Panama

Current Economic Situation and Outlook

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INTRODUCTION

Panama is one of the emerging market countries that has weathered the recent economic crisis extremely well. Since 2007, its GDP has been in the 9 to 11 percent range while most of the rest of the world (especially the developed nations) have been struggling to attain growth in the 2 to 3 percent range.

This paper identifies reasons for this recent success, and also examines current trends in order to predict the trajectory of Panama's near-term economic future. Panama is a small country, with fewer than 4 million people, yet its economic story has many facets. A few of the most important for the near-term future will be addressed in this paper, including the current project to expand the Panama Canal, the effect of corruption in Panama's special economic zones, the plight of the residents of rural Panama, Panama's broken relationship with Venezuela, and the potential effect of a Nicaraguan canal to rival the Panama Canal.

Key to Panama's future, as it has been for 100 years, is the Panama Canal. The current expansion project is behind schedule, as it is due to complete in 2015, rather than the 2014 originally promised, but major ports and shipbuilders are dredging and building larger ships to take advantage of the third and larger set of locks.

Panama's Special Economic Zones, one of which is the second largest in the world, next to Hong Kong, are also a key source of revenue from exported services, Panama's largest economic sector.

From a monetary perspective, the Balboa currency is Panama's most interesting characteristic. Tied to the US dollar, it shelters Panama from most of the exaggerated inflation spikes experienced by other Latin American nations, but the absence of a central bank leaves its financial institutions without a "lender of last resort" in case of problems. Finally, the possibility of political or social instability needs to be considered with respect to the current and likely future situation of the people.

Each of these topics will be considered in turn, followed by a final paragraph to summarize the outlook and provide an assessment of likely future outcomes.

Current Economic Picture

Panama is characterized as a dual economy; consisting of a canal-affiliated export services economy, and the rest of the country (Bossolo et al., 2011), mostly dependent on agriculture, which is much less developed and much more impoverished. The primary driver of the recent boost to GDP is the 5.5 billion dollar Canal Expansion project and other major infrastructure projects including upgrades to the Panama Canal railway; bringing construction-related imports and construction jobs, while leaving the conditions of the rural agricultural worker and informal economy participants relatively unchanged.

GDP

Although most of its population is employed in the agricultural sector, most GDP derives from the services sector, both from services related to the Panama Canal and Import/Export services in the Special Economic Zones.

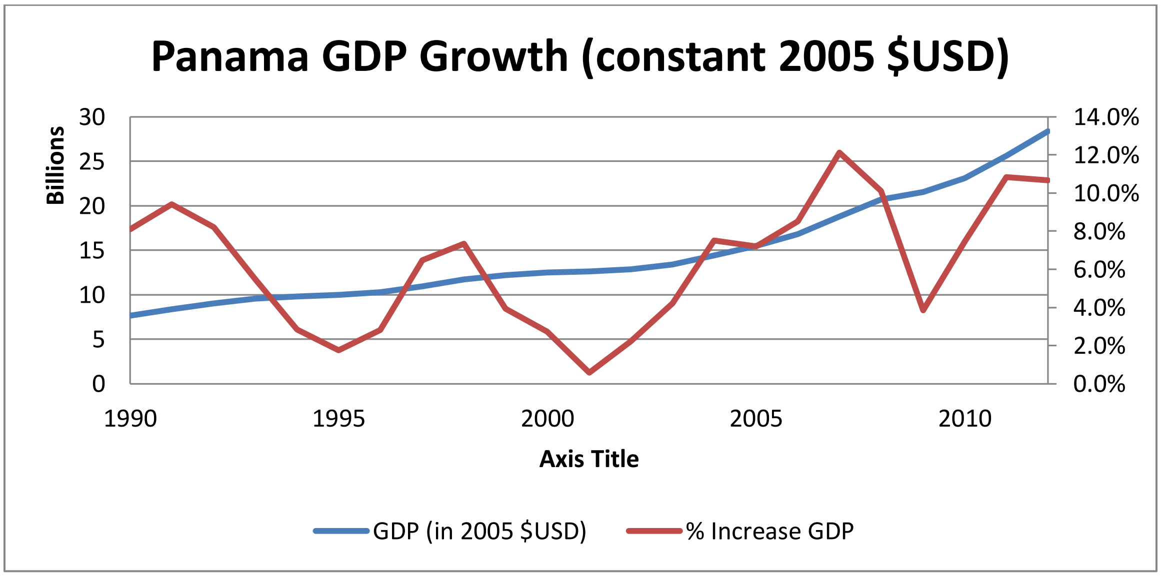
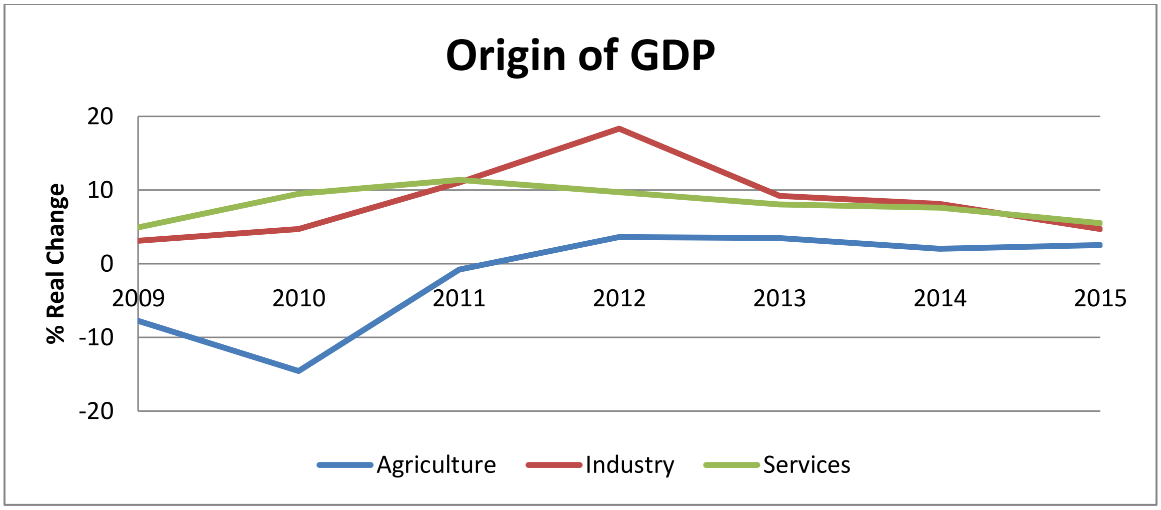


FIGURE 1 WORLDBANK DATA

Most of the exceptionally high increases in GDP seen in the past few years can be directly traced to expenditures on the Panama Canal expansion project, which is slated to wind up by the end of 2015. After the end of this project, GDP is anticipated to resolve to a more moderate 5% per year level. (EIU, 2014)



2. IMF data , 2014 and 2015 are forecasts

Inflation

Inflation is kept in check by the Balboa's adherence to the US$. Most recently estimated at 3.7%. it has seen some increase due to the capital infusion into the economy for the Canal expansion. (EIU, 2014) With the withdrawl of Quantitative Easing (QE) in the United States, the Balboa is expected to get stronger against the Euro along with the dollar, which will hurt Panama's goods exports to the EU, but this is not expected to have a large effect as Panama's exports to the EU are not very high.

Poverty and Inequality

Poverty in Panama is primarily found in rural areas outside the cities and especially in the indigenous areas, where most residents work in the agricultural sector. In the past few years, many of these impoverished farmers have migrated to the urban areas in search of work, which has been plentiful due to the canal expansion project, but those left behind in the rural areas still struggle with an inadequate land tenure system, and inadequate infrastructure to bring product to market, making it difficult to escape a subsistence existence. (IFAD,2010; Beaubien, 2012).

A World Bank report in 2011 (Bossolo et al., 2011) through a combination micro and macro economic analysis, predicted that the FDI and jobs that come with the canal expansion would accrue primarily to the already dynamic services export sector due to the relative lack of infrastructure investment in agriculture.

According to World Bank figures, poverty in Panama has declined precipitously in the past few years, declining from 38.3% in 2006, to 27.6% in 2011, the most recent data available. Substantial reductions in poverty make widespread social uprisings less likely in the absence of other provocations.

Panama Canal

Since 2000, the Panama Canal has been controlled entirely by the Panama Canal Authority (PCA), an independent organization (in particular, independent of the Panamanian government). In 2013, the Canal realized revenues of 2.4 billion Balboas, of which 981.8 million Balboas was contributed to the Panamanian national treasury. (PCA, 2013). The Panama Canal is widely acknowledged to be well run and transparent, even being honored as one of Ethisphere's Most Ethical Company in 2014, for the 4th consecutive year. (Ethisphere, 2014)

Expansion

The $5.25 billion addition of the third set of locks to the Panama Canal will double the capacity of the canal by 2015, and will allow Asian shippers to bring their goods to Eastern and Gulf coasts for less money and bolster Panama's strategic advantage as a center of commerce and business center. The largest shpps accommodated through the new locks will be able to carry almost three times as many containers. (JOC, 2013)

The Grupo Unido por el Canal (GUPC) consortium working to build the third set of locks to expand the canal is led by Spain's Sacyr, and includes the Italian Company Salini Impregilo, the Belgian firm Jan de Nul group and Panama's Constructora Urbana S.A. The project comprises about a quarter of Sacyr's yearly revenue. GUPC won the bid for the project in US$3.2bn, underbidding others contenders by about US$1bn.

In December of 2013, a dispute erupted over 1.6 billion dollars in cost overruns, which halted work for weeks in early 2014 and put the project in jeopardy (Mallen, 2014). The builders and the Canal authority blamed each other for the additional expense, which had been planned to cost $3.2 billion. Finally a new agreement was signed by both parties as well as the insurer Zurich on March 14th, extending the deadline for completion of construction out to December of 2015. The agreement provides for each party to contribute $100 million to start the project moving again, and a $400 million surety bond from the insurer Zurich. The PCA is extending a moratorium on the refund of advance payments until 2018.

The work stoppage on the expansion was unlikely to become permanent, as ports worldwide and especially in the US and Caribbean have been dredging and enlarging to accommodate the larger ships which will be using the new, larger set of Panama Canal locks. In 2013, the US Department of Transportation, Maritime Division estimated that 63 US ports and their private partners would spend $46 billion upgrading their facilities between 2013 and 2017 (, 2013). Panamax ships (the largest the current canal will accommodate) are being replaced with larger vessels that will be able to fit through the expanded canal, once complete. (Molinski, 2014)

Special Economic Zones

A central development strategy in Panama is the use of Special Economic Zones (SEZ's) to attract Foreign Direct Investment. Panama's two SEZ's, the Colon Free Zone and Pacifico occupy a unique geographical advantage due to Panama's position as the gateway to the Panama canal and also position on the smuggler's route between South and North America.

The Colon free trade zone was established in 1948 in order to stimulate commerce and FDI. The zone quickly became a world-wide center for import and re-export as had been hoped. However, the access to trade routes and liberal rules also attracted actors who were involved in illegal activities, especially smuggling and money laundering. (Reyes, 2011) Even high level Panamanian officials became involved, up to and including former Panamanian dictator General Noriega, who was found to have a significant interest in a bank in the CFZ that was then found to be laundering money for the M-19 and drug dealers.

In recent years, Panama has passed Tax assessment and transparency laws in an attempt to suppress money laundering and tax evasion activities, especially targeted to comply with anti-money-laundering laws in the US and elsewhere (IMF, 2014). . Panama's credit rating now stands at BBB, and is not showing any signs of slipping.

CORRUPTION

The world economic forum estimates that the most problematic factor for doing business in Panama is corruption. Corruption is a problem for business in that outcomes tend to be unpredictable; almost by definition, there is a lack of transparency, and stated prices are only the beginning of costs. The Corruption Perception Index (CPI) from Transparency International paints a vivid picture (see graph). Panama's estimated CPI has remained relatively stable between 35 and 38 since the year 2000, but its ranking has fallen from the 51st highest of 91 countries in 2000, to 102nd of 177 countries in 2013 (higher ranking is worse perceived corruption).

Work undertaken by the author has found a negative correlation between inbound FDI and the Corruption perception index (CPI) for CPI's below about 62. It is not clear how strong an affect corruption has on outside investment, but certainly some initiatives have been "scared off" a highly corrupt and inhospitable business environment.

Year	Rank	CPI	CPI-LCL	CPI-UCL	# Countries
2001	51	37*	31*	40*	91
2005	65	35*	31*	40*	158
2010	73	36*	31*	47*	178
2012	83	38	33	44	174
2013	102	35	31	39	177

* Values multiplied by 10 for comparison with current metric.

NICARAGUA CANAL

Since the 16th century, the possibility of a canal bisecting Nicaragua from the Atlantic to the Pacific has been under discussion. Although the isthmus is wider in Nicaragua than in Panama, the potential Nicaraguan site has the advantage of being hundreds of miles north (closer to US and Caribbean ports) and significantly closer to sea level than the Panama Canal route. Now, under the leadership of Daniel Ortega, this dream is coming closer to reality.

In June of 2013, a Chinese entrepreneur, Wang Jing, and his new company HKND, won a US$40bn contract to build a canal across Nicaragua. A feasibility study is underway with McKinsey as well as the Chinese government owned China Railway Construction company. Wang Jing is believed to have strong ties within the Chinese government, but he is saying little about his background or other projects. (Hille, 2013)

Although the Nicaragua Canal would be further north than the Panama Canal, and will therefore cut some distance off North American transit routes, it is likely that the canal transit itself will take a significantly longer time than the transit of the Panama Canal, and will therefore not be a significant improvement for most Canal traffic.

In 2005, China became the country with the second highest traffic in long tons through the Panama Canal, after the United States (ACP, 2005). It has remained in that position since, attaining over 46 million long tons in 2013, as compared with over 136 million long tons from the United States. However, even at 46 million tons, freight from China comprises only about 11% of the total canal traffic (421 million long tons in 2013).

From the quantity and sophistication of infrastructure projects in China, we can assume that HKND is likely to have access to engineering resources to be able to successfully design a Nicaraguan Canal if they determine that the project is practical. However, until the exact anticipated route is identified and all the potential issues identified and evaluated, the project is still speculative.

Balboa – Monetary and Fiscal Situation

The Panamanian currency, the Balboa, is pegged as equal to the US dollar, which equivalence tends to have a substantial moderating influence on inflation. Even with the influx of capital for the canal expansion, near-term inflation is expected to remain below 4% for the next few years. The expansion project investment has led to an increase in the current account deficit to $3.4 bn, but it is expected to shrink again once the expansion project is over, now scheduled for the end of 2015. (EIU, 2014). As an estimated 37% of oceangoing ships are now too large for the current canal, the expansion project investment is expected to pay off in increased income to Panama and profits to the Panama Canal Authority for the foreseeable future.

Breaking News – Conflict with Venezuela

As this is being written, Venezuela is threatening to not pay loans it has received from Panamanian exporters as part of its break in diplomatic ties due to Panama’s call for the Organization of American States (OAS) to investigate recent violence in Venezuela. Panamanian diplomats have been told to leave the country.

Venezuela’s foreign minister, Elias Jaua, says the debt is fraudulent, as the goods were never received. (Associated press, 2014) but this refusal is coming suspiciously at a time when Venezuela’s currency has seen a precipitous devaluation, raising its debt total to Panama to an estimated $1 bn. One Venezuelan economist, Francisco Chirinos, claims that the pending loan accounts total closer to $2 bn US and the Venezuelan national treasury is in a shortage of foreign currency. (Tase, 2014) On the black market, the primary responsive market for Venezuela’s currency, its value has dropped several fold.

The diplomatic breakdown may potentially affect Venezuela’s investments in the Colon SZE, which could be a significant problem as Venezuela is the Colon SZE’s largest partner, accounting for about 30% of its total business. (Mallen, 2013)

US / Panama Trade Promotion Agreement

The United States-Panama Trade Promotion Agreement (TPA) was signed on June 28, 2007. Panama approved the TPA on July 11, 2007. The TPA was signed into law in the United States on October 21, 2011, and entered into force in both countries on October 31, 2012. (USTR, 2014) The terms of the treaty include more favorable tariffs and lower restrictions than most other WTO countries and an agreement for Panama to improve its Tax transparency laws. Panama has modified its domestic tax transparency laws in 2010-2011 to improve its ability to comply with the agreed US government requirements.

Although substantial documentation is available on the negotiation process and expected benefits to the United States of this agreement, little information is available regarding its actual effects, except one comment from an America businessman that “it’s easier for a Terrorist

TOURISM

Tourism comprises a small but growing sector of Panama’s GDP, and unlike Canal and SEZ zone economic activities, has the potential to improve opportunities for inhabitants of more rural parts of Panama, who have previously been left behind in the economic boom. About 85% of the poor in Panama live in rural areas (World Bank, 2007) and the Panamanian government’s investments have been focused on the Panama Canal expansion rather than rural improvements.

According to a World Bank working paper (Klytchnikova, 2012), the tourism industry has the potential to reduce poverty by bringing jobs out to the rural parts of Panama and also driving infrastructure improvements necessary to serve the tourist markets, which would also help the agriculture industry by improving access to markets. Panama already has a significant tourism industry; expenditures by foreign tourists in 2006 totalled $970 million, accounting for 6% of GDP. Although much of current tourism is based on shopping (82% in 2008 according to a survey performed by the authors of the World Bank report), the authors make the case for investments in beach, cultural, ecotourism, and adventure tourism in more rural and impoverished areas of the country to attract tourists with different vacation goals. Receipts from foreign tourists also tend to have a multiplier effect as much of hotel and restaurant receipts are typically spent in the same region.

CONCLUSION – LOOK INTO THE FUTURE

Although Panama is a small country, with a total population of under 4 milllion, its economic situation has many dimensions, both positive and negative. Some of the key positive and negative factors are listed below, with a brief statement as to their anticipated effects.

Factors expected to have positive impacts include:

- **The Panama Canal and its expansion:** The sterling reputation and operational efficiency of the Panama Canal Authority have made the Canal a reliable asset to world trade that is likely to bring ongoing income to Panama and its people for the foreseeable future. In addition, the investment in the current expansion is likely to lead to augmented traffic due to pent up demand, and preparations in Eastern coast and Caribbean ports indicate that the worldwide inventory of ships is only going to increase in the future.
- **Special Economic Zones (SEZ’s):** Although rife with smuggling and money laundering, the conjunction of the world class trade channels both overland and through the canal, with the liberalized trade and financial regulations is a magnet for all kinds of enterprise, even with the off-putting aroma of corruption.
- **Panama’s Fiscal and Monetary policy:** Although many Latin American countries have gotten themselves in trouble through overvaluation of their currencies while being pegged to the US dollar, the Balboa is unlikely to meet a similar fate due to the transparency of Panama’s economic policies and procedures and their real investments in infrastructure that will benefit all the trading world. Fiscally, Panama tends to spend its revenues on the sectors responsible for its long-term financial solvency, the Canal and the financial and export services sector.

Factors expected to have negative or potentially negative impacts to Panama's economy include:

- **Corruption, especially in the SeZ:** The biggest disincentive to direct investment from legitimate businesses in Panama is the perception of a culture of corruption, smuggling, and money laundering, especially in the special economic zones. This perception is not improving as measured by independent organizations such as Transparency International. Corruption is one of the leading causes of political instability and political instability is almost always economically disruptive as well. One positive move made by the government was to enact laws to enhance transparency with respect to bank deposits from other countries, notably the United States, which will help its relationships with these important trading partners but which may not be enough to guarantee ongoing stability.
- **Poverty and Inequality:** Although the overall economic metrics are generally positive, Panama has a significant portion of its population living in poverty and even extreme poverty, and the economic advantages are not reaching them. Without a determined effort, this economic inequality will not improve and may become a source of instability. By the end of 2015, the big infrastructure project, the canal expansion will wind down and the thousands who were able to find construction jobs will need other employment. It may well behoove the government to consider investment and/or favorable regulations to industries such as agriculture and tourism that may bring decent livelihoods to Panama's undereducated and underdeveloped rural regions.
- **Vulnerability due to the unique monetary situation:** Although the equality of the Balboa with the US$ has provided stability and reliability over the years, the lack of a central bank may cause problems in situations like the current standoff with Venezuela, where some banks who are owed money on the up to $2 billion in Venezuelan loans may have to write the loans off and accept substantial losses. It's not clear that the banks are better off in this situation without a central bank to provide a "lender of last resort."
- **Potential competition from a Nicaragua canal:** The Nicaraguan canal, if it is actually built, will take at least several years to complete. It is by no means a certainty at this point, as the initial engineering study is still underway, and the anticipated cost is enormous (estimated between $40 billion and $100 billion). Although Nicaragua is several hundred miles farther north than the Panama canal and will therefore reduce transit time to and from the canal, it is also going to be substantially longer than the canal in Panama and therefore transit time through the canal is likely to be longer. Any navigable canal in Nicaragua will provide some substantial competition, however, and the Panamanian government would do well to develop incentives and infrastructure for other industries to provide alternative sources of revenue.

All in all, Panama's future is bright for the economic elite, even as the construction of the Panama Canal expansion is realized, but a couple of economic clouds on the horizon indicate that some diversification of Panama's portfolio of industries may be wise, to help all its citizens join in the prosperity and to attract world class companies with a low tolerance for smuggling, money laundering, and other lawlessness.

If the new administration of Panama's government continues to make good decisions like the segregation of the Panama Canal authority from the national government, then Panama can expect to experience continued healthy economic growth in the upcoming years.

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