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February 17, 2023

Statement by Mr. Subramanian and Mr. Jain on Panama
(Preliminary)
Executive Board Meeting
February 22, 2023

1. We thank staff for their comprehensive reports on Panama. We also thank Mr. Bevilaqua, Mr. Fisher Hogan, and Mr. Fuentes for buff statement.

2. **Panama's economy strongly recovered from the pandemic shock; however, GDP levels remained well below pre-crisis projections**. As projected by staff, the economy will grow by 5.0 per cent in 2023 and 4.0 per cent in the medium-term (2024-28). The growth potential of the economy has been affected by gradual slowdown in investment in recent years following the completion of major public infrastructure projects. *Staff may like to comment: (i) Whether the demand for private sector construction projects has also diminished and (ii) Which other sectors (other than mining) offer growth opportunities?*

3. **Inflationary pressures emerged in 2022 which were addressed by providing temporary food and fuel subsidies**. Nevertheless, the authorities were able to reduce the non-financial public sector deficit in 2021 and 2022 amid improvement in revenues and compression in spending on transfers as the economy recovered. The current account widened in recent years, but it was comfortably financed by robust flows of foreign direct and portfolio investment.

4. **Despite the fact that Panama is a dollarized economy, the domestic lending rates have not risen significantly in tandem with hike in the Fed Funds rate (FFR)**. In case the domestic lending rates slowly adjust to FFR, it would be important to know: *How much of banks' loan portfolio is held on a floating rate basis? Further, staff may like to comment: Whether any credit market frictions exist in the form of administered interest rates for select sectors.*

5. **Panama's banking sector survived well after the pandemic shock as the share of non-performing loans has increased only modestly.** The banking sector, however, has large exposure to construction and real estate sector. We note from staff's analysis that construction sector may no longer be a major contributor to domestic growth which may impact the health of the banking sector.

6. **We join staff in stressing that reforms that aim at strengthening financial integrity and financial sector resilience are critical to preserve Panama's role as a regional financial center.** In this regard, we emphasize that the authorities should take note of staff's detailed policy recommendations on key policy gaps. With some outstanding issues of the Financial Action Task Force action plan, Panama was supposed to demonstrate significant progress by February 2023. From the authorities' views, however, we note that some delay is possible, though they are fully committed to undertake reforms on the remaining issues.

7. **Panama being a dollarized economy and a regional financial hub has different challenges while dealing with global shocks, especially relating to monetary policy shocks in advanced economies.** While further increase in FFR could lead to spikes in sovereign bond yields and disruptions to external financing, large withdrawal of foreign deposits could impact liquidity in the banking sector as highlighted by staff. However, we are encouraged to note that Panama's reserve adequacy indicators are better relative to the benchmarks which are used to assess the reserve adequacy of fully dollarized economies.

8. **Another important area of reforms that has been highlighted in "Selected Issues" document is Panama's tax system.** Due to high tax expenditure, low corporate income tax productivity, narrow VAT base, country's tax collection has been historically low. Authorities need to take note of staff's recommendations to modernize Panama's tax system by increasing its progressivity and transparency, reducing distortions, and aligning it with international best practices. In our view, these reforms are essential for country's growth and fiscal sustainability. Further, Panama also needs to overhaul its domestic tax system keeping in view of the proposed reforms in the international tax system (especially relating to the global minimum tax rate). *Staff may like to comment: If the proposed changes in the international tax regime are implemented, what would be the impact on foreign financial flows to Panama?*

9. Finally, we conclude that staff report has highlighted various strengths and weaknesses of the Panama's economy. Staff's policy recommendations on various policy gaps are ideal to provide a broad direction for country's reform agenda going forward. We wish the authorities and people of Panama all the best for their endeavors.