Country update **PANAMA**

Summary

After having posted 7.6% economic growth in 2010, Panama's economic success story on the back of the Panama Canal expansion and a substantial public investment program continued throughout this year. Economic growth in 2011 will likely come in at about 8%, before cooling down to a still solid 5% next year, indicating declining risks of overheating. As government finances stayed within the limits set by Panama's Fiscal Responsibility Law, the country's government debt continues to decline on the back of strong economic growth. Yet, considerable fiscal risks could emerge in the medium-term as the government defers the recognition of the costs of its investment program, especially if global economic growth and Panama Canal revenues turn out to be lower than anticipated. The recent ratification of a free-trade agreement with the US should strengthen Panama's growth potential, while plans for the creation of a sovereign wealth fund for future revenues from the Panama Canal and a liquidity fund to support banks in the absence of a deposit insurance system should boost investor confidence. Benefiting from falling unemployment, the current administration enjoys relatively high approval ratings, which provide general support for its five-year strategic plan to strengthen and diversify the local economy. Despite the recent break-up of the governing coalition, policy continuity remains ensured, as President Martinelli restored his parliamentary majority.

Things to watch:

- Continued fiscal prudence
- Creative public debt accounting practices

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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
	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)	58 / 187
Ease of doing business (rank)	61 / 183
Economic freedom index (rank)	59 / 179
Corruption perceptions index (rank)	73 / 178
Press freedom index (rank)	81 / 178
Gini index (income distribution)	52
Population below $1.25 per day (PPP)	n.a.

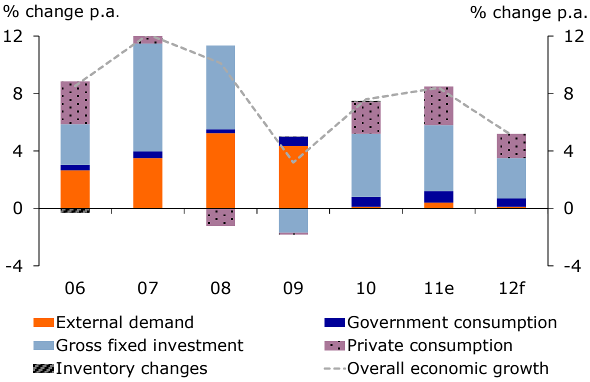
Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Venezuela	21	Japan	26
South Korea	17	China	20
Greece	6	Singapore	13
Ecuador	6	South Korea	10
Main export products (%)			
Bananas			8
Shrimp			4
Sugar			2
Coffee			2
Main import products (%)			
Capital goods			25
Petroleum products			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

Introduction and update

Benefitting from the ongoing expansion of the Panama Canal and a large-scale public investment program intended to turn the country into a regional logistics hub, Panama's economic performance so far exceeded earlier estimates, withstanding the current global economic slowdown. With the finishing of the canal expansion anticipated for 2014 and most of the public investment projects being co-funded by multilaterals, Panama's investment-driven economic success story will likely prove resistant to a worsening of the external environment. We therefore expect that the country will continue to outperform most of its regional peers in the coming years, while the breadth of the public investment program and the exploitation of synergies arising from the Panama Canal expansion should markedly improve the small local economy's diversification and resilience to external shocks in the future. Additionally, the recent approval of Panama's long-awaited free-trade agreement with the US will likely boost its goods and services exports. Despite the large-scale public investment program, Panama's government finances remain solid so far, as budget deficits remain within the boundaries set by the Fiscal Responsibility Law and its public debt ratio declines on the back of current strong economic growth. However, as part of the limited budget deficits can be explained by the deferral of public expenditures, fiscal challenges could arise in the medium-term if economic growth were to cool markedly after the conclusion of the public investment program (see also final section).

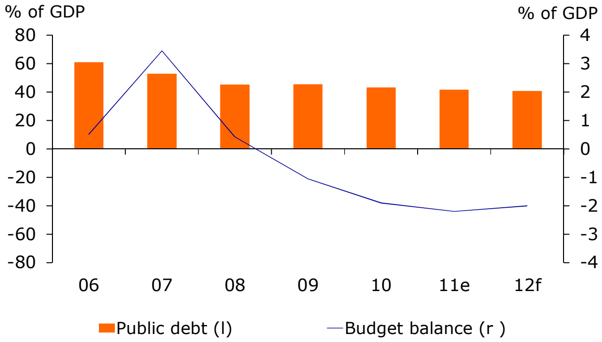
Resilient economic growth in the short-term amid the global economic slowdown
While most economies saw downward corrections to their economic growth forecasts for this year, Panama represents a notable exception. Driven by stronger than anticipated investments and private consumption, Panama will most likely grow by 8.4% this year. In our June 2011 country risk report, we expected economic growth to come in at 6.8% this year. Since financing for Panama's investment boom has been broadly ensured before the onset of the current global growth slowdown, construction activities will continue, which should largely shield Panama's economy against a marked economic downturn in the near future. While downside risks to Panama's short-term growth outlook are limited, the risk of a possible overheating of the economy on the back of strong public investment has been abating recently. Even though the ongoing economic expansion continues to generate demand-side pressures in the small local economy, a gradual decline in inflation indicates that this risk to the growth outlook seems to diminish. Economic growth is expected to decline to about 5% next year and inflation levels will likely cool down to about 4.5%. We consequently expect that, on balance, the risks to Panama's short-term economic outlook have not changed dramatically.

Chart 1: Economic growth



Source: EIU

Chart 2: Public finances



Source: EIU

Deferred and hidden fiscal costs of the public investment program
Even though Panama's strong economic performance has been largely driven by the government's large-scale public investment program, public expenditures have remained within the boundaries set by the Fiscal Responsibility Law. While part of the explanation for these relatively small deficits in times of heavy public investments lies in a denominator effect, subtle shifting of investment expenses off the public sector's balance sheet also play a worrying role. Two techniques of moving de-facto public investments and associated debts off-balance have been the reclassification of state entities as semi-autonomous state institutions and 'build now, pay later' contracts with private companies. In the case of the former, debt positions of the reclassified state entities do not show up in Panama's public debt figures any more, even though the government incurs a contingent liability, given the semi-autonomous status of these companies. In the case of the latter, using so-called 'turn-key' contracts, the government contracts out investment projects to private sector companies. Upon completion, these projects will be operated by the public sector. As the private sector assumes the debt funding of these projects in the short-term and the Panamanian government first recognizes these debts once the projects are completed, it effectively employs a cost deferral mechanism. Provided that the large-scale infrastructure investments increase the country's economic growth in the coming years, Panama could outgrow these future debts. In this

case, these measures could prove to be valuable tools to speed up Panama’s growth without increasing its public debt ratio. Yet, if economic growth turns out to be lower than anticipated, these arrangements could also result in a major increase in public debt levels in the medium-term, particularly so if additional revenues from the expanded Panama Canal suffer from lower global economic growth. Being confronted with rising concerns about these risks, the Panamanian government has presented a proposal to limit public-private partnership projects to 3% of GDP. Still, given a worsened outlook for the global economy and possibly lower than anticipated Panama Canal revenues, increased attention for Panama’s public finances is warranted.

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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	7.6	8.4	5.1
Consumer prices (average % change pa)	2.5	4.2	8.8	2.4	3.5	5.8	4.7
Current account balance (% of GDP)	-2.6	-7.1	-11.8	-0.2	-11.0	-11.7	-11.6
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	7.6	8.4	5.1
Gross fixed investment (% real change pa)	16.6	41.0	25.3	-6.5	18.5	17.5	10.0
Private consumption (real % change pa)	4.4	0.9	-2.1	-0.2	4.4	5.4	3.5
Government consumption (% real change pa)	3.1	4.1	2.6	6.4	7.2	8.0	5.5
Exports of G&S (% real change pa)	11.1	22.0	17.8	-5.6	12.9	9.6	5.3
Imports of G&S (% real change pa)	7.4	18.1	12.2	-12.2	15.6	11.0	6.2
Economic policy							
Budget balance (% of GDP)	0.5	3.5	0.4	-1.1	-1.9	-2.2	-2.0
Public debt (% of GDP)	61	53	45	46	43	42	41
M2 growth (% change pa)	22	16	15	11	11	10	9
Consumer prices (average % change pa)	2.5	4.2	8.8	2.4	3.5	5.8	4.7
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	4.1	3.5	4.0
Balance of payments (mln USD)							
Current account balance	-448	-1407	-2722	-44	-2953	-3620	-3960
Trade balance	-1715	-3190	-4546	-2123	-4615	-5610	-6160
Export value of goods	8475	9334	10323	11133	11330	13370	15040
Import value of goods	10190	12524	14869	13256	15946	18970	21200
Services balance	2273	2836	3155	3329	3333	3730	4140
Income balance	-1258	-1306	-1570	-1460	-1861	-1960	-2160
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	1610	1570
Other capital flows (negative is flight)	-2681	844	437	-1909	833	-520	-230
Change in international reserves	125	600	489	605	-314	300	300
External position (mln USD)							
Total foreign debt	10392	10241	10721	12418	13217	14240	15310
Total debt service due, incl. short-term debt	1871	911	932	982	1171	1250	1350
Total foreign exchange reserves	1335	1935	2424	3028	2715	3010	3310
International investment position	-11797	-13627	-15745	-15942	-18100	n.a.	n.a.
Total assets	29013	35823	39684	42735	47621	n.a.	n.a.
Total liabilities	40809	49450	55429	58677	65721	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	-18.1	-18.1
Current account balance (% of GDP)	-2.6	-7.1	-11.8	-0.2	-11.0	-11.7	-11.6
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	46	45
Foreign debt (% of XGSIT)	73	62	58	67	68	63	62
International investment position (% of GDP)	-68.8	-68.8	-68.5	-66.2	-67.3	n.a.	n.a.
Debt service ratio (% of XGSIT)	13	5	5	5	6	6	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	241	246
Liquidity ratio	189	197	195	229	198	192	195

Source: EIU

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