Rabobank

Country report **PANAMA**

Summary

Amid a challenging external environment, Panama continues to belong to the world's fastest-growing economies. Benefitting from the ongoing expansion of the Panama Canal and a sizeable public infrastructure investment program intended to turn the country into a regional logistics hub, economic growth reached 10.6% last year. This year, growth is expected to cool down to about 9% before moderating to about 7% next year, which should reduce overheating pressures signaled last year. Following the disintegration of President Martinelli's coalition government, political stability has been restored and the president's popularity has recovered, which should bode well for policy continuity. On the fiscal front, a sovereign wealth fund (SWF) has been established to save the anticipated windfall gains from the Canal expansion, but it remains to be seen whether the government will stick to the SWF's rules and manages to achieve the aspired asset accumulation. Meanwhile, mainly driven by the large infrastructure projects, the current account deficit increased to 13% of GDP last year, but it remains largely financed by foreign direct investments.

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Panama

National facts		
Type of government	Constitutional democracy	
Capital	Panama City	
Surface area (thousand sq km)	75	
Population (millions)	3.5	
Main languages	Spanish (official)	
	English	
Main religions	Roman Catholic (85%)	
	Protestant (15%)	
Head of State (president)	Ricardo Martinelli	
Head of Government (president)	Ricardo Martinelli	
Monetary unit	USD	
Economy		**2011**
Economic size	*bn USD*	*% world total*
Nominal GDP	31	0.04
Nominal GDP at PPP	66	0.08
Export value of goods and services	24	0.11
IMF quotum (in mln SDR)	207	0.10
Economic structure	*2011*	*5-year av.*
Real GDP growth	10.6	8.4
Agriculture (% of GDP)	4	6
Industry (% of GDP)	17	17
Services (% of GDP)	79	77
Standards of living	*USD*	*% world av.*
Nominal GDP per head	8574	79
Nominal GDP per head at PPP	18407	148
Real GDP per head	7192	88

Social and governance indicators	rank / total
Human Development Index (rank)	58 / 187
Ease of doing business (rank)	61 / 185
Economic freedom index (rank)	55 / 179
Corruption perceptions index (rank)	86 / 183
Press freedom index (rank)	113 / 178
Gini index (income distribution)	51.9
Population below $1.25 per day (PPP)	6.6%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
US	15	Japan	24
South Korea	15	China	23
Japan	11	Singapore	18
Honduras	9	US	13

Main export products (%)	*2010*
Apparel	28
Chemicals	26
Electrical appliances	12
Agricultural produce	6
Main import products (%)	2010
Apparel	20
Chemicals	17
Machinery & transport equipment	15
Electrical appliances	12
Openness of the economy	2011
Export value of G&S (% of GDP)	79
Import value of G&S (% of GDP)	86
Inward FDI (% of GDP)	9.2

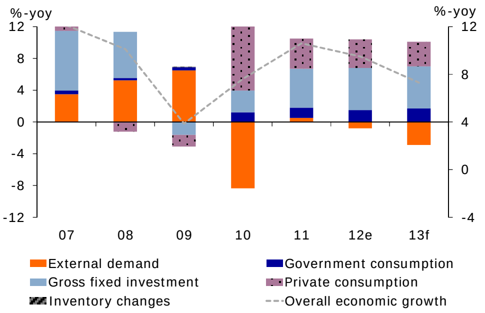
Source: EIU, CIA World Factbook, UN, Heritage Foundation, International Trade Center, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Panama is a small and very open economy on the border between Central and South America with a nominal GDP of USD 31bn in 2011 and about 3.5m inhabitants. With a 2011 nominal GDP per capita of USD 8,574, or USD 18,407 in PPP terms, Panama is one of the wealthiest Central American countries. Panama's fully dollarized free-market economy is mainly based on services, which account for about 80% of GDP, while the industrial and agricultural sector account for 17% and 4% of GDP, respectively. Compared to the small size of the economy, the services sector is relatively diversified, as Panama's favorable geographic location and the importance of the Panama Canal for international shipping has turned the country into a regional financial and logistics hub. While transshipping and port operations of the Panama Canal still form the backbone of the logistics sector, the Colón free trade zone has become Latin America's leading merchandise distribution center in recent years. Also, the local tourism sector is gaining ground in the Central American region. Panama's manufacturing industries mainly focus on the production of textiles, chemical products and aircraft spare parts. In spite of sizeable copper deposits, Panama's mining sector remains small, but holds considerable potential.

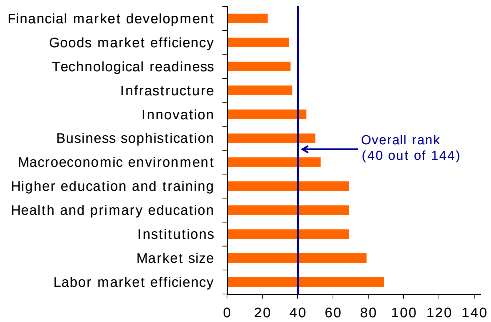
Owing to the combination of a completely open capital account, dollarization and low inflation, strict bank secrecy laws, as well as relative political stability in recent decades, Panama has turned into a regional financial center. Even as international pressure has led to increased bank transparency, the sector still remains attractive for foreign depositors, particularly those from politically instable countries in the region. Reflecting conservative banking practices in the absence of a central bank that could function as a lender of last resort, asset quality remained strong, as the sector's non-performing loan ratio remained relatively constant at about 1.3% of total loans. The banking system remained well-capitalized and highly liquid in recent years, while it continues to mainly rely on deposit funding. The sector's strong fundamentals should shield it against increased stress on international financial markets, though rising interest rates on the sector's very high external debt and short-term deposit withdrawals pose some risks. However, even in the absence of a central bank, the government should be able to provide liquidity assistance if needed, whereby the commercial Banco Nacional de Panamá could act as an agent.

Figure 1: Economic growth



Source: EIU

Figure 2: Competitiveness
Rank (1 is best)



Source: World Economic Forum

Panama's economy continued to outperform its Latin American peers in 2011, as economic growth strengthened further from 7.6% in 2010 to 10.6% last year. Once more, growth was mainly driven by the ongoing expansion of the Panama Canal and the implementation of a large-scale public infrastructure investment program, which are expected to also drive growth in the coming years. As about 70% of the public investments are expected to be financed from current revenue, while the remaining financing is provided by multilateral lenders, the implementation of the projects should be relatively shielded against worsening conditions on international financial markets. Moreover, thanks to the ample liquidity and strong asset quality of Panamanian banks, additional domestic funds should be available if the need were to arise. Meanwhile, given full employment, private consumption growth will likely remain strong. Mainly reflecting a deteriorated external environment, Panama's economic growth is expected to weaken to a still very strong 9.5% this year, before declining to about 7% in 2013.

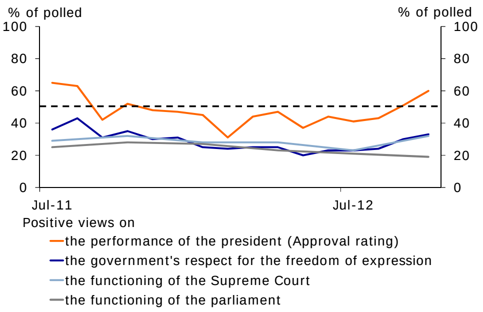
Political and social situation

Panama's political situation is expected to remain stable until general elections will be held in May 2014. Even though President Ricardo Martinelli's coalition government, which comprised his own center-right Cambio Democrático-party (CD) and the centrist Partido Panameñista (PP), collapsed in September 2011, the president managed to stay in office. Owing to various defections from the now-opposition PP faction and the opposition center-left Partido Revolucionario Democrático (PRD) faction to the CD, President Martinelli currently enjoys the support of 40 of the 71 members of the Panamanian parliament.

At first glance, Mr Martinelli appears to have benefitted from the coalition crisis as his party now enjoys an absolute parliamentary majority. However, it cost him dearly in terms of approval ratings, which declined from 63% in August 2011 to 31% in February 2012. While part of the strong decline can be explained by the President's handling of the coalition crisis, the emergence of corruption allegations related to the acquisition of helicopters form the Italian manufacturer AgustaWestland further undermined the public's support for the President. Still, in spite of a series of corruption scandal involving senior government officials, as well as violent protests against his heavy-handed policies, Mr Martinelli and his government managed to regain the public's trust in recent months and the presidential approval rating recovered to 60% in October 2012. This should improve the policy outlook for the remainder of his presidential term. Notwithstanding, the various scandals have seriously hurt the President's reputation and they add to the public's continuous opposition towards Mr Martinelli's plans to revoke a constitutional ban on consecutive presidential terms.

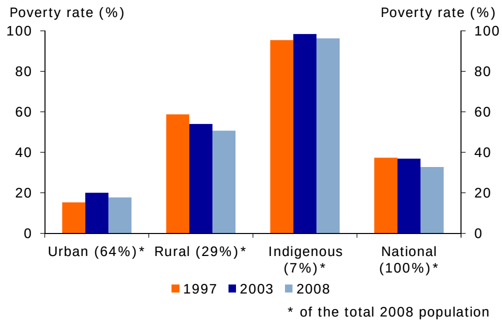
In spite of Panama's strong economic growth in recent years, the country's society remains characterized by considerable income inequality and marked differences in economic development between the densely populated areas along the Panama Canal and the hinterland. While economic growth and poverty alleviation programs brought the nationwide poverty rate down from 37% in 1997 to 32% in 2008, particularly Panama's indigenous areas, home to about 7% of the population, lag seriously behind. In 2008, 96% of the inhabitants of those territories were considered poor according to the national poverty line. Meanwhile, Panamanian's trust in public institutions, particularly in the national parliament and the Supreme court, is relatively low, and citizens' concerns about the freedom of the press have increased, recently. Recurrent corruption scandals in combination with concerns about low government transparency also seem to weaken the population's faith in the state's institutions. Against this background, President Martinelli's at times heavy-handed policies tend to spark violent and sometimes even deadly protests that in several cases eventually forced the President to repeal his policies.

Figure 3: Public views on institutions



Source: Dichter&Neira

Figure 4: Poverty and regional inequality



Source: World Bank

Owing to its geographic location on major drug trafficking routes to the US, Panama has been affected by drug-related violence, but the country's homicide rate (21.6 murders per 100,000 inhabitants), though markedly higher than in neighboring Costa Rica, remains far below the levels seen in the countries of the Northern Triangle (El Salvador, Guatemala, Honduras). Still, insecurity ranks high among Panamanians' concerns, second only to worries about high costs of living, the population's most pressing concern. In order to better be able to fight internationally operating drug-cartels, Panama increased its security collaboration with Costa Rica, particularly in the field of information exchange and training of police staff.

Panama's external relations mainly focus on its regional peers and the US, with which the country has cordial relationships. Panama participates in the Dominican Republic-Central America Free

Trade Agreement (DR-CAFTA), while a free-trade agreement with the US has recently become effective. Reflecting the regional challenges posed by high levels of drug-related violence, Panama has increased its security co-operation within the region. Beyond its region, Panama's policy efforts aim at the conclusion of additional tax information exchange agreements to improve the reputation of its financial sector that was once known for its strict bank secrecy laws.

Economic policy

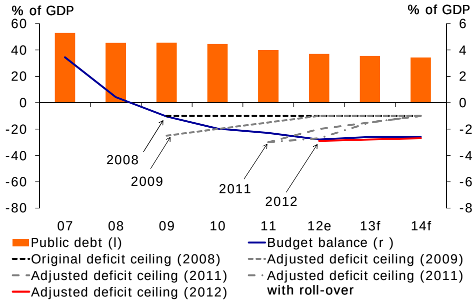
Panama's current economic policy efforts concentrate on the implementation of a five-year strategic plan, which was presented by the Martinelli administration in 2010. The plan stipulates large-scale infrastructure investments into four key sectors, agriculture, financial services, logistics and tourism, as well as road and airport infrastructure in order to turn Panama into the 'hub of the Americas'. Reflecting the need to develop the country's hinterland, increased investments into irrigation systems and refrigeration capacities are intended to boost the productivity of the agricultural sector. Moreover, efforts are made to support the local tourism sector in order to position Panama as a main destination for high-end and eco-tourism. The strategic plan also proposes sizeable social infrastructure investments into hospitals, schools, housing, and sanitation, as well as the development of a metro system for Panama City. In total, these investments will amount to about USD 13.5bn (43.5% of 2011 GDP), excluding the current expansion of the Panama Canal which costs about USD 5.25bn (17% of 2011 GDP). As financing for these investments is ensured and the Panamanian politicians across all parties support the implementation of the strategic plan, most of the projects should be realized by 2015. According to IMF estimates, these investments could boost Panama's annual potential growth from 4% to 7.5%.

Given estimates that annual government revenues from the Panama Canal will double from about USD 850mln to around USD 1.7bn once the Panama Canal expansion is complete in 2015, a sovereign wealth fund, the Fondo de Ahorro de Panamá (FAP), was created last May. According to the rules governing the funding of the FAP, all transfers of the Panama Canal Authority in excess of 3.5% of GDP shall be deposited in the FAP. Provided these transfers increase to 4.25% of GDP by 2025, the FAP should have accumulated assets worth 6% of GDP in that year. Asset withdrawal, though subject to strict conditions, will be possible right from the start of the FAP in 2015. The government may tap into the FAP's funds if annual GDP growth in two consecutive quarters falls below 2%, if costs related to a state-of-emergency exceed 0.5% of GDP, or if it intends to prepay sovereign debt of up to 0.5% of GDP as long as the FAP's asset amount to at least 5% of GDP. Provided governments adhere to the rules and projections for additional Panama Canal revenue do not turn out to be too optimistic, the FAP could boost Panama's sovereign creditworthiness and thereby free funds for social development. Unfortunately, however, recent repeated alterations of Panama's fiscal responsibility law in order to accommodate higher than anticipated budget deficits do not bode well in this respect.

Mainly due to President Martinelli's firm commitment to push ahead with the public infrastructure program as swiftly as possible in spite of last year's warnings against overheating, Panama has run recurrent budget deficits in the last years and will likely do so in the near future. While strong economic growth and two recent tax reforms boosted government revenues, a 30% increase in capital expenditures has more than compensated for improving tax intakes. Consequently, this year's budget deficit is expected to worsen to 2.8% from 2.3% last year, while next year's budget deficit is expected to marginally improve to 2.6%. Since Panama's 2008 Fiscal Responsibility Law (FRL) stipulated an annual deficit ceiling of 1% of GDP, as mentioned above, several waivers to increase the deficit ceiling have been used in recent years in order to accommodate higher deficits.

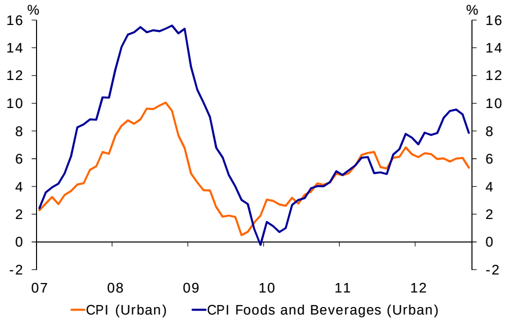
In line with a change of the FRL that was related to the creation of the FAP, the 2012 deficit ceiling was eventually raised to 2.9% of GDP (see figure 5), while a gradual return to the 1% deficit ceiling is anticipated in 2018. Even though the deficit limits remain low, particularly compared to Panama's strong economic growth, the repeated increases have undermined the trust in Panama's willingness to adhere to its own fiscal rules. Notwithstanding, Panama's public debt ratio is expected to decline to 37% of GDP this year, down from 40% last year, before falling to 35% in 2013. This trend may change, however, if growth were to fall markedly. In this respect, various turnkey infrastructure projects could increase the public debt ratio markedly, once Panama's government has to repay the private sector that had financed these projects during the construction period.

Figure 5: Public finances



Source: EIU, Fitch

Figure 6: Inflation



Source: Reuters Ecowin

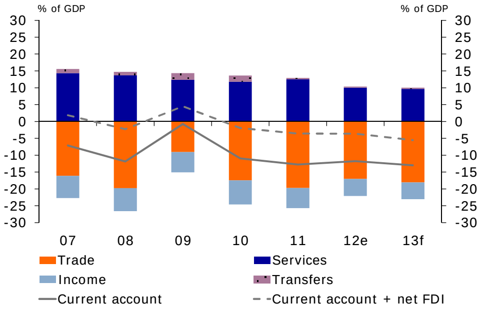
Since Panama's completely dollarized economy does not have a central bank, its monetary policy is determined by the Federal Reserve. Therefore, the government can only influence inflation (expectations) by means of fiscal policy. As inflation had been rising from already elevated levels last year, public spending cuts could have had a dampening effect. The government, however, decided to further boost capital expenditures last year, even as inflation reached a level of 6% compared to a long-run average of about 2% prior to the beginning of the public infrastructure investment program. Even though food and oil price hikes explain part of the elevated inflation rate, labor shortages also contribute, which indicates lingering overheating risks as the economy is growing above potential. In line with slowing economic growth, next year's inflation rate is expected to cool down to about 5%. Notwithstanding, inflation remains well above the levels seen in the US, which does not bode well for Panama's price competitiveness position, as the completely dollarized economy lacks the possibility to improve price competitiveness by means of devaluing its currency. Meanwhile, once completed, the large-scale infrastructure projects could lead to markedly lower transportation costs, which could (partly) compensate for recent losses in competitiveness.

Balance of Payments and external position

Since Panama's domestic savings are too small to finance the sizeable public infrastructure investments, the country has been running large current account deficits in recent years, which are unlikely to decrease significantly before the completion of most construction projects. Panama's current account deficit deteriorated from 11% of GDP in 2010 to 12.7% last year, as strong domestic demand and imports related to the various infrastructure projects drove a trade deficit of almost 20% of GDP. Even though the structural services surplus improved to 12.5% of GDP, it could not compensate for the worsening of the trade deficit. Next year's current account deficit is expected to marginally improve to about 12% of GDP, as both the trade deficit and services surplus are expected to fall due to weakening global growth that should translate into lower Panama Canal revenues and domestic demand growth. Moreover, owing to Panama's combination of a dollarized economy and a completely open capital account, insufficient external financing (i.e. a current account deficit in excess of net capital account inflows) will automatically reduce the money supply and cause imports to contract to a level for which sufficient financing is available.

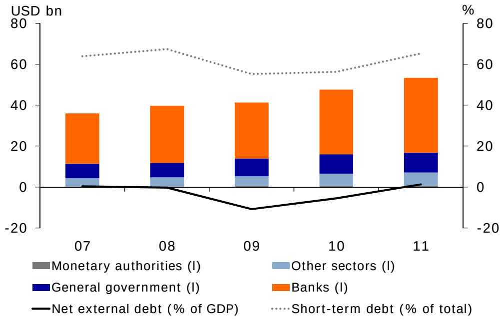
The large current account deficits significantly increase the country's exposure to external shocks, as it renders local economic development heavily dependent on the availability of foreign financing. While some comfort can be derived from the fact that about three-quarters of recent years' current account deficits have been financed by foreign direct investment, a gradual increase in debt financing since 2010 contributes to an already very sizeable gross external debt position of about 170% of GDP. While official reserves only amount to a limited 10% of GDP, Panama's net external debt stood at a manageable 1.3% of GDP (USD 400m) last year. Given debt service costs of just 13% of current account earnings and a liquidity ratio of 160%, Panama should not face difficulties servicing its external debt in the short- to medium-term.

Figure 7: Current account



Source: EIU

Figure 8: Gross external debt



Source: Fitch

Panama's financial sector accounts for most of the country's external debt load, which reflects its role as a regional financial hub. In spite of its large external asset holdings, the sector's net external debt is estimated to amount to about 20% of current account receipts, which exposes it to shifts in investor sentiment. As most of the sector's debt is short-term, it is particularly exposed to refinancing risks and rising interest rates. However, given the sector's favorable asset quality and capitalization levels, as well as its appeal to foreign depositors from politically instable Latin American countries, access to international financial markets should be ensured over the short- to medium-term. Also, the government's ability to shoulder the sector's estimated contingent liabilities of about 14% of GDP should increase foreign investors' confidence. We caution, however, that the sector is not immune to a general increase in risk aversion vis-à-vis Panama and emerging markets in particular.

Panama

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	12.1	10.1	3.9	7.6	10.6	9.5	7.3
Consumer prices (average % change pa)	4.2	8.8	2.4	3.5	5.9	6.1	4.8
Current account balance (% of GDP)	-7.1	-11.8	-0.7	-11.0	-12.7	-11.8	-13.0
Current account balance plus net FDI (% of GDP)	1.9	-2.3	4.5	-2.0	-3.6	-3.6	-5.5
Total foreign exchange reserves (m USD)	1935	2424	3028	2715	2315	3310	3610
Economic growth							
GDP (% real change pa)	12.1	10.1	3.9	7.6	10.6	9.5	7.3
Gross fixed investment (% real change pa)	41.0	25.3	-6.2	11.6	20.0	19.9	18.2
Private consumption (real % change pa)	0.9	-2.1	-2.8	24.4	6.6	6.6	5.9
Government consumption (% real change pa)	4.1	2.6	4.1	12.2	13.0	13.9	15.0
Exports of G&S (% real change pa)	22.0	17.8	-1.0	1.7	10.6	4.5	6.9
Imports of G&S (% real change pa)	18.1	12.2	-9.9	15.1	11.0	6.2	11.7
Economic policy							
Budget balance (% of GDP)	3.5	0.4	-1.1	-2.0	-2.3	-2.8	-2.6
Public debt (% of GDP)	53	45	46	45	40	37	35
M2 growth (% change pa)	16	15	11	9	8	16	12
Consumer prices (average % change pa)	4.2	8.8	2.4	3.5	5.9	6.1	4.8
Exchange rate LCU to USD (average)	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Recorded unemployment (%)	6.8	5.8	6.9	6.8	4.5	4.4	4.5
Balance of payments (m USD)							
Current account balance	-1407	-2722	-179	-2862	-3892	-4190	-5220
Trade balance	-3190	-4546	-2181	-4555	-6016	-6070	-7260
Export value of goods	9334	10323	12038	12680	16929	17970	20950
Import value of goods	12524	14869	14218	17235	22946	24040	28210
Services balance	2836	3155	2978	3074	3814	3590	3890
Income balance	-1306	-1570	-1449	-1859	-1819	-1820	-1990
Transfer balance	253	238	472	477	129	110	150
Net direct investment flows	1777	2196	1259	2350	2800	2900	3000
Net portfolio investment flows	-1112	40	-964	-1060	-113	-260	-280
Net debt flows	498	538	1700	126	532	1160	1140
Other capital flows (negative is flight)	844	437	-1212	1132	273	1400	1660
Change in international reserves	600	489	605	-314	-400	1000	300
External position (m USD)							
Total foreign debt	35800	39500	40700	47000	52700	n.a.	n.a.
Short-term debt	22800	26800	26800	29100	33700	n.a.	n.a.
Total debt service due, incl. short-term debt	2600	3500	2700	2900	3500	n.a.	n.a.
Total foreign exchange reserves	1935	2424	3028	2715	2315	3310	3610
International investment position	-13627	-15745	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	35823	39684	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	49450	55429	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-16.1	-19.8	-9.1	-17.5	-19.7	-17.0	-18.1
Current account balance (% of GDP)	-7.1	-11.8	-0.7	-11.0	-12.7	-11.8	-13.0
Current account balance plus net FDI (% of GDP)	1.9	-2.3	4.5	-2.0	-3.6	-3.6	-5.5
Inward FDI (% of GDP)	9.0	9.5	5.2	9.0	9.2	8.1	7.5
Foreign debt (% of GDP)	181	172	169	176	172	n.a.	n.a.
Foreign debt (% of XGSIT)	216	214	206	223	197	n.a.	n.a.
International investment position (% of GDP)	-68.8	-68.5	-66.3	-64.2	-59.3	n.a.	n.a.
Debt service ratio (% of XGSIT)	16	19	14	14	13	n.a.	n.a.
Interest service ratio incl. arrears (% of XGSIT)	10	9	8	8	6	n.a.	n.a.
FX-reserves import cover (months)	1.6	1.7	2.2	1.6	1.1	1.5	1.4
FX-reserves debt service cover (%)	74	69	112	94	66	n.a.	n.a.
Liquidity ratio	174	169	196	174	161	187	184

Source: EIU, Fitch, Rabobank