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Panama Economics and Strategy

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The risk of fiscal mirage

- **Risk off has allowed for some relative risk compression, but we remain wary of fiscal fundamentals**
- **Hefty costs could arise from extending the conflict with FQM**
- **Uncertainty on the genuineness of fiscal consolidation**
- **Fiscal challenges seem exacerbated by upcoming electoral process**

Demand for Panama bonds has been higher relative to our expectations, which has motivated a 14bps reduction in relative spreads (vs EMBIG) MTD. We think this has been **mostly driven by global risk-off** as markets reassess expectations on international interest rates, fuelling appetite for high-rated notes. In this regard, even if we believe that a slow-motion de-rating process is in progress, Panama remains an IG credit. This feature probably explains Panama's overperformance in periods of unsupportive global factors. Nonetheless, the latter does not hide the fact that fiscal fundamentals seem fragile. Royalties from copper mining will become of the utmost importance in terms of shaping the path of fiscal revenues. Yet negotiations with First Quantum Minerals (FQM), the Canadian company that owns a majority stake in *Cobre Panamá*, have stagnated. *Cobre Panamá* is one of the 20 largest copper mines in the world by production capacity (+300k tonnes per year), and whose proven and probable reserves amount to 3.0bn tonnes of the mineral. Discussions with FQM about a new concessional contract have repeatedly failed and they reached a critical juncture last week when the company was indirectly forced to stop its production processes. On a different note, even if the government managed to meet the fiscal deficit ceiling for 2022 (albeit by a small margin), this was not publicly hailed, probably due to the controversial way in which this was attained.

Hefty costs could arise from extending the conflict with FQM. The announcement by *Minera Panamá* last 23 February of the need to suspend its operations in the pit *Cobre Panamá* constitutes, evidently, a significant defeat for both parties in the negotiation. Obviously, however, the social, political, and economic costs of a prolonged dispute for the country could be much larger. Since starting commercial production in 2019, the company's interlinkages with the rest of productive activities as well as its relevance for external accounts have grown significantly. The weight of the mining sector in real GDP jumped from just 1.8% in 2018, to 7.1% in 2021. Copper exports amounted to USD2.2bn in the January-September 2022 period, representing 76.8% of external sales. More critically, Panama's structural current account deficit dropped from an average of 7.1% of GDP between 2015 and 2019, to 3.0% of GDP in 2021, and only 0.7% in 1H22. A protracted standstill of the pit would have important short-term economic consequences, not to mention the negative impact on FDI over the long term. In the context of incomplete information about the specific reasons that have caused the failure of negotiations, the government will face a hard time avoiding the political cost of the situation.

Uncertainty on the genuineness of fiscal consolidation. The way in which the Panamanian government has met the fiscal goals in the last two years is to a certain degree controversial based on the implicit need to introduce last minute freezes in discretionary spending (2021) and the dependence on changes to GDP estimates (2022). In part, the lack of convincing fiscal results is accentuated by issues related to the accounting system in place (cash-

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basis accounting), with a migration to newer and more appropriate fiscal methodologies (accrual-basis accounting), in line with IMF recommendations, still pending. Furthermore, a history of hidden arrears, the repeated use of escape clauses, and amendments to the fiscal rule (before the pandemic) have reduced our confidence in the overall fiscal framework and the credibility of public authorities. As we discuss below, recent developments do not do much to ease concerns on the actual scope of the fiscal overhaul.

Authorities manage to meet fiscal targets on paper. Macrofiscal figures released last week revealed that the non-financial public sector (NFPS) closed the year with a deficit of 3.9% of GDP, just a tad below the 4% ceiling established by the Fiscal and Social Responsibility Law (FSRL). The outcome constitutes an improvement from the 6.5% of GDP deficit recorded in 2021, on the back of a combination of strong revenues and limited spending growth on a cash basis. Note, however, that if the National Statistics Institute (INE) had not published upwardly revised GDP figures in early February, national authorities would have breached the deficit limit. It is interesting to recall that in 2021 the fiscal target was also met at the last minute, by implementing a freeze in capital expenditures during the last month of the year (see Panama Economics and Strategy, A swallow that does not make summer, 25 February).

Revenues bounce back but recovery is still halfway. The strong economic expansion observed in 2022, which the government estimated at a surprising 10.5% in real terms, bolstered a fast increase of 13.8% in total non-financial public sector's revenues. This positive performance was also favoured by several strategies put in place by policymakers to incentivise payments of pending tax debts, especially a flexibilisation of terms to normalise the situation of many taxpayers after COVID-19. As a result, current revenues of the central government surged 17.0% in the period, with tax collection as its main driver with a jump of 27.7% in the year. However, at 7.6% of GDP in 2022, tax proceeds still stand 0.3ppt below the 2019 mark and are down 1.1ppt of GDP relative to 2018. In addition, non-tax revenues –composed mainly by tolls and contributions from the Panama Canal- posted a mild 2.6% increase in 2022 that was consistent with a subpar volume of cargoes crossing the canal (+1.2% y-o-y through October).

Primary spending moderates on a cash basis. Despite facing an acute social crisis in July, the government managed to reduce the pace of expansion in total public expenditures, which ended 2022 with an increase of 1.7% (4.1% in 2021). In particular, primary spending grew 3.1% in the year, reaching a level that, in terms of the size of the economy, was equivalent to 19.6% of GDP. This figure is almost 2ppt below the level of 2021 and is also lower *vis à vis* the rather steady average of 20.2% of GDP for 2015-18. Nevertheless, primary outlays in 2022 were still significantly above the 2019 print of 18.7% of GDP. It is worth highlighting that cash-basis comparisons may be distorted by the changes in floating debt or arrears. Fiscal reporting methodologies in Panama are not yet fully compatible with IMF standards and, in recent fiscal years, this has led to the accumulation of large, undocumented arrears.

The "timely" revisions to GDP figures. Fiscal performance benefited from faster-than-expected GDP growth, which boosted revenues and offered some leeway in the necessary moderation of public spending after COVID-19. However, this denominator effect, which changes the USD level of the fiscal ceiling each period, was accentuated last year by a major revision to GDP figures for 2018-2021. Indeed, the National Statistical Institute (INE) published, *only one week before the release of 2022 macrofiscal report*, revised GDP figures with base year 2018, which replaced the prior 2007 base. The new macroeconomic estimates resulted in a level of nominal GDP in 2021 that was 6.0% larger than previously announced, an outcome that favoured all fiscal metrics up to that

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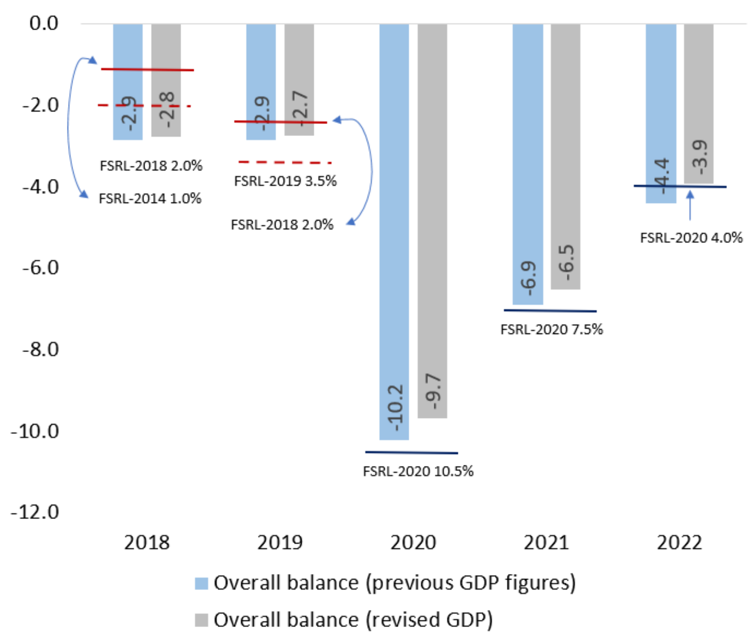
year and that created a positive base effect going into 2022. The combined adjustment in the official GDP projection used to assess the fiscal balance implied a 12.1% increase in 2022 GDP, when compared to the estimate used in the January-September fiscal report. If INE had not released new GDP figures, the fiscal deficit would have reached 4.4% of GDP, breaching the FSRL ceiling even after incorporating double-digit nominal growth (see Chart 1).

Chart 1. NFPS Balance and fiscal ceilings (in % of GDP)



Sources: BancTrust & Co. based on Economics and Finance Ministry and INE.

The challenges of staying in the fiscal consolidation path in 2023 and beyond. The government now faces the need to contain spending in a pre-electoral year, with the presidential vote scheduled for next May 2024. The ceiling of 3% for the NFPS deficit (2% in 2024) could be challenging due to the anticipated slowdown in economic activity and revenues, and more structural issues related with the unsustainability of the pension system and a still notoriously low tax-to-GDP ratio. In this regard, despite their strong expansion in 2022, tax collection keeps lagging relative to the rest of the Latin American and Caribbean region (see Chart 2). In this context, reaching an agreement with FQM is, without a doubt, a critical first step in the process to reform the tax regime and improve revenue collection. The capacity of the country to effectively achieve the long-term fiscal deficit target of 1.5% of GDP relies crucially in this structural change.

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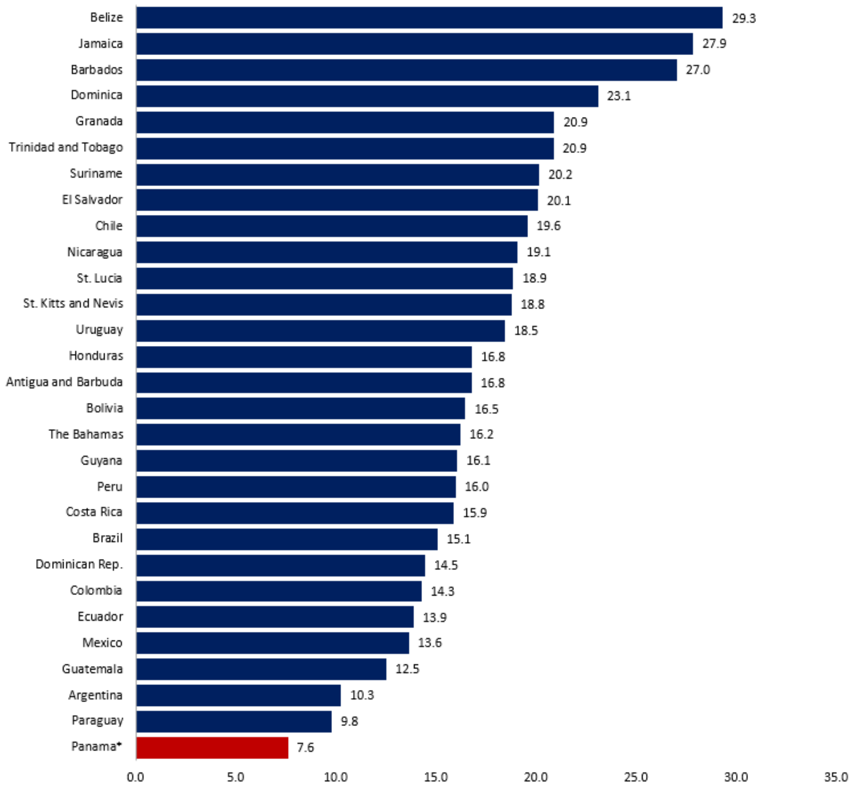
Chart 2. Tax revenues in the Latin American and Caribbean region - 2021 (as % of GDP)



*2022 estimate.

Sources: BancTrust & Co. based on ECLAC, Economics and Finance Ministry and INE.

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