Abstract

The conflict between Russia and Ukraine and its geopolitical ramifications could have major consequences for Panama’s economy. This paper examines these consequences by focusing on four possible channels: (i) the rise in international food and energy prices and the impact on household budgets and the current account; (ii) changes in trade routes and trade flows and their effect on traffic through the Panama Canal, which in turn affect logistics services and government revenues; (iii) the reconfiguration of global value chains/deglobalization and opportunities for nearshoring; iv) the effect of economic sanctions and their impact on the country’s financial system and the need to accelerate measures to counter money-laundering and the financing of terrorism.
Executive summary

1. In the 15 years leading up to the onset of the pandemic crisis, Panama was one of the fastest-growing economies in Latin America and the Caribbean, with an average growth rate of more than 6 percent between 2005 and 2019. As a result, the country’s GDP per capita is among the highest in the region, on par with high-income economies.

2. This growth was made possible by the country consolidating a strategic vision that positioned it as a nexus between North and South America. It achieved this through large investments in transport and logistics infrastructure such as the Panama Canal, ports and airports, which are connected to special economic zones (SEZs) that have attracted significant flows of foreign direct investment.

3. This strategy converged with the creation of a regional financial services centre that supported the international trade and investment activities that were facilitated by the Panama Canal. Significant real estate investment was another focus area: by boosting the construction sector, it generated employment and income. More recently, the emergence of large-scale mining activity has brought major opportunities for sustaining significant investment flows, leading to growth in exports and government revenues.

4. This growth led to progress on social indicators such as the poverty rate, which dropped from 37 percent in 2005 to 22 percent in 2019. However, progress on other indicators, such as inequality, has not been so significant. In 2019, Panama’s Gini coefficient stood at 0.50, one of the highest in the region. This inequality in income distribution partly reflects the significant disparities between the development levels of different regions within the country. This is evidenced, for example, by huge differences in access to services and poverty rates. These findings suggest that most of the benefits of the country’s growth have been concentrated in the capital.

5. Panama, like other economies in Latin America and the Caribbean, has recovered relatively quickly from the Covid-19 crisis in terms of activity levels (it returned to pre-pandemic levels in the second quarter of 2022). However, some sectors are still lagging (tourism, construction, restaurants and recreation, etc.). On the other hand, the labour market has not fully returned to normal. By the end of 2021, the unemployment rate was 12 percent (as compared to 8 percent on average for 2017–2019), and the informality rate had risen to 47 percent (as compared to 43 percent in 2017–2019).

6. Given these circumstances, the conflict between Russia and Ukraine has the potential to delay economic recovery in the aftermath of the pandemic. The war could impact Panama through at least four channels: (i) rising international food and energy prices and their negative consequences on household budgets and the current account, given that Panama is a net importer of fuel and, to a lesser extent, food; (ii) changes in trade flows and their effect on cargo transit through the Panama Canal, which in turn affects logistics services and government revenues; (iii) in the medium and long term, both the pandemic and the geopolitical conflicts brought about by the war could lead to a reconfiguration of global value chains, bringing negative consequences for international trade and transit through the canal, although they might also bring opportunities for Panama to become a destination for nearshoring, given its strategic location and excellent transport and logistics infrastructure; and iv) the effect of economic sanctions and their repercussions on the country’s financial system, since the implementation of these sanctions may imply a need to accelerate measures to counter money-laundering and the financing of terrorism.
7. The sharp rise in international oil prices has led to significant increases in gasoline prices in the country, which rose by more than 50 percent in the first half of 2022, reaching approximately USD 5 per gallon (USD 1.50 per litre) in June 2022. In May 2022, this increase triggered social protests that led the Government to introduce fuel subsidies on 1 July. While the protests focused on the escalation in gasoline prices, they served to channel broader grievances around access to social services (e.g., public expenditure on education). This has put pressure on the public budget, which is still stabilizing after the sharp increase in the deficit during the pandemic (a deficit of 4 percent of GDP is projected for 2022, compared to 7.5 percent in 2021).

8. The new gasoline subsidies (which have kept prices below USD 3.25 per gallon since 18 July and will initially remain in place for six months) have implied expenditures of approximately 1.0 percent of GDP in 2022, which will increase to 1.6 percent in 2023 if the circumstances that led to the subsidy continue. Although these expenditures are fully justified given the objective of mitigating the impact of rising prices on household budgets, the lack of targeting has had negative redistributive effects. For example, the highest income quintile, which mainly uses private cars for its transport needs, has benefited the most, receiving more than 50 percent of the subsidy. In contrast, the poorest quintile, which makes intensive use of public transport, receives less than 5 percent of the subsidy (this share is lower than that of income, meaning that these subsidies are clearly regressive).

9. The amounts allocated in recent years to various social programmes to combat poverty and extreme poverty (Red de Oportunidades [Network of Opportunities], 120 a los 65 [120 for the over-65s] and the Programa de Asistencia Social Educativa Universal [Programme for Universal Social Assistance for Education, PASE-U]) are similar to the total expenditure on the fuel subsidy in 2022 or 2023. Targeting these subsidies involves greater design challenges compared to the discounts to other services such as electricity. However, one way forward could be to establish a lump-sum transfer system based on a consumption estimate with a maximum cap (conditional on price developments). This new transfer could be added to existing ones. A mechanism of this sort would also allow this aid to be allocated to those who need it most and save resources for other social programmes.

10. Food prices in Panama increased less than fuel (around 5 percent year-on-year as of June), but the Government nonetheless established a programme to subsidize the price of some items from the basic food basket (the Productos Panamá plan). In addition, several food items are exempt from VAT (ITBMS). However, there may also be room to adjust these VAT exemptions, as evidence shows that many items that are included are not part of the consumption basket of lower-income households. Again, as with fuel, better targeting of such subsidies would save resources and allow them to be allocated to those who need them most.

11. The rise in fuel prices affected the trade balance (in goods); the trade deficit is estimated to increase from 6.1 percent of GDP in 2021 to 7.1 percent of GDP in 2022, while the imbalance in the current account will increase from 2.2 percent of GDP to 5.1 percent over the same period. The increased trade account deficit caused by the higher cost of fuel imports has been offset by higher copper ore exports. By 2022, these exports are expected to account for 75 percent of total goods exports (over US$2.5 billion). The increase in copper production and exports will also have a positive effect on government revenues (they account for around 0.6 percent of GDP in 2022). This would partly offset higher spending on fuel and food subsidies, making it easier for the Government to reach the 2022 fiscal deficit target of 4 percent of GDP.
12. With regard to the effects of the war on international trade flows and its possible consequences on traffic through the Panama Canal, the evidence up to the middle of 2022 shows that there have been no significant repercussions. In 2021, international trade grew vigorously (12 percent) as a result of the recovery from the pandemic, which also led to traffic through the canal rallying significantly (21 percent). By 2022, growth in global trade is expected to stabilize at a rate of around 4 percent to 5 percent, fairly similar to before the pandemic, although this estimate depends to some extent on the significance and scale of a possible global recession.

13. The energy crisis that Europe is facing as a result of the war could affect traffic through the canal. LNG exports from the US to Asia and China have been particularly significant in recent years. Recent data suggests that the United States has partly redirected these shipments to Europe after Russia’s LNG exports to the continent were suddenly shut off. In the first four months of 2022, three-quarters of total LNG exports from the US have gone to Europe, up from one-third a year ago.

14. Beyond the short-term impacts on trade, the war and its consequences on China-US political relations could exacerbate international companies’ incipient tendency to diversify their suppliers by seeking options closer to their consumer markets (nearshoring). This phenomenon would have negative consequences on global trade and could negatively affect some trade routes, such as that between China and the East Coast of the United States, which would affect traffic through the canal. However, the evidence on these deglobalization processes is still weak.

14. These processes to relocate global production chains are still in their infancy, but they represent an opportunity that Panama and Central America could take advantage of, given their strategic position and logistics and transport infrastructure. They could leverage these factors to boost trade and increase their participation in value chains with North American countries. This would imply enhancing their productive capacities through greater subregional integration within the CACM-DR, so as to make the most of the opportunities that the CAFTA-DR agreement will bring. For example, some estimates suggest that if the region were to capture 10 percent of current US imports from countries outside the Western Hemisphere, exports from Latin America and the Caribbean could increase by US$78 billion per year, a significant part of which would come from Central American countries as well as Mexico.

15. One final aspect of the Russia–Ukraine conflict that could have repercussions for Panama relates to economic sanctions that major Western economies have imposed on Russia. This may increase pressure on Panama to complete the adaptation of its financial regulations to combat money-laundering and the financing of terrorism, as required by the Financial Action Task Force (FATF). This requirement is based on the fact that the financial system is one of the main ways to ensure compliance with these sanctions. Although Panama has made progress in this area, some measures remain to be implemented, such as the disclosure of information on companies’ final beneficiaries. Noncompliance with anti-money-laundering regulations would have negative consequences, such as higher financing costs on lines of credit from international correspondent banks based in Panama (in the most extreme case, these credit lines could be cancelled outright).
1. Introduction

Panama has become one of the fastest-growing economies in Latin America over the last 20 years. As a result, its per capita GDP has almost tripled in that time, reaching levels similar to those of high-income economies (approximately US$30,000 PPP by 2019). This growth was underpinned by significant public investments in transport and logistics infrastructure that included the expansion of the Panama Canal, the construction of the metro and new airport, and significant private investments in the residential construction sector and the financial system through the International Banking Center.

Through these activities, the construction sector more than doubled its share of total GDP, achieving average annual growth of 17 percent, going from 7 percent in 2007 to almost 16 percent in 2019. Economic activity relating to the canal and the financial system has significantly expanded production and exports of financial services and transport and logistics, as have the country’s special economic zones (SEZs). More recently, the entry into operation of the Cobre Panamá mine has dramatically boosted the mining sector’s role in the economy (it accounted for almost 7 percent of GDP in 2021), which also translated into a significant increase in exports.

This growth went hand-in-hand with a significant reduction in the poverty rate, which went from 37 percent in 2005 to 22 percent in 2019. However, less progress has been made on other social indicators, such as inequality levels, access to quality education and social protection. During the same period, the Gini coefficient fell from 0.54 to 0.50, one of the highest values in the region. There is a sharp contrast between levels of economic and social development in Panama City and the rest of the country, especially the rural and coastal areas where the indigenous population is concentrated. This disparity between the central and more peripheral regions of the country suggests that the accelerated growth that Panama has experienced on aggregate has not been spread evenly across the territory.

Against this backdrop of accelerated growth but with economic and social gaps between populations and territories, two major shocks swept the world economy, hitting Panama particularly hard. The first of these was the COVID-19 pandemic, which immediately led to the shutting down of critical activities such as construction, transport and tourism, causing GDP to plummet in 2020 (-17 percent, one of the largest drops in the region). The economy rallied significantly in 2021, growing by 15 percent, but only climbed back up to pre-pandemic levels in the first half of 2022. Although economic activity has made a dramatic recovery, labour markets are lagging behind. In this regard, unemployment and informality rates remain high, standing at about 12 percent and 47 percent, respectively, at the end of 2021, compared to average values of 7 percent and 42 percent in the three years leading up to the pandemic.

The economy was still emerging from the aftermath of the Covid-19 pandemic when Russia invaded Ukraine in February 2022 and war broke out between the two nations, once again destabilizing world markets. This new disruption has clearly delayed the process of economic recovery and added new economic and social costs.

The purpose of this paper is to analyse how the new international outlook, which is marked by the conflict between Russia and Ukraine, will affect the Panamanian economy. These consequences may be channelled through the impact on the international prices of major commodities (food, energy, mining), the effects on trade flows or the implications of the economic sanctions on Russia, through the repercussions they have on financial regulations.
On the commodity price side, the sharp rise in fuel and food prices has a negative impact on household budgets. At the same time, the fact that Panama is a net importer of these products (to a lesser extent in the case of food) may signal difficulties for the country’s external accounts. Significant increases in gasoline prices in the domestic market have already triggered social conflicts in the country. These in turn prompted the Government to establish subsidies to contain increases to consumer prices. The lack of targeting in the implementation of these subsidies has had a negative impact on income distribution, since gasoline consumption is concentrated among the higher-income strata. The rise in food prices has not had such significant consequences on household welfare—even for the poorest households, given that they spend a larger share of their income on this. This is due to the price controls and subsidies that have been implemented for the basic food basket and because Panama has significant domestic production of these products.

On the mining commodity side, the economy has benefited from the rise in the price of copper, which, as mentioned above, has become one of its main export items. Copper prices were already on the rise before the war as a result of the reopening of the global economy and the increased demand for this metal as a result of the energy transition. This factor largely offset the impact of higher oil and fuel prices on the balance of trade. It also contributed to the economic recovery in 2021 and 2022 and had a positive impact on public accounts.

The war between Russia and Ukraine has also had repercussions on international trade. The crisis has not particularly impacted direct trade between Panama and these two countries (which accounts for just 0.1 percent of the country’s total). Instead, its effects may be felt through the consequences it may have on operations at the Panama Canal, which experienced record activity in 2021 and is a major source of public revenue and of foreign currency, via exports of transport and logistics services. While traffic flow projections for 2022 point to a slowdown compared to 2021 (as was also the case for global trade flows), they suggest that the war in Ukraine has not yet had a significant impact. This reduction in traffic may have been (and still could be) due, for example, to lower trade flows in agricultural goods, given the restrictions on Ukrainian and Russian exports of grain and other products, or to the diversion of US hydrocarbon (oil and gas) exports from China to Europe. Second, in the medium term, negative effects may be observed via the possible reconfiguration of global value chains if geopolitical disputes between the US and China escalate. This would affect trade flows between these two countries and would have negative repercussions on the trade route between China and the East Coast of the United States, which generates the most traffic through the canal. Beyond trade disputes, the “shortening” of production chains had already begun in response to the crisis in supply flows caused by the pandemic, which prompted companies to diversify their sources of inputs.

Finally, Panama’s financial system has traditionally acted as a hub for offshore operations, serving both regional and global clients. The war in Ukraine has led to a series of sanctions on Russian banks and companies. Monitoring compliance with these sanctions may force Panama to finish bringing its financial regulations in line with international standards on final beneficiary ownership reporting and other anti-money-laundering measures. Failure to comply with these requirements and the country being kept on the grey list could affect activities in this sector, which plays a critical role in the economy.

The fiscal effects of the disruptions caused by the war do not appear to have had a serious effect on the public accounts in the short term. Greater expenditure on fuel subsidies can be financed at least in part by the increase in copper royalties, which will be higher from 2022 onward due to the recent change in the royalty’s regime. However, the problem of financing the social security system deficit remains a serious issue and it could deviate the achievement of the established objectives for the fiscal deficit (4 percent of GDP), albeit not by a significant margin. Beyond the short term, the social crisis triggered by the rise in international fuel prices has given rise to demands to strengthen spending in certain critical areas of social infrastructure (e.g. education).
that underpin intergenerational mobility and improve income distribution in the medium term. There is also a need to further strengthen economic infrastructure, such as by building roads to connect the country’s interior with the main centres of consumption to counteract the geographical disparities in development. The responses to these demands cannot be financed through fiscal deficits that destabilize public debt, but rather through genuine increases in state resources. To achieve this, it may be relevant to propose partial adjustments to some taxes to improve tax revenues. These revenues, currently at around 10 percent of GDP, are too low, especially considering Panama’s relative high per capita income level.

The rest of this study is as follows. Section 2 describes the pattern of economic and social growth in Panama prior to the war in Ukraine, including the consequences of the Covid-19 pandemic. Section 3 briefly analyses the effects of the war on international markets, in terms of both the rise in commodity prices and the effects of this on supply chains and trade flows. Section 4 contains a detailed review of the repercussions of these shocks on the Panamanian economy. It analyses the impacts on household spending on energy and food and the Government’s response via subsidies, the effects that may arise via the impact of international trade flows on traffic through the canal, the consequences on the current account and public finances, the implications for the readjustment of global value chains and, finally, the economic sanctions and their repercussions on the financial system. Section 5 contains some concluding remarks.

2. The Panamanian economy in the run-up to the crisis in Ukraine

Before analysing the impact of the Ukraine crisis on Panama, it is worth describing the country’s growth over the last 15 years, the transformations that this process has brought about in its economic structure, and the behaviour of some social indicators. Another point of interest is assessing the consequences of the Covid-19 crisis and how far the economy had recovered when the war broke out. This background information helps provide context for the outcomes of the conflict in Ukraine on the Panamanian economy.

2.1. Growth, macroeconomics and social indicators before the pandemic

Panama has experienced very rapid growth over the last 15 years, averaging over 6 percent annually (figure 1, panel A). This growth was sustained by investment rates of more than 30 percent of GDP, which were among the highest in Latin America (and globally) during this period (figure 1, panel A). This allowed the country to almost triple its per capita GDP between 2006 and 2019, when it reached around US$30,000 in PPP dollars (US$16,000 in current dollars). This is among the highest levels in Latin America, along with Chile and Uruguay (figure 1, panel B).
High levels of investment explained the strong growth in GDP, which resulted in large-scale infrastructure projects such as the Panama Canal expansion project, new ports, the Panama City metro and new terminals at the international airport.\(^2\) At the same time, private investment in the real estate sector expanded. All of this changed the structure of the Panamanian economy. For example, it led to a significant increase in the construction sector’s share in GDP (and employment), which went from about 7 percent in 2007 to almost 16 percent in 2019 (figure 2). One sector that maintained a significant share of the economy despite the growth of other sectors was transport, storage (logistics) and communications, which represented 15 percent of GDP in 2019, making it the third-largest sector after retailing and construction. This of course reflects activity associated with the Panama Canal and other transport infrastructure investments mentioned above. The financial system’s share of GDP also increased, reaching 8.5 percent in 2019 (up from 7 percent in 2007). One sector that has experienced significant recent growth that is not yet captured by the 2019 statistics is the mining sector, following the start of production at the Cobre Panamá mine. As will be explored in greater detail below, in 2021 this sector accounted for almost 8 percent of GDP, compared to less than 1 percent in 2007. Among the sectors whose shares went down were agriculture, manufacturing, real estate and professional services.

\(^2\) After an intensive construction programme (2009–2016), the new Cocolí and Agua Clara locks added a third lane to the Panama Canal through which Neopanamax ships can pass. Construction on the first Panama City metro line began in February 2011, and the line was opened in 2014. The entire project is expected to be completed by 2024. The new terminal at the international airport was opened in 2022, doubling the facility’s capacity. Investments in the airport totalled more than US$917 million over a five-year period.
The large increase in investment and growth was associated by a significant imbalance in trade in goods. These deficits were partly offset by a surplus in the services account as a result of export growth in transport and logistics, tourism and financial services (figure 3, panel A). The total current account deficit reached a record high of almost 14 percent of GDP in 2014 and coincided with the rise in oil and other energy commodity prices. In the following years, it stabilized at around 8 percent of GDP due to corrections in oil prices and the completion of major construction projects, which reduced the country’s imports. Panama has had no problems financing this external imbalance due to the significant inflow of FDI capital, which represented average values of 8 percent of GDP in 2015–2019. These FDI volumes are also several times higher than the average for Latin America during that period (figure 3, panel B).

### Figure 3. Trade balance and current account (panel A) and average FDI 2015–2019 (panel B)

#### Panel A

![Graph of trade balance and current account from 2005 to 2019]

#### Panel B

![Graph of average FDI from 2015 to 2019 for Panama, Central America, and Latin America and the Caribbean (LAC)]


Note: In panel B, Central America includes the following countries: Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama. Latin America and the Caribbean: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, Venezuela, Antigua and Barbuda, Barbados, Cuba, Dominica, Dominican Republic, Grenada, Haiti, Jamaica, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, and Trinidad and Tobago.
Further support for the country’s growth came from a macroeconomic context of stability in which inflation has always been kept under control (1.5 percent on average in 2007–2019) as a result of the adoption of the US dollar as the local currency (though a 1:1 fixed exchange rate regime with the balboa). Fiscal policy, the only countercyclical instrument available to the Government, has performed moderately well, achieving relatively low public account deficit levels. The fiscal deficit fluctuated at around 2.2 percent of GDP between 2014 and 2019, benefiting from the country’s dynamic economic growth and transfers from the Panama Canal to the treasury (2.2 percent of GDP on average), although the tax burden has remained relatively stable at a relatively low level (below 10 percent of GDP)\(^3\).

This moderate fiscal behaviour has been reinforced by the entry into force of the Fiscal Social Responsibility Law in 2008, which sets targets for deficits in public accounts. Numerous adjustments have been made to these targets through escape clauses and regulatory changes. However, the overall objective of keeping the non-financial public sector (NFPS) deficit on a downward path in order to keep debt below 40 percent of GDP has been met during the pre-pandemic period. The reform of the Fiscal Social Responsibility Law in October 2018 further strengthened the institutional framework by increasing the transparency of the target deficit, in addition to creating a Fiscal Council to independently evaluate compliance with the regulations (CAF, 2022a).

The country’s rapid growth led to increased employment and household income, leading to a substantial reduction in poverty rates, which have dropped to 22 percent of the population in recent years (figure 4, panel A). However, there have not been similar gains in inequality indicators. In 2019, Panama’s Gini coefficient was 0.50: although this is down from 15 years previously, it remains one of the highest in the region (fourth after Brazil, Honduras and Colombia) and it is in sharp contrast with the country’s relatively high per capita income levels.

**Figure 4.** Poverty and inequality rates (panel A) and regional poverty (panel B)

![Poverty and inequality rates](image)

Panel A

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</table>

Panel B


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\(^3\) As will be seen in more detail below, low revenue collection is mainly due to low tax rates and major exceptions to key taxes such as VAT and corporate income taxes.
Furthermore, the improvement observed in the country’s overall poverty rates conceals significant geographic heterogeneity, with a significant gap between Panama City and the rest of the country, especially between urban and rural areas (figure 4, panel B). Poverty is particularly high in Panama’s indigenous regions: Emberá (64 percent), Ngäbe Buglé (83 percent), and Guna Yala (73 percent). This is also true of the border provinces of Bocas del Toro and Darién (45 percent and 44 percent, respectively). Poverty levels between regions partly differ because the benefits of the economic growth observed over the last 15 years have been unevenly distributed throughout the country. Panama City and the surrounding areas have benefited the most, evidenced by the fact that GDP concentration in these areas increased from 70 percent in 2007 to approximately 75 percent in 2019 (BID, 2019; CAF, 2019).

Other social indicators such as access to education have improved, and recent years have brought gradual increases in enrolment at all levels of education, but for tertiary education access remains very low compared to countries with similar income levels. For example, enrolment rates in primary and secondary education reached 98.9 percent and 81.9 percent in 2019, respectively. However, at 23.3 percent, the enrolment rate in tertiary education is still very low compared to countries with similar per capita GDP, such as Chile (where it is 45.5 percent). Regardless of the average for the country as a whole, there is significant inequality in access to secondary education between rural and urban areas (68.5 percent versus 89.5 percent) and income quintiles (60.9 percent in the lowest-income quintile and 89.5 percent in the highest) (BID, 2019).

The significant inequality observed in Panama’s household income levels and the economic capacity of each region has not been offset by state action through the taxation system and social spending. This is because social spending levels (excluding pension payments) have remained at values close to 9 percent of GDP in recent years. These levels compare unfavourably with the average for Latin America (around 12 percent of GDP) and are significantly lower than in other countries in the region with similar per capita income, such as Chile and Uruguay (around 16 percent). Generally speaking, Panama invests less in every area of social spending than the region on average, but the differences are particularly marked for social protection (income transfers and other forms of assistance to low-income families) and education (BID, 2019).

These low levels of social spending are partly due to the fact that recent administrations have prioritized public investment spending. However, the country’s low tax revenue (around 10 percent of GDP)—which is strikingly low in relation to its high GDP per capita—is also a constraint to expanding this spending.

2.2. The impacts of the pandemic

The pandemic has had a significant negative effect on Panama’s growth. It was one of the economies in the region where GDP fell the most (around 17 percent in 2020) due to disruptions in the construction, tourism, retailing and entertainment sectors. These sectors spearheaded the recovery in 2021 and the first quarter of 2022 (figure 5, panel A). At the aggregate level, the recovery in 2021 was significant, with 15.4 percent average growth over the year (14 percent year-on-year growth in the first quarter of 2022 as compared with the first quarter of 2021). However, this fell short of bringing GDP back to pre-pandemic levels, which it only achieved by the end of the first quarter of 2022. The recovery was partly due to the significant expansion of the mining sector once operations at the Cobre Panamá mine came fully into operation (figure 5, panel B).

As well as access indicators, it is also worth assessing the impact of teaching on student learning. Panama performed poorly in the 2018 PISA tests: more than half of 15-year-old Panamanian students do not understand what they read and 7 out of 10 cannot solve a basic mathematical calculation. In the PISA’s global ranking of subjects, Panama came 76th in reading, 76th in maths and 75th in science out of the 77 countries tested.
Figure 5. Aggregate growth and sector growth, 2019–2022

Panel A. Growth Q1 2021–Q2 2022

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<tr>
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<td>Hospitality</td>
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<td>Health, education and social services</td>
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<td>Trade</td>
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<tr>
<td>Construction</td>
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<td>Real estate and business services</td>
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<td>Transportation, storage and communications</td>
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<td>Mining</td>
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<td>Public services</td>
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<td>Manufacturing</td>
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<td>Agriculture, fisheries and livestock</td>
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<td>Government services</td>
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Panel B. Growth Q1 2019–Q2 2022

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<td>Financial brokering</td>
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<td>Real estate and business services</td>
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<td>Hospitality</td>
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<td>Construction</td>
<td>-9.6%</td>
</tr>
</tbody>
</table>


As is discussed in box 1, the start of production at the new copper mine will bring about a very significant expansion of the mining sector, while also bringing in large export and fiscal revenues.\(^5\)

**Box 1. Cobre Panamá Mine**

Mining production in Panama is set to rise from the average of 1.5 percent of GDP over the last 10 years to 9.5 percent of GDP in 2023. Historically, production in the sector has been limited to quarrying for construction materials. Mining GDP is expected to soar as a result of the launch of the open-pit copper mine in Donoso, near the Caribbean coast. The Cobre Panamá mine is the largest private investment project in Panama’s history (US$6.3 billion). With a projected 34-year lifespan, this open-pit mine will reach full production capacity in 2023, with an output of 320,000 tonnes per year. This will result in exports equivalent to US$2 billion (potentially reaching or exceeding 5 percent of GDP).

The project is being developed by First Quantum Minerals (Canada) and includes an international port and a 300 MW power plant in addition to the mine itself. Operations began in February 2019, and the first 31,400 tonnes of ore were exported to China in June that year.

Source: CAF (2022a).

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\(^5\) Section 4 provides up-to-date estimates the impact of the increased copper production on export and tax revenues.
However, the recovery in economic activity has not been reflected in the country’s labour markets: the unemployment rate remains high, close to 12 percent in the fourth quarter of 2021, or almost 4 percentage points above pre-pandemic values (figure 6). The informal employment rate is also high, reaching 48 percent in the same period, up almost 5 percentage points over the average for 2017–2019.6 Taking a longer-term view, informal employment fell until 2011–2012, reaching a low of 37 percent. However, despite the rapid growth of the Panamanian economy in subsequent years, not only did informality rates not continue falling, but they actually increased even before the pandemic hit.

**Figure 6.** Labour market: unemployment rate and informality (2005–2021)

The strong economic recovery in 2021 led to a significant drop in the fiscal deficit, which reached 5.5 percent of GDP by late 2021, down from 9.7 percent in 2021 and well below the target of 7.5 percent set for that year. These positive results were largely explained by increased tax revenue (up 12.4 percent annually) and the fact that spending remained virtually stable (-0.2 percent annually), with a sharp contraction in investment (17.7 percent annually).

Before the outbreak of the crisis in Ukraine and its consequences on growth, the Panamanian economy was expected to expand by around 6 percent in 2022. This forecast partly reflected the fact that the economy has not yet fully recovered from the effects of the pandemic. However, it will need to be revised downward considering the consequences of the conflict on the global economy and its repercussions in Panama. This is the focus of the following two sections of the paper.

### 3. Consequences of the crisis in Ukraine on the global economy

Against this backdrop of economic recovery in the aftermath of the pandemic, but with employment and social indicators still lagging behind, Panama is facing a new challenge as a result of the conflict in Ukraine. The new crisis has led to a sharp increase in the prices of energy (oil and gas), some minerals and fertilizers and food. These increases are the result of both Russia and Ukraine being major producers of these commodities and

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6 This increase in informality and unemployment rates compared to where they stood before the pandemic values has almost certainly had negative consequences on poverty indicators, although this could not be verified due to a lack of official data.
the war significantly affecting their supply. For example, Russia accounts for approximately 25 percent of total natural gas exports; together with Ukraine account for 50 percent of the international iron ore trade; and the two countries are the main global suppliers of fertilizers, along with Belarus. On the food side, Russia and Ukraine account for almost 30 percent of total wheat exports and slightly less for barley (figure 7, panel A).

The outbreak of the war further boosted the price of these commodities, which had already risen as a result of the global economic recovery in 2021. Oil prices increased by 50 percent between December 2021 and June 2022, then stabilized at a lower level between July and August. For gas, the increases have been even more significant, and costs have doubled over the course of 2022. Grain prices also rose by more than 40 percent in the same period (figure 7, panel B). Finally, the price of copper, which has become extremely significant in Panama’s export basket, increased by almost 25 percent in 2021 as the world economy returned to normal. It increased even further (just over 6 percent) in the first part of 2022 as a result of the war and then fell between July and August.

Figure 7. Global exports from Russia and Ukraine and commodity prices

On top of its effect on commodity prices, the war has the potential to increase the logistics problems associated with global value chains and delays in the supply of certain industrial inputs. The ongoing lockdowns in Chinese cities as a result of the pandemic have further complicated the production and transport of many intermediate goods. These delays began to ease in late 2021 but increased again in early 2022. The war in Ukraine may exacerbate these problems, given the closure of certain trade routes, such as across the Black Sea (figure 8, panel A). These delays have affected the recovery of global manufacturing output, which has stagnated since the end of 2021 (figure 8, panel B).
Figure 8. Supply chain costs: Baltic Dry Index\(^7\) (panel A) and global manufacturing output, PMI\(^8\) (panel B)

Rising energy and food commodity prices and ongoing supply chain problems affecting manufactured goods have boosted inflation rates in the world’s major economies. In the United States, for example, annual inflation was at 9.1 percent in June and 8.5 percent in July. There were hefty price increases in the Eurozone, too, reaching an annual rate of 7.5 percent in June (figure 9, panel A). Higher inflation is leading the world’s major central banks to raise interest rates. For example, US Federal Reserve has announced increases that will take interest rates to almost 3.5 percent by the end of 2022, and they are expected to be close to 4 percent by the end of 2023 (figure 9, panel B).

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\(^7\) This is a shipping freight-cost index for dry bulk cargoes on up to 20 key ocean routes based on time-charter hire rates around the world, issued by the Baltic Exchange in London. It is a daily calculation of the average seaborne freight rate for major solid and bulk commodities such as coal, iron ore, grain or sugar. It reflects the number of contracts for the shipment of goods that are concluded on the world’s main shipping routes.

\(^8\) This is a macroeconomic indicator that is generally used to obtain information on private sector companies, one of the most significant variables when measuring countries’ economic circumstances. It is calculated by observing variables such as production, new orders, employment and product prices in different companies. It is based on surveys of business people and includes different variables that provide an overview of the state of production of each firm. These variables are assigned percentage values that reflect their importance and are as follows: new orders (30 percent), output (25 percent), employment (20 percent), delivery time to suppliers (15 percent) and stock of raw materials (10 percent). The estimation methodology yields a number that indicates whether the sector is expanding (a score above 50) or contracting (below 50).
The combination of higher inflation (which reduces real income and household spending) and rising interest rates (which increase the price of credit for investment and consumption) is fuelling expectations of a dramatic slowdown in economic activity in the world’s major economies. Growth projections for 2022 have already been revised downward. For example, in the US, the economy is expected to grow by 1.9 percent in 2022 and 1.1 percent in 2023 (with some analysts forecasting negative growth in the latter). In Europe, growth is also expected to decelerate significantly from 2.5 percent in 2022 to 1.1 percent in 2023. In China, meanwhile, 4 percent growth is expected in 2022 (figure 10).
One direct consequence of this slower growth, coupled with higher transport costs and supply problems affecting value chains, is that growth in world trade would also slow to 4.5 percent in 2022\(^9\) after rallying by almost 12 percent in 2021 (figure 11).

**Figure 11.** Growth in global trade, 2018–2026

This scenario of heightened uncertainty around inflation, rising rates and slower global growth has led to significant declines in major stock markets and, more recently, increases in US Treasury bond rates (figure 12, panel A). This could affect access to financing for Latin American and Caribbean countries, especially those that are facing substantial increases in their trade and current account deficits as a result of the energy and food price shocks. The evidence shows that country risk rates have risen slightly, but access to capital markets has not been substantially reduced (figure 12, panel B). In August 2022, Panama’s risk rate was among the lowest in the region (2.27 percent), half the average for Latin America (4.66 percent).

**Figure 12.** Stock market performance and sovereign risk indicators

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\(^9\) This projection for the global trade growth rate provided by the EIU is in line with the averages observed before the pandemic, and thus does not seem to reflect the negative impacts of the war in Ukraine and its consequences on transport infrastructure and shipping routes, and the increase in freight costs.
4. Impacts on Panama’s economy

The repercussions of the war in Ukraine in Latin America, particularly in Panama, do not revolve around export and import flows to and from Ukraine and Russia, as these account for less than 0.1 percent of Panama’s total trade (and less than 0.6 percent of the regional average).

Instead, the effects of the war are mostly indirect and come via various channels. The first of these is the sharp rise in energy and food prices. In addition to driving widespread increases in price levels, this increase is negatively affecting the welfare of families, especially those in lower-income brackets, who spend a large share of their income on these items. This has led to major protests and demands for price freezes or fuel and food subsidies (see section 4.1).

As Panama is a net importer of energy and food (albeit to a lesser extent), the increase in the international price of these products will affect the trade balance and the current account. This negative effect may be partially or wholly offset by the dramatic growth in the country’s copper exports, which have also benefited from higher prices.

The war in Ukraine may also impact Panama via the reduction in international import and export flows and its consequences on traffic through the Panama Canal. This effect is due to downturns in exports and imports from Russia and Ukraine to the rest of the world and to second-round effects caused by other geopolitical conflicts sparked by the war (e.g., between China and the US). Approximately 6 percent of world trade is moved through the canal, so this could have a significant impact on logistics activity and state revenues in Panama if it were to occur.

Turning to more structural matters, the pandemic and geopolitical issues may affect trade flows by prompting deglobalization and the partial reshoring of global value chains. Specifically, trade between China and the US could be reduced as companies seek to diversify their suppliers by adding sources of inputs that are closer to their consumer markets. This would imply fewer ships passing through the canal (e.g., those heading to the East Coast of the United States). However, it could create opportunities for Panama to participate in these new (shorter) value chains, given its strategic location and logistical advantages.

All of these factors will impact public finances. As mentioned above, Panama’s fiscal deficit dropped sharply in 2021 compared to the previous year. It is expected to fall further in 2022, reaching 4.2 percent of GDP, close to the target value established in the fiscal regulations. However, given its consequences on food and energy prices, global trade and traffic through the canal, the crisis in Ukraine could have negative fiscal implications through both increased spending and lower revenues. This reduction would only be partially offset by the increase in mining royalties.

Finally, the economic sanctions imposed on Russia by Western economies may put further pressure on Panama to comply with the requirements of financial system regulations seeking to prevent money-laundering and the financing of terrorism. Panama is still on the grey list of countries that do not fully comply with these requirements.

All the factors just described are analysed in greater detail below.
4.1. Effects of rising energy and food prices on household welfare

The increase in international food and energy prices has been passed on to the domestic prices of these products in Panama, especially in the case of fuel. Fuel prices have grown significantly since the beginning of 2022 and have worsened since the start of the war. For example, the prices of diesel, LPG and gasoline rose by between 50 percent and 60 percent from January to June 2022 (going from approximately US$1 to US$1.50/1.60 per litre), increasing by more than 70 percent year-on-year (figure 13, panel A). On the food side, there were significant escalations in the price of some items, such as eggs, oils and coffee (13 percent year-on-year). However, the increase in the overall consumption basket was less marked.

The upswing in these prices has had a significant impact on overall inflation and on the transport and food components of the consumer price index (CPI) (weighting 16.8 percent and 22.4 percent, respectively, in the overall index). This impact was particularly marked in the case of transport, which experienced a cumulative annual increase of almost 20 percent in June 2022. The food CPI rose by 5 percent, similar to the overall increase in prices, which rose by 5.2 percent year-on-year in June, far above the average of 1.5 percent over the last 10 years (figure 13, panel B).

Figure 13. Fuel prices and CPI components

Rising food and energy prices could potentially jeopardize the poorest households the most, as these spend a higher proportion of their income on these items. In particular, food accounts for 31.1 percent of total expenditure for households in the lowest income quintile, but stands at just 11.1 percent for the wealthiest households (the fifth quintile). The share of expenditure on transport is lower in households in the bottom income bracket (9.1 percent) than those in the highest bracket (20.3 percent). This is because the former spends much more on public transport (which is generally subsidized), while the latter consume a larger share of gasoline for use in private transport, which is generally less subsidized (figure 14, panel A). Taking this expenditure structure and the evolution of household prices into account, we see that inflation has hit poorer households somewhat less than richer ones (figure 14, panel B).
The sharp increase in the prices of gasoline and some products in the basic food basket led to protests by the population and productive sectors that began in May 2022 but intensified in July, when there were blockades in various parts of the country. This unrest has prompted the authorities to take measures. On 15 July, maximum prices were set for 18 items that make up the basic food basket\textsuperscript{10}. On 26 July, the Product's Panamá programme was created, offering 25-percent discounts on 36 domestic agricultural products sold in shops run by the Agricultural Marketing Institute (IMA).\textsuperscript{11} Both programmes were initially implemented for six months.

Public transport in the Panama City area is run by the Government, and fares have not increased significantly in recent years. With regard to the increase in gasoline prices, the main factor triggering protests in 2022, the Government began establishing subsidies and monetary transfers (digital fuel vouchers) for the transport, rural and commercial freight sectors to reduce the impact of price hikes on these sectors. On 1 July 2022, the Government reached an agreement with transportation providers on a subsidy that kept gasoline prices at US$3.95 per gallon. However, the protests continued and led to the latest negotiation (18 July) to agree to increase the subsidy with the aim of capping gasoline prices at US$3.25 per gallon for six months. This price has brought the cost of gasoline back down to where it was in April 2021.

Traditionally, gasoline subsidies in Panama have been among the least significant in the energy sector. Like in other countries, the largest subsidies go to electricity and then to LPG. Diesel has also received smaller subsidies, which are relevant for public transport. As expected, these energy subsidies have followed the ups and downs of the international price of hydrocarbons, including relative high points in 2014–2015 and sharp declines in 2016–2017 (figure 15).\textsuperscript{12} In 2020, during the pandemic, the electricity subsidy was stepped up (for

\textsuperscript{10} For details, see Executive Decree No. 13 of 13 July 2022.

\textsuperscript{11} The Ministry of the Economy and Finance should finance these subsidies. The authorities have not yet published an estimate of how much these subsidies will cost. For details, see Executive Decree No. 17 of 26 July 2022.

\textsuperscript{12} This includes electricity, given the use of diesel and other fuels in power plants.
consumption of up to 500 kW through the Tariff Stabilization Fund) as a form of support for families during the emergency. This support was extended in the first part of 2021. Fuel prices rose throughout the year, reaching US$5.17 per gallon in October. However, no subsidies were established until 2022, as mentioned above.

**Figure 15.** Evolution of energy subsidies

There are several alternative ways of implementing subsidies for different energy items, and experiences of this in Latin America (and globally) have been very diverse (box 2). One of the most commonly used and most efficient methods is lump-sum transfers on top of other programmes already in place for the most vulnerable households and sectors. The advantage of this method is that it targets assistance to those who need it most because they are in a low-income bracket or make intensive use of energy. At the same time, it does not distort prices so they still reflect relative scarcities and prompts the households and economic sectors that receive these transfers to economize their consumption.

On the other hand, to make the prices of some of these energy products less volatile (particularly gasoline), stabilization funds have been established in some countries in the region that maintain prices within a certain band (or at a fixed benchmark price). When prices fall below the lower limit, revenue is collected and is used to subsidize prices when they rise above the upper limit. This mechanism is self-financing in principle but distorts market values affecting savings and production decisions. However, it may be justified when there are sudden, temporary changes to the prices of these products.

Source: Contraloría General de la República (2021).
Box 2. Energy subsidy design and implementation in Latin America (electricity, LPG and gasoline)

When designing and implementing subsidy policies for energy (electricity, LPG and fuels), it is important to be clear about the policy’s objective. Broadly speaking, there are two possible purposes. First, to target support for low-income households that cannot afford to pay for their energy needs. Second, to moderate the impact of sharp fluctuations in energy prices caused by supply or demand shocks that are perceived to be temporary and that may affect much of the population and businesses, in which case the mechanism would apply to all users.

Mechanisms for targeting subsidies to low-income families

With respect to policies that seek to meet the first objective, the challenges of design and implementation include ensuring that all households that really need the subsidy have access to it (that is, avoiding exclusion errors) and that higher-income households that could afford the service do not receive it (avoiding inclusion errors). To deal with inclusion and exclusion issues, it is essential to have accurate information on consumption expenditures and how this correlate with certain socio-economic household characteristics (e.g., income, size, place of residence, etc.). Another important factor is access to administrative records that make it easy to identify these households. International experience shows that up-to-date information of this type is not available in several Latin American countries, at least for LPG and fuels. The solution is to estimate a level of expenditure on these items (through a survey), to use transfers—which could be added to those already received by these households for other reasons (e.g., food support, non-contributory pensions or education-related transfers)—and possibly to vary these subsidies in the event of major fluctuations in the price of these products.

Implementing transfer-based subsidies such as these has the added advantage of not distorting the prices these households pay, thus creating an incentive to save regardless of the resources they receive (IMF, 2022). Two interesting examples of LPG subsidies are El Salvador and Peru. In El Salvador, cash transfers cover the costs of both the cylinders themselves and refilling them and are implemented through a code sent to the beneficiary’s cell phone. In Peru, beneficiary households receive a monthly discount (which was increased from PEN20 to PEN25 in April 2022) that is delivered through a numerical code on their electricity bill that can be redeemed at authorized sales points. In the case of gasoline, one interesting example is Indonesia: in 2005, 2008 and 2015, the country established a temporary cash transfer programme for 19 million families, who were selected based on existing databases designed for other social programmes. The literature abounds with analyses of experiences of using these transfers to alleviate the cost of energy items such as gas or gasoline. One recent example concerns Iran.

The mechanisms for targeting electricity subsidies are easier to apply in logistical terms than those for LPG, gasoline and diesel. This is because the targeting criteria are more transparent since more information is available on average consumption per individual and household. These subsidies are usually channelled via a tariff structure that includes a subsidy up to a given consumption ceiling, which should be related to the consumption of the lowest-income households. For example, this ceiling is 100 kW/month in Uruguay, 200 kW/month in Colombia, 250 kW/month in Argentina and 240 kW/month in Brazil. In Argentina, Brazil and Colombia, subsidies also include individual household conditions associated with socio-economic status (e.g., income below the minimum wage, being enrolled in other social programmes, etc.).
Mechanisms to stabilize energy prices (applied to fuel)

Some countries have established schemes to reduce the volatility of energy prices, especially fuel prices. As mentioned above, in this case, the objective is to moderate the impact on domestic prices of the fluctuations in international fuel (oil) values that may affect both households and businesses. In general, price stabilization funds are established to collect revenue when rates fall below the benchmark price, which is then used to finance subsidies when market values climb above this price. Colombia established a system of this sort in 2007. Likewise, Peru created the Petroleum Fuel Price Stabilization Fund (FEPC) in 2004, and in 2010 the Government established a complementary price band (such that the benchmark price was no longer fixed). Mexico has a simpler sliding price policy that varies when international oil prices change. When the latter increase significantly, domestic prices do not rise by the same magnitude. To mitigate the recent increase in oil prices triggered by the conflict in Ukraine, Brazil simply eliminated federal fuel taxes as a way to moderate the pass-through of the increase to the domestic market.

One problem that arises with stabilization fund mechanisms is how to set the benchmark price and adjust it as shocks become permanent. If this is not addressed, the system will quickly run up deficits and require support from the State (and thus would no longer be self-financing). This is the case in Colombia, where the mechanism has caused persistent budget imbalances since 2010, such that the national Government has had to take on the resulting debts. These debts have turned the system into an open subsidy that cost more than 1 percent of GDP in 2021 and 2022 (see Comité Autónomo de la Regla Fiscal, 2022). In Peru, given the significant increase in the international price of fuels, other forms of gasoline and bulk LPG (for cars) have been temporarily included in the FEPC as a way of moderating domestic price hikes (Ministerio de Economía y Finanzas de Perú, 2022).

In sum, when designing energy subsidy policies, it is important to have clarity about what the measures seek to achieve. If the aim is to reduce volatility in response to sharp (but temporary) international price shocks, perhaps the easiest way is to establish a ceiling that reduces the pass-through to the domestic market, such as via maximum benchmark prices or by temporarily reducing taxes (as Brazil has done). Creating stabilization funds is also an option, but these should be adjusted to prevent them from constituting significant, permanent and indiscriminate price subsidies. On the other hand, there is the more structural objective of helping low-income families to afford these services. When this approach is used, it is important to target support to reduce exclusion and inclusion errors. In this case, the most advisable mechanism is targeted lump-sum transfers that take consumption ceilings into account.

There is a large body of literature that analyses fuel subsidy reforms in the context of climate change mitigation policies in which subsidies are replaced by lump-sum transfers to households. These transfers can be designed to target the most vulnerable households or can be applied to the entire population. The outcomes depend on what happens to non-fuel prices after the subsidies are removed. In Iran, a reform of this sort failed in 2010 because of how it impacted inflation and the Government’s fiscal deficit (Breton and Mirzapour, 2016; Clements et al., 2013; Moshiri, 2015).

Source: Compiled by the author.
As mentioned above, Panama has adopted a much simpler strategy, partly as a consequence of the political and social conflict that broke out in July 2022. In the case of gasoline, the country’s approach involves a subsidy to keep the maximum sale price at a value close to US$3.25 per gallon, which applies to almost all users. Recent estimates of the cost of this subsidy for 2022 that were included in the 2023 budget law put it at around US$717 million, or 1 percent of GDP. For 2023, the National Assembly approved a budget of US$1.2 billion for the subsidy, equivalent to 1.6 percent of GDP (Asamblea Nacional, n.d.; CAF, 2022c). Furthermore, the Brent benchmark oil price for 2024 is estimated to be around US$85 (Economist Intelligence Unit, 2022a). If this policy is maintained, it would imply a subsidy equivalent to approximately 1.4 percent of GDP that year.

A simple incidence analysis takes into account each income quintile’s share in transport expenditure (see figure 16, panel A) and assumes that the subsidy is allocated to each quintile in proportion to the updated expenditure for July 2022. The analysis comes to the not particularly surprising conclusion that a large share of this support goes to households in the highest income bracket. Specifically, 51.5 percent (the equivalent of US$365 million) is allocated to the highest quintile, while just 5 percent (US$36 million) goes to the poorest bracket.  

**Figure 16.** Benefit incidence of gasoline subsidy by income quintile (panel A) and income concentration (panel B)

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13 In principle, the petrol subsidy does not cover consumption for luxury cars. However, enforcing this condition is very hard to monitor, so the benefit incidence exercise does not take it into account.

14 This distribution among the different quintiles underestimates the subsidy benefits that end up going to higher-income brackets, as it is based on the share of income/total expenditure on transport—in the household expenditure survey (EIGH), expenditure on gasoline is not listed separately—which includes expenditure on other items such as public transport. These other categories account for a larger share of low-income household expenditure, increasing the transport share for these households (and reducing that of wealthier families).
The fact that the benefits of the gasoline subsidy are significantly concentrated in higher-income brackets does not necessarily imply that the subsidy is regressive. To assess this, the subsidy needs to be compared with the Gini income index (see footnote 16). At the quintile level, the concentration of income and subsidy benefits is very similar (figure 16, panel B), such that these subsidies appear to be slightly regressive (the Kakwani indicator gives a value close to zero).16

If it were politically feasible to change the design of the subsidy such as by allocating resources through a lump-sum transfer to families in the first two or even three quintiles would imply significant savings that could be allocated to other social programmes.17

Establishing transfers that compensate for the increased transport costs caused by higher gasoline prices may involve some implementation challenges, as discussed in box 2. The design principle is for this to be implemented through a demand-side subsidy. One alternative approach to implementation is to add a new programme for this specific purpose to the transfer system that is already in place in Panama (taking into account a fuel consumption cap that may possibly be conditional on how prices evolve). This system consists of three types of conditional cash transfer schemes administered by the Ministry of Social Development (MIDES): 1) Red de Oportunidades [Network of Opportunities]: this encourages the inclusion of families living in poverty and extreme poverty in national development by guaranteeing health and education services through the delivery of monetary aid; 2) 120 a los 65 [120 for over-65s]: this consists of a monthly cash transfer to people aged 65 and over without a pension and who are living in conditions of vulnerability, social risk, marginalization or poverty; 3) Ángel Guardián [Guardian angel]: this provides financial support of 80 Balboas per month to cover food and medicines and thus improve the quality of life of people with severe disabilities in conditions of dependency and extreme poverty.

Another significant programme is the Programa de Asistencia Social Educativa Universal [Programme for Universal Social Assistance for Education, PASE-U], formerly known as the Beca Universal [Universal Scholarship]. The objective of this programme is to encourage school enrolment and attendance, prevent absenteeism, grade repetition and school dropout, so as to promote the performance of students in primary, middle-school, secondary and special education from extremely poor or impoverished households. To this end, families receive annual contributions of between 270 Balboas and 450 Balboas (divided into three payments) on the condition that children and young people attend school and meet certain performance requirements. The programme currently benefits 671,000 students nationwide.

Spending on conditional cash transfer programmes and PASE-U has recently increased from 0.57 percent of GDP in 2014 to 0.97 percent in 2019, most of which goes to the 120 to the over-65s and PASE-U programmes (0.40 percent and 0.51 percent of GDP, respectively).

Interestingly, the amounts allocated in recent years to these social programmes to combat poverty and extreme poverty are similar to the expenditure on the fuel subsidy described above in 2022 or 2023. Clearly, were these subsidies to be better targeted to complement existing transfers such as the Network of

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15 The fact that the subsidy is biased in favour of the wealthy can be demonstrated by calculating the concentration index that results from subtracting the area under a curve showing a proportionally equal distribution of the subsidy (a straight Lorenz curve) versus the curve that describes the actual distribution of the subsidy by income level (a convex Lorenz curve, given the higher incidence in high-income families).

16 As is mentioned in footnote 14, it is to be expected that spending on gasoline is comparatively more concentrated in high-income brackets than spending on public transport. As a result, the subsidy appears to be regressive. In the case of electricity subsidies, although they benefit higher-income families to a greater extent, their incidence is less concentrated than income, so they are generally progressive, as has been found in the case of Argentina (see Puig et al., 2021).

17 Of course, if a decision is made to move in this direction, a more accurate measure of expenditure on gasoline per income quintile should be used.
Opportunities or 120 to the over-65s programmes, it would not only allow them to be allocated to the people who need them most but would also save resources that could be used to expand existing transfers. The evidence suggests that these programmes do entail exclusion problems, in the sense that there are poor families who are not receiving this support. For example, in 2017, the Network of Opportunities programme only reached 38.1 percent of extremely poor households with children between 6 and 18 years of age (BID, 2019). There is also significant leakage, in that a significant share of these programmes benefit non-poor families (figure 17).

**Figure 17.** Households receiving social programmes, by poverty level (2019)\(^\text{18}\)

Regardless of what is ultimately done with the fuel subsidy to improve targeting, the point worth underlining here is that in a country like Panama, where social spending accounts for less than 9 percent of GDP and in which social protection expenditure is less than 2 percent of GDP, allocating 1 percent of GDP to fuel subsidies that clearly benefit high-income families does not seem to contribute to the agenda to reduce inequality that the country has been pursuing for some years now. This is particularly true in a context that these subsidies may be extended over time. In any case, if this initiative is kept in place, its effects on inequality may be partly offset by adjustments to some taxes to strengthen tax revenue and give the State more resources for investing in infrastructure and social programmes (this issue is discussed again below).

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\(^{18}\) The extreme poor are those with incomes below the per capita value of the basic food basket. The non-extreme poor have incomes equal to or above the per capita value of the extreme poverty line with which they can afford the basic food basket, but which are below the per capita value of the general poverty line. In other words, their incomes fall short of meeting other basic non-food needs (housing, education, health, transport, clothing, etc.).
4.2. Consequences of the war on activity in the Panama Canal

The canal contributes to the economy via two channels. First, the Canal Zone is a supply hub for shipping-related services (insurance, maintenance and other professional services). It promotes port development, which generates income from service exports. Second, revenue from tolls, income taxes, dividends and other fees that the Canal Authority transfers annually to the State make it a major source of government revenue.

As mentioned above, the Russia–Ukraine conflict and the various ramifications of this (rising transport prices, the global downturn, supply chain problems, etc.) may affect the volume of trade, which would have knock-on effects on the benefits that the canal brings to the Panamanian economy.

Before the war broke out in Ukraine, 6 percent of world trade used the canal as a route to reach its destination; for example, between the east coast of the USA and China (see details below). The canal accounted for approximately 7 percent of Panama’s GDP and employs around 8,000 people. Following the expansion project that was implemented between 2006 and 2016, the canal now has three sets of locks, which have been affected by periods of drought in the country due to El Niño and other phenomena associated with global climate change (Zegarra, 2017; Economist Intelligence Unit, 2022b; Autoridad del Canal de Panamá, 2022a and 2022b). To date, the most intense episode of drought that significantly affected activity through the canal was in 2016. The year saw the lowest number of transits since 2010, a drop of approximately 4 percent, greater than was observed during the Covid pandemic in 2020 (figure 18). From 2017 onwards, the increase in traffic has been driven by the opening of these new locks.

**Figure 18. Number of Panama Canal transits by fiscal year**

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<td>13,795</td>
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<tr>
<td>2019</td>
<td>13,785</td>
</tr>
<tr>
<td>2020</td>
<td>13,369</td>
</tr>
<tr>
<td>2021</td>
<td>13,342</td>
</tr>
</tbody>
</table>

Source: Compiled by the author using data from Georgia Tech Panama (n.d.).

In addition to being one of the most significant economic activities in Panama, as mentioned above, the canal is also one of the most important sources of revenue for the Government. In line with the information provided by INEC (Instituto Nacional de Estadística y Censo, n.d.), Panama Canal-related revenues accounted for 13.4 percent of total government revenue between 2016 and 2019, which is equivalent to 2.8 percent of GDP (figure 19). The factors affecting the dynamics of these revenues that can be observed in figure 19 include the effects of the 2016 drought discussed above and the increase in the number of locks from 2017 onwards.
Figure 19. Contributions of the Canal to the National Treasury (percentage of GDP)

The main trade route through the Panama Canal is between the East Coast of the United States and Asia (figure 20, panel A), in particular, between the US and China and Japan. The products that are most transported through the canal are oil related products (figure 20, panel B), most notably LNG. Of particular significance is the trade in LNG between the US and China, given that 22 percent of total US LNG exports through the canal are sent to this country (Sáenz, 2018). Other products that are transported through the canal correspond to containerized cargo, which includes major exports of machinery, apparatus and electrical devises and nuclear material from the US to China. Conversely, China’s exports to the US through the canal are mainly manufactured goods. Flows in both directions accounted for 51 percent of total canal traffic in 2021. US exports to Japan are mostly fossil fuels (including LNG), while US imports from Japan are mostly vehicles, manufactured goods and pharmaceuticals. After the USA, Japan and China, the countries that import the most through the canal are South Korea, Chile, Mexico, Peru, Panama and Colombia. Likewise, the countries that export the most after the USA and China are Colombia, Canada, Chile and Mexico.

Source: Compiled by the author with data from Ministerio de Economía y Finanzas (2020 and 2022).
The data above shows that canal activity is often largely determined by economic relations between the US and China. The Russia–Ukraine war may affect both this traffic and that between other nations through several channels. First, although Panama declared itself neutral by virtue of its 1977 treaty with the US and therefore did not impose sanctions on Russian trade through the canal, sanctions from other economies, especially the US and Europe, could still have a major impact on the canal. Compounded by the disruptions to supply chains caused by the conflict itself due to the devastation of Ukraine’s road infrastructure and the closures of shipping channels in the Black Sea and Bosphorus Strait, this could lead to fewer transits (Economist Intelligence Unit, 2022b). Beyond the direct effect of sanctions, the consequences of higher inflation, energy prices and interest rates on economic growth in major economies and their impact on global trade must also be taken into consideration. However, the WTO (2022) found that in the second quarter of 2022, world trade continued on a recovery trend, and has thus been somewhat resilient to the conflict in Ukraine. Likewise, the projections available for the whole of 2022 and 2023 do not reflect a sharp drop compared to previous years without crises (figure 21).

Despite the repercussions of the conflict in Ukraine, the recovery of global trade during 2022 is partly based on the decline in freight costs that has occurred in 2022 and is expected to continue until 2023 as supply chains that had deteriorated since 2020 return to normal. In fact, this is the key factor underlying forecasts that global trade growth will return to its historical average (3.6 percent), with emerging economies benefiting the most from reductions in the cost of maritime transport.

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Figure 20. Volume of trade (tonnes) on the main trade routes using the Canal (panel A) and goods transported by product type (panel B), 2021

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19 Despite the repercussions of the conflict in Ukraine, the recovery of global trade during 2022 is partly based on the decline in freight costs that has occurred in 2022 and is expected to continue until 2023 as supply chains that had deteriorated since 2020 return to normal. In fact, this is the key factor underlying forecasts that global trade growth will return to its historical average (3.6 percent), with emerging economies benefiting the most from reductions in the cost of maritime transport.
On top of the economic sanctions imposed on Russia, their effect on trade and the impact of the global economic cycle, another type of geopolitical risk could affect traffic through the canal, namely the diplomatic and economic relations between the US and China. This could become one of the greatest non-epidemiological threats to international trade (Economist Intelligence Unit, 2022a and 2022b). Underlying this is President Joe Biden’s decision to maintain technology, financial and investment bans on certain Chinese companies, coupled with recent political tensions between the two countries over events in Taiwan.

Likewise, China’s unwillingness to condemn Russia for its invasion of Ukraine could also potentially worsen its relationship with the US and Europe. It also may lead to China replacing some of its oil purchases from the US with purchases from Russia. Alternatively, some US LNG exports to China may be redirected to Europe. Indeed, against the backdrop of the energy crisis in the Eurozone, this region became the most important destination market for US exports of LNG in 2022. Specifically, the US shipped three-quarters of all its LNG to Europe in the first four months of 2022, up from one-third a year earlier (Freitas, 2022). All of these geopolitical considerations could jeopardize Panama Canal activity, although gauging their magnitude is still difficult.

In addition to the impacts of the conflict in Ukraine, the global economic cycle and other geopolitical factors, another source of risk are droughts, which affect canal operations because water from Gatun Lake is needed to lift ships through the locks. As noted above, this factor led to a significant drop in traffic in 2016. As this water is also essential for human consumption, the two uses come into conflict during droughts. This conflict may be aggravated by the trend towards higher residential consumption, which is set to increase from 480 MMC to 600 MMC by 2025 (Zegarra, 2017). This would decrease the availability of water for use in the canal in a dry year, according to predictions from the National Oceanic and Atmospheric Administration (NOAA) for the coming years. This factor means there is a downside risk to the forecast horizon for economic activity in Panama due to the effect of droughts on the canal operations, which could have a 16-point impact (of a maximum of 25 points) on the Panamanian economy (Economist Intelligence Unit, 2022b)²⁰.

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²⁰ Scenarios and scores are taken from the EIU Risk Briefing. Risk scenarios are potential developments that could substantially change the business operating environment in the next two years. Risk intensity is a probability and impact score on a 25-point scale.
In short, the balance of effects so far suggests that the conflict in Ukraine and the consequences of this on commodity prices and supply chains does not appear to be a factor that would significantly reduce the flow of international trade in the short term (indeed, this is still recovering from the impact of the pandemic), and thus have a negative knock-on effect on canal activities. Perhaps of greater concern may be the consequences of a geopolitical conflict between China and the United States that affects trade between these two countries. Finally, the most probable scenario is the possibility of further droughts, which would create an adverse environment for canal activities. Given how central these are to Panama's GDP and public finances, this scenario could cause the country's productive activity to deteriorate significantly.

4.3. Aggregate effects on external accounts and public finances

Drawing on the analysis so far, it may be relevant to assess the aggregate consequences of the Ukrainian conflict on Panama's external accounts and public finances. Both aspects are critical in terms of the short- and medium-term effects on the macroeconomy and in defining policies for financing both the external deficit and the deficit affecting public accounts.

Trade balance and current account

Panama is a net importer of oil and gas products, which account for approximately 20 percent of the trade deficit in recent years. The country is also a net food importer, but to a lesser extent (figure 22).

Figure 22. Panama’s net imports of fuel and food and their share in the trade deficit, 2005–2018 (billions of US$)
The conflict between Russia and Ukraine caused a deterioration of the trade balance of Panama, as has also been documented in other countries in the region (Giordano and Michalczewsky, 2022). Indeed, the trade deficit increased by 90.3 percent in the first quarter of 2022 compared to 2021 (0.5 percentage points of GDP). This deterioration was explained by the fact that imports increased more than exports, even though the latter benefited from the increase in copper sales abroad. On the import side, the 63.4 percent increase in oil prices between the first quarter of 2022 and the first quarter of 2021 resulted in a 180 percent increase in the value of oil imports, even though the increase in tonnes purchased only increased by 122 percent. In response to these trends in prices and volumes, the trade account deficit is expected to increase from 6.1 percent of GDP in 2021 to 7.1 percent of GDP in 2022, and the current account deficit to move from 2.2 percent of GDP to 5.1 percent in the same period. The current account deficit would fall to 4 percent in 2023 and would only drop below 2 percent in 2024.

Aside from the effect of oil, the outlook for Panama’s external sector is also explained by the slow recovery of revenues from non-trade-related services and some sectors such as tourism, which have not yet returned to pre-Covid levels. As mentioned before, copper export earnings will be the only factor to exert a positive effect on the external imbalance. There has been a rapid increase in the country’s copper exports since the Cobre Panamá mine came in operation in 2019. Exports have risen from US$792 million that year to US$2,813 million in 2021, when they represented 4.4 percent of GDP (and have climbed to 4.5 percent of GDP for the first half of 2022 alone). In 2022 and 2023, copper exports are expected to account for about 75 percent of the country’s total goods exports (figure 23).

**Figure 23.** Evolution of copper exports and share of total goods exports, 2017–2022 (in millions of US$)

*Source: Intelcom (n.d.).

21 The significant increase in the trade deficit is partly due to the low baseline for comparison in the first quarter of 2021, when the pandemic was still heavily influencing economic activity.
The larger current account deficit in 2022 is expected to be partially financed by FDI, as has been the case in previous years. However, these flows have not yet returned to their pre-pandemic levels as a result of worsening external financial conditions. Specifically, Panama’s FDI as a percentage of GDP fell from 6.6 percent in 2019 to 4 percent in 2020. Although it dropped as low as 2.1 percent in 2021, it is expected to end 2022 at 3.1 percent and peak at 3.8 percent in 2023, still well below pre-Covid levels (Economist Intelligence Unit, 2022b).

Impacts on fiscal accounts

This section analyses the effect of the conflict in Ukraine on public accounts in an attempt to summarize the different impacts that various outcomes of the conflict have on public revenues and expenditures in the Panamanian economy. First, the sharp rise in international oil prices has prompted the Government to establish fuel subsidies. Second, the war could affect traffic through the canal with negative consequences on public revenues from this source. Finally, one factor that is not directly associated with the conflict but has potentially significant repercussions on public revenues are the mining royalties resulting from increased copper production and exports.

Section 4.1 established that the new fuel subsidies would represent 1.0 percent of GDP during 2022 and 1.6 percent in 2023. In terms of canal activity revenues, the analysis in section 4.2 concluded that no major changes in transit flows are expected in the short term in a scenario where geopolitical conflicts between China and the US do not escalate and there is no major drought like the one that struck in 2016.

Finally, there is the effect of higher royalty revenues as a result of increased copper production and exports. On this point, it should be noted that the new terms of the contract for the Cobre Panamá mine came into force in 2022. These increase royalties on production from 2 percent to 12 percent, eliminating the 25 percent income tax exemption and establishing a minimum payment to the treasury of 0.6 percent of annual GDP.

Estimates based on data on the behaviour of royalty revenues put these close to the minimum. Royalty revenues increased by 69 percent between the first half of 2021 and 2022. However, royalty receipts still account for a small share of total government revenue (just 0.5 percent of tax revenues, equivalent to 0.02 percent of GDP). This is because the new regime has not yet been fully implemented. At the new rate of 12 percent, it is estimated that the annual revenue would be close to the minimum set by the Government (0.6 percent of GDP).

On this basis, it is clear that royalty receipts could offset a significant proportion of the higher fuel subsidy expenditures that are expected in 2022 and 2023. In the absence of increases in other expenditures (e.g. education or other social spending, or capital spending, which were reduced in 2021), the net effect of these changes does not appear to be very significant. This would imply that the 4 percent fiscal target for 2022 may be achievable, although there could be a slippage of around 0.2–0.3 percentage points of GDP. However, meeting the deficit targets implies postponing the necessary increases in social spending (e.g. education and social protection) and public investment. Both aspects may jeopardize the chance of more sustained, inclusive growth in the long run.

Therefore a medium-long-term strategic vision of Panama’s development may justify the possibility of partially adjusting some taxes to provide the State with resources to finance these higher expenditures. As mentioned above, average tax revenues before the pandemic were approximately 10 percent of GDP, one of the lowest in the region (the average for Latin America is 16.5 percent).

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22 This deviation does not take into account the deficit in the Social Security Fund and the food subsidies that are part of the Productos Panamá programme, for which no expenditure estimate is yet available.
After comparing Panama’s tax structure with that of other Latin American countries (and to a lesser extent, OECD countries), what stands out is the low share of corporate income taxes, property taxes, and VAT (figure 24). In Panama, VAT - also known as the Impuesto de Traslado de Bienes Materiales y Servicios [Tax on the Transfer of Tangible Goods and Services, ITBMS] - is levied on the final consumption of goods and services. The revenue from this tax only represents 2.5 percent of GDP, while the average for Latin America is 6.1 percent. VAT accounts for 53 percent of Panama’s lower tax revenues compared with the rest of the region. The next most important factor is corporate income tax, which accounts for another 22 percent (Garcimartín et al., 2020). Low VAT revenues are due not only to the fact that this tax rate is low (7%), but also to the fact that numerous products and services are exempt from it.23,24

Figure 24. Panama’s tax structure compared to regional averages (percentages)

Based on this very brief (and probably incomplete) diagnostic exercise, the Government could explore changes to the tax structure to increase state revenue, which could include some of the following points: i) strengthening VAT (ITBMS) by increasing rates and reviewing exceptions, which should mostly include products from the basic food basket and services, which make this tax less regressive; ii) harmonizing corporate income tax with a fixed rate in which there are no differentiated treatments by sector (for example, the lower rate applied to the financial sector). Conversely, there is a strong need to implement a reform of the social security system (the Social Security Fund) which, according to various estimates (INDESA 50, 2019), may run out of reserves in the coming years. This would imply the need to resort to other sources of revenue (e.g. royalties) that would otherwise be used to increase social spending (e.g. on education and social protection).

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23 Garcimartín et al. (2020) report that many of these VAT exemptions include products that are mostly consumed by high-income households, making the incidence of the tax more regressive than it would be if the exempted goods and services were better targeted.

24 The high share of social security contributions is explained by the low total revenues mentioned above, which in turn are determined by the low revenue from other taxes (e.g. VAT).
4.4. Analysis of potential medium-term effects on global value chains

The conflict in Ukraine could eventually accelerate a process of deglobalization whereby producers in the world’s major economies find it necessary to diversify the supply of basic and intermediate inputs by sourcing these from within their own economies (reshoring), from other markets closer to home (nearshoring) or to locations where the risk of geopolitical conflict is lower to avoid costly disruptions to their business.

Before the outbreak of the war in Ukraine, the Covid-19 pandemic led companies to re-evaluate their dependence on China as a source of intermediate inputs and its role as the “world’s factory”. The country’s zero-tolerance Covid policy has led to the closure of major cities and ports, causing supply chain disruptions, and triggering plans for supply chain diversification. Other countries in Southeast Asia—such as Vietnam, Malaysia, and Thailand—stand to benefit from this process (Economist Intelligence Unit, 2022a).

The war in Ukraine and its consequences on the political relations between China and the US could exacerbate this as yet preliminary trend, which would have knock-on effects on global trade. This may have a negative impact on some trade routes, such as that between China and the East Coast of the United States, which would in turn impact traffic through the canal.

However, the evidence so far on these deglobalization processes is still weak. Generally speaking, there are no expectations of a mass exodus of companies from China seeking to relocate to Western countries (e.g. Europe), where production processes are more expensive. In any case, as mentioned above, new investments could be directed to other Southeast Asian countries that already have significant regional productive ties with China, which would make it less costly for companies to replace suppliers. On the matter of reshoring processes, although there have been some announcements in specific sectors—semiconductors, for example—of factories opening in the main countries that design and develop these technologies (e.g. the US), this is still far from widespread.

Still, it is worth asking whether Panama and Central America could take advantage of some of these trends at the margin if they were to become a reality, given their strategic position. Geographical proximity to Mexico, the United States and Canada and logistics and transport infrastructure are all advantages when it comes to boosting trade and participation in global value chains involving these origins/destinations. This effect could be enhanced by greater subregional integration to increase production capacities. According to some estimates (Dempsey, 2022), if the region were to capture 10 percent of current US imports from countries outside the Western hemisphere, exports from Latin America and the Caribbean could increase by US$78 billion per year, a significant part of which would come from Central American countries and Mexico.

In this sense, the Central American Common Market plus the Dominican Republic (CACM+DR), also known as SICA (Central American Integration System), is a platform from which member countries could appeal to multinational companies looking to diversify their suppliers. The CACM+DR is an interesting example of trade integration. Compared to the other subregions of Latin America and the Caribbean, intrabloc trade in goods and services has grown steadily over time, reaching 14 percent of the total in 2015–2018 (close to 22 percent in the case of goods), more than any other subregional agreement (figure 25). In particular, intraregional trade within CACM+DR is higher than within MERCOSUR, despite the latter including two of the largest economies in the region. Moreover, within trade in goods, goods of industrial origin account for a growing share (23 percent in CACM+DR as compared to 18 percent on average for Latin America).
Figure 25. Evolution of the share of intraregional exports in total exports of goods and services, by region or trading bloc (percentages)

Beyond regional trade, CACM+DR/SICA is closely tied to value chains with the Mexican and US markets (extraregional chains) in which the value-added included in exports of both intermediate and final goods is even more important than that incorporated in exports to the regional market. This process is more intense in the case of Mexico and its NAFTA partners, where the domestic value-added included in exports to these destinations represents 16 percent of the economy’s total value-added, while in CACM+DR/SICA it stands at 11 percent (figure 26).
Figure 26. Participation in regional and extraregional value chains

Panel A. MERCOSUR

Panel B. South America-Pacific

Panel C. Mexico

Panel D. Central America and Dom. Rep.

Notes: The evolution of the share of foreign trade-related activities in total value added is presented for each Latin American region, broken down by destination market (regional or extraregional) and by traded good type (final or inputs/chain).


Central America is obviously not as large as the Mexican economy, nor does it have the same production capacity, but it does have the CAFTA-DR agreement, which was reached in 2004. This has brought down bilateral tariff barriers, which average approximately 2 percent for imports from NAFTA, while exports there from the CACM-DR only face tariffs of 1 percent (table 1).
Table 1. Domestic and external tariffs by trading blocs (percentages), 2017

<table>
<thead>
<tr>
<th>Importing region</th>
<th>Mercosur</th>
<th>Pacific Alliance</th>
<th>AC</th>
<th>CACM+DR</th>
<th>CARICOM</th>
<th>EU</th>
<th>NAFTA</th>
<th>ASEAN+3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mercosur</td>
<td>0.04</td>
<td>1.55</td>
<td>0.55</td>
<td>7.59</td>
<td>7.77</td>
<td>7.78</td>
<td>6.75</td>
<td>7.77</td>
</tr>
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<td>Pacific Alliance</td>
<td>1.23</td>
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<td>0.62</td>
<td>2.31</td>
<td>5.03</td>
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<td>0.55</td>
<td>4.50</td>
</tr>
<tr>
<td>AC</td>
<td>0.69</td>
<td>1.04</td>
<td>0.26</td>
<td>6.15</td>
<td>6.70</td>
<td>4.29</td>
<td>4.30</td>
<td>7.09</td>
</tr>
<tr>
<td>CACM+DR</td>
<td>5.37</td>
<td>2.79</td>
<td>4.58</td>
<td>0.65</td>
<td>4.54</td>
<td>3.82</td>
<td>2.05</td>
<td>5.34</td>
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<tr>
<td>CARICOM</td>
<td>12.24</td>
<td>12.10</td>
<td>12.10</td>
<td>11.49</td>
<td>2.57</td>
<td>6.91</td>
<td>12.25</td>
<td>12.26</td>
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<tr>
<td>EU</td>
<td>3.57</td>
<td>0.60</td>
<td>0.37</td>
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<td>0.02</td>
<td>0.00</td>
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<td>NAFTA</td>
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<td>1.42</td>
<td>0.24</td>
<td>2.95</td>
</tr>
<tr>
<td>ASEAN+3</td>
<td>6.87</td>
<td>5.86</td>
<td>6.28</td>
<td>6.83</td>
<td>6.91</td>
<td>6.17</td>
<td>6.46</td>
<td>1.98</td>
</tr>
</tbody>
</table>

Note: Average applied tariffs (percentages) in 2017. The importing region is the trading bloc applying the tariff and the exporting region is the region receiving the tariff. Source: Sanguinetti et al (2021).

This evidence thus shows a major connection between Central American and North American markets, which may expand as a consequence of new incentives for companies to diversify the sources of their inputs and intensify nearshoring. Given its transport and logistics advantages, Panama could take advantage of these circumstances to insert itself further into these chains based on transformation and value-adding processes that improve connections between the productive activities that take place within its SEZs (e.g. Colón) and the logistics and transhipment activities associated with the canal and the country’s ports. The so-called EMMA Law (Special Regime for the Establishment and Operation of Multinational Companies for the Provision of Services Related to Manufacturing), which was passed in August 2020, is an initiative that aims to achieve this objective by facilitating investments by multinational companies that seek to provide services to subsidiary or associated companies.

Promoting these productive chains may also require greater coordination of actions with neighbouring countries within the CACM-DR/SICA to attract investment to the subregion and negotiate the reduction of barriers still in place with the NAFTA countries. Another area of interest may be strengthening the initiative that has recently been launched by the Alliance for Development in Democracy between Panama, Costa Rica and the Dominican Republic, which seeks to position these countries as recipients of investment by US firms.

But Panama and Central America need to strengthen more than their connection with North America. To serve these markets, they may also need to supply inputs and participate in value chains with South American countries. More than anything, they need to focus on their closest neighbours to the south, such as Colombia and the other countries in the Pacific Alliance and the Andean Community of Nations (AC). Bilateral tariffs with these subregions are higher (table 1). Geographical proximity to these economies could also lead to productive integration processes that add value and diversify the country’s exports.
4.5. The effect of economic sanctions on the financial system

One final aspect that is significant for Panama are the money-laundering monitoring measures that the country has committed to adopting before the FATF. The expansion of offshore financial services for both domestic and foreign clients boosted the growth of the economy in recent years. As a result, Panama now has a sophisticated financial system that includes extremely important regional and global players.

This critical role is demonstrated by the fact that the services provided by the so-called International Banking Center (IBC) represent 6.5 percent of GDP and account for 2.5 percent of employment in the country (CAF, 2022b). These institutions serve domestic clients and those from other countries in the region and may have ties to the trade and logistics activities of the canal and the SEZs. The IBC’s assets are equivalent to 194 percent of GDP. It includes 88 banks, of which 49 have a general licence, 26 have an international licence and 13 are branches of foreign banks (CAF, 2022a). The difference between general and international licences is that the former allows financial brokering activities to be carried out in Panama and abroad, while the latter allows banks to have offices in Panama but only to broker operations abroad.

Given the size and sophistication of the Panamanian financial system, it is unsurprising that the financial depth of the economy is one of the greatest in the region, with credit to the private sector approaching 85 percent of GDP in recent years, very close to the OECD average (figure 27, panel A). Similarly, the real interest rate remained almost three times lower than the average for Latin American countries and was again similar to that of developed economies (figure 27, panel B). Finally, the low level of country risk, as measured by the EMBI index (which captures the sovereign spread) and the investment grade rating from credit rating agencies since 2010 point to the fact that risk perception among international investors is favourable. All this translates into lower financing costs and greater availability of funds.

**Figure 27.** Domestic credit to the private sector (panel A) and real interest rate (panel B)

Panel A

<table>
<thead>
<tr>
<th></th>
<th>Percentage of GDP</th>
</tr>
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<tbody>
<tr>
<td>OECD</td>
<td>109</td>
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<tr>
<td>Panama</td>
<td>83</td>
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<td>Latin America</td>
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Panel B

<table>
<thead>
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<th>Percentage</th>
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</thead>
<tbody>
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<td>OECD</td>
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</tr>
<tr>
<td>Panama</td>
<td>4</td>
</tr>
<tr>
<td>Latin America</td>
<td>11</td>
</tr>
</tbody>
</table>

Source: Compiled by CID/CPN with data from the World Bank.
Despite how developed Panama’s financial system is, it is not without problems, however. This is particularly true in relation to the services it provides to the small and medium-sized enterprise (SME) sector in the country. These companies face significant barriers to accessing credit. Only 21 percent report having a loan or line of credit and only 67 percent have a bank account, compared to average rates for Latin America and the Caribbean of 45.9 percent and 90.4 percent, respectively. Some 1.3 percent of Panamanian SMEs report using banks to finance their investment activities and 9.4 percent to finance working capital, while these rates stand at 28 percent and 39 percent, respectively, for the region as a whole (World Bank, 2010).

As a result, there are still challenges to be overcome if the hefty flow of resources and services provided by banks and other financial institutions are to be used to a greater extent to support the productive sector. This is especially true for activities that go beyond the canal and the SEZs, as this would help to boost development in manufacturing, agriculture, tourism and other activities that have strong potential in other areas of the country.25

For this to happen, first of all, the soundness and credibility of the system must be propped up through effective regulation and control. The context for this is unusual in Panama: as a consequence of its dollarized monetary system, the country does not have a central bank that carries out functions that exist in other countries (e.g. implementing countercyclical monetary policy). Of course, the advantage of dollarization has been to keep the inflation rate low (it is tied to that of the US). Indeed, this is one of the factors that stimulated the development of financial services. However, the absence of a central bank—which functions as a lender of last resort — forces institutions to hold higher reserves so as not to expose themselves to liquidity problems. This has a negative impact on credit expansion. This is especially true in the case of the SME sector, where risks are higher, as mentioned above.

Another factor that drove the growth of the financial system in Panama, particularly with regard to offshore services, was the reduced regulatory burden on investors and clients of these services. For example, legislation dating back to the last century allows companies not to disclose the ownership structure of companies and corporations. However, to prevent these laxer regulations being used to cover up illicit activities (money-laundering), the international community, through the FATF, has demanded that Panama adopt measures to address such matters. Panama must comply with this requirement to be removed from the grey list of countries that are not cooperating in the fight against money-laundering and the financing of terrorism.

The war in Ukraine and the implementation of economic sanctions on Russia may increase pressure from major Western economies for Panama to adopt these measures, as the financial system is one of the main ways to ensure compliance with sanctions.

Not complying with these obligations and remaining on the grey list could come at a significant cost to the economy. As described above, Panama is a regional financial centre where international banks and private investors provide funds to finance both domestic companies and companies from the rest of Latin America and the Caribbean. Therefore noncompliance with anti-money-laundering regulations could have negative consequences that would lead to higher financing costs on lines of credit from international correspondent banks based in Panama (in the most extreme case, these credit lines could be cancelled outright). This would affect the flow of loans to the private sector, which is currently one of the highest in Latin America, as noted above.

25 Due to length constraints, this paper does not elaborate on policies that would be relevant for each of these sectors beyond access to finance. For example, major reforms in land tenure and ownership regulations are needed in the rural sector. For more details, see CAF (2019) and IDB (2019).
Since 2019, when the conditions that Panama had to meet to be removed from the grey list were established, the country has made substantial progress on compliance with several of the actions in question. As mentioned in the FATF report of June 2022, the country has complied with 11 of the 15 recommendations. However, some of the most relevant points are outstanding, such as: 1) the verification and updating of information on the final beneficial owners of companies; 2) the requirement for companies and corporations to make financial information available to the authorities; 3) demonstrating the judicial system’s capacity to investigate and charge individuals or companies involved in money-laundering operations.

These problems do not only concern banks: previous FATF reports have mentioned law firms, casinos, the Colón Free Zone, the real estate sector, and other non-financial institutions that have been used as mechanisms for committing financial crimes due to the lack of controls and oversight in the country. Despite these concerns, Panama has made progress in this area. Law 254 of 11 November 2021 extends the legislation passed in 2015 and explicitly incorporates these organizations as non-financial subjects supervised by the Superintendency of Non-Financial Subjects for the prevention of money-laundering and the financing of terrorism.

5. Conclusions

Over the last 15 years, Panama has become one of the fastest-growing economies in Latin America and the Caribbean. Its GDP per capita is currently one of the highest in the region, on par with those of high-income economies. This growth was made possible by implementing a strategic vision that positioned the country as a nexus between North and South America as a result of large investments in transport and logistics infrastructure. These include the Panama Canal, ports and airports, which are connected to Special Economic Zones (SEZs) that have attracted significant flows of foreign direct investment. These investments were combined with the creation of a regional financial services centre that helped provide support for the international trade and investment activities that were facilitated by the canal. Significant real estate investment was another focus area: by boosting the construction sector, it has generated employment and income. More recently, the emergence of large-scale mining activity has brought major opportunities for sustaining significant investment flows, leading to growth in exports and government revenues.

Despite these advances, the country has not experienced similar growth in social indicators beyond a very commendable drop in poverty indicators. The level of inequality in income distribution is one of the highest in the region, and improvements in access to secondary and tertiary education and social protection (e.g. transfers to the poorest households) do not befit a high-income economy such as Panama. These shortcomings in social indicators are partly explained by the huge inequality between different areas of the country, suggesting that most of the benefits of the country’s recent growth have been concentrated in the capital.

Panama, like other economies in Latin America and the Caribbean, has recovered relatively quickly from the Covid-19 crisis in terms of activity levels, although some sectors are still lagging (tourism, construction, restaurants and recreation, etc.). The labour market has not yet recovered: unemployment and informality rates are still above pre-pandemic levels. During this partial recovery, the conflict between Russia and Ukraine could aggravate the social situation. This has been evidenced by the recent protests triggered by the increase in gasoline prices but served to channel broader demands regarding access to social services.
Beyond the effects on fuel prices and the need to establish subsidies to alleviate the effect on household budgets—the implementation of which has, however, led to redistributive effects that benefit the higher-income brackets of the population—the short-term economic impacts of the war in Ukraine do not seem to be particularly significant for the critical sectors that drive growth, such as the canal, the financial system or other service activities. All the same, the country should take advantage of this situation to promote an agenda for inclusion that should focus not only on the most vulnerable social groups but also on the geographical disparities that have plagued development in the country to date. Achieving this requires greater public resources for investing in economic infrastructure (e.g. roads) and social infrastructure (e.g. education) that integrates these groups and regions into the formal economy. These investments cannot be financed by higher deficits and borrowing, as this would destabilize the economy. It might therefore be appropriate to consider partial adjustments to some taxes to strengthen tax revenue. These resources could be used to finance investments that would enable new sources of wealth generation in sectors such as agriculture and industry, which would enable so far marginalized workers and regions to benefit from the country’s development process.

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