Panama

Economic Outlook

Third Quarter 2010

Economic Analysis

- The figures for Panama's economic growth have been revised upwards from 4.1% to 6.0% in 2010 and from 5.2% to 6.3% for 2011. This is due to stronger than expected private demand, the positive impact of the extension of the Panama Canal, and expectations of a higher rate of increase in public spending on infrastructure starting in the second half of this year.
- Inflation is expected to hike to 4.0% at the end of 2010, in line with stronger domestic demand, increased sales taxes, and upward pressure on the prices of foods and fuels resulting from the recovery in global activity.
- The growth in the rate of execution of public works will lead to an increase in the deficit of the non-financial public sector to close to 1% of GDP at year-end 2010, though this is still within the limits laid down by the Law on Fiscal and Social Responsibility.
- The strong upturn in domestic demand will lead to an increase in the current-account deficit, estimated at to 7.0% of GDP in 2010, which will be financed by flows of foreign direct investment.
- In a scenario of economic weakness in developed countries, economic growth in Panama could moderate towards the end of 2010 and in 2011, particularly as a result of the lower level of world trade. The strength of domestic demand, bolstered by the continuity of the investment plan in infrastructure, would help prevent a major slowdown in the economy, as long as capital flows finance a larger current account deficit without major problems.

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Publication date: October 13th 2010

1. Reassessment of global economic prospects

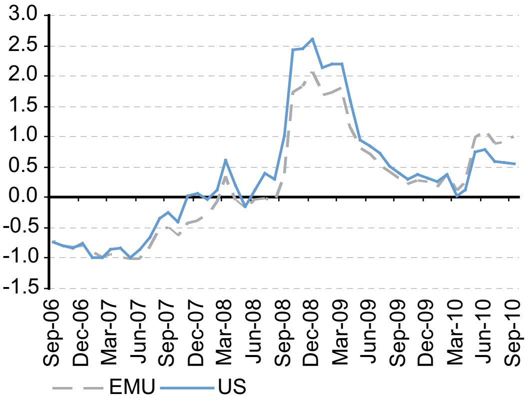
Financial stress in Europe is still a source of concern, though systemic risk is lower than before the summer. Fiscal consolidation remains crucial to sustain confidence, and will not have a large negative impact on growth beyond the short-term

Financial risks derived from the problems of sovereign debt formed a vicious circle that ended up increasing market risk and absorbing liquidity, particularly in Europe. However, the strong increase in financial tensions in Europe in the second quarter began to ease in July (see Chart 1). The publication of the results of the stress tests in Europe had the positive effect of lowering tension, although there has been a clear difference between countries. This difference is key to understanding Ireland's relative deterioration and the resilience of the Spanish economy. In the case of Spain, doubts about the financial system have eased, as the implementation of the stress tests is rigorous and their results appear credible. Notwithstanding this, financial market stress in Europe is still the main source of risk for the region, especially given the link between sovereign concerns and risks to the financial sector, given their national and cross-border exposure.

The world economy will slow down going forward, but in a mild and differentiated way. This situation will be convenient for China and the rest of the emerging countries in Asia, as it will lead to convergence in growth at more sustainable rates. However, private demand in the U.S. will continue to be fragile without official support, while in Europe confidence will be negatively affected by the consequences of the financial crisis. World trade will maintain a strong growth rate, led by strong demand in emerging economies

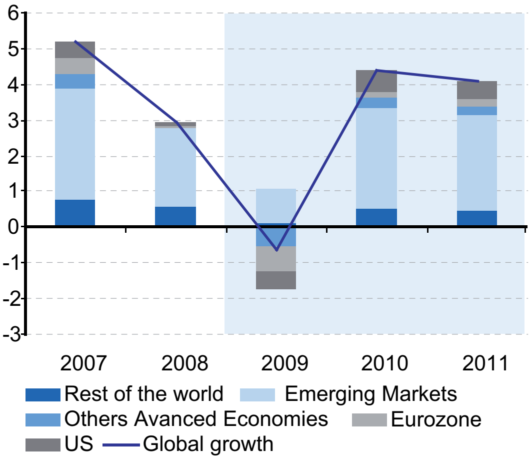
Global economic growth will slow over the coming months (see Chart 2). The serious financial tensions in Europe will affect confidence and reduce growth in the second half of 2010 and the start of 2011. In addition, foreign demand will not be as solid as in the first half of the year, although it will provide some support for economic activity. In China, the slowdown in GDP growth in the second quarter and some indicators suggesting reduced activity are signs that adjustment measures by the authorities are effectively steering the economy towards more sustainable rates of growth. The economy will also slow down in Latin America in 2011, although growth rates will continue high. As a result, the divergences between advanced and emerging economies will continue to grow, as will those within each of these groups. In an environment of low growth in developed economies, world trade will continue to be boosted by the strength of emerging economies and will remain on path towards a steady recovery, with rates of growth in traded volumes of 9.4% in 2010 and 8.7% in 2011 and 2012.

Chart 1
Financial Stress Index*



* Compound financial stress index for three credit markets (sovereign, corporate and financial), restrictions on liquidity and volatility of interest rates, exchange rates, and equity markets.
Source: BBVA Research

Chart 2
Global GDP growth and contributions



Source: BBVA Research

Monetary policy in advanced economies will be lax for a long time, adding pressure to exchange rates worldwide. Strong capital inflows and dynamic domestic demands pose increasing policy dilemmas for emerging economies

Financial tensions in Europe and uncertainty with respect to the rate of recovery in the U.S. has led central banks in both regions to delay their first increases in interest rates, as well as to maintain reference rates very low for a prolonged period. Inflationary pressures in both areas will continue to be under control. This will allow expansive monetary policies to be maintained. The weakness of recent U.S. data increases the possibility of new rounds of quantitative easing, which has put downward pressure on the dollar. The additional stimuli implemented by the Fed contrast with a less flexible approach by the ECB, with the result that the dollar could continue to deteriorate over coming months. In any event, in the medium term the withdrawal of quantitative stimuli, an improved outlook for the U.S. economy and a possible reaction by the ECB to the strength of the euro, sustain a scenario in which there is room for a reversal of the recent dollar/euro trend. At the same time, we expect appreciating pressures on emerging economies to continue due to increased global liquidity, stronger macroeconomic fundamentals and positive return differentials favoring renewed capital inflows. Both Asia and Latin America confront increasing monetary and exchange-rate policy dilemmas, between cooling strong domestic demand and preventing strong capital inflows and preserving competitiveness in foreign markets. Some countries have started introducing administrative measures to discourage strong capital inflows and some others have slowed their rate of monetary tightening.

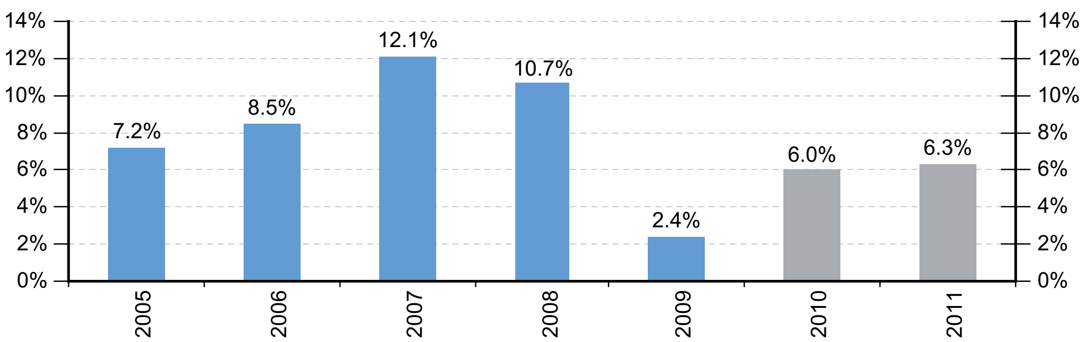
2. The Panamanian economy will maintain high growth based on strong private demand and increased investment

The performance of the Panamanian economy reveals a faster than expected recovery, based on the strength of private demand and expansion in public investment, particularly on works to extend the Panama Canal. This suggests that the economy should be capable of maintaining a robust growth, even in the possible scenario of a weak global economic cycle with continued financial tensions in Europe and a significant moderation in U.S. growth.

Recent GDP growth figures (5.8% in the first quarter and 6.3% in the second) confirm the strength of consumption and the boost from public investment. At the same time, these factors reflect a strong service economy, particularly in transport, telecommunications and retail trade, boosted by the growth of consumer confidence and the rise in tourism. The financial sector has uncoupled temporarily from this trend reflecting the weak performance of international financial markets.

Chart 3

GDP annual growth (year-on-year change)

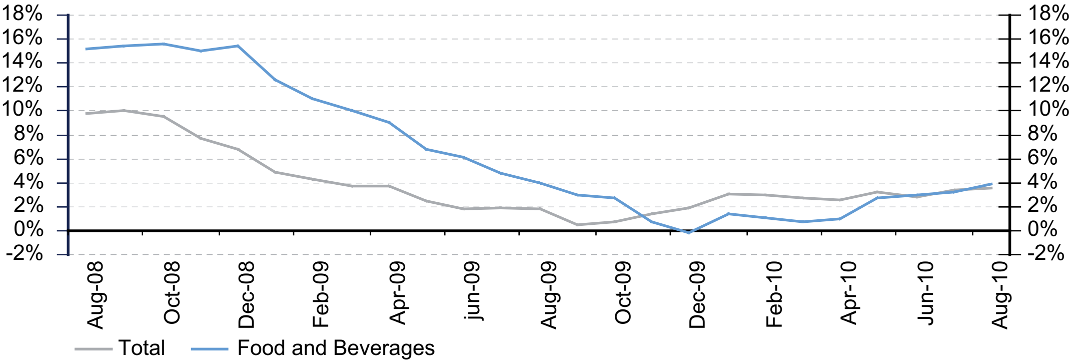


Source: Contraloría General de la República and BBVA Research

In this context, pressure on inflation has increased slightly and biased our initial forecast of 3.0% for the end of year upwards. This bias takes into account sustained increases in international fuel and food prices, the impact of the adjustments in sales taxes[1] and greater pressure from a lower negative output gap, given the stronger aggregate demand. As a result, inflation is expected to close the year at 4.0% and remain at around 3.3% in 2011. This will lead to an appreciation in the real exchange rate in Panama, given the expectations of moderate inflation in the United States (1.4% in 2010 and 1.6% in 2011).

Chart 4

Monthly inflation (year-on-year change %)



Source: Contraloría General de la República and BBVA Research

Based on the observed behavior of the GDP in the first half of the year, and taking into account the strong recent indicators and slight slowdown in global growth, Panama is expected to grow at 6.0% in 2010 and 6.3% in 2011. Growth will be determined by the rise in domestic demand, which will be moderated by a negative contribution of foreign demand. Despite this positive outlook on growth, it is unlikely that the economy will return quickly to the high employment levels seen in 2008, as a significant proportion of the activities driving growth are capital-incentive and there are major rigidities in the labor market. As a result, the unemployment rate is expected to fall marginally, from 6.6% at the end of 2009 to 6.4% in 2010 and 6.2% in 2011.

The expansion of the Panama Canal is an important source of growth and is progressing according to plans. In addition, the government's Strategic Plan includes an ambitious infrastructure program, with investment of around 13.6 billion balboas over the next five years. The plan includes the construction of major roads[2] and airports, as well as the development of a system of mass transport in Panama City. These works will help boost competitiveness in the economy and close the infrastructure gap that the country suffers at present. In the first six months of the year the infrastructure program progressed slowly due to problems in the coordination and execution of the works. However, the recent swifter approval of contracts suggests that spending will speed up and be concentrated in the second part of the year, thus leading to a greater boost for growth from public investment.

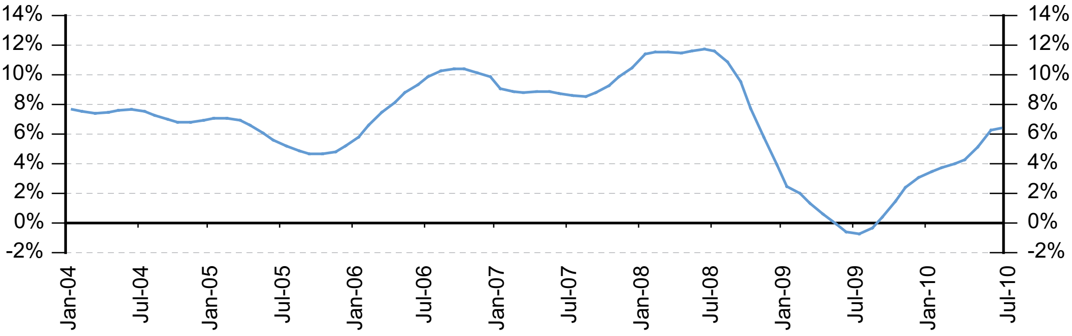
Leading indicators show that the economy has maintained strong growth in the third quarter. In particular, the monthly indicator of output (IMAE) registered growth of 6.2% in July, thus maintaining the expansion rate of previous months (see Chart 5). Credit has started to pick up, with a growth rate of 11.2% y/y in August, led by dynamic mortgage lending, up 13.1% y/y, and a reactivation in consumer and corporate credit. These figures reflect greater optimism with respect to economic performance and increased activity in the Colon Free Zone.

1: The tax reform of 2010 included an increase from 5% to 7% in the tax on the sale of goods and services, in force from July this year.

2: Among the road construction projects are the extension of the Panama-Colón highway, reconstructing the road infrastructure in the Colón Free Trade Zone and the extension of the Northern Corridor to Tocumen Airport.

Chart 5

IMAE Year-on-year change (Cycle trend)



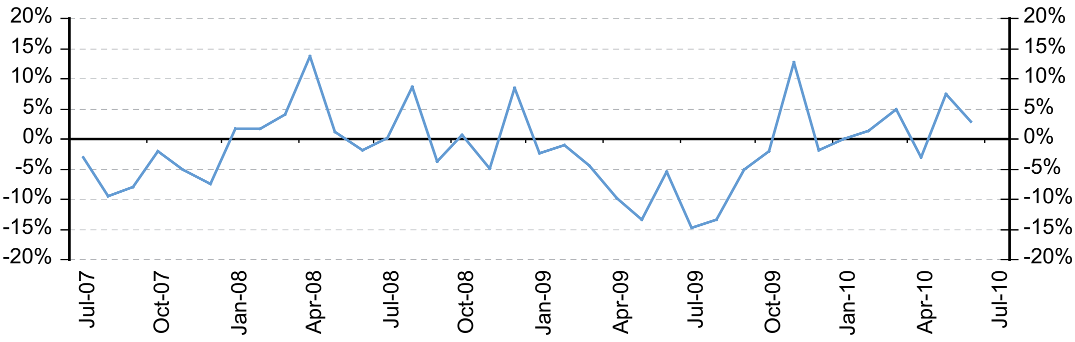
Source: Contraloría General de la República y BBVA Research

Recovery of the transport of goods through the Panama Canal (see Chart 6) is evident since April, and is expected to maintain a moderate recovery in line with the forecasts of world trade growth. In addition, it is important to note that the income associated to the Canal activity will be boosted through approved tariff increases, which will compensate for more moderate trade movements. Dynamics of the service exports (tourism, re-exports, ports and logistics) will partially offset a negative trade balance resulting from greater imported volumes of consumer and capital goods, stimulated by increased infrastructure spending, and higher prices of food and fuels, of which Panama is a net importer.

The strength of domestic demand is expected to generate a major deterioration in the foreign accounts. Starting from a near-balanced current account in 2009, we expect a deficit near 7.0% in 2010. In the future, this will be a key factor to take into account in terms of macroeconomic sustainability, as a balance of payments deficit could lead to a squeeze on money supply and pressures on the local financial system.

Chart 6

Panama Canal cargo volume in thousands of tons (year-on-year change)



Source: Contraloría General de la República and BBVA Research

The outlook with respect to foreign capital flows is favorable based on the positive economic growth prospects, the investment grade of Panamanian sovereign debt achieved in 2010, and the new trade agreements[3] signed in recent months. In addition, access to external financial resources will be enhanced by the persistence of low interest rates in developed countries and the ample global liquidity. However, fluctuations in the levels of global risk aversion, leading to an increase in the cost of finance and/or a moderation in capital flows, cannot be ruled out, and external financing will continue to be a major source of vulnerability for the economy.

3: Panama has signed and approved free trade agreements with Taiwan, El Salvador and Singapore, as well as partial agreements with Colombia and Central America. It has a preferential customs tariff treaty with the United States. However, the free trade agreement signed in 2007 has still not been ratified by the United States Congress. This year Panama extended the treaty with Colombia and signed a FTA with Canada and trade agreements with the European Union.

On the fiscal front, the strong public finances in the first half of the year, with a deficit of the non-financial public sector of 0.3% of GDP, down on the 0.9% registered in the same period last year, have benefited from increased tax revenues, but also from the limited execution of infrastructure spending[4]. Tax revenues have increased thanks to adjustments to rates and a more efficient collection. Regarding infrastructure, the weak performance of investment in the first half of the year should give rise to major adjustments that lead to an upturn in the second half of the year. This is likely to put pressure on the non-financial public sector, increasing its deficit to close to 1% of GDP at the close of 2010, still under the ceiling of 2% under the Law on Fiscal and Social Responsibility. At the same time, a dynamic execution of public investment will result in a moderate deviation from the path of public debt included in the government's financing plan, which has a target of reducing the ratio of debt to GDP from 44.4% at the end of 2009 to 35% in 2014.

It is important to point out that under Panamanian law, the Panama Canal Authority (ACP) is an autonomous institution with a budget process that is independent of the government budget. Thus, the finance of the Canal works does not have an effect on the general deficit of the non-financial public sector. The investment in this major project is estimated at USD 5,250 million, of which USD 2,300 million come from finance from multilateral credit institutions and the remaining USD 2,950 will be financed from operating income of the Canal.

3. Global economic slowdown would contain growth dynamics

In conditions of strong financial stress at an international level and substantially lower growth in the major developed countries over the coming quarters, growth in Panama would lose strength towards the end of 2010 and in the first half of 2011. In particular, a more moderate foreign demand would generate a drop in the traded volume through the Panama Canal, dampening the dynamics of growing sectors such as trade and tourism, and leading to a higher current account deficit and a reduction in government revenues. Despite these effects, and as shown by the recent crisis in the world economy, domestic demand and continued public investment could offset the deterioration in the foreign environment without leading to a major slowdown in the local economy.

At the same time, it is important to consider the possible implications of the stepped-up efforts by policy makers to avoid a scenario of extreme economic weakness. In fact, the lax stance of monetary policy in developed countries will have important effects in terms of increasing capital flows to emerging economies. In a dollarized economy, such as Panama, this situation could imply other risks related to a quick strengthening of domestic demand. This is particularly relevant given the high liquidity of local financial markets and the strong competition among banks, which have kept interest rates at very low levels. Under these conditions, an excessive increase in spending that speeds up growth above potential would imply high deficits in the current account and greater inflationary pressure. This would increase the external vulnerability of the economy and, to a certain extent, reverse the effects of the government's policies to boost competitiveness in strategic sectors.

4: Figures from the General Comptroller point to a capital investment during the first six months of the year that is substantially below the figure included in the budget, and 10.2% down on the figure last year.

4. Improving infrastructure: challenge for fiscal policy

Public spending will continue to be a major source of growth in domestic demand over the coming years. However, the recent international crisis has highlighted the importance of fiscal discipline and credible economic policies in mitigating the negative effects of the economic cycle. The government's intentions of speeding up the modernization of infrastructure and transport will have to be consistent with the fiscal restrictions faced by the country, given its high level of public debt. It is thus possible that some of its spending plans may have to be cut to avoid a deterioration of the public accounts. In addition, problems cannot be ruled out as a result of weaknesses in the institutional capacity to execute spending. Government initiatives to promote competitiveness, such as the recent measures to nationalize concessions in the Southern and Northern Corridors due to bad administration could be considered undue intervention by the state and a potential risk for the sustainability of public finances.

The government also aims to continue progress in negotiating trade agreements with strategic partners such as South Korea and Colombia, following the successful adoption of the FTA with Canada. Although efforts are being made to sign the FTA with the United States, the greater protectionist feeling there could be a factor working against a speedy confirmation of the treaty. The government should therefore make an effort to strengthen trade links with the Asian region, in particular with China, which is its second trading partner after the U.S. At the same time, it will have to complete the signature of agreements to avoid double international taxation and facilitate the exchange of tax information with countries where this is pending approval, as a requirement for the country to be removed from the OECD gray list.

5. Tables

Table 1

Macroeconomic forecasts: annual

	2009	2010	2011
GDP (% y/y)	2.4	6.0	6.3
Inflation (% y/y, average)	1.9	4.0	3.3
Deposit interest rate, 3 months (% eop)	2.5	2.2	2.6
Private consumption (% y/y)	3.7	4.4	4.7
Public consumption (% y/y)	3.0	3.5	4.2
Investment (% y/y)	-8.8	21.6	12.9
Fiscal balance, non-financial public sector (% GDP)	-1.0	-1.0	-1.2
Current account (% GDP)	0.0	-7.0	-7.5

Source: BBVA Research

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