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Panama Watch

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The Panamanian economy confronted the international crisis successfully and will have the best performance out of the Latin American countries in 2009

In spite of international liquidity tensions during 4Q08, Panamanian financial system performance was positive in 2009

Investment in important infrastructure projects will support the economic recovery in 2010 and should increase potential GDP growth

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Second semester 2009

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Executive Summary

In the recent past the Panamanian economy grew at unprecedented rates that are reflected in a significant improvement in public funds as well as in the progress of social indicators. Good economic performance and strong forecasts have increased the possibilities of reaching investment grade very soon.

The strong growth led the GDP to rise above its potential, provoking a recovery from inflation - excluding foods and fuels - as well as a considerable expansion of the deficit in current accounts. The infrastructure projects that are currently in progress, or that are next in line, will have a positive impact on the growth rate of the potential product.

The Panamanian economy has faced the international crisis successfully. Over the course of 2009, activity slowed down due to the adverse international environment: transportation, trade, and construction were the most affected activities. Building activity is undergoing a transformation process where it will focus, in the near future, on the housing necessities of the medium and lower income populations, and will leave the boom in condominiums for foreign investors behind.

The labor market has felt the downturn in economic growth. Although the increase in the unemployment rate has been moderate, the impact is expected to continue in coming quarters in that activities that are labor force intensive will take time to recover strength. Inflation has left behind the crashes that temporarily threw it off its equilibrium rate, and no inflationary demand pressures are expected in the near future.

Public funds show - for the first time - an institutional framework that seeks to strengthen them in order to obtain investment grade. The recent Fiscal and Social Responsibility Law faces its first test of credibility to see whether the fiscal policy has been successful in partially offsetting the declining stage of the economic cycle.

The financial system faced the global crisis successfully. Despite the liquidity tensions that came up at the end of 2008, during the present year good performance indicators were maintained thanks to a prudential self-regulation scheme, policies that were adequate to face the increase in the risk premium, and the backup economic policy provided.

The complexity of the Panamanian financial system creates challenges that should be avoided in the immediate future as to consolidate the transit towards a sustainable growth track. The efforts of the economic authorities are focused on getting off the OECD list of tax paradises.

The modernization of the Panama Canal and an ambitious program of other infrastructure works mark the starting point for the recuperation of economic growth starting in 2010. The recovery of household and business confidence, and also efforts to continue attracting foreign direct investment, allow for some optimism about the performance of the economy and the financial sector.

2. The macroeconomic environment

Background

The Panamanian economy experienced an unprecedented stage of expansion

Between 2004 and 2008, the Panamanian economy experienced its largest expansion in recent history with an average annual growth of 9.2%. The reasons for the boom, common to other economies in the region, were the significant growth of the global economy, the increase in global trade, abundant capital flows, and the revaluation of assets, particularly real estate. This favorable environment coincided with the handover of canal administration to the Panamanian State in 1999 and the strategic transformation that was put into place to make it the axis of a maritime conglomerate focused on logistics and transport. These efforts positioned the route as one of the most competitive trade routes between the Americas and Asia.

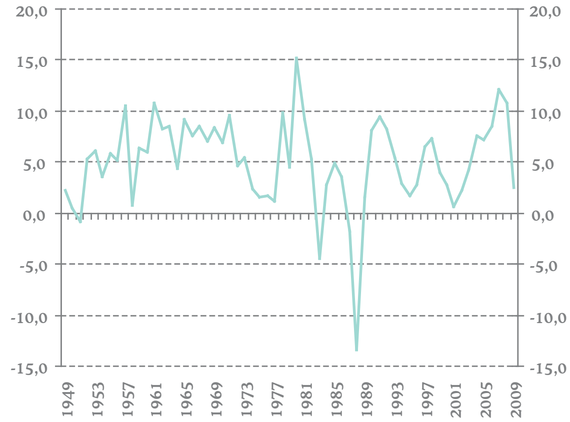
Favorable foreign conditions were reflected in the Panamanian economy by the positive contribution of the net foreign demand for the exportation of services, mainly associated with the activities of the Panama Canal. In the same vein, broad liquidity and low interest rates allowed for an investment expansion in construction and also in capital goods, which caused the spending rate as a percentage of the GDP to recover to the same levels as those before 1999. In contrast, private spending increased to an average rate of 5.0%, which could be considered moderate, particularly when compared with rates from the mid-1990s.

The favorable foreign shocks that the Panamanian economy faced benefited the growth of its most important economic sectors. Transport and telecommunications GDP, which represents about 20% of the economy's total product, grew at an average rate of 15% between 2004 and 2008. Likewise, retail commerce was one of the most dynamic sectors with an average growth of 9.8%, in contrast with a more moderate increase in household spending. Both residential and public works construction and financial services increased an average of 17.3% and 12.3%, respectively.

The largest growth was reflected in an improvement of public funding and social indicators, and raised the possibility of reaching investment grade

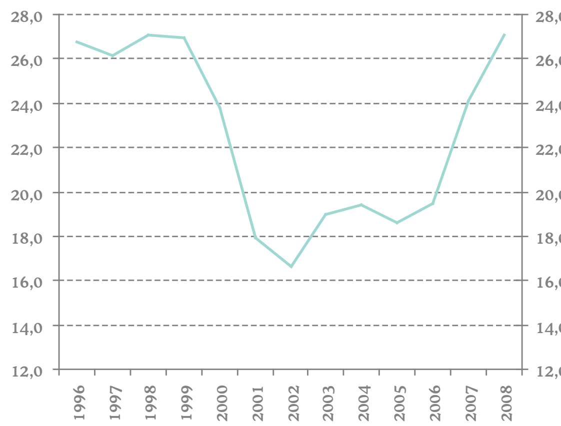
The boom phase allowed for a significant reduction in public debt, reaching 45% of the GDP. The balance of Panamanian debt, mainly of foreign origin, stabilized at the end of 2008. The growth of the GDP allowed, in part, for the correction of the significant imbalance that public funding has presented since the mid-1990s. In fact, between 2005 and 2008, income from taxes increased 82% and went from representing 9% of the GDP to 11%. Also, non-tax incomes, coming mainly from Panama Canal dividends and toll payments, increased from 6.4% to 7.8% of the GDP. In that same period, total spending increased by 53%, reflecting a laxity in fiscal policy with a procyclical

Gross Domestic Product of Panama
(year-on-year change)



Source: CGRP BBVA ERD

Investment
(Percentage of GDP)



Source: CGRP BBVA ERD

Gross Domestic Product in 2008

	Growth	Investments
Agriculture, livestock, and forestry	3,8	3,80%
Fishing	16	2,20%
Exploitation of mines and quarries	30,9	1,40%
Manufacturing Industries	4	6,20%
Electricity, gas, and water supply	3,5	2,60%
Construction	31,2	5,70%
Wholesale and retail commerce	7,4	14,30%
Hotels and restaurants	7,5	2,80%
Transport, storage, and communications	18,5	21,40%
Financial intermediation	15,7	8,70%
Real estate	1,2	5,60%
Private education	3,8	0,60%
Welfare and private healthcare services	3,9	0,90%
Other activities and services	8,3	2,90%
(-) Financial intermediation services assigned to domestic consumption	6,4	2,10%
Subtotal – market production	12,2	76,90%
Construction	19,7	0,20%
Real estate	9,6	9,10%
Private homes with domestic services	1,8	0,60%
Subtotal – final private use production	9,3	9,90%
Subtotal – other non-market production	3,8	7,00%
Gross Added Value in basic investments	11,2	93,80%
(+) Taxes on net subsidies products	3,7	6,20%
GDP	10,7	100,00%

Source: CGRP BBVA ERD

Gross Domestic Product
(year-on-year change, %)

	2004	2005	2006	2007	2008
Domestic	5,1	7	5,9	8,9	10,7
Final consumption	3,9	8,1	4,2	1,4	6,1
Private consumption	4,3	8,8	4,4	0,9	6,7
Public consumption	1,9	4,1	3,1	4,1	2,6
Gross Capital Formation	9,9	2,8	13,5	38,9	24,2
Foreign	18,5	11,3	11,1	22	10,3

Source: CGRP BBVA ERD

Public Debt
(% of GDP)

* July 31 figure
Source: CGRP and MEF BBVA ERD

Balance of Payments
(millions of dollars)

	2007	2008
Current Account	-1430	-2864
Goods balance sheet	-3183	-4775
Services balance sheet	2818	3262
Factors balance sheet	-1318	-1589
Transfers balance sheet	253	238
Capital Account	44	57
Financial Account	3110	2902
FDI	1907	2402
Inv. net portfolio	-1125	-526
Medium and long term	1149	-249
Public	473	180
Private	676	-429
Short term	1179	1275
Errors and omissions	-1107	553
Global balance sheet	617	648
Financing	-617	-648

Source: CGRP BBVA ERD

bias: spending as a percentage of the GDP increased moderately from 25% to 26%. Also, significant institutional advances have occurred with the implementation of the Social and Fiscal Responsibility Law, such as the current discussion of a tax reform project that seeks to increase collection, simplify the tax system and correct equilibrium problems at the same time.

The strong economic growth and the increase of the investment rate reflected a deterioration of the current account deficit, which rose above 12% of the GDP in 2008, a high level when compared to the recent average rate of 8%. FDI flows were sufficient enough to finance the deficit until the year 2007. In 2008, net capital flows, unlike FDI, experienced a restructuring with a reduction in the portfolio of foreign investments made by Panamanians, a decrease in net debt flows from the financial system explained principally by liquidity tensions in the fourth quarter, and a larger amount of debt taken on by the public and other sectors. Despite the reduced purchases in foreign assets during 2008, it is important to note that since 2005 there has been a process of net asset accumulation that creates a reserve for facing an eventual crash in the balance of payments.

The credit assessment has been upwardly revised four times since 2004. It is currently BB+ with a positive outlook, one step away from obtaining investment grade. The risk assessing agencies have recognized the advances in the Panamanian economy, and the current government has signaled obtaining investment grade as a medium term goal. The markets have also favorably evaluated the progresses of the economy and its encouraging outlooks, reflected in the sustained decrease of the EMBI since 2004. Despite the temporary upturn in country risk displayed in the fourth quarter of last year after the worsening of the global crisis caused by the Lehman Brothers bankruptcy, it has declined again in recent months, and today it is close to that of an investment grade country.

Social indicators had a favorable evolution during this five year period. The percentage of the population that lives below the poverty line decreased from 36.8% to 32.4%. These advances are a reflection of the improvements that the labor market experienced. The unemployment rate was cut in half even in front of an increase in population that stayed at 17.5% between 2004 and 2008, which was capable of absorbing a good part of EAP growth, reducing the total number of unemployed from 160,000 to 82,000 in the same period. The increased job demand was explained by the favorable performance of labor intensive sectors like construction, tourism, and retail sales. It was rounded off by an average private salary increase of 19.5% between 2003 and 2007, when the accumulated inflation of the same period was around 10.3%. Despite this, the Gini index showed a modest reduction of 240 pb to reach 52.4% in 2007, and therefore continued to show a very unbalanced income distribution.

The growth phase that took place between 2004 and 2008 allowed the economy to function above its equilibrium level, as is suggested by the broad positive gap that the GDP reached at the end of last year. Other indicators, such as the increase in inflation (not including food), or the expansion of the deficit in the current account, confirm this strengthening.

New investment projects would generate a permanent increase in potential growth

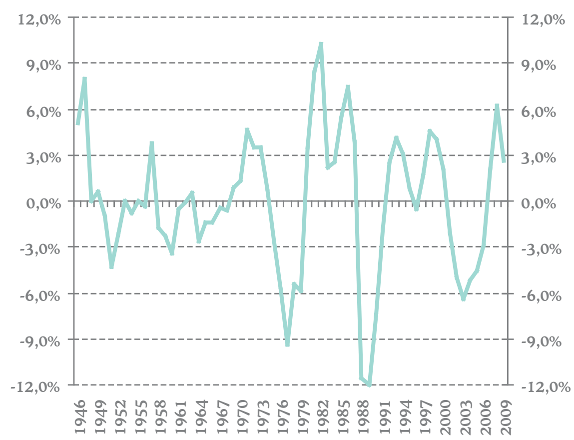
Medium term outlooks are favorable. The expansion of the Panama Canal, the execution of other infrastructure projects, and the incorporation of new lands to activities like tourism, will surely have a favorable impact on the potential GDP, which could raise its growth rate at least one percentage point, reaching 5.5%. Despite the significant advances that have taken place during this century, there are persistent factors that present a latent risk for the economy and that, furthermore, constitute potential growth inhibitors. Social inequality continues to be one of the major weaknesses of the economy, limiting the increase of household consumption and generating persistent political pressures on public spending needs. Likewise, it is imperative to expand access to, and to improve, education, especially higher education, where the labor market begins to face bottlenecks, shown in the increased growth in salaries for qualified labor. On the other hand, there are infrastructure limitations, particularly roadways, public transportation, and sewage systems, that could also play a role in the development into which the economy has been guided. Finally, since Panama is a small economy with a strong dependence on capital flows, a latent risk is the capacity to face foreign crashes. For now, recent performance in the face of the global crisis has been a test that reflects the resistance and maturity of its institutions.

S & P Country Risk Classification

2003	Negative BB
2004	Negative BB
2005	Stable BB
2006	Stable BB
2007	Positive BB
2008	Stable BB+
2009	Positive BB+

Source: CGRP and S&P BBVA ERD

Output Gap



Calculations: BBVA ERD

Box: Reforms implemented to strengthen growth in public balances

The boom experimented by the local economy in the last four years was a key tool in correcting the fiscal deficit of the Panamanian government. Similarly, recent fiscal reforms have been helping the continued improvement of the management of public funds, while searching for more transparency, equality, and efficiency in the system.

With hopes of institutionalizing fiscal discipline and assuring responsibility in the management of public funds, the National Assembly approved the Fiscal and Social Responsibility Law (FSRL) in 2008. Under this law, an NFPS (excluding the Panama Canal Authority) deficit ceiling was established at 1% of the GDP, and the objective of reducing the relative size of the public debt to 35% of the GDP for the year 2015 was outlined. The law also implemented the duty of governments to present, at the beginning of each term, a strategic plan that includes economic, social, and financial programming for 5 years, and also a defined public investment plan.

Said law also includes an escape clause that allows the government to expand the deficit to 3% of the GDP in the case of (i) a Panamanian economic growth of less than 1% during two consecutive quarters, or (ii) less than 5% during one quarter, while the global economy grows less than 1% during two consecutive quarters. In the particular case of President Martinelli's administration, the legislation will allow 2009 to close with a fiscal deficit near 3% of the GDP and grant the new government more tools for strengthening the economy, in order to fulfill campaign promises, while keeping the current international context in mind. For the following periods, the deficit must be reduced to 2% of the GDP for 2010, and to 1% of the GDP for 2011.

In addition, President Martinelli's government has established a fiscal reform that will be carried out in 2010, where there will be possible changes to the LRFS, as well as modifications to Panamanian tax system. Inside this tax reform is the considered elimination of the Alternative Calculation of Income Tax (ACIT) for natural persons, and in its place, the adoption of a flat tax, which would charge the same rate to all declarers. Furthermore, the reduction of income tax from 30% to around 15% or 10% is established, as well as the elimination of some subsidies and fiscal exemptions for certain sectors, such as the bank and the Colón Free Zone.

The main objective of this tax reform is the simplification of the current tax system. Through this reform, Panama will also be able to improve its position in the Doing Business ranking of the World Bank, where, due to the complexity of its tax system, it is located among the worst in the world in the "tax payment" category. Therefore, the measure will allow for an increase in collections, attract investments thanks to a lowered income tax, and increase the competition of the country by managing the taxation more efficiently.

National Central Government balance sheet
(percentage of GDP)

NCG Income (% GDP)	2005	2006	2007	2008
Taxes	8,7	10,3	10,7	10,6
Direct taxes	4,3	5,7	5,6	5,4
Indirect taxes	4,3	4,6	5,1	5,1
Non-tax	6,4	8,2	8,5	7,8
Dividends from the Canal	1,3	2	2,5	1,5
Tolls from the Canal	1,3	1,6	1,8	1,5
Other income	0	0,1	0,3	1,3
Total NCG income	15,1	18,6	19,5	19,7
NCG Spending (% GDP)	2005	2006	2007	2008
Current spending	15,9	15,9	14,2	13,9
Personal Services	5	4,7	4,5	4,1
Debt service	4,4	4,2	3,5	3,1
Current transfers	2,8	3	3	3
Investment spending	2,5	2,5	4,1	5,6
Total NCG Spending	18,4	18,4	18,3	19,5

Source: CGRP, MEF and FMI — BBVA ERD

NCG income distribution
(Percentage, Total = 100)

NCG Income	2005	2006	2007	2008
Taxes	57,6	55,4	54,9	53,8
Direct taxes	28,5	30,6	28,7	27,4
Indirect taxes	28,7	24,9	26,3	26
Non-tax	42,4	44,1	43,6	39,6
Dividends from the Canal	8,6	10,5	12,8	7,6
Tolls from the Canal	8,6	8,6	9,2	7,7
Other income	0	0,5	1,5	6,6

NCG spending distribution
(Percentage, Total = 100)

NCG Spending	2005	2006	2007	2008
Current spending	86,4	86,4	77,6	71,3
Personal Services	27	25,5	24,6	21
Debt service	23,9	22,8	19,1	15,9
Current transfers	15,2	16,3	16,4	15,4
Investment spending	13,6	13,6	22,4	28,7

Source: CGRP, MEF and FMI — BBVA ERD

In 2009 economic activity slowed due to the adverse international environment

The shock of the foreign crisis impacted the economy of Panama in the first three months of the year, when the GDP experienced a recession in comparison with the immediately preceding quarter. Domestic demand declined as shown in retail sales, and the least growth in the construction sector. The restrictions for accessing global liquidity that took place in mid-September of the previous year were reflected by a drastic decline in financial activity in the last four quarters. Finally, the global trade recession has affected canal activity, which has registered a significant decline in transport, storage, and communications services, the main sector of the economy with a 20% contribution to GDP.

The behavior of the economy during the second quarter of the year should indicate that the impact of the crash was left behind, and a recovery process had begun. However, the information available up until September from the Monthly Economic Activity Index (MEAI) shows that it will be a slow process, which will begin to change after the fourth quarter of the year. Surveys from the Chamber of Commerce, Industries, and Agriculture of Panama from August show a moderate recovery in household and business confidence due to the better development of the international environment, relief from liquidity tensions, and the end of the electoral process that took place in July. This increase in confidence should be reflected in a recovery of private investment spending and consumption in the coming quarters.

Construction activity conveyed, in part, the effects of the foreign crash

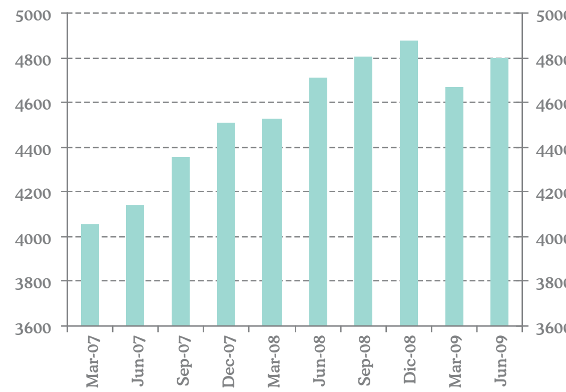
Building constructions faced a significant decrease in activity, going from growth rates higher than 20% in the first quarter to 2.5% in the second quarter of the year. This phenomenon is explained, mainly, by the decline in the start of new residential and non-residential buildings due to a decrease in demand, particularly from foreign investors, and from more credit restrictions that were put into place after the worsening of the global crisis.

In June 2009 there was an unprecedented increase in the approvals of projects for building constructions, which can be explained by the maturity of a tax stimulus for housing constructions, which allows the exemption of real estate taxes for 20 years. Therefore, this impulse must be considered temporary and also uncertain; the approval of these projects does not necessarily imply that the projects will be carried out. In the rest of the year, the development of infrastructure projects, like the Cinta Costera and the Panama Colon Highway, will continue to stimulate activity. Likewise, the finalization of the condominium projects that are currently in progress will maintain a building dynamic.

The labor market has felt the effects of the economic growth decline

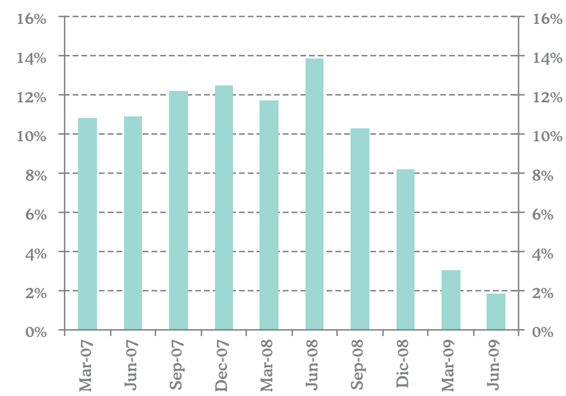
The lessened dynamism in economic activity over the last few quarters has been reflected by a deterioration of the labor market. An increase in the unemployment rate by one percentage point can be explained

Gross Domestic Product
(millions of dollars)



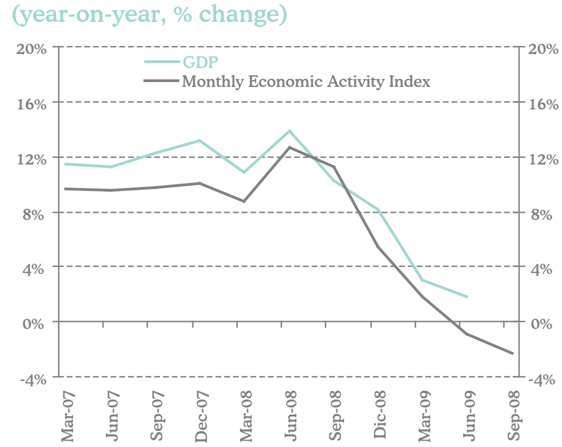
Source: CGRP BBVA ERD

Gross Domestic Product
(year-on-year % change)



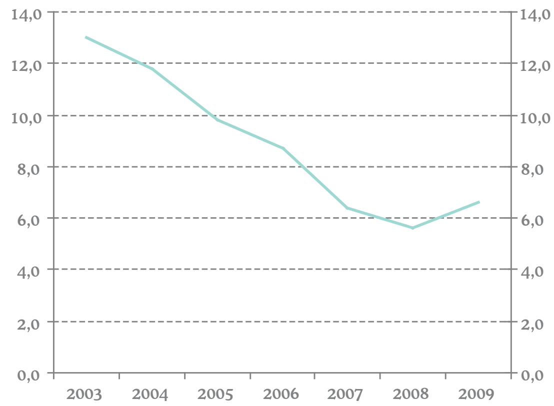
Source: CGRP BBVA ERD

GDP vs. Monthly Economic Activity Index
(year-on-year, % change)



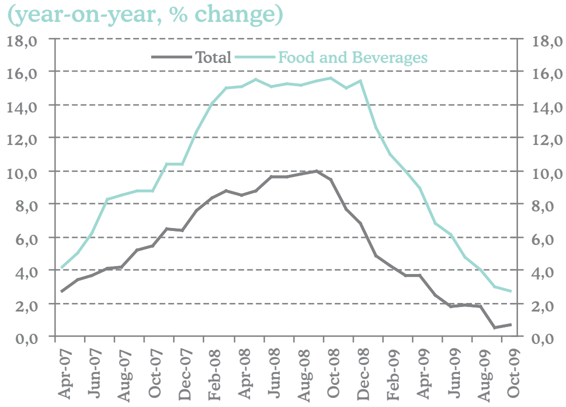
Source: CGRP BBVA ERD

Total Unemployment
(% - information updated until August)



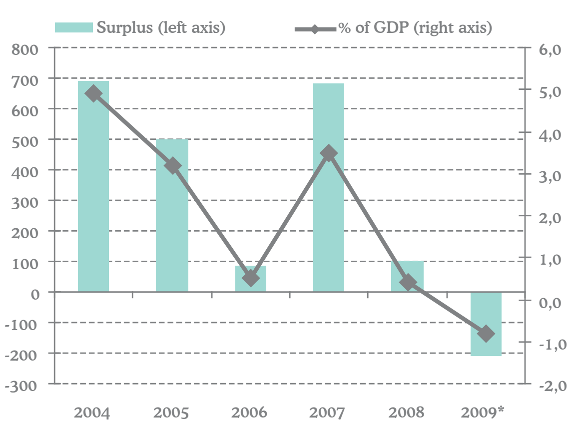
Source: CGRP BBVA ERD

Inflation
(year-on-year, % change)



Source: CGRP BBVA ERD

NFPS Surplus
(millions of dollars, percentage)



* July 30 figure
Source: CGRP BBVA ERD

by a sensible decrease in the generation of new jobs, which has prevented the absorption of the economically active population.

One of the main challenges that the economy faces is preventing this process from continuing to decrease during the next year. Keeping in mind that less activity is expected in the construction of buildings, it will be necessary to make larger efforts in infrastructure projects to try to make up for the loss of jobs in this sector.

It is expected that the efforts that have been made to continue attracting foreign investment will be reflected in the creation of new jobs. The development of call centers, new tourism projects, and the establishment of regional management centers of different multi-national companies will continue demanding labor intensive services.

Inflation leaves temporary shocks behind

During this year, the shocks that increased inflation in the recent past have been reversed. The strong reduction in the differences of prices for foods and drinks has been the main factor behind the collapse of inflation. Up to September 2009, total inflation was 0.5%, with which it accumulated a decrease of 950 pb compared to the maximum that was recorded a year ago. The decline in international fuel prices has been shown in negative variations in the areas of transportation and energy. In the same vein, lower economic activity also had an influence on the significant moderation in the adjustment of prices in other sectors, such as entertainment, culture, and recreation.

It is expected that inflation will stabilize around its long term level, 2.5%, in the coming months. The upturn in international prices of raw materials should begin to be shown in an increase in the domestic price of fuels and energy rates. On the other hand, inflationary demand pressures are not expected in such quantity that the weak growth forecast for this year will lead the economy to operate at a level close to its potential.

Public funds face the challenge of complying with the Fiscal Responsibility Law in a declining phase of the economic cycle

In June of this year, new escape clauses were included in the Fiscal Responsibility Law which will permit the non-financial public sector (NFPS) to incur a deficit of 3.0% of the GDP in the event of a drastic reduction in global economic growth (less than 1%). This has allowed for the implementation of a moderately counter-cyclical tax policy where spending, especially in investments, has increased, although tax incomes have been reflecting the impact of the economic growth decline, particularly non-tax, with a decline up to August that was close to 37%, mainly from the effects of low transport flow in the Canal.

The tax challenge for the next year is to comply with the contemplated transitional track in the law that implies, at the beginning, a deficit no higher than 2.0%. Despite the fact that a recovery in economic growth is expected, being the first credibility test for this law, it is very probable that it will require a cut in public spending and in investments in order to reach that objective.

The balance of payments shows the transmission of foreign crashes to the Panamanian economy

During the first quarter of the year, the account deficit was similar to the figure registered in the same period of the previous year. This excess spending was maintained despite a significant decrease in foreign savings. This can be explained, in the first place, by a significant decrease in foreign direct investment flows (FDI) that plunged to almost half. Despite this drastic cut, the level from the first part of this year is comparable to that which was recorded during the first six months of 2007. On the other hand, there was a significant capital outflow in Panamanian's overseas portfolio investments, which were made up for with a higher capital inflow due to foreign debt, particularly of banks, which was evidenced in the return of overseas financing lines due to a relief in liquidity tensions.

It is very noticeable that during this period, import figures were similar to those recorded a year ago, despite the strong reduction in the international price of raw materials. This suggests an increase in the volume of goods imported for the canal expansion, and predicts a moderate adjustment in domestic demand.

Keeping the international environment forecasts and financing that has been guaranteed for the Panama Canal expansion project in mind, it is expected that the country will continue to attract capital flows in the coming years. Despite the favorable forecasts, given the size of the economy and the dependency on those flows, this variable represents one of the main vulnerability factors requiring contingency measures, like access to credit from multilateral entities, as well as from the reserves of the banking system.

The modernization of the Panama Canal establishes the starting point for the recovery of the GDP

In coming quarters, it is expected that in the way the global recovery process plays out, the Panamanian economy will go back to a sustained growth track. As trade becomes normalized, the transport sector will recover its role as the driving force of the economy. Other branches, such as residential construction and financial services will continue to be strong since there is still a significant unmet housing demand, and the conditions for granting credit are also normalizing.

Although at the global level a weak growth stage is expected, in the case of the Panamanian economy, the recovery process could be faster due to the effect that the work on the Panama Canal modernization will have, being the most important infrastructure project in recent history. The development of these works will allow the GDP to increase again during the coming years at rates close to 6.0%, well above the historic average. On the other hand, it is expected that the economy will increase its growth potential due to the effects that this project has on competiveness, from the volume of resources destined in complementary works, and for maintaining Panama as a strategic point between Asia and the economies of continental countries with Atlantic Ocean coasts.

Another impulse for the economy will come from the completion of other infrastructure investment projects. It is believed that investments

Balance of Payments
(millions of dollars)

	1S08	1S09
Current Account	-778,2	-700,2
Goods balance sheet	-1678,1	-1632,3
Services balance sheet	1627,8	1587,2
Factors balance sheet	-850,9	-766,9
Transfers balance sheet	123	111,8
Capital Account	22	16,6
Financial Account	1872,7	705,9
FDI	1257,9	765
Inv. Portfolio - outgoing	552,2	-905,8
Inv. Portfolio - incoming	-34,3	323
Other inv. - outgoing	-3442,6	38
Monetary Authorities	0	0
General Government	0	0
Banks	-3093,1	442,4
Other sectors	-349,5	-404,4
Other inv. - incoming	3539,5	485,7
Monetary Authorities	2,9	-7
General Government	204,3	102,1
Banks	3213,3	265,5
Other sectors	119	125,1
Errors and omissions	-641,7	112,1
Global balance sheet	474,8	134,4
Financing	-474,8	-134,4

Fuente: CGRP SEE BBVA

in the construction of new highways will continue, and there is also the consideration of developing a massive transit system in Panama City with the implementation of a subway. Also, the culmination of the Panama Pacifico Economic Area will optimize the existing maritime enclave.

It is most probable that the residential construction industry will enter into a transformation process in order to face the challenges of the coming years. In Panama there is still a high housing deficit, mainly in the low- and medium-income populations, which offers the possibility of beginning projects aimed at providing housing solutions, the very same which will maintain a significant demand as long as there is not a major decline in the labor market.

3. Financial context

The financial system with good indicators and an elevated penetration of its activity at the national and regional levels

The Panamanian financial system is characterized by complexity in the type of players present: banks with three types of licenses can exist. Banks that have a general license that are authorized to conduct local and foreign operations; those with an international license that are not authorized to receive domestic deposits, but do participate in the interbank market; and banks with representation licenses that are authorized for the exclusive promotion of businesses.

Due to the characteristics of its operation and the effect on the macroeconomic performance of Panama, only the National Banking System (NBS) is included in this report, which includes the 43 banks that have a general license and two official banks (National Bank of Panama and Savings Accounts). The main activity of the NBS is traditional financial intermediation with significant participation from the non-domestic sector in the funding of the system and its portfolio. Of the total assets of the NBS, portfolios represent about 60%, investments in securities 16%, and liquid assets around 16%.

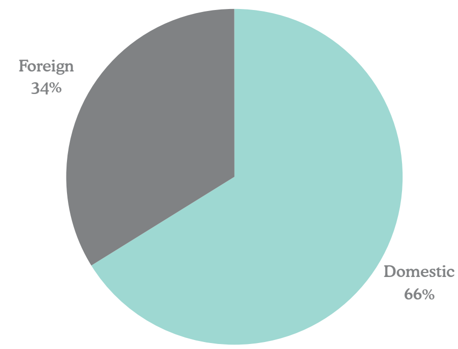
Non-domestic deposits represent around 33% of total deposits, of which 77% are private and come mainly from Latin American countries like Costa Rica, Venezuela, and Ecuador. Domestic deposits represent about 67% of the total, of which 77% are private, and the rest are from banks and official entities. In this last point, the role of the National Bank of Panama is crucial in that the current legislation for public Panamanian entities is very restrictive about the destination of public deposits. As far as loan portfolios go, domestic loans represent more than 73%, and non-domestic 27%.

In this sense, the role of the non-domestic sector in the NBS is very important, and Panamanian banks have a growing role in the regional financing of Central and South America. In addition to the opportunities that these characteristics of Panamanian banks offer, there are also risks, as the need for non-domestic funding resources, and the exposure of non-domestic portfolios, make the NBS vulnerable to the performance of other countries.

Along these lines, a point in favor of the performance of the system is that the banks are well-capitalized, mature portfolio indicators are low, and provisional levels are high. On the other hand, the five most important banks of the NBS have 61% of the total loan portfolio. Likewise, with the new Banking Law that was implemented in Panama in August 2008, an improvement in the levels and quality of supervision is guaranteed, and a more comprehensive supervision plan was created, which guarantees the performance of a stable system in the future.

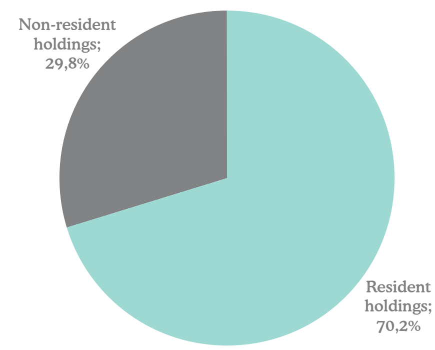
In terms of portfolio quality, low portfolio maturity indicators, around 1.6% of the total portfolio, respond to a very healthy and generalized practice in the system of granting loans, with a nominal discount for both the consumer portfolio and the mortgage portfolio. This plays an important part in banks' portfolios in terms of workers from the formal sector, and particularly from the official sector. Although there are no

Total Deposits of the National Banking System



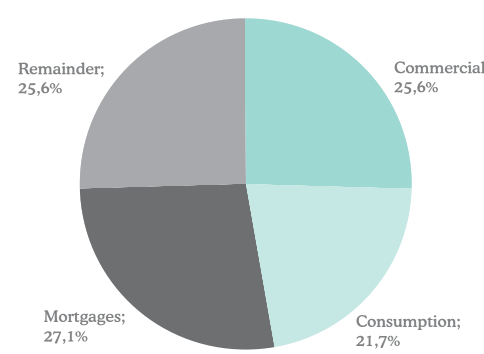
*September 2009 data
Source: Banking Superintendance BBVA ERD

Composition of the Credit Portfolio of the National Banking System



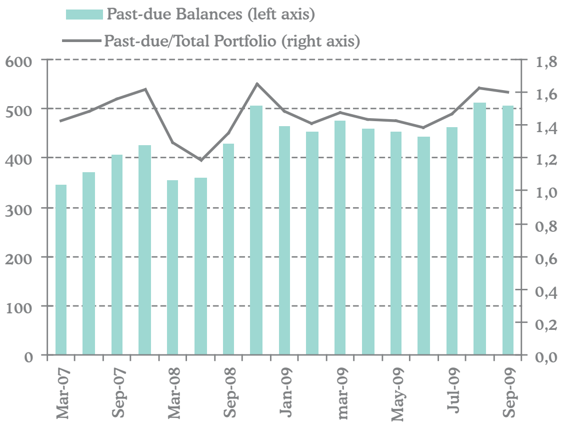
*Data from September 2009
Source: Banking Superintendence BBVA ERD

Composition of the Total Portfolio of the National Banking System



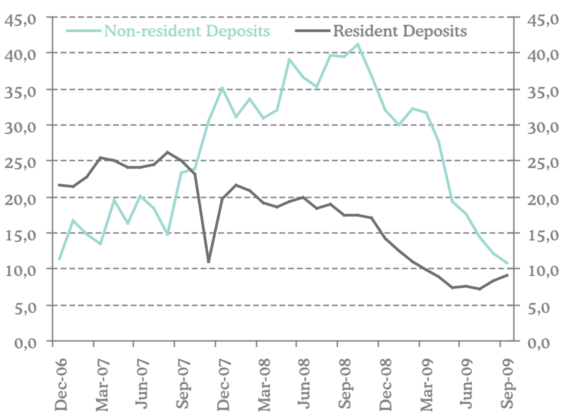
*September 2009 data
Source: Banking Superintendance BBVA ERD

Past-due Balances
(millions of dollars, percentage)



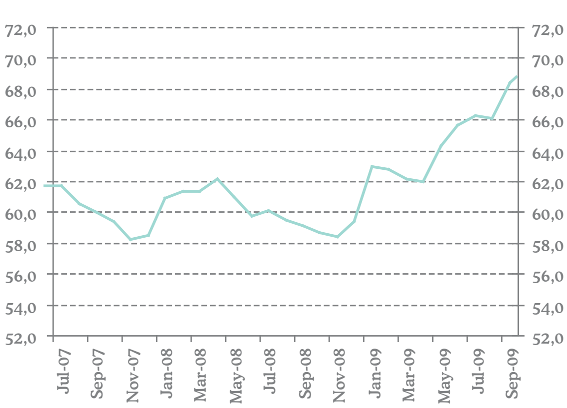
Source: Banking Superintendence BBVA ERD

National Banking System Deposits
(year-on-year, % change)



Source: Banking Superintendence BBVA ERD

National Banking System Liquidity Index
(monthly average, percentage)



Source: Banking Superintendence BBVA ERD

recent calculations about the debt level of families and companies in Panama, anecdotal evidence shows that both the employed and the retired have elevated levels of debt, to which they must commit a good part of their monthly incomes. However, the levels of debt would present a risk only if the debtors were to lose their jobs, but massive job losses are not expected in the short term.

The performance of the system is very important in Panama's case because of its penetration, among other things. The portfolio and deposits of the NBS make up more than 150% of Panama's GDP, respectively. However, although there is a great penetration of financial activity, there is a low level of banking penetration in Panama in certain population groups that do not have formal employment, or that belong to the most impoverished classes of the population.

The complexity of the Panamanian financial system creates challenges that have been successfully avoided during the international crisis

The Panamanian banking system adequately dodged the penetration of the international crisis in 2008, and even though it was not immune to the decreases in, and rising prices of, loans at the international level, it was successfully able to maintain the level of deposits and the liquidity of the system. The system only suffered isolated incidents in non-domestic deposit withdrawals that were not significant in the big picture.

In particular, despite the non-existence of a last resort loaner, the system has well-calibrated alert signals, and as such, the liquidity levels increased significantly in the face of international uncertainty. Likewise, an isolated incident of the unraveling of liquidity in a domestic financial institution - as a consequence of the activities of its foreign counterpart - was handled adequately by authorities and had no significant repercussions in the system.

In addition, as a preventative measure at the beginning of 2009, the government of exiting President Torrijos created a Financial Stimulus Program (FSP) with financing from multilateral organizations and the National Bank of Panama. The FSP sought to give loans to the banking institutions that needed them to be able to give credit at the national level. However, the good performance of the system measured by how it handled the crisis and the decrease in domestic demand for credit, means that the FSP has been used only marginally up until now.

Similar to the experiences of other financial systems in the region, the decline in domestic and international confidence starting in the last quarter of 2008, along with the delay of some investment plans, caused a slowing of the loan portfolio that has only recently begun to turn up again. All of the portfolios types have been affected by the economic climate, but the most affected has been the commercial portfolio, where the activity that contributed most to the plunge was the loan to the Colon Free Zone (CFZ), which represents about 45% of the total commercial portfolio. The consumer portfolio has also suffered a downturn, since it is related to personal consumption and the purchase of automobiles. The mortgage portfolio currently remains the most dynamic credit type.

A slow rhythm of credit activity recovery is expected for 2010 economic performance

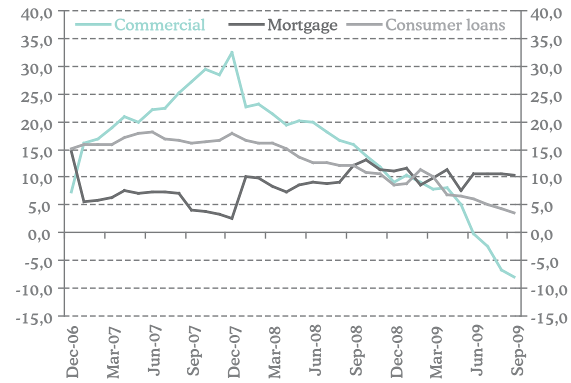
It is expected that by the start of 2010, a slow recovery track will begin in the loan portfolio as an aid to the performance of the Panamanian economy. Particularly, the CFZ portfolio should become active again in mid-2010, when it is expected that its activity will recover.

In the medium term, the mortgage portfolio will continue to be strong due to the significant unmet housing needs in the middle- and low-income populations of Panama, and also due to the benefits that the same people can access with the Preferential Interest Law (in effect in accordance with the 2008 reform, until 2014). As far as the commercial portfolio goes, it is hoped that the planned infrastructure works will strengthen the country's productive activity, and with it, the demand for credit. Both the huge effects of the Panama Canal expansion, and of the cleaning of the bay, or the possible construction of the Panama City subway system, and other possible projects, would have effects on private activity, and therefore on financing needs.

The Panamanian financial system has a weakness due to a deterioration of international financial conditions owing to elevated exposure to non-domestic capital. However, this weakness proved to be very marked in accordance with recent events resulting from the intensification of the global crisis starting in September 2008. The solid performance indicators of the financial system, the quality of regulation, low maturity portfolio indicators, and the capacity of self-regulation have proven to be the supports of the system in times of high pressure. Along these lines, the characteristics of the system, without the existence of a central bank and a national currency, impose additional challenges to the system, and to the Panamanian governmental authorities, that are being successfully avoided.

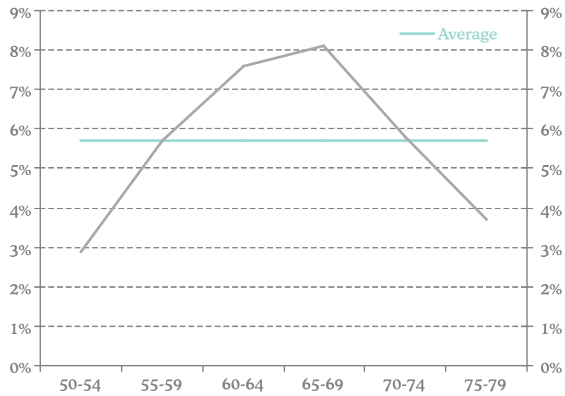
A huge challenge for the Panamanian banking system in the short and medium term is its exclusion from the OECD's list of tax paradises. Among the authorities of the NBS and of the private sector there exists a relative consensus that the costs of exclusion from said list are less for the financial system and the macroeconomic performance than for the expected benefits of not having said international stigma. There is a clear leadership shown in the recently inaugurated government of President Martinelli in the signing of double taxation accords with various countries that allows them to get off the above-mentioned list. In any case, this will be a long-lived effort that must reach beyond 2010.

National Banking System Liquidity Index
(monthly average, percentage)



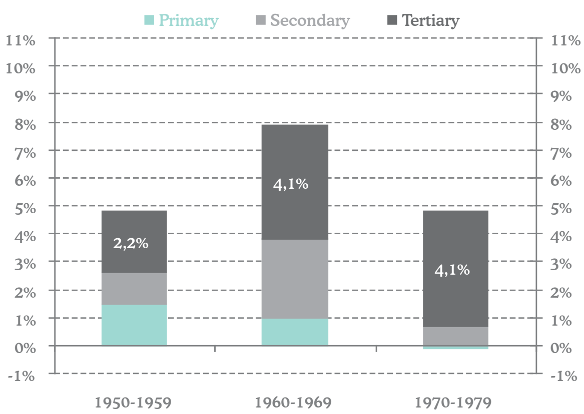
Source: Banking Superintendence BBVA ERD

National Banking System Liquidity Index
(monthly average, percentage)



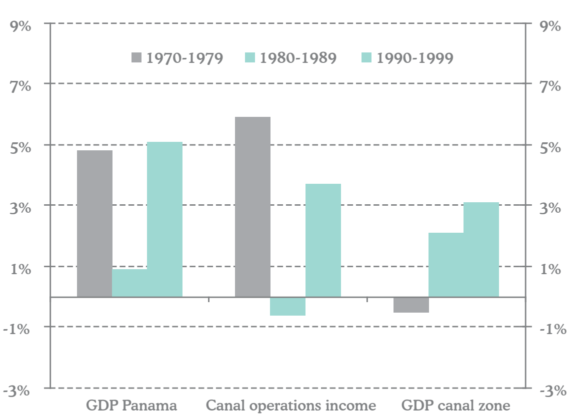
Source: CGRP BBVA ERD

Contribution to the GDP growth rate by economic sector



Source: Intracorp and ACP BBVA ERD

GDP growth rates and Canal Activity



Source: Intracorp and ACP BBVA ERD

The Panama Canal and the Expansion Project as the driving force of Panamanian economic growth

The Panama Canal, with an inter-oceanic passage of approximately 80 kilometers, provides a navigation route that shortens distances, reduces costs, and facilitates global maritime transit. Due to its importance to international trade, the Panama Canal is considered one of the strongest activities in the Panamanian economy, representing more than 20% of the GDP. Largely, taking advantage of canal activity has given Panama the tools to create employment, and investment and production opportunities, which have stimulated economic growth, which is why this nation is recognized in the Latin American region. Likewise, it has played a key role in how the national economy has faced the foreign environment.

Background of the Canal

After a decade of construction, and an investment of approximately 390 million dollars from the United States government, the Panama Canal was inaugurated on April 15, 1914. From 1950 to 1979, the Canal was controlled and operated completely by the United States. With the signing of the Torrijos-Carter treaty in 1977, it was established that the Panamanian government would begin to administer the canal beginning on December 31, 1999. Since the signing of said treaty until the beginning of its effectiveness two decades later, the Canal went through a transitional period under the joint administration of the United States and Panama. Starting in 1999, the Panama Canal Authority (PCA) is the Panamanian government entity responsible for its administration, operation, and maintenance.

According to calculations from the consulting firm Intracorp[1], the contribution of the Canal Zone to the Panamanian GDP went from 26.3% (US$185.1 million) in 1950 to 16.7% (US$599.8 million) in 1979[2]. This was a product of the fact that all other activities, particularly those of the tertiary sector, developed very rapidly, which diminished the relative importance of the Canal. During the 85 years of the United States' administration of the Canal, transfers to the Panamanian State added up to 1.9 billion dollars.

In 1999 when the Canal was completely transferred to the Panamanian State, its economic impact in 1982 prices, rose to US$1.333 billion, representing 18.6% of the GDP, 20.4% of employment at the national level, 28.6% of the government's income, and 41.2% of total exports.

The Canal today

The main users of the Canal as far as freight goes, are the United States, China, and Chile, while the products that most travel its routes are freight containers and products derived from oil. The two most significant routes originate on the East coast of the United States and head for Asia and the West coast of South America.

The national treasury receives 75 Balboan cents for each ton

1 Study on the Economic Impact of the Canal on the Domestic Environment. 2004
2 1982 Prices

CPSUAB[3] that goes through the Canal, plus the payment for the supply of public services, surpluses, and dividends. In addition to these, the PCA also pays income taxes and contributes to social security and to the educational security of its employees.

Currently, the transit capacity of the Canal is about 300 to 310 million tons CPSUAB yearly. The maximum dimensions allowed to use its routes are those of a Panamax ship, which is 34 meters wide and 320 meters long. Furthermore, the infrastructure also imposes restrictions on the height and drafts of the ships, these being 58 meters and 12 meters, respectively.

For the fiscal year 2008[4], the volume that passed through the Canal, measured in tons CPSUAB, was recorded at a total of 309.6 million, with a downturn of 1% with respect to the previous fiscal year. The income from tolls rose to US$ 1.317 billion, registering a year-on-year growth of 11.3%, as a consequence of the implementation of the raise in fees that was approved in 2007, a part of which is supposed to help cover the costs of the Canal expansion project. During this period, the direct contributions to the State were US$ 701 million, which is 35% of income from the Canal (US$2,007,100,000) and 16% of the current income of the Central Government.

In terms of the volume of traffic, Canal transit was lightly affected by the international environment, keeping in mind that for the fiscal year of 2009, 299.1 million tons CPSUAB were recorded, reflecting a downturn of 3.4% from the previous period. However, the income from tolls showed a year-on-year increase of 9.2%, or US$1.438 billion. In this way, the increase in the tolls fees made up for the decrease in trade volume that passed through this inter-oceanic route. For this period, income from the Canal would reach an approximate sum of US$2.207 million, which would reflect a growth of 10% with respect to the previous year.

Canal Expansion Project

The sustained increase of international trade and the demand for passage through the Canal in recent years made the need for beginning an infrastructure expansion project very clear. With the objectives of increasing the capacity and improving efficiency and productivity, the year 2007 saw the start of the Canal Expansion Project (CEP), which established the construction of a third set of locks and the widening and deepening of the navigational floors of Gatun Lake, of the entrances from the Pacific and Atlantic Oceans, and of the Gaillard Cut. These works have a total estimated cost of US$5.250 billion, keeping in mind the effects of inflation and different contingencies, and they are expected to be completed in 2014.

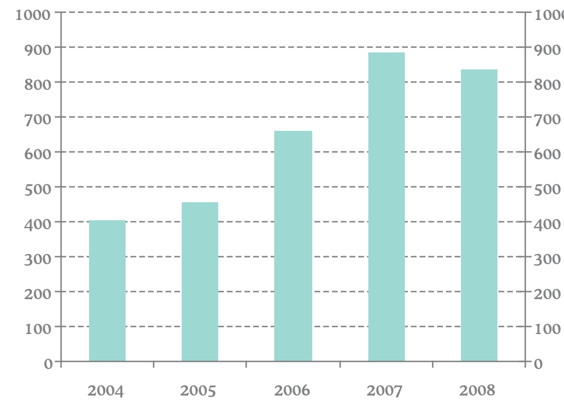
Upon completing the works, the capacity of the expanded Canal will be increased to be able to handle Pospanamax ships, with maximum dimensions of 49 meters in width, 366 meters in length, and 15 meters in drafts. Likewise, the new infrastructure will be able to support a volume of traffic of up to 600 million tons CPSUAB, doubling its current capacity in this way.

Of the total estimated cost of the PCA, US$2.3 billion (12.2% of the GDP and 96% of the 2008 IDE) was provided through the financing

3 Sistema Universal de Arqueo de Buques del Canal (Universal Canal Shipping Tonnage System)

4 The fiscal year of the PCA runs from October 1 to September 30

Contributions from the Panama Canal to National Government Income
(millions of dollars)

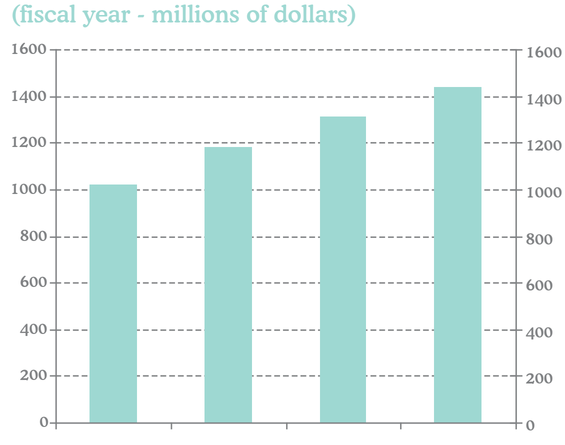


Source: CGRP BBVA ERD

Panama Canal Tonnage
(fiscal year - millions of tons CPSUAB)

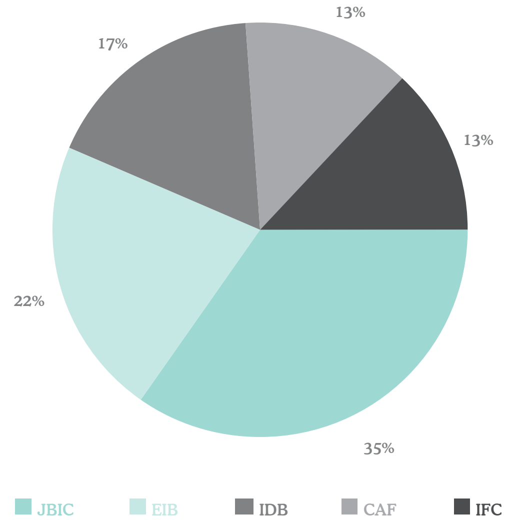
Source: ACP and CGRP BBVA ERD

Income from Panama Canal Tolls
(fiscal year - millions of dollars)



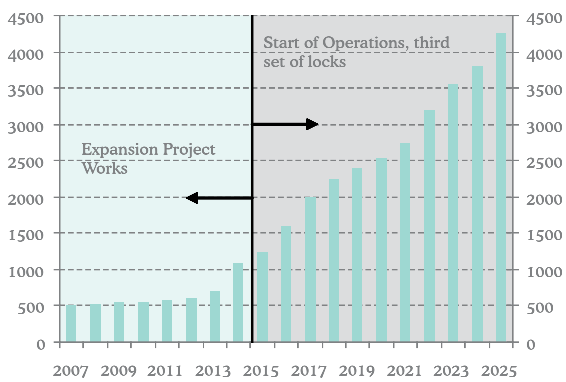
Source: ACP and CGRP BBVA ERD

Panama Canal Expansion Project Funding
(Multilateral Organizations)



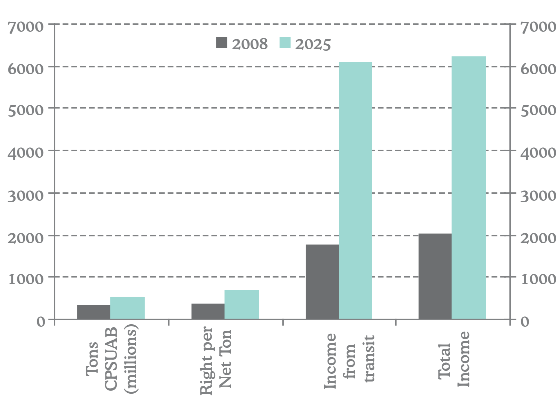
Source: BBVA ERD

Direct Contributions from the Canal extended to the National Treasury
(millions of dollars)



Source: ACP BBVA ERD

Financial Results of the Expanded Canal
(millions of dollars)



Source: ACP BBVA ERD

of five multilateral credit organizations: The Japanese Bank for International Cooperation (US$800 million), European Investment Bank (US$500 million), Inter-American Development Bank (US$400 million), Andean Development Corporation (US$300 million), and the International Finance Corporation (US$300 million). It is worth noting that this loan was made without a guarantee or the endorsement of the Panamanian State, and it is therefore considered the sole obligation of the PCA. The remaining amount to cover the total cost of the work (US$2.95 billion) will be financed with the operative incomes of canal activity, which will increase due to the increase in toll fees and in the volume of transit in the Canal.

During the construction period of the project, from 2007 to 2014, the Canal will continue its operations and will contribute to the National Treasury in the estimated amount of US$6.191 billion. Starting from when these works will be inaugurated in 2015, until 2025, keeping in mind the increased income from tolls, and supposing that the passage volume duplicates, the total contributions to the Panamanian State will rise to US$30.705 billion5, almost two times the GDP of 2008.

The estimates for the year 2025 assume that the total income of the Canal will reach the approximate sum of US$6.2 billion, adjusted for possible inflation (which would indicate a growth close to 200% with respect to the level in fiscal year 2008). Furthermore, it is estimated that contributions to the National Treasury will rise to US$4.2 billion, six times that of 2008.

In accumulated terms, in the period between 2015 and 2025, it is estimated that the additional income for tolls will reach US$10 million, aside from the income received from other maritime services (around US$2.5 billion). In this way, during the first eleven functioning years, total income from the expanded canal will surpass approximately US$12.5 billion, compared to current canal activity.

Economic impact of the Canal and its expansion

Since the start of operations, the Canal has had a strong impact on the Panamanian economy because it serves as an immediate exporter of services, and furthermore, the axis of several activities that depend directly or indirectly on its functioning. Said activities, known together as the Canal Economic System (CES), or the Canal Conglomerate, are related to other sectors of the economy, giving the canal apparatus a multiplying effect on the domestic economy.

Included within the CES are, among others: port activities, shipping agencies, railroads, fuel sales to the ships, the Colon Free Zone, tourism, financial services, and telecommunications. The international demand for some of these activities (i.e. CFZ) creates domestic demand for others (i.e. banking loans), which translates into a synergy between different sectors of the economy, and converts the Canal in the driving force of the Panamanian economic growth.

For this reason, the expansion project means, aside from the increase in State incomes from canal activity, a considerable increase in the overall level of activity of the whole Canal Conglomerate. Within the projections of the impact of the project, it is estimated that CES exports will triple by the year 2025, and that the investments of the

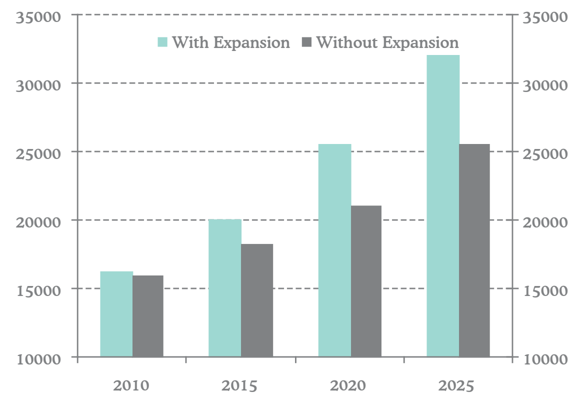
5 Expansion Project. Panama Canal Authority

conglomerate will rise 40%. Therefore, the estimated effect of the expansion on the Panamanian GDP, which will speed up beginning with the start of operations on the third set of locks, represents a growth of approximately 68% with respect to the level of the year 2008. According to the PCA, the GDP for the year 2025 is estimated at US$ 31.7 billion6, which would represent almost double the figure for 2008, and would be equivalent to an average minimum growth rate above 4% annually over the next sixteen years.

In terms of employment, the Canal expansion will create around 35,000 to 40,000 new jobs, directly or indirectly related to the project while the works are being completed. However, in the medium and long term, the effects of the expansion project on employment will be much higher, as a consequence of the impact that it will have on other conglomerate activities. It is estimated, for example, that employment will grow between 0.5% and 0.75% per year, in addition to how much it would grow if these works were not taking place. Furthermore, this would implicate a significant reduction in both the informal worker rate and the unemployment rate.

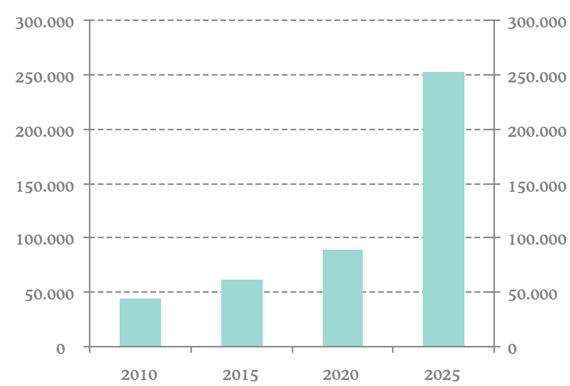
In conclusion, the Panama Canal has played a very relevant role in the domestic economy, achieving its position at the global level, and stimulating a large part of the country’s economic growth. With the expansion project of said infrastructure, the Panamanian economy will be able to assure, in the long term, strengths in production, investment, and employment.

Gross Domestic Product with and without Canal Expansion
(millions of dollars)



Source: ACP BBVA ERD

Jobs directly and indirectly created by the Canal Expansion
(people)



Source: ACP BBVA ERD

6 In 2005 dollars

Panamá

Economic Indicators	2007	2008	2009 *	2010*
Activity				
Nominal GDP (millions of USD)	19485	23088	23896	24971
Real GDP (% variation)	12,1	10,7	3,5	4,5
End of period inflation				
CPI (%)	6,4	6,8	1,2	2,8
Foreign Sector				
Exports (millions of USD)	9338	10290	8849	9911
Exports % GDP	47,9	44,6	37	39,7
Imports (millions of USD)	12521	15065	12805	14342
Imports % GDP	64,3	65,3	53,6	57,4
Trade balance (millions of USD)	-3183	-4775	-3956	-4431
Trade Balance % GDP	-16,3	-20,7	-16,6	-17,7
Current account balance (millions of USD)	-1430	-2863	-2581	-2897
Current account balance % GDP	-7,3	-12,4	-10,8	-11,6

BBVA Economic Research Department

Contexto Internacional

Commodities (end of period)								
	2008	2009	2010		2008	2009	2010
Brent (USD/barrel)	45,6	60,6	68,3	Soy (USD/t.)	343	368	339
Copper (USD/t.)	3070	5732	3969	Maize (USD/t.)	144	130	136
				Wheat (USD/t.)	216	168	160

	Real GDP (%)				Inflation (end of year, %)*			
	2007	2008	2009	2010	2007	2008	2009	2010
U.S.	2,1	0,4	-2,5	1,5	2,9	3,8	-0,7	1,1
EMU	2,7	0,6	-3,8	0,2	2,1	3,3	0,3	0,8
Japan	2,3	-0,7	-5,3	1,1	0,5	1	-1,5	-0,3
China	13	9	8,3	9,3	4,8	5,9	-1,1	1,2
Latin America								
Argentina	8,7	5,7	-2,5	2,6	8,5	7,2	7,5	10
Brazil	5,7	5,1	0	4,7	4,5	5,9	4,2	4,6
Chile	4,7	3,2	-1,2	4,1	7,8	7,1	-0,7	2,5
Colombia	7,5	2,4	0,1	2,4	5,7	7,7	2,4	3,8
Mexico	3,3	1,4	-7,2	3,1	3,8	6,5	4	5,2
Peru	8,9	9,8	1,1	4,3	3,9	6,7	0,6	2,1
Venezuela	8,4	4,9	-2,1	-0,5	18,7	31,3	29,3	35,1
LATAM [1]	5,7	4	-2,6	3,5	5,8	8,1	5,6	7,1
LATAM excluding Mexico	6,7	4,9	-0,6	3,6	6,7	8,6	6	7,7

* U.S. and EMU inflation: average for the period

	Public Sector Balance (% of GDP)				Current Account Balance (% of GDP)			
	2007	2008	2009	2010	2007	2008	2009	2010
U.S.	-1,2	-3,2	-9,9	-9,5	-5,2	-4,9	-2,6	-2
EMU	-0,6	-2	-6,6	-7,2	0,1	-1,1	-0,8	-0,3
Japan	-0,4	-0,5	-0,9	-1	-4,9	3,2	2,1	2,1
China	0,7	-0,4	-3,8	-4,4	11	9,8	5,3	4,7
Latin America								
Argentina [2]	1,1	1,4	-2	-0,4	2,9	2,2	2,8	2,5
Brazil	-2,8	-2	-3,5	-2,6	0,1	-1,8	-1	-2,2
Chile [2]	9,9	4,9	-3,9	-1,9	4,4	-2	2,7	1,9
Colombia	-2,7	-2,3	-4,2	-4,5	-2,8	-2,8	-2,4	-1,6
Mexico	-1,1	-2,1	-3	-3,7	-0,8	-1,4	-1	-1,5
Peru	3,1	2,1	-1,8	-1,1	1,1	-3,3	-1,3	-2
Venezuela [2]	4,5	-0,2	-4,6	-6,3	9	13,1	1,4	2,5
LATAM [1]	-0,6	-1,1	-3,3	-3	0,8	-0,4	-0,4	-1
LATAM excluding Mexico	-0,1	-0,5	-3,4	-2,7	1,4	-0,1	-0,1	-0,6

[1] Average of the 7 countries listed; [2] Central Government

	Exchange rate (against $, end of period)				Official Interest Rate (end of period %)			
	2007	2008	2009	2010	2007	2008	2009	2010
U.S.					4,3	0,5	0,1	0,1
EMU ($/€)	1,5	1,3	1,4	1,3	4	2,5	1	1
Japan (yen/$)	113	96,1	98	100,9				
China (CNY/$)	7,6	7	6,8	6,8	7,47	5,31	5,31	6,12
Latin America								
Argentina	3,1	3,4	3,9	4,3	13,52	19,08	13,5	14,03
Brazil	1,8	2,3	1,7	1,62	11,25	13,75	8,75	10,25
Chile	499	649	560	564	6	8,25	0,5	3
Colombia	2015	2244	2020	2070	9,5	9,5	3,5	4,25
Mexico	10,9	13	13,2	12,7	7,5	8,25	4,5	4,5
Peru	2,98	3,11	2,9	2,95	5	6,5	1,25	2
Venezuela	2,2	2,2	2,2	2,2	11,4	16,2	15,2	13,8

Notes

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