

Credit Suisse - Panama: Laying the groundwork for take-off

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Emerging Markets Economics Research

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The following is an unedited extract from our Global Emerging Markets Outlook report published on 24 March 2006.

Panama: Laying the groundwork for take-off

- Real GDP expanded 6.4% in 2005 and the medium-term growth outlook is strong. Output growth in 2005 was led by 11-13% real increases in banking, hotels and restaurants (tourism), transportation and communication, and commercial activity in the Free Zone. The Panama Canal registered its third consecutive year of double-digit growth in toll revenues.
- The medium-term growth outlook is strong. In 2006-07, we expect real growth to remain in the 6-7% range, supported by external demand, still-buoyant growth in global trade and output, a surge in construction activity (construction permits rose 91% in 2005) and a pick-up in investment in anticipation of the expansion of the Panama Canal. Tourism, including "residential tourism" involving a growing number of retirees from the US, is also fueling the development of coastal areas and surge in residential construction. Longer term, Panama's low human capital stock and inefficiencies in the energy sector could constrain growth in the absence of investment in social (education) and physical (electricity) infrastructure.
- Fiscal reforms in 2005 produced a sharp improvement in fiscal accounts; the non-financial public sector deficit fell to 3.3% of GDP in 2005 from 4.9% of GDP in 2004. Excluding \$112mn in one-off expenditures related to the bond exchange in 2005, the fiscal deficit was even lower at 2.6% of GDP. The outturn reflected revenue growth (15.8%) above that of expenditures (4.6%), which turned a primary deficit of 0.6% of GDP in 2004 into a primary surplus of 2% of GDP in 2005. Moreover, the recent passage of social security reform puts public finances on a more sustainable and predictable path.
- We expect fiscal deficits and the public debt burden to continue declining in 2006-07. Revenue gains should outpace expenditure growth as the government implements the second phase of fiscal reforms adopted last year. The 2006 budget envisages a 2.9% of GDP fiscal deficit, on the assumption that capital spending increases by 70%. We think capacity constraints are likely to result in lower capital spending by around 1% of GDP, but at the same time politically costly civil service reforms might not progress on schedule. On balance, we expect the fiscal deficit to approach 2% of GDP in 2006 and the public debt to GDP ratio to drop to 62% in 2006 from 70% in 2004. The pace of deficit reduction could slow when the government starts contributing in 2007 \$75mn (0.5% of GDP) per year into the social security fund. Under most foreseeable scenarios, the public debt burden should decline in the coming years, and under a probable high growth scenario could fall below 50% of GDP by 2009.
- In the second half of 2006, we expect the government to hold a referendum on – and win approval for – the expansion of the Panama Canal. The Panama Canal Authority (PCA) is reportedly scheduled to finalize its expansion program in March.

The PCA's board will then submit the program to the president, who in turn, will secure cabinet approval before submitting it to Congress. Congress would then need to pass a law that mandates a referendum. Opinion polls in March show that President Torrijos enjoys his highest approval rating since last November. By contrast, support for the expansion of the canal has declined nine percentage points to 56% over the same period. Nonetheless, we expect voters to approve the project after the government makes a concerted effort to campaign in favor of the expansion.