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PANAMA
COUNTRY RISK ANALYSIS

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PANAMA

COUNTRY RISK ANALYSIS

Executive Summary

Transfer Risk

Panama's near-term transfer risk (the unwillingness or inability to continue remittances of capital, dividends, or interest payments to foreigners) is moderately low. International reserves, at $207 million at the end of 1983, represented somewhat more than one month's import cover for all imports, including Canal Free Zone imports for re-export. More importantly, reserves cover seven months' of domestically consumed imports. Panamanian authorities have had on-going discussions with both the IMF and IBRD that allow continued access to the credit of these institutions. Moreover, Panama's role as an offshore banking center provides strong impetus to remain creditworthy and contributes to the country's continued low transfer risk. High creditworthiness is integral to any financial center and Panamanian authorities recently have demonstrated a willingness to do everything within their power to repay debt in a timely fashion without resort to a formal debt rescheduling. Thus, in the near-term, Panama possesses an ability and willingness to remain current on external payments.

Economic Risk

The Panamanian economy is in a second year of recession due to the slowdown in world trade and finance. As a result, fiscal and external deficits initially rose rapidly until the authorities, under the auspices of an IMF stabilization program and an IBRD structural adjustment loan, moved quickly to reduce government spending and imports. Because the authorities moved decisively to curtail spending, Panama has been able to avoid excessive short-term borrowing and external debt accumulation. The country has maintained a good dialogue with international banks that allows Panama to refinance principal repayments without difficulty and its interest payments are current. Panama enjoys a good degree of creditworthiness that has only been slightly tarnished by the recent economic slowdown. Economic reform under the structural adjustment loan, especially with respect to investment spending, give good reason to believe that the country's economic risk will improve in the next three to five years.

AID Loan to Panama

AID's proposed housing loan to Panama will make a substantial contribution to the country's housing program and at the same time help it to realize measurable savings over alternative sources of financing. Moreover, the grace periods of the housing loan can be structured to bridge a period of

relative illiquidity for the country. Debt service in the years 1985 and 1986 is expected to be comparatively more difficult because of slower earnings and hence a 3-5 year grace period on interest repayment would be useful. The 10-year grace on repayment of principal is less relevant as the country is not expected to have any debt service difficulties at that time. The size of interest and principal payments from AID's housing loan will have no appreciable affect upon total debt service over the life of the loan.

Table 1

Key Economic Indicators

	1982	1983	1984E	1985E	Average 1985-89E
Real GDP (% change)	5.5	0.0	1.0	3.0	3.0
Inflation (% change)	4.3	2.1	1.8	2.0	4.0
Trade balance* ($ millions)	-630	-586	-550	-600	-700
Current account ($ millions)	-140	165	200	150	100

* Includes Free Zone imports, exports and re-exports.

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Current Economic Developments

Panama's real GDP growth was nil last year due to the slump in offshore banking activity and canal tolls. The economy will improve only marginally in 1984 before attaining moderate growth in 1985 and beyond. Agriculture realized 3% real growth last year, but this was largely due to government price subsidization of some crops. In cooperation with its IMF program, these subsidies are being phased out and as a consequence, the agricultural sector should experience little growth this year or next. Panama's agricultural sector has been a perennial lagger, but increasing investment is being channelled into areas identified as having a comparative advantage in export trade.

The structure of Panama's economy has changed dramatically in the past two decades from a closed agricultural economy to an open international-oriented service economy. For example, agriculture's share in GDP has fallen from 23% in 1960 to 10% in 1983, while financial services, which were almost nil in 1970, accounted for 13% of GDP last year. Panama's entire service economy now comprises nearly one-half of GDP.

Panama's openness has generally fostered good economic policies that have earned it an important niche in international finance. But at the same time, the economy is now more subject

to the vicissitudes of world trade and the swings in Panama's business cycle can be considerable. However, the country's economic management seem to have adapted to the faster changing environment and are able to quickly formulate and implement policy changes.

Panama has been very successful in recently bringing down inflation to about 2% or less. This is all the more remarkable because fiscal policy is the only available policy instrument for domestic price stabilization. There is no monetary authority given that the U.S. dollar is legal tender within the country and the nation's stock of money depends upon short and long-term capital flows in the balance of payments. High international interest rates have been drawing Panamanian dollars abroad and domestic credit is presently tight, helping to slow private spending. Slower government spending has also been an important component to the lower inflation outlook.

Fiscal Policy

The government's principal goal in its IMF Stabilization Program has been to reduce the fiscal deficit through a combination of lower spending and increasing tax revenues. In 1982, the deficit reached a very high equivalent of 11% of GDP, necessitating rapid fiscal reform (see Table 2). Since the July 1983 IMF program began, there appears to have been a dramatic

reduction in the 1983 deficit to about 6% of GDP. (However, unofficial estimates put the 1983 deficit as high as $400 million or almost 9% of GDP). The IMF program, which is also supported by an IBRD Structural Adjustment Loan (SAL) and Inter-American Development Bank funds, expect tax revenue collection to rise faster than expenditures enabling the budget deficit to remain below 5.5% of GDP throughout the 1985-89 period. An important secondary objective of this medium-term program is to reduce the role of the public sector through encouragement of private sector investment. Both domestic and foreign investment are expected to eventually replace state enterprises and official intervention in domestic price setting.

Table 2

Government Finance
($ millions)

	1980	1981	1982	1983E	1984E	1985-89 Targets
Revenue	695	826	1,055	1,047	1,095	4.0% growth
Expenditure	886	1,058	1,517	1,317	1,370	3.0% growth
Deficit	-191	-232	-462	-270	-275	N/A
Deficit as % of GDP	5.4	5.5	11.0	6.0	5.5	5.5% or less

The Offshore Banking Sector

At the end of 1983, international banks had booked $25.6 billion of loans in Panama, which was down from the $27.9 billion peak reached in December, 1982. This ranked Panama fifth in asset size among the world's 13 offshore banking centers. In terms of employment and income, banking has been the fastest growing sector in the Panamanian economy. The 127 international banks with offices in Panama paid taxes and fees that amounted to almost 9% of GDP last year and employed almost 2% of the country's labor force. Since 1983, however, a slowdown in bank lending to Latin America, which accounts for 73% of all loans booked in Panama, has adversely affected growth in the sector. Panamanian authorities are attempting to halt the slide in offshore banking by attracting the offshore banking units (OBUs) that are leaving the declining Miami, Florida market. Due to the considerable advantages that offshore banking enjoys in Panama, the sector is unlikely to shrink significantly, although its future growth will remain linked to successful renegotiaton of Latin American debt.

Panama's offshore banking activities also place a special burden on the country's economic management. Due to the adverse effects a debt rescheduling would have on offshore banking confidence, the country must strive heartily to remain current

on external payments. Moreover, foreign exchange controls of any kind would be an anathema to its role as a financial center. As a result, Panama has no restrictions on external payments for visibles, invisibles or capital flows. This requires the maintenance of a minimal level of foreign exchange reserves to bridge occasional periods of illiquidity. Finally, the U.S. dollar is legal tender and circulates freely in Panama. The balboa is the local currency but is issued in coin only and is pegged to the U.S. dollar at par. This arrangement effectively eliminates monetary policy as a tool in Panama's domestic economic adjustment as no central bank exists to control monetary emission. The nation's money supply is essentially adjusted by U.S. dollar flows on capital account in the balance of payments.

Policy Reform and External Creditor Relations

In 1983, Panama borrowed $337 million from commercial bank creditors of which $278 million was used to refinance maturing principal repayments. This year an additional $288 million of principal is expected to be refinanced with bank creditors. Due to its importance as an offshore banking center, Panamanian authorities have been careful to emphasize that these are normal refinancings of principal and not formal debt reschedulings. Interest payments are current and the country is able to borrow medium and long-term funds in eurocurrency markets.

Panama's 18-month $160 million IMF stand-by program will expire at the end of 1984. IMF officials are presently in the country discussing a second stand-by for next year. The principal conditions of both stand-bys involve: decelerating the rate of public sector investment in development programs; reducing the fiscal deficit to about 5-6% of GDP; and reforming of customs administration to improve revenue collection. Panama's relations with the IMF have been characterized as cooperative, and there is every expectation that a second stand-by will be mutually agreeable. Panama's quota at the IMF is approximately $109 million and the country, at 328% of quota, is in the middle range of credit tranches, leaving over $200 million in additional borrowing capacity with the Fund. In addition, Panama has drawn $63 million in compensatory financing for export earnings shortfalls that were due to circumstances beyond the country's control.

Panama's one-year $60 million SAL expired at at the end of June, 1984. The success achieved in the first program has prompted the IBRD and government authorities to seek a follow-on SAL of roughly the same amount. Both SAL's concentrate on developing Panama's comparative advantage in non-traditional exports and further opening up external trade through gradual elimination of tariff and non-tariff barriers. There will also be considerable investment in infrastructure (including sizable housing expenditures) that will allow Panama to exploit its

comparative advantage in banking and other financial services. Crops and agri-industries (cocoa, coffee, palm oil, bananas, cattle and fishing) will be encouraged, while inefficient subsidization of other non-economic crops will be ended (i.e., sugar and some tree crops). A second major thrust of the SAL will focus on reforming the labor code that has discouraged private investment or unduly encouraged capital-intensive investment. Light manufacturing and imported parts for assembly and re-export are expected to benefit from these SAL reforms.

Substantial progress was achieved under the first SAL because many of the initial decisions could be made by the executive branch of government with relatively little political discord. The second SAL will be dealing with problems of a more difficult nature and many of the decisions will involve politics and the national legislature. This is not to say that the second SAL will not succeed, but only that progress will be more difficult.

Balance of Payments

In May, 1984 the IMF's commodities price index of 34 primary products reached a 3-1/2 year high, although the index was only 12% above its five-year low of 1982. Since May, 1984, however, the index has fallen about 7% so that commodity prices

are just barely above the lows of 1982. This has occurred despite a pick-up in industrial country economic activity and rising consumption demand for commodities. High U.S. interest rates have made it too expensive to hold sizeable commodity inventories and thus the overall demand for primary products is down. A strong U.S. dollar has also kept commodity prices expensive in non-U.S. dollar terms which has further weakened European demand.

The most important factors in the near-term outlook for commodity prices will continue to be U.S. interest rates and the strength of the U.S. dollar. Commodity prices should be able to recoup some of their recent losses when interest rates and the dollar turn down after mid-1985 as expected. However, a rapid long-term rise in commodity prices is unlikely in view of the increased supply capacity that has been built in recent years in many LDC's. Moreover, industrial countries have become more efficient in the use of primary products which has raised the amount of GDP produced per unit of primary product consumed. Even so, growing population and industrialization around the world will support a steadily rising demand for the volume of commodities with the most likely outcome being a gradual price rise in the longer term, albeit at a slower pace than in the past.

Panama's most important commodity exports are bananas, shrimp and sugar and excepting sugar, the prices of these commodities have held up reasonably well. The volume of exports, however, declined in 1983 and will improve only marginally this year. A similar situation exist with respect to Panama's service earnings. They were nearly halved in 1982 from a considerable slowdown in Canal traffic and are not back to former levels. Panamian authorities, however, reacted swiftly to the fall in foreign exchange earnings by sharply cutting imports. This policy successfully resulted in limiting the current account deficit to 1982 only (see Table 3).

Panama's overall net capital inflow has typically been strong, but this sometimes obscures significant short term capital outflows as occurred in 1981 and 1982. The outflows seem to have resulted in a significant rundown of foreign liabilities between June, 1982 and December, 1982 (see Table 4). One of the goals of the IMF Stabilization Program has been to stabilize the short term capital outflow, and judging by the most recent change in net foreign assets, it appears that some success has been achieved.

As indicated in Table 3 below, the medium to long-term outlook for Panama's balance of payments is good. The current account is expected to be in slight surplus and a strong capital inflow should continue. This should permit a moderate rate of development without excessive external debt accumulation.

Table 3

Balance-of-Payments Summary
($ millions)

	1981	1982	1983	1984	1985	Average 1985-89
Trade balance*	-752	-630	-586	-550	-600	-700
Exports (fob)	2,568	2,412	1,726	1,850	1,900	2,600
Imports (fob)	-3,320	-3,042	-2,312	-2,400	-2,500	-3,300
Service balance (net)	800	455	711	700	700	750
Transfers (net)	31	35	40	50	50	80
Current account	79	-140	165	200	150	100
Capital account (net)	955	1,321	1,000	900	800	900
Change in reserves	+3	-19	+106	+50	+50	+50

*Includes Free Zone imports, exports and re-exports

External Debt Profile

Almost 90% of Panama's external debt is owed to commercial banks, but despite the burden of this relatively higher costing debt, the debt-service ratio at the end of last year was a low 6% of current account receipts. Even including short-term repayments due within one year raises the debt-service ratio only modestly to a still low 10%. This ranks Panama among the lowest of LDC debtor nations. However, about one-half of Panama's external debt is on variable interest rate terms which gives rise to a moderate degree of interest rate risk.

Moreover, Panama's external debt is relatively high on a per capita basis at approximately $1700 per person, which is also a comparatively high 78% of per capita GDP.

As noted in Table 4 below, Panama's external asset positio has undergone a marked change. Until the end of 1982, a trend had been estalished that was reducing the size of foreign liabilities, i.e., net foreign assets were becoming less negative. In mid-1983, however, foreign liabilities of the banking system, especially the Panamanian Treasury, increased sharply. As noted earlier, the deterioration of the banking systems' net foreign assets appears to have been halted. Similarly, Panama's external position with respect to international commercial banks has been improving. The liability line represents Panama's role as a financial center with foreign deposits and loans booked in the country, and the asset line is mostly the value of foreign vessels registered in Panama.

Due to the largely successful efforts to control the growth of Panama's external debt, it is expected that debt will rise by about 3% between 1983 and 1986, before increasing by a still moderate 5% or more throughout the remainder of this decade. Debt service over the period will be manageable, although it will be relatively high (in comparison to current account earnings) in the 1984-86 period due to recent past borrowings.

Panama has been successful in rolling over principal repayments with commercial banks and there is every expectation that this will continue. To the extent possible, however, it would be helpful to have grace periods that bridge the country's 1984-86 period of relatively more difficult debt repayment. It is important to note, however, that Panama's debt service burden throughout the period will be both modest and manageable. This is especially true when Panama's debt situation is compared to that of other LDC's.

Table 4

External Position of Panama with International Banks
($ millions)

	Dec '79	Dec '80	Dec '81	June '82	Dec '82	June '83	Dec '83
Assets	17,836	14,396	15,046	14,283	16,030	16,699	18,290
Liabilities	21,132	21,588	25,716	25,173	27,865	26,772	25,609

Source: Bank for International Settlements, Basle, Switzerland, April, 1984.

Net foreign assets with all foreign entities	-913	-605	-722	-428	-89	-537	-424

Source: IMF, International Financial Statistics, various issues.

Table 5

Public/Publicly Guaranteed and
External Debt Including Undisbursed
($ millions)

	1982	1983	1984	1985	1986	1987	1988	1989
Total debt outstanding	3,387	3,600	3,710	4,155	4,363	4,581	4,810	5,051

Sources: 1982 base year IBRD, World Debt Tables; projections as per assumptions discussed above.

Table 6

Public Debt Service*
($ millions)

	1983	1984	1985	1986	1987	1988	1989	1990
Official creditors	81	87	90	101	151	160	160	160
Private creditors	413	447	460	515	496	519	553	581
Total debt service	494	534	550	616	647	679	713	681
Less: Net private rollovers	(278)	(288)	(264)	(250)	(250)	(250)	(250)	(250)
Equals net debt service	216	246	286	366	397	429	463	431
Total debt service ratio (%)**	5.5	7.0	8.0	9.0	7.3	6.8	7.2	7.0

Source: 1983 base year IBRD, World Debt Tables; projections as discussed above.

* Projected debt service assumes that official creditor terms are 8% interest, 20 year maturity and 5 years grace period; private creditor terms are 14.5% interest, 8.5 years maturity and 4 year grace period. Net debt service acknowledges that commercial banks customarily rollover principal repayments on medium and long term debt as long as the country maintains creditworthiness. The debt service ratio above, however, is based on debt service before rollovers.

** The debt service ratio is calculated on current account receipts.