

Panama: 2003 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; 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 2003 Article IV consultation with Panama, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 17, 2003, 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 February 27, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of March 22, 2004 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 22, 2004 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Panama.

The document listed below has been or will be separately released.

Selected Issues and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

PANAMA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Panama

Approved by Markus Rodlauer and G. Russell Kincaid

February 27, 2004

- **Discussions.** A staff team held discussions in Panama City during October 23–November 6 and December 16–17. The team met with the minister of economy and finance, the general manager of the National Bank of Panama, other senior officials, representatives of banks and the business sector, and the main presidential candidates.
- **Team.** W. Lewis (Head), M. Dehesa, O. Hendrick, J. Prat, and R. Romeu (all WHD). A. Macia (OED) attended the discussions of the first mission, which was also joined by T. Alleyne (WHD) during the final week. Messrs. Lewis and Hendrick participated in the December mission.
- **Previous consultation.** At the conclusion of the 2002 Article IV consultation on July 10, 2002, Directors welcomed the fiscal responsibility law as a useful tool for sound fiscal policies. They considered that its sustained implementation should be supported by structural reforms in the fiscal area, particularly pension reform. They also recommended increased labor market flexibility.
- **Fund relations.** Panama has accepted the obligations of Article VIII, sections 2, 3, and 4 of the Fund's Articles of Agreement and maintains an exchange system that is free of restrictions on the making of payments and current transfers for current international transactions (Appendix I). Panama participates in the GDDS, and its metadata are posted on the Fund's Data Standards Bulletin Board.

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ACRONYMS

CAC	Collective Action Clause
CSS	Caja de Seguridad Social (Social Security Fund)
EFF	Extended Fund Facility
GDDS	General Data Dissemination Standard
GDP	Gross Domestic Product
GFS	Government Finance Statistics
IDB	Inter-American Development Bank
ILO	International Labor Organization
NFPS	Nonfinancial Public Sector
NPV	Net Present Value
OFC	Offshore Financial Center
PSBR	Public Sector Borrowing Requirement
SBA	Stand-By Arrangement
UNDP	United Nations Development Program
WTO	World Trade Organization

EXECUTIVE SUMMARY

Background

- A recovery of economic activity gathered strength in 2003, with real GDP growth estimated at close to 4 percent. Continued low inflation reflects the full dollarization of the economy. Banking activity also recovered, following the downturn of 2001–02.
- The fiscal responsibility law of 2002 aims at lowering the public debt burden through annual limits on the fiscal deficit. The deficit limit (2 percent of GDP) was met in 2002, but preliminary data suggest it may have been exceeded in 2003.
- The medium-term outlook is sound, assuming continued pursuit of prudent fiscal policies, growth-enhancing structural reforms, and adequate investment in economic infrastructure and human capital, particularly in the export-oriented service sector where the country has a comparative advantage.
- Elections are scheduled for May 2004, and the thrust of market-friendly policies is expected to continue after the change of government in September.

Policy discussions

- **2004 fiscal policy.** To meet the fiscal deficit limit in 2004, measures yielding about 1 percent of GDP are needed. The authorities have decided on measures that would cover about half of this gap, and are working to identify additional ones to ensure observance of the deficit limit. The staff recommended adoption of a quarterly program to help guide fiscal policy during the political transition.
- **Fiscal reforms.** Sustained compliance with the fiscal responsibility law will require structural reforms, including further improvement of tax administration; civil service reform, and a deepening of the tax reform of 2002, in part by broadening the tax base.
- **Pension reform.** Comprehensive reform of the pension system is needed to ensure its viability. The authorities are taking some administrative steps to reduce the deficit, but comprehensive reform will have to be done by the new government.
- **Financial sector.** The prudential framework has been strengthened and is now fully compliant with Basel Core Principles. The authorities prefer not to establish formal lender-of-last-resort and deposit insurance schemes, given the focus of the prudential system on crisis prevention and ample liquidity cushions in the banks.
- **Medium-term growth strategy.** The authorities intend to further develop Panama as a hub for transportation, communication and related export-oriented services. Policy initiatives to this end include further trade liberalization and legislation for special economic zones to allow greater flexibility in the terms of employment.

I. BACKGROUND AND RECENT DEVELOPMENTS

A. A Brief Perspective

1. **Panama's economy is fully dollarized (since 1904) and relatively open.** Panama's comparative advantage lies in the service sector, accounting for about 80 percent of GDP, including the operations of the Panama Canal, the Colon Free Zone, and a large banking system that is integrated with international financial markets. The banking system is sound and well regulated. Annual output growth averaged 3.7 percent over the decade to 2002. With public debt over 60 percent of GDP, prudent fiscal policies are essential, in support of which a fiscal responsibility law was enacted in 2002. Key among needed fiscal reforms is an overhaul of the social security system. Full dollarization also makes flexible labor markets a priority.
2. **Panama's social indicators compare favorably with the average for Latin America, but there are marked differences among geographical areas.** The poverty rate is 37 percent on average (65 percent in rural areas, where 38 percent of the population live in extreme poverty), with a particularly high concentration of poverty among indigenous people (95 percent). Other indicators of the standard of living—including education levels, life expectancy, and employment—are significantly higher in urban than rural areas. As part of the effort to reduce poverty, programs to improve the quality and targeting of social spending are being supported by the World Bank and UNDP.

B. Recent Economic Developments

3. **A pronounced slowdown of Panama's economy took place in 2001–02 (Figure 1 and Table 1).** Real GDP grew by only ½ percent a year in 2001–02, held back by the winding down of large investment projects, the global economic slowdown (which affected the transport and other export-oriented service sectors) and a weak regional economy (which depressed net exports from the Colon Free Zone).
4. **Real GDP growth recovered in 2003 to an estimated 3.9 percent.** The recovery has been led by a boom in construction (partly stimulated by a December 2002 tax law),¹ the primary sector (particularly the fishing industry), and a rebound of export-oriented services in the latter part of the year, notably trading activity in the Colon Free Zone and ports. Unemployment declined modestly in 2003, but it remains high at above 13 percent.
5. **Inflation remains low, reflecting full dollarization.** It rose to 1.8 percent during 2002, reflecting some pickup in domestic demand (compared with zero inflation in 2001 when domestic demand had declined). Inflation diminished in 2003, to a 12-month rate of 1 percent in October.

¹ Construction that is authorized before end-2003 and completed before end-2004 will be exempt from property taxes for 20 years. Subsequently, a shorter tax-exempt period will apply.

6. **The public finances have deteriorated in recent years.** The nonfinancial public sector (NFPS) balance shifted into a deficit in 2001, which widened in 2002 (Tables 2 and 3). A drop in tax collections in 2001 reflected the slowing economy, and over the last few years the finances of the social security system have weakened considerably as a result of higher pensions and a large increase in staffing and administrative expenses.²

7. **Policy actions were taken in 2002 to strengthen fiscal discipline and increase revenues.** A fiscal responsibility law was enacted in May 2002, limiting the NFPS deficit to 2 percent of GDP and targeting a gradual reduction in public debt to 50 percent of GDP.³ The deficit limit for the year was observed, partly reflecting cuts in spending in the second half of the year as well as some extraordinary capital revenues.⁴ In December 2002, the Assembly approved a tax reform that yielded an estimated 0.4 percent of GDP in additional revenue in 2003 (Box 1).

8. **However, in 2003 the deficit limit appears to have been exceeded.** Higher revenues from tax reform were offset by lower nontax receipts,⁵ while capital revenues were much lower than in 2002.⁶ Cuts in both current and capital outlays in the last quarter of the year were not sufficient to bring the NFPS deficit to within the 2-percent of GDP limit specified under the fiscal responsibility law; the deficit is estimated to have reached 2½ percent of GDP.⁷

9. **The banking system experienced some stress during 2002 as a result of the turbulence in financial markets in South America, but it began to recover in 2003.** Banks operating in Panama—particularly foreign banks—experienced large withdrawals of deposits by nonresidents in 2002, and responded by curtailing foreign credit operations (Figure 2). However, the impact on banks' domestic operations was less severe, with domestic deposits and credit to the private sector contracting only modestly. Deposit spreads (over LIBOR) rose

² Employment in the social security agency (CSS) rose by 43 percent from 2000 to 2002. The director of the CSS was replaced in late 2003.

³ Features of the law are described in the Staff Report for the 2002 Article IV Consultation, Box 1.

⁴ Capital revenue included capital gains from buybacks of Brady bonds equivalent to 0.9 percent of GDP.

⁵ In particular, dividends paid by privatized enterprises and the National Bank of Panama were reduced, and interest income from the Development Trust Fund declined.

⁶ Buybacks of Brady bonds and associated capital gains, originally expected in the latter part of 2003, did not take place.

⁷ The law does not provide for penalties in the case of noncompliance with the fiscal rules.

in 2001–02, particularly for local banks, a higher risk premium reflecting the turbulence in financial markets in South America (Figure 3). Private sector credit and bank deposits resumed a slow growth in the second half of 2003, and falling deposit spreads during the same period gave further evidence of recovery of the banking sector (Table 4).

10. **The fundamentals of the banking system remain sound, despite the contraction of assets in 2002.** Capital adequacy ratios exceeded 17 percent on average as of November 2003; liquidity is ample; and banks sharply improved their profitability in 2003 thanks to the rebound in the sector and cost-cutting measures by several banks (Table 5). Nonperforming loan ratios decreased somewhat in 2003, to less than 3 percent on average as of end-September 2003.

11. **Bank interest rates have trended downward since international interest rates started to decline in 2000 (see Figure 3).** Foreign banks lowered deposit rates faster than local banks, reflecting their closer integration with international financial markets, while domestic lending rates have declined with a lag.

C. Political Situation

12. **The government, with a thin majority in the Assembly, has emphasized consensus-building in its economic policy-making.** It has employed national dialogues on issues of economic recovery and social security reform to build consensus for policy change. Presidential and congressional elections are scheduled for May 2004, and the change of government will take place in September. The economic policies advocated by the main presidential candidates do not signal a departure from the market-friendly policies of the current administration.

II. OUTLOOK AND RISKS

13. **The staff projects a further recovery of real GDP growth to over 4 percent in 2004.** The recovery will benefit from accelerating growth in domestic demand, as well as the impact of an improved external environment on the export-oriented transport, communication and tourism sectors. The external current account deficit is projected to increase to 3½ percent of GDP in 2004, as rising net exports of the Colon Free Zone are expected to be offset by higher public sector interest payments (Table 6). Inflation is projected to remain low at around 1½ percent. The projections assume that the statutory fiscal deficit limit of 2 percent of GDP is observed.

Macroeconomic Framework			
(In percent of GDP, unless otherwise indicated)			
	2002	2003	2004
Real GDP growth (in percent)	0.8	3.9	4.2
Inflation (in percent; end of period)	1.8	1.2	1.3
External current account	-0.8	-3.2	-3.6
International reserves			
In billions of U.S. dollars	1.2	1.0	1.1
In months of imports	3.6	3.0	3.1
Nonfinancial public sector			
Primary balance	2.3	1.9	2.8
Overall balance	-1.9	-2.4	-2.0
Public debt	63.6	65.4	63.4

14. The near-term growth outlook is subject to downside risks, but also a significant upside potential:

- The recovery would be weaker if the regional economy were to recover more slowly than anticipated, dampening the rebound of net exports from the Colon Free Zone. Downside risk would be compounded in the event of sizeable slippage from the fiscal deficit limit, which could affect confidence and investment.

	Sources of Growth					Proj. 2004
	(Contribution to the growth of real GDP, in percentage points)					
	2000	2001	2002	2003		
Domestic demand	-1.1	-3.4	2.7	2.2	3.8	
Consumption	1.6	-1.1	2.9	1.2	2.7	
Public	0.3	0.5	-0.2	0.5	0.3	
Private	1.4	-1.6	3.1	0.6	2.3	
Investment	-2.8	-2.4	-0.2	1.0	1.1	
Public	-0.5	0.3	0.3	0.3	-0.3	
Private	-2.3	-2.6	-0.5	0.8	1.3	
Foreign balance	4.4	3.8	-1.9	1.7	0.4	
Exports	0.7	1.2	-0.1	2.1	2.1	
Imports	3.7	2.6	-1.8	-0.4	-1.7	
GDP	3.3	0.3	0.8	3.9	4.2	

- Economic activity could recover more rapidly than projected if recent positive trends in the service sectors strengthen further (in response to the improving external environment), private consumption remains buoyant in 2004, or the construction boom proves stronger than projected.

15. Underlying vulnerabilities center on the high public debt and the policy constraints implied by full dollarization. In particular:

- The relatively high public debt limits the room for maneuver of fiscal policy.⁸ The resulting vulnerability is compounded by the full dollarization and consequent absence of monetary and exchange rate policies.
- Full dollarization imposes stringent demands on the policy framework, owing to the reduced range of policy instruments and the need for labor market flexibility. If they are met, dollarization is a source of strength and stability, but if not, the economy could be overwhelmed by a variety of shocks.
- Dollarization also may enhance the risk of a potential deposit run, since there is no lender of last resort. Key buffers against this risk should include a strong fiscal sector and a sound banking system, in which banks maintain ample liquidity and have business plans for responding to unanticipated liquidity needs.

⁸ The statutory 2-percent of GDP deficit limit, if pursued as a short-term (annual) target, would also limit the room for maneuver of fiscal policy.

- The economy, because of its openness and integration with the global economy, is vulnerable to adverse developments in the external environment. Besides the need for greater room for maneuver of fiscal policy, external competitiveness requires reforms to enhance productivity and labor market flexibility.

16. **A baseline scenario through 2008 assumes that the fiscal deficit is maintained at 2 percent of GDP, in line with the legal limit (Appendix V, Table 1).**⁹ Real GDP growth is assumed at 3¾ percent a year, equal to the average over the last decade (Box 2). Under this scenario, the public debt declines to 57 percent of GDP by 2008, but there are large gross fiscal financing needs in the latter years of the projection period which could be a source of vulnerability to rollover risk. Also, there is virtually no room for countercyclical policy under the baseline scenario, owing to the assumption that the fiscal deficit ceiling under the fiscal responsibility law is treated as a target each year. A risk to this scenario is if the incoming administration were unable to build consensus for the needed reform of the pension system and to comply with the fiscal rules.

17. **The staff recommended a somewhat stronger medium-term fiscal position.** A scenario with an average deficit of 1 percent of GDP would bring the public debt ratio to about 50 percent by 2008, substantially reduce the gross financing needs, and provide room for automatic stabilizers to operate. The staff's recommended scenario also assumes the implementation of growth-oriented structural reforms that would raise the economy's growth path (see Appendix V).

18. **Sensitivity analysis shows that the public debt dynamics are vulnerable to policy slippage and shocks (see Appendix V).** If no measures are taken to reduce the fiscal deficit (implying a departure from fiscal rules, with the deficit rising to 4 percent of GDP in 2008), the public debt ratio would decline only marginally (to 60 percent of GDP), with significantly increased gross financing needs. This would leave the country vulnerable to shocks, particularly to growth and interest rates.

19. **A potentially large expansion of the Panama Canal is being studied that could have a far-reaching impact on the economy's growth prospects.** A proposal may be ready by mid-2004. A decision to proceed with the project, with an investment cost ranging up to 50 percent of GDP, would be taken only on the basis of a national referendum, and the project would be completed in the next decade. The financing strategy would be to obtain an

⁹ The fiscal responsibility law also limits the growth rate of nominal debt (to 80 percent of the growth in nominal GDP) if real GDP growth exceeds 1.5 percent. Effectively, the *debt limit* constrains the deficit when real GDP growth is in the range of 1½–3 percent. For example, if nominal GDP growth is 5 percent, implying a maximum 4-percent increase in nominal debt, the *deficit limit* of 2 percent of GDP would likely be the binding constraint on fiscal operations.

investment-grade credit rating for the Panama Canal Authority, and seek private sector financing that does not rely on a government guarantee.

III. POLICY DISCUSSIONS

20. Discussions centered on the economic recovery in 2003 and outlook for 2004; the stance of fiscal policy; social security reform; and the government's strategy for raising economic growth over the medium term.

21. **A recurring theme during the discussions was the importance of building consensus for policy reforms in order to ensure their sustainability.** The authorities successfully employed a dialogue and consultation process that resulted in unanimous legislative support for the fiscal responsibility law in 2002. In the area of social security reform, however, the objective of reaching full consensus has not been achieved; the national dialogue on social security reform, which began in 2001, has so far not resulted in an agreement on substantive proposals for pension reform. The next administration will have to carry the process forward in a way that leads to policy decisions for the needed reforms.

A. Fiscal Policy

22. **The authorities considered that the fiscal responsibility law provides an appropriate framework for the conduct of fiscal policy.** Although the deficit limit in 2003 was probably exceeded, they noted that the law's objective of reducing the debt burden will be achieved, and that the framework has proven important in maintaining fiscal discipline in the run-up to elections.

23. **The staff concurred on the beneficial role of the fiscal rules and emphasized the importance of adhering to them in 2004.** Staff noted that projections based on the approved budget for 2004 imply a need for measures equivalent to about 1 percent of GDP, in order to meet the 2-percent GDP deficit limit.¹⁰ To meet the limit, the staff recommended steps to improve the social security balance and to postpone some of the budgeted increases in government employment (with a projected total impact of 0.6 percentage point of GDP). Additional measures to close the remaining gap could include further restraint of low-priority expenditure.

24. **The authorities emphasized their commitment to continued compliance with the fiscal responsibility law in 2004.** They explained that some measures for reducing the fiscal

¹⁰ While the budget projects a deficit of 2 percent of GDP, it is based on over-optimistic assumptions for capital revenue.

deficit in 2004 were already being taken. They thought that cuts in nonessential spending could close the remaining gap.¹¹

25. **The staff recommended that the authorities prepare a quarterly fiscal program consistent with the annual fiscal rules, to guide policy implementation during the political transition and avoid a repeat of the stop-go pattern of 2003.** The authorities agreed that this would be useful, and noted their intention to implement—as recommended by staff—spending restraint in a way that avoids accumulation of arrears.

26. **While recognizing the benefits of a stronger fiscal position over the medium term, the authorities considered adherence to the fiscal responsibility law as sufficient.** Lowering the debt-to-GDP ratio gradually to 50 percent was the core goal of the fiscal responsibility law, which should ensure medium-term debt sustainability. They also noted that announcing a more ambitious target might risk undermining the broad national consensus that has been built around the law. Staff suggested that some refinements of the fiscal responsibility law be considered going forward, such as rules to guide policy implementation during political transitions, and defining debt limits in a way that permits the pre-funding of deficits. The authorities noted that such changes could only be effected by the next government.

27. **The authorities' debt management strategy seeks to improve the maturity structure of debt and deepen the domestic capital market.** Three- and five-year treasury notes began to be issued in 2002, helping to define a Panamanian yield curve. Global bond issues, totaling US\$3.7 billion since 1999, have been used to meet fiscal financing needs and retire Brady bonds.¹² The authorities have decided that all future sovereign bond issues would include collective action clauses (CACs), starting with a bond issue of US\$250 million in January 2004.

28. **The authorities agreed with the staff on the need for a comprehensive reform of the pension system to restore its solvency and ensure medium-term fiscal sustainability.** Their approach aims first at improving the finances of the system through gradual reductions in staffing and steps to raise the yield on the social security fund's portfolio. The second stage would entail a comprehensive reform to be implemented after the September 2004 change in government. The participants in the national dialogue on social security reform, representing

¹¹ The projections in Tables 2 and 3 include the measures which the government already has decided upon (lowering operating expenditure in the social security sector and raising the yield of the social security fund's portfolio), leaving some 0.7 percent of GDP of measures to be adopted.

¹² The latest buyback of Brady bonds (US\$400 million, in January 2004) reduced the stock of Brady bonds to less than US\$400 million.

government, business, and labor, have presented a variety of proposals for reducing the large actuarial deficit (Box 3).¹³

29. **The authorities acknowledged the need for other structural reforms to sustain compliance with fiscal rules.** Steps that should be considered are to improve tax administration; rationalize government expenditure through civil service reform (better aligning staffing levels with needs and improving the public sector wage-setting mechanism); and deepen the 2002 tax reform, mainly by broadening the tax base and reducing exemptions.

B. Financial Sector Policies

30. **The supervisory framework has been strengthened.** Since the Module 2 OFC report of 2001, which reported a high level of compliance with most Basel Core Principles, the authorities have taken actions toward reaching full compliance (mainly improving offsite and onsite inspections and the regulation of banks' equity investments). Several other recommendations also have been implemented, including enhanced legal protection for supervisors; strengthened procedures for bank mergers and acquisitions; and progress with the consolidated supervision of financial entities, which in some cases involves cooperation with regulators in other jurisdictions.¹⁴

31. **The authorities have taken the view that a formal lender-of-last-resort scheme is not needed in Panama.** They explained that the banking system derives its strength from a strong regulatory and supervisory framework, and from the market discipline that is fostered by the absence of official safety nets and contingency mechanisms to cushion liquidity shortfalls. They believed that, given the strong emphasis on crisis prevention, transparency, market discipline, the potential benefits of formal contingent credit mechanisms would be outweighed by the attendant moral hazard. The authorities noted that both foreign and domestic banks maintain high levels of liquidity. The liquidity ratio (liquid assets in relation to deposits) averaged 28 percent as of end-November, and the average liquidity ratio that includes marketable securities is over 40 percent for both foreign and domestic banks.¹⁵

¹³ An actuarial model is being developed with assistance from the UNDP to estimate the uncovered liabilities of the pension system. Unofficial estimates from 1998 suggest that these unfunded obligations are over 50 percent of GDP in NPV terms, including future obligations to contributors who have not yet retired.

¹⁴ The status of compliance with the Basel Core Principles will be assessed by an MFD mission for the Module 2 OFC follow-up, scheduled for March/April 2004.

¹⁵ More than half of the securities are marketed outside Panama, and one third of the total comprises investment-grade securities, thus providing a high degree of liquidity.

32. **The authorities also believe that there is no clear need to establish a deposit insurance scheme.** They explained that its absence in Panama has not had a demonstrably adverse effect on confidence in the banking system, and that protection of small depositors is provided by giving priority over most other claims to the payment of deposits up to US\$5,000. In their view, deposit insurance would create moral hazard and could create significant contingent fiscal liabilities. Given the absence of lender-of-last-resort and deposit insurance schemes, the staff emphasized the importance of maintaining a strong supervisory framework for the financial sector, with a focus on crisis prevention, transparency, market discipline, and ample liquidity cushions, as well as a sound fiscal policy. The staff also encouraged the authorities to consider to adjust for inflation the ceiling on small deposits with priority over other creditor claims in the event of bank liquidation (in accordance with provisions in the Banking Law).

33. **The authorities attach a high priority to combating money laundering and the financing of terrorism.** Panama has a comprehensive legislative framework to combat money laundering, and it has ratified the UN International Convention for the Suppression of the Financing of Terrorism. The authorities are preparing draft legislation that would criminalize the financing of terrorism.

C. Trade Policy, Competitiveness, and Labor Market

Trade

34. **The government's strategy to raise growth is to further develop Panama as a hub for transportation, communication, and related services.** These are areas of comparative advantage that, under the right framework, can attract foreign investors seeking the country's well-developed service infrastructure. The authorities explained that free trade agreements are central to their strategy for boosting investment and growth. In their view, the most important benefits of free trade agreements accrue indirectly by encouraging foreign investors with a regional focus to establish operations in Panama, making use of the transportation, financial, and communications infrastructure. A free trade agreement with Taiwan Province of China was concluded in the second half of 2003, and discussions on an agreement with the United States (Panama's main export market) are to begin in April. Based on Panama's economic integration treaty with the Central American countries in 2002, a trade agreement with El Salvador has been concluded, and negotiations with Costa Rica and Nicaragua are under way.

35. **Panama's trading system is relatively open.** It has a low average tariff but also prohibitively high tariffs on selected agricultural products (300 percent for certain poultry products).¹⁶ The authorities explained that some import tariffs and subsidies on nontraditional

¹⁶ The unweighted average tariff is 8.6 percent, and the country has a rating of 1 (i.e., open) on the Fund's 1–10 trade restrictiveness index.

exports would be phased out by end-2005 under the terms of accession to the WTO.¹⁷ They expect to replace export subsidies with more general tax incentives for the manufacturing sector, consistent with WTO rules, through a law on industrial policy that became effective February 2004. The authorities estimated the law's fiscal impact to be neutral, as the new tax expenditures would be about offset by the elimination of export subsidies.

Competitiveness

36. **The real effective exchange rate has declined sharply since 2002 (Figure 6), but there are questions about Panama's competitiveness from a broader perspective.** Panama ranked 59th out of 85 countries in a recent competitiveness study by the World Economic Forum,¹⁸ owing to perceptions of weak public institutions and weaknesses in the business environment such as labor market rigidities and certain licensing requirements and laws that discourage investment. A competitiveness project supported by the Inter-American Development Bank (IDB) includes reforms in these areas to promote private sector investment and employment.¹⁹ The competitiveness problems appear to be less severe in the large international services sector, which is subject to less regulation than the agriculture and manufacturing sectors, whose performance has lagged that of other sectors in recent years. The staff noted, however, that declining industrial production did not justify the preferential income tax treatment that is planned for this sector in the recent legislation on industrial policy.

Labor Market

37. **The authorities are seeking to promote a more efficient labor market in ways that are politically and socially acceptable.** The labor code poses obstacles to job creation because of the difficulty of laying off employees when needed; it also imposes high nonwage labor costs and inhibits temporary employment. The authorities pointed out that it would be very difficult to achieve broad domestic consensus on comprehensive reform of the labor code. Instead, they are proposing legislation for special economic zones near the Panama Canal, which would allow for greater flexibility in the terms of employment—particularly for businesses that need to operate at night or on weekends—and thereby foster job creation. They hope that the success of such “pilot” projects might reduce opposition to extending those labor practices to the entire country.

¹⁷ Panama joined the WTO in 1997.

¹⁸ Panama's ranking among Latin American countries was more favorable (8th of 21 countries).

¹⁹ In particular, the project seeks to remove sector-specific barriers to foreign investment and to enhance the transparency of the legal framework for foreign investors.

D. Other Issues

38. **The authorities have made progress in implementing a number of recommendations of the last Article IV consultation.** In particular, the authorities' focus on meeting the debt and deficit sustainability targets embodied in the fiscal responsibility law is consistent with the thrust of Directors' recommendations on fiscal policy, even though the deficit limit was probably exceeded in 2003. Directors had urged the authorities to implement a revenue-enhancing tax reform; as noted, a tax package was approved in late 2002, yielding about ½ percent of GDP in 2003. The draft law now before the Assembly providing for more flexible terms of employment in special economic zones follows the recommendation to strengthen the legal framework to facilitate job creation and investment.

39. **Progress has been more limited in other areas of structural reform where the pace of implementation depends on progress in building consensus.** In particular, a broad domestic consensus remains to be achieved on pension reform, which is key to medium-term fiscal sustainability. The authorities noted that the need to build consensus for policy reforms was a key factor that determined the extent and speed with which they could implement Fund policy advice. In many cases, a key challenge involved achieving legislative approval of reforms.

40. **The timeliness and coverage of economic statistics is generally adequate for monitoring purposes, but some weaknesses remain.** A recent revision of the national accounts is an improvement.²⁰ Also, the authorities are working to reduce reporting lags for fiscal data. The frequency and coverage of labor market statistics should be improved.

IV. STAFF APPRAISAL

41. **A recovery of the economy is under way.** The economic slowdown in 2001–02 reflected developments in the regional economy, and initial signs of a recovery in early 2003 gathered strength in the course of the year. The recovery is expected to continue in 2004.

42. **The fiscal responsibility law provides a sound framework for fiscal policy.** It has helped maintain a focus on the need for a prudent fiscal stance and expenditure restraint. The staff welcomes the authorities' commitment to this framework, which is aimed at limiting fiscal deficits and ensuring medium-term debt sustainability.

43. **The main focus of fiscal policy for 2004 should be to ensure the observance of the fiscal responsibility law.** Meeting the deficit limit this year is essential for the credibility of the fiscal rules and will require the adoption of additional measures. The staff encourages the authorities to prepare a quarterly fiscal program for this election year to guide fiscal policy during the political transition.

²⁰ GDP coverage was extended to include the canal (after its reversion to Panama at end-1999) and some informal sector activities; GDP for 2002 was revised upward by 18 percent.

44. **A comprehensive reform of the pension system is needed to restore its solvency.** The staff encourages the authorities' efforts to improve the finances of the social security system by rationalizing its staff and improving the social security fund's portfolio management. However, more fundamental reforms are also needed that will generate sufficient savings to cover the direct and contingent liabilities of the pension system. Sustained compliance with fiscal rules will also require other structural reforms, including steps to improve tax administration, civil service reform, and deepening the 2002 tax reform by further broadening the tax base and reducing exemptions.

45. **Staff welcomes the progress in further strengthening bank regulation and supervision.** The authorities have implemented the recommendations made during the OFC Module 2 assessment, bringing the supervisory framework into greater compliance with Basel Core Principles. Progress has been particularly noteworthy in the areas of inspections and in implementing consolidated supervision of regional banking institutions, in collaboration with regulators in other jurisdictions. Current arrangements, including a strong supervisory framework focused on crisis prevention, transparency, and ample liquidity cushions in the banking system, have served the financial system well. While the staff recognizes the preference not to introduce deposit insurance, the authorities should consider protecting the social safety net for small depositors by inflation-adjusting the size of deposits with priority status in the event of a bank liquidation.

46. **The staff supports the emphasis in the government's growth strategy on exploiting the country's comparative advantage in the export-oriented service sector.** To this end, policies seek to focus on providing the needed economic infrastructure, promoting good governance, and strengthening the environment for productive investment and job creation. The task of designing and implementing policy reform in this area is challenging, and the IDB-supported competitiveness project is a welcome effort to this end. Reducing labor market rigidities will be particularly important, and the staff encourages the authorities' efforts to seek the necessary consensus for reforms in this area, initially through greater flexibility in the terms of employment in special economic zones.

47. **The staff supports the authorities' plans for further trade liberalization.** In pursuing bilateral and regional trade agreements, the authorities should make sure that these agreements are broad-based, comprehensive, and consistent with multilateral trading arrangements being pursued under the Doha Round.

48. **The medium-term outlook is sound, assuming continued pursuit of prudent fiscal policies and growth-enhancing structural reforms.** On this basis, prospects are for sustained growth with a declining public debt burden, and a possible expansion of the Panama Canal could give a significant further boost to Panama's longer run growth potential.

49. It is proposed that the next Article IV consultation with Panama take place on the standard 12-month cycle.

Box 1. Tax Reform

Reforms in 2002

- The 2002 tax law included a combination of tax reductions and increases with a projected net revenue yield of 0.4 percent of GDP in 2003 (the authorities' proposal envisaged a yield of 0.8 percent of GDP). The main components of the approved law are:
 - The annual exemption under the personal income tax was raised from US\$3,900 to US\$10,400.
 - Banks' income, previously largely exempt, became taxable.
 - Some fiscal incentives are being phased out over five years (including tax exemptions for construction).
 - The corporate income tax rate was lowered from 30 percent to 28 percent.
 - The VAT base was widened to include selected services, albeit with many exceptions.
 - A 5-percent consumption tax was levied on a selective basis, mainly for luxury goods.
 - Tax exemptions for the housing sector were modified for better targeting to low-income housing.
- A law to reform the main tax agency was approved in 2002, supported by regional technical assistance to improve tax administration.

Agenda for future reform

- Broaden the VAT to encompass a wider range of services.
- Close loopholes and reduce poorly targeted tax expenditures.
- Provide the tax administration authority with the required legal framework to enforce the law and reduce tax evasion.

Box 2. Sources of Growth

- **The collapse in output in Panama resulting from the political crisis of the 1980s was followed by a period of broad economic recovery**, particularly in the dominant service sector, which accounts for almost 80 percent of GDP. The growth of export-oriented services was facilitated by Panama's integration into the world economy, and services exports, anchored around the Panama Canal, the Colon Free Zone, and an open and well regulated banking system. Strong growth in the 1990s was followed by the regional slowdown of 2000-01.
- **Despite the strong growth record of the 1990s, total factor productivity growth has been stubbornly low** (Table). Key reforms needed to boost productivity growth include reducing labor market frictions (below), and improving education by, for example, promoting skills relevant to service exports such as language training.

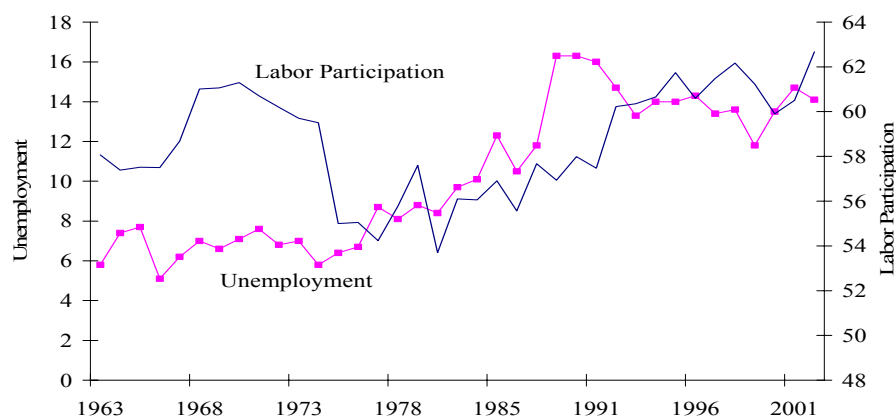
Panama: Contribution to Growth
(Average, in percent)

	GDP	Factor Contribution			Sectoral Growth Rate		
		Capital	Labor	Productivity	Primary	Secondary	Tertiary
1981-1985	3.5	-4.4	1.4	6.5	5.1	-0.6	5.0
1986-1990	-0.4	-8.0	1.3	6.3	0.8	-3.1	-0.9
1991-1997	5.4	8.6	1.3	-4.5	2.8	8.7	4.6
1998-2002	3.5	2.2	1.2	0.0	2.8	-1.1	4.3
2003-2008	3.8	2.4	1.3	0.1	4.2	4.6	3.7

Notes: Estimates are based on a Cobb-Douglas production function (with 0.6 capital share), capital growth given by change in real investment, and a five year moving average for growth of labor post-2002. Domestic investment for 1989-1990 is averaged to control for political instability. The tertiary sector is comprised of services.

- **Panama's unemployment rate has persisted above 10 percent for many years, exacerbated by a rising labor participation rate.** The high structural unemployment may be partly attributable to overregulation and labor market frictions. Labor market reforms should include instituting part-time and evening work schedules, test periods for employees, and decreasing severance packages. The difficult political challenge of implementing labor reform has led the authorities to focus initially on changes in labor market conditions in special economic zones (para. 37).

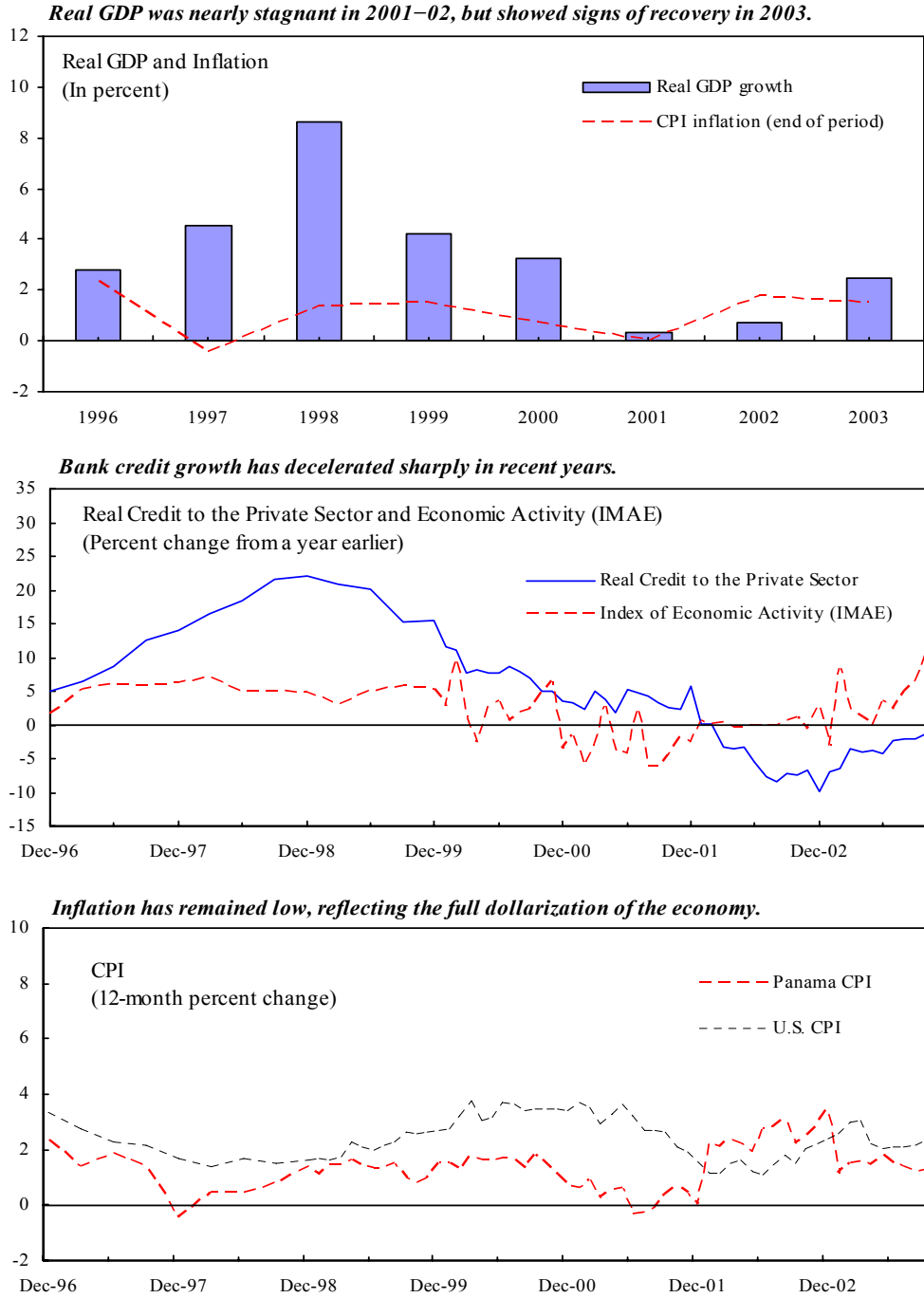
Panama: Unemployment and Labor Participation Rates



Box 3. Social Security Reform

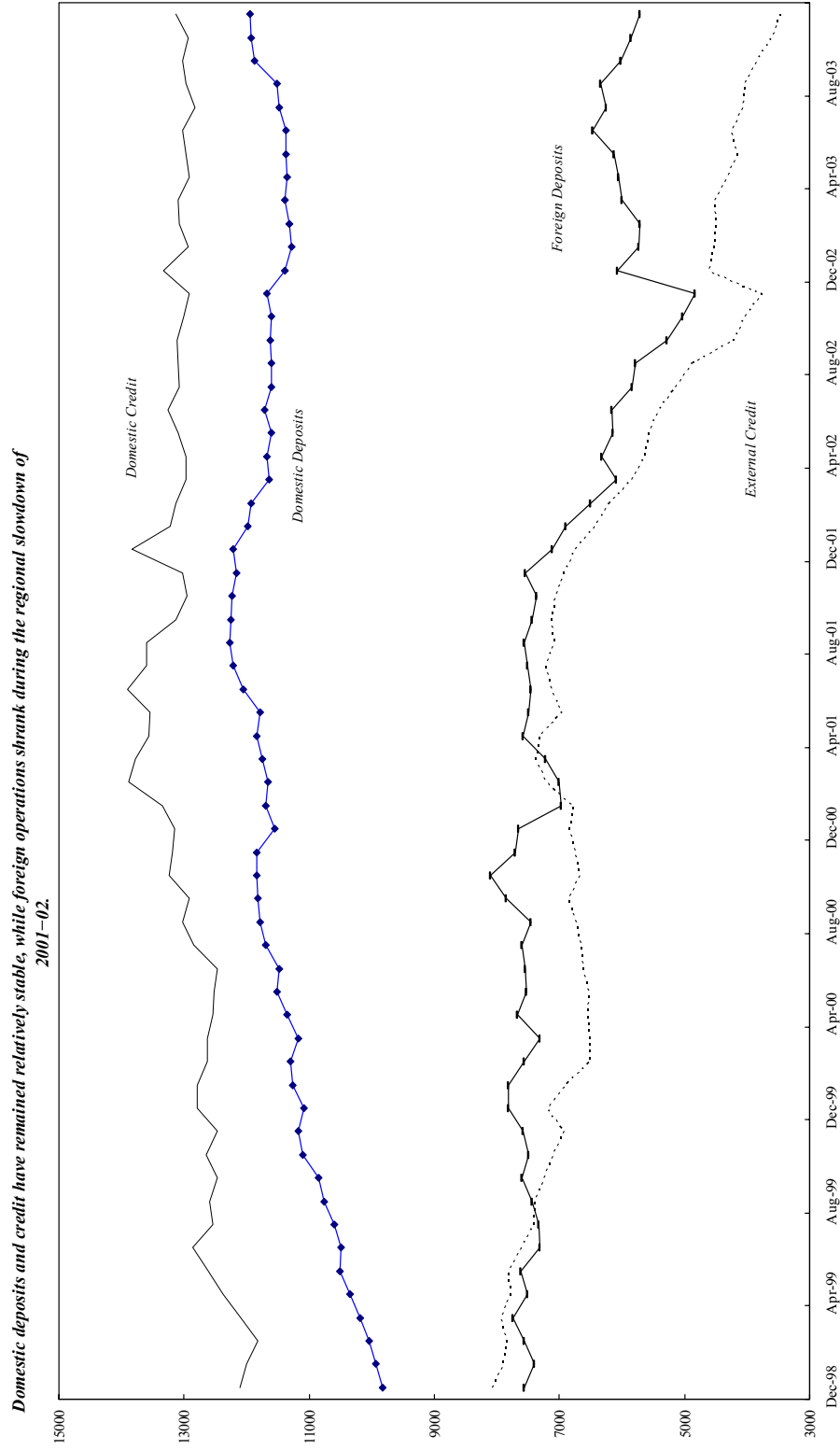
- **The balance of the Social Security Fund (CSS) has deteriorated in recent years**, from a surplus of US\$133 million in 1999 to a deficit of US\$18 million in 2002. The deficit is expected to have widened further in 2003.
 - The reserves of the CSS are well below the legal requirement, which is to cover obligations to current pensioners. This uncovered obligation was estimated at US\$2.1 billion (16 percent of GDP) in a 1998 ILO study. The total unfunded obligations, taking into account the claims of current contributors, were estimated at 56 percent of GDP.
 - The reserves of the CSS would be depleted by 2023, according to the 1998 study. A revised ILO study in 2001 estimated that reserves would be depleted by 2018.
 - The financial imbalance in the CSS has been exacerbated by a sharp increase in personnel and operating costs, owing mainly to a 60-percent increase in employees from 1999 to 2002.
- **The financial problems are rooted in the imbalance between pension benefits and contributions to the pay-as-you-go pension system.** Already, contributions do not cover current benefits, and the deficit will widen progressively in the absence of a comprehensive reform of the system. Benefits include:
 - For a minimum contribution period of 15 years, a worker receives a pension of 60 percent of the reference wage, and for every additional year of contribution payments, 1¼ percentage points is added.
 - The retirement age for men is 62 years and for women 57 years.
 - A nonbinding ceiling of US\$1,500 a month applies for most pensions (with the average pension being about US\$500).
- **A reform of the social security system is needed to ensure its sustainability.**
 - The government has promoted a national dialogue on social security reform. The dialogue has been anchored by task forces for each of the CSS's four programs: disability, old age, and death benefits (IVM); maternity and health care; workmen's compensation; and the CSS administration.
 - The UNDP is assisting as a facilitator of the debate and a compiler of the proposals presented by the government, employers, workers, and civil society.
 - Consensus has been reached on aspects of three programs, but the task force on pensions (IVM) has reached no conclusions. Proposals tabled have included higher contribution rates, a longer minimum contribution period, and changes in retirement age (employers), and the preservation of existing benefits (workers).

Figure 1. Panama: Economic Activity and Inflation, 1996–2003



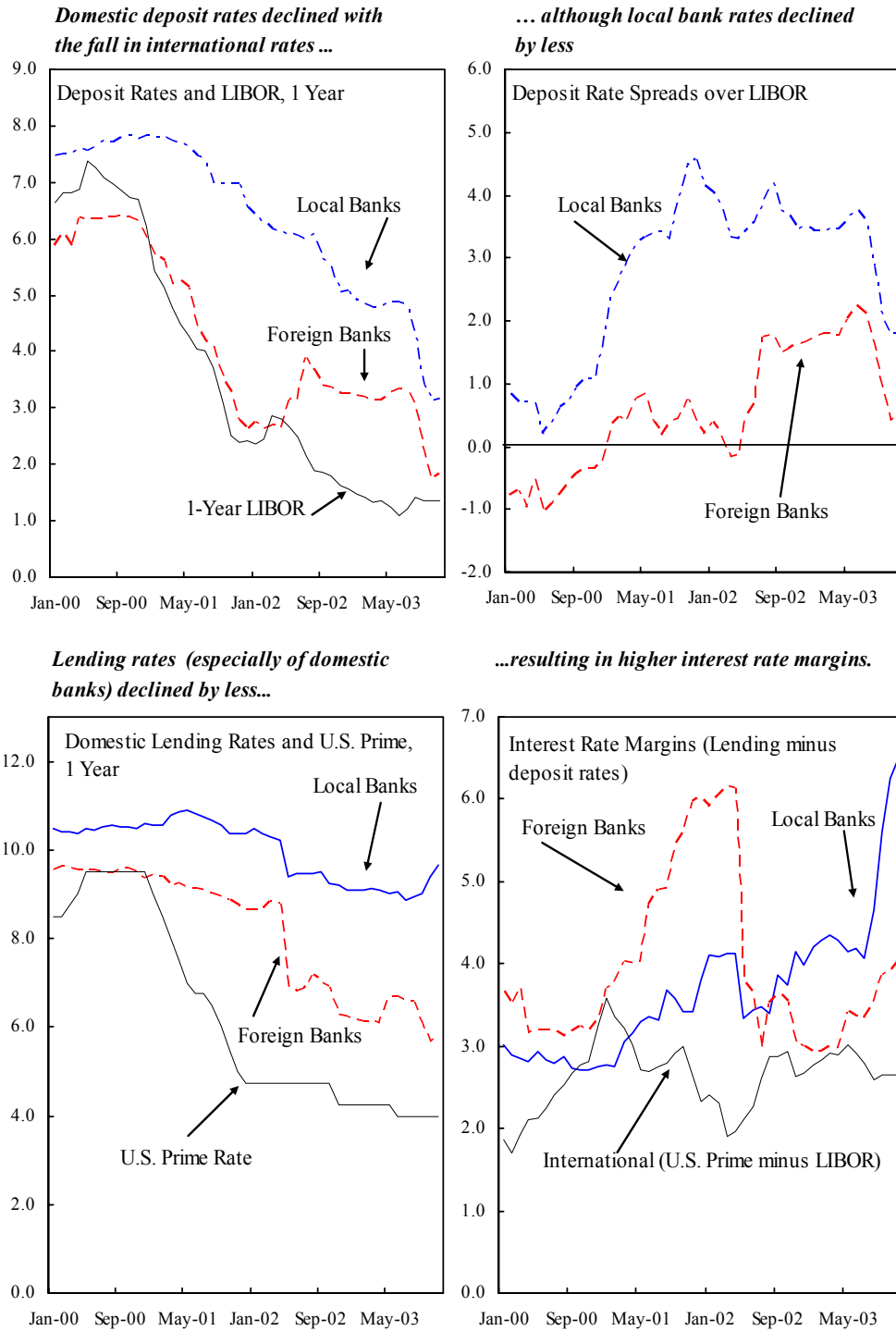
Sources: Comptroller General; Information Notice System; and Fund staff estimates.

Figure 2. Panama: Credit and Deposits in the Panamanian Banking System
(In millions of U.S. dollars)



Source: Superintendency of Banks.

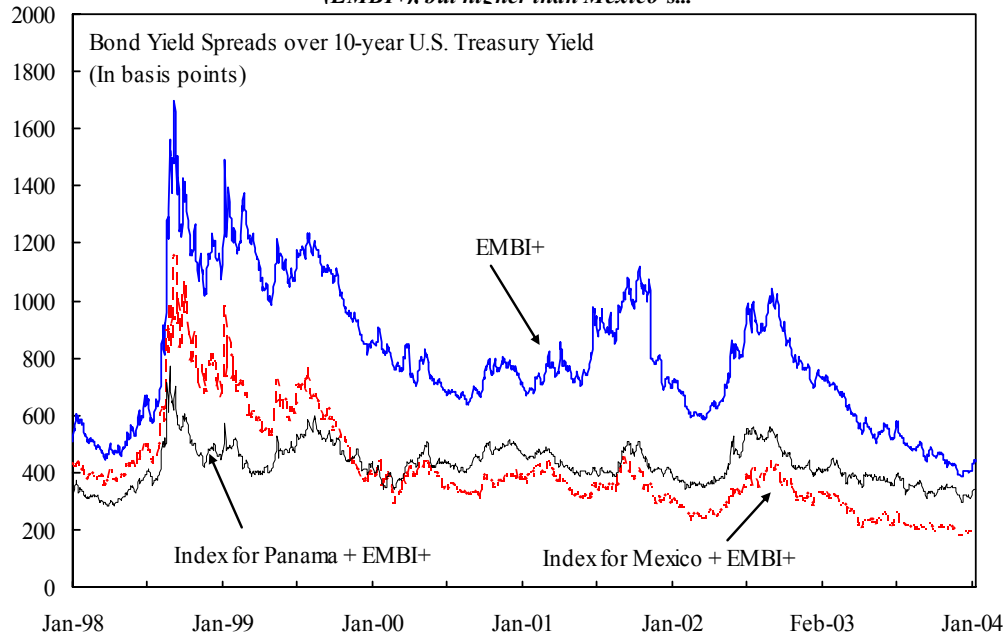
Figure 3. Panama: Interest Rates and Spreads, 2000–03
(In percent)



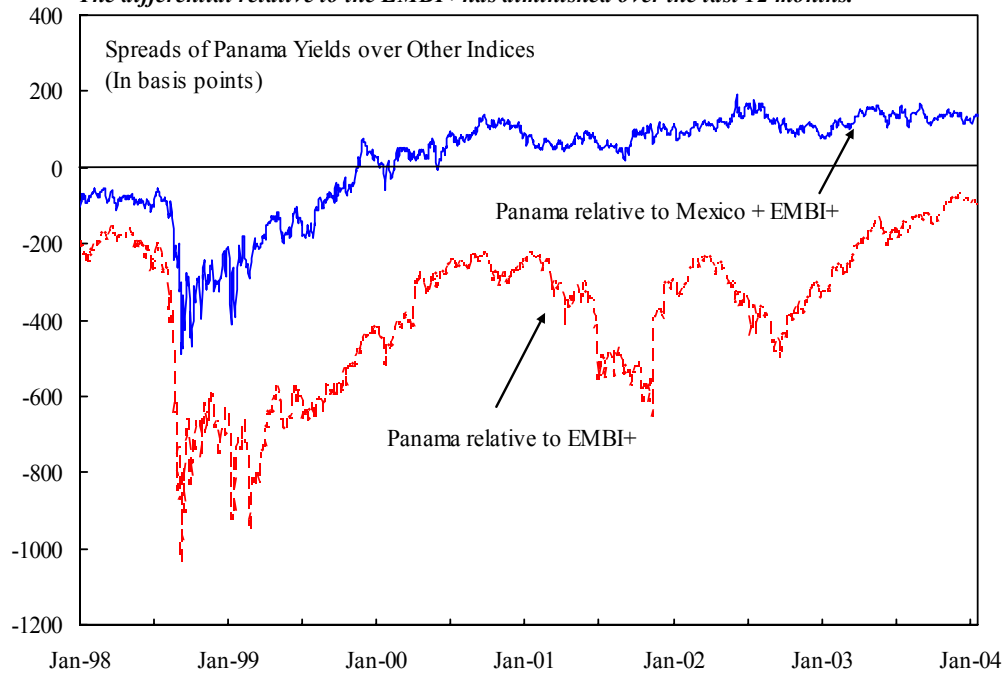
Sources: Superintendency of Banks; and Bloomberg.

Figure 4. Panama: Regional Sovereign Bond Spreads, 1998–2003

Panama's sovereign spreads are consistently lower than the average for emerging markets (EMBI+), but higher than Mexico's...



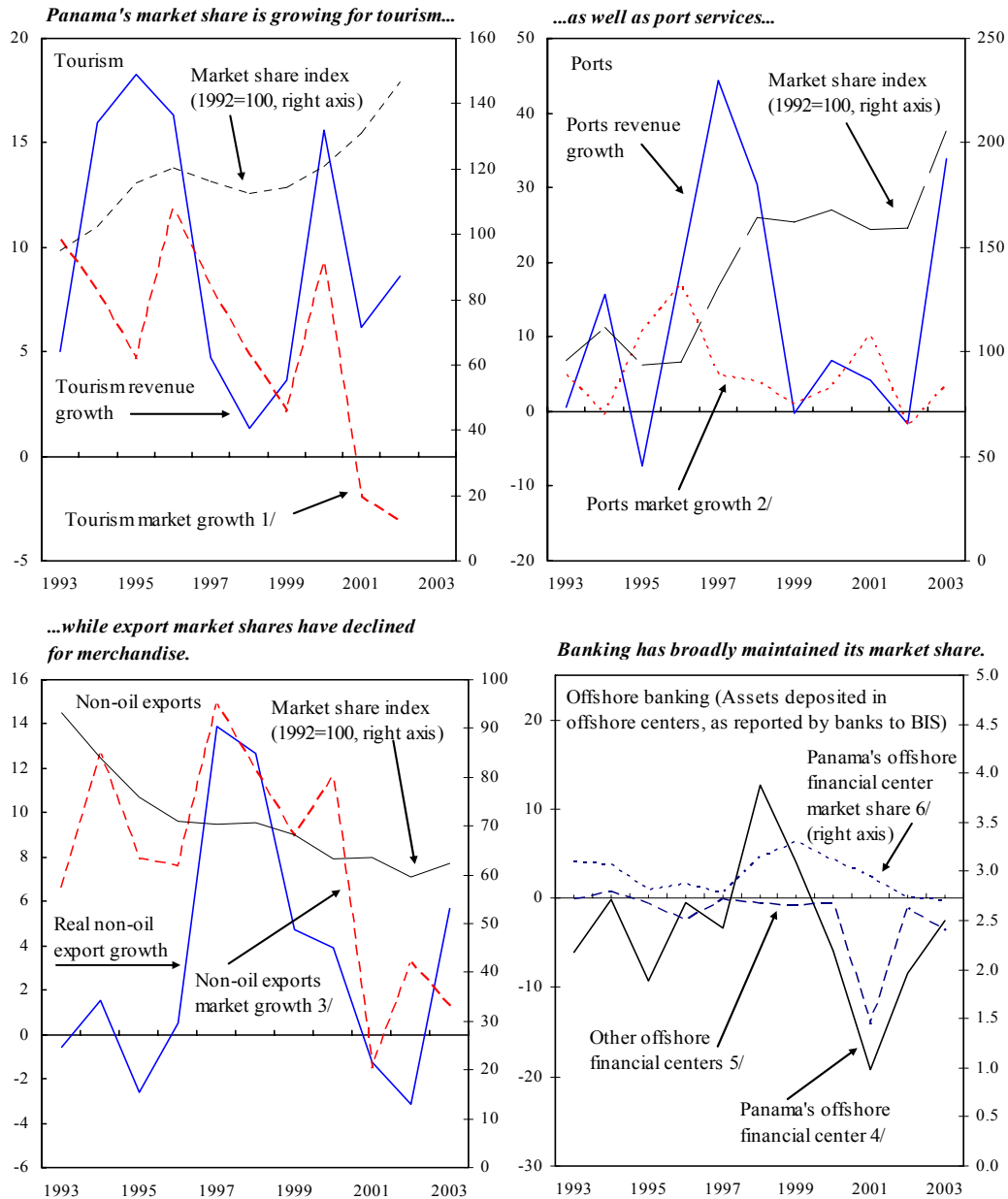
The differential relative to the EMBI+ has diminished over the last 12 months.



Source: J.P. Morgan.

Figure 5. Panama: Export Performance, 1993–2003

The performance of service exports outpaces that of merchandise exports.



Sources: BIS; Panamanian authorities; and Fund staff estimates.

1/ Based on foreign exchange earnings in 27 Latin American countries.

2/ Ports market growth is based on the WEO index of world trade.

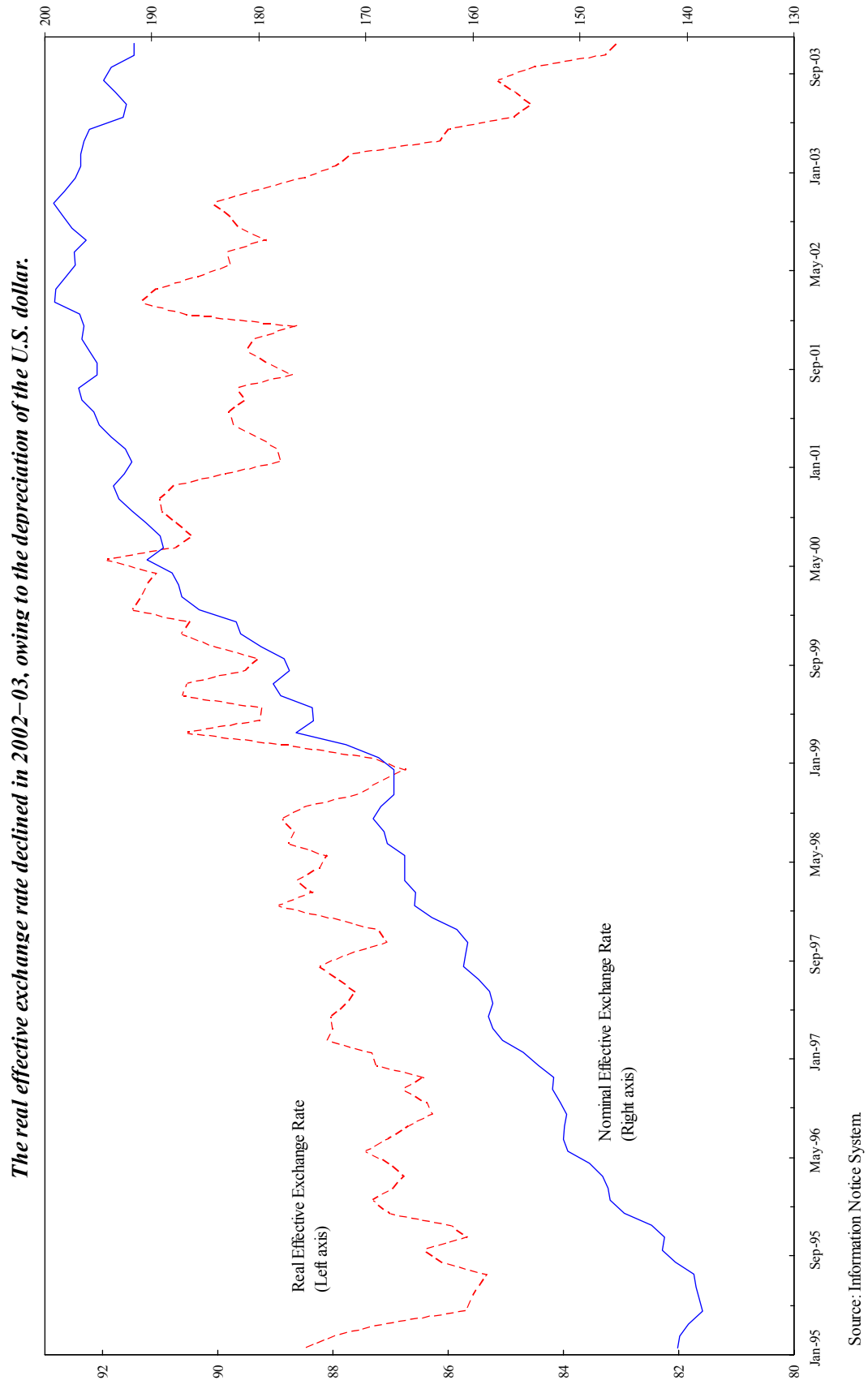
3/ Based on WEO data for Panama's main trading partners.

4/ Growth of total assets.

5/ The other four of the five largest offshore financial centers: Hong Kong SAR, Cayman Islands, The Bahamas, and Singapore.

6/ Panama's share of the assets of the five largest offshore financial centers.

Figure 6. Panama: Real and Nominal Effective Exchange Rates, 1995-2003
(1990=100)



Source: Information Notice System.

Table 1. Panama: Selected Economic Indicators

	2000	2001	2002	Est. 2003	Proj. 1/ 2004
(In millions of balboas)					
GDP at current prices	11,938	12,059	12,296	12,916	13,610
(Annual percent change)					
Production and prices					
Nominal GDP	4.8	1.0	2.0	5.0	5.4
Real GDP (1996 prices)	3.3	0.3	0.8	3.9	4.2
GDP deflator	1.5	0.4	1.2	1.1	1.1
Consumer price index (end of year)	0.7	0.0	1.8	1.2	1.3
Domestic demand (at constant prices)					
Public consumption	2.6	5.3	-2.3	5.2	3.1
Private consumption	2.2	-2.6	5.1	1.0	3.8
Public investment	-10.4	6.8	6.0	6.5	-5.6
Private investment	-8.2	-10.5	-2.0	3.5	6.2
(In percent of GDP)					
National accounts					
Gross domestic investment	28.5	26.0	25.6	25.6	25.7
Public sector	3.9	4.1	4.3	4.4	4.0
Private sector	24.7	21.9	21.3	21.2	21.7
Gross national saving	22.8	24.6	24.7	22.4	22.1
Public sector	3.8	1.7	1.4	1.6	1.8
Private sector	18.9	22.9	23.3	20.8	20.2
Nonfinancial public sector					
Revenue and grants	26.1	24.9	25.3	24.7	25.0
Expenditure	25.6	26.6	27.2	27.2	26.9
Current	21.7	22.5	22.9	22.7	22.9
Capital	3.9	4.1	4.3	4.4	4.0
Overall balance	0.5	-1.7	-1.9	-2.4	-2.0
External current account 2/	-5.8	-1.4	-0.8	-3.2	-3.6
Nonfinancial public sector debt					
External	58.2	63.3	63.6	65.4	63.4
Domestic	46.9	51.9	51.6	49.6	49.4
	11.2	11.4	12.0	15.8	14.0

Sources: Office of the Comptroller General; Superintendency of Banks; and Fund staff estimates and projections.

1/ Assumes active fiscal projection in 2004, in which the nonfinancial public sector deficit is consistent with the limits established in the fiscal responsibility law.

2/ Includes current official transfers.

Table 2. Panama: Summary Operations of the Nonfinancial Public Sector 1/
(In percent of GDP)

	1999	2000	2001	2002	Prel. 2003	2004	
						Budget	Staff Proj.
Revenue and grants	24.6	26.1	24.9	25.3	24.7	29.3	24.7
Current revenue	23.9	25.5	24.2	24.3	24.4	27.4	24.6
Tax revenue	10.6	9.4	8.6	8.5	8.8	9	8.6
Nontax revenue of central government 2/ <i>Of which</i>	5.9	7.4	6.6	7.0	6.5	5.6	6.8
Panama Canal Authority	1.2	1.2	1.2	1.2	1.2	...	1.2
Social security agency	6.1	6.2	6.1	5.9	6.0	12.4	6.1
Public enterprise operating balance <i>Of which</i>	0.9	2.6	2.2	2.4	2.7	0.0	2.5
Panama Canal Authority	0.0	1.9	1.4	1.6	2.0	...	1.7
Other 3/	0.4	0.0	0.7	0.4	0.3	0.0	0.6
Capital revenue 4/	0.6	0.5	0.7	1.0	0.3	1.6	0.2
Grants	0.0	0.0	0.0	0.0	0.0	0.3	0.0
Expenditure	25.8	25.6	26.7	27.2	27.2	31.2	27.4
Current primary expenditure	17.7	17.6	18.3	18.7	18.4	21.7	18.6
Central government	9.1	8.8	8.9	8.9	8.7	9.7	9.0
Rest of the general government	8.6	8.8	9.3	9.8	9.7	12.0	9.6
Social security agency	7.4	7.6	8.1	8.6	8.6	...	8.5
Decentralized agencies	1.2	1.2	1.2	1.2	1.1	...	1.1
Interest	3.6	4.1	4.3	4.2	4.3	4.8	4.7
Capital	4.5	3.8	4.1	4.3	4.4	4.6	4.0
<i>Of which: Panama Canal Authority</i>	0.0	0.8	0.9	1.1	1.0	1.0	1.0
Measures to be identified 5/	0.0	0.0	0.0	0.0	0.0	0.0	0.7
Overall balance	-1.2	0.5	-1.7	-1.9	-2.4	-1.9	-2.0
Financing (net)	1.2	-0.5	1.7	1.9	2.4	1.9	2.0
External	2.1	0.9	3.0	2.7	1.7	2.9	2.3
Net disbursements	2.2	1.0	5.9	1.1	0.5	2.9	2.3
Deposits (increase -) and other	-0.1	-0.1	-2.9	1.6	1.2	0.0	0.0
Domestic	-3.0	-1.4	-1.3	-0.8	0.8	-1.0	-0.3
Trust Fund 6/	-2.5	-0.2	1.0	0.0	0.0	0.7	0.4
Panama Canal Authority	0.0	-1.1	-0.5	-0.5	-1.0	-0.7	-0.7
Others	-0.6	-0.1	-1.8	-0.2	1.7	-1.0	0.0
Privatization	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Savings	2.6	3.8	1.7	1.4	1.6	1.1	1.8
Primary balance	2.4	4.7	2.6	2.3	1.9	2.9	2.8
Fiscal deficit (millions of balboas)	-138	62	-206	-236	-314	-258	-269
GDP (millions of balboas)	11,391	11,938	12,059	12,296	12,916	13,610	13,610

Sources: Office of the Comptroller General; Ministry of Economy and Finance; and Fund staff estimates and projections.

1/ Includes the operations of the Panama Canal Authority (PCA) which reverted to Panama on December 31, 1999.

2/ Excludes US\$116 million advance interest from the Development Trust Fund in 2001.

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

4/ Includes capital gains from buying back Brady bonds of US\$26.6 million in 2001; US\$88.8 million in 2002; and US\$18 million in 2003.

5/ Revenue and expenditure measures not yet decided upon by the authorities, but which are required to comply with the Fiscal Responsibility Law.

6/ Includes US\$5 million in 2003 and US\$60 million in 2004 to finance infrastructure projects as approved in Fiscal Responsibility Law.

Table 3. Panama: Summary Operations of the Central Government

	1999	2000	2001	2002	Prel. 2003	2004	
						Budget	Staff Proj.
(In percent of GDP)							
Revenue and grants	17.1	17.7	16.3	16.9	16.1	17.6	16.0
Current revenue	17.0	17.7	15.9	16.2	16.0	16.4	16.0
Tax	10.6	9.4	8.6	8.5	8.8	9.4	8.6
Nontax	6.4	8.3	7.2	7.6	7.1	7.0	7.4
Capital revenue	0.0	0.0	0.5	0.7	0.1	1.0	0.0
Grants	0.0	0.0	0.0	0.0	0.0	0.2	0.0
Total expenditure	19.1	18.8	19.0	18.7	18.5	20.2	19.3
Current	15.7	16.5	16.3	16.0	15.9	16.2	16.6
Capital and onlending	3.4	2.3	2.7	2.7	2.7	4.0	2.7
Savings 1/	1.4	1.2	-0.4	0.1	0.1	0.4	0.0
Additional measures 1/							0.7
Overall balance	-2.0	-1.1	-2.6	-1.8	-2.4	-2.6	-2.7
Financing (net)	2.0	1.1	2.6	1.8	2.4	2.6	2.7
External	2.3	1.1	3.0	2.7	1.7	2.9	2.3
Domestic	-2.4	0.0	-0.4	-0.8	0.8	-0.2	0.4
<i>Of which:</i> Trust Fund	-2.1	0.0	1.0	0.0	0.0	0.7	0.4
Privatization	2.1	0.0	0.0	0.0	0.0	0.0	0.0
(In millions of balboas)							
Memorandum item:							
Nominal GDP	11,391	11,938	12,059	12,296	12,916	13,610	13,610

Sources: Office of the Comptroller General; Ministry of Economy and Finance; and Fund staff estimates and projections.

1/ Revenue and expenditure measures not yet decided upon by the authorities, but which are required to comply with the Fiscal Responsibility Law.

Table 4. Panama: Monetary Accounts

	1999	2000	2001	2002	Est. 2003	Proj. 2004
(In millions of balboas at end of period)						
Net foreign assets	1,296	1,506	1,693	1,744	2,488	2,670
Net international reserves	1,233	1,455	1,635	1,706	2,452	2,634
National Bank of Panama	825	707	1,116	1,171	1,013	1,113
Rest of banking system	409	748	519	535	1,440	1,521
Long-term foreign liabilities	62	51	58	39	36	36
National Bank of Panama	56	46	52	36	34	34
Rest of banking system	6	5	6	3	2	2
Net domestic assets	6,921	7,446	8,112	8,152	7,862	8,235
Public sector (net credit)	-1,181	-1,216	-1,422	-1,399	-1,134	-1,141
Central government (net credit)	457	315	158	128	381	407
Rest of the public sector (net credit)	-1,638	-1,531	-1,580	-1,526	-1,515	-1,548
Private sector credit	10,297	10,851	11,735	10,891	11,105	11,748
Private capital and surplus	-2,258	-2,555	-2,631	-2,425	-2,745	-2,893
Other assets (net)	63	365	430	1,084	636	520
Liabilities to private sector	8,217	8,952	9,805	9,896	10,350	10,904
Total deposits	8,217	8,952	9,805	9,875	10,305	10,859
Demand deposits	1,165	1,166	1,296	1,342	1,458	1,531
Time deposits	5,391	6,145	6,572	6,271	6,400	7,089
Savings deposits	1,660	1,641	1,938	2,262	2,447	2,239
Bonds	0	0	0	20	45	45
(12-month change in relation to liabilities to the private sector at the beginning of the period)						
Net foreign assets	-13.5	2.6	2.1	0.5	7.5	1.8
Net domestic assets	22.1	6.4	7.4	0.4	-2.9	3.6
Public sector credit (net)	-0.9	-0.4	-2.3	0.2	2.7	-0.1
Private sector credit	19.0	6.7	9.9	-8.6	2.2	6.2
Private capital and surplus	1.1	3.6	0.9	-2.1	3.2	1.4
Other assets (net)	5.1	3.7	0.7	6.7	-4.5	-1.1
Liabilities to the private sector	8.6	8.9	9.5	0.9	4.6	5.4
(12-month percent change)						
Memorandum items:						
M2 1/	8.6	8.9	9.5	0.9	4.6	5.4
Private sector credit	16.2	5.4	8.1	-7.2	2.0	5.8
Share of demand deposits in total deposits (in percent)	14.2	13.0	13.2	13.6	14.1	14.1
(In percent of GDP)						
Total deposits	72.1	75.0	81.3	80.3	79.8	79.8
Credit to private sector	90.4	90.9	97.3	88.6	86.0	86.3

Sources: Superintendency of Banks; National Bank of Panama; Savings Bank; and Fund staff estimates and projections.

1/ M2 comprises bank deposits; estimates of U.S. currency in circulation are not available.

Table 5. Panama: Commercial Bank Performance Indicators, 1999–2003 1/
(In percent at end-period, unless otherwise noted)

	1999	2000	2001	2002	2003			
					Mar.	Jun.	Sep.	Nov.
Asset quality								
Nonperforming loans as percent of total loans								
Banking system	1.8	1.4	2.8	3.4	3.4	3.3	2.9	...
Domestic banks	1.7	1.4	3.0	4.6	4.3	4.1	3.6	...
Foreign banks	1.8	1.2	2.7	2.6	2.5	2.5	2.2	...
Ratio of provisions to nonperforming loans								
Banking system	105.2	133.8	87.9	132.0	142.1	123.0	126.5	...
Domestic banks	112.6	158.2	85.5	54.8	58.4	57.6	67.2	...
Foreign banks	116.3	163.7	89.9	267.4	284.7	234.2	235.1	...
Profitability								
Pretax return on average assets								
Banking system	1.4	1.3	1.0	0.5	1.6	2.3	2.2	2.4
Domestic banks	1.5	1.6	1.3	2.0	1.9	2.0	1.9	1.9
Foreign banks	1.4	0.8	0.7	-1.5	1.3	2.8	2.6	2.5
Liquidity								
Ratios to total deposits								
Liquid assets								
Banking system	34.3	35.5	31.4	29.4	29.1	31.1	27.3	28.1
Domestic banks	39.9	38.8	34.0	29.0	27.7	28.2	24.4	25.1
Foreign banks	28.0	31.9	28.3	29.9	31.1	34.9	31.2	32.2
Liquid assets plus marketable securities								
Banking system	41.0	43.3	40.2	40.3	43.7	44.1	39.8	41.1
Domestic banks	46.7	52.6	43.1	41.9	45.8	45.2	39.5	41.0
Foreign banks	34.8	40.1	36.7	38.1	42.3	43.8	40.2	41.5
Capital adequacy ratios								
Ratio of capital to risk-weighted assets								
Domestic banks	11.3	13.5	13.6	14.5	14.8	17.1	17.6	17.6
Foreign banks 2/	9.8	17.2	17.9	22.5	22.5	22.2	20.6	20.6
Ownership								
Foreign banks' share of banking system assets (in percent)	50.6	50.1	50.1	43.8	43.3	43.5	42.5	41.1

Sources: Superintendency of Banks and Fund staff estimates.

1/ Data refer to the domestic banking system, comprising general license banks. Foreign banks are those with general license banks.

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

Table 6. Panama: Balance of Payments

	2000	2001	Prel. 2002	Est. 2003	Proj. 2004
(In millions of U.S. dollars)					
Current account	-689	-174	-104	-414	-491
Trade balance including Colon Free Zone	-1,143	-696	-1,037	-1,030	-1,033
Exports, f.o.b.	1,047	1,079	970	1,017	1,089
Imports, f.o.b.	-2,705	-2,304	-2,354	-2,510	-2,657
Net exports from Colon Free Zone	515	529	346	463	536
Re-export, f.o.b.	4,791	4,914	4,345	4,002	4,245
Imports, f.o.b.	-4,276	-4,384	-3,998	-3,539	-3,710
Services, net	854	899	992	1,170	1,208
Travel, net	269	310	350	406	411
Transportation, net	545	537	598	718	748
Other services	39	52	44	46	48
Income, net	-577	-602	-308	-799	-924
Private sector	-330	-289	20	-433	-454
Public sector	-247	-313	-328	-367	-471
<i>Of which</i>					
NFPS interest	-366	-415	-449	-485	-554
Current transfers, net	177	226	250	245	258
Capital and financial account	203	890	95	265	600
Capital account (public sector grants)	2	2	0	0	0
Financial account	201	889	95	265	600
Public sector	103	325	349	221	363
Nonfinancial public sector	117	339	321	235	376
National Bank of Panama	-6	-7	-8	-8	-8
Other net flows	-8	-7	36	-5	-5
Private sector, medium and long-term	931	-270	-433	-174	532
Direct investment	700	405	78	654	536
Portfolio investment	-96	-743	-27	-127	-154
Loans	327	69	-484	-701	151
Short-term flows	-832	833	179	218	-294
Errors and omissions	395	-301	71	0	0
Overall balance	-91	416	63	-149	109
Financing	91	-416	-63	149	-109
Net foreign assets of the National Bank of Panama	117	-409	-54	158	-100
Net use of Fund credit	-52	-34	-8	-9	-9
Exceptional financing	26	27	0	0	0
(In percent of GDP)					
Memorandum items:					
Merchandise exports	8.8	8.9	7.9	7.9	8.0
Merchandise imports	-22.7	-19.1	-19.1	-19.4	-19.5
Net exports from Colon Free Zone	4.3	4.4	2.8	3.6	3.9
Current account	-5.8	-1.4	-0.8	-3.2	-3.6
Direct foreign investment	5.9	3.4	0.6	5.1	3.9

Sources: Office of the Comptroller General; and Fund staff estimates and projections.

Table 7. Panama: Gross External Debt Flows of the Nonfinancial Public Sector
(In millions of U.S. dollars)

	1999	2000	2001	Prel. 2002	Est. 2003	Proj. 2004
Total disbursements	630	485	1,219	1,076	391	153
Multilaterals	79	84	94	115	99	148
IBRD	31	22	26	30	14	37
IDB	38	53	59	71	73	106
IMF	0	0	0	0	0	0
Others	10	9	10	14	12	6
Bilateral and guaranteed suppliers	43	22	21	26	12	4
Commercial banks	8	28	6	6	5	1
Global bonds	500	350	1,098	930	275	0
Total debt service	741	758	950	1,395	801	766
Multilaterals	142	176	160	138	202	248
IBRD	41	45	46	46	53	69
IDB	67	69	72	74	126	149
IMF	30	58	37	9	11	12
Others	4	4	5	9	12	18
Bilateral and guaranteed suppliers	73	87	84	44	40	37
Commercial banks	9	33	7	10	9	9
Brady bonds	250	196	222	521	218	57
Global bonds	268	266	477	681	333	415
Amortization	414	391	536	946	316	212
Multilaterals	76	106	89	76	118	148
IBRD	22	24	26	28	35	38
IDB	28	28	28	34	66	87
IMF	23	52	34	8	9	9
Others	2	2	2	7	9	13
Bilateral and guaranteed suppliers	54	67	67	33	29	27
Commercial banks	6	32	6	9	8	8
Brady bonds	178	120	148	453	161	29
Global bonds	99	66	225	374	0	0
Interest	327	366	415	449	485	554
Multilaterals	66	69	71	62	84	100
IBRD	19	20	20	18	18	30
IDB	39	41	44	40	60	62
IMF	7	6	4	1	2	3
Others	2	2	3	2	3	5
Bilateral and guaranteed suppliers	18	19	17	12	11	11
Commercial banks	2	1	1	0	0	0
Brady bonds	72	76	74	68	57	28
Global bonds	169	200	252	307	333	415
Memorandum items:						
Debt service as percent of exports of good and services	22.6	21.3	26.3	39.1	20.1	18.1
Debt service as percent of GDP	6.5	6.3	7.9	11.3	6.2	5.6
Exports of goods and services	3,279	3,557	3,613	3,569	3,987	4,241
GDP	11,391	11,938	12,059	12,296	12,916	13,610

Sources: Office of the Comptroller General; Ministry of Economy and Finance; and Fund staff estimates and projections.

Table 8. Panama: Debt of the Nonfinancial Public Sector

	1999	2000	2001	2002	Est. 2003	Proj. 2004
(In millions of U.S. Dollars)						
External debt	5,566	5,604	6,263	6,349	6,409	6,725
Multilaterals	1,164	1,113	1,099	1,175	1,156	1,157
IBRD	298	284	283	287	266	264
IDB	699	711	727	795	803	821
IMF	147	90	54	50	41	32
Others	21	28	35	43	46	40
Bilateral and guaranteed suppliers	435	380	330	331	314	291
Commercial banks	19	13	13	9	7	0
Brady bonds	1,782	1,648	1,496	954	776	747
Global bonds	2,167	2,450	3,325	3,880	4,155	4,530
Domestic debt	1,444	1,304	1,350	1,449	1,472	1,312
Private creditors	654	620	748	870	1,005	908
Public Financial Institutions	790	684	603	579	467	421
Total	7,010	6,908	7,613	7,798	7,881	8,036
(In percent of GDP)						
Total	61.9	58.2	63.3	63.6	65.4	63.4
External	48.9	46.9	51.9	51.6	49.6	49.4
Domestic	13.0	11.2	11.4	12.0	15.8	14.0
Memorandum items:						
Official definitions for Law 20 1/						
Total public debt (gross) 2/	7,692	7,732	8,401	8,521	8,929	9,085
Net total public debt 3/	6,290	6,294	7,066	7,211	7,639	7,856
In percent of GDP 4/	55.2	52.7	58.6	58.6	59.1	57.7
GDP (millions of U.S. dollars)	11,391	11,938	12,059	12,296	12,916	13,610

Sources: Office of the Comptroller General; Ministry of Economy and Finance; and Fund staff estimates and projections.

1/ Definitions used for the debt limits stipulated in the Law 20 (Fiscal Responsibility Law).

2/ If real GDP growth is higher than 1.5 percent, the growth in total public debt, including government debt held by the social security agency, should not exceed 80 percent of the growth in nominal GDP.

3/ Total public debt net of Development Trust Fund assets and collateral for public debt (Brady bonds).

4/ The net total public as a ratio of GDP should decline to a maximum of 50 percent by 2017.

Table 9. Panama: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	Est. 2003	Proj. 2004
Financial indicators						
12-month percent change in broad money	8.6	8.9	9.5	0.9	4.6	5.4
12-month percent change in private sector credit	16.2	5.4	8.1	-7.2	2.0	5.8
Deposit rate (6-month; in percent) 1/ 2/	6.2	6.5	5.5	3.8	3.6	...
External indicators						
12-month percent change in merchandis exports	1.0	22.8	3.0	-10.0	4.8	7.1
12-month percent change in merchandis imports	3.9	-2.4	-14.8	2.2	6.6	5.9
Current account balance	-10.2	-5.8	-1.4	-0.8	-3.2	-3.6
Capital and financial account balance	12.0	1.7	7.4	0.8	2.1	4.4
<i>Of which :</i>						
Direct Investment	7.6	5.9	3.4	0.6	5.1	3.9
Public sector external debt	48.9	46.9	51.9	51.6	49.6	49.4
In percent of exports of goods and services 3/	169.7	157.6	173.4	177.9	160.7	158.6
External interest payments (in percent of exports of goods and services) 3/	10.0	10.3	11.5	12.6	12.2	13.1
External amortization payments (in percent of exports of goods and services) 3/	12.6	11.0	14.8	26.5	7.9	5.0
Exchange rate (balboas per U.S. dollar)	1.0	1.0	1.0	1.0	1.0	1.0
REER, 12-month percent change (depreciation -) 4/	4.3	-0.7	-1.4	-0.1	-4.7	...
Net international reserves at end of period						
In millions of U.S. dollars 5/	825	707	1,116	1,171	1,013	1,113
In months of imports of goods and services	2.6	2.5	3.7	3.7	3.0	3.1
In percent of broad money	10.0	7.9	11.4	11.9	9.8	10.2
In percent of short-term external debt	210.5	132.0	117.9	370.2	477.8	548.6
Memorandum items:						
Nominal GDP (millions of balboas)	11,391	11,938	12,059	12,296	12,916	13,610
Exports of goods and services (millions of U.S. dollars) 3/	3,279	3,557	3,613	3,569	3,987	4,241

Sources: Ministry of Economy and Finance; and Fund staff estimates and projections.

1/ Period average for the banking system.

2/ For 2003 average for January-November.

3/ Includes net exports of the Colon Free Zone.

4/ Data through November 2003.

5/ Corresponds to net foreign assets of the National Bank of Panama (a publicly owned commercial bank).

Table 10. Panama: Social Indicators

	Panama	Central America		Latin America and the Caribbean
		Average	Range	Average
Rank in 2003 UNDP Human Development Index (out of 175 countries)	59	100.4	42–121	...
GDP per capita PPP, U.S. dollars (2001)	5,750	4,880	2,450–9,460	7,050
Life expectancy at birth (years) (2000)	74.7	71	65.8–78.1	70.4
Under-5 mortality (per 1,000 live births) (2001)	19	31	11–43	28
People not expected to survive to age 40 (in percent of population) (2000)	6.8	10	3.7–14.1	9.7
Undernourished people (as percent of total population)	18	19	5–29	12
Population without access to an improved water source (2000)	10	14	5–23	22
Per capita health expenditure, U.S. dollars (2000)	464	266	108–474	...
Physicians per 100,000 people (2002)	117	107	61–178	...
Adult illiteracy (2001)	7.9	23	4.3–33.2	11.7
Primary school net enrollment (2000–01) (percent of relevant age of the population)	100	85	81–91	93.3
Secondary school net enrollment (1997) (percent of relevant age of the population)	62.0	37	26–49	65.3
Income share of:				
The top 20 percent of the population	52.8	59	51–63.6	...
The lowest 20 percent of the population	3.6	3	2–4.5	...
Gini index	48.5	54	46–60	...
Percent of population below official poverty line 1/	37.3	51	19–67.4	50.7
Corruption perceptions index, 2002 2/	3.0	3	2.5–4.5	3.4

Sources: World Bank World Development Indicators 2002; Szekely, Lustig, Cumpa, and Mejia (2000); UNDP Human Development Report 2001, 2002, and 2003; and Transparency International (www.transparency.org).

1/ Not comparable across countries due to methodological issues. For Guatemala, Honduras, and Nicaragua, the information refers to the Poverty Reduction Strategy Paper.

2/ The CPI score relates to perceptions of the degree of corruption as seen by business people, academics and risk analysts, and ranges between 10 (highly clean) and zero (highly corrupt).

Panama—Fund Relations
(As of January 31, 2004)

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

A. Financial Relations

II. General Resources Account:		SDR Million	Percent of Quota
Quota		206.60	100.0
Fund holdings of currency		224.75	108.79
Reserve position in the Fund		11.86	5.74

III. SDR Department:		SDR Million	Percent Allocation
Net cumulative allocation		26.32	100.0
Holdings		0.56	2.14

IV. Outstanding Purchases and Loans:		SDR Million	Percent of Quota
Extended Arrangement		30.00	14.52

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	06/30/00	03/29/02	64.00	0.00
EFF	12/10/97	06/20/00	120.00	40.00
Stand-By	11/29/95	03/31/97	84.30	84.30

VI. Projected Obligations to the Fund: (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	6.67	6.67	6.67	6.67	3.33
Charges/interest	1.03	0.88	0.74	0.60	0.46
Total	7.70	7.55	7.41	7.26	3.80

VII. Exchange Rate Arrangements

Under the Fund's safeguards assessment policy, National Bank of Panama (NBP) was subject to the transitional procedures with respect to the Stand-By Arrangement, 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, as reported in the Staff Report for the 2002 Article IV Consultation, May 22, 2002.

B. Nonfinancial Relations

VIII. 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 B 1 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.

IX. Last Article IV Consultation:

The 2002 Article IV consultation was concluded on July 10, 2002. Panama is on the standard 12-month consultation cycle.

X. Technical Assistance:

- a. MFD: In May 2001, a mission visited Panama to review compliance with the Basel Core Principles under Module 2 of the Fund's offshore Financial Sector Initiative.
- b. STA: In April 2001, a STA expert visited Panama to provide assistance on a number of issues relating to the compilation of the national accounts, including the implementation of the 1993 SNA. In September 2002 a mission visited Panama to support the authorities' participation in the Coordinated Portfolio Investment Survey (CPIS).

XI. Resident Representative:

None.

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

IDB lending operations	Disbursed	Undisbursed
Ongoing operations 1/		
Agriculture	31.6	26.2
Education	19.2	38.9
Energy	52.5	49.5
Environment	32.7	68.7
Health	5.6	29.4
Reform and modernization of the State	52.6	54.2
Science and technology	15.0	9.4
Social development	17.9	39.3
Tourism	1.0	1.5
Transportation	60.6	61.4
Urban development	10.7	20.6
Water supply and sewerage	6.9	4.9
Total	306.3	404.2
IDB loans approved since 1960		
Total operations 2/	1,994.8	...
Cancellations 2/	398.0	...
Principal payments 2/	728.7	...
Debt outstanding as of March 31, 2003 2/	807.3	...
New commitments CY 2003 3/	53.3	...
Disbursements CY 2003 3/	99.1	...
Recent activities:		

During CY2002 US\$10.0 million was cancelled from the Financial Sector Loan. In CY2003, the Bank approved three loans totaling US\$53.3 million (highway improvement, urban poverty reduction, and municipal development). Anticipated approvals for CY2004 are US\$100.5 million and expected disbursements for CY2004 are US\$85.0 million.

Source: The Inter-American Development Bank.

1/ As of December 31, 2003.

2/ As of March 31, 2003.

3/ As of February 6, 2004.

Panama: Relations with the World Bank

The most recent Country Assistance Strategy (CAS) for Panama, covering the period 1999–2001, included among its central objectives a continued support toward reducing poverty and inequality through a selective focus on environmentally sustainable development. Accordingly, the Bank directed its investment and technical assistance to programs that aim to increase rural incomes, curtail environmental degradation, conserve biodiversity and stem deforestation.

Using the program flexibility built into the 1998 CAS, the Bank has delivered assistance over the past five years at the broad reform agenda and at the sectoral level. As of December 31, 2003, the Bank portfolio consists of six investment projects. The total commitment amounts to US\$148.2 million, of which US\$82.2 million is undisbursed. The overriding objective of the Bank strategy in Panama has been to reduce the high incidence of poverty and improve the nutrition, health and education of low-income groups, targeting the rural population and indigenous communities. Projects like Basic Education II, Land Administration, Rural Poverty and Natural Resources and the Social Investment Fund have helped achieve these goals.

One of the priorities of the government's economic program is trade liberalization and reform through the negotiation of bilateral, multilateral and regional trade agreements. The Bank, through the Public Policy Reform Technical Assistance Loan, approved in July 2001, is helping to strengthen the government's capacity for economic policy formulation and implementation and is providing assistance for: (i) trade policy negotiations, the implementation of commitments under the World Trade Organization, and regional trade talks; (ii) capacity building in standards and technical regulation; (iii) strengthening the protection of intellectual property rights, and (iv) upgrading equipment, and the construction of new databases and information systems.

Most recently, the announcement of negotiations with the United States on a free trade agreement (FTA) has given way to a review of planned studies, seminars, and other tasks included in the original TA project. After the new government assumes office in September 2004, there will be discussions about a coordinated set of instruments to strengthen export performance and facilitate trade. Capacity-building assistance through the TA project will provide a foundation for continued progress in trade expansion and export-led growth.

Financial Relations of the World Bank Group with Panama
(In millions of U.S. dollars)

IBRD Lending Operations As of December 31, 2003	Disbursed	Undisbursed
Total ongoing operations by sector	66.0	82.2
Social investment	21.2	6.8
Environment	28.8	41.6
Health, population and nutrition	2.6	1.7
Education	8.6	26.4
Public sector management	4.7	5.8
Total operations since 1953		
Disbursements	907.4	
Principal payments 1/	-636.7	
Debt outstanding 2/	270.3	
Gross disbursements by calendar year:		
2001	26.1	
2002	29.9	
2003	16.4	

Source: The World Bank.

1/ Including amounts sold to third parties (US\$9.2 million).

2/ Net of valuation changes (US\$-0.4 million).

Panama—Statistical Issues

Economic statistics are generally adequate for monitoring purposes, but there is a need for more timely reporting. Fiscal expenditure and financing data are transmitted to the Fund with a lag of six to eight weeks. A program is under way to improve government finance statistics through the implementation of an integrated financial administration system (SIAFPA). Panama has participated in the Fund's General Data Dissemination System (GDDS) since December 2000 and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB).

1. Real sector

The authorities are completing a revision of the national accounts with a change in the base year from 1982 to 1996, based on the 1993 SNA. The project entails an update on the measurement of certain activities and the implementation a new sectoral classification system. Coverage has been extended to activities that did not exist in 1982 and are now included in the calculations. The accounts now include resident banks and enterprises operating in the Colon Free Zone (ZLC) by strictly applying the residency criterion of the balance of payments and national accounts recommendations. Financial services are now allocated to users, including exports. The revised data are available by productive sector for the period 1996–2002. At present the demand side of the new GDP series is not available. The weights underlying the consumer price index (CPI) were derived from a household budget survey conducted in 1983/84. The authorities plan to introduce a new CPI index in the first half of 2004 based on weights of the 1997/98 household survey. Consumer price data are available through November 2003.

Pending issues: The time series of GDP by use for the 1996 base has not been published. Despite recent improvements, preliminary estimates of real GDP volume remain unreliable and untimely, in part because of delays in data collection.

Technical assistance: The United Nations Economic Commission for Latin America and the Caribbean is supporting the development of a supply-use table.

2. Government finance

Data on central government finances, public enterprises and agencies are compiled only on a cash basis. Monthly and quarterly data for the operations of the budgetary central government are currently available through September 2003. Data provision to STA is less timely: the last month available for IFS data is April 2003, and the latest annual data submitted for publication in the *Government Finance Statistics Yearbook 2003* are for 2001.

Pending issues: Monitoring of public sector financial developments would be facilitated if data were provided on an accrual basis and were more timely, if the consistency of information on intrapublic sector transfers were further improved, and if the coverage of the

investment program were made complete. The authorities' decision in 2003 to include the operational balance of the Panama Canal Authority, within the non financial public sector statistics will require a consistent and timely flow of information on a calendar basis. The SIAFPA coverage of the central government accounts was completed in 2003, and work is under way to incorporate decentralized agencies such as the Social Security Agency. In addition to broadening SIAFPA's scope of coverage, there is a need to address the issue of unrecorded expenditures, some of them likely due to accumulation of arrears. In this regard, the authorities requested technical assistance from the Statistics Department to implement the 2001 *Government Finance Statistics Manual 2001 (GFSM 2001)* for a comprehensive review of the coverage and methodology currently in use in the fiscal accounts. A STA mission is scheduled to be in Panama City in February 2004. A preliminary report, including a tentative timetable for a migration to the *GFSM 2001* would be ready by March 2004.

Technical assistance: Training related to the *GFSM 2001* was provided to Panamanian officials during the six-week course offered at Headquarters during March–April 2003.

3. Monetary accounts

Provision of data by the monetary authorities has been regular and reasonably current. These data are available monthly through November 2003. Data on the operations of the commercial banks are prepared by the Superintendency of Banks with a lag of one to two months, although they are reported for publication in *IFS* with somewhat longer lags. There is a lack of consistent data prepared on the financial positions of the National Mortgage Bank and the Agricultural Development Bank. In the last two years a joint effort of the banking system and the Superintendency of Banks improved the timeliness of monetary statistics production and minimized errors through better information technology. The wider coverage of financial soundness indicators improved the transparency of the banking system statistics.

4. Balance of payments

STA technical assistance missions during 1996–2001 helped improve the compilation procedures and systems, reduce lags in data collections, and develop procedures for quality control. The authorities provided additional budgetary and staff resources to deal with administrative problems and the lack of adequate data processing equipment. This technical assistance has led to significant improvements in the quality and timeliness of external sector statistics, including through periodic reconciliation of external debt statistics discrepancies with multilateral lenders. International Investment Position data for 1995–2002 have been compiled. The most recent data on balance of payments statistics pertain to June 2003.

Pending issues: Despite substantial progress, data are still subject to sizeable revisions. Revised estimates of merchandise imports and transportation services released in 2003, resulted in a lower current account deficit over the period 1999–2001 relative to previously reported calculations. As a result, the revised current account deficit for 2000 and 2001 were revised down by 1.8 and 2.9 percentage points of GDP, respectively. Revised foreign direct

investment data modified previous estimates by more than 1 percent of GDP during the period 1999–2002. These revisions may reflect improvements in coverage, but they also suggest that there is room for improvement in quality control procedures. The authorities are currently working on a full reconciliation between data of the banking sector and balance of payments capital flows consistent with the compilation method introduced by the Superintendency of Banks in 2002. Data are not yet available on nonfinancial private sector debt or on transactions involving financial derivatives.

Technical assistance: In September 2002 a STA mission visited Panama to support their participation in the Coordinated Portfolio Investment Survey (CPIS).

Panama: Core Statistical Indicators
(As of February 9, 2004)

	Exchange Rates	International Reserves	National Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Public Debt
Date of latest observation	Fixed	12/03	12/03	n.a.	11/03	11/03	11/03	11/03	9/03	9/03	2002	12/03
Date received	n.a.	1/04	1/04	n.a.	1/04	1/04	2/04	2/04	2/04	11/03	6/03	2/04
Frequency of data	n.a.	Monthly	Monthly	n.a.	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly	Annually	Monthly
Frequency of reporting	n.a.	Monthly	Monthly	n.a.	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly	Annually	Monthly
Source of update	n.a.	Banco Nacional	Banco Nacional	n.a.	Super. De Bancos	Super. De Bancos	Contraloria	Contraloria	Contraloria	Min. of Economy	Contraloria	Min. of Economy
Mode of reporting	n.a.	E-Mail	E-Mail	n.a.	E-Mail	E-Mail	E-Mail	E-Mail	E-Mail	Courier	E-Mail	E-Mail
Confidentiality	n.a.	Unrestricted	Used only by staff	n.a.	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted
Frequency of publication	n.a.	Annually	Annually	n.a.	Quarterly	Quarterly	Monthly	Monthly	Quarterly	Quarterly	Annually	Quarterly

Panama: Debt Sustainability Analysis¹

Total public sector debt in the baseline scenario appears sustainable, although it leaves little room for countercyclical policies and is somewhat vulnerable to shocks (Figures 1 and 2). The baseline scenario assumes a fiscal deficit of 2 percent of GDP, consistent with the authorities' commitment to the deficit limit under the fiscal responsibility law. The public debt/GDP ratio declines to 52 percent by 2008, close to the long-term target of 50 percent stipulated in this law. However, the baseline gives little room for countercyclical fiscal policy, and it entails large gross fiscal financing needs, particularly in the latter part of the projection period when debt amortization is high. There is only moderate vulnerability to temporary shocks, many of which would leave the public debt ratio on a declining path over the medium term (Table 3). The main exception would be a shock to GDP growth,² which would increase the public debt ratio. External debt dynamics would be vulnerable to a simultaneous shock from several key parameters (Table 4).

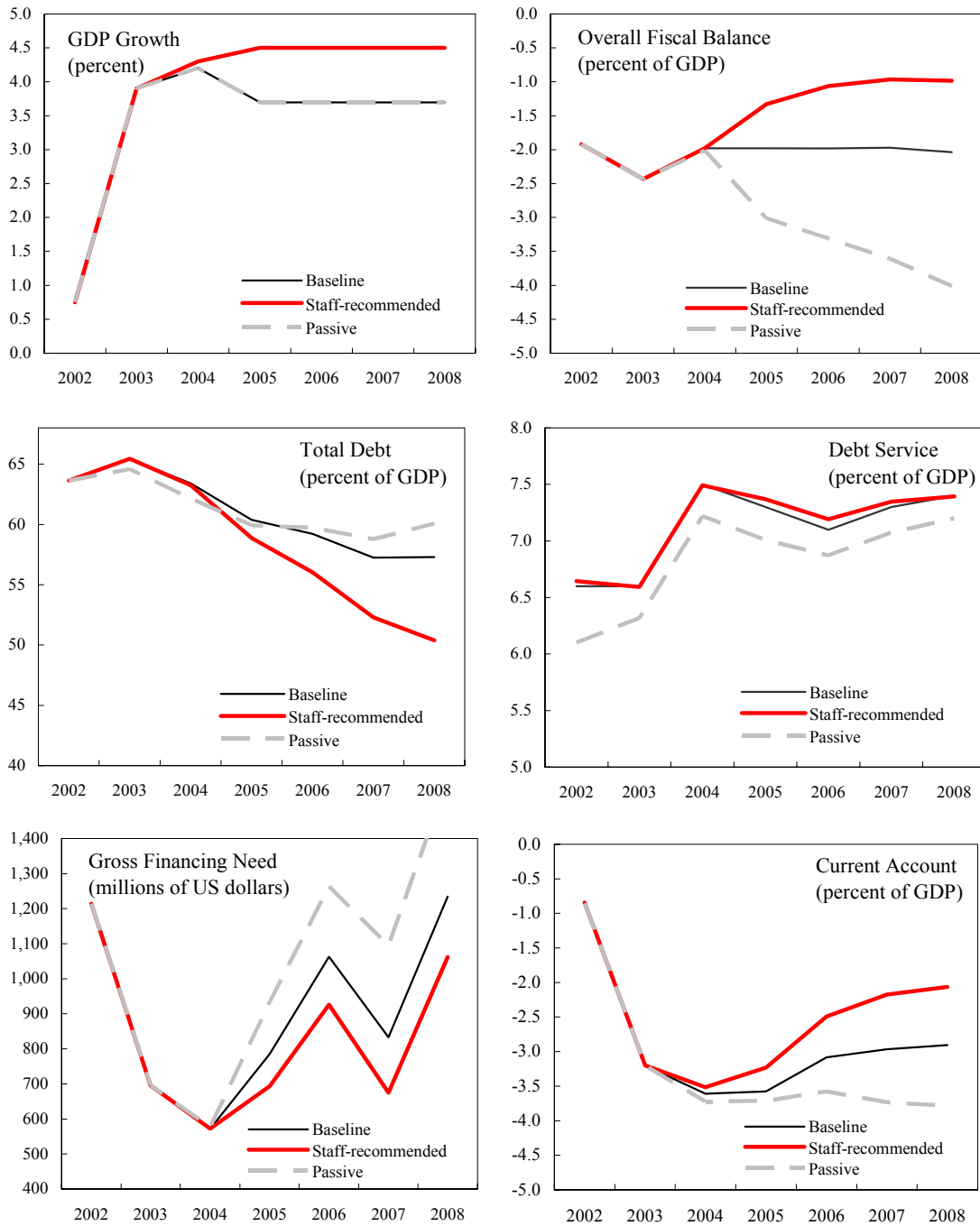
A staff-recommended alternative scenario would yield faster progress in lowering the debt-to-GDP ratio and gross financing needs. This scenario assumes a 1-percent of GDP deficit by the end of the projection period, as well as structural reforms that are assumed to boost annual GDP growth to 4–5 percent. This scenario would bring the total public debt ratio below 50 percent, the target specified in the fiscal responsibility law.

A scenario without fiscal measures (implying a departure from fiscal rules) results in a more modest reduction in the public debt ratio and raises financing needs significantly. The public debt ratio would decline to 56 percent by 2008. Most temporary shocks would leave the public debt ratio on a declining path in 2004–08, the main exception being a large output shock, as in the baseline scenario.

¹ The DSA includes standard sensitivity tests around the baseline medium-term scenario. The methodology used is in line with that endorsed in *Assessing Sustainability*, 5/28/02.

² A 2-standard deviation shock to GDP growth results in an assumed decline in GDP in 2004–05, owing to the observed volatility of Panama's growth rates.

Figure 1. Panama: Alternative Medium-Term Scenarios 2002–08 1/

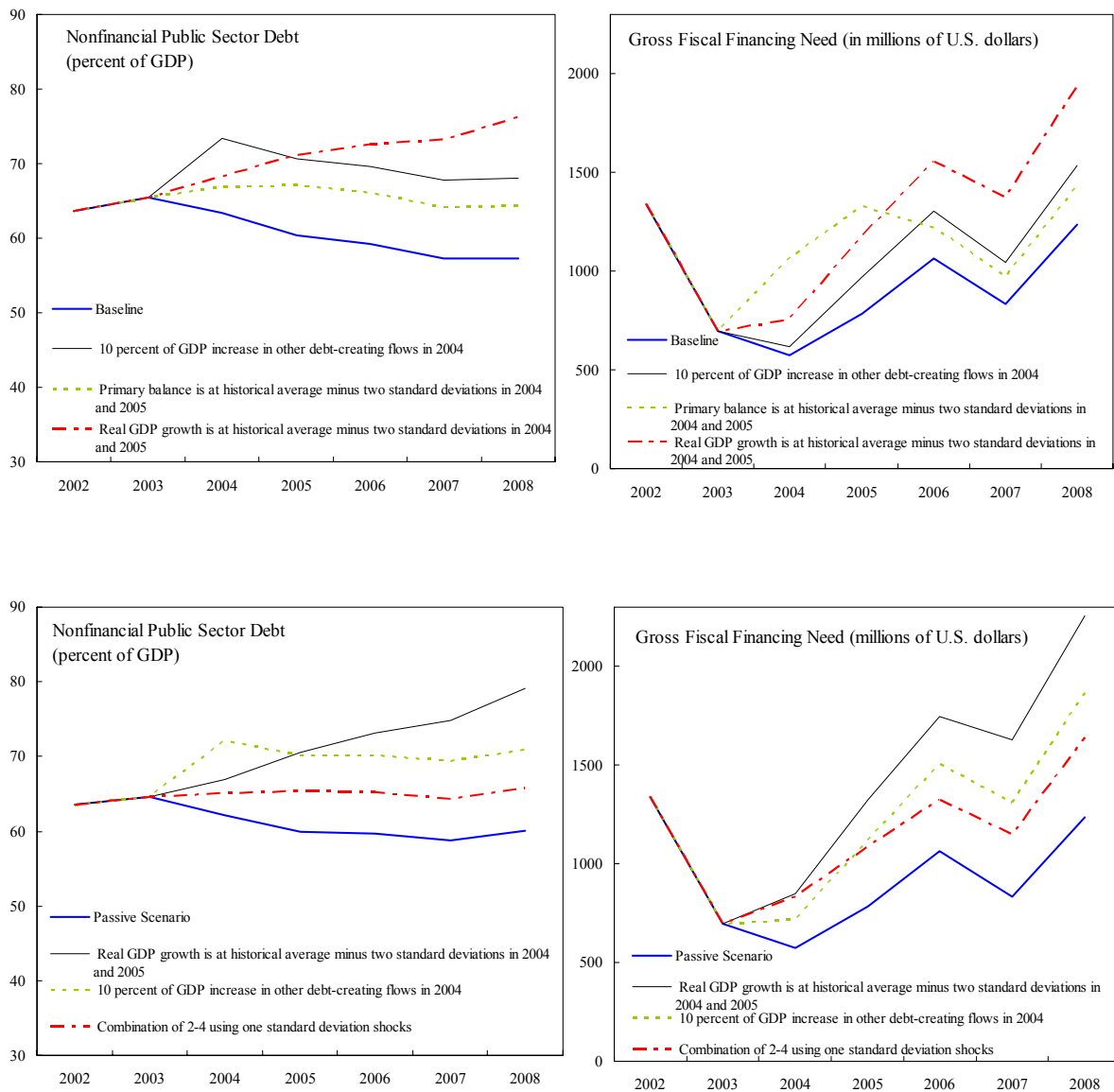


Source: Staff projections.

1/ The passive scenario assumes a higher fiscal deficit than the baseline; the staff-recommended scenario assumes higher GDP growth and a lower deficit path, as indicated in the top two panels.

Figure 2. Panama: Debt Sustainability — Sensitivity Analysis

Shocks to the baseline scenario 1/



Source: Fund staff calculations.

- 1/ Assumes compliance with fiscal rules.
- 2/ Assumes no fiscal measures (implying a departure from fiscal rules).

Table 1. Panama: Medium-Term Macroeconomic Framework–Baseline Scenario

	2000	2001	2002	Est. 2003	Projections				
					2004	2005	2006	2007	2008
(Percent change)									
Economic growth and prices									
Real GDP at market prices	3.3	0.3	0.8	3.9	4.2	3.7	3.7	3.7	3.7
Real domestic demand	-1.1	-3.4	2.7	2.2	3.8	3.6	3.2	3.4	3.3
GDP deflator	1.5	0.7	1.2	1.1	1.1	1.4	1.9	1.9	1.8
CPI (period average)	1.4	0.3	1.0	1.2	1.3	1.5	2.0	2.0	2.0
(In percent of GDP)									
Savings and investment									
National savings	22.8	24.6	24.7	22.4	22.1	22.2	22.8	22.9	23.2
Public sector	3.8	1.7	1.4	1.6	1.8	1.9	2.2	2.2	2.1
Private sector	18.9	22.9	23.3	20.8	20.2	20.3	20.7	20.8	21.0
External savings	5.8	1.4	0.8	3.2	3.6	3.6	3.1	3.0	2.9
Gross domestic investment	28.5	26.0	25.6	25.6	25.7	25.7	25.9	25.9	26.1
Public sector	3.9	4.1	4.3	4.4	4.0	4.1	4.3	4.4	4.4
Private sector	24.7	21.9	21.3	21.2	21.7	21.7	21.6	21.6	21.7
Consolidated public sector									
Revenue	26.1	24.9	25.3	24.7	25.0	24.8	24.9	24.9	24.9
Expenditure	25.6	26.6	27.2	27.2	26.9	26.8	26.9	26.9	27.0
Primary balance	4.6	2.5	2.3	1.9	2.8	2.4	2.3	2.2	2.2
Overall balance	0.5	-1.7	-1.9	-2.4	-2.0	-2.0	-2.0	-2.0	-2.0
Domestic financing	-1.5	-1.3	2.1	0.8	-0.3	-0.5	-0.7	-1.3	-1.5
External financing	1.0	3.0	-0.1	1.7	2.3	2.5	2.7	3.3	3.5
Total public debt	58.2	63.3	63.6	65.4	63.4	60.4	59.2	57.3	57.3
Total interest payments (percent of debt)	7.0	6.7	6.6	6.6	7.5	7.3	7.1	7.3	7.4
External									
Exports, f.o.b. 1/	29.8	30.0	29.0	30.9	31.2	31.3	31.7	32.0	32.4
Imports, f.o.b. 1/	-32.2	-28.3	-29.5	-29.8	-29.9	-30.0	-30.0	-30.1	-30.3
Net exports of Colon Free Zone	4.3	4.4	2.8	3.6	3.9	4.1	4.4	4.8	5.1
Current account balance	-5.8	-1.4	-0.8	-3.2	-3.6	-3.5	-2.9	-2.7	-2.5
External debt	46.9	51.9	51.6	49.6	49.4	49.5	49.5	50.2	51.0
Memorandum items:									
Nominal GDP (millions of U.S. dollars)	11,938	12,059	12,296	12,916	13,610	14,311	15,125	15,984	16,879
Gross financing needs									
Total	363	773	1,214	696	572	785	1,063	833	1,235
External	352	960	864	410	488	520	1,072	622	1,313

Sources: Office of the Comptroller General; Ministry of Economy and Finance; and Fund staff estimates and projections.

1/ Figures do not include the Colon Free Zone.

Table 2. Panama: Medium-Term Macroeconomic Framework—Alternative Scenarios

	2000	2001	2002	Est. 2003	Projections				
					2004	2005	2006	2007	2008
Staff-Recommended Scenario 1/ (Annual percentage change)									
Economic growth and prices									
Real GDP at market prices	3.3	0.3	0.8	3.9	4.3	4.5	4.5	4.5	4.5
Real domestic demand	-1.1	-3.4	2.7	2.2	3.8	4.2	3.8	4.1	4.3
GDP deflator	1.5	0.7	1.2	1.1	1.1	1.4	1.9	1.9	1.9
(In percent of GDP)									
Savings and investment									
National savings	22.8	24.6	24.7	22.4	22.1	22.4	23.4	23.7	23.9
Public sector	3.8	1.7	1.4	1.6	1.8	2.5	3.0	3.1	3.2
Private sector	18.9	22.9	23.3	20.8	20.2	19.9	20.4	20.5	20.7
External savings	5.8	1.4	0.8	3.2	3.5	3.2	2.5	2.2	2.1
Gross domestic investment	28.5	26.0	25.6	25.6	25.6	25.7	25.9	25.8	26.0
Public sector	3.9	4.1	4.3	4.4	4.0	4.0	4.2	4.3	4.4
Private sector	24.7	21.9	21.3	21.2	21.6	21.6	21.6	21.5	21.6
Consolidated public sector									
Overall balance	0.5	-1.7	-1.9	-2.4	-2.0	-1.3	-1.1	-1.0	-1.0
Domestic financing	-1.5	-1.3	2.1	0.8	-0.2	-0.2	-0.3	-0.7	-0.7
External financing	1.0	3.0	-0.1	1.7	6.4	1.6	1.4	1.7	1.7
Total public debt	58.2	63.3	63.6	65.4	63.2	58.9	56.0	52.3	50.4
External									
Current account balance	-5.8	-1.4	-0.8	-3.2	-3.5	-3.2	-2.5	-2.2	-2.1
External Debt	46.9	51.9	51.6	49.6	49.2	48.1	46.5	45.4	44.3
Memorandum items:									
Nominal GDP (millions of U.S. dollars)	11,938	12,059	12,296	12,915	13,621	14,430	15,364	16,358	17,410
Gross financing needs	352	960	864	410	473	390	873	375	1,017
Passive Scenario 2/ (Annual percentage change)									
Economic growth and prices									
Real GDP at market prices	3.3	0.3	0.8	3.9	4.2	3.7	3.7	3.7	3.7
Real domestic demand	-1.1	-3.4	2.7	2.2	3.8	3.6	3.3	3.5	3.5
GDP deflator	1.5	0.7	1.2	1.1	1.1	1.4	1.9	1.9	1.9
(In percent of GDP)									
Savings and investment									
National savings	22.8	24.6	24.7	22.4	22.1	22.3	22.8	22.7	22.7
Public sector	3.8	1.8	1.4	1.6	1.9	1.2	1.1	0.8	0.4
Private sector	19.0	22.8	23.3	20.8	20.3	21.1	21.6	21.9	22.2
External savings	5.8	1.4	0.9	3.2	3.6	3.5	3.2	3.2	3.4
Gross domestic investment	28.5	26.0	25.6	25.6	25.7	25.7	25.9	25.9	26.0
Public sector	3.8	4.1	4.3	4.4	4.1	4.4	4.6	4.6	4.6
Private sector	24.7	21.9	21.3	21.2	21.6	21.4	21.3	21.3	21.4
Consolidated public sector									
Overall balance	0.5	-1.6	-1.9	-2.4	-2.0	-3.0	-3.3	-3.6	-4.0
Domestic financing	-0.4	-0.9	2.1	0.8	0.2	-0.2	-0.3	-0.7	-0.8
External financing	1.0	3.0	-0.1	1.7	1.8	3.3	3.6	4.4	4.8
Total public debt	58.2	63.3	63.6	64.6	62.1	59.9	59.7	58.8	60.0
External									
Current account balance	-5.8	-1.4	-0.8	-3.2	-3.7	-3.7	-3.6	-3.7	-3.8
External debt	46.9	51.9	51.6	49.6	48.9	49.8	50.7	52.4	54.4
Memorandum items:									
Nominal GDP (millions of U.S. dollars)	11,938	12,059	12,296	12,916	13,608	14,307	15,123	15,984	16,884
Gross financing needs	369	763	1,214	696	577	933	1,263	1,094	1,568

Sources: Office of the Comptroller General; Ministry of Economy and Finance; and Fund staff estimates and projections.

1/ Assumes a stronger fiscal position than the baseline and growth-enhancing structural reforms.

2/ Assumes no fiscal measures are taken (implying a departure from fiscal rules).

Table 3. Panama: Public Sector Debt Sustainability Framework, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual				Est.				Projections				
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Debt-Stabilizing Primary Balance 8/ 1.2	
Public sector debt 1/ Of which: foreign-currency denominated													
Change in public sector debt	59.2	61.9	58.2	63.3	63.6	65.4	63.4	60.4	59.2	57.3	57.3		
Identified debt-creating flows (4+7+12)	48.0	51.1	46.0	51.1	52.2	53.1	48.1	47.0	48.5	47.9	50.2		
Primary deficit	-4.8	2.6	-3.7	5.2	0.3	1.8	-2.0	-3.0	-1.2	-2.0	0.0		
Revenue and grants	-7.0	-3.3	-3.4	1.1	1.7	-0.6	-1.4	-1.1	-1.3	-1.2	-1.0		
Primary (noninterest) expenditure	-0.6	-2.4	-4.6	-2.5	-1.3	-1.9	-2.8	-2.4	-2.3	-2.2	-2.2		
Automatic debt dynamics 2/	23.7	24.6	26.1	24.9	24.3	24.7	25.0	24.8	24.9	24.9	24.9		
Contribution from interest rate/growth differential 3/	23.2	22.2	21.5	22.4	23.0	22.8	22.2	22.4	22.7	22.7	22.7		
Contribution from real interest rate	-4.0	1.3	1.3	3.7	3.0	1.3	1.4	1.3	1.0	1.0	1.2		
Contribution from real GDP growth	0.9	3.7	3.2	3.9	3.5	3.6	4.0	3.5	3.1	3.1	3.2		
Contribution from exchange rate depreciation 4/	-4.9	-2.4	-1.9	-0.2	-0.5	-2.4	-2.6	-2.2	-2.1	-2.1	-2.0		
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	0.0		
Privatization receipts (negative)	-2.4	-2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual, including asset changes (2-5)	2.2	5.9	-0.3	4.1	-1.4	2.4	-0.7	-1.9	0.1	-0.8	1.0		
Public sector debt-to-revenue ratio 1/	249.5	251.4	223.2	254.0	262.4	264.6	254.0	243.1	237.4	229.5	229.6		
Gross financing need 5/ in millions of U.S. dollars	5.9	5.1	3.0	6.4	10.9	5.4	4.2	5.5	7.0	5.2	7.3		
	640.7	583.2	362.8	773.3	1,339.1	695.8	572.4	784.9	1,062.5	832.5	1,234.6		
Key Macroeconomic and Fiscal Assumptions													
Real GDP growth (in percent)	8.7	4.2	3.3	0.3	0.8	3.7	4.2	3.7	3.7	3.7	3.7		3.8
Average nominal interest rate on public debt (in percent) 6/	5.3	6.4	6.9	7.4	6.8	5.1	7.6	7.3	7.4	7.5	7.8		7.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.9	6.5	5.5	6.7	5.6	3.0	6.0	5.9	5.5	5.6	6.0		5.9
Inflation rate (GDP deflator, in percent)	3.4	-0.1	1.5	0.7	1.2	1.4	1.1	1.1	1.4	1.9	1.8		1.5
Growth of real primary spending (deflated by GDP deflator, in percent)	9.9	-0.3	0.0	4.7	3.3	2.4	3.4	1.2	4.6	5.1	3.8		3.7
Primary deficit	-0.6	-2.4	-4.6	-2.5	-1.3	1.5	-1.9	-2.8	-2.4	-2.3	-2.2		-2.3
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2004-08 7/	65.4	62.2	57.8	55.3	52.0	65.4	62.2	61.7	62.2	61.7	61.7		1.1
A2. Primary balance under no policy change in 2004-08	65.4	64.1	62.1	62.1	62.2	65.4	64.1	62.1	62.2	61.7	63.4		1.2
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005	65.4	65.3	64.5	63.4	61.5	65.4	65.3	64.5	63.4	61.5	61.6		1.3
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005	65.4	68.3	71.1	72.6	73.2	65.4	68.3	71.1	72.6	73.2	76.2		1.6
B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005	65.4	66.9	67.1	66.0	64.2	65.4	66.9	67.1	66.0	64.2	64.4		1.4
B4. Combination of 1-3 using one standard deviation shocks	65.4	67.3	67.9	66.9	65.0	65.4	67.3	67.9	66.9	65.0	65.2		1.4
B6. 10 percent of GDP increase in other debt-creating flows in 2004	65.4	73.4	70.6	69.6	67.8	65.4	73.4	70.6	69.6	67.8	68.1		1.4

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(1 - p)(1 + r) - g + ae(1 + r)] / (1 + g - pr - pp)$ times previous period debt ratio, with r = interest rate; p = 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).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $1 - r - \pi(1 + g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $ae(1 + r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ The key variables include real GDP growth, real interest rate, and primary balance in percent of GDP.

8/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table 4. Panama: External Debt Sustainability Framework, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual				Projections				Debt-Stabilizin Noninterest Current Account			
	1998	1999	2000	2001	2002	2003	2004	2005		2006	2007	2008
External debt	48.9	48.9	46.9	51.9	51.6	49.6	49.4	49.5	49.5	50.2	51.0	-1.2
Change in external debt	-3.0	0.0	-1.9	5.0	-0.3	-2.0	-0.2	0.1	0.0	0.6	0.8	
Identified external debt-creating flows (4+8+9)	-12.2	7.7	-0.5	2.5	-1.2	-2.1	-4.0	-1.7	-2.0	-2.3	-2.4	
Current account deficit, excluding interest payments	6.6	7.8	2.9	-2.2	-2.4	-3.0	-1.0	-0.4	-0.5	-1.0	-1.2	
Deficit in balance of goods and services	5.3	5.5	2.3	-1.6	1.2	0.4	-1.0	-1.2	-1.2	-1.6	-1.8	
Exports	30.3	28.9	29.7	30.1	28.4	27.6	29.3	29.6	29.6	30.0	30.3	
Imports	35.6	34.4	32.0	28.5	29.6	28.1	28.3	28.4	28.4	28.4	28.5	
Net nondebt creating capital inflows (negative)	-15.8	-0.9	-4.2	1.7	-1.5	-0.4	-4.5	-2.7	-2.7	-2.6	-2.6	
Automatic debt dynamics 1/	-3.1	0.9	0.8	3.0	2.6	1.3	1.5	1.4	1.2	1.2	1.4	
Contribution from nominal interest rate	2.6	2.9	3.1	3.4	3.6	3.8	4.1	3.9	3.9	3.9	4.0	
Contribution from real GDP growth	-4.0	-2.0	-1.5	-0.2	-0.4	-1.9	-2.0	-1.7	-1.7	-1.7	-1.8	
Contribution from price and exchange rate changes 2/	-1.7	0.0	-0.7	-0.3	-0.6	-0.6	-0.6	-0.7	-0.9	-0.9	-0.9	
Residual, incl. change in gross foreign assets (2-3)	9.2	-7.8	-1.4	2.5	0.9	0.1	3.8	1.8	2.0	2.9	3.3	
External debt-to-exports ratio (in percent)	161.7	169.3	158.1	172.8	181.7	179.6	168.7	167.0	167.5	167.4	168.3	
Gross external financing need (in millions of U.S. dollars) 3/	1,360	1,625	1,107	690	1,101	419.9	625.6	694.0	1226.1	688.6	1331.9	
In percent of GDP	12.4	14.3	9.3	5.7	9.0	3.3	4.6	4.8	8.1	4.3	7.9	
Key Macroeconomic Assumptions												
Real GDP growth (in percent)	8.7	4.2	3.3	0.3	0.8	3.7	4.2	3.7	3.7	3.7	3.7	3.8
GDP deflator in U.S. dollars (change in percent)	3.4	-0.1	1.5	0.7	1.2	1.6	1.1	1.4	1.9	1.9	1.8	1.5
Nominal external interest rate (in percent)	5.7	6.1	6.6	7.4	7.2	5.2	7.6	8.6	8.2	8.3	8.5	8.3
Growth of exports (U.S. dollar terms, in percent)	-5.4	-0.6	7.8	2.3	-3.6	4.0	6.8	6.4	5.5	7.1	6.8	6.6
Growth of imports (U.S. dollar terms, in percent)	3.6	0.7	-2.4	-10.2	6.2	4.2	6.8	-0.5	6.1	5.7	5.5	5.7
Current account balance, excluding interest payments	-6.6	-7.8	-2.9	2.2	2.4	-1.5	3.0	1.0	0.4	0.5	1.0	1.2
Net nondebt creating capital inflows	15.8	0.9	4.2	-1.7	1.5	3.7	4.5	2.7	2.7	2.6	2.6	2.6
A. Alternative Scenarios												
A1. Key variables are at their historical averages in 2004-08 4/						49.6	51.1	50.6	50.2	50.9	51.9	-1.1
A2. Key variables under no policy change in 2004-08						49.6	48.9	49.8	50.7	52.4	54.4	-1.1
B. Bound Tests												
B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005						49.6	49.8	50.4	50.4	51.1	52.0	-1.1
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005						49.6	52.2	55.0	55.1	55.9	56.9	-1.3
B3. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005						49.6	50.6	52.1	52.1	52.8	53.8	-1.2
B4. Noninterest current account is at historical average minus two standard deviations in 2004 and 2005						49.6	59.5	69.3	69.9	71.0	72.4	-0.6
B5. Combination of 1-4 using one standard deviation shocks						49.6	57.0	64.5	64.9	65.8	67.1	-0.9

1/ Derived as $[1 - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. 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/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

Statement by the IMF Staff Representative
March 22, 2004

This statement contains information that has become available since the staff report was issued on March 1, 2004. The information does not change the staff appraisal.

- Real GDP growth was 4.1 percent in 2003, according to preliminary national accounts data, somewhat better than the staff estimate of 3.9 percent presented in the staff report. Also, real GDP growth in 2002 was revised upward from 0.8 percent to 2.2 percent.
- Consumer price inflation was 1.7 percent during 2003, compared with the staff estimate of 1.3 percent.
- The unemployment rate for 2003 (measured each year in August) was revised to 12.8 percent, compared with a preliminary figure of 13.4 percent (and 13.5 percent in August 2002).
- Preliminary data on the balance of payments for 2003 confirm the rebound of export-oriented services in the latter part of the year, notably trading activity in the Colon Free Zone and ports; the external current account deficit was 3.2 percent of GDP, in line with the estimate in the staff report. Foreign direct investment was US\$792 million in 2003, compared with the staff estimate of US\$654 million.
- On March 11, the Minister of Economy and Finance announced that the nonfinancial public sector deficit for 2003 was 1.9 percent of GDP, compared with the limit of 2 percent of GDP under the Fiscal Responsibility Law. The staff has not yet received details of the fiscal accounts and is consequently not able to ascertain whether the lower deficit than reported in SM/04/65 (1.9 percent vs. 2.4 percent of GDP) is attributable to a stronger revenue performance or greater expenditure restraint than anticipated by staff.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Panama

On March 22, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Panama.¹

Background

Following two years of weak growth, economic activity recovered in 2003 as real GDP grew about 4 percent. The recovery has been led by a boom in construction, the primary sector (particularly fishing), and a rebound of export-oriented services in the latter part of the year. Unemployment declined modestly in 2003, although it remains high at about 13 percent. Inflation remained low.

Fiscal policy is guided by a fiscal responsibility law, enacted in May 2002, which limits the nonfinancial public sector deficit to at most 2 percent of GDP and targets a gradual reduction in public debt to 50 percent of GDP. The deficit limit was observed in 2002, and official data indicate continued compliance with the fiscal law in 2003, with a deficit of 1.9 percent of GDP. The fiscal deficit that is comparable with data for periods prior to the fiscal rules is 3.6 percent of GDP, despite spending cuts in the last quarter of 2003, as higher revenues from a tax reform in late 2002 were offset by lower nontax receipts and substantially lower capital revenues than in 2002.

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. 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.

The debt management strategy seeks to improve the maturity structure of debt and deepen the domestic capital market. Three- and five-year treasury notes began to be issued in 2002, helping to define a Panamanian yield curve. Global bond issues, totaling US\$3.7 billion since 1999, have been used to meet fiscal financing needs and retire Brady bonds. The authorities have begun to implement a policy of including collective action clauses in their bond issues.

The banking system experienced some stress during 2002 as a result of the turbulence in financial markets in South America, but it began to recover in 2003. Large withdrawals of deposits by nonresidents in 2002 led to a scaling back of foreign credit operations, while domestic deposits and private sector credit contracted modestly and deposit spreads (over LIBOR) rose, particularly for local banks. Private sector credit and bank deposits resumed growth in the second half of 2003, and falling deposit spreads gave further evidence of the banking sector's recovery.

The fundamentals of the banking system remain sound, and the supervisory framework for the financial system has been strengthened. Capital adequacy ratios exceed 17 percent on average; liquidity is ample; banks sharply improved their profitability; and nonperforming loan ratios decreased somewhat, to less than 3 percent on average as of end-September 2003. The authorities have taken various actions toward reaching full compliance with the Basel Core Principles, including steps to improve offsite and onsite inspections, in line with the recommendations of an IMF Offshore Financial Center Module 2 assessment in 2001.

The recovery of economic activity is continuing in 2004. The buoyancy of construction is helped by tax incentives that expire at end-2004, and the export-oriented transport, communication and tourism sectors should benefit from an improved external environment.

Recent free trade agreements—including an agreement with Taiwan Province of China—are aimed at encouraging foreign investors with a regional focus to establish operations in Panama, making use of the transportation, financial, and communications infrastructure. These service sectors are areas of comparative advantage that are a focus of the government's medium-term growth strategy.

Executive Board Assessment

Executive Directors welcomed Panama's recent economic recovery and the strengthening of the banking system in a setting of low inflation. Directors considered that further fiscal consolidation underpinned by structural reform will be essential for keeping public debt dynamics under control, and for helping to manage the risks associated with a fully dollarized economy. The main challenges in 2004 will be to maintain a sound fiscal policy through compliance with fiscal rules, address the urgent need for social security reform, and step up the pace of growth-enhancing structural reforms.

Directors commended the authorities for their commitment to fiscal discipline through adherence to the fiscal responsibility law and their efforts to enhance revenues through the December 2002 tax reform. At the same time, Directors, noting the somewhat weaker-than-anticipated fiscal

outturn in 2003, stressed the need to take the fiscal measures that may be needed to adhere to the deficit limit for 2004. In this regard, Directors encouraged the authorities to adopt a quarterly program to help guide fiscal policy during the political transition in 2004. Additional reforms are needed to ensure sustained compliance with the fiscal rules, including civil service reform, and steps to improve tax administration and to further broaden the tax base and reduce exemptions. Noting that a strengthened economic infrastructure is essential for enhancing Panama's growth prospects, Directors cautioned against undue reliance on capital expenditure cuts to meet the fiscal rule. Some Directors also suggested that the authorities aim for a more ambitious deficit reduction in times of strong economic performance, to safeguard fiscal sustainability over the medium term.

Directors urged the authorities to reverse the deterioration in the finances of the social security agency and take early action to restore its solvency. In this vein, they welcomed the steps taken to increase the return on the pension fund reserves and to rationalize operating expenditures. Nevertheless, a comprehensive reform of the pension system is needed, as under current policies the pension fund will be exhausted within 10-15 years. Directors therefore welcomed the momentum toward reform created by the National Dialogue on social security, which has raised public awareness of the urgency of pension reform, and they encouraged the authorities to build on it.

Directors agreed that Panama's total public sector debt is likely to be sustainable, but with little room for countercyclical fiscal policy. They advocated making faster progress toward lowering the debt-to-GDP ratio and gross financing needs. Directors concurred with the authorities' debt management strategy to improve the maturity structure of debt and deepen the domestic capital market. They welcomed the authorities' decision to include collective action clauses in all their future sovereign bond issuances.

Directors welcomed the progress made by the Superintendency of Banks in strengthening bank regulation and supervision, in particular in the areas of inspections and consolidated supervision of regional banking institutions. The banking system has remained sound for many years, despite the absence of a lender of last resort and a deposit insurance scheme, thanks to a prudent fiscal policy and a strong regulatory and supervisory framework that emphasizes crisis prevention, transparency, and market discipline.

Directors noted that Panama has a comprehensive legal framework to combat money laundering, and has ratified the UN International Convention for the Suppression of the Financing of Terrorism.

Directors supported the authorities' growth strategy, which aims at exploiting the country's comparative advantage in the export-oriented service sector. The success of the strategy will require an improvement in the environment for productive investment and job creation. In particular, it will be important to reduce labor market rigidities, and Directors encouraged the authorities to seek consensus for reforms in this area. Directors welcomed other elements of the strategy, in particular the promotion of good governance, and the identification and removal of

barriers to foreign investment, including through a more transparent foreign investment legal framework.

Directors commended the authorities for maintaining a relatively open trade regime, and for their commitment to free trade principles.

Directors noted that Panama's economic and financial statistics are generally adequate for surveillance purposes. They encouraged the authorities to improve the timeliness and quality of fiscal data, and in this regard, they welcomed the authorities' interest in adopting the standard of the 2001 GFS Manual.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Panama: Selected Economic Indicators

	2000	2001	2002	Est. 2003	Proj. 1/ 2004
(Annual percentage change, unless otherwise indicated)					
Real economy					
Nominal GDP	4.8	1.0	3.4	5.2	5.4
Real GDP (1996 prices)	3.3	0.3	2.2	4.1	4.2
Consumer price index 2/	0.7	0.0	1.8	1.7	1.3
Unemployment	13.3	14.7	13.5	12.8	...
Money and credit					
Broad money 3/	8.9	9.5	0.9	4.6	5.4
Credit to private sector	5.4	8.1	-7.2	2.0	5.8
Deposit rate 6-month	6.5	5.5	3.8	3.6	...
(In percent of GDP, unless otherwise indicated)					
Savings and investment					
Gross domestic investment	28.5	26.0	25.6	25.6	25.7
National savings	22.8	24.6	24.7	22.4	22.1
External savings	5.8	1.4	0.8	3.2	3.6
External sector					
Current account	-5.8	-1.4	-0.8	-3.2	-3.6
Capital and financial account	1.7	7.4	0.8	2.1	4.4
Real effective exchange rate (depreciation -)	-0.7	-1.4	-0.1	-7.8	...
External public debt	46.9	51.9	51.6	50.5	50.3
Nonfinancial public sector					
Revenue and grants	26.1	24.9	25.3	24.5	25.0
Expenditure	25.6	26.6	27.2	28.1	27.0
Overall balance	0.5	-1.7	-1.9	-3.6	-2.0
Overall balance for monitoring of Law 20 4/	-1.9	-2.0

Sources: Panamanian authorities; and IMF estimates.

1/ Fund staff projections.

2/ End of period.

3/ Corresponds to total private sector deposits in the banking system.

4/ Law 20 is the Fiscal Responsibility Law of May 2002.

**Statement by Murilo Portugal, Executive Director for Panama
and Alfredo N. Maciá, Advisor to Executive Director
March 23, 2005**

1. Our Panamanian authorities are grateful to the staff for the open policy dialogue with the Fund and for the support to their efforts to maintain macroeconomic stability by strengthening fiscal prudence, moving forward with crucial reforms, and enhancing the investment environment.
2. Economic growth rebounded at over 6 percent of GDP in the first quarter of 2004, a trend that has been largely maintained throughout the year, with real GDP growth reaching 6.2 percent by end-year, compared to 4.1 percent in 2003. This robust economic performance has been broad based resulting from strong construction activity, agricultural exports, tourism and entertainment, the Panama Canal operations, and the Free Zone. Inflation remained subdued despite pressures of higher transport and oil costs, with end-of-year inflation projected at 1.5 percent compared to 1.7 percent at end-2003. According to the 2004 Household Survey, the unemployment rate decreased to 11.8 percent at end-2004, compared to 13.1 percent at end-2003. Prospects for 2005 are favorable, with GDP growth expected to remain well above the last decade's average.
3. Panama's external competitiveness is favorable. The real effective exchange rate has declined with the depreciation of the US dollar; the country has increased its export volumes and expanded its market share in a number of services. While the external current account deficit at end-2004 reached 8 percent of GDP compared to a 4 percent deficit at end-2003, it was almost totally covered by foreign direct investments that reached 7.3 percent of GDP. Exports grew at a faster rate than imports, and the revenues of the Panama Canal Authority (ACP) increased 15.8 percent in FY2004, breaking the one billion dollar level.

Fiscal Policy

4. As it took office on September 1, 2004, the new administration encountered a deteriorated fiscal stance, with the non-financial public sector deficit reaching 5.0 percent of GDP at end-2004. The authorities adopted immediate action to start reversing the fiscal situation, including the non-renewal of personnel contracts, and an immediate expenditure restraint of US\$225.8 million. They also developed a plan to gradually reduce unpaid arrears with suppliers.
5. The 2005 budget envisages a fiscal deficit of 3.8 percent of GDP, with stiff controls on current public expenditures. The authorities expressed their commitment to protect outlays for key social sectors and to improve the targeting of subsidies for electricity, water, cooking gas, and preferential interest rates for low-income housing. On investments, the authorities will provide for the continuation of priority infrastructure projects related to water distribution, electricity, and irrigation. The authorities are also going to propose new norms to be included into the Fiscal Responsibility Law to enhance fiscal transparency, provide for clear enforcement of fiscal policy, and promote healthier public finances. The staff

considered the authorities' fiscal policies and targets appropriate and in line with the Fund's recommendations.

6. The public debt level increased to US\$9.98 billion at end-December 2004. The authorities have already started to take structural measures to tackle the deteriorated fiscal stance and growing public debt. As mentioned below, a fiscal reform yielding a 1 percent of GDP has been approved, and a social security reform package is under discussion, in addition to the tighter government expenditure controls that have been put in place.

Financial Sector

7. Panama's banking system has remained strong with assets at US\$33.2 billion, a 4.5 percent increase compared to 2003, ample liquidity, and high capital levels. The liquid assets to deposit ratio was 42 percent last September. The capital adequacy ratio stood at 18.6 percent, compared to a regulatory required CAR of 8 percent. The return on capital for the banking system was 16.2 percent and the return on assets, at 2.3 percent, was slightly higher than in 2003. Non-performing loans declined to 1.8 percent from 2.7 percent in 2003. Domestic credit has grown steadily, with both foreign private banks and public banks accounting for most of the growth.

8. The SoB has enhanced its consolidated and cross-border supervision of the banking system and is taking steps to move forward on the main issues regarding the Basel II risk requirements so that they are in place by 2008. Banking system surveys are now in progress to evaluate future capital requirements, risk supervision, and the legal framework for adopting the Basel II rules. An MFD mission is to travel to Panama shortly to complete a Model 2 OFC review. The mission will look into the AML/FT, the insurance sector legislation, and the domestic stock market framework vis-à-vis international standards.

Structural Reforms

9. The Torrijos administration announced on January 12, 2005 an overall fiscal reform package. By February 2, the legislature approved Law no. 6 (explained in Box 1), an equitable fiscal law that calls for fiscal discipline by the government and increased revenues to be paid by the private sector. Public payroll is to be scaled down by early 2008 to a range of about 165-170 thousand from the existing over 180 thousand taking into account exceptions in health, education and security services. The fiscal law also imposes ceilings on current expenditures, professional service contracts and, amongst other measures, reduces by 60 percent the number of vacancies within the next three years. The new law increases operating fees, eliminates the industrial incentive law of 2004, and the exports incentives certificates (CAT's), which will expire at end-2005. It also limits tax breaks on donations, while taxing a share of Panamanians' foreign income. It widens the income tax base including in it representation expenses, and envisages an anticipated withholding tax of 10 percent. Implementation of the representation expenses measure took place last February; the Free Zone new operating fees will take effect in June of 2005; and other tax measures in January 2006. The revenues to GDP ratio are expected to increase to 15.4 percent from the

present 14.6 percent level. Strong fiscal discipline and the prospect of a social security (SS) reform may bring the investment grade up on Panama's sovereign rating.

10. Consultations aimed at a social security reform started in mid-2001 under the UNDP sponsorship and were previously discussed during the 2003 Article IV consultation. Our authorities are cognizant of the urgency to push forward an overall reform despite the political cost. The reforms may entail changes in contributions, retirement age, services coverage, and in the replacement payments, amongst other issues, in order to ensure the long-term fiscal sustainability of the system. In mid-February, an information campaign about the precarious fiscal situation of the SS system was launched to increase awareness of the population. The reform package, which retains full ownership by the authorities, will reach the legislature as soon as the consultation process is concluded with the civil society and stakeholders.

11. Other important structural reforms aimed at improving Panama's competitive strategy, which already are in their initial stages, include judicial reform, deregulation, governmental restructuring, attracting foreign investments, and promoting exports.

12. Free trade agreements are at the top of the 2005 agenda. Panama is presently negotiating trade agreements with Costa Rica, Mexico, Nicaragua, Singapore, and the United States. In addition, Panama wants access to other markets and has interest in joining the G-3 Group integrated by Mexico, Venezuela, and Colombia. Furthermore, the country has joined Ecuador, Honduras, Guatemala, Costa Rica, Colombia, and Nicaragua on efforts to curb the EU proposed "tariff only" for banana imports to be in effect in January 2006. EU has proposed a US\$300 dollar tariff per ton --from the present US\$75 per ton-- when the 2.6 million-ton quota system expires. Panama exports 80 percent of its production to the EU and has to compete with the duty-free banana from the Africa, Caribbean, and Pacific group (ACP).

13. The negotiation of a free trade agreement with the United States (US), which started in April 2004 and has gone through eight rounds of talks, will broaden the attraction of US investments into Panama and strengthen the country's growth potential in the medium term. The areas remaining for a ninth and conclusive round of negotiations are agricultural products, access to the Panama Canal procurements, and textiles among others, while most non-agricultural issues have now been settled.

Investment Activity

14. The reverted areas of the Panama Canal keep on attracting large foreign and local investments. The second bridge over the Panama Canal accounting for a US\$200 million public investment effort is now in the final conclusion of its access routes. In addition, ACP implemented an investment and maintenance program of nearly US\$170 million in 2004. Private investments surged at over US\$300 million primarily in the maritime sector, tourism, commercial services and infrastructure. On port facilities, the Panama Ports Company (PPC-Hutchison Wampoa) concluded in 2004 a port expansion at a cost of over US\$200 million

that will allow it to service Panamax ships. In addition, the Evergreen and Manzanillo International Terminal (MIT) has upgraded its ports facilities.

15. Other investments outside the Panama Canal reverted areas include a new shopping mall and hotel in Panama City costing US\$100 million that are now in service, and the expansion of Tocumen international airport, which began at end-2004. The hydroelectric plant Bayano increased its capacity by 20 percent after a US\$40 million investment. In addition, La Fortuna hydroelectric is starting a US\$ \$225 million expansion program to increase its capacity to 150 megawatts. At end-2004, total electricity production stood at slightly over 5,000 megawatts, with 58 percent produced by hydroelectric plants.

16. In addition to these investments, several mega investment projects are also being considered, which will substantially increase the growth potential of the economy. The most important of these projects is the construction of new sets of locks in the Panama Canal, an approximate investment of over US\$4.5 billion. In 2004, the Canal serviced 14,035 ship-crossings, a 6.7 percent increase compared to 2003, with a large portion accounted for by super ships, including Panamax ships. At the present rate of growth in cargo and ship-crossings, the capacity of the canal may be reached by 2012. A referendum is expected to take place late this year to authorize the expansion of the canal, which has an estimated construction time of eight years. Today, the main users of the canal are the U.S., China, Japan, Taiwan, and Chile. The expansion of the Canal will broaden Panama's participation in the regional and global trade through the use of its waterway.

17. In November 2004, President Torrijos signed with President Uribe a Memorandum of Understanding to pursue the construction of a gas pipeline and build an electricity inter-connection between Panama and Colombia. Venezuela is also pursuing an agreement with Panama to interconnect a gas pipeline to the Colombia-Panama project given market demands from China and the U.S. West Coast. The gas pipeline project has an estimated cost of US\$200 million and could be in operation in 24 months. The Colombian electricity 300 megawatts interconnection has two alternate routes of 571 km and 514 km costing US\$169 million and US\$139 million respectively.

18. Venezuela is also considering transporting oil in the trans-Panama oil pipeline (Petroterminales) built in 1982 to transport Alaskan oil, which now operates below its pumping capacity of 860,000 bbl per day. Both countries initiated talks on the gas and oil pipelines in early January 2005.

19. A third mega project under consideration is the construction of a port in the Pacific coast with an investment of US\$600 million. Evergreen, Port of Singapore Authority (PSA), China Ocean Shipping Co. (COSCO), Maersk Sealand, and P& O are five of the maritime enterprises interested in the concession.

20. PPC-Hutchinson Wampoa and MIT port operator will invest US\$500 million in 2005 for expanding their port facilities in the Atlantic side of the Canal. MIT has already invested US\$300 million in its port facilities and PPC-Hutchinson Wampoa has a total investment to date of US\$340 million in the Balboa Port located in the Pacific side of the Canal.

Conclusion

21. The challenges of the new administration center around needed reforms to enhance the country's economic growth potential, improve government finances, and strengthen transparency and accountability. There is a strong commitment by the authorities for the zero-tolerance policy on the fight against corruption. An Anti-Corruption Council was established, and audits of specific government institutions are underway to investigate corruption allegations. These are clear steps taken by the Torrijos administration to support its anti-corruption policy. In addition, the new administration has sent the UN Convention Against Corruption to the Legislature for approval. Our authorities are aware of the need to further enhance the private sector environment and pursue policies to strengthen foreign investments. The President has announced the reactivation of the "Compete Panama" program, in partnership with the IDB, to reduce the red tape to the establishment of new businesses, thereby enhancing business creation, investments, and employment generation. Our authorities would like to state their strong determination to improving social conditions for the poor and the most vulnerable groups, supported by the strong political mandate of the May 2004 elections.