931	B/ 2,912	B/ 4,363,019	B/ 593,550	B/51,085.67	B/273,125
1970	141	B/582,522	B/ 16,487	B/11,721,464	B/1,130,924	B/95,241.01	B/292,829
1971	118	B/651,141	B/ 10,677	B/ 4,738,758	B/ 878,861.4	B/80,905.75	B/351,170
Total Net Fixed Assets							
1969	135	B/ 78,684	B/ 0	B/ 1,777,367	B/ 187,417	B/16,070.91	B/ 25,145
1970	141	B/ 87,402	B/ 0	B/ 1,794,472	B/ 188,785	B/15,898.59	B/ 25,205
1971	118	B/127,553	B/ 0	B/ 1,817,160	B/ 258,674	B/23,712.58	B/ 42,701
Paid-In Capital							
1969	131	B/114,365	B/ 0	B/ 712,260	B/ 139,448	B/12,183.66	B/ 60,060
1970	141	B/111,053	B/ 0	B/ 712,260	B/ 141,761	B/11,938.40	B/ 51,000
1971	119	B/135,211	B/ 0	B/ 995,040	B/ 166,443	B/15,257.81	B/ 67,700
Retained Earnings							
1969	132	B/ 95,430	B/(142,435)	B/ 1,095,403	B/ 143,924	B/12,526.96	B/ 55,488
1970	141	B/111,866	B/(145,852)	B/ 943,398	B/ 142,348	B/11,987.87	B/ 67,369
1971	119	B/122,921	B/(166,130)	B/ 903,469	B/ 133,264	B/12,216.24	B/ 96,410
Stockholder Equity							
1969	132	B/210,006	B/ (60,005)	B/ 1,357,403	B/ 229,304	B/19,883.22	B/136,799
1970	141	B/222,447	B/ (96,905)	B/ 1,655,658	B/ 230,967	B/19,450.94	B/153,006
1971	119	B/246,835	B/ (13,040)	B/ 1,208,470	B/ 222,180	B/20,367.18	B/178,910
Ratio of Retained Earnings to Equity							
1969	132	.524	.425	1.02	.314	.027	.558
1970	141	.553	(.44)	1.10	.300	.025	.604
1971	119	.559	(.534)	1.28	.328	.030	.610

TABLE B.1.--Continued.

	Number of Observations	Unweighted Mean	Minimum Value	Maximum Value	Standard Deviation	Standard Error of Mean	Median
Total Debt							
1969	132	B/245,301	B/ 0	B/ 3,574,954	B/ 491,706	B/42,960.55	B/ 95,136
1970	141	B/283,754	B/ 0	B/ 3,159,731	B/ 494,170	B/41,765.02	B/ 98,717
1971	118	B/392,133	B/ 0	B/ 4,558,864	B/ 776,465	B/71,784.18	B/110,647
Ratio of Total Debt to Equity							
1969	129	1.350	(3.667)	10.321	1.923	.169	.739
1970	138	1.533	(2.652)	13.128	2.053	.192	.756
1971	116	1.774	.001	25.342	3.220	.299	.792
Ratio of Net Fixed Assets to Total Assets							
1969	134	.203	0	.998	.248	.021	.087
1970	141	.216	0	.971	.258	.022	.100
1971	117	.237	0	.944	.258	.024	.122
Rate of Return on Equity Before Taxes							
1969	132	.352	(.494)	8.028	.712	.062	.233
1970	140	.353	(3.16)	10.517	.957	.081	.211
1971	116	.258	(2.52)	6.109	.656	.061	.182
Net Profit After Tax							
1969	144	B/ 31,460	B/ (142)	B/ 122,749	B/ 22,133	B/ 1,844.411	B/ 23,624
1970	148	B/ 33,007	B/ (11,629)	B/ 134,733	B/ 21,561	B/ 1,766.362	B/ 28,287
1971	122	B/ 30,557	B/(113,607)	B/ 117,587	B/ 33,051	B/ 2,992,346	B/ 28,670
Rate of Return on Capital After Tax							
1969	135	.197	.0021	8.341	.722	.062	.095
1970	141	.162	(.466)	3.708	.360	.0308	.093
1971	118	.161	(.257)	4.35	.468	.043	.087
Rate of Return on Equity After Tax							
1969	123	.260	-1.0	3.093	.351	.031	.197
1970	140	.277	(3.161)	7.896	.744	.063	.174
1971	118	.208	(2.122)	4.629	.506	.046	.151

TABLE B.1.--Continued.

	Number of Observations	Unweighted Mean	Minimum Value	Maximum Value	Standard Deviation	Standard Error of Mean	Median
Ratio of Net Profit After Tax to Net Sales							
1969	142	.170	(.002)	.738	.174	.014	.103
1970	143	.158	(.282)	.665	.169	.014	.100
1971	121	.112	(1.47)	.672	.233	.021	.075
Dividends Paid							
1969	144	B/ 7,169	B/ 0	B/ 101,934	B/ 17,626	B/ 1,468.853	B/ 0
1970	140	B/ 15,226	B/ 0	B/ 505,050	B/ 53,141	B/ 4,491.318	B/ 0
1971	124	B/ 13,977	B/ 0	B/ 345,204	B/ 40,425	B/ 3,630.274	B/ 0
Ratio of Dividends Paid to After Tax Profit							
1969	144	.225	0	3.504	.567	.047	0
1970	140	.400	0	7.622	1.039	.088	0
1971	124	.081	(50.279)	16.796	4.883	.438	0
Ratio of Net Sales to Total Assets							
1969	135	1.898	.032	58.463	5.233	.452	1.178
1970	140	1.515	.040	14.20	1.842	.157	1.074
1971	118	1.645	.001	15.311	2.221	.205	1.089
Interest Expense							
1969	142	B/ 6,268	B/ 0	B/ 137,607	B/ 17,808	B/ 1,494.42	B/208
1970	143	B/ 8,498	B/ 0	B/ 211,299	B/ 26,461	B/ 2,212.79	B/321
1971	123	B/ 11,345	B/ 0	B/ 259,569	B/ 36,673	B/ 3,306.74	0
Times Interest Earned							
1969	81	53.407	.913	984.182	135.492	15.054	10.481
1970	77	27.571	.888	211.033	46.265	5.272	8.486
1971	58	21.198	(.108)	387.009	60.431	7.935	6.058

APPENDIX C

CUESTIONARIO

1. Producto Principal de la Cia.

2. Hace cuañtos años opera:

   A. 1-5 años
   B. 6-10 años
   C. 10-15 años
   D. mas de 15 años

3. Es esta Cía:

   A. Propiedad y Controlada pro ciudadanos panameños
   B. Subsidiaria de una Cia. extranjera
   C. Propiedad y Controlada pro panameños y extranjeros no residentes
   D. Otra.

   Si la No. 3 contestó (C), conteste la pregunta No. 4, si no fué (C), siga con la pregunta No. 5

4. Quién domina con propiedad y control:

   A. Panameños
   B. Extranjeros no residentes

5. Es la Compania:

   A. Propiedad familiar o Cia. cerrada
   B. Propiedad abierta donde la mayoria de los accionistas no son empleados de la misma o famillares de los miembros de la directiva.
   C. Propiedad abierta donde la mayoría de los accionistas son empleados de la misma o familiares de los miembros de la directiva.

6. Durante los dos (2) últimos periodos fiscales, obtuvo la Cia., capital adicional para sus operaciones.

   A. Si
   B. No

7. Si la respuesta a la pregunta anterior fué afirmative, como se obtuvo el capital adicional.

   A. Deuda a corto plazo
   B. Dueda a largo plazo
   C. Emisión de acciones

D. Mediante fuentes internas. (Retención de Utilidades u otras reservas)
E. Otro.

Si la respuesta a la pregunta anterior fué (A), conteste la pregunta No. 8, si no fue (A), siga a la pregunta No. 9.

8. En realidad qué procentaje de préstamos a corto plazo eren de largo plazo.

9. Cuáles fueron los usos específicos del incremento de capital:

   A. Expansión de planta o facilidades de producción
   B. Aumentos de Inventarios
   C. Aumento de Créditos a clientes
   D. Otro.

10. En los últimos dos (2) años la Cia. ha vendido valores?

   A. Si
   B. No

11. Si la respuesta anterior fué afirmativa, qué clase de valores se vendian:

   A. Acciones Comunes
   B. Acciones Preferidas
   C. Bonos
   D. Otros

12. A quiénes se vendieron los valcres:

   A. Directores, ejecutivos o empleados de la empresa
   B. Parientes y amigos
   C. A otras Compañias
   D. A un banco o bancos
   E. Al publico en general

13. Durante los proximos tres (3) años, además de la depreciancíón y superavit ganado, necesitará su compañia fuentes adicionales de las que se pueden conseguir capital para costear nueovos activos fisicos y/o capital en giro permanente.

   A. Si
   B. No

14. Si usted pudiera escoger, como preferiría financiar la empresa.

    A. Pidiendo a Instituciones financieras
    B. Vendiendo valores (Bonos o acciones) pública o privademente.

15. Aproximadamente, cuántos accionistas tiene la empresa?

    A. 1-10
    B. 11-25
    C. 26-50
    D. 51-100
    E. Mas de 100

16. Ha tenido alguna vex la companiá que usted representa, algún proyecto o expansión que no pudo financiarse pro las Instituciones financieras existentes en Panamá:

    A. Si
    B. No

17. Cuál es su status en la cia.:

    A. Presidente
    B. Director
    C. Generente o Administrador General
    D. Otro

APPENDIX D

CLASSIFICATION OF COMPANIES SURVEYED BY

QUESTIONNAIRE, 1972 DATA

1.	Classification	Frequency	Percent
	Industrial-Manufacturing	18	36.0
	Retail-Commercial	28	56.0
	Construction	3	6.0
	Transportation	1	2.0
	TOTAL	50	100.0

Questionnaire Results

		Number	Percent
2.	A.	9	18.0
	B.	4	8.0
	C.	12	24.0
	D.	25	50.0
		50	100.0
3.	A.	37	74.0
	B.	4	8.0
	C.	4	8.0
	D.	4	8.0
	No. Ans.	1	2.0
		50	100.0
4.	A.	4	8.0
	B.	1	2.0
	No. Ans.	45	90.0
		50	100.0
5.	A.	23	46.0
	B.	21	42.0
	C.	6	12.0
		50	100.0
6.	A.	26	52.0
	B.	24	48.0
		50	100.0
7.	A.	9	17.3
	B.	10	19.2
	C.	3	5.8
	D.	6	11.5
	E.	0	0
	No. Ans.	24	46.2
		52	100.0

8. No Response.

9.	A.	9	15.5
	B.	12	20.7
	C.	8	13.8
	D.	5	8.6
	No. Ans.	24	41.4
		58	100.0
10.	A.	12	24.0
	B.	38	76.0
		50	100.0
11.	A.	11	22.0
	B.	0	0
	C.	1	2.0
	D.	0	0
	No. Ans.	38	76.0
		50	100.0
12.	A.	6	12.0
	B.	1	2.0
	C.	1	2.0
	D.	0	0
	E.	4	8.0
	No. Ans.	38	76.0
		50	100.0
13.	A.	26	52.0
	B.	22	44.0
	No. Ans.	2	4.0
		50	100.0
14.	A.	41	82.0
	B.	9	18.0
		50	100.0
15.	A.	28	56.0
	B.	5	10.0
	C.	4	8.0
	D.	1	2.0
	E.	12	24.0
		50	100.0
16.	A.	6	12.0
	B.	44	88.0
		50	100.0
17.	A.	8	14.3
	B.	6	10.7
	C.	22	39.3
	D.	20	35.7
		56	100.0

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