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CAPITAL MARKET DYNAMICS

Foreign Exchange ► The well-established monetary regime based upon the structural dollarization of the economy has somewhat isolated the country from the abrupt gyrations in currency and commodity markets over the past two years. The US dollar (USD) as measured by its trade-weighted index (DXY) has appreciated by 30% against its major peer currencies since June 2014, though it seems to have reached a level of stabilization in the first months of the year. Policy shifts to be implemented by the US central bank will directly impact the cost of local financing in the near term. Looking ahead, the non-tradable sectors of the economy might need a major boost in productivity to mitigate the adverse effect of USD strength on national competitiveness.

Sovereign Debt & Credit Ratings ► Panama maintains a robust sovereign credit profile.Total public sector debt will average 40% of GDP in 2017-18. Rating agencies have maintained a "stable" outlook on Panama's ratings for several years while the government retains comfortable access to international private credit financing; indeed, global debt securities account for 66% of total external debt. Financial market metrics, as indicated in credit default swaps (CDS), reinforce the solid credit position enjoyed by Panama as a sovereign borrower. At present, CDS market pricing indicates that Panama's debt is perceived better than that of Mexico and Colombia. Meanwhile, an international bond issue might be executed in the coming months.

ECONOMIC OUTLOOK

Growth ► Panama remains the fastest growing economy in the American continent. Its privileged location as a regional hub for transport and logistics services, supported by the expanded inter-oceanic canal, has allowed the development of a thriving real estate market and dynamic construction activity (up 8% y/y in 2016). Following a 4.9% expansion in 2016, real GDP growth will likely reach 5% this year and accelerate to 5.5% in 2018. The Panama Canal activity will remain affected by global trade dynamics, particularly in the corridor between Asia and the Americas. The domestic economy will continue to benefit from trade flows with the fast-growing Asia Pacific region and from an ambitious public sector infrastructure development programme.

Inflation & Monetary Context ► The inflation context is healthy. Despite the adverse effects from crude oil prices and strong economic activity, consumer price inflation still remains below 2% y/y. However, intensifying domestic demand activity coupled with somewhat tight labour markets have led to a gradual increase in inflationary pressures over the past six months. Official data shows manageable labour market conditions with the formal unemployment rate edging the 5% mark. In line with the consensus of economic analysts, we estimate that the headline inflation rate will remain in the 2-2.5% y/y range through the end of 2018.

Fiscal & Current Account Balance ► The fiscal situation in Panama is improving on the grounds of increasing revenue stemming from canal traffic activity, structural tax reforms and sustainable domestic economic activity. The government, however, remains committed to its ambitious infrastructure development plan which, according to some observers, might somewhat erode the fiscal position. The non-financial public sector deficit, which closed at 2.5% of GDP in 2016, is estimated to decline to 2% of GDP by the close of this year. Meanwhile, the current account deficit, at 5% of GDP, is always an issue of constant monitoring given the country's inability to use the exchange rate as a mechanism of policy adjustments. However, strong inflows of foreign direct investment (up 15% y/y to US$5.2 billion in 2016) comfortably cover the totality of the external financial gap.

INSTITUTIONAL FRAMEWORK & POLITICAL ENVIRONMENT

Governance ► Panama has been relatively immune to the policy uncertainties instilled by the newly elected USA administration. The administration of President Juan Carlos Varela (in power until May 2019) is benefiting from the expanded canal and speeding up the execution of labour-intensive public sector infrastructure investments with the ensuing boost to the construction sector. On the foreign policy front, the Varela administration has repeatedly voiced its goal to join the four-member Pacific Alliance initiative. To this end, further progress on improving the regulatory and surveillance framework of the offshore financial sector will be required. Developments in Venezuela's civil conflict will continue to disrupt goods trade and migration flows in the near term.

Financial Sector ► The financial sector will remain in structural transformation as Panama implements the necessary adjustments to adapt its offshore financial centre arquitecture to the new international regulations regarding financial transparency and tax information exchange. The annual review by the International Monetary Fund (IMF) conducted in March 2017 stressed the need to continue advances in this regard. The IMF text also stressed the need to mitigate potential systemic risk from increased household indebtedness.

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