INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/11

PANAMA

January 2019

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PANAMA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Panama, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its December 12, 2018 consideration of the staff report that concluded the Article IV consultation with Panama.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on December 12, 2018, following discussions that ended on October 3, 2018, with the officials of Panama on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 20, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Panama.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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December 28, 2018

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IMF Executive Board Concludes 2018 Article IV Consultation with Panama

On December 12, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Panama.

Despite slowing in 2018, Panama is expected to remain among the most dynamic economies in the region with strong fundamentals. Growth is estimated at 3.7 percent in the first half of 2018 (compared to 5.4 percent a year ago), reflecting a sharp deceleration in key sectors including construction, which was affected by a prolonged strike in April/May. The unemployment rate increased marginally to 5.8 percent in March 2018 from a year ago, reflecting less dynamic activity. Inflation remains subdued at 0.8 percent (year on year) in September 2018, (compared to 0.5 percent in December 2017) despite supply shocks that have increased food and fuel prices. The overall deficit of the Non-Financial Public Sector (NFPS) reached 1.6 percent of GDP in the first half of 2018 (compared to deficit of 0.2 percent of GDP in the first semester of 2017), due to accelerated budget execution to support the economic weakening. The external current account deficit stood at 8.0 percent of GDP in 2017, as a significant increase in oil imports (fueled by higher international oil prices) was offset by strong service exports, driven partly by additional revenue from the expanded Panama Canal. Credit growth has decelerated as financial conditions have started to tighten.

The outlook remains positive, albeit set against heightened downside risks. Growth is projected at 4.3 percent in 2018, but to rebound to 6.3 percent in 2019 supported by the opening of a large mine (*Minera Panamá*) and a recovery in construction, and subsequently converge to its potential of 5½ percent over the medium term. Inflation is expected to average about 2 percent. The external current account deficit, mostly covered by FDI, is expected to reach 9 percent of GDP in 2019 and gradually decline to about 5½ percent of GDP over the medium term. Fiscal policy is expected to remain guided by the amended Fiscal Responsibility Law (FRL). The overall NFPS deficit is projected to increase to 2 percent of GDP in 2018–19 and gradually fall to 1½ percent of GDP over the medium-term, keeping public debt sustainable and below the FRL indicative of target of 40 percent of GDP. Key risks relate to setbacks in implementing the remaining Financial Action Task Force (FATF) recommendations and making continued

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

progress on tax transparency, continued oversupply in the domestic property markets, delays in completing the large mining project (following the recent Supreme Court ruling which creates uncertainty about some elements of the contract), political uncertainty ahead of the upcoming elections; a sharper-than-expected tightening of global financial conditions, and rising trade protectionism.

Executive Board Assessment[2]

Executive Directors commended Panama's impressive growth performance and noted that macroeconomic fundamentals remain solid, with growth set for a rebound in the near term. Directors considered that, while the outlook remains positive, the balance of risks is tilted to the downside. Against this background, they called for sustained policy efforts to strengthen the AML/CFT framework and enhance tax transparency to preserve Panama's competitive advantage as a regional financial center. They also recommended measures to enhance financial sector resilience and reforms to facilitate continued robust and inclusive growth.

Directors welcomed the recent good progress on technical compliance with FATF standards, bringing Panama on par with its peers, while underscoring the importance of effective implementation of the Anti-Money Laundering/Combatting the Financing of Terrorism (AML/CFT) framework. In this context, they encouraged the authorities to continue strengthening supervisory capacity for AML/CFT oversight, including through risk–based approaches, and further addressing AML/CFT risks to which Panama is exposed. Directors emphasized the need to promptly address the remaining shortcomings in the AML/CFT framework, including making tax crimes a predicate offense to money laundering and ensuring the availability of timely and accurate beneficial ownership information of entities incorporated in Panama. In addition, the authorities should advance the implementation of tax transparency initiatives to ensure a successful Global Forum assessment against enhanced standards.

Directors were encouraged by the authorities' continued commitment to a prudent fiscal stance and agreed on the importance of preserving the track record of fiscal discipline to keep the public debt-to-GDP ratio on a downward trajectory. They concurred that the revised deficit ceilings provide the budgetary space to accommodate additional capital spending, given the softening activity this year, but recommended a gradual withdrawal of the stimulus in the near term as growth gathers pace. Directors also saw scope for raising tax revenue through improvements in revenue administration to support key social expenditures. They welcomed modifications to the social fiscal responsibility law, which simplified and enhanced the transparency of the fiscal rule; and noted the approval of a law to establish a fiscal council, which further bolsters the fiscal framework.

Directors noted the stability of the financial system and the continued progress in financial sector reforms, including the alignment of prudential regulations with Basel III. They urged the authorities to strengthen risk-based supervision and reiterated the importance of putting in place

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

robust frameworks for crisis management and bank resolution. In addition, Directors recommended measures to further strengthen macro-prudential policies and systemic risk oversight, including through improved inter-agency coordination.

Directors called for a reinforcement of the structural reform agenda to sustain high potential growth, while also reducing inequality. They agreed on the need to sustain productivity growth through reforms to improve skills and education quality, attract talent, and further improve the investment climate. Strengthening social policies to continue reducing poverty, improve income distribution, and ensure inclusive growth over the medium-term were also encouraged.

Panama: Selected Economic and Social Indicators

Population (millions, 2016)	4.0	Poverty line (percent, 2017)	20.7
Population growth rate (percent, 2016)	1.6	Adult literacy rate (percent, 2010)	94.0
Life expectancy at birth (years, 2016)	77.9	GDP per capita (US$, 2017)	15,317.7
Total unemployment rate (August, 2018)	6.0	IMF Quota (SDR, million)	376.8

				Projection					
	2015	2016	2017	2018	2019	2020	2021	2022	2023
				(Percent change)					
Production and prices									
Real GDP (1996 prices)	**5.8**	**5.0**	**5.4**	**4.3**	**6.3**	**5.8**	**5.6**	**5.5**	**5.5**
Consumer price index (average)	0.1	0.7	0.9	1.5	2.0	2.1	2.0	2.0	2.0
Consumer price index (end-of-year)	0.3	1.5	0.5	1.5	2.0	2.1	2.0	2.0	2.0
Output gap (% of potential)	-0.4	-0.3	-0.1	-1.2	-0.5	0.1	0.0	0.0	0.0
Domestic demand (at constant prices)									
Public consumption	**7.0**	**11.8**	**10.1**	**9.0**	**5.6**	**5.0**	**5.6**	**4.9**	**3.7**
Private consumption	7.5	19.1	17.2	6.3	6.8	5.4	4.3	4.8	4.1
Public investment 1/	-8.8	-1.1	-10.2	-4.8	9.5	1.1	2.8	-0.9	4.1
Private investment	6.5	0.8	6.1	6.6	4.9	5.2	4.6	5.0	4.3
Financial sector									
Private sector credit	**11.4**	**8.4**	**6.5**	**5.0**	**6.0**	**7.1**	**6.8**	**6.8**	**6.9**
Broad money	5.5	4.1	5.2	5.3	6.7	8.0	7.6	7.5	7.5
Average deposit rate (1-year)	2.7	2.7	2.7	...	...	...	...	...	...
Average lending rate (1-year)	3.3	3.5	3.5	...	...	...	...	...	...
External trade									
Exports of goods and services	**-1.5**	**-9.1**	**7.9**	**3.9**	**9.6**	**9.3**	**7.2**	**6.5**	**6.4**
Imports of goods and services	-11.1	-6.4	5.8	8.5	6.1	5.9	5.8	6.1	6.2
				(In percent of GDP)					
Saving-investment balance									
Gross domestic investment	**44.7**	**44.6**	**43.8**	**44.0**	**43.5**	**42.9**	**42.3**	**41.8**	**41.2**
Public sector	6.3	5.9	4.8	4.4	4.5	4.3	4.2	3.9	3.7
Private sector	38.4	38.7	39.0	39.6	39.0	38.6	38.1	37.8	37.5
Gross national saving	36.8	36.6	35.8	35.0	35.9	36.7	36.8	36.3	35.8
Public sector	4.9	5.2	6.0	5.1	5.5	5.5	5.3	5.0	4.8
Private sector	32.0	31.5	29.8	29.8	30.3	31.2	31.5	31.3	31.0
Public finances 1/									
Revenue and grants	**22.6**	**22.6**	**22.1**	**22.2**	**22.2**	**22.3**	**22.1**	**22.0**	**21.8**
Expenditure	25.9	25.5	24.1	24.4	24.5	24.1	23.8	23.3	22.8
Current, including interest	16.9	17.2	17.4	18.3	18.1	18.0	17.9	17.7	17.5
Capital	8.9	8.3	6.8	6.2	6.4	6.1	5.9	5.5	5.3
Overall balance, including ACP 2/	-3.3	-2.9	-2.1	-2.2	-2.3	-1.8	-1.7	-1.3	-1.0
Overall balance, excluding ACP 2/	-2.2	-1.8	-1.6	-2.0	-2.0	-1.7	-1.7	-1.5	-1.5
Total public debt									
Debt of Non-Financial Public Sector 3/	**37.2**	**37.4**	**37.8**	**38.3**	**37.3**	**36.2**	**35.2**	**34.1**	**33.2**
External	28.8	29.2	29.7	29.8	27.6	24.1	21.6	19.7	17.8
Domestic	8.4	8.1	8.1	8.5	9.7	12.1	13.5	14.4	15.4
Debt of ACP	5.1	4.8	4.1	3.5	2.9	2.4	1.9	1.5	1.2
Other 4/	3.3	4.0	3.7	3.5	3.2	3.0	2.8	2.6	2.4
External sector									
Current account	**-7.9**	**-8.0**	**-8.0**	**-9.0**	**-7.6**	**-6.2**	**-5.6**	**-5.4**	**-5.4**
Net oil imports	3.5	3.4	3.8	5.1	5.1	5.0	4.9	4.8	4.7
Net foreign direct investment inflows	7.3	8.0	7.5	6.6	5.8	5.9	6.0	5.8	5.8
External Debt	160.6	155.1	143.7	150.7	153.0	153.3	152.6	151.3	150.7
Memorandum items:									
GDP (in millions of US$)	54,316	57,821	61,838	65,465	70,981	76,706	82,632	88,926	95,704

Sources: Comptroller General; Superintendency of Banks; and IMF staff calculations.
1/ Includes Panama Canal Authority (ACP).
2/ Starting from 2015, includes overspending allowed under Article 34 of Law 38 of 2012.
3/ Non-Financial Public Sector according to the definition in Law 31 of 2011.
4/ Includes contingent liabilities of ENA, ETESA, and AITSA.

INTERNATIONAL MONETARY FUND

PANAMA

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

November 20, 2018

KEY ISSUES

Background. Panama has had the longest and fastest economic expansion in recent Latin American history. The economy has expanded at an average rate of about 6 percent per annum over the last quarter of a century, with Panama achieving one of the highest per capita income in Latin America. More recently, GDP grew by about 5½ percent in 2017 (driven by the expanded Canal), and then slowed to 3¾ percent (y/y) in H1-2018. Inflation remained subdued, reaching almost 1 percent (y/y) in September 2018. The external current account deficit stayed at 8 percent of GDP in 2017, mostly covered by FDI. The fiscal position continued to be strong, with the overall deficit of the non-financial public sector (NFPS) at about 1½ percent of GDP. Credit growth has decelerated as financial conditions have started to tighten.

Outlook and Risks. The outlook remains positive. Growth is projected to decelerate to 4⅓ percent in 2018 and to rebound to 6⅓ percent in 2019 before converging to its potential of 5½ percent over the medium-term. However, the balance of risks is tilted to the downside. Domestic risks include reputational risks from potential setbacks in addressing outstanding GAFILAT recommendations and tax transparency initiatives, as well as risks to financial stability and the real sector from the oversupply in property markets and winding down of several large infrastructure projects. External risks include rising protectionism, a sharper-than-expected tightening of global financial conditions that may contribute to an appreciation of the U.S. dollar, and weaker-than-expected global growth.

Policy Advice. Maintain the conditions for sustained growth by preserving Panama's competitive advantage as an attractive destination for business. Further enhance AML/CFT and tax transparency and information exchange, including criminalization of tax evasion, to prepare for the Global Forum and GAFILAT reviews and solidify Panama's position as a regional financial center. Preserve fiscal discipline and establish a fiscal council. Ensure adequate buffers to mitigate fiscal risks. Further enhance revenue administration and review of tax exemptions to create space for key social needs. Rebalance expenditure from current to strategic public investment and enhance recording the public investment in fiscal accounts. Continue vigilant monitoring of the financial system and alignment of prudential regulation with Basel III. Enhance the role of the Financial Coordination Council in systemic risk assessment and put in place robust frameworks for macroprudential policy, crisis management, bank resolution and FinTech regulation.

Approved by:
Patricia Alonso-Gamo (WHD) and Zuzana Murgasova (SPR)

Discussions took place in Panama City during September 24-October 3, 2018. The staff team comprised Alejandro Santos (head), Joel Okwuokei, Olga Bespalova, Julia Faltermeier, Ruth Petcoff (all WHD), and Francisco Figueroa, who joined the mission from October 2-3. Kimberly Beaton, Metodij Hadzi-Vaskov and Vibha Nanda (all WHD) assisted the team from Washington. Alfredo Macia (OED) also participated in the meetings. The team met with the Minister of Economy and Finance Eyda Varela de Chinchilla, Banks Superintendent Ricardo Fernandez, as well as other senior public officials, and private sector representatives.

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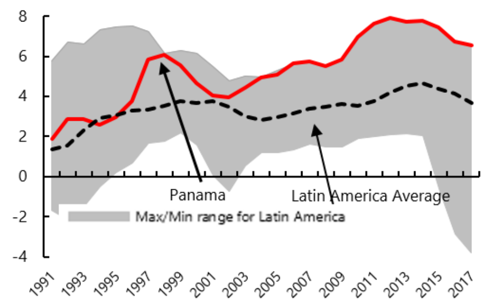
CONTEXT

Panama has been one of the most dynamic economies in the world for decades thanks to a strengthening of policy frameworks, the effects of globalization on trade, high investments, the emergence of a vibrant international financial services sector, and the expansion of the Panama Canal. Future success will depend on designing policies supporting strong and inclusive growth.

1. **Panama has been the fastest growing economy in Latin America over the last quarter of a century**. Following a period of macroeconomic instability, financial fragility and severe debt payment problems in the 1980s, Panama adopted an ambitious stabilization and reform agenda in the 1990s that led to high growth and a tripling of per capita income in real terms. Over the last decade, the economy has grown at an average rate of about 6½ percent per annum fueled by high investment, a dynamic financial sector, a thriving service sector (supported by the recent expansion of the Panama Canal), and significant increases in productivity. Panama has had the highest investment ratio in the continent at an average of over 40 percent of GDP in the last decade, and the largest relative accumulation of the capital stock.[1]

Latin America: Real GDP Growth
(In percent; 10 year moving average)



Sources: WEO and IMF staff estimates
LA includes ARG, BOL, BRA, CHL, COL, CRI, DOM, ECU, SLV, GTM, HND, MEX, NIC, PAN, PRY, PER, URY and VEN.

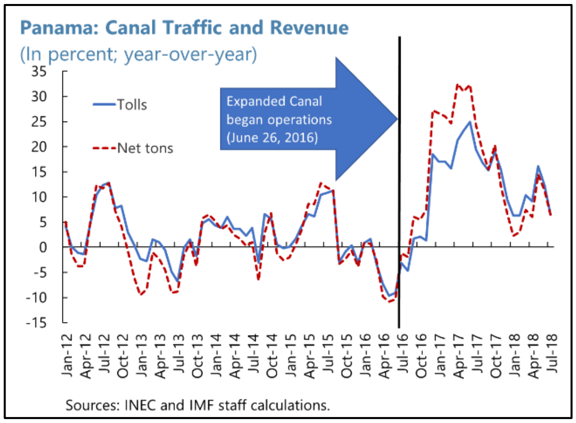
2. **The challenge ahead is to preserve the strong growth performance against the background of a deteriorating environment.** In the short run, the challenge is to maintain an adequate level of domestic demand as the construction cycle is coming to an end and large public works projects like the expansion of the Panama Canal and the airport are finished or soon to be concluded. At the same time, the external environment is deteriorating as trade disputes could reduce global trade volumes (and traffic through the Canal) and higher interest rates in the United States would dampen private investment and consumption. In the long run, the challenge is to reinforce the structural reform agenda to create the conditions for higher potential growth while reducing poverty and inequality. This requires a strengthening of education and public health services. In the immediate future, the complex political setting limits the scope for the implementation of significant reforms. The current government, which came to power in July 2014, has entered its last year in Office, with elections scheduled for May 2019, and a minority in the National Assembly, reducing the probability of implementing politically difficult policies.

RECENT DEVELOPMENTS

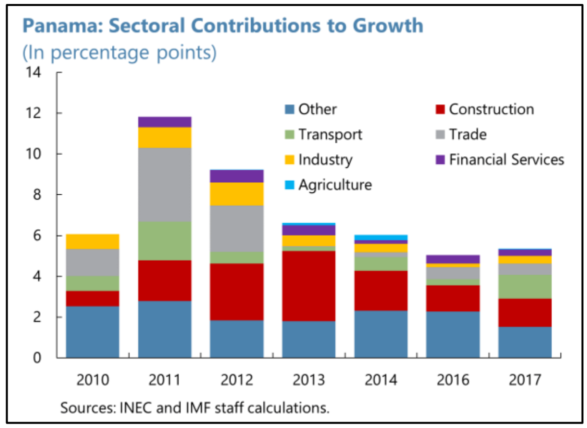
After robust growth last year, activity has subsequently softened due to a weakening in the construction sector. Inflation remains contained and without pressures. Credit has decelerated as domestic and external financial conditions have become less accommodative. The current account deficit has deteriorated in 2018 (due to higher oil prices) but remains adequately financed by FDI. The fiscal position has remained strong and in line with the fiscal rule.

[1] See the 2018 Article IV Selected Issues Paper, Chapter 1 for an overview of Panama's growth performance.

3. After robust growth last year, economic activity has temporarily slowed in 2018. The strong growth of 5.4 percent in 2017 (the highest in Latin America) was driven by a buoyant transport and logistics sector, reflecting heavy shipping traffic in the first full year of operation of the expanded Canal and robust construction activity related to large private and public infrastructure projects. However, data for the first half of 2018 indicate that activity has subsequently softened across key activities, with growth estimated at 3¾ percent due partly to a weakening in the construction (after a prolonged strike) and service sectors. The unemployment rate increased by 0.2 percentage point to 5.8 percent in March 2018 from a year ago, reflecting weakening activity.

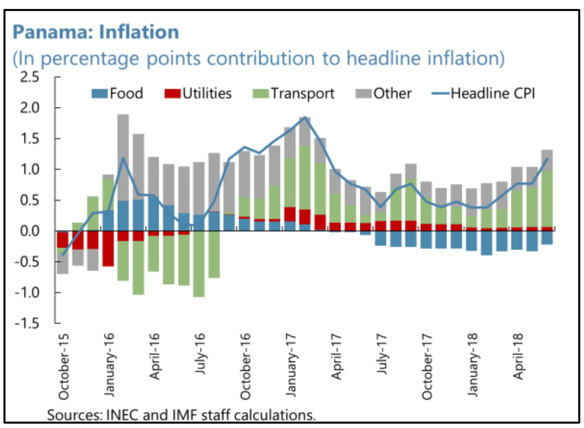


Panama: Canal Traffic and Revenue
(In percent; year-over-year)
Sources: INEC and IMF staff calculations.

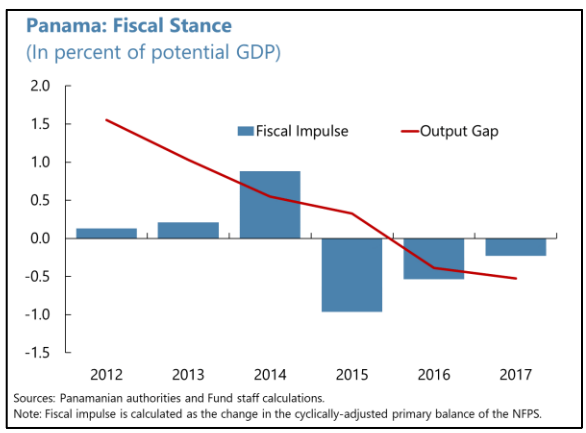


Panama: Sectoral Contributions to Growth
(In percentage points)
Sources: INEC and IMF staff calculations.

4. Inflation remains subdued. After easing to 0.5 percent (y/y) at end-2017, headline inflation picked up in September 2018 to 0.8 percent (y/y) mostly as a result of supply shocks, reflecting continued pressures from higher international fuel prices and a gradual normalization of food prices. Core inflation (excluding food and fuel prices) has remained stable at around 0.7 percent (y/y) in September 2018.



Panama: Inflation
(In percentage points contribution to headline inflation)
Sources: INEC and IMF staff calculations.



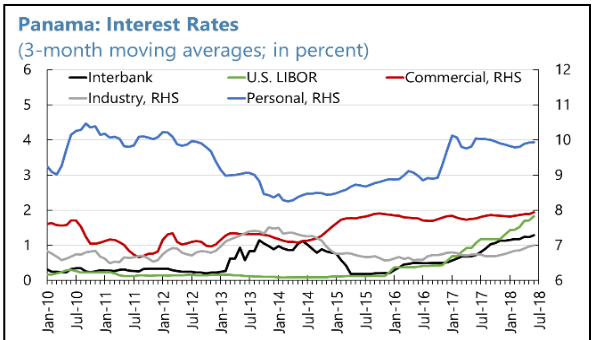
Panama: Fiscal Stance
(In percent of potential GDP)
Sources: Panamanian authorities and Fund staff calculations.
Note: Fiscal impulse is calculated as the change in the cyclically-adjusted primary balance of the NFPS.

5. The fiscal position has continued to improve, helped by higher Canal contributions. The overall deficit of the non-financial public sector (NFPS) is estimated to have narrowed to 1.6 percent of GDP in 2017 (from 1.8 percent a year earlier), which is within the limits established by the Social and Fiscal Responsibility Law (SFRL).[2] Revenues were broadly in line with economic activity, with higher

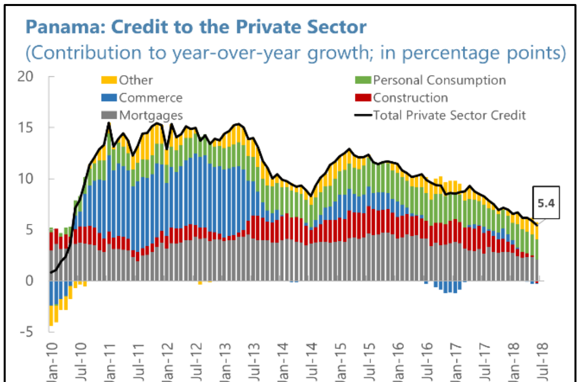
[2] The SFRL establishes the limit of the fiscal deficit for the NFPS (L) according to a formula. Such limit is equal to (what the law calls) the "adjusted" fiscal deficit (A) (which is set at 1 percent of GDP for 2017, and ½ of GDP for 2018 and beyond)

Canal contributions compensating for underperforming tax collections. Expenditures were compressed despite a substantial increase in public sector wages as public investment was crowded out. Preliminary data indicate that the overall deficit was 1.6 percent of GDP in the first half of 2018, compared to 0.2 percent of GDP last year, reflecting accelerated budget execution. On balance, fiscal policy was slightly contractionary in 2017 and is assessed to be supportive in 2018.

6. **Credit growth has decelerated as financial conditions have started to tighten.** Banks' funding costs have started to gradually rise with global interest rates, putting upward pressure on lending rates and reducing credit demand. Banks have also simultaneously been tightening credit supply, partly in response to increased indications of oversupply across some segments of the property market, with lending for construction and mortgages accounting for about 44 percent of total credit to the private sector. Credit supply has also tightened to realign credit with slower deposit growth (the main source of banks' funding). Overall, credit to the private sector grew 5.4 percent (y/y) in July 2018, down from 8.6 percent at end-2016. Nevertheless, despite the gradual increase in interest rates and slower credit growth, financial conditions remain moderately accommodative (Box 1).



Sources: SBP, Federal Reserve. Commercial, industrial and personal interest rates are the simple average of interest rates of Panamanian and foreign banks for 1-5 year terms. The interbank rate is the 1-month interbank rate.



Sources: SBP and Fund staff calculations.

7. **The external current account deficit remains adequately covered by foreign direct investment.** The external current account (CA) deficit stayed at 8.0 percent of GDP in 2017 (similar to that in 2016) as a significant increase in oil imports (fueled by higher international oil prices) was offset by strong service exports, driven partly by additional revenue from the expanded Panama Canal. Panama's real effective exchange rate (REER) depreciated by 6.3 percent in 2017 and appreciated by 1.6 percent in the first nine months of 2018, with limited impact on the current account deficit.[3,4] The current account deficit remains mostly financed by foreign direct investment (FDI), of which over ⅔ is driven by the reinvested earnings of multinational firms into Panama.

adjusted for Canal contributions (C) below a 3.5 percent of GDP threshold (or L=A+(3.5-C)). According to this formula, the maximum deficit allowed for 2017 was 1.8 percent of GDP which compares favorably with the actual deficit of 1.6 percent.

[3] Excluding the impact of Venezuela on Panama's REER.

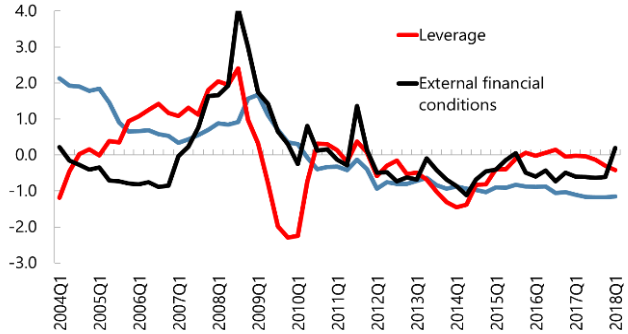
[4] Panama has accepted the obligations of Article VIII, Sections 2(a), 3, and 4, and maintains an exchange rate system that is free of restrictions on the making of payments and transfers for current international transactions.

Box 1. Growth at Risk (GaR)

Accommodative financial conditions support economic growth in the near-term but can contribute to the build-up of financial imbalances over time and put economic growth at risk. This box assesses financial conditions in Panama and uses the GaR approach to link financial conditions to the distribution of future growth outcomes for Panama.[1/]

Financial conditions in Panama have recently tightened somewhat, but on balance remain somewhat accommodative. Three distinct financial conditions indices are estimated to capture recent dynamics in: the domestic price of risk (interest rates, asset returns and price volatility), leverage (credit aggregates and growth), and external conditions (global risk sentiment, commodity prices and growth in key trading partners). These indices suggest that the price of risk in particular remains broadly accommodative, while leverage and external financial conditions are broadly neutral, having tightened and coinciding with the slowdown in credit growth domestically and the normalization of U.S. monetary policy and increase in commodity prices globally, respectively.

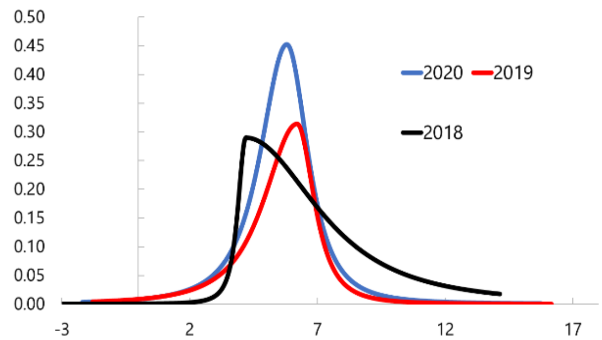
Panama: Financial Conditions
(Index)



Sources: Author calculations. Higher values indicate tighter financial conditions.

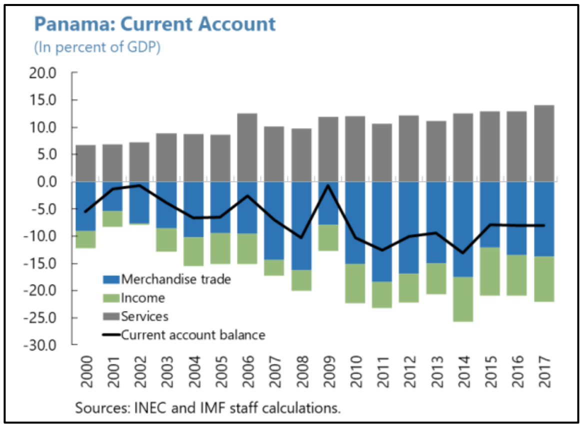
While overall accommodative financial conditions continue to support near-term growth prospects, they may put financial stability and growth at risk over the medium-term. Given current financial conditions the GaR model forecasts that, under a severely adverse growth scenario (one with 5 percent probability) for 2018 the growth outlook for Panama would be 3.9 percent compared to the outlook. However, this does not take into account the abrupt stoppage in construction activity during the strike that is estimated to reduce growth by 1 percentage point for 2018. The impact of a severely adverse growth scenario would be more acute on a 3-year horizon where economic growth would be 2.3 compared to the outlook for 5¾ percent growth for 2020.

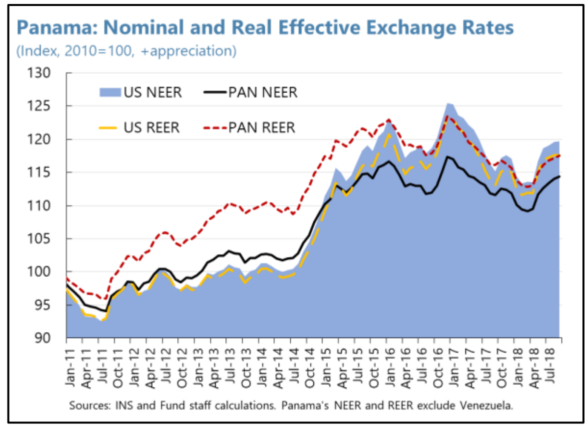
Panama: Growth Density Forecasts
(Probability)



Sources: IMF staff calculations. Forecast densities for growth, one, two and three years ahead.

1/ Additional details are available in the related 2018 Article IV Selected Issues Paper, Chapter 3.





OUTLOOK AND RISKS

While the outlook remains favorable, the balance of risks is tilted to the downside. Domestic risks include setbacks in ongoing efforts to comply with international standards on AML/CFT and tax transparency, and the oversupply in property markets. External risks include a sharp tightening of global financial conditions, an appreciation of the U.S. dollar, a slowdown in world trade, and weaker-than-expected global growth.

8. While economic activity is expected to slow down in 2018, Panama is projected to remain among the most dynamic economies in Latin America. Growth is expected to decelerate to 4.3 percent in 2018, due to a prolonged strike in the construction sector in April and May and the weaker-than-expected performance in the first half. Growth is projected to rebound in 2019 to 6.3 percent with the recovery from the impact of the construction strike and the expected opening of a large copper mine (*Minera Panamá*).[5] While still broadly accommodative financial conditions are expected to continue to support the near-term growth outlook, the ongoing tightening of financial conditions is expected to persist and contribute to a moderation of investment to more sustainable levels over the medium-term (Box 1). As a result, growth is projected to converge to its potential of about 5½ percent over the medium-term. Inflation is expected to pick up in 2018 mainly due to higher international fuel prices and to gradually converge toward 2 percent over the medium-term.

9. Fiscal policy is expected to remain guided by the amended fiscal responsibility law over the medium term. The overall NFPS deficit is projected to increase to 2 percent of GDP in 2018-19 and gradually fall to around 1½ percent of GDP over the medium-term. In the absence of an improvement in tax collections, this would imply a gradual declining path for public investment. Public debt is sustainable (well below the SFRL indicative target) and it is projected to gradually decline to about 33 percent of GDP (Annex IV).

[5] A recent Supreme Court ruling (declaring Law 9 (1997) unconstitutional) has created uncertainty on some elements of the contract between the government and *Minera Panamá* (including its special tax regime). However, the government has stated that the contract with *Minera Panamá* remains valid and the US$6 billion project will continue. This is the largest private project in Panama's history.

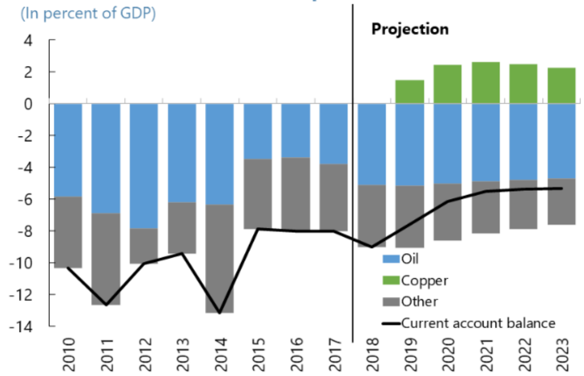
Panama: Medium-term Macroeconomic Outlook

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projection					
Macroeconomic Developments				(Annual percent change)					
Real GDP	5.8	5.0	5.4	4.3	6.3	5.8	5.6	5.5	5.5
Output gap	-0.4	-0.3	-0.1	-1.2	-0.5	0.1	0.0	0.0	0.0
CPI inflation (average)	0.1	0.7	0.9	1.5	2.0	2.1	2.0	2.0	2.0
Credit to the private sector	11.4	8.4	6.5	5.0	6.0	7.1	6.8	6.8	6.9
				(In percent of GDP)					
Fiscal Accounts and Public Debt									
Overall balance, excluding ACP	-2.2	-1.8	-1.6	-2.0	-2.0	-1.7	-1.7	-1.5	-1.5
Structural primary balance	-0.6	-0.1	0.1	-0.1	-0.3	-0.1	-0.2	0.0	0.0
Non-Financial Public Sector (NFPS) gross debt 1/	37.2	37.4	37.8	38.3	37.3	36.2	35.2	34.1	33.2
Non-Financial Public Sector (NFPS) net debt 2/	34.6	34.9	35.5	36.2	35.3	34.3	33.5	32.6	31.7
External Sector									
Current account balance	-7.9	-8.0	-8.0	-9.0	-7.6	-6.2	-5.6	-5.4	-5.4
Foreign direct investment	-7.3	-8.0	-7.5	-6.6	-5.8	-5.9	-6.0	-5.8	-5.8

Sources: Ministry of Economy and Finance; INEC; SBP; and IMF staff calculations.
1/ Non-Financial Public Sector according to the definition in Law 31 of 2011.
2/ NFPS gross debt minus financial assets at Panama's Savings Fund (FAP).

10. External imbalances are expected to continue to decline over the medium-term. Panama's external position is broadly consistent with fundamentals and desired policy settings (Annex III). Higher oil prices are expected to fuel a temporary increase in the CA deficit (to 9.0 percent of GDP in 2018). However, over the medium term, exports will increase rapidly as a new mine begins exporting in 2019, helping to narrow the CA deficit to about 5½ percent of GDP. FDI is expected to continue to adequately finance the CA deficit over the medium term.

Panama: Current Account Impact of Commodities
(In percent of GDP)



Sources: INEC and IMF staff calculations.

11. The balance of risks is tilted to the downside (See Annex II).

- ***Domestic risks***. Setbacks in addressing outstanding GAFILAT recommendations could expose Panama to reputational risks, lead to reduced access to external funding, higher financing costs, and outflows from the regional financial center. Continued oversupply in property markets could trigger a correction in prices and negatively affect financial stability. Delays in completing the large mining project (following the recent Supreme Court ruling) could lower export prospects. Political uncertainty in advance of the upcoming elections could deter private investment and weaken economic activity.
- ***External risks.*** A sharp tightening of global financial conditions would increase domestic interest rates, leading to higher debt service and refinancing risks. Should rising U.S. interest rates exert appreciation pressure on the U.S. dollar, Panama's REER would also face appreciation pressures, potentially eroding external competitiveness and exports. Escalating trade tensions would lead to slower growth in world trade as well as lower exports and growth in Panama through lower

transits on the Panama Canal and associated fiscal revenue and lower growth in key trading partners, with potential indirect effects on investment. Weaker-than-expected global growth could weaken exports and dampen government revenue.

Authorities' Views

12. The authorities broadly agreed with staff's views on the outlook and risks. They were optimistic about the outlook for 2018, considering that the recovery in the construction sector could take place more rapidly in part due to the acceleration of ongoing public investment projects. They emphasized the importance of risks stemming from trade tensions and the delicate political environment in advance of the 2019 elections that could make it difficult to advance important reforms. However, they noted that there is no evidence of a slowdown in trade traffic in the Canal. The authorities agreed with staff's assessment of public debt sustainability and external stability.

POLICY DISCUSSIONS

Discussions focused on maintaining Panama's robust growth performance and its competitive advantage as an attractive destination for business against the background of amplified downside risks. The mission stressed the importance of strengthening AML/CFT framework and enhancing tax transparency to cement Panama's position as a regional financial center. Equally important is to preserve fiscal discipline as this is the main macroeconomic stabilization instrument (in a dollarized economy with no central bank), and to reinforce the fiscal framework with the establishment of a fiscal council. Given the importance of the financial system, the mission encouraged monitoring developments closely and to bolster systemic risk assessment, risk-based supervision and to put in place robust frameworks for macroprudential policy and crisis management.

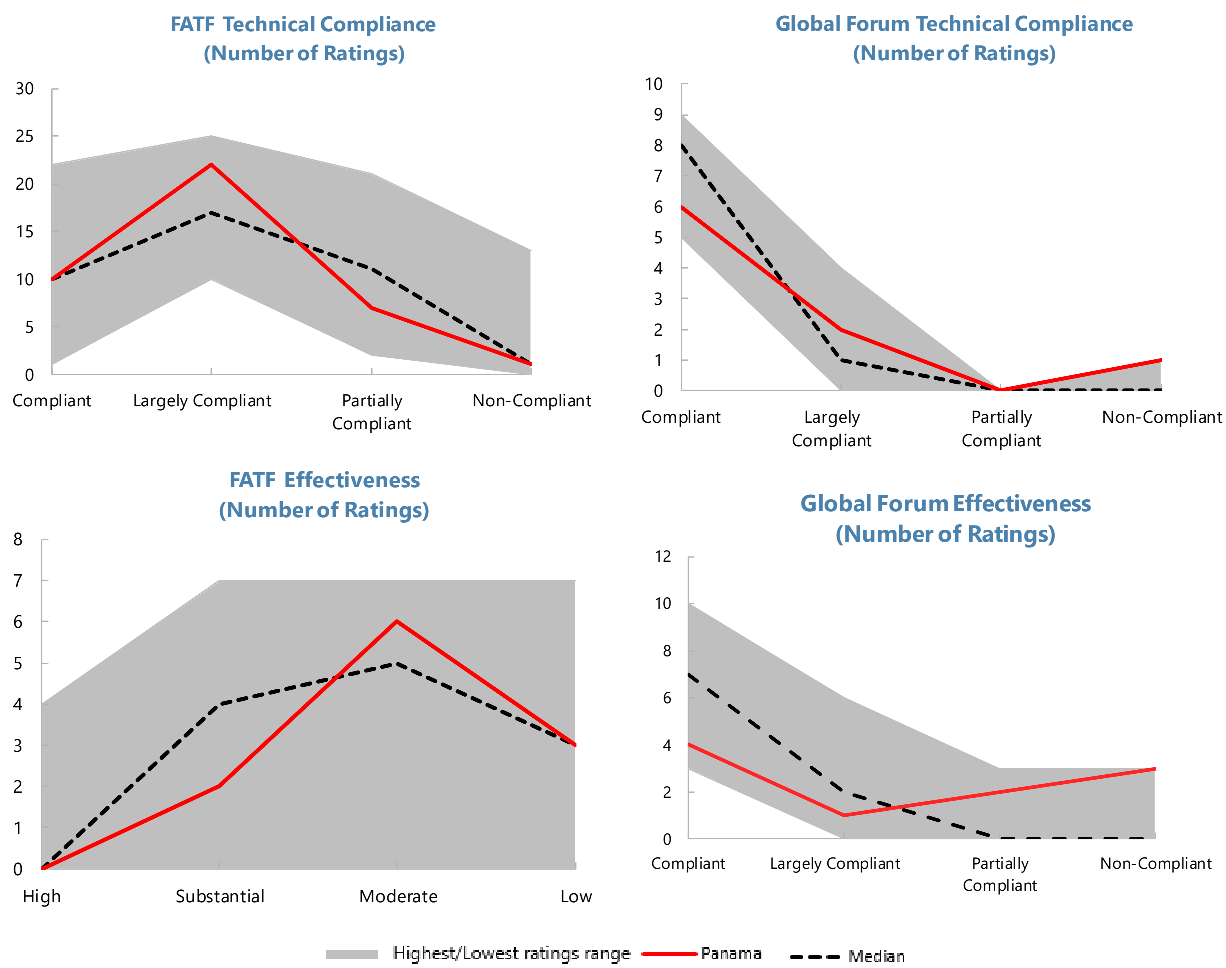
A. Advancing Financial Integrity and Tax Transparency

13. Panama received a favorable assessment in GAFILAT's latest AML/CFT evaluation published in January 2018, especially on technical compliance. This assessment confirms the authorities' significant progress toward compliance with the AML/CFT standards. Overall, Panama was assessed to be largely compliant on the technical elements of the FATF standard, bringing Panama on par with its comparators (Box 2). However, important weaknesses were identified in the effectiveness of the AML/CFT framework. Subsequently, the authorities prepared an Action Plan to address priority areas, with implementation being closely monitored by GAFILAT.

Box 2. Compliance with FATF and Global Forum's Standards

Panama fared well overall on technical compliance with FATF recommendations among comparators, but its performance is low in effectiveness. In the ratings of the latest assessments conducted from late 2016 to early 2018 (against the 2012 standards using the 2013 FATF methodology), Panama fared well in terms of technical compliance with the standard, among a select group of 25 mostly offshore centers and regional peers.[1] Panama was rated 'Compliant' in one-quarter of the 40 recommendations, same as the median of the group, and 'Largely Compliant' in 22 recommendations, better than the median. However, Panama is lagging most comparators on the effectiveness of the implementation of the regime, perhaps because most of the recent revisions to the AML/CFT framework have not be sufficiently tested.

Panama: Comparison with Select Group of Offshore Centers and Regional Peers



Source: Official data from FATF and the Global Forum, and Staff calculations.

The Global Forum's ratings suggest that Panama's performance on tax transparency is relatively weak compared to other jurisdictions.[2] This is because despite provisionally upgrading Panama's overall rating from 'Non-compliant' to 'Largely Compliant' (reflecting the progress made under its Fast Track Review Process in mid–2017) the Global Forum has not revised the ratings of the essential individual components from the Phase 2 assessment conducted in November 2016. Based on the full first round assessment, Panama's framework for information exchange and its implementation is still considered not to meet standards pending a comprehensive assessment later this year.

[1] Countries and jurisdictions covered include: Bahamas, Barbados, Canada, Costa Rica, Ireland, Isle of Man, Macao SAR, Malaysia, Mexico, Panama, Samoa, Singapore, Switzerland, USA, as well as, Australia, Cuba, Jamaica, Fiji, Guatemala, Honduras, Mongolia, Nicaragua, Thailand, Trinidad and Tobago, and Vanuatu.

2 Reflecting data availability, the list of countries and jurisdictions include the first 14 in the previous footnote as well as: Bahrain, Bermuda, Brazil, British Virgin Islands, Cayman Islands, Chile, Colombia, Hong Kong SAR, Luxemburg, Seychelles, Turks and Caicos.

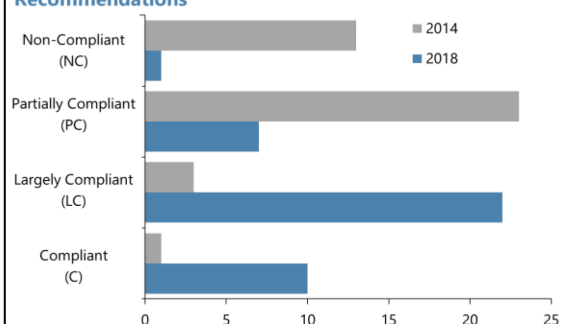
14. Staff supports the authorities' determination to strengthen the effectiveness of the AML/CFT supervisory framework. The authorities' supervisory capacity continues to be strengthened with more resources and training. AML/CFT–focused onsite inspections have intensified across sectors since 2015, especially for designated nonfinancial businesses and professions (DNFBPs) identified as high risk in the 2017 National Risk Assessment, through implementation of risk-based approaches. Greater AML/CFT awareness, including with training for DNFBPs, is yielding positive results. Notwithstanding, staff urged the authorities to enhance their understanding of ML/FT risks, improve the financial intelligence unit's capabilities, continue monitoring the risks posed in the highly vulnerable sectors (real estate, free zones, lawyers) and further strengthen implementation capacity of the supervisory agencies, considering the very high number of financial and non-financial intermediaries in Panama.[6]

Panama: AML/CFT Supervision
(Number of supervisions conducted)

	2015	2016	2017
Intendencia	31	35	69
IPACOOP	202	211	295
SSRR	71	78	122
SBP	73	102	116
SMV	26	18	20
Total	**403**	**444**	**622**

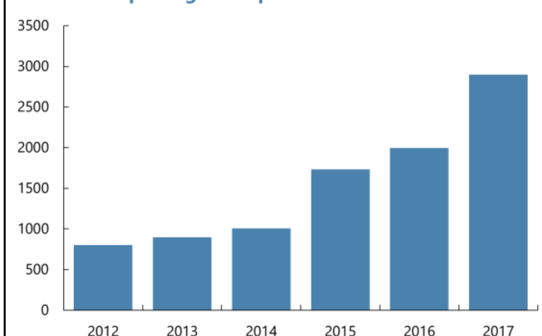
Source: National Commission for AML/CFT and IMF staff calculations.

Panama: Technical Compliance with the 40 FATF Recommendations



Sources: IMF(2014) and GAFILAT(2018)

Panama: Reporting of Suspicious Transactions



Sources: National Commission for AML/CFT and IMF staff calculations.

15. Staff encouraged the authorities to continue enhancing financial integrity to bring Panama closer to international standards and strengthen its position as a regional financial center. Despite the overall favorable assessment, GAFILAT also found that progress is needed in ensuring timely availability of up-to-date and accurate beneficial ownership information and accounting records of Panamanian corporations established by resident agents (lawyers) who were not properly supervised in the past. It will be important to review the registration requirements for these entities at the Public Registry and apply effective dissuasive action to resident agents, who do not comply with the information requirements relating to them. The challenging list of deficiencies that Panama needs to address before the next FATF plenary in February next year include: criminalization of tax evasion (including bringing tax crimes in the scope of ML offences), availability of a comprehensive AML statistics, regulation of remittance houses, and the timeliness of suspicious transactions reporting. Staff urged the authorities to approve the draft legislation to criminalize tax evasion that is before the National Assembly. Effective implementation of the AML/CFT framework should remain a priority.

[6] See the 2018 Article IV Selected Issues Paper, Chapter 2 for a comprehensive overview of Panama's financial integrity issues, including taking stock of the situation and policy challenges ahead.

16. Efforts continue to enhance tax transparency and information exchange. With technical assistance from the Fund, the authorities are modernizing revenue administration and, together with a stronger Financial Intelligence Unit, are now able to promptly provide tax information both for domestic and foreign use. The authorities have started to report tax information to the U.S. authorities (under the Foreign Account Tax Compliance Act, FATCA) and have implemented the new automatic exchange of information standard, i.e., the OECD's Common Reporting Standard (CRS), with first exchanges taking place in September 2018. However, the authorities are behind in implementing some minimum standards on Base Erosion and Profit Shifting (BEPS).[7] In addition to about 30 bilateral agreements already in place, Panama signed the OECD's Multilateral Competent Authority Agreement (MCAA) in January 2018 for the automatic exchange of financial account information with selected countries, in the last quarter of 2018, thereby extending its information sharing network. Panama was found to be "provisionally largely compliant" by the Global Forum under its fast–track review in mid–2017, pending a full assessment that commenced in September 2018 against enhanced standards. Staff urged the authorities to further advance the implementation of tax transparency initiatives towards a successful Global Forum's assessment.

Authorities' Views

17. AML/CFT and tax transparency is a top priority for the Panamanian authorities. In that context, they are pressing ahead with preparations for the Global Forum and the GAFILAT reviews. They are optimistic that a number of legislative initiatives will be approved, including the criminalization of tax evasion during the current legislative period of the National Assembly. They agreed that a continued strengthening of AML/CFT will be important to solidify Panama's competitive position as a regional financial center. The authorities highlighted progress made since 2013 in revamping the AML/CFT framework, to the extent that opening a bank account in Panama today is extremely difficult because of strict due diligence measures. They noted that technical assistance from the Fund has been and will remain valuable in advancing initiatives in these areas.

B. Strengthening the Effectiveness of Fiscal Policy

18. Fiscal policy remains the main macroeconomic stabilization tool in Panama. With a fully dollarized economy and no central bank, there is no monetary policy. While banks try to smooth out movements in interest rates, eventually interest rates are dictated by conditions in the United States. There is scope for macro-prudential policy, but the authorities have yet to actively use these policies to influence credit growth (except the introduction of dynamic provisioning). Fiscal policy is the main instrument used for macroeconomic purposes but is limited in practice by the deficit ceiling under the SFRL, with the authorities opting to adhere to fiscal discipline.

19. Progress with fiscal discipline achieved in recent years needs to be preserved. The authorities have repeatedly demonstrated commitment to fiscal discipline over the past few years, when

[7] Panama is subject to peer review on these four Minimum Standards, namely, Action 5 on Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 6 on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 13 on Transfer Pricing Documentation and Country-by-Country Reporting, and Action 14 on Making Dispute Resolution Mechanisms More Effective.

the stance of fiscal policy was contractionary despite a (negative) output gap. In this context, they continued to refrain from fully using the fiscal space allowed under the SFRL in 2017, prioritizing commitment to prudence over stabilization objectives. For 2018, some fiscal stimulus is appropriate given the transitory weakening of economic activity, and staff envisages a mildly expansionary fiscal stance. The credibility of fiscal policy (and the SFRL) has been repeatedly confirmed in international capital markets as evidenced by recent bond placements on favorable terms.

20. The National Assembly recently approved amendments to the SFRL that will simplify and improve the transparency of the fiscal rule. To further strengthen the fiscal framework, the National Assembly approved amendments to the SFRL in October, replacing the complicated rule which includes the "adjusted deficit" (i.e., A) and the adjustor for shortfalls in Canal contributions (i.e., 3.5-C) with a simple ceiling on the headline deficit of the NFPS. The modified SFRL establishes the limits to the deficit of the NFPS at 2 percent of GDP in 2018-19, 1¾ percent in 2020-21, and 1½ percent of GDP after 2021, with the target over the medium-term broadly consistent with the expected limit under the previous law.[8] As the rule remains pro-cyclical, the government argued for ½ of GDP of additional capital spending for 2018 given the weakening activity, and a gradual withdrawal of the impulse later on. Although the modified SFRL provides a needed stimulus this year (to be used on capital spending), a gradual withdrawal of the impulse in the near term is warranted given the expected strengthening of activity. An expenditure rule was adopted that will contain the growth in current primary spending of the central government to potential GDP and expected inflation, and an adjustment to the accrual rules of the Panama's Savings Fund (FAP), to save half of the excess Canal contribution to the budget (threshold set at 2½ percent of GDP). There is a need to establish a clear link in the framework between the path for deficit ceilings and a debt target that is consistent with Panama's need to ensure adequate buffers to mitigate fiscal risks related to unfunded pension liabilities, and contingent liabilities of public companies and the financial sector.[9]

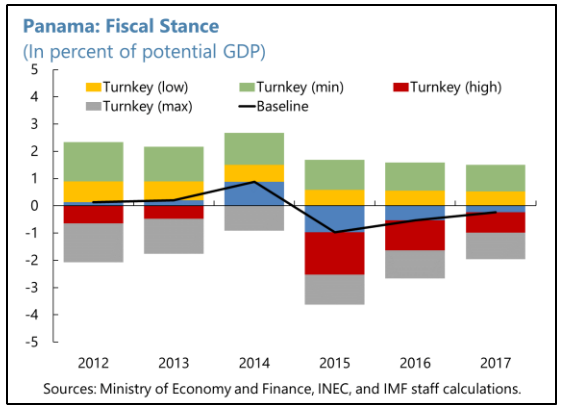
21. The initiative to establish a fiscal council will further strengthen the fiscal framework. The draft bill the authorities sent to the National Assembly in October 2017, to create an independent fiscal council was approved in late October 2018. The fiscal council is tasked with assessing and monitoring fiscal assumptions, plans and performance, will further promote accountability, and help nurture informed public debate about the goals and results of fiscal policy.

22. There is a need to strengthen the recording of public investment in the fiscal accounts. The use of turnkey and deferred payment contracts allows to separate the timing of construction, the recognition of the corresponding liability, and the recording of the cash transaction as capital expenditure in the public accounts, a practice that impairs the ability to gauge the stance of fiscal policy. There is high uncertainty about the actual stance of fiscal policy (see text figure), depending on

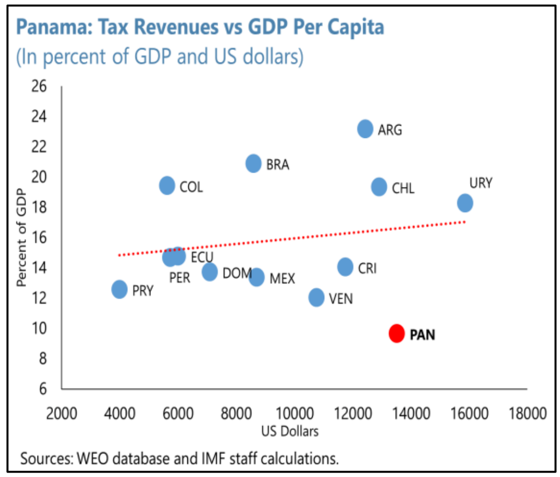
[8] This is broadly similar to an earlier bill submitted in June and withdrawn a month later because of lack of political support, except that it had set the NFPS deficit at 1½ percent of GDP starting in 2019.

[9] Latest actuarial report suggests that the reserves of the unfunded defined benefit system will be depleted by 2027, absent parametric reforms. The estimated fiscal cost after 2027 is 1-2 percent of GDP. See IMF Country Reports No. 16/337, for more discussions.

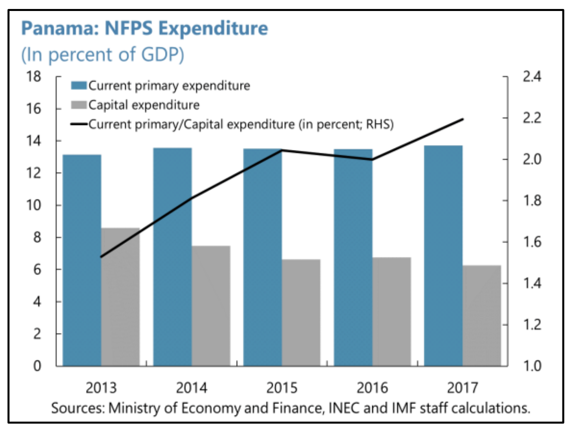
the exact share of accrued obligations that was executed in a year. In this context, systematic data provision on all different stages of public investment projects will enhance the scope for conducting macroeconomic analysis and policymaking (accrual recording of these expenditures is best practice). This is relevant given fiscal policy's exclusive role to provide counter-cyclical response in the absence of other macroeconomic stabilization tools.



23. Further progress in revenue administration and review of tax exemptions are crucial to generate resources needed for key social objectives. Panama's tax revenues remain among the lowest in the region and significantly below countries at similar income levels. Besides numerous tax exemptions and incentives, underperformance in tax collection likely reflects structural weaknesses in customs and tax administration. Governance and institutional capacity of the customs administration needs to be improved, including by enhancing human resources, limiting discretionary powers, reforming the control processes, and improving data collection and management. In addition, a publication of a list of estimated foregone revenues due to tax incentives and exemptions will help initiate public debate to review these complex schemes that continually erode the tax base.



24. The rapid growth of current expenditures needs to be curbed to provide additional room for needed strategic public investment. Current expenditure growth has been driven by a significant increase in public sector wages, particularly in education, health and security services. Given the fiscal rule, this trend implies a continued decline in capital expenditure. The current-to-capital expenditure ratio increased by a half since 2013, going from 1.5 to 2.2 in 2017. There is an urgent need to restrain current expenditure growth, particularly the wage bill and transfers and subsidies and preserve strategic investment projects that are vital for growth prospects.



Authorities' Views

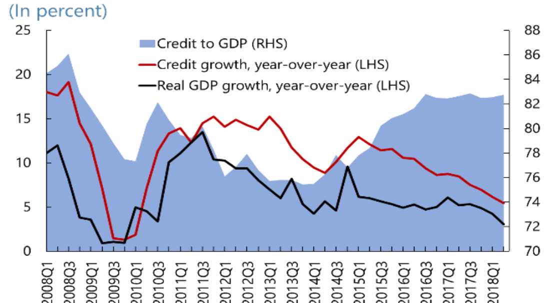
25. The authorities reaffirmed their commitment to fiscal discipline but emphasized the need to support weakening activity in 2018, which the modified SFRL accommodates by allowing ½ percent of GDP in additional fiscal deficit. They requested the National Assembly to expedite the approval of the draft bill to establish the fiscal council to further strengthen the fiscal framework. They believe the expenditure rule will help contain the growth in current primary spending. They are taking steps to avoid budgetary surprises and better track turnkey projects which entail future disbursements.

C. Financial Sector Reform to Build Resilience

26. The financial system remains solid, but continued vigilance is appropriate to prevent the emergence of systemic risk. Although credit growth has decelerated, and the credit-gap remains moderate, credit remains elevated as a share of GDP. Aggregate asset quality indicators suggest that credit dynamics continue to evolve in line with fundamentals, with low and well-provisioned NPLs relative to Panama's peers, although their level doubled from two years ago and bears careful monitoring (Box 3). The rise in NPLs has been concentrated in mortgages, construction and commercial and personal credit, mostly due to vulnerabilities associated with a relative oversupply in property markets, persistent challenges faced by companies operating in the Colon Free Zone, and rising interest rates. While NPLs appear adequately provisioned on aggregate, their coverage varies across segments of the banking system, with foreign banks maintaining higher provisions than domestic banks, and should also be closely monitored.

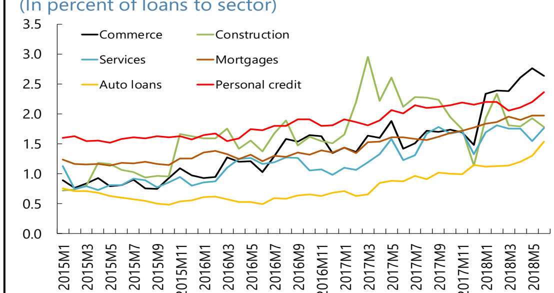
27. Banks remain profitable, well capitalized and relatively liquid. On aggregate, banks' profitability has stabilized after coming under downward pressure from rising funding and compliance costs, but smaller banks have faced greater challenges absorbing rising costs. As a result, and, in the context of an industry where the nine largest banks (out of 49 banks serving the domestic economy) hold about 70 percent of banking system assets, pressures for market consolidation are expected to rise. Liquidity remains above prevailing regulatory norms but needs to be strengthened to meet the new liquidity coverage ratio (LCR) requirement (which will become gradually effective by 2022).[10] Banks, which represent about 90 percent of financial system assets, remain well-capitalized.

Panama: Growth of Credit to the Private Sector
(In percent)



Sources: INEC, SBP, Fund staff calculations.

Panama: NPLs by Economic Sector
(In percent of loans to sector)



Sources: SBP and Fund staff calculations.

[10] Banks' liquidity is lower than regional peers (see text table) as banks are not required to maintain reserves given the absence of a central bank.

Panama: Selected Financial Soundness Indicators Compared to Regional Peers

	Costa Rica	Dominican Republic	Guatemala	Honduras	Nicaragua	Panama	El Salvador	CAPDR[2]	LA5[3]
Regulatory Capital to Risk-Weighted Assets	17.1	18.7	15.7	13.8	15.3	15.9	16.6	16.1	16.0
Capital to Assets Ratio	10.0	9.8	7.4	11.1	7.7	12.6	13.1	10.2	11.3
Nonperforming Loans (NPLs) to Total Loans Ratio	2.4	2.1	2.4	2.4	1.4	1.8	1.9	2.1	3.1
Provisions to Nonperforming Loans Ratio	135.9	143.2	58.4	132.8	178.3	88.9	n.a.	122.9	133.8
Return on Assets	0.9	1.7	1.5	1.9	2.6	1.6	1.0	1.6	1.9
Return on Equity	6.2	14.9	15.7	18.9	22.1	13.6	7.8	14.2	17.2
Liquid Assets to Total Assets Ratio	29.1	70.7	29.7	24.3	21.4	12.2	22.2	29.9	20.3

Sources: FSI database - IMF, SBP.
1. As of June 2018, except for Dominican Republic (September 2017) and Brazil (March 2018).
2. Comprises Costa Rica, Dominican Republic, Guatemala, El Salvador, Honduras, Nicaragua, and Panama.
3. Comprises Brazil, Chile, Colombia, Mexico and Peru.

Panama: Financial Soundness Indicators

	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2
Overall Financial Sector Rating	L	M	L	M	M	M	M	M	L	L	M
Credit cycle	L	L	L	L	L	L	L	L	L	L	L
Change in credit / GDP ratio (pp, annual)	0.8	1.0	1.2	1.1	1.6	1.3	1.0	0.1	0.0	0.1	0.1
Growth of credit / GDP (%, annual)	1.0	1.2	1.5	1.3	2.0	1.6	1.2	0.1	0.0	0.1	0.1
Credit-to-GDP gap (st. dev)	0.0	0.2	0.4	0.8	0.2	-0.2	-0.6	-1.3	-1.9	-1.7	-1.4
Balance Sheet Soundness	L	M	L	M	M	M	M	M	L	L	M
Balance Sheet Structural Risk	L	L	L	L	L	L	L	L	L	L	L
Deposit-to-loan ratio	114.8	115.6	115.8	112.5	113.4	112.6	112.8	110.2	110.5	109.3	107.1
Balance Sheet Buffers	L	M	L	M	M	M	M	M	L	L	M
Leverage	L	L	L	L	L	L	L	L	L	L	L
Leverage ratio (%)	10.1	10.4	10.6	10.9	10.5	11.0	11.3	11.6	11.4	11.4	11.5
Profitability	L	L	L	L	L	L	L	L	L	L	L
ROA	1.4	1.3	1.3	1.3	1.2	1.4	1.5	1.5	1.5	1.5	1.6
ROE	14.1	12.2	12.4	12.6	12.0	13.4	13.6	13.1	13.5	13.7	13.7
Asset quality	M	H	M	H	H	H	H	H	M	M	H
NPL ratio	1.0	1.2	1.1	1.3	1.3	1.5	1.5	1.7	1.4	1.8	1.8
NPL ratio change (%, annual)	8.7	34.1	16.3	48.3	23.9	30.5	39.3	28.8	14.3	13.6	23.9

28. **Macro-financial vulnerabilities persist but data gaps hinder their complete assessment.** Much of the recent increase in private sector debt has been related to developments in property markets and occurred in a low interest rate environment. Anecdotal evidence suggests that property prices had risen in tandem with credit and are likely to come under pressure, with some signs of moderation in prices on new homes and decline in rents for commercial properties, signaling over-supply across both residential and commercial real estate, especially in the high-end market segment. The anticipated rise in interest rates in the predominantly variable rate environment, particularly in the context of a slowdown in the domestic economy or a correction in property prices, could escalate credit risks and further deteriorate banks' asset quality, with strong macro-financial linkages leading to a drag on economic activity (Box 3). Such dynamics could be propagated by a reduction in interest relief provided under the system of preferential mortgages for low-income housing. Addressing data gaps with respect to household and corporate balance sheets and housing prices remains critical for adequate risk assessment. Stress tests conducted by the Superintendency of Banks (SBP) suggest that onshore banks' capital would remain adequate in the event of macroeconomic and interest rate shocks,

however, it would be appropriate to consider more severe shocks and important to remain alert to emerging risks.[11]

29. Coordination on systemic risk oversight and macroprudential policies should be strengthened.[12] The SBP continues to lead the assessment of systemic risk with the Financial Coordination Council (CCF) largely facilitating cooperation on prudential supervision.[13] Progress to strengthen cooperation under the CCF through new Memoranda of Understanding (MOUs) and joint inspections of financial conglomerates for the first time in 2017 is welcome; but should be complemented with an enhanced role for the CCF in systemic risk assessment. Alternatively, moving toward a more centralized supervisory structure over the medium-term would facilitate consolidated supervision and systemic risk assessment and strengthen financial stability. Publication of the financial stability report prepared by the SBP would enhance transparency and accountability of the authorities' ongoing efforts to strengthen financial resilience. Development of a framework and tools for macroprudential policy remains imperative to provide sufficient policy flexibility to address macro-financial risks in the dollarized economy.

[11] See the 2018 Article IV Selected Issues papers for an analysis of growth-at-risk (chapter 3) and Panama's interbank exposures (chapter 4). The SBP growth assumptions are broadly consistent with a growth-at-risk scenario with a 10 percent probability, but a more conservative scenario with a 5 percent probability would be appropriate.

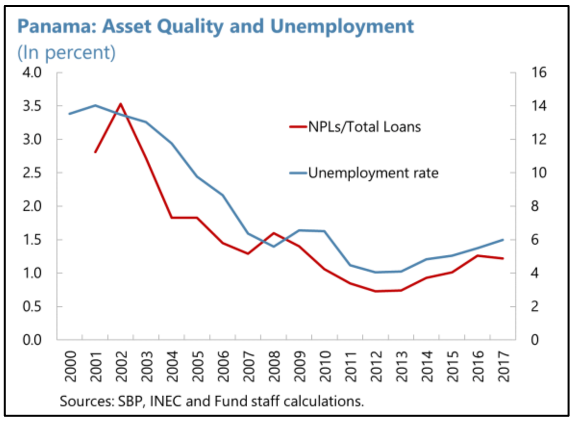
[12] See IMF Country Report No. 17/106 for a detailed overview of the Panamanian financial system and its oversight, and recommendations to strengthen systemic risk oversight and macroprudential policy.

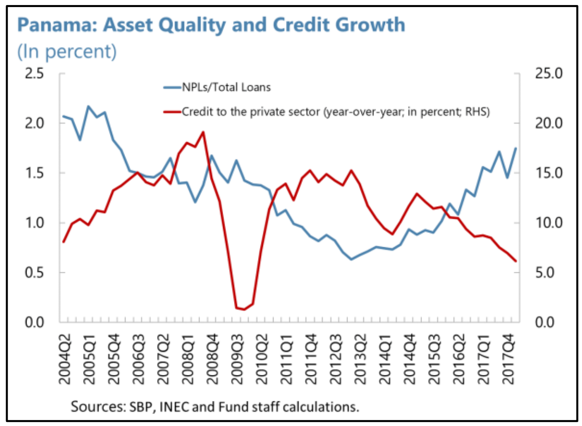
[13] The CCF comprises of the supervisors of banks, insurance, securities, cooperatives, pensions, and is presided by the Superintendent of Banks (SBP).

Box 3. Asset Quality and Economic Activity

There is a need to closely monitor the recent deterioration in asset quality to prevent the emergence of systemic risks from the build-up of debt in recent years. Bank asset quality remains generally sound but has deteriorated in recent years, following the period of robust credit growth in the environment of low global interest rates, and could come under further pressure due to rising global interest rates, dominance of variable rates and persistent oversupply in property markets. This box examines the role of NPLs as a potential driver of macro-financial feedback loops, which could trigger further deterioration in asset quality.

NPLs affect bank lending and may result in adverse macro-financial feedback loops. High NPLs typically reduce the supply of credit, including by reducing bank profitability, tying up capital because of higher risk weights on impaired assets, and raising banks' funding costs because of lower expected revenue streams and investors' heightened risk perceptions. Reduced credit supply, in turn, can weaken economic activity, further increasing NPLs. Indeed, the NPL ratio in Panama is positively correlated with unemployment and negatively correlated with growth in credit to the private sector, which in turn is positively correlated with economic activity, suggesting that the increase in NPLs may be associated with subdued growth.





VAR estimates confirm the potential importance of feedback effects between the real economy and asset quality in Panama's banking sector.[1/] A weaker macroeconomic environment reduces borrowers' debt servicing capacity and leads to a statistically significant increase in the NPL ratio. Conversely, a deterioration in asset quality reduces credit growth and economic activity: at its peak, a 1 percentage point increase in the NPL ratio reduces credit growth by 1.5 percentage points and growth by 1.2 percentage points. Banks' existing capital buffers should help to mitigate the extent of feedback between a further deterioration in asset quality, credit, and economic growth, while the recent strengthening of provisions following the transition to IFRS9 will help to facilitate recognition of losses, but close monitoring and effective supervision will be critical to prevent further deterioration of asset quality.

1/ The model treats all variables as endogenous and includes the ratio of NPLs to total loans, growth of credit to the private sector, real GDP growth, and inflation. Unemployment is excluded from the model given the lack of quarterly data available. For more details, see the 2018 Article IV Selected Issues Paper, Chapter 5.

30. Efforts to strengthen prudential regulation and complete its alignment with Basel III need to be complemented with enhanced risk-based supervision to improve resilience of the financial system:

- ***Capital requirements.*** The definition of regulatory capital has been aligned to Basel III and capital charges on credit and market risk have been introduced, with the latter becoming effective in mid-2019.[14] The remaining priority is to finalize regulations on operational risk, which the SBP anticipates completing in the second half of 2018. With limited policy tools available to support financial stability in the event of a systemic shock given the absence of a central bank and well-defined liquidity support mechanisms, the SBP is also prudently considering introducing a capital conservation buffer for all banks and additional capital requirements for identified domestic systemically important banks (D-SIBs) to further enhance resilience of the regional financial center.[15] Banks and D-SIBs appear well-placed to adhere to the additional capital buffers under consideration without the need to raise additional capital or deleverage.[16]

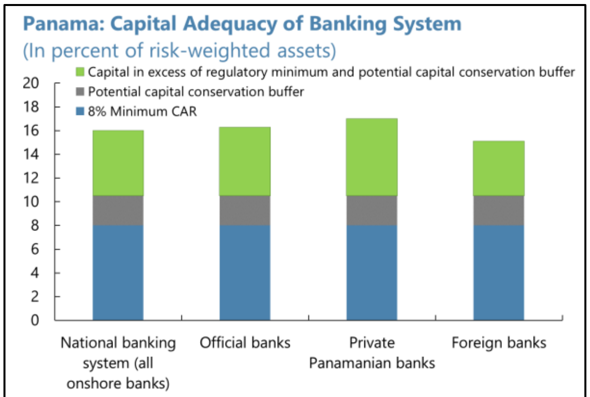
- ***Provisions.*** The transition in accounting standards and reporting from IAS39 to IFRS9 was completed in January 2018, resulting in improved provisioning coverage of NPLs on aggregate and reversing the deterioration following the implementation of dynamic provisioning in 2014. However, the aggregate improvement was driven almost entirely by foreign banks, with the provisioning coverage of domestic banks remaining broadly stable. In light of the recent deterioration in asset quality, it will be important to carefully monitor implementation of the new standard across banks to ensure that all banks are maintaining adequate provisions, and that dynamic provisioning is enhancing banks' capital buffers rather than facilitating a reallocation of banks' provisions between specific and dynamic provisions.[17]
- ***Liquidity.*** The introduction of the liquidity coverage ratio (LCR) in early 2018 is an important step to enhance liquidity and resilience of the banking system, particularly given the lack of lender of last resort. However, the authorities should consider faster transition toward the new requirement than the planned gradual annual phasing-in by January 2022 with full application to all banks.
- ***Supervision.*** With the transition to Basel III nearly complete, the focus should shift to strengthening risk-based supervision of both banks and non-banks, the latter remains at a nascent stage. Staff welcomes Panama's efforts to strengthen securities supervision, which enabled it to become a full signatory to IOSCO in 2017.

[14] Banks are in compliance with the new definition of regulatory capital, which was amended in 2015 (as well as the minimum leverage ratio requirement of 3 percent), well before the end of the phase-in period in 2019.

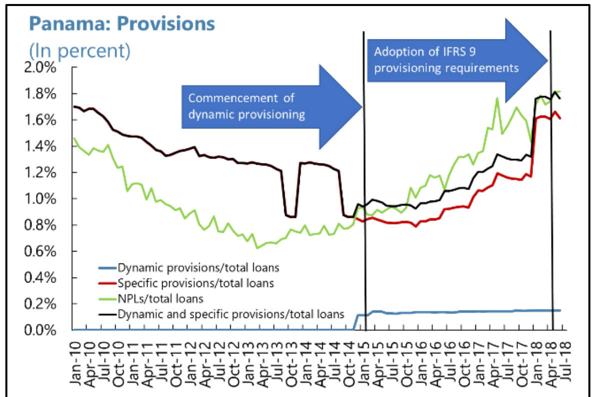
[15] The SBP has developed a methodology to identify D-SIBs consistent with the Basel regulations.

[16] All banks' capital buffers already exceed the regulatory minimum plus an additional capital conservation buffer of 2.5 percent of risk-weighted assets (in line with Basel III). Most banks preliminarily identified as D-SIBs would be able to absorb a further additional capital buffer of 2.5 percent of risk-weighted assets. However, this assessment does not consider the potential impact of capital charges for market and operational risk.

[17] Dynamic provisioning is similar to the countercyclical capital buffer under Basel III and is a stand-alone capital account item that banks are required to maintain in addition to the 8 percent minimum capital requirement.



Sources: SBP and Fund staff calculations. The capital conservation buffer under consideration is assumed to be set at 2.5% of risk-weighted assets in line with Basel III.



Sources: SBP and Fund staff calculations.

31. A robust framework for crisis management and bank resolution should be put in place in the near term to cement financial stability. The absence of a mechanism to provide significant liquidity to the financial system in the event of a systemic shock and deposit insurance remain critical gaps in Panama's crisis management framework. A draft law to strengthen the bank resolution framework is under consideration to enhance and expand resolution tools (bridge bank, purchase and assumption, asset management companies) and its approval will enable the SBP to resolve financial institutions effectively and timely. Crisis preparedness would be enhanced through the elaboration of a crisis management plan.

32. Supporting financial development through FinTech will need to be carefully balanced with an appropriate regulatory framework. Draft legislation is under consideration to modernize the financial sector and support the growth of FinTech, including through the creation of a regulatory sandbox. In its design, it will be important to mitigate potential financial stability implications by ensuring that the supervision of emerging financial products and technologies is placed under the appropriate supervisory agency with commensurate resources and to ensure that the regulatory environment is consistent with the progress made to strengthen financial integrity.

Authorities' Views

33. The authorities indicated their commitment to strengthening oversight of the financial sector, including of systemic risks. They highlighted the progress made to strengthen supervision coordination through the CCF and will consider the feasibility of further supervisory integration. The authorities emphasized that Panama has taken important steps in the transition to Basel III, including regulations on capital quality and risk-weighted assets, as well as establishing provisions for market and operational risk. They consider their plan to phase-in the LCR requirement by 2022 appropriate, noting that some banks already comply with it. They agreed to strengthen the crisis management and risk resolution frameworks and are in the process of creating a liquidity fund; in the meantime, the National Bank reallocates liquidity through selected collateralized lending to commercial banks. The authorities consider that the introduction of the deposit insurance remains unlikely in the near-term given moral hazard and funding concerns. The National Bank began developing a new payment system platform (i.e., real time gross settlement), which will be implemented in several stages, beginning in 2019, eliminating the counterparty risk and mitigating systemic risk. The authorities agreed with the need to develop FinTech within the context of a suitable regulatory framework and pointed to the draft legislation, which creates a regulatory sandbox for the sector based on initial experiences by other countries. The authorities are still considering the merits of publishing the financial stability report.

D. Other

34. Statistics are broadly adequate for surveillance. With IMF technical assistance, the authorities have worked toward implementing the enhanced General Data Dissemination System and have published essential macroeconomic data through a National Summary Data Page (NSDP). Enhancing the independence, financial resources, and capacity of the National Institute of Statistics will be important to strengthening statistics. Priorities include improving the quality and timeliness of expenditure-side national accounts, the frequency of labor market information, particularly on unemployment, and addressing data gaps on housing prices, household and corporate indebtedness, which continue to hinder assessment of systemic risks to financial stability.

STAFF APPRAISAL

35. Despite slowing in 2018, Panama is expected to remain among the most dynamic economies in the region. Panama is poised for a strong growth in the near term, supported by construction, transport, logistics and exports from a new copper mine. In the absence of sustained, strong policy efforts, medium-term growth is expected to moderate to its potential, although it will remain among the most dynamic in the region. External imbalances are expected to decline and to remain broadly consistent with fundamentals and desirable policy settings. Public debt is expected to remain on a downward trajectory. Key risks relate to setbacks in implementing the remaining GAFILAT recommendations and making continued progress on tax transparency, a sharper-than-expected tightening of global financial conditions and rising trade protectionism.

36. Effective implementation of the AML/CFT framework must remain a priority. Building on the recent favorable assessment by GAFILAT, the authorities should continue strengthening supervisory capacity for AML/CFT oversight, including through risk-based approaches given the significantly high number of financial and non-financial intermediaries operating in Panama. It will also be important to further enhance the understanding of AML/CFT risks to which Panama is exposed, particularly in the highly vulnerable sectors. Outstanding gaps in the legal framework should be addressed promptly to strengthen Panama's position as a regional financial center. Making tax crimes a predicate offense to money laundering by approving the draft legislation without further delay and ensuring the availability of beneficial ownership and accounting records of Panamanian entities are important to avoid being listed as a non-cooperative jurisdiction, and thereby eroding the recent gains.

37. Efforts to further enhance tax transparency and information exchange should continue. Actions being taken to share tax information more widely and promptly under the OECD's common reporting standard and the Multilateral Competent Authority Agreement should continue. Going forward, the priority should be to further advance the implementation of tax transparency initiatives towards a successful Global Forum's assessment against enhanced standards.

38. Sustained fiscal discipline is required to keep public debt on a downward trajectory. While a small fiscal impulse is appropriate in 2018 given the softening in economic activity, a gradual withdrawal of the impulse in the coming years will be necessary as the economy strengthens. There is urgent need to contain current expenditure growth to provide room for strategic public investment critical. The track record of fiscal discipline ensures public debt sustainability, and an external position broadly consistent with fundamentals and desirable policy settings.

39. Staff welcomes the amendments to the SRFL which aim to simplify and enhance transparency of the fiscal rule. The proposed new rule sets limits on the headline deficit of the NFPS at 2 percent of GDP in 2018-19, 1¾ percent in 2020-21, and 1½ percent of GDP after 2021. The new deficit limits will provide the necessary budgetary space to accommodate an adequate fiscal impulse (given the weakened economic activity). Staff agrees with the authorities that the fiscal impulse for 2018 should be accommodated with additional capital spending. The proposed law to establish a fiscal council was approved by the National Assembly to further strengthen the fiscal framework.

40. Efforts to enhance the assessment of the impact of fiscal policy on economic activity should continue. Efforts should be made to eliminate the disconnect between actual execution and recording and accounting of investment projects financed by turnkey and deferred payment contracts, to better gauge the fiscal policy stance. It will be important to provide data on these projects on a systematic basis, covering all the different stages.

41. Continued and sustained progress to strengthen revenue administration is needed. Governance and institutional capacity of the custom administration needs to urgently improve, along several dimensions, namely, human resources, ad hoc exemptions, control processes, and data collection and management. In addition to initiatives to modernize tax administration, strong action is also needed to review complex tax incentives and exemptions that continually erode the tax base.

42. Systemic risk oversight should be strengthened to build financial resilience and guard against macro-financial feedback loops. Addressing data gaps with respect to household and corporate balance sheets and property prices remains a top priority. Coordination on the assessment of systemic risk across financial sector supervisors and with the Ministry of Economy and Finance should also be enhanced through the CCF. An institutional framework for macroprudential policy and tools should be developed to provide more policy flexibility in addressing macro-financial risks.

43. The alignment of prudential regulations with Basel III is welcome. With the regulatory framework now broadly aligned to Basel III, the priority should shift to a strengthening of risk-based supervision of both banks and non-banks. It will also be important to put in place robust frameworks for crisis management and bank resolution frameworks, including by adequate liquidity support for banks and enhancing the range of resolution tools available to facilitate the timely resolution of failed banks. FinTech has the potential to transform Panama’s regional banking sector, with close supervision and adequate regulation of developments needed to nurture the benefits while preserving financial stability.

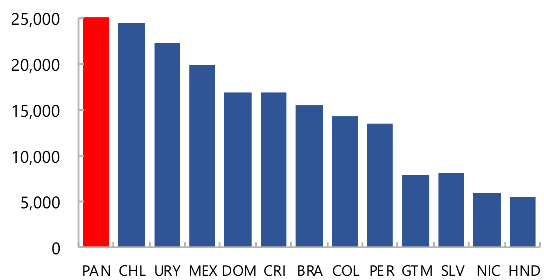
44. A reinforcement of the structural reform agenda will be necessary to maintain high potential growth while reducing poverty and inequality. High sustained growth will require continued improvements in productivity and competitiveness, as well as a strengthening of policies related to education and public health services. Improvements in total factor productivity will involve a substantial update in skills, training and quality of education, relaxation of regulations to facilitate attraction of foreign talent, and renewed efforts to further improve the investment climate. At the same time, it will be important to strengthen social policies to continue reducing poverty, improve income distribution and ensure inclusive growth over the medium-term.

45. Staff propose that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Panama: Socio-Economic Indicators

Per capita income is the highest in Latin America…

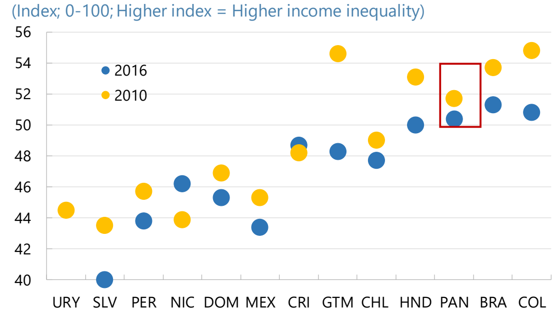
PPP GDP per capita, 2017 [1.]



Sources: WEO October 2018 database and Fund staff calculations.
1. Countries selected belong to group of LA6 (Brazil, Chile, Colombia, Mexico, Peru and Uruguay) and CAPDR (Costa Rica, Honduras, Nicaragua, El Salvador, Dominican Republic, Guatemala and Panama).

…but inequality remains high relative to regional peers.

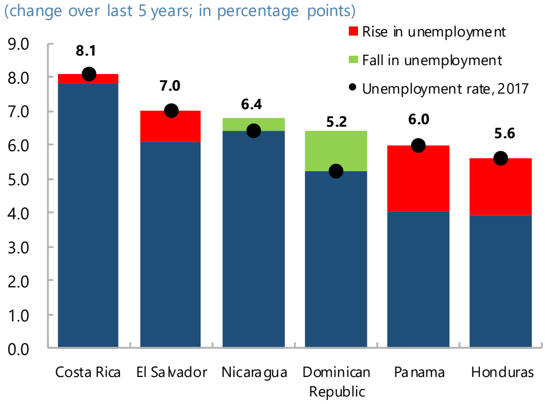
Panama: GINI Coefficient
(Index; 0-100; Higher index = Higher income inequality)



Sources: World Bank and Fund staff calculations.
1/ Higher index = Higher income inequality.
Note: In 2010 series, data for Nicaragua, Chile and Brazil corresponds to 2009 and for Guatemala to 2006. In 2016 series, data for Nicaragua and Guatemala correspond to 2014 and for Brazil to 2015.

Unemployment has fallen and remains comparable to regional peers.

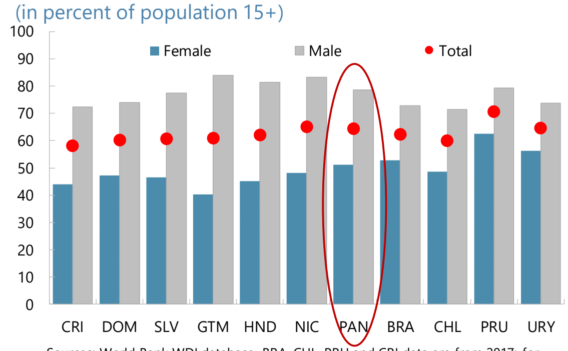
Panama: Unemployment Rate
(change over last 5 years; in percentage points)



Sources: IMF WEO; and Fund staff calculations.

Labor force participation rates are in line with regional peers.

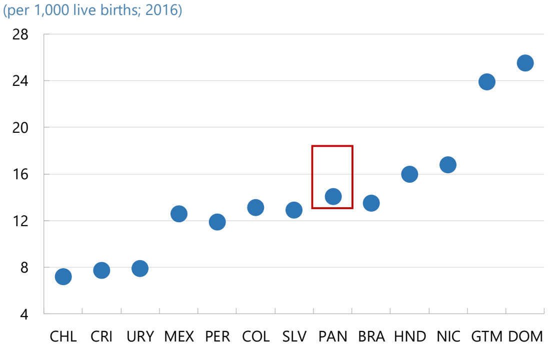
Panama: Labor Force Participation
(in percent of population 15+)



Sources: World Bank WDI database. BRA, CHL, PRU and CRI data are from 2017; for DOM, SLV, GTM, HND, PAN and URY are from 2016; for NIC is from 2014.

Infant mortality is comparable to regional peers, but…

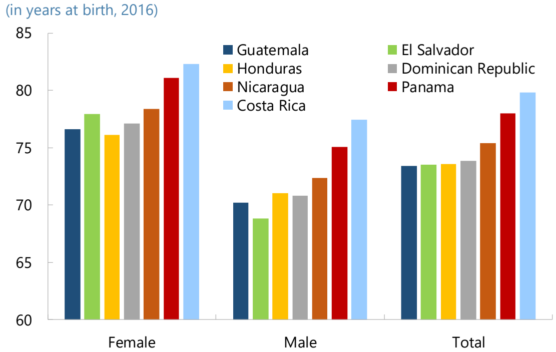
Panama: Infant mortality rate
(per 1,000 live births; 2016)



Sources: World Bank and Fund staff calculations.

…life expectancy is higher than in most regional peers.

Panama Life expectancy
(in years at birth, 2016)

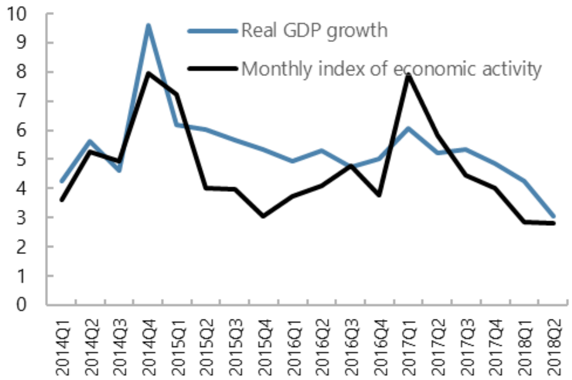


Sources: WDI-WB database and Fund staff calculations.

Figure 2. Panama: Real Sector Developments

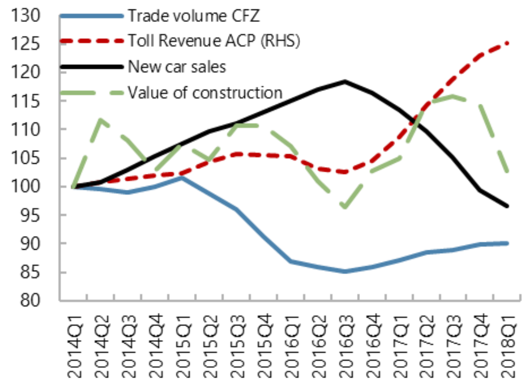
Economic activity has slowed...

Panama: Economic Activity
(in percent; year-over-year)



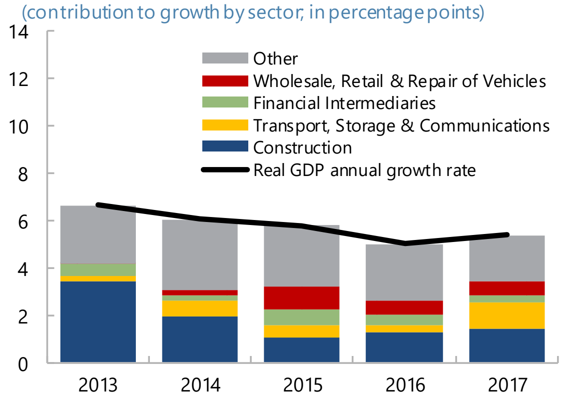
...with activity in the construction sector, in part due to the strike in the sector in April/May 2018...

Panama: High-Frequency Indicators 1/
(Index 2014Q1=100)



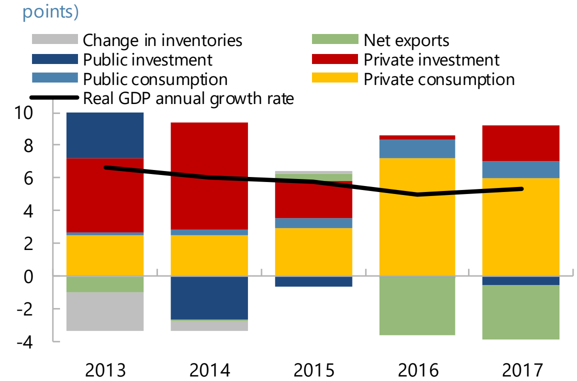
...following a prolonged boom in the construction sector that has driven recent economic dynamics.

Panama: Real GDP Growth
(contribution to growth by sector, in percentage points)



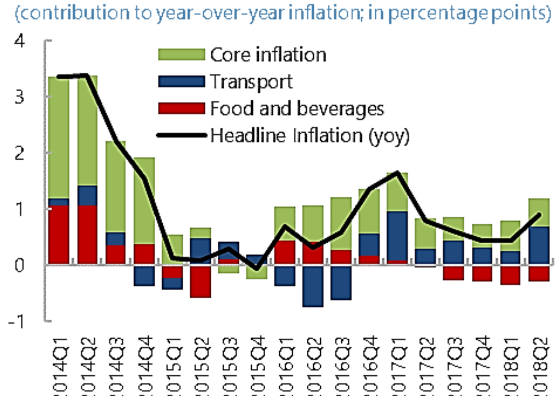
...together with strong consumption.

Panama: Real GDP Growth
(contribution to growth by demand component; in percentage points)



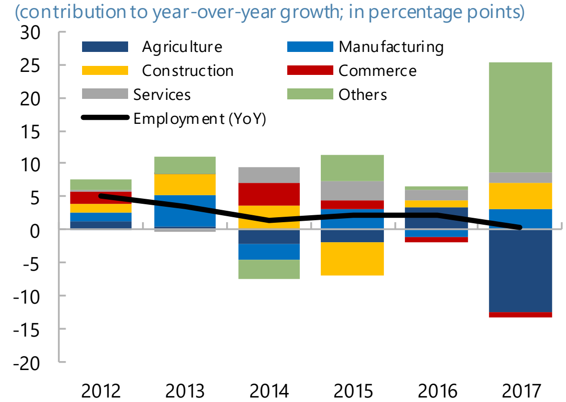
Inflation remains subdued but has started to rise with international fuel prices.

Panama: Inflation
(contribution to year-over-year inflation; in percentage points)



Aggregate employment growth has slowed, with divergent dynamics across economic sectors.

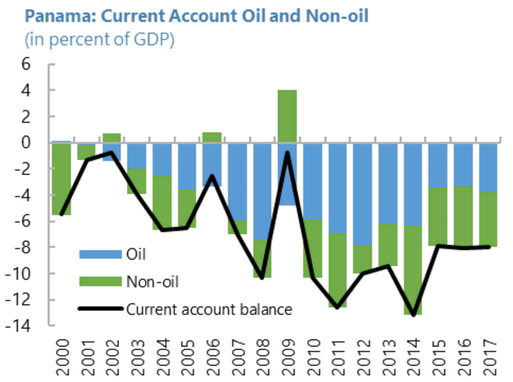
Panama: Employment Growth
(contribution to year-over-year growth; in percentage points)



Sources: National authorities and IMF staff calculations. 1/ 4-quarter moving averages. Zona Libre de Colon (ZLC) measured in gross metric tons.

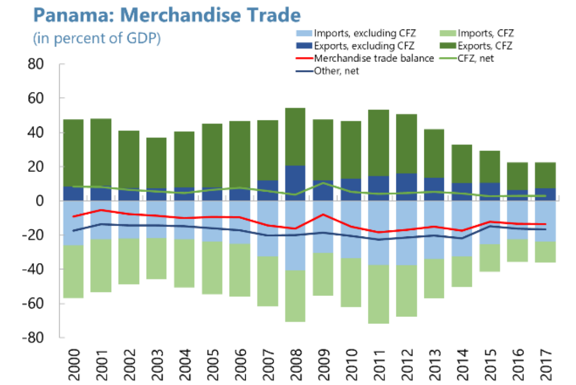
Figure 3. Panama: External Sector Developments

The current account deficit has remained stable, despite rising oil prices…



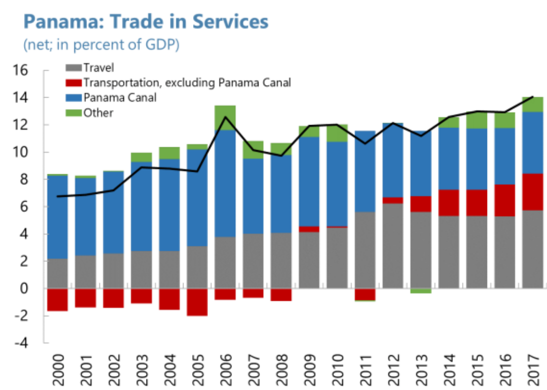
Sources: INEC and IMF staff calculations.

…which contributed to a small increase in the merchandise trade deficit.



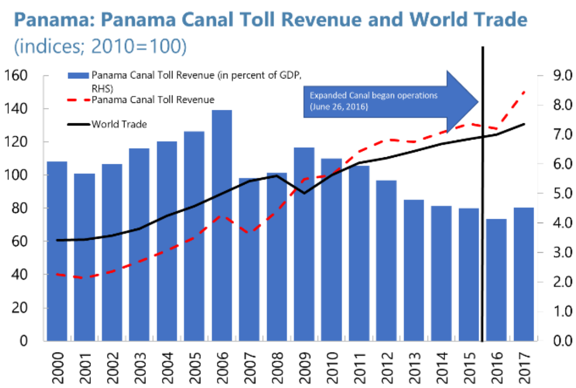
Sources: INEC and IMF staff calculations.

The surplus on trade in services continued to grow…



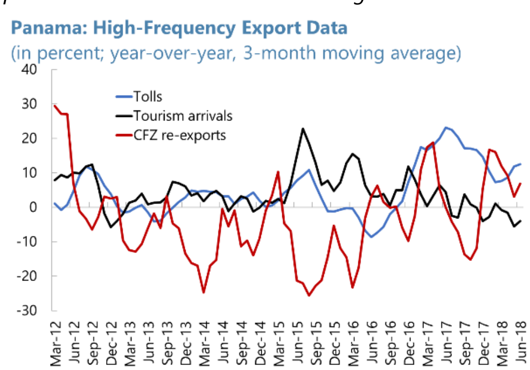
Sources: INEC and IMF staff calculations.

…partly due to strong revenues from the expanded Panama Canal.



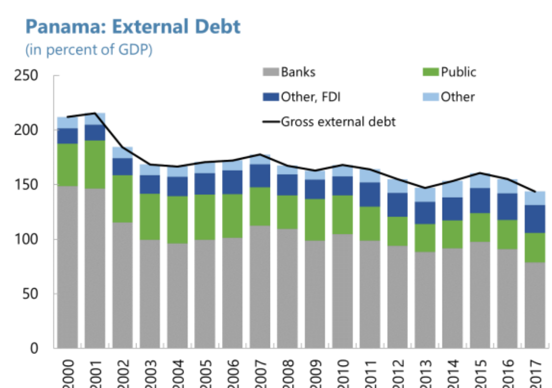
Sources: IMF World Economic Outlook, INEC and IMF staff calculations.

High frequency data suggests that the CFZ continues to recover but that tourism is slowing and the impact of the expanded canal on toll revenue waning.



Sources: INEC and IMF staff calculations.

External debt remains on a downward trajectory.

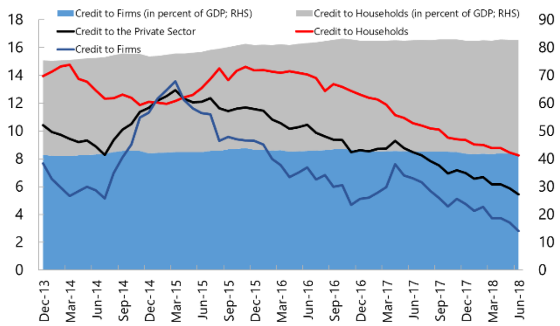


Sources: INEC and IMF staff calculations.

Figure 4. Panama: Macrofinancial Developments

Credit remains high despite decelerating credit growth.

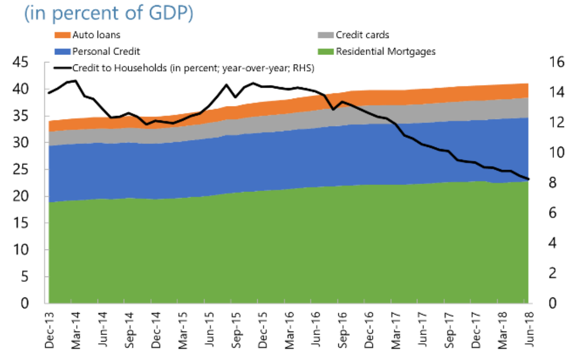
Panama: Credit to the Private Sector
(year-over-year; in percent)



Sources: SBP and Fund staff calculations.

Household credit drove the increase in credit-to-GDP in recent years, but is moderating…

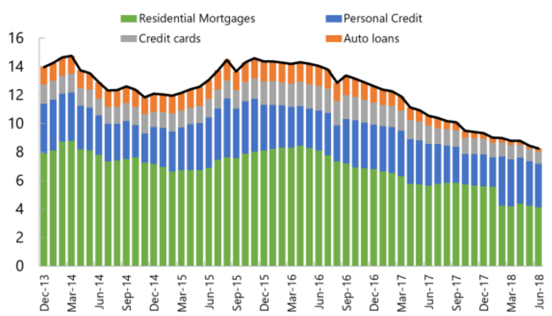
Panama: Credit to Households
(in percent of GDP)



Sources: SBP and Fund staff calculations.

…across all components, with the deceleration in mortgage lending driving that in household credit growth.

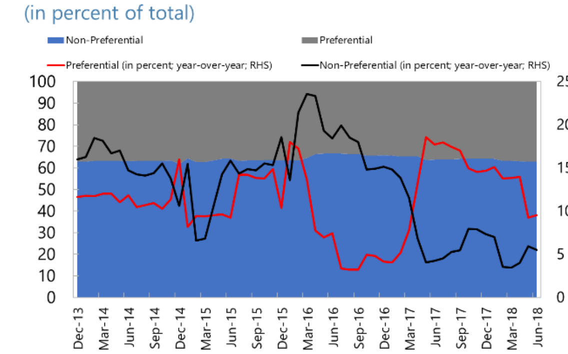
Panama: Credit to Households
(contribution to year-over-year growth; in percentage points)



Sources: SBP and Fund staff calculations.

A large chunk of mortgage lending benefits from interest rate subsidies, with growth in subsidized mortgages for lower-cost housing helping to offset a deceleration in non-subsidized mortgage lending

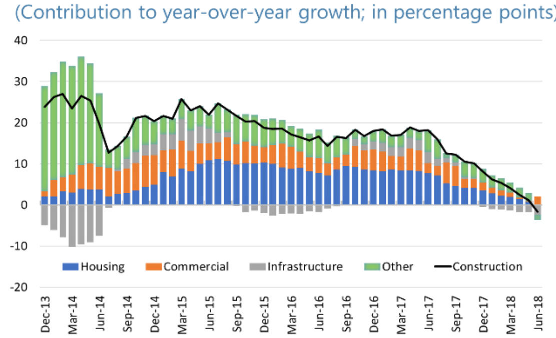
Panama: Residential Mortgage Credit
(in percent of total)



Sources: SBP and Fund staff calculations.

The moderation in property markets has also be reflected in lower lending for the construction sector, across all segments of property markets…

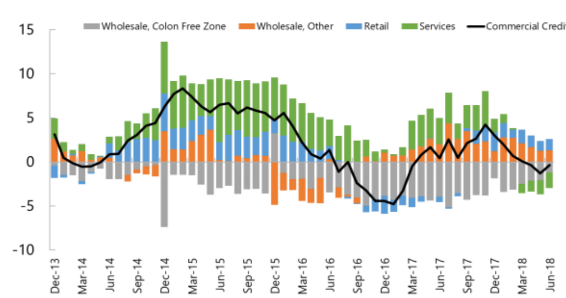
Panama: Construction Credit
(Contribution to year-over-year growth; in percentage points)



Sources: SBP and Fund staff calculations.

…while banks continue to reduce their exposure to the still struggling Colon Free Zone, pulling down commercial credit.

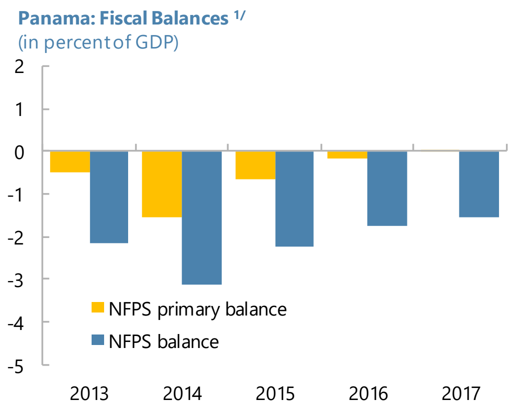
Panama: Commercial Credit
(contribution to year-over-year growth; in percentage points)



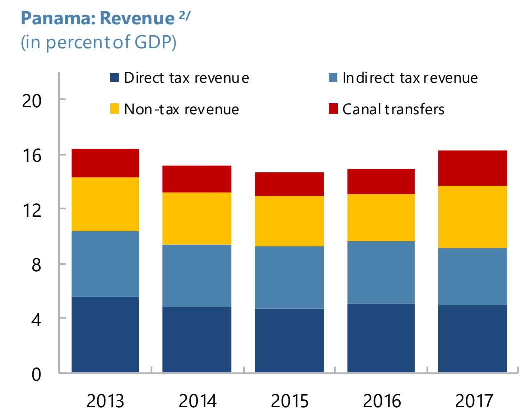
Sources: SBP and Fund staff calculations.

Figure 5. Panama: Fiscal Developments

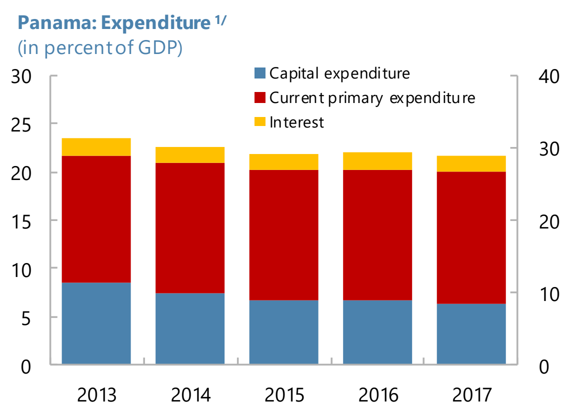
The fiscal deficit narrowed further…



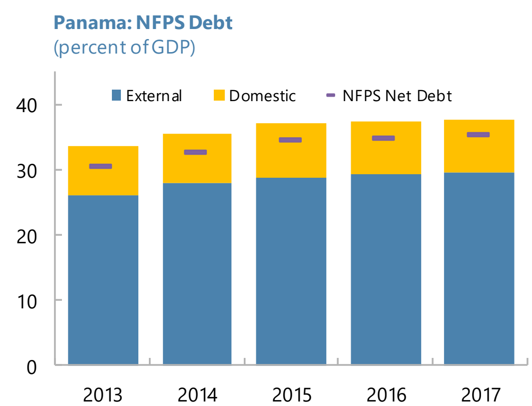
…as non-tax revenue and canal transfers increased, offsetting a decline in tax revenue.



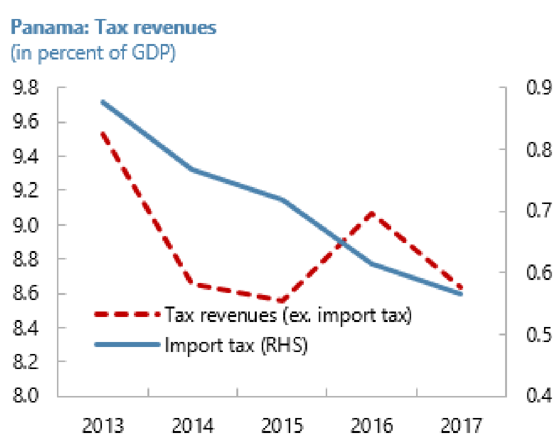
Expenditure remained contained…



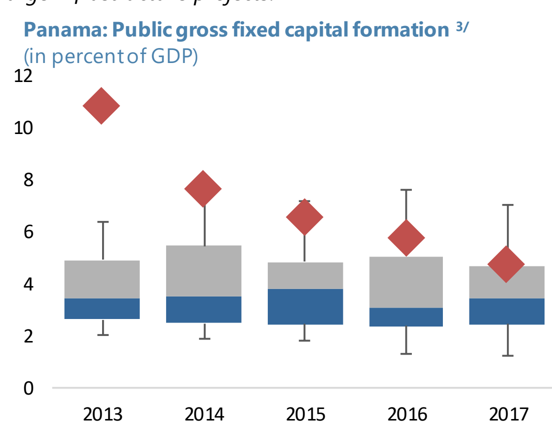
…and debt remains stable below the ceiling set in the fiscal rule.



Tax revenues have stabilized but challenges in customs administration continue to affect import taxes.



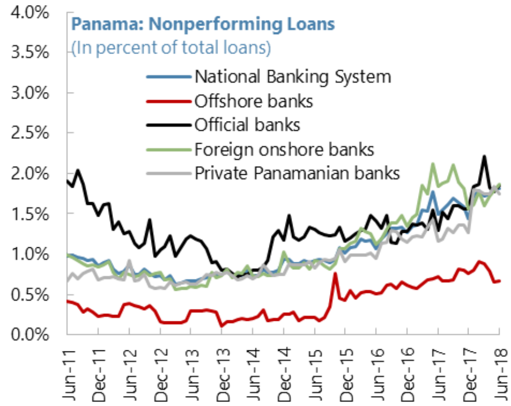
Public investment has fallen the completion of several large infrastructure projects.



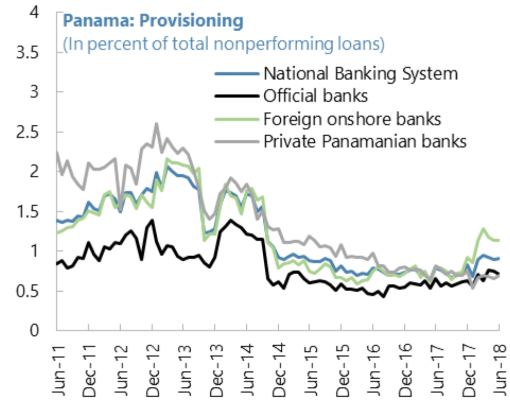
Sources: National authorities; WEO database and IMF staff calculations.
1/ Non-financial Public Sector.
2/ Data refer to the Central Government.
3/ Countries considered in the chart are CAPDR (Guatemala, Honduras, Nicaragua, El Salvador, Costa Rica, Panama, and the Dominican Republic) and LA6 (Brazil, Chile, Colombia, Mexico, Peru, and Uruguay).

Figure 6. Panama: Banking Sector Soundness

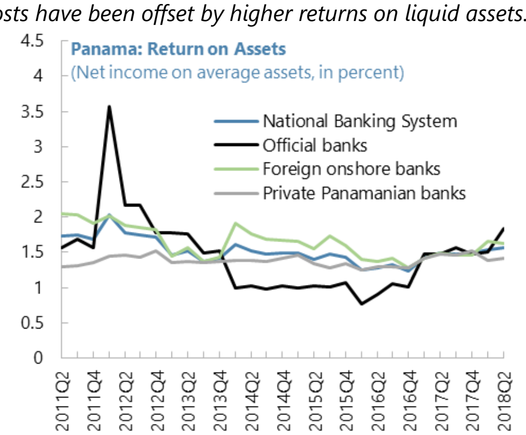
NPLs remain low but have doubled in recent years…



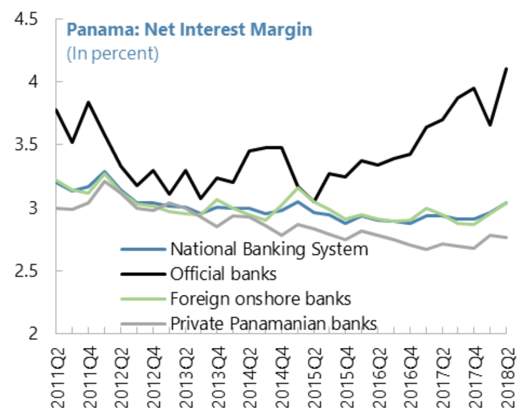
…while provisioning coverage improved sharply in 2018 with the adoption of IFRS 9 provisioning requirements.



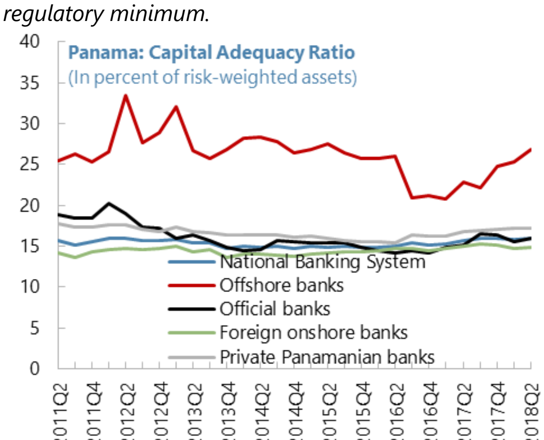
Banks' profitability has remained stable as rising funding costs have been offset by higher returns on liquid assets…



…and net interest margins have remained broadly stable.



Banks' capital adequacy remains well in excess of regulatory minimum.



Banks' liquidity has remained broadly stable.

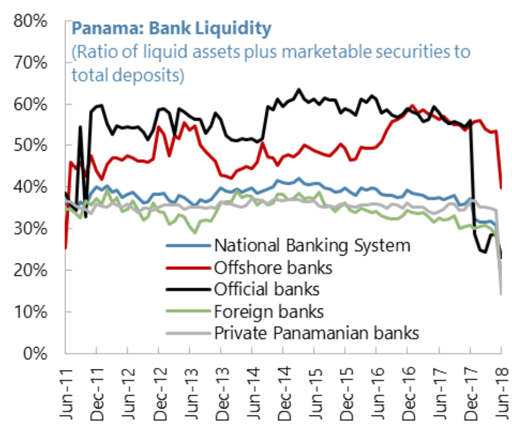


Table 1. Panama: Selected Economic and Social Indicators

Population (millions, 2016)	4.0	Poverty line (percent, 2017)	20.7
Population growth rate (percent, 2016)	1.6	Adult literacy rate (percent, 2010)	94.0
Life expectancy at birth (years, 2016)	77.9	GDP per capita (US$, 2017)	15,317.7
Total unemployment rate (August, 2018)	6.0	IMF Quota (SDR, million)	376.8

						Projection					
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
					(Percent change)						
Production and prices											
Real GDP (1996 prices)	**6.6**	**6.0**	**5.8**	**5.0**	**5.4**	**4.3**	**6.3**	**5.8**	**5.6**	**5.5**	**5.5**
Consumer price index (average)	4.0	2.6	0.1	0.7	0.9	1.5	2.0	2.1	2.0	2.0	2.0
Consumer price index (end-of-year)	3.7	1.0	0.3	1.5	0.5	1.5	2.0	2.1	2.0	2.0	2.0
Output gap (% of potential)	0.0	-0.5	-0.4	-0.3	-0.1	-1.2	-0.5	0.1	0.0	0.0	0.0
Domestic demand (at constant prices)											
Public consumption	**2.1**	**3.0**	**7.0**	**11.8**	**10.1**	**9.0**	**5.6**	**5.0**	**5.6**	**4.9**	**3.7**
Private consumption	4.2	4.6	7.5	19.1	17.2	6.3	6.8	5.4	4.3	4.8	4.1
Public investment 1/	33.4	-25.8	-8.8	-1.1	-10.2	-4.8	9.5	1.1	2.8	-0.9	4.1
Private investment	16.5	22.3	6.5	0.8	6.1	6.6	4.9	5.2	4.6	5.0	4.3
Financial sector											
Private sector credit	**12.1**	**9.1**	**11.4**	**8.4**	**6.5**	**5.0**	**6.0**	**7.1**	**6.8**	**6.8**	**6.9**
Broad money	7.2	8.2	5.5	4.1	5.2	5.3	6.7	8.0	7.6	7.5	7.5
Average deposit rate (1-year)	2.7	2.7	2.7	2.7	2.7	...	...	...	...	...	...
Average lending rate (1-year)	3.3	3.3	3.3	3.5	3.5	...	...	...	...	...	...
External trade											
Exports of goods and services	**-2.2**	**-5.2**	**-1.5**	**-9.1**	**7.9**	**3.9**	**9.6**	**9.3**	**7.2**	**6.5**	**6.4**
Imports of goods and services	-2.8	-2.5	-11.1	-6.4	5.8	8.5	6.1	5.9	5.8	6.1	6.2
					(In percent of GDP)						
Saving-investment balance											
Gross domestic investment	**44.0**	**45.2**	**44.7**	**44.6**	**43.8**	**44.0**	**43.5**	**42.9**	**42.3**	**41.8**	**41.2**
Public sector	10.4	7.3	6.3	5.9	4.8	4.4	4.5	4.3	4.2	3.9	3.7
Private sector	33.6	37.8	38.4	38.7	39.0	39.6	39.0	38.6	38.1	37.8	37.5
Gross national saving	34.6	32.0	36.8	36.6	35.8	35.0	35.9	36.7	36.8	36.3	35.8
Public sector	6.8	4.9	4.9	5.2	6.0	5.1	5.5	5.5	5.3	5.0	4.8
Private sector	27.8	27.1	32.0	31.5	29.8	29.8	30.3	31.2	31.5	31.3	31.0
Public finances 1/											
Revenue and grants	**24.4**	**22.7**	**22.6**	**22.6**	**22.1**	**22.2**	**22.2**	**22.3**	**22.1**	**22.0**	**21.8**
Expenditure	28.4	27.5	25.9	25.5	24.1	24.4	24.5	24.1	23.8	23.3	22.8
Current, including interest	16.8	17.1	16.9	17.2	17.4	18.3	18.1	18.0	17.9	17.7	17.5
Capital	11.7	10.4	8.9	8.3	6.8	6.2	6.4	6.1	5.9	5.5	5.3
Overall balance, including ACP 2/	-4.1	-4.8	-3.3	-2.9	-2.1	-2.2	-2.3	-1.8	-1.7	-1.3	-1.0
Overall balance, excluding ACP 2/	-2.2	-3.1	-2.2	-1.8	-1.6	-2.0	-2.0	-1.7	-1.7	-1.5	-1.5
Total public debt											
Debt of Non-Financial Public Sector 3/	**33.6**	**35.6**	**37.2**	**37.4**	**37.8**	**38.3**	**37.3**	**36.2**	**35.2**	**34.1**	**33.2**
External	26.2	28.0	28.8	29.2	29.7	29.8	27.6	24.1	21.6	19.7	17.8
Domestic	7.4	7.6	8.4	8.1	8.1	8.5	9.7	12.1	13.5	14.4	15.4
Debt of ACP	3.1	4.5	5.1	4.8	4.1	3.5	2.9	2.4	1.9	1.5	1.2
Other 4/	4.0	3.6	3.3	4.0	3.7	3.5	3.2	3.0	2.8	2.6	2.4
External sector											
Current account	**-9.4**	**-13.1**	**-7.9**	**-8.0**	**-8.0**	**-9.0**	**-7.6**	**-6.2**	**-5.6**	**-5.4**	**-5.4**
Net exports from Colon Free Zone	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net oil imports	6.2	6.3	3.5	3.4	3.8	5.1	5.1	5.0	4.9	4.8	4.7
Net foreign direct investment inflows	7.7	8.1	7.3	8.0	7.5	6.6	5.8	5.9	6.0	5.8	5.8
External Debt	147.1	153.3	160.6	155.1	143.7	150.7	153.0	153.3	152.6	151.3	150.7
External public debt 5/	29.3	32.5	33.9	34.0	33.8	33.3	30.5	26.4	23.6	21.3	19.0
Foreign liabilities of the private sector	117.8	120.8	126.7	121.1	109.9	117.4	122.6	126.9	129.0	130.1	131.8
Foreign liabilities of the private sector, excl. domestic banks	63.0	64.3	65.8	61.9	52.4	60.4	67.4	73.2	76.8	79.1	84.4
Foreign liabilities of the private sector, excl. offshore banks	84.1	85.4	90.0	89.2	88.8	97.2	103.8	110.3	115.4	119.4	120.5
Foreign liabilities of the private sector, excl. all banks	29.3	28.9	29.1	30.0	31.3	40.2	48.6	56.7	63.2	68.4	73.1
Memorandum items:											
GDP (in millions of US$)	46,718	51,228	54,316	57,821	61,838	65,465	70,981	76,706	82,632	88,926	95,704

Sources: Comptroller General; Superintendency of Banks; and IMF staff calculations.
1/ Includes Panama Canal Authority (ACP).
2/ Starting from 2015, includes overspending allowed under Article 34 of Law 38 of 2012.
3/ Non-Financial Public Sector according to the definition in Law 31 of 2011.
4/ Includes contingent liabilities of ENA, ETESA, and AITSA.
5/ Includes the ACP.

Table 2. Panama: Summary Operations of the Non-Financial Public Sector[1/]

(In percent of GDP)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projection					
Revenues	**19.6**	**20.2**	**20.1**	**20.1**	**20.2**	**20.2**	**19.9**	**19.7**	**19.4**
Current revenue	19.5	20.1	20.1	20.1	20.2	20.2	19.9	19.6	19.3
Tax revenue	9.3	9.7	9.2	9.2	9.3	9.4	9.4	9.4	9.4
Nontax revenue	3.7	3.4	4.5	4.3	4.3	4.2	4.0	3.9	3.7
o/w: Panama Canal fees and dividends	1.8	1.8	2.7	2.6	2.6	2.5	2.3	2.2	2.1
Social security agency	5.6	5.8	5.8	5.9	5.9	5.9	5.8	5.7	5.5
Public enterprises' operating balance	0.2	0.1	0.1	0.3	0.3	0.3	0.3	0.3	0.3
Other 2/	0.7	1.1	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Capital revenue	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	**21.9**	**22.0**	**21.7**	**22.1**	**22.2**	**21.9**	**21.6**	**21.2**	**20.9**
Current primary expenditure	13.5	13.5	13.7	14.7	14.6	14.5	14.5	14.5	14.3
Central government 3/	8.1	7.9	8.1	8.6	8.6	8.6	8.6	8.6	8.6
Rest of the general government	5.5	5.6	5.7	6.1	6.0	6.0	6.0	5.9	5.7
Social security agency	5.0	5.1	5.2	5.6	5.6	5.5	5.5	5.4	5.3
Decentralized agencies	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Interest	1.7	1.7	1.7	1.7	1.7	1.7	1.6	1.6	1.6
Capital	6.6	6.7	6.3	5.7	6.0	5.7	5.5	5.2	4.9
Overall balance, excluding ACP 4/	**-2.2**	**-1.8**	**-1.6**	**-2.0**	**-2.0**	**-1.7**	**-1.7**	**-1.5**	**-1.5**
Panama Canal Authority (ACP)									
Revenue	4.8	4.3	4.6	4.7	4.6	4.6	4.5	4.5	4.5
Current primary expenditure	1.6	1.8	1.7	1.7	1.6	1.5	1.6	1.6	1.5
Transfers to the government	1.8	1.8	2.7	2.6	2.6	2.5	2.3	2.2	2.1
Interest payments	0.1	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1
Capital expenditure	2.3	1.6	0.5	0.5	0.5	0.4	0.4	0.4	0.3
Overall balance	-1.1	-1.2	-0.4	-0.2	-0.3	-0.1	0.0	0.2	0.5
Overall balance, including ACP	**-3.3**	**-2.9**	**-2.1**	**-2.2**	**-2.3**	**-1.8**	**-1.7**	**-1.3**	**-1.0**
Net financing, excluding ACP	2.7	0.2	1.0	2.0	2.0	1.7	1.7	1.5	1.5
External	2.4	2.1	2.4	1.8	0.1	-1.4	-0.6	-0.3	-0.5
Domestic	0.3	-2.0	-1.4	0.2	1.9	3.1	2.3	1.8	2.0
Memorandum items:									
Primary balance (excluding ACP)	-0.7	-0.2	0.0	-0.4	-0.4	-0.1	-0.2	0.0	0.0
Structural primary balance (excluding ACP) 5/	-0.6	-0.1	0.1	-0.1	-0.3	-0.1	-0.2	0.0	0.0
Primary balance (including ACP)	-1.4	-1.0	-0.2	-0.3	-0.4	0.1	0.1	0.4	0.7

Sources: Comptroller General; Ministry of Economy and Finance; and IMF staff calculations.

1/ Official presentation excludes the operations of the ACP as it is not part of the NFPS.

2/ Includes the balances of the nonconsolidated public sector and revenue of the decentralized agencies.

3/ Different from Table 3 as it excludes the transfers to other agencies.

4/ Starting from 2015, includes overspending allowed under Article 34 of Law 38 of 2012.

5/ Primary balance adjusted for the output gap.

Table 3. Panama: Summary Operations of the Central Government[1/]
(In percent of GDP)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projection					
Revenues and grants	**13.0**	**13.2**	**13.8**	**13.4**	**13.6**	**13.6**	**13.4**	**13.2**	**13.1**
Current revenue	12.9	13.1	13.7	13.4	13.6	13.6	13.4	13.2	13.1
Taxes	9.3	9.7	9.2	9.2	9.3	9.4	9.4	9.4	9.4
Direct taxes	4.7	5.1	4.9	4.9	5.0	5.1	5.1	5.1	5.1
Income tax	4.2	4.6	4.4	4.4	4.4	4.3	4.3	4.3	4.3
Tax on wealth	0.5	0.5	0.5	0.5	0.6	0.8	0.8	0.8	0.8
Indirect taxes	4.5	4.6	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Import tax	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
ITBMS	2.4	2.6	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Petroleum products	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other tax on domestic transactions	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Nontax revenue	3.7	3.4	4.5	4.3	4.3	4.2	4.0	3.9	3.7
Dividends	3.4	3.4	5.0	4.8	4.9	4.7	4.4	4.1	3.9
Of which : Panama Canal Authority	1.1	1.2	1.9	1.8	1.9	1.8	1.7	1.6	1.5
Panama Canal Authority: fees per ton 1/	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.6	0.6
Transfers from decentralized agencies	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Other	-1.0	-1.1	-1.8	-1.7	-1.7	-1.6	-1.4	-1.3	-1.2
Capital revenue	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	**17.0**	**17.2**	**16.9**	**16.7**	**16.9**	**16.7**	**16.4**	**16.0**	**15.8**
Current	11.0	10.7	10.9	11.1	11.0	11.1	10.9	10.8	10.9
Wages and salaries	4.0	4.3	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Goods and services	1.4	1.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Current expenditure of CSS	0.7	0.5	0.6	0.3	0.2	0.2	0.2	0.2	0.2
Transfers to public and private entities	3.2	2.8	2.6	3.1	3.1	3.1	3.1	3.1	3.1
Interest	1.7	1.7	1.7	1.7	1.7	1.7	1.6	1.6	1.6
Domestic	0.3	0.3	0.4	0.4	0.4	0.5	0.7	0.7	0.7
External	1.4	1.4	1.4	1.4	1.3	1.2	0.9	0.8	0.9
Capital	6.0	6.5	6.0	5.6	5.9	5.6	5.5	5.1	4.9
Savings 2/	1.9	2.4	2.8	2.4	2.6	2.5	2.5	2.4	2.3
Overall balance 3/	**-4.0**	**-4.0**	**-3.1**	**-3.2**	**-3.4**	**-3.1**	**-3.0**	**-2.7**	**-2.7**
Financing (net)	3.3	1.8	2.9	3.0	3.1	2.9	2.8	2.5	2.4
External	2.4	2.1	2.4	2.0	0.1	-1.5	-0.7	-0.4	-0.6
Domestic	1.0	-0.3	0.5	1.0	3.1	4.4	3.5	2.9	3.0
Memorandum items:									
Primary balance	-2.3	-2.3	-1.4	-1.5	-1.7	-1.4	-1.4	-1.2	-1.0
GDP (in millions of US$)	54,316	57,821	61,838	65,465	70,981	76,706	82,632	88,926	95,704

Sources: Comptroller General; Ministry of Economy and Finance; and IMF staff calculations.
1/ Includes public service fees.
2/ Current revenues and grants less current expenditure.
3/ Starting from 2015, includes overspending allowed under Article 34 of Law 38 of 2012.

Table 4. Panama: Summary Balance of Payments
(In percent of GDP; unless otherwise stated)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projection					
				(In percent of GDP)					
Current account	**-7.9**	**-8.0**	**-8.0**	**-9.0**	**-7.6**	**-6.2**	**-5.6**	**-5.4**	**-5.4**
Merchandise trade excluding Colón Free Zone, net	-14.8	-16.3	-16.7	-17.7	-16.3	-15.2	-14.8	-14.8	-15.0
Exports, f.o.b.	10.6	6.3	7.2	8.2	9.3	9.9	9.8	9.4	9.0
Of which: Copper	0.0	0.0	0.0	0.0	1.3	2.2	2.4	2.3	2.1
Of which: Gold	0.0	0.0	0.0	0.0	0.2	0.2	0.2	0.2	0.1
Imports, f.o.b.	25.4	22.6	23.9	25.9	25.6	25.1	24.6	24.2	23.9
Of which: Oil	6.0	5.4	6.9	8.9	8.6	8.1	7.6	7.2	7.0
Merchandise trade from Colón Free Zone, net	2.7	2.9	3.0	2.7	2.6	2.5	2.5	2.4	2.4
Re-exports, f.o.b.	18.7	16.1	15.1	13.8	13.0	12.7	12.5	12.3	12.0
Imports, f.o.b.	16.0	13.2	12.2	11.1	10.5	10.2	10.0	9.8	9.7
Services, net	13.0	12.9	14.0	13.5	13.6	13.9	14.1	14.3	14.5
Travel, net	5.3	5.3	5.7	5.5	5.7	5.9	6.2	6.4	6.6
Transportation, net	6.4	6.5	7.2	7.9	7.8	7.7	7.7	7.6	7.6
Of which: Canal	4.5	4.1	4.5	4.7	4.5	4.3	4.2	4.0	3.8
Other services, net	1.3	1.2	1.1	0.1	0.1	0.2	0.3	0.3	0.4
Income, net	-8.8	-7.5	-8.3	-7.5	-7.5	-7.4	-7.3	-7.4	-7.4
Primary, net	-8.6	-7.3	-8.1	-7.3	-7.3	-7.2	-7.2	-7.2	-7.2
Of which: Direct investment	-7.2	-5.9	-6.7	-5.3	-5.3	-5.3	-5.3	-5.4	-5.4
Secondary, net	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Of which: Workers' remittances	-0.7	-0.7	-0.6	-0.6	-0.7	-0.7	-0.7	-0.7	-0.8
Capital account	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Financial account	**-7.1**	**-11.8**	**-10.2**	**-9.0**	**-7.6**	**-6.1**	**-5.5**	**-5.4**	**-5.4**
Foreign direct investment, net	-7.3	-8.0	-7.5	-6.6	-5.8	-5.9	-6.0	-5.8	-5.8
Of which: Reinvested earnings	-6.2	-4.2	-5.1	-3.9	-3.0	-2.9	-3.0	-3.0	-3.0
Portfolio investment, net	-0.4	-0.1	-1.3	-1.2	0.6	2.2	1.0	0.4	0.6
Financial derivatives, net	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	0.7	-4.5	0.2	-1.4	-2.8	-2.8	-0.9	-0.4	-0.5
Resrve assets, net	-0.1	1.1	-1.6	0.3	0.4	0.4	0.3	0.3	0.3
Net errors and omissions	**0.7**	**-3.8**	**-2.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:									
Exports of goods and services (annual percent change)	-1.5	-9.1	7.9	3.9	9.6	9.3	7.2	6.5	6.4
Imports of goods and services (annual percent change)	-11.1	-6.4	5.8	8.5	6.1	5.9	5.8	6.1	6.2
Oil trade balance (percent of GDP)	-3.5	-3.4	-3.8	-5.1	-5.1	-5.0	-4.9	-4.8	-4.7
Gross international reserves (in millions of U.S. dollars)	4143	4745	3788	3964	4232	4510	4798	5103	5432
Net international investment position (in percent of GDP)	-71.6	-76.2	-81.4	-94.4	-94.1	-92.6	-91.0	-89.6	-88.2
Gross external debt (percent of GDP)	160.6	155.1	143.7	150.7	153.0	153.3	152.6	151.3	150.7

Sources: INEC; and IMF staff calculations.

Table 5. Panama: External Vulnerability Indicators
(In percent, unless otherwise specified)

	2013	2014	2015	2016	2017	Projection 2018	Projection 2019
Financial indicators							
Broad money (12-month percent change)	7.2	8.2	5.5	4.1	5.2	5.3	6.7
Private sector credit (12-month percent change)	12.1	9.1	11.4	8.4	6.5	5.0	6.0
Deposit rate (6-month; in percent) 1/	1.8	1.9	1.8	1.7	1.8	…	…
External indicators							
Merchandise exports (12-month percent change)	-7.0	-14.1	-5.5	-18.7	6.9	4.2	10.0
Merchandise imports (12-month percent change)	-5.5	-3.0	-12.8	-7.9	7.7	8.7	5.8
Current account balance (in percent of GDP)	-9.4	-13.1	-7.9	-8.0	-8.0	-9.0	-7.6
Capital account balance (in percent of GDP)	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance (in percent of GDP)	-9.2	-10.3	-7.1	-11.8	-10.2	-9.0	-7.6
Of which: direct investment	-7.5	-6.6	-5.8	-5.9	-6.0	-5.8	-5.8
Non-Financial Public Sector external debt (in percent of GDP)	26.2	28.0	28.8	29.2	29.7	29.8	27.6
In percent of exports of goods and services 2/	41.1	50.9	56.3	66.9	67.5	69.0	63.1
External interest payments							
In percent of exports of goods and services 2/	6.2	7.4	8.0	9.0	9.0	10.7	12.3
External amortization payments							
In percent of exports of goods and services 2/	113.8	132.2	153.9	185.8	172.2	146.6	147.1
REER, percent change (average, depreciation -) 6/	4.4	-2.3	-0.8	-8.6	-11.8	-13.0	…
Gross international reserves at end of period							
In millions of U.S. dollars 3/	3,145	3,549	3,694	4,341	2,966	3,142	3,410
In months of imports of goods and services	1.2	1.6	1.7	1.9	1.2	1.2	1.2
In percent of broad money 4/	10	10	10	11	7	7	8
In percent of short-term external debt 5/	9	9	8	10	8	7	7
	(In millions of U.S. dollars)						
Memorandum items:							
Nominal GDP	46,718	51,228	54,316	57,821	61,838	65,465	70,981
Exports of goods and services 2/	29,762	28,218	27,797	25,260	27,249	28,310	31,022
Imports of goods and services 2/	31,518	30,723	27,307	25,548	27,033	29,327	31,120

Sources: Ministry of Economy and Finance; and IMF staff calculations.
1/ One-year average for the banking system, comprises general license banks, excluding offshore banks.
2/ Includes net exports of the Colón Free Zone.
3/ Corresponds to gross foreign assets of the National Bank of Panama (a publicly-owned commercial bank).
4/ M2 consists of resident bank deposits only; estimates of U.S. currency in circulation are not available.
5/ Excludes off-shore banks' external liabilities. Short-term public external debt includes next year amortization.
6/ REER for 2018 is for January-June 2018

Table 6. Panama: Summary Accounts of the Banking System[1/]
(In millions of U.S. dollars, unless otherwise stated)

	2013	2014	2015	2016	2017
Net foreign assets	**5,928**	**6,074**	**5,021**	**3,974**	**1,752**
Net domestic assets	**26,424**	**28,932**	**31,916**	**34,493**	**38,726**
Public sector (net credit)	-5,128	-5,938	-6,918	-7,772	-7,301
Central government	-448	-854	-1,112	-1,209	-505
Rest of the public sector	-4,680	-5,085	-5,806	-6,562	-6,796
Credit to the private sector	36,548	39,883	44,439	48,161	51,310
Investments	4,596	5,442	6,145	6,777	8,039
Private capital and surplus	-7,128	-8,113	-8,872	-9,597	-10,390
Other items (net)	-2,465	-2,343	-2,878	-3,076	-2,933
Domestic liabilities to private sector	**32,352**	**35,005**	**36,937**	**38,468**	**40,478**
Total deposits	**32,116**	**34,719**	**36,616**	**38,264**	**40,324**
Demand deposits	7,695	8,213	8,114	8,148	8,250
Time deposits	16,485	17,681	19,135	20,493	21,796
Savings deposits	7,936	8,824	9,367	9,622	10,278
Bonds	**236**	**287**	**321**	**204**	**155**
			(Percent change)		
Net foreign assets	**-0.3**	**2.5**	**-17.3**	**-20.9**	**-55.9**
Net domestic assets	**32.4**	**9.5**	**10.3**	**8.1**	**12.3**
Credit to the private sector	12.1	9.1	11.4	8.4	6.5
Broad Money 2/	**8.0**	**10.7**	**8.3**	**5.1**	**-1.5**
			(In percent of GDP)		
Onshore banks					
Credit	**121.0**	**122.2**	**128.3**	**126.1**	**121.1**
Credit to the domestic private sector	78.2	77.9	81.8	83.3	83.0
Credit to non-residents	42.8	44.4	46.4	42.8	38.1
Deposits	**119.1**	**120.2**	**122.9**	**121.3**	**111.7**
Domestic private sector deposits	68.7	67.8	67.4	66.2	65.2
Government deposits	13.9	15.0	15.8	15.2	13.3
Of which , central government	3.4	4.6	4.5	3.4	1.9
Non-resident deposits	36.5	37.4	39.7	39.9	33.2
Offshore banks					
Credit	23.1	20.7	20.1	18.0	16.4
Deposits	22.7	21.7	23.0	20.9	18.2
			(Annual percent)		
Interest rates					
U.S. Federal Funds rate	0.1	0.1	0.4	0.4	1.0
Interbank interest rate 1 month	0.8	0.9	0.3	0.5	0.9
Average commercial lending rate 1 yr	6.8	7.1	7.5	7.4	8.0
Average consumer/personal lending rate ´	9.6	9.4	9.0	8.9	9.5
Average industrial lending rate 1 yr	6.4	6.5	6.9	7.3	7.9
Mortgage interest rate (excluding preferei	6.1	5.9	5.6	5.5	5.5
Average savings deposit rate 1 yr	2.7	2.7	2.7	2.7	2.7

Sources: Superintendency of Banks; National Bank of Panama; Savings Bank; and IMF staff calculations.

1/ Domestic banking system only (comprises general license banks; does not include offshore banks), unless otherwise specified. Nonresident deposits, credit, and investement are reported in the net foreign assets.

2/ Broad money consists of onshore bank deposits only; estimates of U.S. currency in circulation are not available.

Table 7. Panama: Financial Soundness Indicators [1/]

(In percent, end-of-period)

	2013	2014	2015	2016	2017				2018	
	Q4	Q4	Q4	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Asset quality										
Nonperforming loans as percent of total loans										
Banking system	0.8	0.9	1.0	1.3	1.6	1.5	1.7	1.5	1.7	1.8
Domestic banks 2/	0.8	1.0	1.0	1.2	1.3	1.2	1.4	1.4	2.0	1.8
Private	0.8	0.7	0.9	1.2	1.2	1.2	1.3	1.3	1.8	1.8
State-owned	0.8	1.2	1.2	1.3	1.4	1.3	1.6	1.6	2.3	1.9
Foreign banks	0.7	1.0	1.1	1.4	1.9	1.9	2.1	1.6	1.6	1.9
Ratio of provisions to nonperforming loans										
Banking system	171.2	90.9	80.8	82.7	70.5	78.9	67.8	81.3	94.6	88.9
Domestic banks 2/	155.3	99.5	78.0	72.1	68.4	72.9	67.0	71.2	66.7	70.0
Private	178.4	131.3	101.0	81.2	76.7	79.6	75.4	75.5	69.3	68.5
State-owned	132.1	67.7	55.1	63.1	60.1	66.2	58.7	66.8	64.0	71.6
Foreign banks	174.4	73.3	72.1	87.2	68.5	80.2	65.1	88.3	128.3	109.9
Profitability										
Net income on average assets										
Banking system	1.4	1.5	1.4	1.2	1.4	1.5	1.5	1.5	1.5	1.6
Domestic banks 2/	1.4	1.2	1.2	1.1	1.5	1.5	1.5	1.5	1.4	1.6
Private	1.4	1.4	1.3	1.3	1.4	1.5	1.5	1.5	1.4	1.4
State-owned	1.5	1.0	1.1	1.0	1.5	1.5	1.6	1.5	1.5	1.8
Foreign banks	1.4	1.7	1.6	1.3	1.4	1.5	1.5	1.5	1.7	1.6
Liquidity										
Ratio of liquid assets to total assets										
Banking system	17.7	19.5	17.0	16.7	15.4	15.0	14.2	13.7	12.5	12.2
Domestic banks 2/	21.7	24.8	20.7	21.2	18.3	19.5	18.1	17.9	14.1	14.9
Private	13.0	12.5	11.0	10.7	10.1	9.4	9.7	10.0	9.4	9.6
State-owned	30.3	37.2	30.5	31.6	26.5	29.5	26.5	25.8	18.9	20.2
Foreign banks	17.6	20.0	18.0	17.4	16.7	15.6	14.5	13.5	13.6	12.4
Ratio of liquid assets plus investments to total deposits 3/										
Banking system	45.4	47.2	45.7	45.1	44.0	43.6	44.5	44.1	42.8	42.4
Domestic banks	49.1	51.7	50.3	50.5	48.6	48.9	49.2	49.9	47.1	46.1
Private	40.6	41.1	40.1	40.3	39.3	38.2	40.6	41.8	40.6	41.7
State-owned	57.7	62.2	60.6	60.7	57.9	59.7	57.8	57.9	53.6	50.4
Foreign banks	44.9	46.8	45.0	43.3	43.1	42.1	42.8	41.0	41.0	40.1
Capital adequacy ratios										
Ratio of capital to risk-weighted assets										
Banking system	14.8	14.7	14.8	15.1	15.3	15.6	16.0	16.0	15.7	15.9
Domestic banks 2/	14.8	15.1	14.8	14.7	15.1	15.4	16.2	16.1	16.4	16.6
Private	14.7	14.7	14.9	15.2	15.3	15.7	15.9	15.9	17.2	17.2
State-owned	14.9	15.6	14.8	14.2	14.9	15.1	16.4	16.3	15.6	15.9
Foreign banks 4/	13.7	13.7	14.2	14.4	14.7	14.9	15.2	15.1	14.7	14.9
Ratio of capital to total assets										
Banking system	9.9	10.1	10.1	10.5	11.0	11.3	11.6	11.4	11.3	11.5
Ownership										
Foreign banks' share of domestic banking system assets	49.1	49.7	49.0	47.2	46.5	45.6	45.4	45.3	45.5	45.2

Sources: Superintendency of Banks; Financial Soundness Indicators (FSI) Database; and IMF staff calculations.

1/ National banking system only, comprises general license banks; does not include offshore banks.

2/ For Panama, average of domestic private banks and state-owned banks.

3/ For Panama, liquid assets, as defined in Article 75 of the 2008 Banking Law, also include marketable short-term securities.

4/ Calculated only for subsidiaries of foreign banks (excludes branches).

Annex I. Implementation of Past IMF Policy Advice

The authorities' macroeconomic and financial policies over the last year have been broadly in line with past Fund advice. During the 2017 Article IV consultation, Directors stressed the importance of continuing to enhance financial integrity through effective implementation of Panama's AML/CFT framework and measures to strengthen tax transparency and ensure effective exchange of tax information. They also emphasized the need to further strengthen the fiscal framework through a fiscal council and improved assessment and management of fiscal risks, as well as improvements in tax and customs administration. Directors also emphasized the need to strengthen financial sector oversight, macroprudential policy and crisis management to build resilience, including by aligning prudential regulations with Basel III, through improved coordination across financial sector supervisors, with the development of macroprudential policy, and the enhancement of Panama's crisis management framework.

1. **Financial Integrity and Tax Transparency**: The authorities are working on their action plan to address remaining gaps identified in the latest assessment of Panama's AML/CFT framework against the global FATF standard by the FATF-style regional body for Latin America, GAFILAT in early 2018. The intensity of AML/CFT supervision has increased, especially for DNFBPs, facilitated by the strengthening of human, financial and ICT capacity. However, the need to make a range of tax crimes a predicate offence to money laundering remains a critical gap in Panama's legal framework for AML/CFT. Recent initiatives to strengthen tax transparency and exchange of tax information include the launch of information exchange with the U.S. authorities (under FATCA) in September 2017. Panama also extended its network of information sharing agreements, after committing to adopt the OECD's multilateral frameworks (Common Reporting Standards (CRS) and Multilateral Competent Authority (MCAA)). The capacity for tax administration capacity for information exchange has strengthened with a reorganized unit responsible for information exchange under the Directorate of General Income (DGI) and increased staffing.

2. **Fiscal Policy**: Fiscal consolidation has continued, with fiscal policy firmly anchored on the Social Fiscal Responsibility Law (SFRL). The authorities introduced draft legislation to strengthen the fiscal rule to replace the "adjusted-deficit" rule with a ceiling on the NFPS headline deficit and to adopt an expenditure rule, which was approved by the National Assembly in October 2018. The draft legislation to establish a fiscal council to strengthen the transparency and accountability of the fiscal framework was submitted to the National Assembly and was approved in October 2018. Measures to monitor fiscal risks and contingent liabilities are still in their early stages. The pace of revenue administration reform, particularly of customs service is short of expectations. Important weaknesses in institutional capacity and governance remain unaddressed.

3. **Financial Sector Reforms**: Prudential regulation has been largely aligned to Basel III. The remaining priority is to align prudential regulations for operational risk with Basel III, which is expected to be completed in 2018. Draft legislation is under consideration to strengthen the bank resolution framework to expand the set of resolution tools in line with advice from IMF technical assistance. Coordination across financial supervisors has continued to strengthen, with inspections of financial conglomerates having taken place for the first time in 2017. However, systemic risk oversight continues to be mainly conducted by the SBP, with the CCF's role in oversight remaining focused on coordination on prudential supervision.

Annex II. Risk Assessment Matrix[1]

Source of Risk	Relative Likelihood	Time Horizon	Expected Impact		Recommended Policy Response
External Risks					
Rising protectionism and retreat from multilateralism	**High**	**Short- to medium-term**	**High**	Escalating and sustained trade actions and spreading isolationism would directly affect Panama through lower exports and growth as slower growth or a decline in world trade would directly lower transits on the Panama Canal and associated fiscal revenue and lower growth in key trading partners would directly lower exports. Increased uncertainty about growth triggered by escalating trade tensions could lead to increased financial market volatility, with the negative consequences for growth potentially exacerbated by increased uncertainty and lower investment.	Continue efforts to diversify key export markets. Advance structural reforms to improve productivity and strengthen competitiveness.
Sharp tightening of global financial conditions	**High**	**Short- to medium-term**	**Medium**	A sharp tightening of global financial conditions, potentially triggerd by a sharper-than-expected increase in U.S. interest rates in response to signs of firmer-than-expected inflation, would increase sovereign financing costs and Panamanian interest rates, leading to higher debt service and refinancing risks, principally for households whose indebtedness has increased. Should rising U.S. interest rates put appreciation pressure on the U.S. dollar, Panama's REER would also face appreciation pressures, potentially eroding Panama's external competitiveness and exprots.	Continue to deepen domestic financial markets and rebalance public sector financing to domestic sources. Consolidate public finances to avoid a sudden, sharp increase in domestic rates and possible crowding out of private investment. Current account to adjust automatically through lower imports. Enhance crisis preparedness of Panama's regional financial center.
Weaker than expected global growth, especially if concentrated in the United States and/or China	**Medium**	**Short- to medium-term**	**Medium**	Slower global growth, especially if concentrated in the United States and/or China, two of Panama's most important trading partners, would lead to an immediate decline in Panamanian output, directly through lower exports and Panama canal activity and value-added activities associated with the canal, including the Colon Free Zone re-exports. Slower canal activity may also indirectly affect the broader economy as lower canal-related income may lead to lower consumer spending and dampen government canal revenue.	Advance structural reforms to improve productivity and strengthen competitiveness. Current account to adjust automatically through lower imports.
Sizable deviations from baseline energy prices	**Medium**	**Short- to medium-term**	**Medium**	A sharp rise in oil prices due to a negative supply shock could lead to a deterioration of the trade balance and current account deficit. On the other hand, a significant drop in oil prices due to materialization of downside risks to growth, or positive supply shocks, would improve the current account.	Advance structural reforms to lower oil dependence, improve productivity and strengthen competitiveness. Current account to adjust automatically through higher or lower imports.
Unsustainable macroeconomic policies	**Medium**	**Short- to medium-term**	**Medium**	Usustainable policies in advanced economies to boost near term growth beyond sustainable levels could exacerbate underlying vulnerability, hurting confidence and growth. Panama would be directly affected throguh lower trade and related confidence effects.	Advance structural reforms to improve productivity and strengthen competitiveness.
Domestic Risks					
Setbacks in strengthening AML/CFT or improving tax transparency.	**Medium**	**Short- to medium-term**	**High**	Reputational damage, reduced external funding and access to international financial services, higher borrowing costs, and increased scrutiny of Panamanian entities.	Advance AML/CFT and tax transparency efforts in line with recommendations from GAFILAT and OECD assessments.
Correction in residential/commercial property markets	**Medium**	**Short- to medium-term**	**Medium**	Sharp reduction in prices/wealth would reduce domestic demand and trigger negative macro-financial feedback loops in the economy. Non-performing loans in the banking system would increase significantly.	Strengthen monitoring of systemic risk. Develop macroprudential policy framework and strengthen financial sector crisis preparedness.
Relaxation of fiscal policy/deficit ceilings.	**Low**	**Medium-term**	**Medium**	Larger borrowing and contribution to fiscal vulnerability. Reduced market confidence.	Build fiscal buffers and commit to fiscal targets below the SFRL ceilings.

[1] The Risk Assessment Matrix (RAM) shows events that could materially affect the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability of below 10 percent, "medium" a probability of between 10 and 30 percent, and "high" a probability of between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short-term" and "medium-term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex III. External Stability Assessment

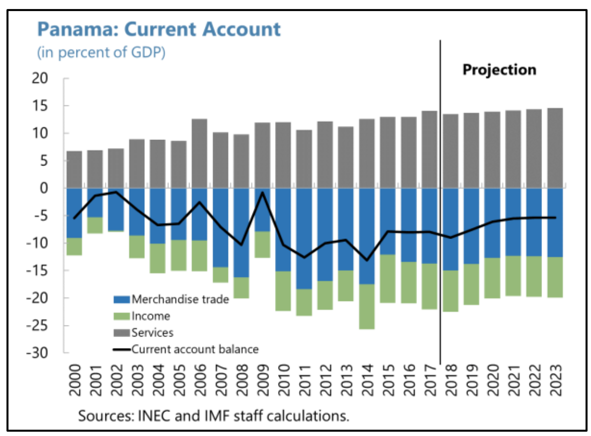
Panama's external position is broadly consistent with fundamentals and desired policy settings. Market-share and survey-based indicators of competitiveness also suggest that Panama remains highly competitive, particularly amongst its LAC peers. Panama's external stability remains closely dependent on continued financial stability and the global economic environment, particularly developments in global interest rates and world trade. Policy efforts should continue to focus on enhancing Panama's resilience to these risks by reducing vulnerabilities and building policy buffers.

A. Background

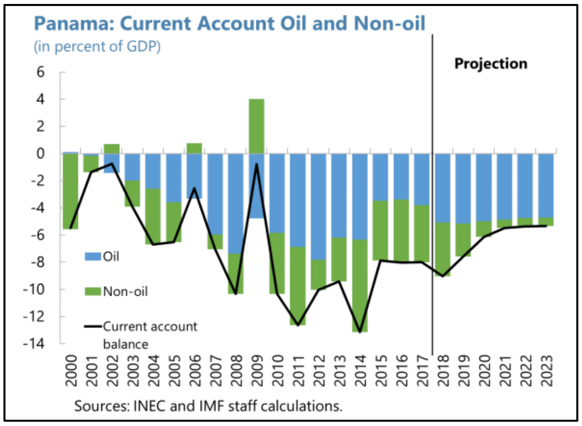
Current Account

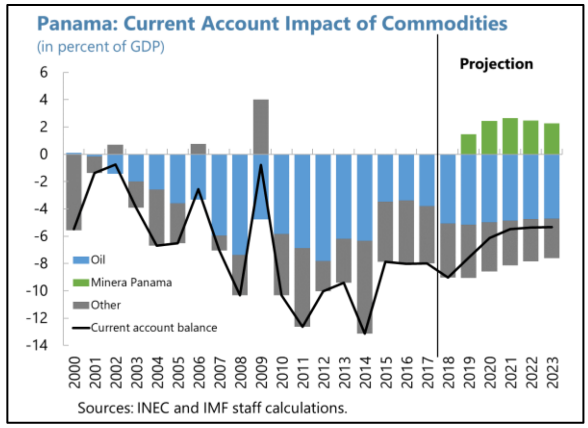
1. **The current account deficit has stabilized.** The deficit continued at 8.0 percent of GDP in 2017 (the same level as in 2016). This sustained a narrowing in the deficit since the most recent peak of 13.1 percent of GDP in 2014. Since the peak, the decline in the deficit has largely been associated with higher private savings as lower global commodity prices reduced the oil import bill, although imports also declined more broadly as several large-scale construction projects wound down. However, the import bill started to rise again in 2017 with the pick-up in global commodity prices. The overall impact on the current account deficit from rising oil prices has thus far been offset by strong service exports, fueled primarily by revenue from the expanded Panama Canal, leading to the stabilization in the current account deficit. The Colon Free Zone (CFZ) continues to grapple with economic challenges in its main export markets (e.g. Venezuela) and an ongoing trade dispute with Colombia, but showed some signs of stabilization in 2017. The stabilization of activity in the CFZ helped to arrest the impact of the deterioration in its trade surplus in recent years on Panama's aggregate trade balance and current account.

2. **Over the medium term, the current account deficit is expected to stabilize below its 2017 level.** Higher oil prices are expected to fuel a temporary increase in the CA deficit in 2018 (to 9.0 percent of GDP), but over the medium-term, the impact will be more than offset by an increase in exports as a new mine starts exports in 2019, helping to narrow the current account deficit to about 5 percent of GDP. The new mine will diversify Panama's exports into primary commodities (mainly copper and gold), exports of which are expected to peak at just under 3 percent of GDP in 2021 when the new mine is expected to reach peak production. However, the recent Supreme Court ruling on the validity of Law 9 creates uncertainty on some elements of the contract with the mining company representing a downward risk to exports. The diversification of Panama's export basket will help to



enhance Panama's external stability by reducing its vulnerability to shocks in its main markets for its service exports (the United States and Central and South America).[1]





3. Panama's efforts to forge stronger relationships with key trading partners and to diversify its export markets should lend support to external stability. Panama established diplomatic relations with China in 2017. The two countries have subsequently signed several bilateral agreements and are now in the early stages of negotiating a free trade agreement, which they envision as a facilitating mechanism for developing Panama into the main point of entry for Chinese products and investment into Latin American. China is already the fourth largest export market for Panama's goods exports and the second largest user of the Panama Canal after the United States. With the aim of further diversifying its economic ties, Panama has also signed free trade agreements with South Korea and Israel and begun negotiations with India. The ongoing trade dispute with Colombia, will, however, continue to complicate bilateral trade with Colombia, particularly exports from Panama's CFZ.

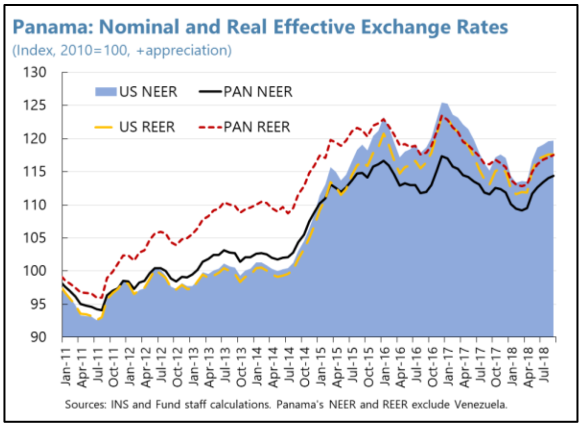
Real Effective Exchange Rate

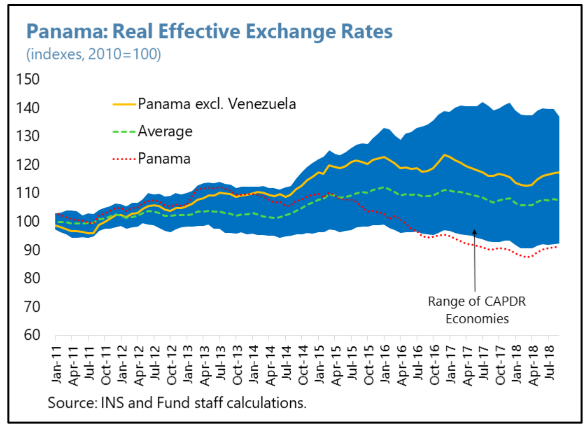
4. The real effective exchange rate (REER) has depreciated. Panama's REER depreciated by 6.3 percent in 2017 and appreciated by 1.6 percent in the first nine months of 2018.[2] Given dollarization, movements in Panama's REER and NEER continue to closely mirror developments in the U.S. dollar and are expected to continue to do so going forward. Should stronger U.S. growth and rising U.S. interest rates put renewed appreciation pressure on the U.S. dollar, Panama would also face appreciation pressures, potentially eroding external competitiveness. However, the assessment of Panama's competitiveness based on movements in its REER continues to be hampered by the use of bilateral goods trade data to determine the relative weights in its REER given that services account for about 70 percent of exports outside of the CFZ. To the extent that the markets for Panama's

[1] See IMF Country Report No.17/106 for a discussion of Panama's main external exposures and a related assessment of potential spillover effects from external shocks.

[2] Excluding Venezuela, a traditionally important trading partner currently experiencing hyper-inflation, from the calculation of Panama's REER.

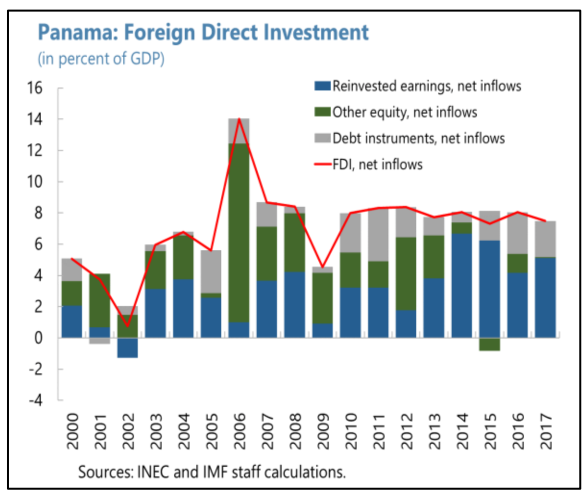
service exports differ from that of its goods exports, the REER may not accurately capture movements in Panama's price competitiveness relative to its trading partners.



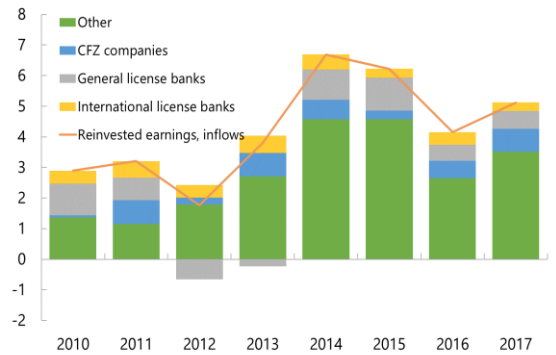


Capital and Financial Flows

5. **The financing structure of the current account deficit has been supportive of external stability.** The deficit has traditionally been financed by FDI, with these inflows expected to continue. These inflows remained robust in 2017, at 7.5 percent of GDP (compared to 8.0 percent in 2016). FDI has been concentrated in equity instruments, with the bulk of equity investment since 2014 primarily comprised of the reinvested earnings of large multinational corporations operating in Panama (versus banks or firms operating in the Colon Free Zone) rather than new investments. Reinvested earnings reached 5.1 percent of GDP in 2017 (of total equity-related FDI flows of 5.2 percent of GDP). Over 2/3 percent of foreign entities' profits (on aggregate) were reinvested into Panama in 2017. Thus, the sustainability of Panama's current account deficit is closely linked to the continued profitability of these multinational firms in Panama and their continued reinvestment of these earnings into Panama. With about a quarter of FDI originating in the United States, recent changes to U.S. corporate tax rules continue to present a risk to the stability of these inflows if they encourage firms to repatriate profits to the United States; however, there have been no signs thus far of a trend toward profit repatriation. At the same time, however, any decline in FDI receipts under the financial account is likely to be offset by a decline in outflows under the income account. Portfolio inflows have played a less important role in financing Panama's current account deficit, have remained relatively stable over time, and are expected to continue to do so.

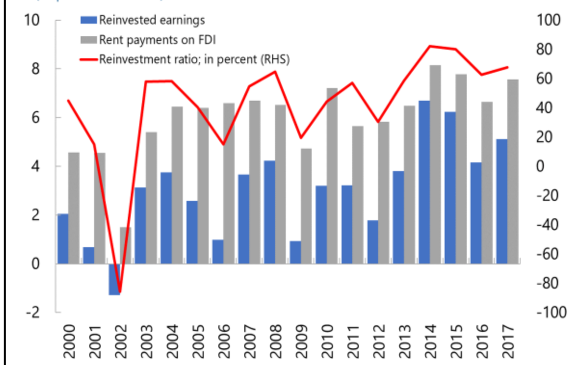


Panama: Reinvested Earnings Inflows
(in percent of GDP)



Sources: INEC and IMF staff calculations.

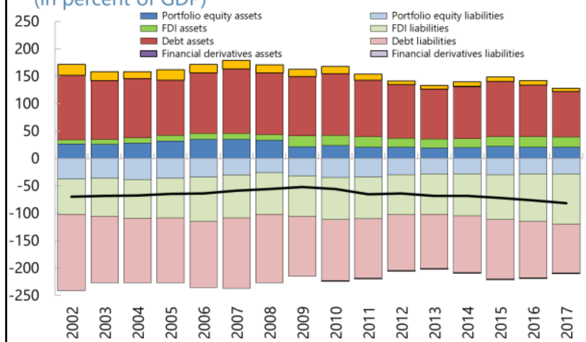
Panama: Reinvestment of Foreign Firms' Profits
(in percent of GDP)



Sources: INEC and IMF staff calculations.

External Balance Sheets

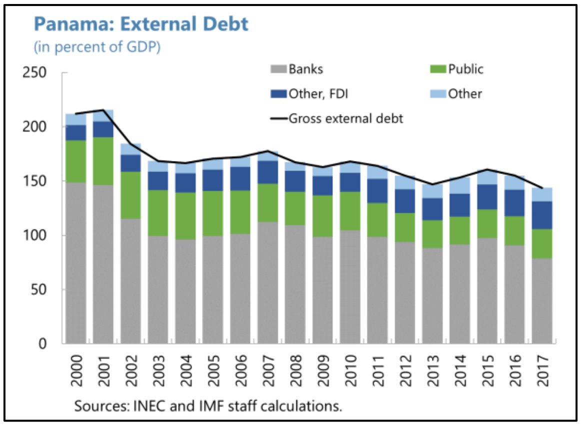
Panama: IIP Composition, by Instrument
(in percent of GDP)

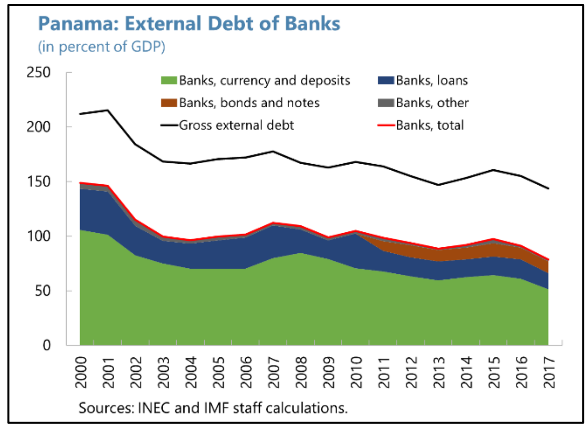


Sources: INEC; IMF staff calculations.

6. **Panama's net external liabilities continued to rise in 2017.** Panama's net international investment position (NIIP) is a net liability position – net liabilities increased to 81.4 percent of GDP in 2017, continuing the upward trend of the last decade. The increase has continued to be driven by the strong equity-related FDI inflows. Nevertheless, the NIIP is expected to remain relatively stable over the medium-term as the current account deficit is projected to fall below that required to stabilize the NIIP (see Section B).

7. **Despite the increase in net external liabilities, external debt fell to 144 percent of GDP in 2017 (from 155 percent in 2016).** External debt remains concentrated in private debt (about 80 percent of total external debt) primarily related to Panama's regional banking sector. As such, the fall in external debt was almost entirely related to a reduction in the banking sector's foreign liabilities as non-resident deposits into the international banking sector declined, mainly from Colombia, Venezuela, and Brazil, continuing the decline observed in recent years. While the pace of deposit outflows from the international banking sector accelerated in 2017, the acceleration does not appear to be a sign of generalized deposit flight, but was rather associated with the closure of a few international license banks operating in Panama as well as the completion of a large-scale credit transaction by one bank backed by pledged deposits, which were released when the loan was cancelled.





8. The international banking sector continues to account for the bulk of Panama's external debt liabilities. Despite the recent decline, the external debt of the international banking center remains sizeable at 79 percent of GDP, accounting for 55 percent of total external debt. FDI-related debt liabilities and government debt each account for a further 18 percent, with private non-FDI external debt limited. With FDI expected to continue to finance the current account deficit, FDI debt-related liabilities are expected to gradually increase as a share of external debt (from about 18 percent in 2017 to about 33 percent by 2023), helping to mitigate Panama's external vulnerabilities. The composition and maturity structure of public external debt has also improved in recent years, reflecting favorable external financing conditions and the authorities' efforts to lengthen the maturity structure of external debt, also lending support to external stability. Most recently, in April 2018, the government issued a 32-year international bond in the amount of US$1.2 billion with an interest rate of 4.5 percent, a spread of 150 basis points over 30-year U.S. Treasury bonds. This bond will further help to strengthen the composition and maturity structure of public external debt and external stability.

9. On balance, external debt is projected to remain elevated but relatively stable over the medium-term. Gross external debt is expected to stabilize around 150 percent of GDP over the medium-term, consistent with the expected stabilization of Panama's NIIP. The external debt sustainability analysis indicates that the medium-term debt profile is resilient to several shocks (Figure 1). However, with a relatively large share of external debt expected to remain concentrated in the non-resident deposits into the international banking system, external stability will remain closely dependent on continued stability in the financial sector.

B. Assessment

10. The external position is broadly consistent with fundamentals and desirable policy settings.[3]

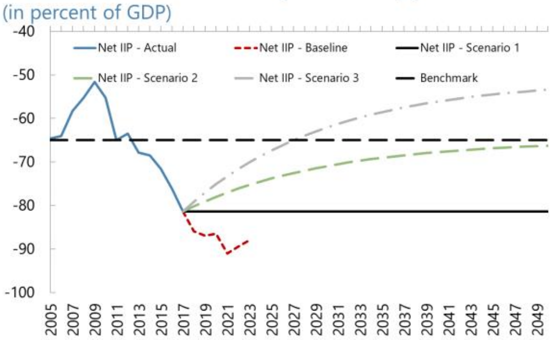
[3] Panama is not included in the EBA-lite REER model.

Panama: EBA-Lite Assessment Results

	Current Account (CA) Norm	CA / Cyclically-Adjusted	REER Gap
EBA-Lite			
Macroeconomic Balance	-2.4%	-8.0%	17.5%
External Sustainability			
Scenario 1: Stablize net IIP at 2017 level (-81% of GDP)	-6.2%	-5.3%	-2.5%
Scenario 2: Stabilize net IIP at -65% of GDP	-4.9%	-5.3%	1.2%
Scenario 3: Stabilize net IIP at -65% of GDP within 10 years	-3.9%	-5.3%	4.4%
Average	-4.3%	-6.0%	5.1%

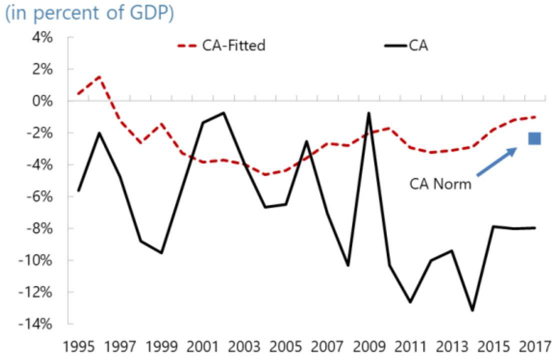
- **The external sustainability approach** estimates that the external position is broadly consistent with fundamentals and desirable policy settings if Panama's NIIP position is stabilized at its 2017 level as projected. This implies an IIP-stabilizing current account deficit of 6.2 percent of GDP and an undervaluation of the REER by 2.5 percent. In contrast, reducing the NIIP to 65 percent of GDP, broadly in line with its average level since 2000, would imply an IIP-stabilizing current account deficit of 4.9 percent of GDP and that the external position is broadly consistent with fundamentals and desirable policy settings, with a small overvaluation of the REER. The external position is moderately weaker than fundamentals and desirable policy settings assuming a faster convergence of the NIIP to 65 percent over ten years (versus twenty).

Panama: Extenal Sustainability EBA-Lite Approach Net IIP
(in percent of GDP)



Source: INEC; IMF staff calculations.

Panama: Current Account Balance EBA-Lite Approach
(in percent of GDP)



Sources: INEC; IMF staff calculations.

- **Estimates from the current account approach** are consistent with a current account gap of -5.6 percent of GDP and a REER overvaluation of 17.5 percent.[4] The gap and the estimated REER overvaluation is driven by a large residual (-7.0% of GDP) under the methodology rather than deviations from desirable policies on a net basis, with the overall policy gap estimated to be positive. The positive policy gap continues to be driven primarily by more expansionary-

[4] An exchange rate elasticity of -0.33 percent is assumed in the calculations, consistent with export and import elasticities of -0.44 and 0.29 under the IMF's EBA-lite approach

than-desirable fiscal policy in the rest of the world, without which Panama would be experiencing a marginally larger current account deficit. In contrast, fiscal policy in Panama remains guided by the SFRL deficit limits.

- **In summary**, given the large residual and inherent uncertainties with the current account approach, staff prefers the external sustainability approach and assesses the real exchange rate to be broadly in line with fundamentals and desirable policy settings.

Panama: EBA-Lite Current Account Panel Regression

	Percent of GDP			Percent of GDP	
(a)	Actual current account	-8.0%	(e)	Fitted current account	-1.0%
(b)	Current account norm = (e) - (g)	-2.4%	(f)	Residual (a) - (e)	-7.0%
(c)	**Current account gap = (a) - (b)**	**-5.6%**	(g)	Policy gap = (h) + (i) + (j) + (k)	1.4%
(d)	Real exchange rate elasticity	-33.0%	(h)	Fiscal policy	1.0%
			(i)	Change in GIR	0.1%
	Real exchange rate gap CA approach = (c)/(d)	**17.5%**	(j)	Private credit to GDP	0.3%
			(k)	Capital control	0.0%

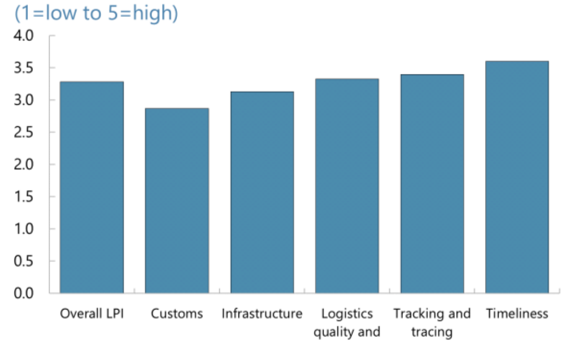
Source: IMF staff calculations.

C. Other Competitiveness Indicators

11. Other indicators suggest that Panama is maintaining its competitiveness in its main exports, but with risks on the horizon. While, on aggregate, Panama's exports have remained relatively stable as a share of world exports, this has reflected gains in Panama's share of service exports. Tourism exports, in particular, had been gaining market share, but the gains in market share relative to competitors in the LAC region have levelled off, likely reflecting the impact of past U.S. dollar appreciation on Panama's tourism exports (which account for about 15 percent of total exports or about a third of service exports). Renewed appreciation pressure on the U.S. dollar would be expected to continue to erode recent gains. However, the impact on Panama's overall competitiveness may be offset by gains in competitiveness from the opening of the expansion of the Panama Canal, which has considerably boosted Panama's exports of transportation services, particularly if Panama successfully leverages the canal expansion to further develop the broader logistics industry. Importantly, Panama's logistics sector continues to be a top-performer, with a score of 3.28 on the World Bank's Logistics Performance Index in 2018, among the top-ranked upper-middle income countries and the country with the second-highest score in LAC (behind only Chile). Panama performs particularly well in the components of the index related to infrastructure and logistics but will have to continue to strengthen customs and timeliness to further build on its comparative advantage in logistics.

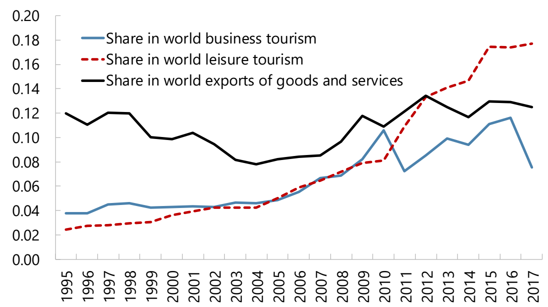
Panama: Logistics Performance Index

(1=low to 5=high)



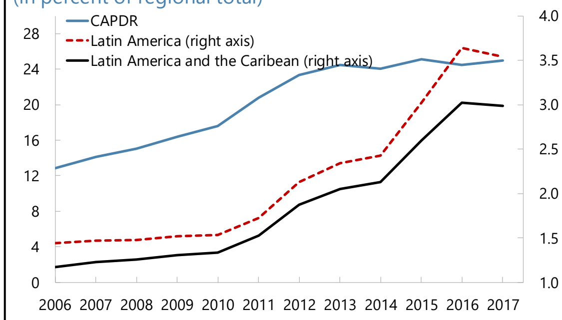
Sources: World Bank Logistics Performance Index, 2018.

Panama: Selected Market Share Indicators of Competitiveness
(in percent of world total)



Sources: World travel & tourism council, UNCTADstat and Fund staff calculations.

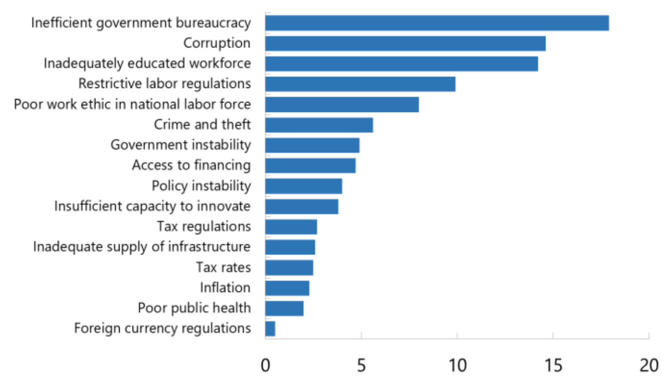
Panama: Market Share in Tourism [1]
(in percent of regional total)



Sources: World Travel and Tourism Council (WTCC) and Fund staff calculations.
1. Tourism includes leisure and business tourism.

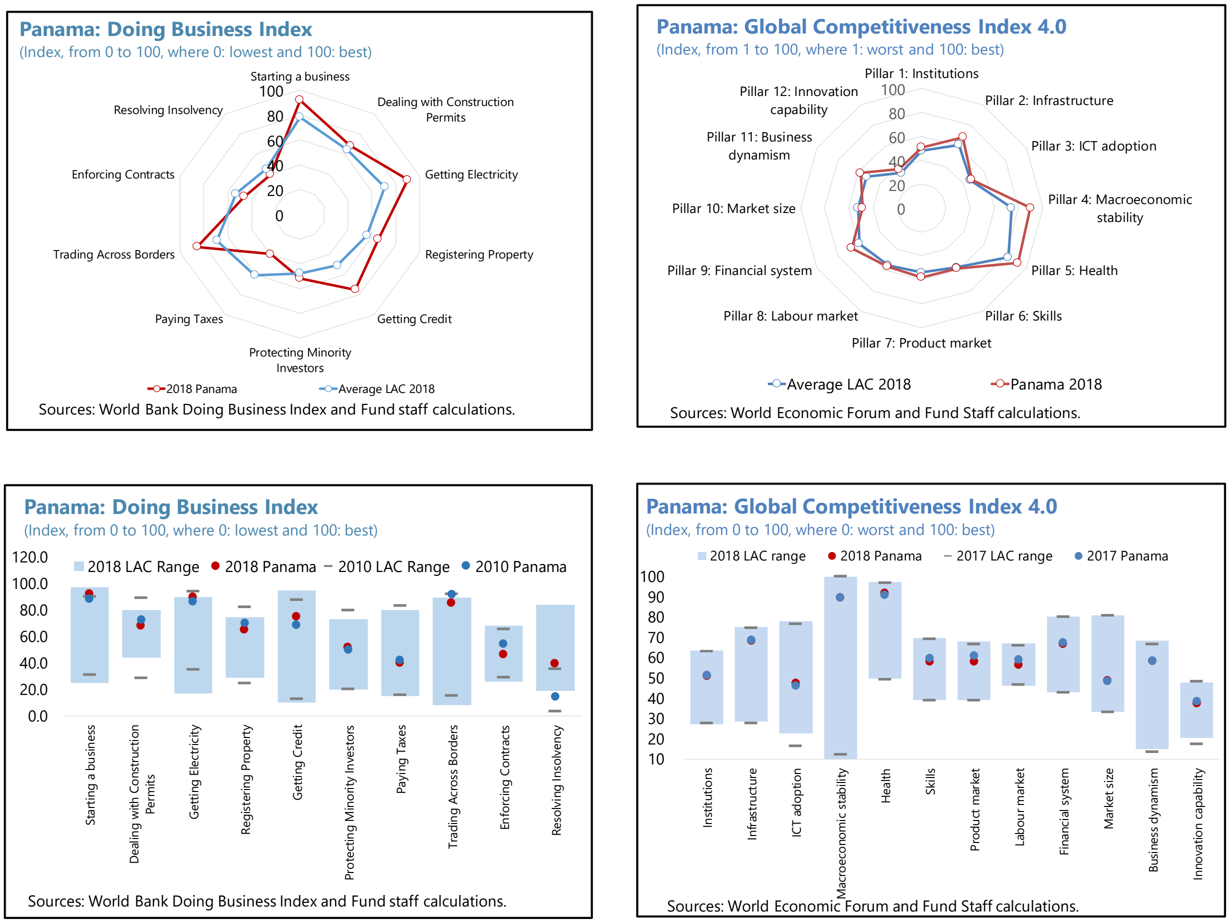
12. Perceptions from survey-based competitiveness indicators suggest that the Panama remains among the most competitive economies in Latin America. In the World Economic Forum's (WEF) Global Competitiveness Index, for example, Panama received an overall score of 61.03 (on a scale of 0 to 100 with 100 being the best) for 2018, compared to an average score of 56.39 for Latin American and the Caribbean (LAC). Nevertheless, Panama's score deteriorated compared to its 2017 score of 61.64. Breaking down the score into its subcomponents, Panama's strengths remain its financial system, its macroeconomic stability, health, and infrastructure, for which categories Panama received the 2nd, 4th, 4th and 5th highest scores in the LAC region respectively. In contrast, strengthening institutions, ICT adoption, skills, the labor market and the innovation capability remain critical to strengthening Panama's competitiveness. These priorities are mirrored in the most problematic factors for doing business identified by the report, which also identifies the need to strengthen education, labor market efficiency and institutions as well as to combat corruption as top priorities to strengthen the business environment. Results from the World Banks' Doing Business report for 2018 put Panama's distance to frontier (where the frontier is the best performance measured on a given indicator) at 65.27 out of 100 (the frontier), a slight improvement of 1.25 from 2017, with Panama outperforming the LAC region (on average) by less than the WEF results. Results suggest that strengthening tax discipline, contract enforcement and insolvency regimes will be important to improve the business environment.

Panama: Most Problematic Factors for Doing Business; 2017-18



Source: Global Competitiveness Report, World Economic Forum. From the list of factors, respondents to the World Economic Forum's Executive Opinion Survey were asked to select the five most problematic factors for doing business in their country and to rank them between 1 (most problematic) and 5. The score corresponds to the responses weighted according to their rankings.

Panama: Survey-Based Competitiveness Indicators



D. Reserve Adequacy Assessment

13. **Reserve coverage remains below standard metrics, although these are not appropriate for Panama's economy.** Panama is a unique country in that it is fully dollarized and does not have a central bank. Officially reported reserves are the net foreign assets of the largest state-owned bank (the Banco Nacional de Panama), which is the government's bank and has a formal role in operating the payments system. As such, Panama's reported reserves are distinct from the concept of international reserves in a country with its own currency. As reported, net international reserves are below both standard reserve adequacy metrics and the IMF's risk-based metric for emerging markets. Officially reported reserves may be supplemented by U.S. dollar assets held by the sovereign wealth fund, although these are limited at just over 2 percent of GDP, and foreign currency deposits held in domestic banks, however, it remains unclear how quickly these resources could potentially be used to address systemic liquidity shortages. Building policy buffers and reducing vulnerabilities therefore remain critical to maintaining external stability.

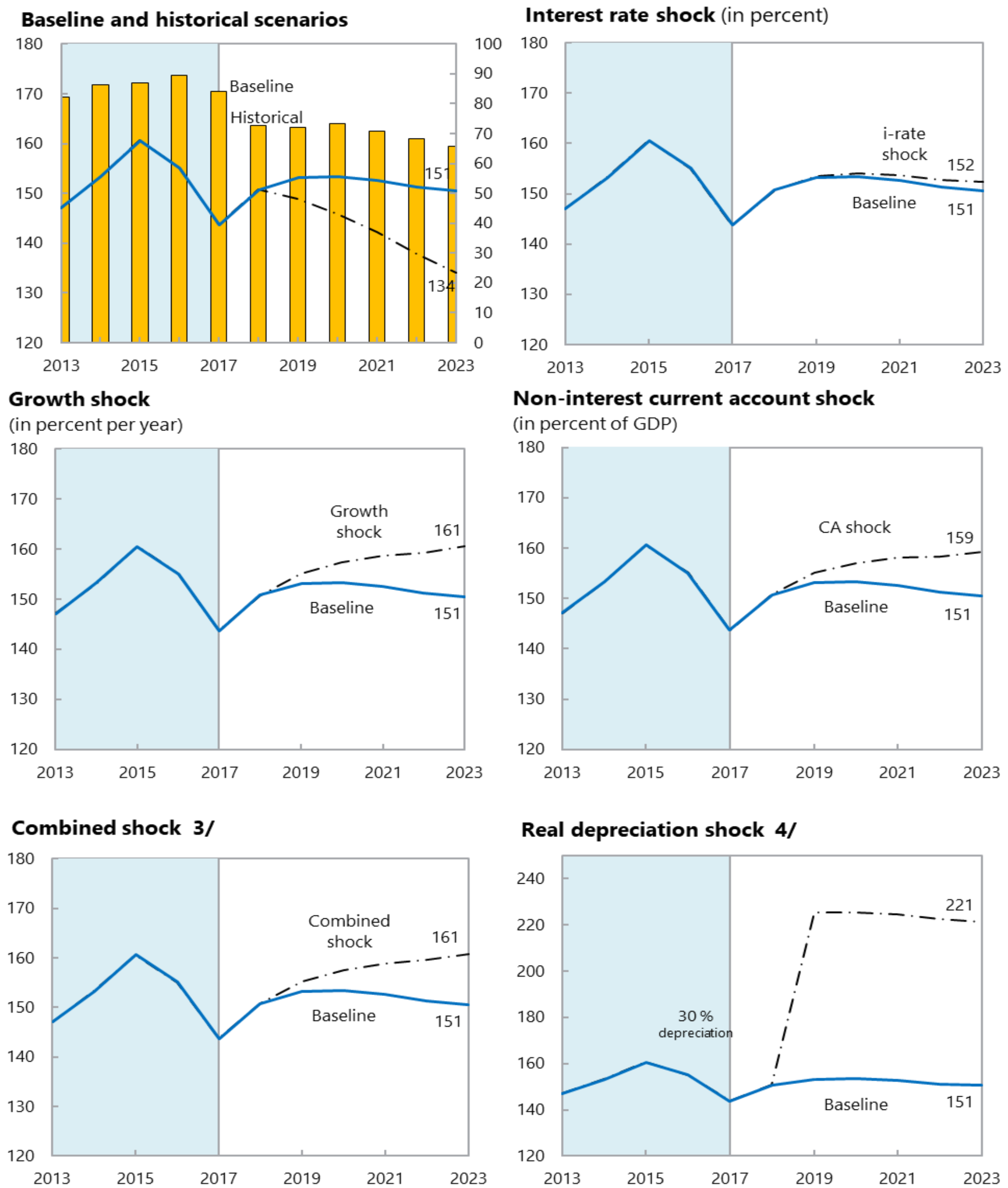
Panama: Reserve Adequacy

Metric	Benchmark coverage	NIR coverage 2016	2017	2022(p)
Months of imports of goods and services	3 months	2.1	1.6	1.6
Broad money (M3)	20%	0.0	0.0	0.0
Short-term debt on a remaining maturity basis	100%	10.1	8.1	9.1
IMF reserve adequacy metric[1]	100 - 150%	18.2	14.6	14.8
External debt, bn USD		89.7	88.9	134.2
(percent of NIR)		1889.8	2346.5	2635.0
Net international reserves, bn USD		4.7	3.8	5.1
Additional reserves needed to reach IMF reserve metric of 100, bn USD		21.4	22.2	29.3

Sources: National authorities and IMF staff calculations.

[1]Emerging market metric for fixed exchange rate countries: net reserves divided by the sum of 30 percent of short-term debt (remaining maturity basis), 10 percent of broad money (M3); 20 percent of IIP MLT portfolio liabilities; and 10 percent of exports.

Figure 1. External Debt Sustainability: Bound Tests 1/ 2/



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective vsribales in the baseline and scenario being presented. Ten-year historical average for the varaiable is also shown.

3/ For the historical scenarios, the hsitorical averages are calculated over he ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent ¼ standard deviation shocks applied to real instrest rate, growth rate, and current accountbalance.

4/ One-time real depreciation of 30 percent.

Figure 2. External Debt Sustainability Framework, 2013-2023

	Actual							Projections						
	2013	2014	2015	2016	2017	10-Year Historical Average	10-Year Standard Deviation	2018	2019	2020	2021	2022	2023	**Debt-stabilizing non-interest current account 6/**
1 **Baseline: External debt**	147.1	153.3	160.6	155.1	143.7			**150.8**	**153.2**	**153.3**	**152.6**	**151.3**	**150.6**	**-12.3**
2 Change in external debt	-8.0	6.2	7.3	-5.5	-11.3			7.0	2.4	0.2	-0.7	-1.4	-0.7	
3 Identified external debt-creating flows (4+8+9)	-15.1	-7.9	-8.1	-9.8	-9.6			-3.3	-6.8	-8.0	-8.3	-8.3	-8.2	
4 Current account deficit, excluding interest payments	5.5	9.0	3.8	4.1	4.0			4.4	2.2	0.5	0.5	0.8	1.1	
5 Deficit in balance of goods and services	3.8	4.9	-0.9	0.5	-0.4			1.5	0.1	-1.3	-1.9	-2.0	-2.0	
6 Exports	63.7	55.1	51.2	43.7	44.1			43.3	43.8	44.3	44.1	43.6	43.1	
7 Imports	67.5	60.0	50.3	44.2	43.7			44.8	43.9	43.0	42.2	41.6	41.1	
8 Net non-debt creating capital inflows (negative)	-7.7	-8.1	-7.3	-8.0	-7.5			-6.6	-5.8	-5.9	-6.0	-5.8	-5.8	
9 Automatic debt dynamics 1/	-12.9	-8.9	-4.6	-5.8	-6.1			-1.1	-3.3	-2.6	-2.8	-3.3	-3.5	
10 Contribution from nominal interest rate	4.0	4.1	4.1	3.9	4.0			4.6	5.4	5.6	5.0	4.5	4.3	
11 Contribution from real GDP growth	-9.2	-8.1	-8.4	-7.5	-7.8			-5.7	-8.6	-8.2	-7.8	-7.8	-7.7	
12 Contribution from price and exchange rate changes 2/	-7.7	-4.9	-0.4	-2.2	-2.3			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	7.2	14.0	15.5	4.3	-1.8			10.3	9.2	8.1	7.6	6.9	7.5	
External debt-to-exports ratio (in percent)	230.9	278.2	313.8	355.0	326.2			348.3	349.8	346.5	346.3	346.9	349.5	
Gross external financing need (in billions of US dollars) 4/	38335.1	44194.1	47174.0	51721.5	51979.4			47455.3	51035.1	56155.6	58471.0	60619.4	62913.6	
in percent of GDP	82.1	86.3	86.9	89.5	84.1			72.6	72.0	73.3	70.9	68.3	65.8	
Scenario with key variables at their historical averages 5/								**150.8**	**148.8**	**145.9**	**142.2**	**137.8**	**134.0**	**-17.1**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	6.6	6.0	5.8	5.0	5.4	6.6	2.8	4.2	6.2	5.8	5.5	5.5	5.5	
GDP deflator in US dollars (change in percent)	5.2	3.4	0.2	1.4	1.5	4.2	2.6	1.5	2.0	2.2	2.0	2.0	2.0	
Nominal external interest rate (in percent)	2.9	3.1	2.8	2.6	2.7	3.2	0.6	3.4	3.9	3.9	3.5	3.2	3.0	
Growth of exports (US dollar terms, in percent)	-2.2	-5.2	-1.5	-9.1	7.9	7.2	14.3	3.9	9.6	9.2	7.2	6.5	6.4	
Growth of imports (US dollar terms, in percent)	-2.8	-2.5	-11.1	-6.4	5.8	7.0	18.7	8.4	6.0	5.9	5.7	6.1	6.2	
Current account balance, excluding interest payments	-5.5	-9.0	-3.8	-4.1	-4.0	-4.4	3.8	-4.4	-2.2	-0.5	-0.5	-0.8	-1.1	
Net non-debt creating capital inflows	7.7	8.1	7.3	8.0	7.5	7.6	1.1	6.6	5.8	5.9	6.0	5.8	5.8	

1/ Derived as $[r - g - r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex IV. Debt Sustainability Analysis (DSA)

Public debt of the non-financial public sector (NPFS) is expected to remain sustainable, declining from 38 percent of GDP in 2017 to about 35 percent of GDP by 2023, reflecting mainly favorable debt dynamics. The gross financing needs will remain moderate, despite a projected increase partly because of the assumed rebalancing towards short to-medium debt.

1. Debt structure and profile. Total public debt of the NFPS stood at 37.8 percent of GDP in 2017 of which 79 percent (29.7 percent of GDP) was external, and the remaining 21 percent (8.1 percent of GDP) was domestic. Short term debt was only 3.8 percent of total, and nearly all the debt is US dollar-denominated.

2. Macroeconomic assumptions: Despite a projected deceleration in economic activity in 2018 to 4.3 percent, near term prospects are for a strong growth of 6.3 percent and 5.8 percent for 2019 and 2020, respectively, supported by construction, logistics and exports from a new copper mine. Against the backdrop of a stable macroeconomic environment and absent strong policy efforts, growth is expected to converge to its potential of 5.5 percent. Inflation is expected to remain low, at around 2 percent. The overall NFPS deficit is projected to rise to 2 percent of GDP in 2018-19, before falling to 1½ percent of GDP over the medium-term.

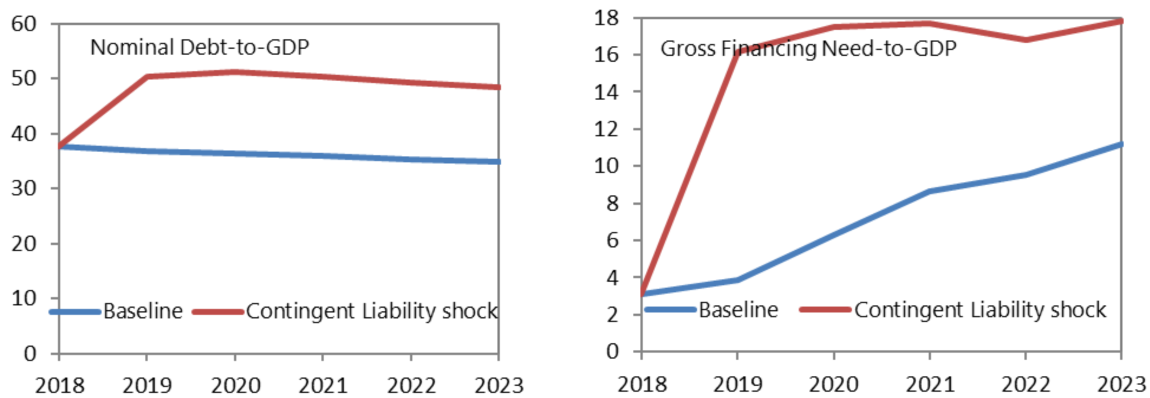
3. Baseline scenario: Public debt is projected to decline by a cumulative 3.0 percent of GDP from its 2017 level to around 35 percent of GDP by 2023, reflecting the favorable automatic debt dynamics. A negative interest rate/growth differential will subtract 3.5 percent of GDP from debt, while projected primary deficit will add 1.0 percent of GDP. Overall, gross external debt (public and private) is projected to continue its downward trajectory, as the current account position strengthens. Gross financing needs will gradually rise to 11.2 percent of GDP 2023 from 3.2 in percent in 2017, reflecting assumed gradual increase in short term-medium debt and liquidation of maturing external bonds.

4. Alternative scenarios: A historical scenario reflecting a strong growth and small primary surplus, all others equal, implies a little faster pace of reduction in the debt-to-GDP ratio to 31.5 percent of GDP relative to the baseline. A second scenario that assumes a slightly weaker constant primary balance than the baseline, but with growth remaining the same, results in a smaller decline of the public debt-to-GDP ratio broadly similar reduction in the debt to GDP ratio. The heat map highlights external financing requirements, and the residency of debt holders as the risks to the debt profile.

5. Stress scenarios. Given Panama's role as an international financial center, a financial contingent liability shock equivalent to 10 percent of the banking system's assets is applied in 2019, together with a one standard deviation shock to real GDP growth in 2019–20, and an interest rate increase by 25 basis points for each percent of GDP deterioration in the primary fiscal balance. Given the sizable banking system, public debt jumps to 50-51 percent of GDP in 2019-20, but falls to 48 percent of GDP by 2023.

6. **Under another stress scenario, the analysis assumes a contingent liability shock of SOEs excluded from the NFPS that falls due in 2019.** Together, the debt of the three entities, which are profitable, is about 3.5 percent of GDP. Here, public debt to GDP ratio rises to 41 percent in 2019, but gradually follows a declining path reaching 38 percent of GDP by 2023.

Figure 1. Stress Scenario



Financial Contingent Liability Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	4.3%	3.5%	3.0%	5.6%	5.5%	5.5%
Inflation (GDP Deflator change)	1.5%	1.3%	1.5%	2.0%	2.0%	2.0%
Non-interest revenue-to-GDP ratio	20.0%	20.1%	20.1%	19.9%	19.6%	19.3%
Non-interest expenditure-to-GDP ratio	20.3%	32.5%	20.2%	20.1%	19.6%	19.2%
Primary Balance	-0.4%	-12.3%	-0.1%	-0.2%	0.0%	0.0%
Nominal Exchange Rate -- average (LCU/USD)	1.00	1.00	1.00	1.00	1.00	1.00
Nominal Exchange Rate -- end of period (LCU/USD)	1.00	1.00	1.00	1.00	1.00	1.00
Interest rate shock (bpts) compared to baseline	0	298	0	0	0	0

Source: Panama Authorities and IMF staff estimates.

Figure 2. Panama: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

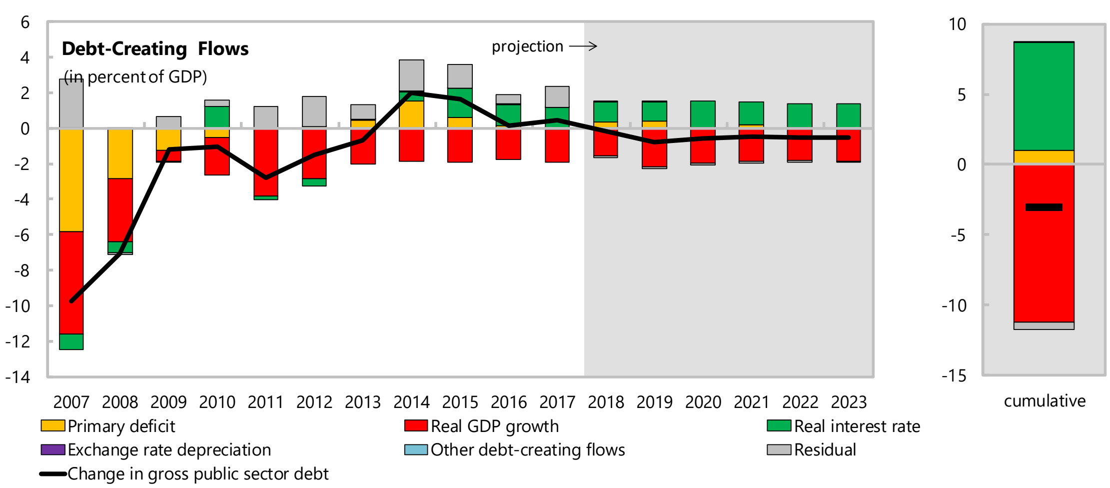
(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of September 19, 2018		
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023	Sovereign Spreads		
Nominal gross public debt	38.1	37.4	37.8	37.7	36.9	36.3	35.8	35.3	34.8	EMBIG (bp) 3/		120
Public gross financing needs	2.0	2.4	3.2	3.1	3.9	6.3	8.7	9.5	11.2	5Y CDS (bp)		56
Real GDP growth (in percent)	7.5	5.0	5.4	4.3	6.3	5.8	5.6	5.5	5.5	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	5.1	1.4	1.5	1.5	2.0	2.1	2.0	2.0	2.0	Moody's	Baa2	Baa2
Nominal GDP growth (in percent)	13.1	6.5	6.9	5.9	8.4	8.1	7.7	7.6	7.6	S&Ps	BBB	BBB
Effective interest rate (in percent) [4/]	6.1	4.9	5.0	4.7	5.2	6.5	6.0	6.2	6.3	Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-2.3	0.1	0.4	-0.1	-0.8	-0.6	-0.5	-0.5	-0.5	-3.0	
Identified debt-creating flows	-3.4	-0.4	-0.7	0.0	-0.7	-0.5	-0.4	-0.4	-0.5	-2.5	
Primary deficit	-0.9	0.1	-0.1	0.4	0.4	0.1	0.2	0.0	0.0	1.0	-0.4
Primary (noninterest) revenue and gra	21.7	20.1	20.0	20.0	20.1	20.1	19.9	19.6	19.3	119.0	
Primary (noninterest) expenditure	20.8	20.2	20.0	20.3	20.6	20.2	20.1	19.6	19.2	120.0	
Automatic debt dynamics [5/]	-2.6	-0.5	-0.7	-0.4	-1.1	-0.5	-0.6	-0.5	-0.4	-3.5	
Interest rate/growth differential [6/]	-2.6	-0.5	-0.7	-0.4	-1.1	-0.5	-0.6	-0.5	-0.4	-3.5	
Of which: real interest rate	0.1	1.2	1.2	1.1	1.1	1.5	1.3	1.4	1.4	7.7	
Of which: real GDP growth	-2.7	-1.7	-1.9	-1.5	-2.2	-2.0	-1.9	-1.8	-1.8	-11.2	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
GG: Net privatization proceeds (nega	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	1.2	0.5	1.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.5	



Source: IMF staff.

1/ Public sector is defined as non-financial public sector.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

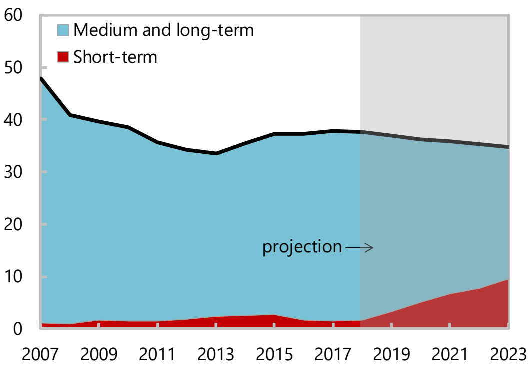
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 3. Panama: Public DSA – Composition of Public Debt and Alternative

Composition of Public Debt

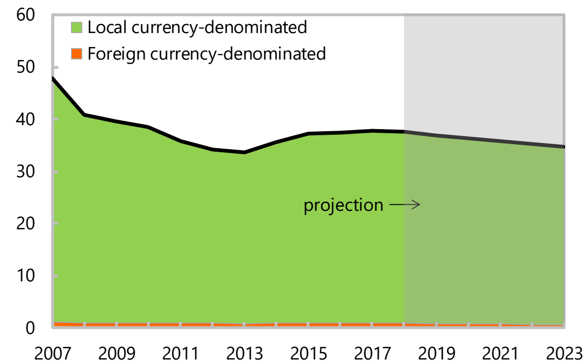
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

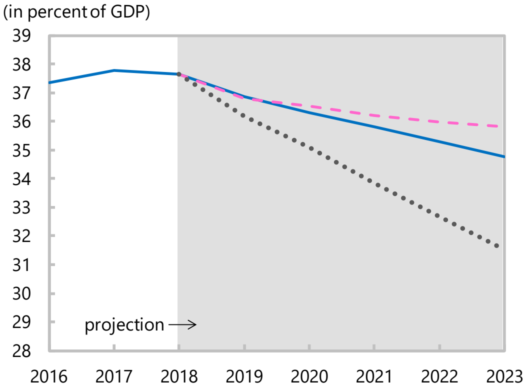


Alternative Scenarios

Baseline Historical Constant Primary Balance

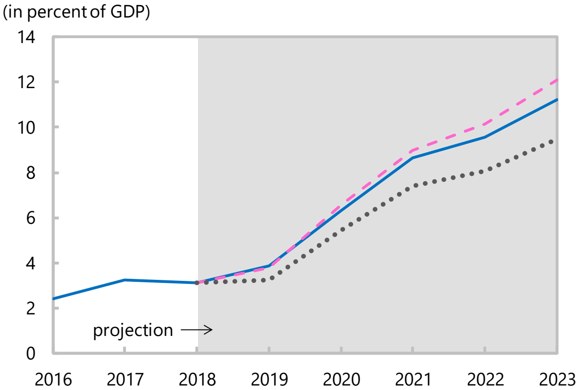
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.3	6.3	5.8	5.6	5.5	5.5
Inflation	1.5	2.0	2.1	2.0	2.0	2.0
Primary Balance	-0.4	-0.4	-0.1	-0.2	0.0	0.0
Effective interest rate	4.7	5.2	6.5	6.0	6.2	6.3
Constant Primary Balance Scenario						
Real GDP growth	4.3	6.3	5.8	5.6	5.5	5.5
Inflation	1.5	2.0	2.1	2.0	2.0	2.0
Primary Balance	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Effective interest rate	4.7	5.2	6.5	5.9	6.2	6.2

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.3	6.6	6.6	6.6	6.6	6.6
Inflation	1.5	2.0	2.1	2.0	2.0	2.0
Primary Balance	-0.4	0.2	0.2	0.2	0.2	0.2
Effective interest rate	4.7	5.2	6.4	5.7	5.8	5.7

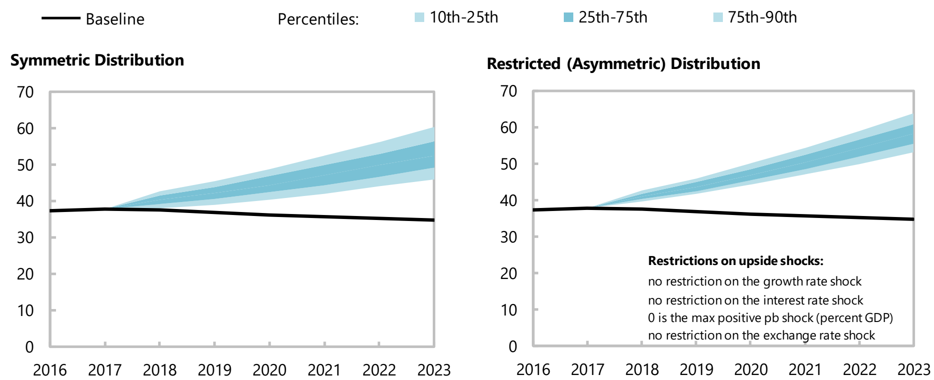
Source: IMF staff.

Figure 4. Panama: Public DSA Risk Assessment

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

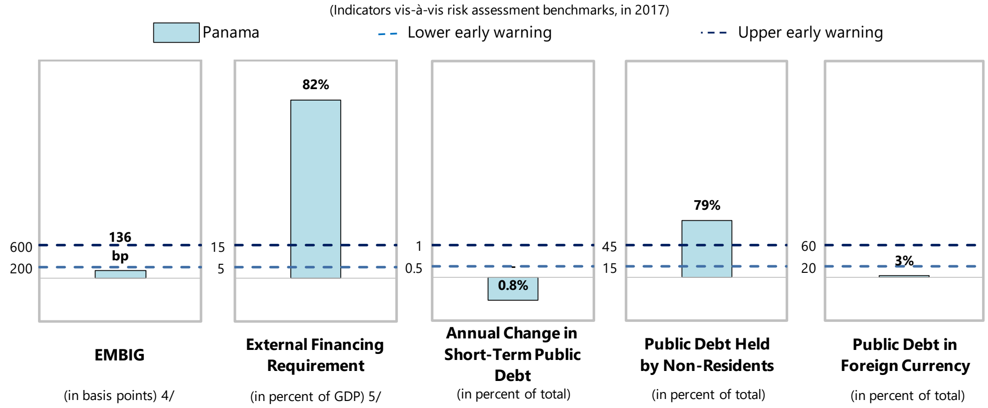
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70 percent is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15 percent is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white. Lower and upper-risk assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 21-Jun-18 through 19-Sep-18.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous record.

INTERNATIONAL MONETARY FUND

PANAMA

November 21, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared by: The Western Hemisphere Department

CONTENTS

FUND RELATIONS

(As of September 30, 2018)

Membership Status: Joined: March 14, 1946; Article VIII

General Resources Account:	**SDR Million**	**%Quota**
Quota	376.80	100.00
Fund holdings of currency	322.40	85.56
Reserve Tranche Position	54.41	14.44

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	197.01	100.00
Holdings	127.98	64.96

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	**Date of Arrangement**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	Jun 30, 2000	Mar 29, 2002	64.00	0.00
EFF	Dec 10, 1997	Jun 20, 2000	120.00	40.00
Stand-By	Nov 29, 1995	Mar 31, 1997	84.30	84.30

Projected Payments to Fund
(SDR Million; based on existing use of resources and present holdings of SDRs):[1]

	Forthcoming			
	2018	2019	2020	2021
Principal				
Charges/Interest	0.17	0.69	0.69	0.69
Total	0.17	0.69	0.69	0.69

Implementation of HIPC Initiative: Not Applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable

Safeguards Assessment. Under the Fund's safeguards assessment policy, the National Bank of Panama (NBP) was subject to the transitional procedures with respect to the Stand-By Arrangement,

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

which was approved on June 30, 2000, and expired on March 29, 2002. The transitional procedures required a review of the NBP's external audit mechanism only. The assessment was completed on July 12, 2001 and concluded that NBP's external audit mechanism was at the time adequate.

Non-financial Relations

Exchange Rate Arrangement. Panama uses the U.S. dollar as the primary means of payment in the local economy. Its national currency (balboa) is issued in the form of coins only and serves as a unit of account. The exchange rate of the balboa is fixed at 1 balboa per U.S. dollar. Panama has accepted the obligations of Article VIII, Sections 2(a), 3, and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

Last Article IV Consultation. The 2017 Article IV consultation was concluded on May 1, 2017. Panama is on the standard 12 month consultation cycle.

FSAP: A first-time FSAP was concluded in September 2011. It confirmed the banking sector's strength and resilience to potential shocks, noting nonetheless that data gaps prevent a full analysis of macro-financial linkages. It concluded that the regulatory framework for banks was broadly adequate, but the regulation of nonbanks had important shortcomings. It recommended to build the capacity to monitor systemic risks and introduce a financial safety net, including a facility aimed at addressing temporary liquidity shortfalls and a limited deposit insurance fund.

Technical Assistance. Panama is a large recipient of technical assistance (TA) directly through the Fund or CAPTAC-DR. Latest assistance covered a broad range of topics. Assistance in the fiscal area included options to strengthen the fiscal framework, tax and customs administration, and fiscal risks. Support was provided with the national accounts, real sector statistics, producer price and export and import prices, and government finance statistics. On the latter, better coordination and definition of roles between the MOF and INEC are essencial to improve data quality and follow the designed work plan. Assistance was also provided in improving external sector statistics to facilitate the transition to BPM6 and strengthening AML/CFT risk-based supervision of the securities market intermediaries, designated non-financial businesses and professions (DNFBPs), as well as enhancing the capacity of the Panamanian financial intelligence unit to conduct operational and strategic analysis. In the financial area, TA concentrated on improving the bank resolution framework and macroprudential policy, the latter as part of a regional TA program. TA has also been provided to improve risk-based supervision, particularly of the banking sector, namely country and transfer risk supervision and to develop a market risk assessment tool.

Resident Representative: None.

RELATIONS WITH THE WORLD BANK-UNDER JMAP

(As of October 17, 2018)

Title	Product	Provisional Timing of Mission	Expected Delivery date (Closing Date)
Lending (Active)	Third Programmatic Shared Prosperity Development Policy Loan (P151804)	Nov-18	Dec-19
	Fourth Programmatic Shared Prosperity Development Policy Loan (P168338)	Nov-Dec-18	Dec-20
	Catastrophe Deferred Draw Down Disaster Risk Management Development Policy Loan (P122738)	Dec-18	Nov-20
	Enhanced Public Sector Efficiency Technical Assistance Loan (P121492)	Sep-18	Dec-19
	Sustainable Production Systems and Conservation of Biodiversity (P145621)	Apr-18	Dec-19
	Strenthening Social Protection and Inclusion System (P155097)	Nov-18	Feb-22
	Burunga Wastewater Management (P154275)	Oct-18	Dec-21
	Indegenous Peoples Intergral Development (P157575)	Oct-18	Jun-23
Advisory Services and Analytics, Trust Funds (Active)	Support to Panama DFRI Strategy Implementation Plan RAS	Nov-18	Apr-19
	Smart Mobility Solutions with Open Innovation RAS	Sep-18	Nov-19
	Economic Empowerment of Indigenous Women (P163286)	Nov-18	Feb-19
	Towards an Effective Implementation of Energy Efficient Initiatives in Panama (P155068)	Nov-18	Apr-19
	Energy Efficiency Fund Design Support - Fondo UREE (P165392)	Nov-18	Sep-19
	Public Private Partnership (P160763)	Jan-19	Jun-20
	Panama City Waterfront Redevelopment and Resilience Program (P166875)	Sep-18	Jun-20
	Setting the Basis for Water Security (P166057)	Nov-18	Jun-20
	Treasury's Fee-for-Service for the Fondo de Ahorro de Panama	Mar-18	Mar-19 (discussion with FAP for a 3-year term renewal)
	Design and Implementation of a Vehicle Technical Inspection and Emission Control Systems for Panama (TF0A4010)	Sep-18	Apr-19

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of October 15, 2018)

In 2017, the IDB disbursed a total of $389.2 million. The Bank approved four loans for a total of $757 million during the year. One of them was a Policy Base Loan (Public Utilities Sustainable Development Support Program) in the amount of $300 million and three investment loans for the following projects: Program to Improve Efficiency and Quality in the Education Sector ($100 million), Program to Improve the Operational Management of the National Water and Sewer Institute in the Panama City Metropolitan Area ($250 million) and Support for the Conservation and Management of Cultural and Natural Heritage ($107 million).

The projection of disbursements for 2018 is around $503.4 million. The IDB has already approved four loans for $562 million in the areas of Transport and Logistics, Territorial Connectivity, Land Border Crossing Integration, Transparency and Equity in Spending on Social Protection; and is expected to approve two loans for $100 million in the areas of Urban Watershed Resiliency and Productive Development through Human Capital.

Panama: Relations with the Inter-American Development Bank
(In millions of U.S. Dollars)

Operations for 2017			
Sector	Approved	Disbursed[1]	Undisbursed Amounts
Modernization of the State	0.0	2.2	19.8
Innovation	0.0	1.7	28.3
Social Protection	0.0	32.1	136.8
Transportation	0.0	0.0	6.8
Water and Sanitation	250.0	33.9	524.8
Education	100.0	12.6	104.8
Fiscal and Municipal Management	107.0	0.0	107.0
Energy	300.0	306.6	6.3
Total	**757.0**	**389.2**	**934.6**

Loan Transactions							
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018[2]**
a. Disbursements	170.8	303.9	392.8	418.6	513.2	389.2	503.4
b. Repayment	104.9	108.7	102.7	114.5	157.5	207.5	183.7
c. Net lending	**65.9**	**195.2**	**290.1**	**304.1**	**355.6**	**181.7**	**319.7**
d. Interest and charges	45.6	55.3	55.9	68.4	80.4	80.7	86.5
e. Subscriptions and contributions	3.6	0.0	2.0	1.7	1.7	0.0	1.3
f. Net transfer	**16.7**	**139.9**	**232.3**	**234.0**	**273.5**	**101.0**	**231.9**

Source: Inter-American Development Bank.
[1] Includes disbursements from approvals in previous years. [2] Estimated.

STATISTICAL ISSUES

(As of October 18, 2018)

Assessment of Data Adequacy for Surveillance
General: Data provided to the Fund has some shortcomings but is broadly adequate for surveillance. The accuracy, timeliness, and publication of economic statistics has improved, but weaknesses in national accounts, government finance, and balance of payment statistics need to be addressed.
Real Sector: The timeliness of real sector data provision has improved, the data however continues to be subject to sizable revisions. After the change of the benchmark estimate year of the national accounts to 2007, the rebased GDP from the production approach has been published on an annual and quarterly basis both at current prices and as chained volumes. Annual GDP series from the expenditure and income approaches are available in current prices. Annual National Accounts series are available for 2007-15, and quarterly data until the second quarter of 2018. The IMF national accounts technical assistance has provided support to improve the compilation of national accounts statistics, including input-output tables, institutional sector accounts, and employment matrices. The quarterly GDP series compiled by the expenditure approach are being developed with IMF technical assistance. The monthly economic activity index has benefited from the use of administrative source data, and from the correct implementation of statistical technics, such as benchmarking and seasonal adjustment. In addition, IMF technical assistance has been provided to develop updated annual and quarterly producer, export, and import price indices; and to support the development of annual economic surveys to non-financial enterprises. A new benchmark compilation to rebase the national accounts series to 2018 is under development, but progress has been slow. The National Institute of Statistics and Census is receiving support from the World Bank to fund technical assistance on national accounts.
Government finance statistics: Further efforts are needed to improve the quality of fiscal data. Apart from timeliness, consistency of data related to the transfers between public sector units should be improved. Since September 2004, the operational balance of the Panama Canal Authority (ACP) was excluded from the official definition of the nonfinancial public sector (NFPS) used for fiscal policy purposes. Information on the ACP is only available in the Annual Report posted in its website (www.pancanal.com) on a fiscal year basis. There is a need to ensure a consistent and timely flow of ACP statistics. Moreover, in 2011, three public enterprises have been excluded from the NFPS accounts and public debt (Tocumen International Airport, ETESA, an electricity distribution company, and ENA, the National Highway company). It would also be necessary to compile and disseminate information on these entities in a timely fashion. The 2012 decree establishing the Savings Fund of Panama (Fondo de Ahorro de Panama, or FAP) mandated reporting of deferred payment schemes (e.g. turnkey projects) in budget documentation. The authorities received technical assistance from the IMF Statistics Department (STA) to implement the Government Finance Statistics Manual 2001 (GFSM 2001) and the Fiscal Affairs Department (FAD) conducted a mission on observance of fiscal standards and codes (ROSC) in October 2005. The August 2012 CAPTAC report on fiscal statistics for financial programming also emphasized the need to increase the information and analysis of turnkey projects' impact on fiscal sustainability. In 2011 through 2013, FAD provided technical assistance in the area of public accounting, including implementation of government accounting reforms and the practical application of the accounting policies established in the International Public Sector Accounting Standards (IPSAS), an important step toward improving fiscal transparency. The authorities have also started to publish the liabilities derived from the turnkey projects and contingent liabilities of state-owned enterprises. The financial accounting system was not prepared to support the recording of transactions and economic events under the accrual method. The authorities

launched a new platform for centralized management of public sector financial information (Integración y Soluciones Tecnológicas del Modelo de Gestión Operativa, ISTMO), which would help enhance transparency and efficiency. Panama has not been reporting fiscal data to STA for publication in the International Financial Statistics or the Government Finance Statistics Yearbook. In the context of CAPTAC-DR's new regional project, a diagnostic mission and a TA mission were held in 2018. The latter focused on revising public sector coverage to include institutional units which are not covered by the fiscal data (see above). There has been lack of progress in irmproving fiscal tables, including public sector debt data
Monetary and Financial Statistics: Panama regularly reports monetary data for depository corporations using the standardized report forms (SRFs) for publication in the *International Financial Statistics..* Panama reports Financial Soundness Indicators (FSIs) to STA on a regular (quarterly) basis with data beginning on 2005. The authorities have started using the aggregate housing price index, collected by a contractor. Data gaps still prevent a deeper analysis of systemic risks as the authorities do not collect adequate data on commercial real estate prices, loan write-offs, loan-to-value ratios, and leverage indicators for households and corporate, as there is no mechanism to monitor debtor's income and value of the acquired property objects after the loan has been granted.
Balance of payments: Quarterly data are available with a delay of about one quarter, and are subject to revisions thereafter. Revised estimates in key trade and investment data may result in substantial revisions of the current account of the balance of payments. These revisions may reflect improvements in coverage, but they also suggest that there is room for improvement in quality control procedures. Data on outward FDI and repatriation of profit and dividends from these investments are only collected from the financial private sector, implying that the current account deficit and the International Investment Position (IIP) are likely being overestimated, due to the lack of coverage of outward FDI of the nonfinancial private sector. Official statistics may also underestimate inward portfolio investment. The authorities conduct timely the Coordinated Direct Investment Survey (CDIS) and the Coordinated Portfolio Investment Survey (CPIS). Quarterly IIP data have been compiled since 2002, and annual data are available since 1998. Panama recently began publishing BOP and IIP data in the BPM6 format.
Data Standards And Quality
Panama has participated in the Fund's General Data Dissemination System (GDDS) since December 2000. A data ROSC was published in October 2006. With STA assistance, in October 2018 Panama implemented the recommendations of the IMF's Enhanced General Data Dissemination System (e-GDDS) by publishing critical data through the National Summary Data Page (NSDP).

Panama: Table of Common Indicators Required for Surveillance

(As of October 22, 2018)

	Date of latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	9/2018	9/2018	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities	9/2018	9/2018	M	M	M
Reserve/Base Money	NA	NA	NA	NA	NA
Broad Money	6/2018	9/2018	M	M	M
National Bank of Panama Balance Sheet	6/2018	9/2018	M	M	A
Consolidated Balance Sheet of the Banking System	6/2018	9/2018	M	M	M
Interest Rates[1]	6/2018	9/2018	M	M	M
Consumer Price Index	9/2018	10/2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[2] – General Government[3]	6/2018	9/2018	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[2]–Central Government	6/2018	9/2018	Q	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt[4]	6/2018	9/2018	M	M	M
External Current Account Balance	6/2018	9/2018	Q	Q	Q
Exports and Imports of Goods and Services	7/2018	9/2018	M	M	M
GDP/GNP	Q2/2018	9/2018	Q	Q	Q
Gross External Debt	6/2018	9/2018	M	M	M
International Investment Position [5]	6/2018	9/2018	Q	Q	Q

Statement by the Staff Representative on Panama
December 12, 2018

This statement updates developments in Panama since the issuance of the Staff Report, which does not alter the thrust of the Staff Appraisal.

- ***High frequency data point to a slow recovery***. The monthly index on economic activity (IMAE) estimates economic growth at 3.8 percent in September 2018 (y/y), up from 3.4 percent in August 2018 (y/y).

- ***Price pressures remain muted***. Headline inflation edged up to 1.0 percent in October 2018 (y/y), compared to 0.8 percent in September 2018, while core inflation (excluding food and fuel prices) remained stable at 0.7 percent (y/y).

- ***The fiscal position continues to be supportive***. The non-financial public sector (NFPS) deficit reached 3.8 percent of GDP through September 2018 compared to 1.5 percent last year. While revenues were broadly stable in nominal terms compared to last year, acceleration in the pace of budget execution, particularly capital spending, is responsible for the more supportive fiscal position in the first nine months of 2018. The government must adjust spending in the last quarter of 2018 to comply with the new deficit limit of 2.0 percent of GDP under the modified fiscal responsibility law. The authorities have reiterated their commitment to the deficit limits under the fiscal responsibility law.

- ***Minor revisions to the national income accounts***. Recently revised data by the National Statistics Institute (INEC) indicates that real GDP growth for 2017 was 5.3 percent, (or 0.1 percent lower than reported in the Staff Report), whereas nominal GDP growth was 7.5 percent (or 0.6 percent higher than in the Staff Report). However, these marginal changes in GDP estimates do not significantly change the ratios to GDP included in the Staff Report.

Statement by Mr. Tombini, Executive Director for Panama and Mr. Maciá, Advisor on Panama
December 5, 2018

1. The Panamanian authorities thank the new mission chief and his team for their productive engagement and policy advice during a comprehensive staff visit in May and the Article IV consultation mission in September. The authorities broadly agree with the team's assessment and policy recommendations.

Recent economic developments

2. In 2017, Panama's GDP growth was the highest in the Latin American and the Caribbean region at 5.4 percent. A labor strike in construction in April and May – which slashed activity in the sector by 40 percent – and a weak performance in some other economic sectors have reduced growth in 2018 by as much as one percentage point to a projected 4.5 percent. A strong rebound in 2019 is expected, with economic growth projected to hover above 6 percent, supported by a large public infrastructure investment program and the beginning of the production of the copper mine *Minera Panamá*. The increase in transport and storage facilities, further utilization of the expanded Canal capacity, and continued expansion of the Colon Free Trade Zone (ZLC) activities will also contribute to such recovery. Labor market remains robust, while inflation is expected to climb slightly to 1.2 percent at end-2018.

3. The authorities continue to support a dynamic public investment program well into the medium term. Public investment budget in 2018 was over US$5.2 billion or about 8.0 percent of GDP, and an equivalent amount has been allocated in the 2019 budget. Large infrastructure projects to be concluded this year and in 2019, totaling over US$ 4.4 billion, encompass the third bridge over the Panama Canal, the city of Colon urban renewal, the Interamerican Highway expansion, the Metro Line 2, and the Tocumen Airport new terminal. Major projects startups in 2019 include the fourth bridge over the Canal and the Metro Line 3 monorail system, totaling about US$ 4.0 billion. Foreign direct investment (FDI) also remains high, comprisi g among others a liquefied natural gas electricity generation plant completed in August 2018, and a new plant to start construction in 2019. FDI has also supported the expansion of port facilities for larger neopanamax ships in the Canal area and the *Minera Panamá*, which is expected to start exporting in early 2019. The above represents a total FDI package of about US$9.1 billion.

4. The current account deficit is projected to increase marginally in 2018. The current account deficit will remain relatively high into the medium term, as government policies continue to support large public infrastructure investments and improve public projects' implementation rate. Also, rising global trade disputes can negatively affect international trade, with clear impact on the Canal revenues. Despite such exogenous risk, the external account is projected to remain well under control in the foreseeable future as the steady flow of FDI should continue to finance most of the current account deficit.

5. Recently, the major rating agencies reaffirmed the investment grade for Panama's sovereign debt. In October 2017, Moody's perspective on Panama improved to positive from a previous stable outlook. In February, Fitch reiterated Panama BBB qualification with stable outlook. In July, Standard & Poor's upgraded the outlook to positive based on the country's growth path, stable fiscal policy, and prudent debt management.

Fiscal stance and public financial management

6. Panama has maintained a prudent fiscal stance and the Non-Financial Public Sector (NFPS) deficit declined to 1.6 percent of GDP in 2017. The Ministry of Economy and Finance (MEF) estimated the fiscal deficit in mid-year 2018 to have remained at 1.6 percent of GDP. In October, the National Assembly approved MEF's request to increase the 2018 fiscal deficit ceiling to 2.0 percent of GDP to cope with the slack in the economy. At the same time, it provided for a more transparent fiscal rule within the Social and Fiscal Responsibility Law (SFRL). The deficit ceiling will be reduced gradually, and by 2022, it will have converged to 1.5 percent of GDP, supporting a fiscal consolidation approach conducive to continued public debt reduction. In September, NFPS gross debt reached 38.1 percent of GDP and net debt, which excludes the US$ 1.3 billion balance of the sovereign wealth fund (FAP - *Fondo de Ahorro de Panamá*), stood at 36.1 percent of GDP. On a related note, in a general-elections year, the outgoing administration can only spend 50 percent of the operational budget – i.e., excluding investment outlays – so that the new dministration that takes office on July 1st has enough budget to conclude the fiscal year.

7. The above ruling of the National Assembly also allows the Panama Canal Authority (PCA) to transfer resources to the FAP. Previously, the transfers to FAP were conditioned to PCA's transfers to the treasury surpassing 3.5 percent of GDP. Such ceiling has been reduced to 2.5 percent of GDP for 2018 and 2019, and it will be further reduced to 2.25 percent of GDP after 2020. With the new rule, authorities expect inflows of funds into FAP over the next few years.

Legislative agenda

8. The Administration remains heavily involved in efforts to have important bills approved by the National Assembly. Amongst the relevant bills in parliament, the establishment of the Fiscal Council, an IMF longstanding recommendation, was approved during the last legislative period, while other important initiatives – namely, the adoption of sanctions to fraud against public administration, the criminalization of fiscal fraud, as well as the elimination of the statute-of-limitation on fiscal fraud and corruption – are in different stages of the legislative process. The proposed fintech legislation awaits initial discussion at committee level. The approval of the bill criminalizing fiscal fraud, to be discussed in the upcoming extraordinary legislative sessions, would not only fulfill one of the Financial Action Task Force of Latin America (GAFILAT) main recommendations highlighted in its latest report but reassert the country's commitment to abide to and support international rules and regulations on AML/CFT. The authorities' ability to garner broad political support is both challenging and crucial, especially as a window of opportunity opens with the extraordinary sessions in the last few weeks of the year.

Financial sector

9. The banking system has remained stable, well capitalized, profitable and closely supervised. Financial indicators suggest a steady and robust position of the national banking sector. According to the latest banking activity report, the capital adequacy ratio (CAR) was slightly up at 16.0 percent compared to the statutory 8 percent; return on assets (ROA) remained at 1.5 percent; and return on equity (ROE) stood at 13.3 percent. Private sector credit expanded at 5.4 percent year-on-year in July, while personal consumption credit increased 8.9 percent, mostly in the form of housing mortgages, auto loans and credit cards. Non-performing loans (NPL) stood relatively flat at 1.7 percent and local deposits in the banking system increased 1.6 percent in August (yoy).

10. Panama has made important progress to improve supervision and transition to Basle III. Regulations on capital quality and risk-weighted assets and provisions for market and operational risks have been adopted. Accounting standards transition to IFRS9 has been completed, improving provisioning coverage. The Financial Coordination Council (CCF) has strengthened supervision coordination and the creation of a liquidity fund to reinforce the crisis management and resolution frameworks is being considered.

Transparency policy and AML/CFT regulations

11. Panama has completed in October 2017 the first automatic exchange of information with the United States under the agreement through the Foreign Account Tax Compliance Act (FATCA). It has since ratified the OECD's Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAC) and the Multilateral Competent Authority Agreement (MCAA). Panama was also found "largely compliant" with the Global Forum's exchange of information on request based on common reporting standards (CRS). In January, the country subscribed OECD's Base Erosion and Profit Shifting (BEPS) convention, which calls for exchange of information on rules against tax avoidance with over 70 participating countries. The authorities are aware of the need to upgrade its administrative and legal framework to comply with BEPS's four minimum standards, which are subject to peer monitoring and evaluation.

12. Under the new AML/CFT legislation, MEF's Intendance of Supervision (IS) oversees activities of designated non-financial business and professions (DNFBP). It enforces reporting requirements in five business sectors including: money transfer agents, casinos, law firms, real estate agents and the ZLC. In 2017, GAFILAT reviewed the effectiveness of the country's regulatory framework determining Panama's considerable progress in the implementation of the FATF 40 technical recommendations since the previous 2012 review. The authorities remain committed to further strengthening GAFILAT recommendations and the effectiveness of the AML/CFT framework.

13. The Fund's Fiscal Affairs Department (FAD) and Legal Department (LEG) have been fully engaged with Panama on targeted technical assistance in various areas during the term of the current administration. FAD has supported the revenues office (DGI) to strengthen automatic exchange of tax information, while LEG has provided over the past two years technical assistance to the IS, the Financial Intelligence Unit (FIU), the Superintendence of Markets (SMV) and the Superintendence of Insurance (SSRP) on AML/CFT regulations and supervision. LEG has also assisted the IS in enhancing its institutional capacity to deal with GAFILAT's reporting requirements and regulations. Such assistance has targeted strengthening the supervision framework on lawyers, notaries, real estate and construction sector, considered as high-risk areas. New sectors such as precious- metal dealers, armor-carriers and used-car dealers are in the technical assistance agenda for 2019. The authorities highly appreciate the Fund's continued technical assistance, which underlines its trusted engagement with Panama.