Panama

Economic Outlook

Second Quarter 2010

Economic Analysis

- The Panamanian economy will pick up due to the expansion of internal demand after the slowdown experienced in 2009.
- Inflation has dropped in response to the slowdown of activity and employment in 2009 and is expected to remain limited in coming years.
- Public finances will improve as a result of the economic upturn and tax increases. On the other hand, a moderate increase of the current-account deficit is expected as a result of the recovery of demand.
- Investment in large-scale infrastructure projects, such as the extension of the Panama Canal, will contribute to increasing the potential growth of the economy. Although 40% of funding for the canal works is guaranteed, the balance depends on the fees for canal use and is, therefore, vulnerable to a fall in international trade volumes.

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1. The challenges ahead for sustained recovery

In recent quarters, the economic situation has improved considerably due to the upturn in emerging economies and in the U.S. World trade is growing at a rate of 7% and our forecasts suggest there will be 4.2% growth in the world economy in 2010. However, doubts remain regarding the EMU's capacity to tackle the problem of high debt levels in some countries. These doubts have led to an increase in sovereign spreads and a new period of financial instability. This situation could affect the European economy, but it could also spill over to the rest of the world. The timing and the scope of these adverse impacts will crucially depend on the effectiveness of the announcements that the European Council made on 9 May regarding the agreed rescue packages and the ECB's exceptional measures. Although these packages have stabilized market conditions in the short-term, uncertainties still lurk on three fronts: i) the rescue package implementation process over the coming months; ii) the credibility of the additional fiscal consolidation in some EMU countries; and iii) the medium-term obligation on central EMU countries regarding the rescue packages.

While economic recovery has been widespread at the start of 2010, its intensity varies widely between countries. This is due to the varying degrees of use of fiscal and monetary policies. These policies have been particularly effective in boosting the economic cycle in China and the U.S. At the same time, emerging economies are benefiting from the growing strength of their domestic demand and from the upturn in terms of trade, in a climate of reduced risk aversion. In this region the recovery is therefore much more consolidated. However, in developed economies, as the expansionary policies ease, there are doubts regarding the sustainability of the recovery beyond 2010.

The Fed is expected to push interest rates up gradually. The first rises are predicted for the start of 2011, with rates slightly above 1% by the end of that year. The differences in the economic fundamentals in the U.S. and the EMU will lead to different monetary policy exit strategies in the two regions. Although economic growth could be slow from 2010 onwards, the risk of a reversal of the current trend is limited in the U.S. and inflationary pressure is still at a very early stage. In contrast, in the EMU, as well as a much more fragile financial situation, the cyclical improvement seems to be uncertain and there are no indications of inflationary pressure. As regards monetary policies in emerging economies, there is no doubt that they need to be toughened. Given the cyclical discrepancies in this region, the exit strategies will vary from country to country. If monetary policy is not made stricter and other measures are not implemented in time, increasing imbalances could be generated in some economies.

At times of greater risk aversion, financial markets tend to be more forward-looking. Financial markets are efficient when it comes to detecting inconsistencies in macroeconomic policies that usually go unnoticed in times of economic boom. In spite of the large rescue package agreed in Europe, significant risk premiums will persist on the sovereign debt market in some European countries in the midst of uncertainties regarding fiscal consolidation processes. The growing contagion has been clear proof of the fragility of the current situation. Economic history is full of examples of "unfounded contagions" from country to country in times of crisis. In these cases, geographical proximity or cyclical similarities are more important than differences in terms of fundamentals. In fact, the current contagion situation is not completely justified by either the financial channel spurred by the breakout of the crisis in Greece or by any similarity in terms of fundamentals. Even though this may be cause for debate, there is a compelling need for some countries to increase their credibility in order to resist pressure from international investors.

There is growing concern over the long-term consequences of increases in public debt. In developed countries this will inevitably lead to upward pressure on real interest rates and high risk premiums for a long time. Even if the recent contagion gradually fades, there will be growing discrimination between countries depending on the credibility of their fiscal situation.

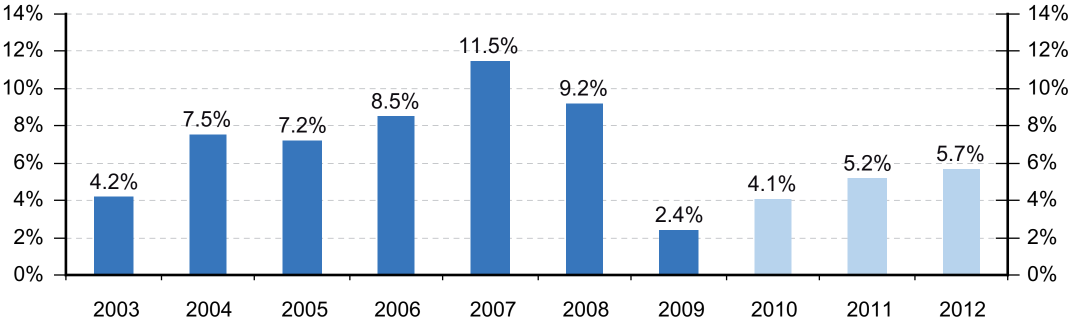
There are two main types of uncertainty arising from the financial sector. Firstly, the slow restructuring of the financial industry, especially in Europe, which could bring about a creditless recovery. This is an increasing concern, because past experience and empirical evidence show the importance of the credit channel in the early stages of economic recovery. There is also uncertainty over the regulatory reform that is already underway. The most likely result is a significant increase in capital and liquidity requirements, which could limit banks' lending capacity over the coming years.

2. Domestic demand will boost growth

The Panamanian economy was able to withstand the difficult international situation in 2009 and set itself apart from the majority of countries in the region by achieving an annual GDP growth of 2.4%. This growth was sustained primarily on domestic consumption as both foreign demand and investment were negatively affected by the international context. As compared to recent records, average growth at a rate of 8.8% in 2004-2008, 2009 growth was slow and affected employment levels with a 1.1 percentage point increase in the unemployment rate and slowed the extraordinary improvements in the labor market experienced by the economy during its boom. The economic slowdown was accompanied by a fall in inflation to annual rates of 2.4% in 2009 which allowed for the price adjustments needed by the economy after demand pressures during the period of growth caused inflation to increase.

Chart 1

Annual GDP Growth (YoY Variation)

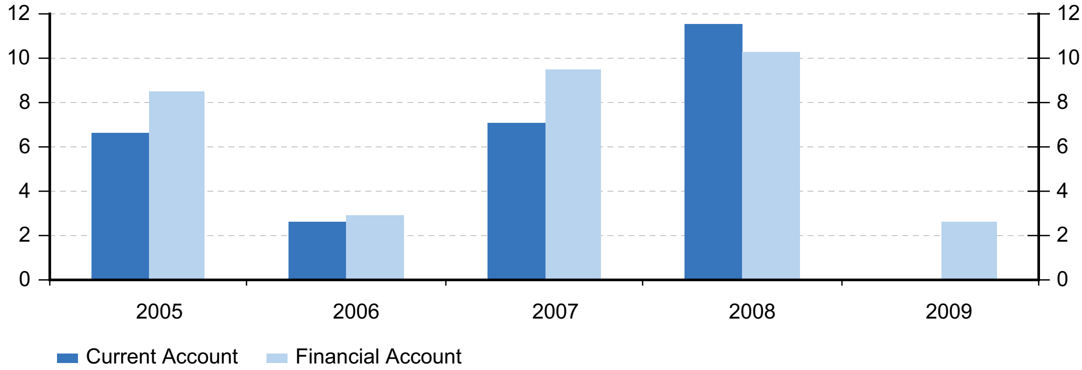


Source: Contraloría General de la República and BBVA Research

Leading indicators for the first half of 2010 show that the economy entered a period of acceleration boosted in large part by the recovery of investment and, to a lesser degree, by consumption and exports. The improvement of expectations for households and entrepreneurs observed in the first months of the year will stimulate private spending in coming quarters, but with less dynamism than that seen in the last expansion cycle. Investment growth will quickly return to the levels seen in 2008 thanks to the continuance of the execution of the ambitious infrastructure plan led by the extension of the Panama Canal, related projects and transportation infrastructure expected to contribute to an increase in Panamanian growth potential. Thus, we expect an expansion of the economy for 2010 and 2011 of 4.1% and 5.2%, respectively.

In terms of building construction activity, improved performance in 2010 is expected following the significant slowdown experienced in 2009 as a result of decreased demand of foreign investors and greater credit restrictions. Recent data shows that part of the dynamism will respond to local demand sustained upon the expansion of mortgage lending and to the start of some licensed works in the second half of last year when they experienced an extraordinary increase to take advantage of the tax stimuli. In terms of other driving forces of growth, the anticipated improvement in the performance of the US and Asian economies and the gradual normalization of global trade are expected to increase revenues from tourism, levels of goods transported through the Canal and the activity of the Canal's Free Zone.

Chart 2
Current Account Deficit Financing (% GDP)



Source: CGRP, FMI and BBVA Research

As of 2010, foreign accounts will undergo moderate deterioration, reflecting the recovery of domestic demand. An increase in the trade balance deficit is expected due to the greater demand for imports of both consumer and capital goods. Its funding will be guaranteed provided that the conditions for accessing the capital markets are better than in the past year and that, with the recent degree of investment, new loans will be undertaken at a lower interest rate and will improve the flow of funds into the Panamanian economy. However, the recent increase in global risk aversion can lead to some short-term tension.

It is expected that inflation will remain controlled in coming years at 2.7% in 2010 and 3.1% in 2012. This projection takes into consideration that the price of food and beverages remains low during coming years and a slightly negative output gap given GDP growth between 2009 and 2010 will be below that of the potential calculated at 5.0%. The latter would reflect the existence of excess installed capacity which allows for a greater growth of the economy without generating inflationary pressures of demand. However, we should not rule out the rising pressures from higher international oil and fuel prices that could affect the categories of Homes and Transport.

Furthermore, public accounts will maintain their course of reducing the deficit and decreasing the debt balance. Bearing in mind that our forecasts are better than those expected by the Government in its 2010-2014 Strategic Plan, better performance is expected for tax revenue, which will free resources for the execution of the infrastructure investment plan without affecting the attainment of the goals established by the Fiscal and Social Responsibility Law. Servicing of the debt for the coming years continues to decrease, which is consistent with a reduction of the balance of public debt as a percentage of GDP. The solid performance of public accounts reflects both the expected improved growth of the economy and the favorable effects of the tax reform approved in the first quarter of 2010 that determined a new income tax design and an increase of the VAT rate.

3. A strong deterioration of the external environment will delay the recovery process

The increase in the risk premium of European countries has spread slightly to emerging economies. Against a backdrop of stronger contagion, capital flows to the region will decrease due to the increase in risk aversion, the growth of world trade will possibly be reduced; and other factors including greater restrictions to accessing the capital market and an increase in the cost of resources would limit growth. In this context, we do not anticipate obstacles to the funding of the canal expansion works corresponding to multilateral institutions, which already made their first payment in 2010. However, a drastic drop in the transit of merchandise through the canal could eventually affect the funding of the proportion reliant on the increase in toll fees and the volume of transit through the Canal, which corresponds to more than 56% of the total value of the expansion.

Moreover, eventual delays in the execution of the investment projects sponsored by the Government will moderate GDP growth. This possibility could arise due to the deterioration of the international environment or to delays in the administrative processes of contracting and execution. In these circumstances, there would be a secondary effect associated with a delay in the recovery of the labor market that would then impact household consumption spending.

4. Decreasing external dependence will be the major challenge for coming years

The favorable growth perspectives for the economy present several challenges. On the one hand, rapid growth could imply an overflowing increase of the current-account deficit that, though it would be largely financed by abundant flows of direct foreign investment and, by foreign indebtedness to a lesser degree, would eventually make the economy more vulnerable to external shocks. Likewise, this type of situation could lead the economy to a period of overheating with inflationary pressures and potential unsustainable increases in asset prices. Along this line, continued work on the process of foreign trade diversification supported by free trade agreements like those negotiated with the United States, or those being negotiated with Colombia and the European Union, is needed. Furthermore, in line with the current government's plans, work is needed on the structural plan for increasing internal savings and productivity. Moreover, and considering the sui-generis policy framework of Panama, characterized by dollarization and no central bank acting as lender of last resort, the importance of maintaining proper fiscal management increases. In this way, the Government has the responsibility to accommodate public spending and investment plans so that economic growth anticipated for coming years evolves in an orderly manner and that its financing and execution does not generate risks to medium-term sustainability.

In line with the need to maintain positive international relations, it is important to continue with the process of signing tax information exchange agreements with OECD member states in order to avoid international sanctions. To date, treaties have been signed with five countries and three more are in the process of negotiation. Considering that the objective set by the OECD is for twelve countries in order to be excluded from the list of tax havens, the Government should make an effort to be able to achieve this commitment before year-end.

5. Tables

Table 1

Macroeconomic Forecasts: Annual

	2009	2010	2011
GDP (% yoy)	2.4	4.1	5.2
Inflation (% yoy, average)	2.4	2.7	3.1
Interest rate on fixed rate deposits (% eop)	2.5	2.6	3.1
Private Consumption (% yoy)	3.7	3.9	4.3
Public Consumption (% yoy)	3.0	3.8	4.9
Investment (% yoy)	-8.8	21.6	7.9
NFPS Fiscal Balance (% GDP)	-1.0	-1.6	-1.2
Current Account (% GDP)	0.0	-3.2	-3.8

Source: BBVA Research

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