BBVA | RESEARCH

Economic Outlook

Panama

First Half 2013
Economic Analysis

- **Global growth continues its steady recovery,** but more uneven prospects for the main economies are limiting its improvement in 2013 and 2014.
- **Panama's GDP will grow by 8.1% in 2013 and 7.6% in 2014.** Investment will be the main driver of the economy over the next two years. In addition, the unemployment rate at all-time lows will boost growth in private consumption.
- **Higher public expenditure will maintain the deficit very close to the maximum permitted limit under the Fiscal Responsibility Law.** Priority should be put on capital expenditure rather than current expenditure to prevent procyclical pressure on domestic demand.
- **Panama has a high structural inflation rate due to its dynamic economy and low unemployment. We estimate that in 2013 and 2014 inflation will close at above 4% YoY** and will remain at a level of around 3.5% YoY in the medium term.

Index

Closing date: May 22, 2013

1. Summary

Global growth continues its steady recovery, but more uneven prospects for the main economies are limiting its improvement in 2013 and 2014.

In the euro zone the recovery has been delayed until 2014, despite the role of the ECB as a firewall for financial tensions, aided by the boost provided to banking union. The ECB has been surprisingly effective as a guarantor of the euro against shocks such as the disordered bailout of Cyprus, the political situation in Italy and the ruling by the Portuguese Constitutional Court.

In Panama, leading indicators at the start of 2013 suggest a very gradual slowdown in the economy, although growth rates will remain high. This process of economic slowdown will be positive in helping to adjust expansion to levels closer to the country's potential GDP.

According to our forecasts, **Panama's GDP will grow at 8.1% in 2013 and 7.6% in 2014.** Playing a key role in this expansion will be investment, which will grow at an annual average of 11.4% over the two years, and public consumption. In addition, the unemployment rate at all-time lows boosts growth in private consumption, although at slower rates than the GDP. Growth in export services will gather pace in the second half of the year. **New sources of expansion should be found to replace public expenditure and guarantee a long-term growth.**

Adjustment in the current-account deficit will continue in 2013 and 2014, supported by a slowdown in domestic demand. **The current-account deficit for the two years will be 8.8% and 7.7% of GDP, respectively.**

The fiscal deficit will come in at 2.8% of GDP in 2013 and 2.7% of GDP in 2014. However, the recent government decisions increasing the upper limit of the Fiscal Responsibility Law for 2013 introduce an upward bias to the figures. In addition, some state-owned companies that are highly committed to the public expenditure plan on large projects are not included in the accounting of the deficit, and this could be underestimating short and medium-term fiscal pressures.

Panama has a high structural inflation rate due to its dynamic economy and record low unemployment rates. **We estimate that inflation will end 2013 and 2014 at above 4% YoY and will remain at a level close to 3.5% YoY in the medium term.** In the medium term, the main risk will continue to be wage pressures arising from a tight labor market.

The external risks faced by Panama's economy come from a reduction in global trade and lower capital flows to emerging countries. A deterioration in the volume of global trade that reduced demand for services derived from the Canal could limit the benefits from its expansion. At the same time, a scenario of a squeeze on external finance would lead to a new adjustment of domestic demand and limit economic growth in the medium term.

2. A more varied global scenario

Global growth continues its steady recovery, but the very different prospects for the leading economies are limiting the improvement in GDP in 2013 and 2014. Quarterly global GDP growth, estimated at 0.7% by BBVA Research at the start of 2013, will have been slightly over 0.6% in the last quarter of 2012, but available indicators point to growing disparity in economic activity, particularly between the most developed economies, with the euro zone once more lagging behind the U.S. and even Japan. In turn, emerging economies will continue to underpin global growth. Overall, the rate of **global growth in 2013 is expected to be 3.3%, only 0.1 point above the figure estimated for 2012 (Chart 1).** In 2014, the rate will be close to 4%, although the risks continue to be downside.

In the euro zone the recovery has been delayed until 2014, despite the role of the ECB as a firewall for financial tensions, aided by the boost provided to banking union. The ECB has been surprisingly effective as a guarantor of the euro against shocks such as the disordered bailout of Cyprus, the political situation in Italy and the ruling by the Portuguese Constitutional Court. As a result, the markets and financial tensions have only reacted to these events to a limited extent (Chart 2). On the negative side, economic indicators show **a general cyclical weakness beyond the European periphery, which justifies the ECB's recent interest-rate cut.**

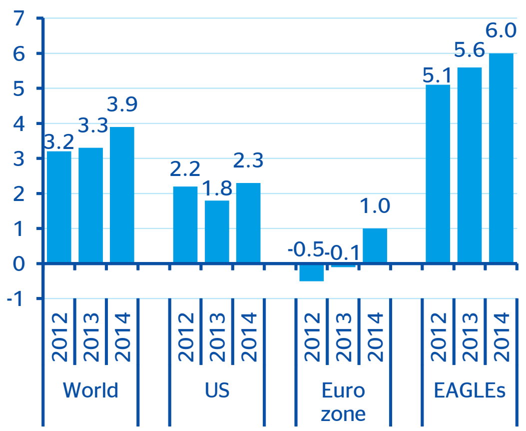
This is a positive measure, although it is unlikely in **itself to reduce the financial fragmentation** that is already having less impact on sovereign issuers and even large corporations, but is continuing to affect households and companies due to the **uneven operation of the banking channel.** The conditions of credit supply in the area as a whole continue to tighten while demand for credit is falling in peripheral countries. Something more is needed than the extension of the liquidity facility for banks at least until mid-2014; measures currently being studied have to be implemented to boost finance for business, with the participation of institutions such as the European Investment Bank.

In this context, our scenario includes a downward revision of euro zone growth. We estimate GDP will fall by 0.1% in 2013 and rise by 1% in 2014, 0.4 and 0.3 points, respectively, below the forecasts in our January publication. In any event, the risks continue to have a downward bias. A key point is that Germany must not remain the only source of growth in the area thanks to its easy access to finance, high level of competitiveness and greater exposure to the best performing sources of global demand.

An additional consequence of the weakness of the European cycle is the growing debate on the appropriate level of fiscal consolidation. It has achieve a credible timetable for cutting the deficit without leading to such a short-term deterioration in growth that it makes the adjustment effort a waste of time. The European Commission's support for the postponement of the public deficit targets in some European countries is in line with the idea of stressing the quality and composition of the fiscal adjustment and emphasizing structural reforms above short-term objectives. **What is Europe missing?** More determined progress towards banking union, shifting the debate on deficit targets to structural measures, and a firmer commitment to the reforms in the peripheral countries.

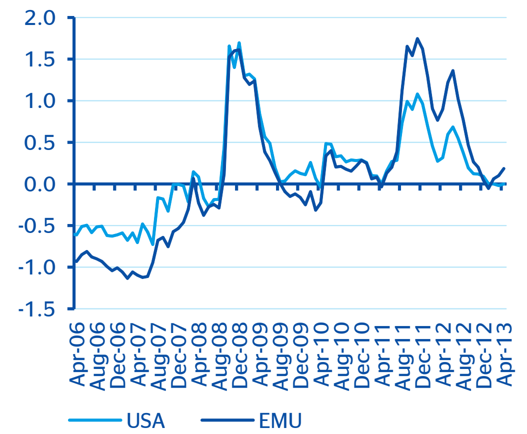
In the U.S., the strength of private demand is sustaining growth prospects despite the brake of fiscal adjustment. Uncertainty regarding fiscal policy in the short term has receded with respect to scenarios that included the closure of government offices (although credible long-term fiscal consolidation measures have still not been taken). The elimination of some tax breaks and the entry into force of expenditure cuts have not triggered alarms in the financial markets (Chart 2), nor do they appear finally to have provided a substantial brake on private expenditure, thanks to **monetary expansion that is maintaining very favorable financing conditions** and is contributing to the improvement of income and wealth. Thus it is reasonable to maintain growth prospects for 2013 at 1.8%, despite the downward surprise of public demand in the GDP figures for the last two quarters.

Chart 1
GDP growth



The EAGLEs are the emerging countries that will contribute most to growth over the next 10 years. They are: China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research

Chart 2
BBVA Financial Stress Indicator



Source: BBVA Research

The Chinese economy lost steam in the first quarter of 2013, with a negative surprise of weak investment, despite the greater strength of foreign demand and growth remaining in line with the government's target of 7.5% for 2013. The measures implemented to limit domestic financial fragility appear to have contributed to the slowdown. However, the change in the growth model towards a greater weight of consumption continues. With inflation also lower than expected, there is less pressure on tightening monetary conditions, so authorities have room for maneuver, given their commitment to sustainable growth for achieving the announced growth target. That is why our growth forecast for China remains unaltered at 8% for 2013 and 2014.

The path of sustained monetary expansion, which the Central Bank of Japan has now joined, involves challenging problems. The idea that investors looking for returns will move to more risky assets may lead to valuations in some markets that are a long way from their long-term fundamentals, which could lead to disordered adjustments when the stimuli are withdrawn. This risk is growing because of the lack of coordination between central banks with quantitative expansion policies, each focusing on its respective domestic anchored inflation targets and sustainable growth. In the case of emerging economies, although for now they are supporting the major capital inflows well, it is essential to remain vigilant regarding the domestic excesses this could generate.

3. Panama: strong economic growth based on increased investment

Panama chalks up three consecutive years of accelerating growth rates

Over the three years from 2010 to 2012, the Panamanian economy grew at an average annual rate of 9.7%, making it the most dynamic country in Latin America. GDP growth was boosted by the construction and mining sectors, where growth rates were close to an average of 20% each year.

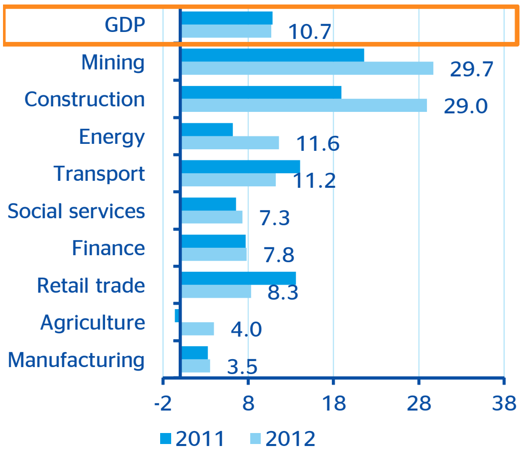
These activities account for 9% of GDP and continued to accelerate in the second half of 2012. They were able to offset some of the downward trends in other sectors such as energy, domestic trade, financial services and transport, which account for around 52% of GDP. As a result, the economy as a whole did not slow down at the close of the previous year, reflecting a greater strength in the face of low global growth and a greater than expected capacity for executing investment expenditure (Chart 3).

Leading indicators at the start of 2013 suggest a very gradual slowdown in the economy, although the growth rates will remain high. The Monthly Index of Economic Activity (IMAE) grew between January and February at an annual 6.5%, below the rate for the fourth quarter of the previous year (9.3%) and for the whole of 2012 (9.5%). At the same time, the sales tax revenues slowed their rate of increase from 15.5% in 2012 to an annual 12.7% at the start of 2013, while growth in cement production fell from 26.2% to 1.1% in the first quarter.

But some indicators continue to show sustained expansion, and at high levels. Among the indicators that picked up their rate of growth in the first quarter are: energy consumption, vehicle sales, total imports in the Colon free trade zone and the total credit of the domestic banking system (Chart 4).

Chart 3

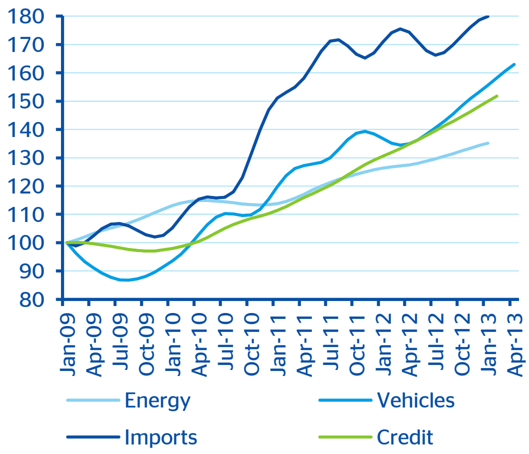
GDP by economic activity, 2011 and 2012 y/y % change



Source: INEC and BBVA Research

Chart 4

Selected leading indicators. Seasonally adjusted index, Jan 09 = 100



Source: INEC, ADAP, Bank Superintendency and BBVA Research

The high rate of investment in Panama for the next two years will sustain a dynamic economy

Available leading indicators following revision show that although Panama's economy is slowing, the pace is less pronounced and more gradual than we had anticipated previously. We have therefore revised upward our growth forecasts for 2013 and 2014, mainly due to the positive component of investment.

Investment was the component that sustained high growth so far and will be the main driver of the economy in the next two years. This will be possible because the country carried out a process of accelerated learning in terms of the project contracting and tendering process. As a result, Panama increased its capacity to manage and execute resources for construction and mining projects, both in the public sector and through private initiative.

We estimate a renewed increase in the weight of investment in the economy in 2013 and 2014. While our calculations put the rate at 29.6% of GDP in 2012, in 2014 the figure will be 31.5% of GDP. This level compares positively with an average rate of investment in Latin America of below 25% of GDP. It is even very close to the maximum rates observed in south-east Asian countries.

Thus Panama is guaranteeing a process of sustained increase in output capacity, while at the same time reducing the probability of an slump in activity over the upcoming years.

According to our forecasts, Panama's GDP will grow at 8.1% in 2013 and 7.6% in 2014 (Chart 5). Playing a key role in this expansion will be investment, which will grow at an annual average of 11.4% over the two years, and public consumption. Fiscal spending normally increases in pre-election periods, in line with the country's economic and political cycle. This will be no exception. We forecast an increase in public consumption of an annual average of 7.2% in 2013 and 2014. Private-sector investment in mining, energy and building will add to the traction of public investment, but these sectors have less weight than those with a major government presence.

The unemployment rate is also at all-time lows and will boost growth in private consumption (see Box), although at slower rates than the GDP (annual average of 7.7% in 2013 and 2014). Finally, services for exports will pick up pace in the second half of the year, when world trade will benefit from the consolidation of the global recovery (Chart 6).

New sources of expansion should be found to replace public expenditure and guarantee a long-term growth

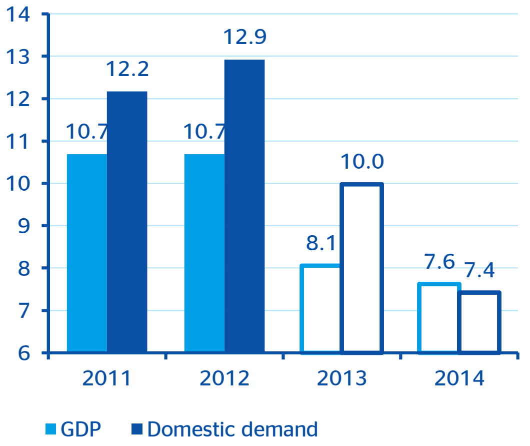
The Panama Canal expansion project will be complete by 2015. The most important mass transport and urban road systems that included a high level of public investment should also be delivered by this date. In addition, the new government will have some budget restrictions for executing new major infrastructure and transport projects, given the fiscal targets to be met and the future amounts that will be committed by the current projects.

Thus the economy will have to find new sources of finance for investment and new projects in which the private sector can participate if it is to maintain a high rate of growth in the medium term. The mining and energy sector is a candidate for exercising this leadership. For this to be the case, mechanisms must be established for participation by the private sector and major internal and external investment flows have to be attracted. The final objective is to gradually reduce the country's dependence on hydrocarbons and the costs derived from faults in the current electricity system.

However, the share of the mining and energy sectors in overall GDP is not high, and they will not be able to offset entirely the lower public expenditure on investment. In other words, there is bound to be a slowdown in economic activity in the medium term. This should help control excess spending and limit the current demand pressures on domestic prices.

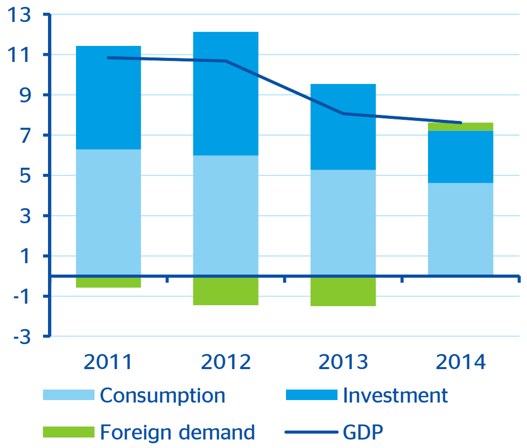
At the same time, this process of moderating activity will be favorable in terms of adjusting expansion to levels closer to the country's potential GDP. According to our estimates, Panama's output capacity will allow a maximum annual growth of 7% without generating domestic demand pressures on inflation and the current account. Expansion at above this level would limit the adjustment of the external deficit and raise inflation rates above 4%.

Chart 5
GDP growth and domestic demand y/y % change



*Domestic demand estimated for 2012 and projected for 2013 and 2014.
Source: INEC and BBVA Research

Chart 6
Contribution by demand components to forecast GDP. As contribution to year-on-year change, %



*Contributions estimated for 2012 and forecast for 2013 and 2014.
Source: INEC and BBVA Research

Gradual correction of the current-account deficit toward more sustainable levels

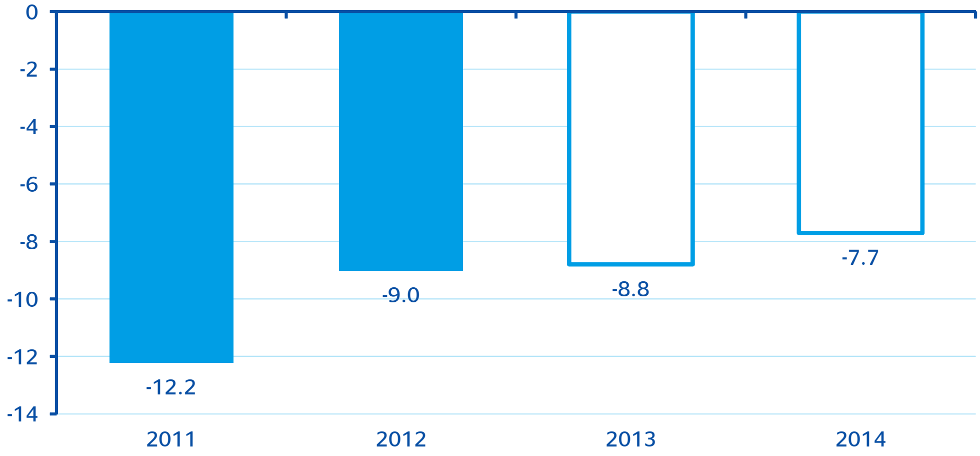
In 2012 the current-account deficit closed at 9% of GDP, under the figure for 2011, when it was 12.2% of GDP. The result shows a healthy adjustment of the external imbalance, as it was achieved in a context of high GDP growth, similar to a year previously. The factors allowing the adjustment came from the economy's greater capacity to generate foreign currency, rather than a weakening of domestic demand.

First, maximum levels of economic activity were achieved in the Colon Free Trade zone, with a significant increase in goods re-export. Second, increased income was generated from transport services, both maritime in the canal and the national airline operations center. As a result, fuel sales in the port increased notably. Third, although the remittance of dividends abroad increased due to the strength of foreign investment, the increase was limited by the significant level of domestic finance of the main projects in the country. In fact, the sectors with the biggest expansion, such as construction and mining, did not have a high level of imported components or foreign investment that could put excessive upward pressure on the current-account deficit.

Adjustment in the current-account deficit will continue in 2013 and 2014, supported by a slowdown in domestic demand. According to our forecasts, the current-account deficit for the two years will be 8.8% and 7.7% of GDP, respectively (Chart 7). Once the major projects in the country are completed, after 2015, the current account will begin to converge to more sustainable levels. This is not only because of less need for external finance, but also due to the increase in the country's logistical capacity and the generation of revenue from canal and air transport.

The current-account deficit will continue to be financed by a combination of foreign direct investment, at a rate of over 70%, credit and portfolio funds. However, the latter two options could have a greater relevance this year and next, to the extent that there is high level of global liquidity as a result of the monetary decisions taken by developed countries. After this, Panama will have to ensure a sustained source of long-term funds for its investment projects, above all if it aims to maintain the improvements in the country's foreign debt, which fell from 60% of GDP in 2000 to levels of slightly above 40% of GDP now.

Chart 7
Current-account deficit. Percentage of GDP



Source: INEC and BBVA Research

Box 1. Challenges in the labor market to maintain productivity and take advantage of the demographic dividend

The demographic dividend in Panama

Panama's population is growing: the annual average rate of growth was 1.9% between 2000 and 2010, and the population increased from 3.0 to 3.7 million people. The proportion of people of a productive age is growing steadily compared with the proportion of people of a potentially inactive age. This is called the demographic dividend.

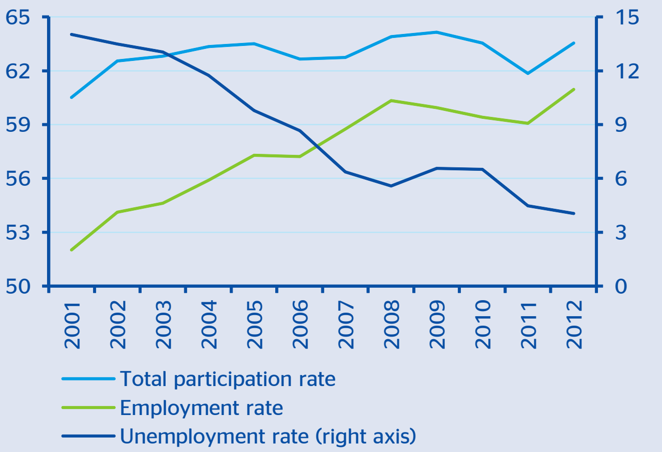
According to CEPAL figures, the demographic dividend will remain in place until 2025. Thus, while in 2000 there were 1.7 people aged between 15 and 64 for each person in the age range between 0 and 14 and over 65, in 2025 this ratio will be 1.9. In other words, the dependency ratio in Panama will continue to fall for another 13 years.

At the same time, an expanding labor supply resulting from the demographic dividend is a growth opportunity for the country. However, the materialization of the benefits of the dividend will depend on the way that the labor force is able to enter the labor market. If the growth of the population of a working age is not absorbed, or if jobs with a low level of productivity are created, only part of the demographic dividend will be used. In other words, not only low levels of unemployment are required, but also an efficient allocation of the labor factor.

Between 2001 and 2012 Panama had historically low rates of unemployment with significant improvements in labor productivity.

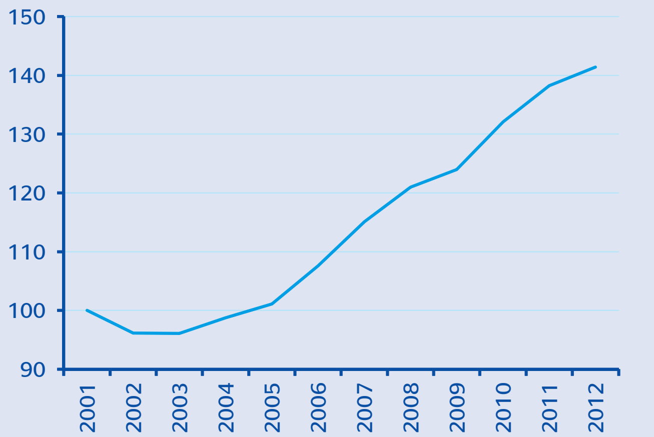
Between 2001 and 2012 the Panamanian economy generated jobs at an average annual rate of 4.1%, thus managing to absorb not only the growth of the population of an age to work (2.6%) and economically active (3.0%), but also reducing the unemployment rate (Chart 8). The employment rate, which is a proxy for demand for labor, is currently at a level that is very close to the overall participation rate, which is a proxy for labor supply. As a result, the economy is enjoying a historically low unemployment rate (4% in 2012), even compared with international levels.

Chart 8
Labor market (2001-2012). As a percentage



Source: INEC and BBVA Research

Chart 9
Labor productivity (GDP/employed) 2001=100



Source: INEC and BBVA Research

Improvements in productivity: The challenge is to maintain them by improving education

As well as strong job creation, labor productivity, measured as GDP per worker, has grown significantly in recent years (Chart 9).The annual average rate of growth was 5% between 2004 and 2012. The sectors that drove this increase most were construction, with an average annual growth of 8%, transport and communication services (7.5%) and hotels and restaurants (6.1%). The productivity of the financial intermediation sector grew in line with the economy's average productivity, at an annual 5%.

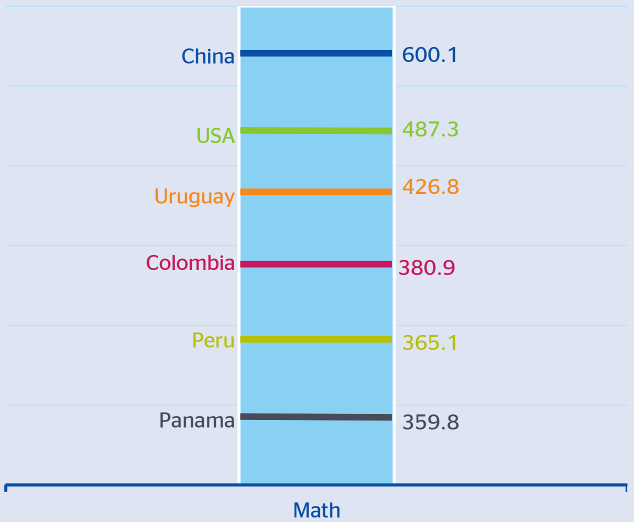
If we examine a longer period, from 2001, productivity fell only at the start of the decade, between 2001 and 2003, probably due to the impact of the slowdown in the United States. In any event, in the complete period 2001-2012, productivity grew by an annual average of 3.2%.

Future productivity gains will depend on improvements in the quality of education and the capacity of local human capital to adapt to the requirements of the productive economy. According to the World Bank, using data from the Household Survey, there were around 100,000 migrant workers in Panama in 2008, amounting to 7% of the total. The same source reveals that the migrants had on average high educational levels, in fact higher than those of the locals. If those cases where they had the same educational level, the quality of education was better in the case of the migrants. In fact, judging by the results of the PISA 2009 tests, Panama has a lower quality education than the countries of origin of its immigrant workers (Chart 10).

This suggests that international immigrants have partly contributed to the increase in labor productivity in Panama. However, it is possible that additional progress in productivity from this source will be restricted by the Panamanian legislation on migration, which sets limits to the number of foreign workers in companies.

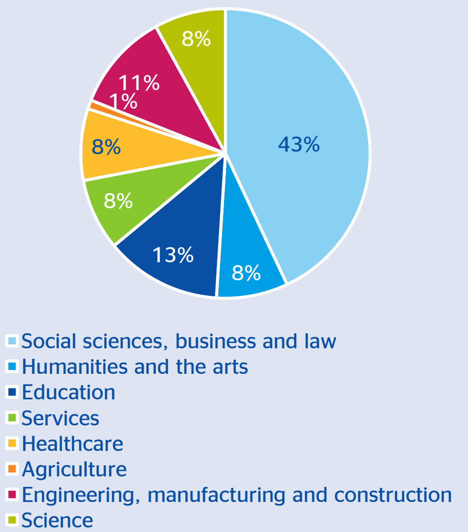
Another significant aspect in terms of productivity is the appropriateness of the workers for their jobs. Judging by the country's structure of production and the main subjects studied by the future professionals, there appears to be a mismatch between labor supply and demand. In fact, most students enroll in the social sciences and humanities (Chart 11). Only 8% study courses related to services (personal, transport, the environment and security), even though the transport sector alone accounts for 25% of Panama's GDP.

Chart 10
Results of the PISA 2009 tests. Average scores



* The PISA test is carried out by the OECD for more than 60 countries. It assesses the competence of students of 15 years of age in analysis, reasoning and communication.
Source: OECD and BBVA Research

Chart 11
Enrolment in tertiary education. Percentage of total



Source: World Bank, based on UNESCO, and BBVA Research

Conclusions and challenges

The labor data in Panama appear conclusive in the sense that economic growth has allowed the creation of sufficient jobs to cover the increase in labor supply produced by demographic change, increases in labor participation and falling unemployment. In addition, the jobs created have been of good quality, judging by the significant increases in productivity. However, sustaining these levels of productivity will depend on improvements in the quality of education and the capacity of human capital to adapt to the requirements of the labor market. This is the only way to guarantee that expanding sectors can receive a sufficiently qualified labor force to guarantee sustained high rates of growth in the medium term.

4. Panama has a high structural inflation rate due to its dynamic economy and unemployment rates at all-time lows

Inflationary pressure in mid-2012, caused by high international cereal prices, eased at the end of 2012 and the start of 2013. As a result, inflation fell from 6.0% in July to 4.6% in December. The rate is now 4.1%, after a significant downward correction in March and April. This trend could be repeated until the end of the third quarter, because of the high comparison base in the same period of 2012, so that prices will increase by under 4%.

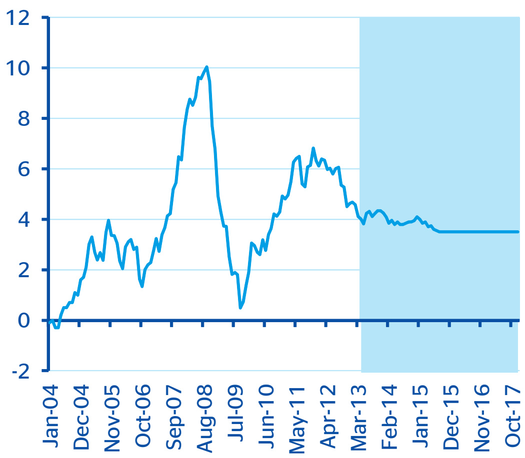
However, according to our forecasts, at the end of the year inflation will end above the current level, closer to 4.5%. The reasons for this upturn are both statistical and structural. The statistical reason is that at the end of 2012 the comparison base was lower due to the general fall in cereal prices and fuels at a global level. Structurally, economic growth will remain high, with a positive output gap and a labor market with all-time low unemployment (see Box).

High growth and labor pressure will be the determinants for maintaining medium-term inflation above the average observed between 2004-2007, when there was major economic growth (annual 8.8%) combined with low inflation (annual 2.5%). The structural change in inflation began in 2008, due to upward pressure from oil prices, and has remained in place until now because the unemployment rate reached record lows and there was higher than potential growth for several years in a row. That is why we estimate that inflation will end 2014 at above an annual 4% and will remain at a level of close to an annual 3.5% in the medium term (Chart 12).

This new inflation trend has led to a real appreciation in the currency since 2006 (Chart 13). The real bilateral exchange rate of the balboa against the dollar appreciated 17% from May 2006 to April 2013, at an annual rate of 2.7%. The appreciation was the result of the difference in inflation between Panama and the United States. While Panama had an annual average inflation rate of 4.9%, in the United States it was 2.2%.

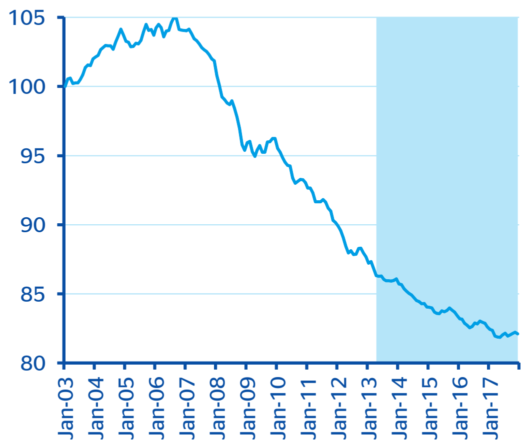
Over the next five years, the trend in the currency will continue to be similar, but the pace of appreciation will moderate, as the difference in inflation trends between Panama and the United States will narrow (3.6% and 2.5% respectively). As a result, the balboa will appreciate in real terms by an annual 0.7%. So far, available data do not reveal any effect on the country's productivity of the balboa's appreciation in real terms (see Box).

Chart 12
Consumer inflation. Annual change, %



Source: INEC and BBVA Research

Chart 13
Bilateral real exchange rate (vs. USD) Jan03=100



* The real exchange rate is calculated as the quotient of the inflation rates in the United States and Panama.
Source: BBVA Research

5. The fiscal deficit will remain very close to the upper limit under the Fiscal Responsibility Law

In 2012 the fiscal deficit of the non-financial public sector (NFPS) was 2.1% of GDP, below the maximum permitted level of 2.9% of GDP for the year under the Fiscal Responsibility Law. However, these figures do not take into account the balance sheets of some companies that are not counted as in the NFPS, such as Empresa Nacional de Autopistas, Tocumen, S.A. and Empresa de Transmisión Eléctrica.

The NFPS data showed a better distribution of central government expenditure, which is now more focused on investment and with slower growth of current expenditure. According to official figures, capital expenditure increased from 31.9% of the total in 2011 to 34.9% in 2012. This is the result of growth of 16.2% in the total expenditure and 28.9% in capital expenditure. In addition, most of the capital efforts, at 76.5%, were financed by current savings, partly thanks to the lower rates of interest for government finance due to the restructuring of the debt portfolio.

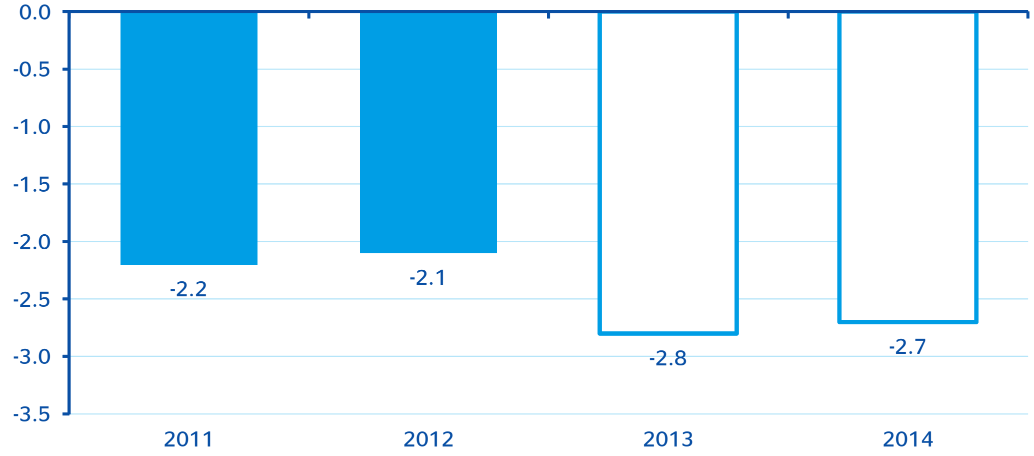
Despite this good results in 2012, we believe that the fiscal deficit will not continue to fall in 2013 and 2014. Quite the reverse, a high level of budgetary execution is expected, despite lower economic growth and possibly lower growth in public revenues. Expenditure will be on both investment and operations. Capital expenditure, which includes turnkey projects, will continue growing at double-digit rates. In fact, the central government has awarded more than USD 2,800 million in turnkey projects lasting through 2018, amounting to 17% of the 2013 budget. Of this total, last year USD 170 million were paid, and it USD 429 million is expected to be paid in 2013, USD 564 million in 2014, USD 532 million in 2015 and USD 238 million in 2016.

The volume of turnkey projects could increase. Under current law, which establishes that the government may not commit more than 20% of the investment budget for each year to turnkey projects, in 2013 projects of around USD 1,500 million could be initiated out of a total investment budget of USD 7,900 million. This budget could be allocated to works outside Panama City, among them the Inter-American highway between Santiago de Veraguas and David, Chiriquí.

In addition to this, the National Assembly has approved a new upward revision of the upper limit of the Fiscal Responsibility Law from 2.8% to 3.1% of GDP for 2013, with the aim of dealing with the damage caused by severe winter conditions in the country. Expenditure on operations will be boosted by the increase of 12.7% in the value of the annual budget for 2013, which was calculated based on a 12% growth of nominal GDP, similar to our forecast. For 2014, the limit under the law has remained unaltered at 2.7% of GDP.

Our forecasts put the fiscal deficit at 2.8% of GDP in 2013 and 2.7% in 2014 (Chart 14). However, the recent government decisions increasing the upper limit of the Fiscal Responsibility Law for 2013 introduce an upward bias to the forecast deficit. Even so, this level of deficit would not be counterproductive for the economy provided that the 2012 trend was maintained: in other words, greater growth on capital expenditure and current expenditure kept in check. This combination will allow an increase in the productive capacity of the country without generating additional demand pressures from fiscal policy, which can trigger additional inflation.

Chart 14
NFPS fiscal deficit. Percentage of GDP



Source: Ministry of Economy and Finance and BBVA Research

6. Reduction of global trade and lower capital flows to emerging countries are the external risks faced by the economy of Panama

Panama will have to tackle two sets of risk. One set is the result of domestic factors and the other arises from global tensions that could occur with a low level of probability. First, Panama has a very tight labor market, with significant wage pressures and high labor demand (see Box). This could affect inflation in the medium term and involve a risk of the economy overheating. The work of limiting this risk should start with the government, which should limit the procyclical nature of its current expenditure and start a credible fiscal adjustment, without adding to the flexibility of its fiscal rules, as happened recently. At the same time, only when Panama can ensure it has a sound base of domestic and external private investment, will it be able to guarantee high rates of growth in the medium term (see Section 3). Otherwise, once public expenditure is adjusted, as it must be, growth could return to lower than potential levels.

Second, the expansion to the Panama Canal was based on the premise of increased global trade and a sustained growth in revenues from services in the Canal Tree Trade Zone. In other words, it is expected that part of the investment will be recovered by the strength of the economy, increased trading capacity and the collection of higher tax revenues and customs tariffs.

Deterioration in the global volume of trade that reduced demand for services derived from the Canal could limit the benefits from expansion. In this case, the government could opt for allowing the deficit to increase and finance the work on the Canal through greater short-term indebtedness. This decision would maintain growth in the country at high levels, although lower than those forecast in a scenario of normal conditions, but it would demand greater fiscal adjustment commitments in the future.

At the same time the country has to face an increase in its current-account deficit due to lower revenues from exports, re-exports and the provision of trade services. This could speed up the process of running down international reserves that has taken place in Panama since 2010, according to available figures from the National Bank of Panama, and require an additional adjustment of domestic demand to return to a sustainable current-account deficit.

A more demanding requirement for closing the current-account deficit would arise in a scenario of major global turbulence that implies a return of international capital to developed countries, which investors consider lower risk. In this case, Panama would have limited access to external sources of finance, both in terms of direct investment and in trade credits, by which it could maintain a balance of payments in equilibrium. This channel of transmission of global financial tensions would therefore lead to a further adjustment in domestic demand and limit the medium-term growth of the Panamanian economy.

7. Tables

Table 1

Macroeconomic forecast annual

	2011	2012	2013	2014
GDP (y/y %)	10.8	10.7	8.1	7.6
Private Consumption (y/y %)	9.7	9.2	8.0	7.3
Public Consumption (y/y %)	7.3	8.0	8.5	5.8
Fixed Investment (y/y %)	19.9	23.0	14.5	8.3
Inflation (y/y % EoP)	6.3	4.6	4.6	4.1
Exchange Rate (vs. USD, EoP)	1.0	1.0	1.0	1.0
Interest Rate (%, EoP)	1.4	1.7	1.8	2.6
Fiscal Balance (% GDP)	-2.2	-2.1	-2.8	-2.7
Current Account (% GDP)	-12.2	-9.0	-8.8	-7.7

Source: INEC, Superbancos, Ministry of Economy and Finance and BBVA Research

Table 2

Macroeconomic Forecast Quarterly

	Inflation (y/y %, EoP)	Reference rate (APR %, EoP)
1Q11	5.5	2.11
2Q11	6.5	2.01
3Q11	6.1	1.42
4Q11	6.3	1.40
1Q12	6.3	1.50
2Q12	5.8	1.44
3Q12	5.4	1.57
4Q12	4.6	1.48
1Q13	4.5	1.54
2Q13	4.6	1.60
3Q13	4.6	1.66
4Q13	4.6	1.79
1Q14	4.0	2.05
2Q14	3.8	2.25
3Q14	3.9	2.36
4Q14	4.1	2.58

Source: INEC, Superbancos, Ministry of Economy and Finance and BBVA Research

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.

This report has been produced by the Colombia Unit:

Chief Econmist for Colombia
Juana Téllez
juana.tellez@bbva.com

Mauricio Hernández
mauricio.hernandez@bbva.com

María Claudia Llanes
maria.llanes@bbva.com

Julio César Suárez
julio.suarezl@bbva.com

Interns:

María Camila Franco
mariacamila.franco@bbva.com

Lizeth Fernanda Fúquene
lizethfernanda.fuquene@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Global Areas:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Contact details:

BBVA Research Colombia
Carrera 9 No 72-21 Piso 10
Bogotá, Colombia
Tel: 3471600 ext 11448
E-mail: bbvaresearch_colombia@bbva.com
www.bbvaresearch.com