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2:30 p.m., July 28, 2008

3. Panama—2008 Article IV Consultation

Documents: SM/08/218 and Supplement 1 and Supplement 2; SM/08/224

Staff: Gold, WHD; Fetherston, PDR

Length: 40 minutes

Executive Board Attendance

M. Portugal, Acting Chair

Executive Directors	Alternate Executive Directors
	S. Itam (AE)
	O. Mamadou (AF), Temporary
J. Silva-Ruete (AG)	
	C. Thompson (AU), Temporary
	D. Orynbayev (BE), Temporary
P. Nogueira Batista, Jr. (BR)	M. Agudelo (BR)
	R. Lin (CC), Temporary
	J. Pineda (CE), Temporary
	S. Ladd (CO), Temporary
	M. Jakubowicz (FF), Temporary
	C. Brinkmann (GR), Temporary
	K. Dheerasinghe (IN)
	J. Cardoso (IT), Temporary
	H.Yamaoka (JA)
	A. Monajemi (MD), Temporary
	A. El-Ganainy (MI), Temporary
	N. Klein (NE), Temporary
	D. Abazorius (NO), Temporary
	A. Tolstikov (RU), Temporary
	S. Alnefaee (SA), Temporary
	C. Sucharitakul (ST)
	Y. Tok (ST), Temporary
	S. Antic (SZ), Temporary
	S. Lin (UA), Temporary
	H. Robinson (UK), Temporary

B. Esdar, Acting Secretary
P. J. Walker, Assistant

Also Present
IBRD: L. Moller. Policy Development and Review Department: M. Fetherston. Western Hemisphere Department: D. Desruelle, J. Fajgenbaum, J. Gold, L. Kaltani, W. Keller. Secretary’s Department: P. Cirillo, M. Yslas. Senior Advisors to Executive Directors: A. Joseph (BR), H. Mori (BR). Advisors to Executive Directors: K. Florestal (BR), J. Luque (AG), A. Maciá (BR), A. Matoto (ST), I. Mwanawina (AE), R. Perez (BR), E. Uanguta (AE).

3. PANAMA—2008 ARTICLE IV CONSULTATION

Mr. Nogueira Batista and Mr. Maciá submitted the following statement:

Our authorities welcome the advice of the Fund and the close working relations with staff.

Economic performance in 2007 surpassed all earlier projections with GDP growth reaching more than 11 percent. For the first quarter of 2008, GDP growth fell to 8.4 percent, more in consonance with Panama's long-term economic performance. Our authorities expect 8 percent growth for 2008 in spite of the U.S. economic slowdown. The present economic expansion is broadly based and supported by domestic demand, increases in free-trade zone activity, tourism, banking intermediation, non-traditional agricultural exports and construction. Construction activity in the first quarter of 2008 increased 32.9 percent over the same period in 2007. Open unemployment has dwindled down from 9.2 percent in 2004 to 4.6 percent at end-2007. Households' purchasing power has increased as additional family members secured employment.

Consumer price inflation rose from only 2.2 percent in 2006 to 6.4 percent at end-2007. This year, it has been rising further, reaching 8.9 percent yoy at end-March, and 9.6 at end-June 2008, as a result of soaring world food and energy prices. As indicated in the Staff Report, most of the rise in inflation is imported. Food, fuel and other transport-related items comprise 45 percent of Panama's CPI. Food price increases account for 50 percent of overall inflation to April 2008, as detailed in the selected issues paper. Core inflation reached 4.3 percent in April 2008 up from 1.7 percent at end-2006. There are prospects for lower inflation in the medium term given the expectations of a slowdown in economic activity and lower international food prices.

In order to tackle high food prices and protect the purchasing power of low income groups the administration has initiated an assistance program to consumers (PAC). In early April, the government frontloaded various initiatives under the PAC program. This began with imports of grains and other products through the agricultural marketing institute (IMA) with the aim of reducing food prices for the most vulnerable part of the population. In addition, in May 2008 a plan was launched to increase the cultivation acreage of maize, rice, sorghum and beans with the objective of attaining selfsufficiency in 2009. This plan includes cutting interest on agricultural loans to 2 percent from 6 percent. In addition, IMA assumes 50 percent of crop insurance premiums and guarantees the purchase of the entire production of rice. PAC also exonerated agricultural machinery and inputs from import tariffs, set lower import tariffs on urea and fertilizers, which now reach small farmers at about half the price of 2007, and eliminated import duties on lentils, canned beans, frozen fish, tuna, pork products, and spices. These initiatives seek to guarantee food security, tackle some market imperfections in the agricultural sector, and stabilize food prices. In June 2008, the government introduced a one-time yearly US$60 bonus for retirees to compensate at least partly for the rise in food prices, and increased from 15 to 20 percent the discounts in all purchases of medicines and drugs by retirees. At the regional level, Panama is participating in the Central American Agricultural Council's plan to increase production of rice, beans, maize and sorghum, as well as to promote imports of fertilizers.

Other PAC measures that took place in early June include new legislation that cuts income tax rates to workers earning up to US$1,000 monthly, and which, starting in 2009, will benefit salaries of up to US$2,500. This will increase the purchasing power of most middle-income wage earner helping them face present inflation pressures. Also, the government decided to establish preferential interest rates for low-income housing – zero interest rates, in the first 10 years of a mortgage, on houses costing up to US$30,000 for first-time-buyers, and savings of up to 4 percentage points for housing units costing up to US$80,000. Preferential interest rates will probably increase the low-income housing demand, facilitate ownership, reduce the housing deficit, and keep construction activity thriving. Low-income housing represents over 82 percent of the total mortgage portfolio in the banking sector. So far, these PAC measures have a moderate fiscal impact estimated at US$15.8 million for 2008.

The Torrijos administration continues to be committed to reducing poverty levels and a better targeting of transfers and subsidies to the poor. The Opportunity Network program (Red de Oportunidades), launched in 2006, is crucial to achieving these goals. The program includes a cash monthly allowance to extremely poor families of US$50 (increased from US$35 in early July 2008). At end-2007 the program reached 35,000 families, by May 2008 it reached 48,000 families, and by end-2008, with the support of the IDB and the

World Bank, it is expected to cover 100 percent or 76,000 of extremely poor families. The program requires the young (ages 4 to 17) to attend school and mothers to make periodical checks to health centers. School attendance rose from 77 to 88 percent in 2007. In addition, the school nutrition program has increased the protein and calorie intake of students in "difficult access" schools. In 2007, it reached 100 percent of primary public schools and 20 percent of junior high public schools benefiting over 470,000 students daily, with an estimated cost of US$15.8 million in 2008 and US$22 million in 2009. In so far as subsidies are concerned, the government managed to improve targeting and expand programs in 2007. Electricity subsidies were reduced in 2007 as they now target exclusively households consuming up to 500 kwh per month. The cooking gas subsidy has a wider coverage in rural areas and increased by 21 percent to US$57.7 million in 2007 from US$47 million in 2006. Petroleum subsidies remain targeted on diesel fuel for public transport. High economic growth and improved targeting of public spending, including the increased cash transfer program, better access to educational facilities, and technical training efforts, have contributed to the decline in poverty levels in the last quinquennium.

The current account deficit is estimated to have increased to about 8 percent of GDP in 2007 from 4 percent of GDP in 2006. Most of the pressure originates from imports of oil products, capital goods, construction-related imports, and consumer durables. FDI's inflows, however, are estimated to have reached over 9 percent of the GDP in 2007. Construction activities in the Panama Canal will exert pressure on the current account deficit, given their import content.

Public finances strengthened further in 2007. The central government recorded a surplus of 1.2 percent of GDP. Total revenues increased 19.4 percent in relation to 2006. The non-financial public sector (NFPS) posted a surplus of 3.5 percent of GDP (0.5 percent in 2006), a substantial improvement since 2004 when the NFPS registered a deficit of 5 percent GDP. This outcome is a result of the strong economic performance and higher tax revenues, expenditure control, and a one-off non-tax receipt from duty-free airport concessions. We note that the ratio of the central government's wage bill to its current revenues has declined from 43 percent in 2004 to 27 percent in 2007. The ratio of interest payments to current revenues decreased from 29 percent to 18 percent in the same period. The NFPS's primary surplus rose to 6.9 percent of GDP in 2007. Tax revenues went up from 8.1 percent of GDP in 2005 to 10.6 percent of GDP at end-2007. The authorities remain confident in a good fiscal performance in 2008. This fiscal space remains crucial to sustain social spending and infrastructure investment in the medium term.

Net public debt of the NFPS has fallen from 62 percent of GDP in 2004 to 46 percent of GDP in 2007. In early June, Panama exchanged 2011 and 2012 global bonds and reopened the 2029 global bond issue, which implies a reduction of over US$67 million in the external debt and lower interest payments until 2011.

A new fiscal responsibility law (FRL), complying with international norms of transparency and accountability, was signed in early June 2008. The new law establishes a limit of 1 percent of GDP for the deficit of the NFPS, compared to a 2 percent limit in the 2002 FRL. It envisages a reduction of net debt to 40 percent of GDP in the next seven years. The authorities wish to thank the Fund for its assistance in the preparation of this law.

Investment Activity

The Panama Canal expansion project estimated at US$5.25 billion, including contingencies of over US$1.5 billion, was initiated in September 2007. To May 2008, a total of US$286 million in excavation and dredging contracts have been awarded. Expenditures have remained below budget in spite of increased world construction costs. Additional savings are expected from lower interest costs for future borrowed funds when compared to initial calculations. The construction of the new set of locks, estimated at over US$2 billion, will be bidded by end-2008. Multilateral banks most likely will participate in the financing of the expansion, but the Panama Canal Authority (ACP) will continue to use its own resources. On the revenue side, ACP expects a 30 percent increase in FY ending September 2008. Already at the end of the second quarter (March 2008), revenues were up 19.3 percent relative to the same period of the previous fiscal year as a result of the July 2007 tariff adjustment, of increases in containerized cargo, and of a surge in cruise ships and dry-bulk vessels crossing the canal. A new tariff adjustment was approved in May 2008. A decline of 6.2 percent in ships crossing is expected in FY2009, the US being the main client of the Canal. ACP's annual dividend to the Republic of Panama for FY2008 is projected to reach US$660 million.

Public and private investments surged again in 2007. Major public projects in execution include: the Panama-Colon four-lane highway (US$215 million); the Bay of Panama project including sewage and drainage (US$360 million); the expansion of Balboa Avenue (US$190 million) to be completed early-2009; and the on-going expansion of Tocumen International Airport (US$95 million). Major private sector projects include investments in port facilities totaling US$770 million. Investments in energy include three projects of the French Suez Energy amounting to US$650 million. The Suez's Cativa project is already in operation, and the Bahia Las Minas and Chiriqui are to come into stream in 2008 and 2009 respectively. Other energy-related projects include the Occidental & Qatar Petroleum oil refinery, an investment of US$8 billion, already in phase 2 and to be concluded in 2014. In addition, Petroterminales (PTP) has initiated the expansion of the existing oil pipeline and new storage facilities with an investment of US$350 million to be concluded in the next four to five years.

The administration is also increasing its investment in technical education to augment the supply of skilled labor for the Canal expansion, the construction and industrial sectors, and the government's major infrastructure projects. The Canal expansion is the recipient of most of the high-skilled welders, heavy equipment operators, mechanics and electricians. International call centers are receiving personnel with English proficiency under the English for Life program. A total of 230,000 have already gone through special training in English and other languages, computer training, tourism, management of small business, farm management and other areas.

Financial Sector

The banking system has remained liquid and untouched by the sub-prime debacle in spite of the large presence of foreign banks. Net profits of the sector increased 20.4 percent supported by an overall credit growth of 25.6 percent. Personal loans – including car loans and mortgages as the strongest performers – remain closely watched by the Superintendency of Banks (SB). Total consolidated assets of the banking sector, as well as domestic and foreign deposits have been increasing rapidly. The average capital adequacy ratio of the sector stood at 14 percent at end-2007 compared to the statutory 8 percent. Return on assets went up to 2.5 percent from 2.3 percent in 2006.

NPLs were down to 1.1 percent end-2007 compared to 1.5 percent at end-2006. On February 2008, a new banking regulation was enacted, which increased SB's independence, strengthened the regulatory and supervisory capacity over financial conglomerates that operate in Panama and in other Central American countries, and facilitated cross border banking supervision.

Trade Agreements

Panama has concluded new trade agreements with Costa Rica, Guatemala, Chile, Nicaragua, and initiated negotiations with Central America and CARICOM. The country is also planning to enter into negotiations with the European Union. The trade agreement with the United States has been concluded and awaits approval by the U.S. Congress.

Mr. Rutayisire submitted the following statement:

We thank staff for its concise set of papers Mr. Nogueira Batista and Mr. Maciá for their informative buff statement.

The Panamanian authorities are to be commended for the strong economic performance registered over the recent years, reflecting the dynamism in services and construction sectors, as well as the buoyant consumption and increasing investments benefiting from enhanced external investors' confidence. On the external side, sustained demand boosted competitiveness. Free trade agreements were concluded with some countries in the region, while negotiations were continuing with some others. As a result of this positive development, real GDP growth rate reached 11.2 percent in 2007, following an average growth rate of 8 percent in 2004-06. Public finances improved well, as was employment. Though the lack of data cast some doubt on any analysis of progress on poverty reduction, the employment improvement, along with the rapid income per capita growth over the recent years, suggests a significant decline of poverty in Panama. However, inflation increased, most of the hike being transmitted by the soaring world food oil and oil prices.

On the Fiscal Policy, we welcome the strong fiscal performance, evidenced by the shift of nonfinancial public sector balance from a deficit of about 5 percent of GDP to a surplus of 3.5 percent of GDP. We note that this performance, associated to the aforementioned rapid growth registered over the recent years, has led to a sharp decline of public debt. In the current context of rising inflation, with increasing pressures on the cost of living, we understand the authorities' reluctance to tighten the fiscal stance. For the medium-term, the authorities' view aimed to project the stabilization of fiscal balance at a small deficit of 0.6 percent of GDP appears realistic, since it took into account the increased capital spending related to Canal project expansion, as well as the need to lower the debt-GDP-ratio below 30 percent of GDP. In this regard, we welcome the approbation of a new fiscal responsibility law, along with the law being prepared, intended to provide a framework for public-private partnerships.

With regard to inflation and financial sector policies, we see merit in the government's measures designed to combat inflation, through reducing income tax on low-income earners, increasing interest mortgage, and broadening the eligibility of subsidized mortgages. Focus on the poorest segment of the population is consistent with the objectives of poverty reduction, as well as the need to fight against income inequality, which remains high in Panama compared to the region and the rest of the world. As regards the banking system, we take good note of the consolidation and merging initiatives underway, which could help increase intermediation in Panama. While we are appreciative of the soundness of the Panamanian banking sector, well preserved from global financial turmoil so far, we agree with the staff on the need to strengthen the supervisory framework of banks at national and regional levels.

Turning to the structural reforms, we welcome the authorities' emphasis on productivity in the agricultural sector and access to financing. By helping boost the agricultural production, this policy of enhancing productivity and facilitating access to financing could be the more appropriate response to any future food crisis. We fully support the ongoing initiatives aiming at strengthening economic ties with neighboring countries in the region, as well as with United States and European Union. In this regard, we urge the authorities to accelerate the pace of the negotiations and finalize the agreements, in particular by finding out the way to remove the existing obstacles, notably with regard to the agreement with the United States. Finally, we join the staff on the need to address the issue of statistic shortcomings, in particular in the social sector, though the data available are broadly adequate for surveillance.

With these remarks, we wish the authorities every success in their endeavors.

Mr. Heath and Mr. Lin submitted the following statement:

Panama's economy has grown impressively in recent years, reflecting sound policies and its pivotal role in regional and global trade. The key challenges for policymakers are to manage overheating pressures and to ensure that fiscal pressures and accelerating credit growth do not undermine the economy's resilience to a deterioration of the external environment. In particular, we caution against complacency that inflationary pressure will dissipate once food and fuel prices stop rising. The evidence of more persistent inflationary pressures is broad and convincing: loosening monetary conditions, booming aggregate demand, increasing core inflation, a record low unemployment level, and a real exchange rate below its estimated equilibrium value. Measures toward greater fiscal discipline and stronger supervision of the financial sector would enhance macroeconomic stability and secure more favorable terms for the economy's sizeable and growing external financing needs.

External Sector / Exchange Rate

The staff's assessment of the exchange rate and external stability provides a valuable input for the overall evaluation of Panama's macroeconomic policies. Dollarization has served Panama well. But with Panama's real exchange rate now below its estimated equilibrium level, domestic demand booming, and inflationary pressures building, macroeconomic stabilization requires tighter fiscal policy.

The documentation of the application of the ERER methodology is helpful. That said, an explanation of why ERER was the only assessment methodology applied formally would also have been appropriate, especially in light of the subsequent qualitative discussion of "appropriate" current account deficits and the international investment position. Would the staff please share its views on this issue?

Financial Sector

The resilience of the banking sector thus far is encouraging. We also welcome the intensified supervisory efforts of the Superintendency of Banks and the authorities' assurances that prudential indicators and lending strategies remain sound, as reinforced in the informative statement by Messrs. Nogueira Batista and Maciá.

Nevertheless, given the rapid growth of credit – especially to the construction sector – we would have appreciated a more thorough assessment by the staff of the underlying risks. How are banks funding this credit expansion, and what risks to bank funding are developing? More generally, what are the staff's views on the evolution of asset quality, capital adequacy, and bank liquidity? Do prudential supervisors have sufficient resources, influence, and independence to contain risks?

Fiscal

We fully endorse the staff's recommendation to tighten fiscal policy and to manage contingent liabilities, carefully to alleviate current inflationary pressures and to create more space for countercyclical policies consistent with the commendable Fiscal Responsibility Law. We understand that rising food and fuel prices have created fiscal pressures, but we agree with the staff that the authorities should target subsidies more effectively to those who are most vulnerable. Given the substantial benefits of tighter fiscal policy, we would like to know where the authorities could find appropriate budgetary savings to offset the effects of such subsidies. Further comment by the staff would be welcome.

Mr. Yamaoka submitted the following statement:

We thank the staff for their informative report, and Mr. Nogueira Batista and Mr. Macia for their helpful statement. We agree with the thrust of the staff appraisals.

High inflation, a positive output gap and a tight labor market are all evidence of the overheating of the Panamanian economy. In particular, in 2007, the growth of the construction sector reached around 20 percent. Under these circumstances, implementing monetary and fiscal tightening to decelerate the growth of domestic demand would be an effective measure to reduce inflationary pressures. Moreover, moderating the credit growth in the construction and real estate sectors would be another policy option.

In this regard, the introduction of universal mortgage subsidization may produce an effect equivalent to introducing mortgage rate cuts, especially if applied to new housing, and this would further stimulate the demand for real estate. Moreover, the government distribution of staple foods, at cost, might also hinder adjustments in the balance of supply and demand. In this regard, we welcome the shared understanding between the authorities and the staff on the necessity of implementing fiscal measures that are well-targeted to the nation's poorest.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Fayolle submitted the following statement:

At the outset, we thank Staff for their interesting set of documents, as well as Mr. Nogueira Batista and Mr. Maciá for their buff statement.

We welcome Panama's remarkable performances over the recent years, with growth reaching in 2007 one of the highest levels in the world, and commend the authorities for having seized this opportunity for consolidating the fiscal position and lowering the public debt. We were particularly pleased to read that, on current trends, debt sustainability is no longer a source of concern.

However, against the backdrop of a slowdown in the US and the global economy as well as high food and oil prices, Panama is facing a deteriorating environment that brings new challenges, especially inflation. We take note that, while Panama was used to a tradition of very low inflation, its recent surge is more pronounced than in other countries in the region.

The acceleration of inflation mainly stems from external shocks. However, as pointed out by Staff, the economy is operating above its potential, fueling overheating pressures. The weak dollar combined with low interest rates are also at the origin of an additional expansionary stimulus. All these factors feed inflationary pressures. In this context, and given the few instruments available in Panama's dollarized economy, we urge the authorities to heed the Staff's advice and to implement a tighter fiscal stance than envisaged to help contain demand and inflationary pressures. We also call for prudence in wages negotiations to avoid triggering an inflationary spiral.

Given that inflation hits the poor the hardest, we strongly encourage the authorities to increase targeted support to the most vulnerable and avoid having inflation reverse the modest recent gains on poverty reduction. We agree with Staff that the authorities may consider raising somewhat the conditional cash transfer program in line with the increase in cost of the consumption basket and widen its coverage to more eligible families. Such a stance is all the more important in the context of Panama's dual economy, where poverty and inequality have remained high despite strong growth over the past years. With regard to poverty updated figures, we look forward to the results of the 2008 LSMS survey.

Having said that, we would welcome further comments from Staff on the following points:

Staff mentions the rapid rise in private sector credit and risks that might undermine households' ability to sustain debt service obligations in the face of high inflation and in the event of an economic slowdown. Could Staff provide us with further details on the composition of credit growth and on their recommendations on this matter?

The impact of high oil prices on inflation was not clear to us. Staff mentions in the report that "energy's contribution to overall inflation, despite the escalation in world fuel prices, is modest as a result of its small weight in the CPI basket" and in the selected issues that "fuel has also been a significant contributor especially when one considers its small weight in the CPI basket." We would be grateful if Staff could clarify the contribution of energy to inflation. We would also be interested in Staff's comments on the level of subsidies in the energy sector and on the pass-through of fuel prices in Panama, in comparison with other countries in the region.

Mrs. Mañalac and Mr. Thompson submitted the following statement:

We thank the staff for a concise but informative set of papers and Messrs. Nogueira Batista and Maciá for their helpful buff statement. We agree with the broad thrust of the staff's analysis and recommendations, and wish to add the following points mainly for emphasis.

We commend the Panamanian authorities on the enviable macroeconomic performance they have overseen in recent years. However, we note a more challenging environment that the authorities are now facing. While the slowdown in the US and the global economy is beginning to weaken output growth, albeit only modestly and from a high level, the substantial rises in the global prices of food and commodities has resulted in a sharp pick-up in inflation to nearly 10 per cent in mid 2008, following a remarkable average of just 1½ per cent in the past two decades.

The strong growth in recent years has been associated with a decline in the unemployment rate to an historic low and capacity constraints are increasingly evident. Notwithstanding the usual statistical uncertainties, the staff's estimates point to a positive output gap in 2007, remaining positive but declining over the next few years. Wages growth has picked up after having been subdued for a number of years and the exchange rate is relatively weak. In this environment, we would join the staff in emphasizing the substantial risks of inflation becoming unanchored. The authorities, however, appear to be somewhat more relaxed about this.

While it is true that much of the pick up in headline inflation has been imported and that global food and fuel prices are expected to level out after 2008, core inflation has also picked up noticeably in the past year and the risks of second-round effects feeding through to higher inflation appear paramount. To better appreciate these risks, we would have welcomed a comment on what is happening with inflation expectations, though this may not be possible due to a lack of data. We were also interested in the staff's observation that wage contracts and transfer payments in Panama are geared to a low inflation environment. We welcome the staff's views on what this means for second-round effects, noting that wages growth had already started to pick up in 2006 (latest available data). More generally, we are interested in a closer examination of the relationship between the output gap and inflation in Panama as this appears to be a major factor underlining inflation risks.

With the decline in US interest rates and weaker US dollar creating more accommodative monetary conditions in Panama, the burden falls on fiscal policy to prevent the economy from overheating. Despite this, the authorities budgeted for a positive fiscal impulse in 2008, with the fiscal surplus projected to be noticeably lower in 2008 than in 2007. Given the inflation risks, we urge the authorities to take heed of the staff's recommendations to implement a tighter fiscal stance.

On the financial side, we are reassured that the banking system is in good shape and has been largely unaffected by the global financial turmoil. We note the increasing share of foreign-owned banks in the domestic banking system as a result of recent mergers. We agree with staff that this gives rise to additional supervisory challenges and underscores the importance of effective cross-border supervisory arrangements. Stronger international financial linkages can bring many benefits, but also increase the risks of offshore financial turbulence being transmitted to the domestic banking system.

Finally, we note that Panama's poverty rate and degree of income inequality is high compared to the region, which we think underscores the staff's recommendation to the authorities to introduce measures to help protect the poorest segment of the population in this period of higher inflation. We note from Messrs. Nogueira Batista and Maciá's buff statement that the Panamanian authorities have been acting on this front.

With these comments, we wish the authorities well in their future endeavors.

Mr. Silva-Ruete and Mr. Luque Gianella submitted the following statement:

We thank the staff for a comprehensive report and Mr. Nogueira Batista and Mr. Macia for their informative buff statement.

We commend the authorities for the strong and sustained performance of their economy. Panama grew 11.2 percent in 2007, one of the fastest growing economies in the world, and it is expected to grow around 8 percent in 2008-09. This growth process is broad-based, but the dynamics of the construction sector, transportation and financial services play a big role in explaining most of the growth dynamics. Nevertheless, rising inflation is a concern. Prices have risen in accordance with international developments, but at the same time, some demand pressures are arising. It is important to note that in the case of Panama, fiscal policy is their only macroeconomic instrument to fight inflation.

Nevertheless, the medium-term outlook is very favorable for Panama. The expansion of the Panama Canal is going to be one of the drivers of the Panamanian economy in future years, but clearly not the only one, for example, the financial sector is consolidating. Additionally, improvements in the business climate guarantee progress in their aggregate productivity and future growth. Furthermore, the approval of a new Fiscal Responsibility Law and of plans to enact a Public Private Partnership Law show the commitment of the Panamanian authorities to the structural reform agenda. This is an extra element that guarantees future growth.

Financial system growth remains strong in Panama. Recent mergers and consolidation have boosted foreign ownership of the banking system. Furthermore, Panama is consolidating itself as the financial center in the region and, therefore, benefiting growth in the area. Nevertheless, as mentioned by the staff, given the rapid rise in the private sector debt, middle- and lower-income households' ability to sustain debt service could be undermined if there were a significant slow down in the economy, threatening the stability of the financial sector. Nevertheless, it is reported that the exposure to bad credits has been minimal so far, despite the international financial turmoil. We commend the authorities for recently enacting a banking law that strengthens the supervisory framework.

The expansion of the Panama canal is going to be a major driver of the future evolution of the economy. There does not seem to be pressures on the cost side after international price hikes, given that the rise in certain inputs have been compensated by changes in financial conditions. However, it is expected that the construction of this massive infrastructure would add up to the current demand pressures, possibly generating bottlenecks in the economy. We would like the staff to comment on future inflation pressures coming from the

Canal expansion project and how the authorities are planning to deal with possible bottlenecks.

Panama's inflation in a context of a dollarized economy certainly creates additional challenges for the authorities. We agree with the staff that a higher surplus may reduce inflationary pressures, but we also understand the local authorities' assertion that imported inflation may be the main driver in the raise in inflation. We would like the staff to comment on the dimension of a possible pass-through from imported inflation to headline inflation, in the context of a fairly open economy, such as Panama, and on the evolution of inflation expectations.

Furthermore, we note the authorities' efforts to protect the poor from the rise in international food and oil prices. An Assistance Program to Consumers (PAC) is now underway, acting in different directions. Nevertheless, these measures will carry a fiscal cost. We would like the staff to comment of the expected fiscal costs of these measures and if they could have an impact on inflation.

Nonetheless, the fiscal performance of Panama was strong in 2007, although a decline is projected in 2008. Again, it is important to emphasize the role of fiscal policy as the only way to fight inflation, especially in the context of a positive output gap.

With these brief comments, we wish the Panamanian authorities continued success.

Mr. Sadun and Mr. Cardoso submitted the following statement:

We thank the staff for their detailed report and Messrs. Nogueira Batista and Mr. Maciá for his awaited and helpful buff statement.

Panama is to be commended for the impressive growth and declining unemployment, boosted by a strengthened external competitiveness, very much motivated by the depreciation of the U.S. dollar. The rapid expansion of services (tourism, communications, and transportation), as well as non-traditional agricultural products has strengthened Panama's economy. However, the external current account deficit has widen and is projected to continue to deteriorate, reflecting surging imports associated with strong domestic demand and higher commodity prices.

The higher commodity prices, the loosened monetary conditions, and the positive output gap have together been fueling inflation, which reached 8.8 percent (y/y) last May, from 2.2 percent in 2006. Additionally, the tight labor market has been putting pressure on wages. To cope with this situation, in the framework of official dollarization, a tight fiscal policy is essential. Therefore, we urge the authorities to adopt a countercyclical fiscal stance in order to help contain demand pressures and to avoid a disruptive wage policy that could undermine competitiveness and business confidence. We note that a new Fiscal Responsibility Law (FRL) was approved by the National Assembly in early May, and we would appreciate staff's elaboration on the absence of specific rules on transfers to the budget from the Panama Canal Authority (PCA).

We welcome the fact that the expansion of the Canal is progressing, and that despite a significant increase in the cost of some inputs, the project is still within budget. We advise close monitoring during all phases of the expansion of the Canal, given its current and expected significant impact on Panama's economy.

We are pleased to note that Panamanian banks do not appear to have been affected by the global financial turmoil and that increased scrutiny by the Superintendency of Banks has not uncovered bad assets. Nevertheless, close monitoring is advisable on the rapid rise in private-sector debt and to the middle- and lower-income households' ability to sustain debt service obligations.

Panama formalized on July 22, 2008 its status as a full member of the Andean Development Corporation—Corporación Andina de Fomento (CAF)—a multilateral financial agency with the task of assisting economic development in the Andean region of South America. Although a very recent fact, we would appreciate if staff could elaborate on this issue.

Mrs. Sucharitakul and Ms. Matoto submitted the following statement:

We thank the staff for the comprehensive reports and Messrs Nogueira Batista and Macia for their informative buff statement.

The outturn on the growth performance of Panama was remarkable despite the weakening global environment. Growth remains robust, underpinned by strong domestic and external demand for housing and infrastructure. The fiscal position has strengthened and unemployment declined substantially, while the well-developed financial center continues to attract significant new investments. In spite of the strong economic performance, like elsewhere, the economy faces near-term challenges from surging inflation driven by escalating international food and energy prices. Going forward, growth is likely to moderate, reflecting the slowdown in the US and the global economy making the priorities of bringing down inflation against a slowing growth momentum all the more challenging.

External Stability

We note that current account deficit widened in 2007, reflecting strong domestic demand and increases in FDI. In the medium term, the current account deficit is projected to continue widening due to the Canal expansion, however, the deficit is expected to stabilize at about 6 percent of GDP and would be financed by FDI and external borrowing. The deficit on current account is projected to revert to the normal average of 5 percent of GDP when the Canal project is completed. Therefore, we broadly agree with staff that external stability is not a major concern.

Dealing with Inflation

We note staff's recommendation to tighten fiscal policy to deal with inflation. The selected issues paper showed that fuel and food price inflation account for more than 50 percent of overall inflation in May 2008. At the same time, core inflation, excluding food and fuel is also rising. This reflects the tight labor market due to the positive output gap. In the light of the above, we support the staff's recommendation to tighten fiscal policy to anchor inflationary expectations. There appears to be some disagreement between staff and authorities over the fiscal target and we wonder if this reflects the underlying disagreement over the direction of fiscal stance. Staff comments would be welcome.

We welcome the targeted measures that the authorities have implemented to help the poor. The authorities have also noted the pressures for further spending to provide a cushion against rising inflation. Thus, the authorities' reservation about tightening fiscal policy is understandable. This reflects the dilemma faced by policymakers around the world – the need to tighten fiscal policy but fiscal measures to help the poor would put pressure on the fiscal balance.

The authorities are rightly committed to improve fiscal consolidation through increased revenue collection and contained discretionary spending, together with improved structural reforms to achieve a fiscal surplus of 3.5 percent of GDP and to significantly reduce the level of public debt. The authorities' efforts to maintain the Canal expansion project within the budget despite the increase in costs is reassuring. Looking ahead, the fiscal surplus is projected to narrow, reflecting the expected decline in transfers from the PCA and a further increase in capital expenditure. The new Fiscal Responsibility Law (FRL) would help to strengthen the fiscal framework and enhance fiscal credibility. However, we note the disagreement between staff and authorities over the setting of the fiscal transfer rule, authorities have explained that PCA is an autonomous company with well-defined objectives and firm commitments on the size of transfer to the government. Could staff elaborate on what these commitments are and whether these are quantitative targets that can be greed upon and are they sufficient to address staff concern about the absence of specific transfer rules?

Financial Sector

We commend the authorities for the recent mergers and consolidation in the financial sector within the region to increase efficiency and lower costs in spite of more challenges for bank supervision. The recently approved bank law would help to strengthen the national supervisory framework and enforce regional supervisory provisions. The financial system has not been affected by the global financial turmoil and banks' deposits continue to increase while the capital adequacy remains strong. Rather, the challenge seems to come from the domestic developments with strong credit growth and accommodative monetary conditions which may fuel further inflation and lead to excessive borrowing in certain sectors. An economic slowdown may put the balance sheet of middle and low-income households under strain, impacting their debt servicing ability. As such, like staff, we urge the authorities to monitor these developments closely.

With these remarks, we wish the authorities success in their future endeavors.

Mr. Nogueira Batista made the following statement:

Our authorities appreciated the candid and straightforward discussions that took place during the Article IV mission. There was a constructive dialogue on policies and their implementation on key issues such as government finance, pro-poor spending, fiscal prudence in the face of the upcoming presidential elections, which will take place in May 2009, and also a continued targeting of government capital expenditure and social policies. Our authorities are also pleased with the presentation of their points of view on policy discussions in the staff report: this was done with clarity and precision.

We thank Board members for their comments on Panama's performance. The advice and recommendations detailed in your statements will be transmitted to our authorities in Panama for their consideration.

We note your support on the following issues: fiscal performance and improved government finances; the measures to offset inflationary pressures to reduce income inequalities and to enhance the purchasing power of the low- and middle-income population; and, the steps taken to improve agricultural productivity and credit availability to the agricultural sector. Directors also welcomed the increased supervisory efforts in the banking sector, as well as the adoption of the law that enhances regional supervision.

But we also take note of the words of caution by Directors concerning the following issues: inflation pressures and the need to tighten the fiscal stance, and to remain watchful for possible second-round effects from external shocks; and, the need to remain vigilant on credit growth and its impact on domestic demand. There was also concern on the possible strain on the debt-servicing capacity of households. We can assure Directors that the Superintendency of Banks will remain attentive to these concerns. The authorities continue to improve the targeting of pro-poor spending and subsidies to enhance the efficiency and the use of resources.

I would like to share with you new information that has recently come to our attention. Last Wednesday, Panama became a member of the Andean Development Corporation (CAF). CAF has offered Panama up to $500 million for financing the Panama Canal expansion, and will open a regional office in Panama before the end of the year. Panama is also in conversations with multilateral international institutions with regard to the financing of the Canal expansion project, and CAF's financing offering adds to international creditors' confidence in Panama.

Mr. Itam made the following statement:

We thank the staff for the informative paper, and Mr. Nogueira Batista and Mr. Macia for their insightful buff statement.

We note that economic activity in Panama has remained robust despite slowing global growth and rising inflationary pressure. We note that the Panamanian authorities have maintained prudent fiscal policy over the past years, with a fiscal balance improving gradually from a deficit of about 5 percent of GDP in early 2000 to a significant surplus in 2007. We commend the authorities for the measures taken to contain expenditures, including a reduction in the size of the civil service, improvement in tax administration, and Social Security reforms.

The authorities' determination to continue maintaining a healthy fiscal balance amid pressures to increase spending, including spending to provide a cushion against a higher cost of living, is commendable. We note that the current expenditure pattern does not seem to be a cause of concern for inflation. As stated in Mr. Nogueira Batista and Mr. Maciá's buff, we also support the authorities' initiatives under the PAC program to ease the impact of inflation, especially high food prices, on the poorest segments of society. We emphasize that measures to assist the poor should be well-targeted and cost-effective.

The Panamanian authorities have continued to maintain a healthy, dynamic, and well-supervised financial sector. Efforts to consolidate and integrate the banking system with the other banks in the region in order to increase its efficiency and lower transaction costs are in the right direction. However, we caution that such a consolidation, despite the benefits, would likely pose challenges and introduce additional responsibilities to the supervisory authorities. In this regard, we urge the authorities to take measures to further consolidate supervisory oversight and cooperation through signing Memoranda of Understanding with the relevant authorities in the region.

On structural reforms, we welcome the authorities' plan to liberalize trade and increase incentives in the agricultural sector as necessary measures to enhance competitiveness and sustainability in this sector. In this regard, we urge the authorities to improve access to financing, insurance, and technical assistance to help increase agricultural production over the medium term.

With these comments, we once again commend the Panamanian authorities for their prudent macroeconomic management, and extend our best wishes for success in their efforts.

The staff representative from the Western Hemisphere Department (Ms. Gold), in response to questions and comments from Executive Directors, made the following statement:

CPI inflation through the month of June was 9.6 percent, up from 8.6 percent in May, mainly driven by food and fuel prices. The monthly index of economic activity shows that the economy is slowing down somewhat more than we had anticipated, and we now project growth in 2008 to be between 7 percent and 8 percent; we were originally projecting 8.3 percent.

As you will have read in Mr. Nogueira Batista's buff, the government has recently introduced additional measures to those described in the staff report to help the most vulnerable groups in society. It has increased the Direct Transfer Program from U.S.$35 to U.S.$50 a month, and it has announced an annual bonus payment of U.S.$60 to individuals living on Social Security. Those are the updates. I would now like to take up some of the questions raised by Directors.

There were a number of questions on the financial market: whether the staff could provide some more evidence of the strong position of the banks; questions about the funding for credit growth; and, questions on the adequacy of the supervision of banks.

Essentially, the staff has been very closely monitoring the financial sector in Panama, given the turbulence in the international financial markets and given Panama's role as a regional financial center. We were happy to learn that it had not been particularly adversely affected by these developments, and we continue to monitor it very closely.

Credit growth has been fueled by very healthy domestic deposit growth due to the higher income, and from inflows from neighboring countries because of Panama's reputation as a very solid and stable financial center.

Deposits have continued to grow despite developments in the U.S., and, at the end of May, liquid assets and marketable securities were 41 percent of total deposits, far exceeding the prudential requirement of 30 percent in Panama.

Bank supervision is considered very strong: the strongest in region. A new Banking Law was enacted in May which was drafted with the assistance of MCM. It will become effective in August and it will provide for additional independence of bank inspectors, and also allows for additional resources for the bank superintendency.

With regard to the composition of credit growth by sector, the two sectors that are leading in terms of credit growth are construction and industry. Both of these sectors have growth of about 35-40 percent through the end of May, but the share of these sectors is actually very modest in relation to total outstanding credit. Total outstanding credit of these sectors is only about 7 and 5 percent respectively.

We were somewhat concerned about the rapid growth of consumption; in particular, the very strong growth for car financing, for example. But this in recent months, growth in this sector has somewhat moderated and at the end of May it increased only 13 ½ percent. I guess the evidence of a slowdown is starting to affect personal credit growth.

There was a question about why the staff did not use alternative methodologies to value the appropriateness of the exchange rate. The approach the staff adopted was quite pragmatic. Our initial analysis using the ERER methodology suggested that the rate was only modestly undervalued, but given inflation developments with the United States, this undervaluation has been declining significantly over the past few months, because inflation in Panama is much faster than the U.S. So, we were not particularly concerned in that regard.

The other analysis also suggests that the expansion in the current account is of a temporary nature. "Temporary" here has to be taken as meaning a time span of several years: in a sense, during the time of the Canal expansion and the other large investments that are taking place in Panama. But over the longer term, we see the current account returning back to its historical norm. Developments in the net International Investment Position suggests that it is very stable and does not suggest that there is a reason for concern.

There were several questions on fiscal policy and the discussions between the authorities and the staff in this area. I would not characterize the differences we had as disagreements, per se, but rather as questions of emphasis. The staff wanted to be somewhat more cautious, taking account of the high domestic demand and the above-potential growth. We are thus advising the authorities to have a somewhat stronger fiscal stance. The authorities generally agree with the staff, but were also cautious in committing to a tighter fiscal stance in light of the additional spending pressures to assist the public with the higher cost of living, address very poor infrastructure, and the need to increase spending for the poor. So, there was a bit of a difference of views on how effective a stronger fiscal stance would be in combating inflation, with the authorities' view being that it would be less effective given that the majority of initial inflationary pressures were being imported.

There was a question on the magnitude of the costs of the additional programs to protect consumers. It is a difficult question to answer because they are not all directly being financed through the government, per se. In Mr. Nogueira Batista's buff, there is the number of $40 million, and I believe that is the direct costs related to the adjustment in the income tax brackets and the additional spending on Red de Oportunidades. For example, the mortgage subsidy is not being financed through the government; it is cross-subsidized through a higher cost of lending. Some of the measures in the agricultural area as well are being cross-subsidized throughout the program. So, it is a very difficult area in which to give a number, per se, but we estimate that even a multiple of the $40 million would still be quite a modest increase in the fiscal deficit, and could easily be absorbed by offsetting actions in other areas.

We were asked to give proposals as to how additional fiscal cost could be offset. I would say that we mostly emphasized a more moderate increase in capital spending. The increase in capital spending over the last few years has been very rapid. Total capital spending in nominal terms has essentially doubled over the last three years. So, there is quite a bit of room to moderate that pace of spending, and it would also help in terms of making sure the resources are being effectively used, because that type of an increase is very difficult to efficiently manage.

There was a question on the Canal transfers, and why the staff was concerned about these transfers reducing the effectiveness of the new Fiscal Responsibility Law. The issue is one that, at some future point, governments could exert political pressures pressure on the Canal Authority, which is an autonomous and independent body, to increase transfers to the government and, thus, circumventing the discipline that the new Fiscal Responsibility Law is intending to bring. The authorities consider this risk very low, but it is, nevertheless, a concern down the road.

Finally, there were a number of questions on inflation and the energy subsidy. Essentially, as noted in the staff report, a large part of inflation is imported, but the fact that growth is so strong and above potential is exerting pressure through the labor market, through some increase in wages. I am happy to take more questions bilaterally.

I would finally add on energy that the pass-through on energy or the high fuel costs are nearly a hundred percent at the pump except for a subsidy for diesel for public transportation, and only in the city of Panama and Colón. So, that is a pretty full pass-through.

On electricity, it is more complicated. There is some subsidization of consumers who use below 500 kilowatts per hour monthly amounts, but even those consumers have their prices adjusted because there is a fuel clause that adjusts it monthly with a two-month delay. So while there is some subsidization, it is contained. The cost of that subsidy is partly compensated by dividend payments by the government-owned generating and distribution companies.

I do have to make one correction that was brought to our attention by Mr. Nogueira Batista. In the selected issues paper, on page 3, we chart the average economic growth of Panama relative to selected Latin American countries and we have a statement saying that it was one of the highest, except for Chile. I think when we added the 2007 number, it overtook Chile as well. So, between 1999 and 2007, Panama had registered the highest annual growth in Latin America. We will correct the text.

Mr. Nogueira Batista made the following concluding statement:

We reissued our buff statement to make a factual correction. The Trade Promotion Agreement with the United States has not yet been ratified by the U.S. Congress, but has already been ratified by the legislative power in Panama.

I would like to thank the staff again for their very interesting and informative work, and Ms. Judith Gold for her replies to questions posed by Directors today.

Panama is a country that alternates streamlined consultations with full Article IV consultations. This year’s full Article IV is an example of why our chair has shown no sympathy for streamlining. I think that the lesson that would have been provided to the Board for today’s discussion would be clearly insufficient.

I would like to say a few words on the macroeconomic situation in Panama, adding some considerations to what we wrote in our buff statement. Maybe we should have included some of this in the buff statement, but I had no time to do it, so I would ask for your patience to listen to some final words which we felt we needed to add.

What is happening in Panama in 2008 is, to some extent, typical of what is happening in Latin America and in the rest of the developing world. The food and fuel price shock hit the economy at a time of rapid domestic expansion, heightening inflation risks.

Given the larger weight of food items in the CPI, inflation is rising faster than in developed countries. An acceleration of inflation led by food prices has a stronger impact on the real wages of the poor, leading to increases in poverty and to income concentration. This is the common pattern which Panama shares.

In Panama, we find the same discussion between the staff and the authorities about the relative importance of external shocks and demand pressures that we have found in other countries of our constituency that have come to the Board recently: Brazil and Suriname for instance.

I would like to mention that some of the indicators that the staff has used in Panama as well as in other countries, even in the U.S. for instance, to gauge the existence or not of significant demand pressures or the stance of monetary policy have been presented to the Board in a very cursory manner. I even mentioned that in the Article IV discussion for the U.S. on some points.

I would suggest that, for instance, data on core inflation or on indices of nontraded products be presented in more detail since these can be quite decisive in assessing the relative importance of demand vis-à-vis external shocks. And may I say that I am also surprised to see that an issue as important as unemployment is covered by only two sentences in the entire staff report and selected issues papers.

Panama has several specificities, one of them being the fact that it is a dollarized economy. Allow me to draw your attention to some of the implications of this fact for economic policy in 2008. As the staff notes, the decline in U.S. policy rates and the weaker U.S. dollar have led to an easing of liquidity conditions in Panama.

Interest rates seem to be negative in real terms, and there has been a substantial depreciation of the real effective exchange rate for Panama in recent years, something that, according to the staff, has contributed to the increase in inflation.

Note that the U.S. accounts for 30 percent of Panama's foreign trade in goods, so changes in the value of the dollar vis-à-vis third currencies may have a larger effect on Panama's effective exchange rate. This is the automatic result of what is going on in the U.S. and of the Federal Reserve's decisions. So, it is somewhat ironic to see the U.S. chair caution against complacency with inflation, and point to loosening monetary conditions in Panama as one evidence of inflation risks.

Panama has no independent monetary or exchange rate policy and is now faced with the following situation: the country that issues the currency used in Panama has decided, for its own legitimate national reasons, that it needs a loose monetary policy; negative real policy rates, including when compared to core inflation, as we saw in the recent U.S. Article IV consultation. The U.S. also seems to welcome the resulting dollar depreciation as a way of stimulating the economy of this country through net exports and of adjusting the U.S. imbalance on the current account.

Panama seems to be in the exact opposite position. If the staff's assessment is correct, domestic demand needs to be contained and monetary conditions would ideally need to be tighter. Some effective exchange rate appreciation would help alleviate inflationary pressures, but this does not depend on decisions taken in Panama.

The problem here is the existence of stark divergences between the economic and financial situation of the U.S. and of a country that uses the U.S. dollar as its currency. In the U.S. there is a weak financial system and a risk of recession. In Panama we have a sound financial system, according to the staff, and a rapidly expanding economy, indeed one of the fastest growing economies in the world and the fastest growing economy in Latin America.

Moreover, the food and fuel price shocks have asymmetric effects on consumer price indices in the U.S. and in Panama, also contributing to the pressure for different policy responses. As one of the selected issues papers informs us, the weight of food in the CPI in Panama is 32 percent, more than double the 15 percent weight in the U.S. CPI. Fuel and other transport-related items account for 13 percent of the index in Panama, and only 5 percent in the U.S.

So, there would be more than one reason for Panama to respond differently, but the response cannot be different in terms of monetary and exchange rate policies. What could be done? One possibility not mentioned by the staff would be to tighten controls over credit, for instance by increasing the reserve requirements of banks, possibly on a selective basis. I wonder why the staff did not mention this; I did not have time to talk to Ms. Gold about this before. The staff instead offers its standard prescription of fiscal tightening. The authorities were not convinced. I wonder if the staff could be more creative and varied when it brings policy advice to member countries, even countries that do not have their own national currency. In almost all cases, I notice fiscal tightening is prescribed. As we all know, the fiscal instrument compared to the monetary one is relatively slow and subject to stronger political constraints.

In the case of Panama, short-term fiscal tightening of as much as 1.5 to 2 percent of GDP is being recommended to a country that is registering very strong fiscal indicators, as you can see in the detailed information provided on this point in the staff report.

The large swing in Panama's fiscal accounts since 2004 is mostly structural, not cyclical or temporary according to the staff: a point that we would like to see highlighted in the PIN. The structural component has been much more important than the swing—and I refer to the swing mentioned by Mr. Itam in his oral intervention— since 2004.

We must agree that it is not easy to persuade a country that exhibits such strong fiscal performance that a further adjustment is recommended in the short run. This is especially so given that the government had to take a series of measures and initiate programs to mitigate the effects of the food and fuel crisis on the poor. We described these measures in our buff; the staff also commented on them. Most of them will have fiscal implications, but the government had to act. The staff has recognized that additional measures are needed to protect the poor.

The report mentions that the government could consider raising the conditional Cash Transfer Program, something that has begun to be done in the meantime as we just heard from Ms. Gold. This increase could be in line with the increase in the costs of basic consumption, and there could also be a widening of coverage according to the staff. Let me note that Brazil has a very similar transfer program. The government has just done what you recommend, as we saw in the recent Article IV consultation for Brazil. Panama is a country where poverty is still a serious problem, although there has been major improvement in recent years. Income concentration is also very high, even when compared to the rest of Latin America, as can be seen in Table 13 of the staff report.

Finally, the government needs to continue with its investment program, which we described in our buff. Please note that the

> improvement in Panama's fiscal indicators has been occurring together with a sustained expansion in its central Public Investment Programs. Table 2 of the staff report shows that nonfinancial public sector savings, including the Panama Canal Authority, increased from 0.3 percent of GDP in 2004 to as much as 9 percent of GDP last year, according to preliminary figures.

The Acting Chair (Mr. Portugal) noted Mr. Nogueira Batista's observation that Panama's economic condition differed to that of the U.S., and reiterated that—in the absence of an independent monetary policy—fiscal policy was an especially important tool for policymakers in Panama.

The staff representative from the Western Hemisphere Department (Ms. Gold) noted Mr. Nogueira Batista's suggestion that the authorities might consider the possibility of raising banks' reserve requirements, but observed that banks already had a significant amount of liquidity, with reserves of 40 percent of liabilities, exceeding the prudential requirement of 30 percent. Further, it suggested that further tightening of reserve requirements could be viewed as draconian and interfere with banks' capacity to take their own policy decisions. Though the staff had discussed this option internally, it was decided not to include it in the staff report; given constraints on length and the fact that the staff did not considered this policy to be appropriate.

The Acting Chair (Mr. Portugal) elaborated that, in addition to the currency peg with the U.S., Panama was an international financial center; the financial sector therefore played a very important role in the Panamanian economy.

The Acting Chair (Mr. Portugal) made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They commended Panama's remarkable growth performance and improved public finances. Despite a deteriorating external environment, economic prospects are favorable, thanks to the Canal expansion project and associated investment, as well as improvements in competitiveness reflected in expanding export services such as tourism, communications, and transportation. While the current account deficit is expected to widen over the medium term, this should not undermine Panama's external stability, given the temporary nature of some of the factors.
>
> Directors commended the authorities for the strengthening of the public finances, noting the remarkable turnaround in the

nonfinancial public sector balance excluding the Panama Canal Authority, notwithstanding a significant increase in capital expenditures. The strong fiscal performance and rapid economic growth has led to a falling public debt ratio and an improvement in Panama's credit ratings.

At the same time, Directors pointed out that managing the sharp rise in inflation, which is due mainly to the higher global food and fuel prices, and the apparent overheating of the economy will be particularly challenging and will put a greater burden on fiscal policy to pursue a countercyclical stance. They encouraged the authorities to pursue such a stance, pointing to the continued positive output gap, inflationary pressures, and an additional expansionary stimulus from the weak dollar and low interest rates. This could be done by targeting a larger surplus, and a few Directors suggested to achieve this through a moderation of capital spending. It would also be important to provide some additional room to expand programs to support the poor.

Directors welcomed the recent measures to ease the impact of inflation on less advantaged income groups, and called for additional measures targeted to help the most vulnerable members of society. Directors noted that the extension of the mortgage subsidy could further stimulate the already booming construction sector.

Directors welcomed the enactment of a new Fiscal Responsibility Law (FRL) and the preparation of a strengthened legal framework for public private partnerships (PPPs). They noted that the new FRL should help safeguard the improvements in public finances and maintain the debt-to-GDP ratio on its downward trajectory. They noted in this regard the staff's recommendation to set clear rules to govern transfers from the PCA to reduce the risks of circumventing the new FRL deficit limits.

Directors observed that Panama's financial market has not been adversely affected by the global financial turmoil, and commended the authorities for stepping up the monitoring of banks' asset quality, liquidity, and risk management. They noted that capital adequacy and financial ratios remain strong and that the dynamic financial sector is expanding rapidly, reflecting foreign investment, consolidation, and regional integration. Directors welcomed the enactment of the new Bank Law, which will strengthen the national supervisory framework and should help enforce regional supervisory provisions. Nevertheless, Directors stressed the need for vigilance, in light of the easing monetary conditions against the background of a rapidly growing economy, a booming housing market, and volatile global financial markets.

Directors commended the authorities' plans to reduce trade protection and increase incentives in the agricultural sector. They noted that although imports and distribution by the government of staple food items may have reduced price pressures, removing distortions and strengthening legal means to address unfair competition would provide a better and more lasting remedy. Reducing tariffs and increasing tariff rate quotas for selected food items is a welcome step to enhance competitiveness and moderate inflation. Directors also observed that steps to enhance productivity in the agricultural sector, including improved access to financing, insurance, and technical assistance, will help increase agricultural production over the medium term and will strengthen food security.

It is expected that the next Article IV consultation will be held on the standard 12-month cycle.

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Secretary