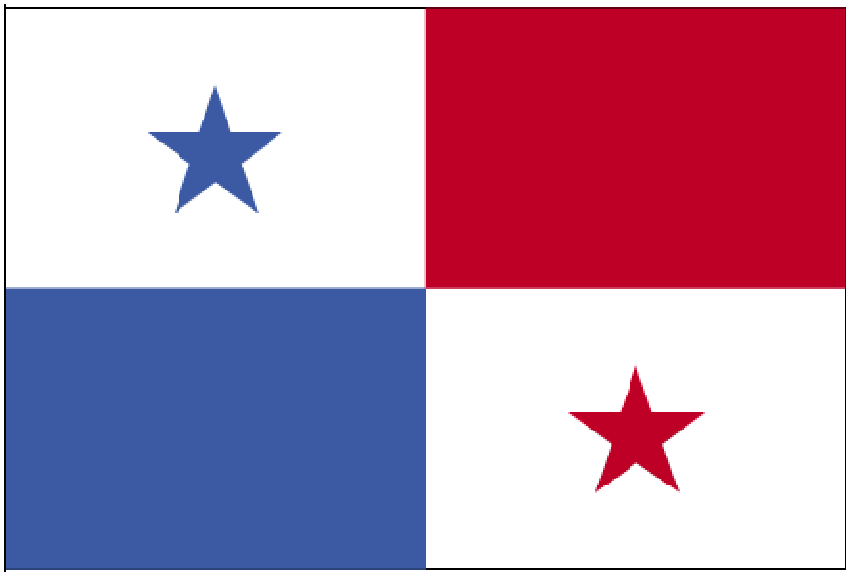
Rabobank

Country report

PANAMA



Summary

Benefiting from the expansion of the Panama Canal and a series of large-scale public investment projects, the Panamanian economy emerged from the global economic crisis as the best-performing Central American economy, posting 7.5% economic growth in 2010. With financing for the Canal expansion being broadly secured, investment-driven growth will remain above 5% in the next two years, boosting tax revenues and lowering public as well as external debt ratios. The generous parliamentary majority of the incumbent business-minded government should ensure the implementation of a five-year strategic plan to strengthen four key sectors by means of increased infrastructure investments. Additionally, continuous efforts to increase transparency in the financial sector should render the ratification of a pending free-trade agreement with the US more likely, which could further boost Panama's potential economic growth in the medium- to long-term.

Things to watch:

- Continued fiscal prudence
- Stability of checks and balances within the political system
- Risk of overheating

Author: **Fabian Briegel**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-64053
F.Briegel@rn.rabobank.nl

Panama

National facts		
Type of government	Constitutional democracy	
Capital	Panama City	
Surface area (thousand sq km)	75	
Population (millions)	3.5	
Main languages	Spanish	
	English	
Main religions	Roman Catholic (85%)	
	Protestant (15%)	
Head of State (president)	Ricardo Martinelli	
Head of Government (president)	Ricardo Martinelli	
Monetary unit	Balboas (PAB), USD	
Economy		**2010**
Economic size	*bn USD*	*% world total*
Nominal GDP	27	0.04
Nominal GDP at PPP	57	0.08
Export value of goods and services	17	0.09
IMF quotum (in mln SDR)	207	0.10
Economic structure	*2010*	*5-year av.*
Real GDP growth	7.5	8.2
Agriculture (% of GDP)	5	7
Industry (% of GDP)	17	17
Services (% of GDP)	79	77
Standards of living	*USD*	*% world av.*
Nominal GDP per head	7660	78
Nominal GDP per head at PPP	16389	139
Real GDP per head	6554	82

Social and governance indicators	rank / total
Human Development Index (rank)	54 / 169
Ease of doing business (rank)	72 / 183
Economic freedom index (rank)	59 / 179
Corruption perceptions index (rank)	85 / 180
Press freedom index (rank)	81 / 178
Gini index (income distribution)	52
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Venezuela	21	Japan	26
South Korea	17	China	20
Greece	6	Singapore	13
Ecuador	6	South Korea	10
Main export products (%)			
Bananas			8
Shrimp			4
Sugar			2
Coffee			2
Main import products (%)			
Capital goods			25
Petroleum products			19
Food products			13
Openness of the economy			
Export value of G&S (% of GDP)			65
Import value of G&S (% of GDP)			70
Inward FDI (% of GDP)			8.8

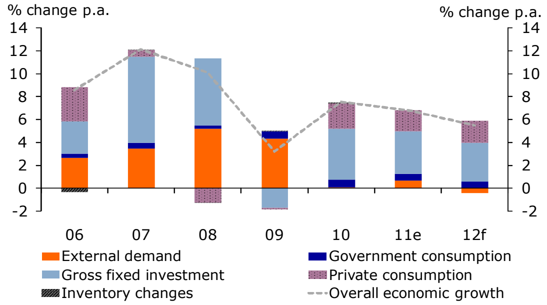
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Panama is a small open economy in Central America with a nominal GDP of USD 27bn. With a population of 3.5 million, its nominal GDP per capita amounts to USD 7,660, or USD 16,389 in PPP terms. Panama's economy is completely dollarized. Due to its geographical location and the importance of the Panama Canal for international trade, the country is a regional logistics and financial hub with a relatively diversified economy. While transshipping and port activities related to the Panama Canal remain a major source of income, the Colón free trade zone has become the leading merchandise distribution center in Latin America. In order to defend Panama's role as a major shipping route, the expansion of the Panama Canal is currently underway, which should double its current capacity by 2014. Owing to its completely open capital account and strict bank secrecy laws, Panama has also become a regional financial center, attracting funds from all across the Americas and the Caribbean. Amidst rising international pressure and negative repercussions for Panama's trade policies, the financial sector has been made more transparent in recent years, especially for foreign tax authorities. Besides logistics and financial services, transport and communication, and to an increasing extent, tourism, constitute major sectors of the local economy. Thanks to the country's extensive copper and gold deposits, mining could become a major source of revenues in the years to come. Despite being relatively diversified, the local economy's small size makes it highly dependent on regional and global economic developments. This holds in particular for the Panama Canal revenues that are largely reliant on trade between the US and China, as well as Latin America and Europe.

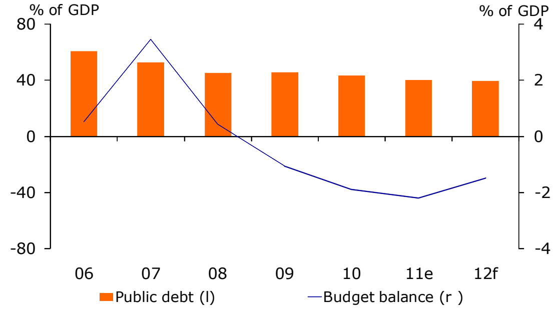
Panama's financial sector remained resilient amidst the global financial crisis, as comparatively low loan-to-value ratios limited banks' exposure to the downturn on the local real estate market. Non-performing loans remained very limited with private domestic banks and foreign banks reporting non-performing loan ratios of 1.3% and 1.5% in early 2010, respectively. Bank capitalization and liquidity levels among domestic and foreign banks remained strong, while the sector's net external asset position increased to about USD 5bn.

Graph 1: Economic growth



Source: EIU

Graph 2: Public finances



Source: EIU

After having avoided dipping into recession in 2009, the Panamanian economy outperformed its Central American peers in 2010, posting 7.5% economic growth. The ongoing widening of the Panama Canal, as well as various public and private infrastructure investments provided a major boost to economic growth and will likely do so in the years to come as 70% of the public investments are self-financed, while the remaining funding comes from multilateral lenders. The financing arrangements should render economic growth resilient to external shocks. Also, given Panamanian banks' ample liquidity and low non-performing loan ratios, additional domestic financing sources for the various investment projects should be available. Private consumption growth will also contribute significantly to economic growth in the next years, as unemployment levels are expected to decline on the back of the extensive construction activities. We consequently expect that Panama will remain among the strongest-growing Latin American economies with economic growth reaching 6.8% in 2011 and 5.5% in 2012. Due to the strong growth performance of the Panamanian economy, the risk of overheating cannot completely be excluded. Yet, since most of the infrastructure investments are done by the government, it should be able to slow down economic growth by reducing its investment activities if the need were to arise.

Political and social situation

The Panamanian political situation is expected to remain stable in the coming years, as the next general elections are scheduled for 2014 and the approval ratings of the incumbent president and head of government, Ricardo Martinelli, remain high. The current government took office in 2009, after Mr. Martinelli, a business magnate and former minister for Canal Affairs of the center-right Alianza por el Cambio (Alliance for Change), won the presidential elections with 60% of the votes. His victory marked the end of the traditional two-party dominance of Panamanian politics by the centre-right Partido Revolucionario Democrática (PRD) and the Partido Panameñita (PP). Since the election result left the PRD in disarray and the PP joined the coalition government, the business-minded Martinelli administration should not face major obstacles in implementing its pro-business agenda. Recent tensions within the coalition arising from the PP's concerns that President Martinelli might abolish the constitutional barrier to immediate re-election have been soothed, but the number of years between successive presidential terms was reduced from ten to five. Since the PP

was satisfied with this change, government stability should be ensured in the coming years. While the current government is known for taking quick decisions, criticism on this approach has increased as some bills were not completely thought through or introduced without sufficient public consultation. Controversy about an amendment to the country's mining code, which would have allowed foreign state-owned enterprises to take stakes in Panamanian mining operations, even sparked violent protests by environmental and indigenous groups. Though the government eventually repealed the bill, illustrating its awareness of the need for public support for its policies, the incident shows that a more gradual approach to policy implementation could prove more effective. This might also lead to reduced tensions with the country's trade unions that claim that Mr. Martinelli's pro-business policies are aimed a weakening their position.
The strength of the incumbent government has spurred concerns that the checks and balances of Panamanian politics might have been weakened as a consequence of a concentration of power in the hands of the executive. In particular, the recent nomination of a former deputy finance minister of the current administration to replace a Supreme Court judge was critically received by the country's judiciary. Even though President Martinelli's approval ratings remain high despite these concerns, he has to address the mounting criticism if he wants to sustain his popularity. This will also entail new initiatives to tackle rising crime levels, which are perceived to be a key policy priority among voters, although drug related crime is far from having reached the extent observed among Panama's regional peers.
Under the current Martinelli administration, Panama's external relations have changed somewhat. While bilateral relations with the US, Panama's key ally, have further improved and a pending free trade agreement will likely be signed in the coming years, Panama's relations with Cuba have cooled markedly. Bilateral relations with neighboring Colombia improved, as both countries consider security co-operation and the conclusion of a free trade agreement.

Economic policy

Panama's economic policies in the coming years will be dominated by a five-year strategic plan presented by the Martinelli administration in early 2010. The plan proposes large scale investments into four key sectors, agriculture, financial services, logistics and tourism, while keeping fiscal expenditures within the boundaries set by the Fiscal Responsibility Law. The government intends to invest USD 5.8bn into these key sectors by 2014. By exploiting the opportunities offered by the current expansion of the Panama Canal and investing heavily into the country's road infrastructure and airports, the government strives to turn Panama's logistics sector into the "hub of the Americas". Additional investments into irrigation systems and refrigeration capacities are intended to boost the country's agricultural sector, while increased attention to the country's tourism sector should position the country as a major destination for high-end and eco-tourism. About USD 3.8bn have been earmarked for social infrastructure spending aimed at hospitals and schools, housing and sanitation, as well as the development of a metro system for Panama City. The general consensus among Panamanian politicians on the need for these investments, as well as favourable financing conditions arising from last year's upgrade of the country's credit rating to investment grade by the main rating agencies should ensure that most of the projects will be realized. According to estimates by the IMF, the direct and indirect impact of the Panama Canal expansion should increase the Panamanian growth potential from 4% to 7.5%.
Besides improving Panama's infrastructure, the Martinelli government is also pursuing various free trade agreements (FTAs). In this respect, the pending FTA with the US is of particular importance to Panama, but ratification by the US Congress has so far been postponed amidst concerns about the transparency of Panama's financial sector. Due to current state of the transparency of its banking sector, Panama is still mentioned on the OECD's grey list of uncooperative tax havens.

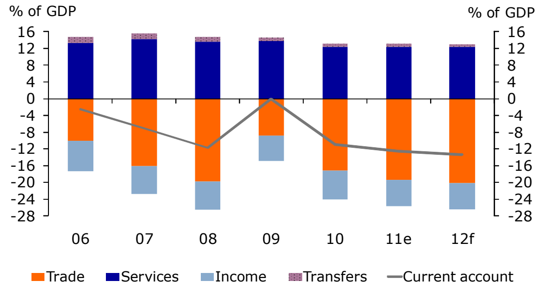
As Panama's strict bank secrecy laws received increasing international criticism, the Martinelli government passed various bilateral tax information exchange agreements (TIEA) and double taxation agreements (DTCs). Once the DTC with Ireland is signed in June, Panama will meet the requirements to be removed from the OECD grey list, which should assist the government in extending the country's network of free trade agreements. With respect to the pending FTA with the US, the recent conclusion of a bilateral TIEA should have removed major obstacles to the ratification by the US congress. However, President Obama did not set a timetable for the ratification during his last meeting with President Martinelli in April, which might lead to a further postponement due to US domestic policy concerns. Given that bank deposits of US resident only account for about 4.4% of all deposits held by foreigners at Panamanian banks as of February 2011, the possible outflow of foreign deposits due to the US TIEA should be limited.
Despite rising tax revenues on the back of the strong economic expansion and two recently introduced tax reforms, the Panamanian government's budget deficit is expected to deteriorate slightly from 1.9% of GDP in 2010 to 2.2% of GDP in 2011, as most of the additional tax revenues are spend on the administration's investment plan and the government incurred additional expenditures on infrastructure repair costs caused by heavy rains last winter. While the 2010 budget deficit met the deficit ceiling of 2% of GDP stipulated by the Fiscal Responsibility Law for that year, the deficit ceiling for 2011 was temporarily raised from 1.5% to 3% of GDP for the 2011 deficit to remain below the deficit ceiling. Due to the temporal increase of the 2011 deficit ceiling, the limits for the following years have been adjusted as well. Consequently, the Fiscal Responsibility Law caps the budget deficits at 2% of GDP in 2012, 1.5% of GDP in 2013 and 1% of GDP in 2014, which should reduce the public debt ratio to about 36% of GDP by 2014. In 2011 and 2012, public debt is expected to decline to 41% and 39% of GDP, respectively.
Panama's completely dollarized economy does not have a central bank and consequently, monetary policy is imported from the US.

Balance of Payments

After having declined to a mere 0.2% of GDP in 2009 on the back of strongly falling commodity prices, Panama's current account deficit reached double-digits again in 2010. The marked increase was mainly due to increased import spending as the economic recovery took hold, spurring domestic demand, and global commodity prices increased strongly. Additionally, the expansion of the Panama Canal and the various large-scale public investment projects led to increased imports of construction materials, as well as communications and transport equipment. The trade balance deficit consequently deteriorated from 8.8% of GDP in 2009 to 17.2% of GDP in 2010. At the same time, Panama's considerable services surplus, which is primarily generated by the Panama Canal, remained steady at about 12% of GDP. The same holds for the country's income balance deficit, which remained at about 6% of GDP. The transfer balance surplus is rather small and hardly compensates for the considerable trade balance deficit. Assuming that commodity prices will remain at elevated levels throughout 2011 and parts of 2012 and most public investment projects will not be completed before 2014, we expect that the current account deficit will reach a level of 12.5% and 13.4% of GDP in 2011 and 2012, respectively.
About 80% of the 2010 current account deficit was financed by net foreign direct investments. Even though the financial and capital account posted a USD 2.2bn surplus, this proved to be insufficient to finance the USD 3bn current account deficit and consequently, foreign exchange reserves had to be drawn down to close the financing gap. For 2011 and 2012, we expect that about 70% of the current account deficit will be covered by net direct investment flows, while net debt inflows will finance the remaining 30%. Given Panama's favorable economic growth differential with respect to similarly rated countries, as well as ongoing capital inflows into

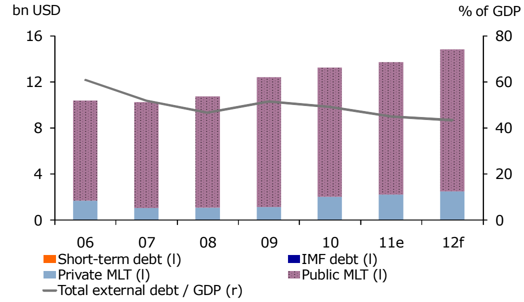
emerging market economies, Panama should manage to attract sufficient amounts of foreign debt inflows to finance its current account deficit. Additionally, the combination of the country's open capital and financial account as well as the complete dollarization of the economy ensure that the current account adjusts to the country's external financing possibilities. Since a twin deficit on the capital and current account would directly reduce the country's money supply, this would lead to lower economic growth and import demand. The resulting current account improvement would also lower the country's external financing requirement, reducing the need for external debt financing.

Graph 3: Current account



Source: EIU

Graph 4: External debt



Source: EIU

External position

Owing to the increased reliance on debt financing of the current account deficit, Panama's total foreign debt stock, standing at USD 13.2bn in 2010 will gradually increase in nominal terms to USD 13.7bn in 2011 and USD 14.8bn in 2012. However, due to strong economic growth expected for these years, the country's total foreign debt stock relative to GDP will decline from about 50% in 2010 to 43% by 2012. Furthermore, the structure of Panama's external debt looks favourable. About 80% of Panama's external debt is public medium- to long-term debt, with private medium-to long-term debt accounting for the remaining 20%. About four-fifth of Panama's debt is owed to private creditors. Owing to the increased reliance on multilateral financing sources for the various infrastructure investment projects, multilateral medium-to-long-term debt will account for about 17% and 21% of total foreign debt in 2011 and 2012, respectively. The average effective maturity of Panama's external debt exceeds 12 years.

With a liquidity ratio of 192% in 2011 and 190% in 2012, Panama's liquidity position will remain very healthy. Its foreign exchange reserves cover about 250% of debt service costs in both 2011 and 2012, and the debt service ratio of 5% is quite low. Since the country enjoys an investment grade credit rating, sufficient external credit should be available in the years to come to finance Panama's investment-driven growth strategy.

Panama

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	8.5	12.1	10.1	3.2	7.5	6.8	5.5
Consumer prices (average % change pa)	2.5	4.2	8.8	2.4	3.5	6.4	5.3
Current account balance (% of GDP)	-2.6	-7.1	-11.8	-0.2	-11.0	-12.5	-13.4
Total foreign exchange reserves (mln USD)	1335	1935	2424	3028	2715	3010	3310
Economic growth							
GDP (% real change pa)	8.5	12.1	10.1	3.2	7.5	6.8	5.5
Gross fixed investment (% real change pa)	16.6	41.0	25.3	-6.5	18.5	14.0	12.0
Private consumption (real % change pa)	4.4	0.9	-2.1	-0.2	4.4	3.7	4.0
Government consumption (% real change pa)	3.1	4.1	2.6	6.4	7.2	6.0	5.8
Exports of G&S (% real change pa)	11.1	22.0	17.8	-5.6	12.9	11.3	8.0
Imports of G&S (% real change pa)	7.4	18.1	12.2	-12.2	15.7	12.5	10.0
Economic policy							
Budget balance (% of GDP)	0.5	3.5	0.4	-1.1	-1.9	-2.2	-1.5
Public debt (% of GDP)	61	53	45	46	43	41	39
M2 growth (% change pa)	22	16	15	11	11	21	16
Consumer prices (average % change pa)	2.5	4.2	8.8	2.4	3.5	6.4	5.3
Exchange rate LCU to USD (average)	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Recorded unemployment (%)	9.1	6.8	5.8	6.4	4.2	3.5	3.9
Balance of payments (mln USD)							
Current account balance	-448	-1407	-2722	-44	-2953	-3830	-4570
Trade balance	-1715	-3190	-4546	-2123	-4615	-5950	-6890
Export value of goods	8475	9334	10323	11133	11330	13110	15000
Import value of goods	10190	12524	14869	13256	15946	19060	21890
Services balance	2273	2836	3155	3329	3333	3820	4230
Income balance	-1258	-1306	-1570	-1460	-1861	-1920	-2130
Transfer balance	253	253	238	210	191	220	220
Net direct investment flows	2557	1777	2196	1773	2363	2800	3000
Net portfolio investment flows	-1298	-1112	40	-916	-664	20	-80
Net debt flows	1994	498	538	1700	107	1110	1570
Other capital flows (negative is flight)	-2681	844	437	-1909	833	200	370
Change in international reserves	125	600	489	605	-314	300	300
External position (mln USD)							
Total foreign debt	10392	10241	10721	12418	13217	13740	14810
Total debt service due, incl. short-term debt	1871	911	932	982	1172	1210	1320
Total foreign exchange reserves	1335	1935	2424	3028	2715	3010	3310
International investment position	-11797	-13627	-15745	-16024	-18182	n.a.	n.a.
Total assets	29013	35823	39684	42735	47621	n.a.	n.a.
Total liabilities	40809	49450	55429	58759	65803	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-10.0	-16.1	-19.8	-8.8	-17.2	-19.4	-20.2
Current account balance (% of GDP)	-2.6	-7.1	-11.8	-0.2	-11.0	-12.5	-13.4
Inward FDI (% of GDP)	14.9	9.0	9.5	7.4	8.8	9.1	8.8
Foreign debt (% of GDP)	61	52	47	52	49	45	43
Foreign debt (% of XGSIT)	73	62	58	67	68	62	59
International investment position (% of GDP)	-68.8	-68.8	-68.5	-66.5	-67.7	n.a.	n.a.
Debt service ratio (% of XGSIT)	13	5	5	5	6	5	5
Interest service ratio incl. arrears (% of XGSIT)	6	4	4	4	4	3	3
FX-reserves import cover (months)	1.3	1.6	1.7	2.4	1.7	1.6	1.6
FX-reserves debt service cover (%)	71	212	260	309	232	250	252
Liquidity ratio	189	197	195	229	198	192	190

Source: EIU

Disclaimer
This document is issued by Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. incorporated in the Netherlands, trading as Rabobank Nederland, and regulated by the FSA. The information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but no representation or warranty, express or implied, is made as to their accuracy or completeness. It is for information purposes only and should not be construed as an offer for sale or subscription of, or solicitation of an offer to buy or subscribe for any securities or derivatives. The information contained herein is not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient. All opinions expressed herein are subject to change without notice. Neither Rabobank Nederland, nor other legal entities in the group to which it belongs accept any liability whatsoever for any direct or consequential loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith, and their directors, officers and/or employees may have had a long or short position and may have traded or acted as principal in the securities described within this report, or related securities. Further it may have or have had a relationship with or may provide or have provided corporate finance or other services to companies whose securities are described in this report, or any related investment. This document is for distribution in or from the Netherlands and the United Kingdom, and is directed only at authorised or exempted persons within the meaning of the Financial Services and Markets Act 2000 or to persons described in Part IV Article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2001, or to persons categorised as a "market counterparty or intermediate customer" in accordance with COBS 3.2.5. The document is not intended to be distributed, or passed on, directly or indirectly, to those who may not have professional experience in matters relating to investments, nor should it be relied upon by such persons. The distribution of this document in other jurisdictions may be restricted by law and recipients into whose possession this document comes from should inform themselves about, and observe any such restrictions. Neither this document nor any copy of it may be taken or transmitted, or distributed directly or indirectly into the United States, Canada, and Japan or to any US-person. This document may not be reproduced, distributed or published, in whole or in part, for any purpose, except with the prior written consent of Rabobank Nederland. By accepting this document you agree to be bound by the foregoing restrictions.