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Economic Outloook

Panama

Second Quarter 2011
Economic Analysis

- **The global economy continues to grow rapidly, driven by emerging economies.** Oil prices are set to remain high in 2011, although the impact on global growth will be limited.
- **Panama should grow near 7.8% in 2011,** driven by government investment and private consumption.
- **Inflation is set to be close to 5.3% on average,** driven by strong business activity and high international commodity prices.
- **Solid prospects for the economy should attract investment** and help finance the large current account deficit.
- **The fiscal deficit will reflect moderate pressure caused by the rate of public investment and spending** on repairing damages incurred during the rainy season.
- **The main risk threatening the economy's performance would be intensification of the political crisis in the Middle East** and the subsequent effects of this on oil prices and world trade flows.

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Closing date: May 13, 2011

1. Recovery, global shocks and vulnerabilities

The global economy will continue growing strongly, but risks are tilted to the downside

The global economy continues to grow at a robust pace, and is still expected to expand by 4.4% both in 2011 and 2012, supported primarily by emerging economies (Chart 1). However, the threat coming from high commodity prices (especially oil) increases the uncertainty and introduces a risk to growth and inflation in most regions, even to some of those that might benefit directly from high commodity export prices. At the same time, local risks identified in the previous issue of the Global Economic Outlook continue more or less unchanged. In particular, financial stress in Europe is likely to continue, especially for Greece, Portugal and Ireland. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets, even as we think that some form of fiscal adjustment will take place in the end. Finally, overheating pressures in emerging markets continue, although going forward they will be more of a concern in South America, given tailwinds from commodity prices.

While high commodity prices pose risks they are unlikely to dent growth

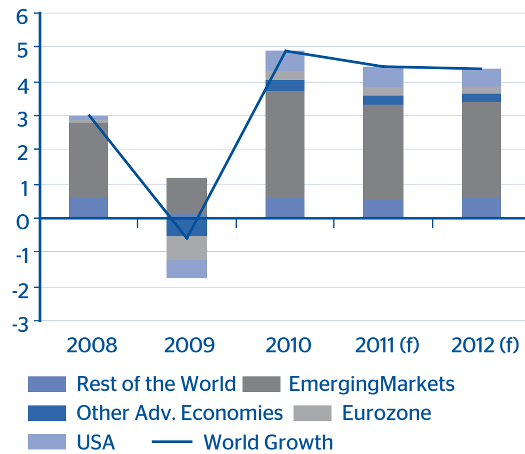
The greatest global risk stems from the rise in oil prices since the beginning of the year, caused mainly by political instability in the Middle East and North Africa (MENA). Although uncertainty is high and protests in the region are still unfolding, in our view, contagion to the point of disrupting oil production in other important oil producers beyond Libya will not occur. Thus, the geopolitical risk premia incorporated in oil prices will gradually be reduced, given ample OPEC spare capacity and OECD inventories, both above historical means. Nonetheless, oil prices may remain high at around US$110-120 per barrel during most of 2011, before receding gradually to around US$100 in 2012.

Given a rise in the price of other commodities such as food and metals as well, the main negatively affected regions will be the major developed countries and most of emerging Asia, the main importers of raw materials. On the other hand, the main beneficiaries of improved terms of trade would be the Middle East and Latin America, which will recycle part of this windfall revenue. However, a shock of this magnitude will be absorbed by the global economy without significantly affecting economic activity. This, together with relatively strong data in the first quarter of 2011, justifies relatively unchanged growth forecasts in most areas, as compared to our February Global Economic Outlook. The main exceptions are Mexico and South America, where strong data in the first quarter of 2011 and better terms of trade warrant a moderate upward revision of our growth forecasts for 2011. Core countries in Europe, as opposed to those in the periphery, will continue to grow, while risks to the U.S. forecasts shift from being biased upwards three months ago to be more balanced now because of higher oil prices.

High oil prices will push up headline inflation, necessitating earlier central bank interest rate increases in most regions

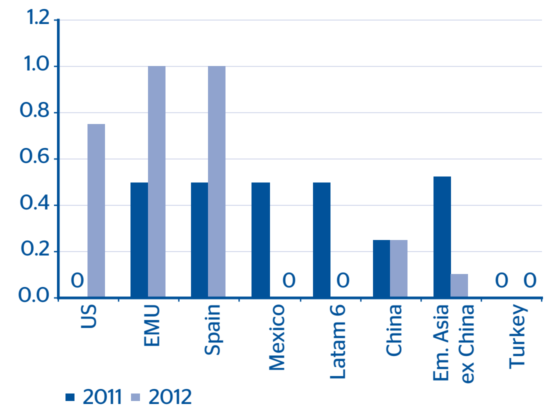
The main effect of the oil shock will be felt on prices. Higher inflation in most economies in 2011-12 will prompt monetary authorities to bring forward, and in some cases push for more aggressive, paths of interest rate increases (Chart 2). Nevertheless, there is still a wide heterogeneity in central bank approaches to the risks stemming from high oil and other commodity prices. In particular, in the US and euro zone, central banks are shifting—to varying degrees—their focus from supporting growth or preventing a tail risk scenario of very low growth and deflation, toward keeping inflation expectations well-anchored, particularly considering that the monetary policy stances are very accommodative. As a consequence, the balance of risks has tilted towards a higher probability of early hikes. The timing of the first hike depends on the perceived need to react to potential risks of second-round effects. The ECB's hawkish approach is to avoid any risk by being pre-emptive (and thus its first hike in April). On the other hand, the Fed, focusing more on the lack of sustainability in the recovery, prefers to wait and act only if risks materialize. Between these two approaches, emerging economies seem open to more front-loaded hikes if needed, but with an eye also on avoiding excessive capital inflows and exchange rate appreciation.

Chart 1
Global GDP growth and contributions



Source: : BBVA Research and IMF

Chart 2
Changes in year-end expected official interest rates relative to February 2011



Source: BBVA Research

Financial tensions in the periphery of Europe will remain high

In Europe the agreements reached during the March summits are useful for the medium term both in terms of economic reforms and to help prevent future crisis. In addition, the changes introduced to the EFSF/ESM are positive to address liquidity concerns. However, financial market tensions in the three peripheral countries with international support (Greece, Ireland and Portugal) will continue as long as doubts persist about the solvency of some countries and thus the risk of debt restructurings that include private investors. These lingering doubts will continue hindering the funding to these economies and sustaining high sovereign spreads and could spread to other countries, even those with high solvency credentials. Thus, a comprehensive approach to debt resolution in case of insolvency is urgently needed, but one that takes into account that undergoing a hard debt restructuring that includes haircuts to private investors has a very high risk of contagion to the rest of Europe, so it will have to be designed carefully.

For its part, Spain has been able to differentiate itself from these three peripheral countries given advances in fiscal consolidation and economic reform including, in particular, those aimed at the financial sector and the labour market. However, continued decoupling and a meaningful reduction in spreads will depend crucially on the satisfactory completion of the recapitalization of the financial system –with a prompt entry of private capital–, on continued fulfilment of fiscal consolidation targets –including in the regional governments– and continuing advancing reforms, especially in the labour market.

In the US, fiscal consolidation will likely be achieved

In the U.S., the political process to reach a sustainable path for public debt involves difficult negotiations between two opposing approaches to deficit reduction. In the end, fiscal consolidation will have to come either from a reduction of entitlements or from higher tax revenues. In our opinion, both parties will reach an agreement that translates into lower deficits and a sustainable debt path, but the political process will be protracted.

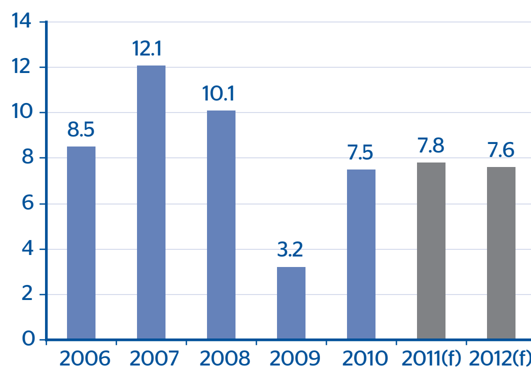
Overheating concerns continue in emerging economies

Emerging economies continue to show risks of overheating, but with marked heterogeneity. Some countries are beginning to confront these risks through more restrictive monetary policy, for example, in the important cases of China and Brazil. We think overheating risks are manageable but, going forward, they may become more pronounced in South America, to the extent that commodity price increases are a tailwind, but act as a headwind for emerging Asia. In addition, doubts about the extent of the slowdown in Japan could weigh on economic activity in most of Asia, given extensive trade links and integrated production chains. Furthermore, current account surpluses in much of Asia provide a buffer for the region, as compared to South America.

2. State investment and private consumption drive Panama's growth

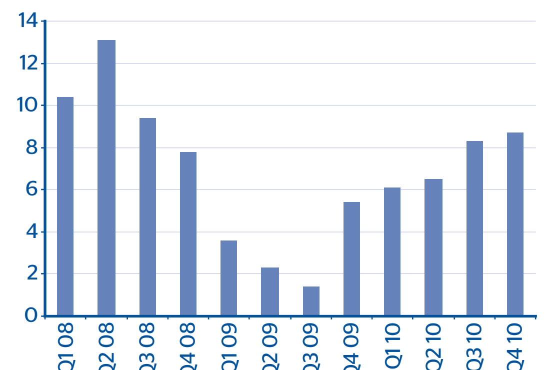
In 2010 the Panamanian economy rallied, registering growth of 7.5% y/y (see Chart 3) and regaining momentum after growth slowed during 2009 (3.2%). Panama thereby consolidated its position as one of the fastest growing economies in Latin America.. Quarterly GDP growth accelerated over the year to 6.3% q/q (8.7% y/y) in the fourth quarter (see Chart 4). This was supported by the strong growth of domestic demand, driven by increased spending on the public sector investments program and Panama Canal expansion works. In 2011 all indications are that the economy will grow around 7.8%, driven by domestic factors as well as a recovery in the foreign sector and international trade.

Chart 3
Annual gross domestic product (% y/y)



Source: Contraloría General de la República and BBVA Research

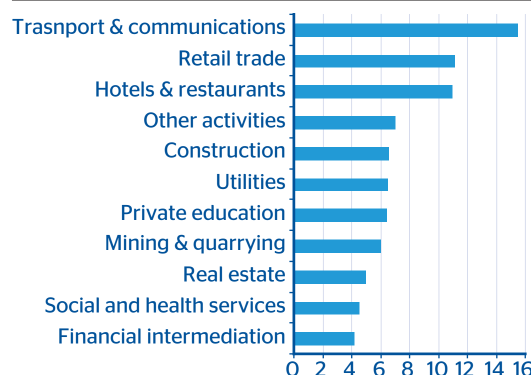
Chart 4
Quarterly Gross Domestic Product (% y/y)



Source: Contraloría General de la República and BBVA Research

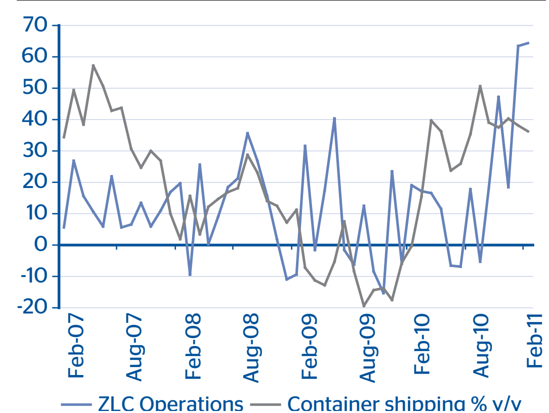
Growth in 2010 was spearheaded by the services sector, with high growth rates in transport, storage and communications, hotels and restaurants and commerce (see Chart 5). The first of these sectors (transport, storage, and communications), which includes port and Panama Canal operations, represented 23.3% of GDP in 2010, an increase of 2pp against the previous year. In 2010 the buoyancy of this sector led to double-digit growth in telecommunications (17.7% y/y), the port sector (26.5% y/y) and air transport (15.6% y/y). This momentum will also remain underpinned by increased movement of goods through the port system and larger ships navigating through the Panama Canal. One particular driver is increased container shipping due to a recovery in international trade (see Chart 6).

Chart 5
GDP by sectors (% y/y)



Source: Contraloría General de la República and BBVA Research

Chart 6
Service sector Indicators (% y/y)

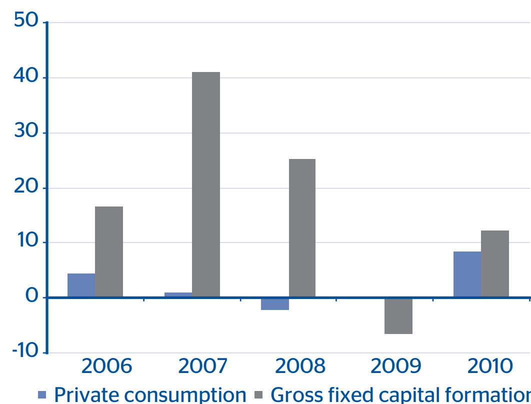


Source: Contraloría General de la República and BBVA Research

In terms of domestic demand, we estimate growth in fixed capital formation of close to 12% in 2010 (see Chart 7), boosted by public sector investment. Over the last year the Panama Canal Authority (PCA) accelerated its rate of investment to 185% y/y in response to the dynamics of the expansion program. Meanwhile, non-financial public sector (NFPS) capital spending was up in the second half, recording growth of 15.2% y/y. In 2011 and 2012, infrastructure projects, such as the Cinta Costera and the Panama Metro, should continue to stimulate activity. However, we are unlikely to see a repetition of the high growth rates recorded in 2010, particularly in terms of the PCA. We therefore expect a greater contribution from private initiatives, which should offset lower public investment growth.

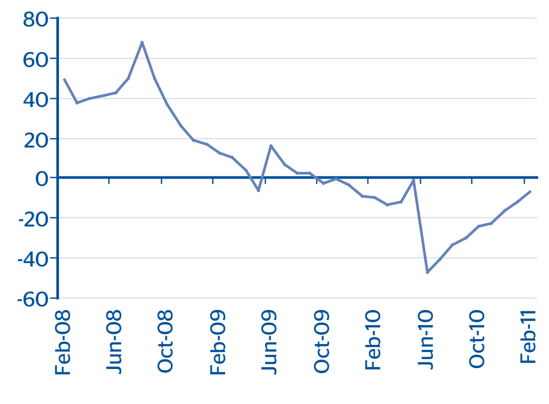
The performance of the housing construction sector, which is showing a considerable recovery according to the latest market figures (see Chart 8), will be key to any recovery in private investment. This is consistent with the growth in housing sales, driven by low and middle level housing (priced under $80 thousand), which have taken over from high-cost units as the growth driver. This construction boost is supported by public sector projects, aimed at providing housing to disadvantaged families, which comes on top of private initiatives to build hotels and shopping malls, all of which will help invigorate the building sector in 2011.

Chart 7
Gross capital formation and private consumption (% y/y)



Source: Contraloría General de la República and BBVA Research

Chart 8
Building permits (USD, acc. 12m, % y/y)



Source: Contraloría General de la República and BBVA Research

Meanwhile, we estimate that household consumption will grow in line with 2010 estimates (8.5% y/y), buoyed by increased employment, support from bank lending and increased tourism. The latter will be driven by growth in hotel capacity and habilitation of airports nationwide to promote tourism.

Finally, progress on the international front suggest an acceleration in trade flows, supporting a favorable outlook for Panama's exports, especially in terms of services related to Canal transit, container ports and the Colon Free Zone. However, the rapid growth of imports will continue, especially capital goods, which indicates a slightly positive contribution from net external demand in 2011. In this context, we expect the growth momentum to continue in 2011, buoyed mainly by domestic demand.

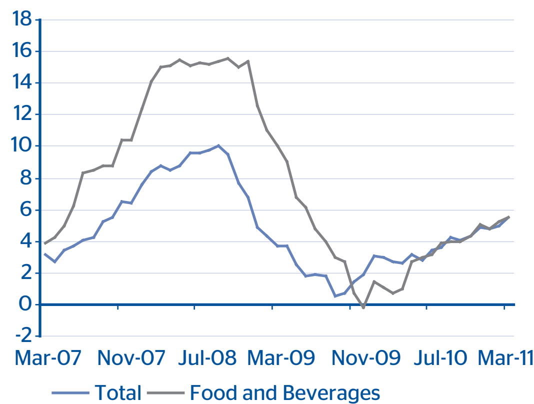
3. Inflation accelerates

Stronger economic activity and rising raw material prices on international markets have been reflected in a significant increase in inflation, up to 5.5% y/y in March (see Chart 9). The factors behind this trend are similar to those seen in 2008, including a positive output gap and a sharp increase in commodity prices, which came on top of pressures exerted by a contracting domestic supply of food products due to flooding late at the end of 2010. Furthermore, the rise in oil prices has led to a sharp increase in transport prices (7.5%). The prices of other consumer basket items have also risen due to vigorous growth in business activity and capacity restrictions.

It is worth pointing out that in an effort to reign in the impact of rising fuel prices, the Government decided to freeze the prices of a gallon of gasoline and diesel for 90 days, which in practice saw it assume a proportion of fuel costs, equivalent to a percentage of the tax levied on these consumables. It also announced that if international prices continue to rise, it would consider taking alternative measures.

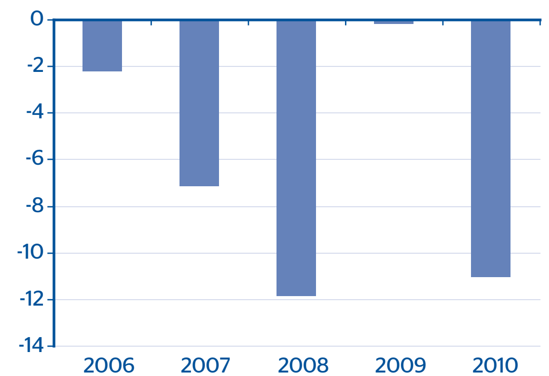
In this context, we forecast inflation of close to 5.3% on average during 2011, moderating in 2012 towards a rate of 4.4%, consistent with the adjustment expected in international commodity prices and the strengthening dollar, due to a more restrictive monetary policy in the United States. However, amid strong momentum in terms of economic activity and in the absence of monetary policy instruments to temper spending, inflation will remain a challenge for economic policymakers, reducing the economy's competitiveness and highlighting outstanding problems facing productivity. While the current government's programs are on track to reduce infrastructure bottlenecks, other important factors include the progress of public policies aimed at issues such as labor flexibility, open trade and workforce education.

Chart 9
Total inflation and food and drink inflation (% y/y)



Source: Contraloría General de la República and BBVA Research

Chart 10
Current Account (% GDP)



Source: Contraloría General de la República and BBVA Research

4. Increased spending is reflected in a sharp deterioration of the current account

In 2010 there was a sharp deterioration in the current account deficit, equivalent to $2.953 billion (11.0% of GDP), which compares with a deficit of $43.5 million (0.2% of GDP) in 2009 (see Chart 10). These figures are explained by a strong increase in domestic demand, which resulted in a significant deterioration in the trade balance, in addition to a considerable factor income deficit (-$1,861). Although such excess spending came with a significant increase in external saving, this was not enough to fully offset the current account deficit. In fact, after several years of sustained accumulation of external assets (since 2005), the latter registered a slight decrease.

Nonetheless, flows of foreign direct investment financed most of the current account deficit. These flows increased 33% in 2010 to $2.363 billion (8.8% of GDP), contrasting with the 19.3% contraction (7.4% of GDP) recorded in 2009.

2010 results confirm Panama's heavy reliance on foreign savings to finance the economy's investments, a situation that makes it vulnerable to external shocks during periods of crisis. We expect the current account deficit to remain large, in the order of 11% -12% of GDP over the coming years, partly because of the investment related to the expansion of the Panama Canal, which is mostly financed by foreign loans. Increased global trade will buoy service exports, although the trade balance and factor income will continue to put the current account under pressure, bearing in mind a slow recovery from goods exports and increased repatriation of dividends by foreign companies operating in Panama. However, we believe capital flows will continue to be attracted thanks to international prospects, optimism concerning strong economic growth over the coming years, the various investment opportunities and favorable country risk indicators, thereby avoiding any abrupt monetary contraction resulting from the loss of reserves.

Rainy season emergencies lead to increased legal limits on the NFPS fiscal deficit

Due to investments from the non-financial public sector, in 2010 the fiscal deficit as a percentage of GDP rose to 1.9%, which is short of the cap (2.0%) established by the Fiscal and Social Responsibility Act (FSRA), but higher than the deficit of 1.0% recorded during the economic slowdown in 2009 (see Chart 11). This result was consistent with high public sector investment as a percentage of GDP (8.4%), which included some advance payments for works in 2011 and 2012. In line with this result, public debt increased in absolute terms, although as a proportion of GDP it fell from 45.6% in the previous year to 43.4%.

NFPS operations are expected to maintain a deficit equivalent to 1.5% and 0.8% of GDP in 2011 and 2012. This estimate takes into account the growth in tax revenues associated to the economic expansive cycle and the effects of an increase in indirect tax rates established in recent tax reforms. On the other hand, estimates for this year take into account the need for additional spending to address the damages caused by floods in late 2010 during the heavy rainy season.

In an effort to give the country more room to maneuver and in response to the emergency, in March the National Assembly approved an amendment to the Fiscal and Social Responsibility Act, lifting the ceiling on the fiscal deficit permitted by the LRFS in 2011 to 3.0% of GDP, up from the previous limit of 1.5%. The amendment also includes a plan to cut the deficit to 1.0% of GDP in 2014, two years later than expected (see Table 1).

Table 1
Fiscal deficit limit according to the LRSF

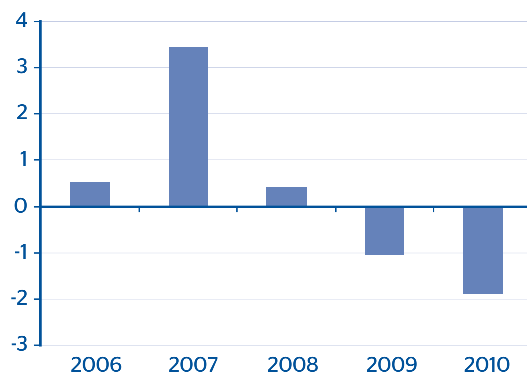
	2009	2010	2011	2012	2013	2014
Maximum LRSF deficit	2.5%	2.0%	1.5%	1.0%	1.0%	1.0%
Deficit authorized for national emergency			3.0%	2.0%	1.5%	1.0%

Source: Ministry of Economy and Finance and BBVA Research

Despite these changes, and to the extent that the estimated expenditure required to respond to rainy season emergencies is lower than the allowances provided by the LRFS, we believe the fiscal deficit should remain comfortably within the limits set by the new legislation, as it has in past years. Additionally, the solid foundations on which the economy is based and positive growth prospects should continue to support access to local and external markets, allowing the financing of slightly higher deficit levels than expected. This is indicated by the successful placement of $500 million ten-year government bonds on the Japanese securities market, with a rate of 2.66%. According to government reports, the additional funds generated by the issue were used to finance investments as well as government social programs.

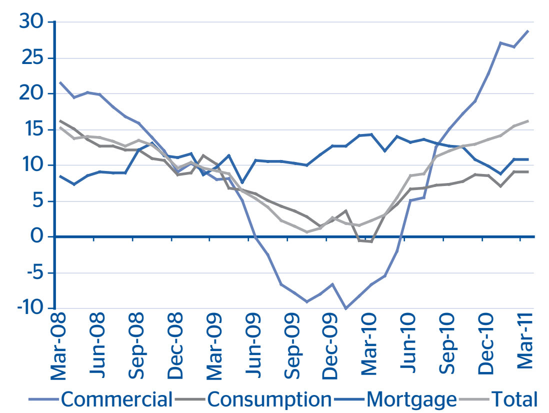
However, the rapid growth in public spending is a factor to watch, to the extent that, if sustained, it could lead to an increase in public debt as a percentage of GDP in 2012 and 2013, which would mean an inflection in the debt reduction recorded since 2005. It is worth noting that, as well as establishing a ceiling on the NFPS deficit, the LRFS targets cutting the relative size of public debt to 35% of GDP by 2015, which would require further fiscal discipline. This will be key if the country is to maintain the investment grade it achieved in 2010.

Chart 11
Fiscal balance (% GDP)



Source: Contraloría General de la República and BBVA Research

Chart 12
Financial system lending (% y/y)



Source: Financial Superintendency and BBVA Research

5. Bank lending grows and financial reforms seek to bring regulations in line with international standards

The vigor of economic activity has boosted lending, which in March recorded a growth rate of 16.1% y/y (see Chart 12). This positive performance has extended to all credit types, with commercial lending being the most buoyant, registering growth of 28.7% y/y, after the significant slowdown observed in 2009. Consumer lending also shows a dynamic behavior (9.1% y/y), both in terms of personal consumption and vehicle purchases. For its part, mortgage lending is recording rapid growth rates (10.8% y/y), driven by the reactivation of the construction sector, outstanding requirements for middle and lower end housing and government incentive policies.

High liquidity levels in the financial system and robust competition between banks should allow interest rates to remain low in 2011 and 2012, providing support to lending growth. This would continue to hold in a scenario in which risks associated with surplus demand remain under control, avoiding sharp adjustments to liquidity in the economy (see Section 6).

Financial reforms will reinforce coordination between regulators and improve FX market regulation

Due to the importance of bringing financial system regulations in line with international standards, the government formed a committee to design a financial system reform aimed at strengthening the regulatory and supervisory framework. As part of this reform, the administration proposed a bill to set up the Securities Market Superintendency, to replace the Securities and Exchange Commission as the regulator and supervisor governing issuers, investment firms, brokers and other stock market operators. One of the key goals of this reform is to reinforce regulation governing FX market operations. Additional aspects of the reform include strengthening institutional coordination and cooperation systems and promoting standardization of financial sector regulations in order to eliminate regulatory gaps.

Furthermore, the reform includes amendments to Law 10 of 1993, governing pension and retirement funds. The measure was aimed at establishing investment parameters for a core fund required by pension and retirement fund managing firms, including investment percentages in foreign instruments. The reform also allows pension and retirement fund managers to set up non-core funds with different risk and returns profiles.

6. Risk factors: further oil price increases and rapid public spending growth

In this context, we believe the main risk facing the economy's performance this year would be an intensification of the political crisis in the Middle East and its effects on oil prices and world trade flows. This would result in an accelerating inflation driven by domestic fuel prices and the subsequent impact on transport and energy costs. However, this scenario would also mean a slowing growth trend, due to the impact on service exports, flows through the Panama Canal and ZLC activities, partially offsetting inflationary pressure linked to the pace of business growth. In any case, the impact on the Panamanian economy should be modest due to the ongoing Panama Canal expansion works and other infrastructure projects, although we would expect a slowdown in public spending in the light of poorer business prospects.

At the local level, the main risk factor is the performance of external accounts and their possible impact on local demand. To the extent that the large current account deficits expected in 2011 and 2012 will be determined by temporary factors, notably the Panama Canal expansion works, the deficit should contract, bearing in mind slowing rates of investment and faster service exports growth. These high deficit levels are supported by sustainable capital flow levels, driven by the global recovery and positive growth prospects. However, risk of slowing external flows should not be ruled out, particularly in a scenario of further oil price hikes and their significant impact on global growth.

Finally, additional risks may emerge due to the increasing impact of larger public investment growth on inflation and external accounts, which could trigger abrupt adjustments in domestic demand. In Panama's case, due to dollarization, excess demand could mean external financing requirements that are larger than capital inflows, which would result in a sharp drop in the country's external assets and an eventual contraction of money supply. This situation would force an adjustment in domestic demand, affecting household spending capacity. At the same time, this deterioration would also generate risks for the financial system, particularly amid rapid lending growth. However, we estimate that under current conditions the risk of this occurring is low, as long as public spending remains on a contained growth trend.

7. Tables

Table 2
Macroeconomic forecasts

	2006	2007	2008	2009	2010	2011e	2012e
GDP (% y/y)	8.5	12.1	10.1	3.2	7.5	7.8	7.6
Fixed investment	16.6	41.0	25.3	-6.5	12.2	9.5	6.0
Private consumption	4.4	0.9	-2.1	-0.2	8.5	8.3	7.8
Inflation (% y/y, avg)	2.5	4.2	8.8	2.4	3.5	5.3	4.4
Open Unemployment (%, eop)	6.7	4.7	4.2	5.2	4.7	4.5	4.3
Fiscal balance (% GDP)	0.5	3.4	0.4	-1.0	-1.9	-1.5	-0.8
Interest rate 3m deposits (%, avg)	3.3	4.1	3.1	2.9	2.7	2.6	2.8
US$ exchange rate	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Current account (% GDP)	-2.6	-7.1	-11.8	-0.2	-11.0	-11.5	-10.8

Source: Contraloría General de la República de Panamá, Financial Superintendency and BBVA Research

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