FitchRatings

Fitch Revises Panama's Outlook to Negative; Affirms IDR at 'BBB'

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Fitch Ratings has affirmed Panama's Long-Term Foreign Currency Issuer Default Rating (IDR) at 'BBB' and revised the Rating Outlook to Negative from Stable.

Key Rating Drivers

The revision of Panama's Outlook to Negative reflects a marked deterioration in fiscal deficits and a significant increase of the government's debt burden, related to accumulation of arrears by previous administration and higher fiscal deficit targets under the modified Fiscal Responsibility Law. In addition, the recent greater-than-anticipated growth deceleration creates additional challenges for fiscal consolidation.

The incoming Cortizo administration has indicated that the prior government resorted to accumulation of arrears and discretion in fiscal accounting practices to meet deficit targets. Arrears will be recognized on the years they were incurred and will lead to an upward revision of fiscal deficits in past years. The authorities cleared supplier arrears in 2019, estimated at 1.8% of GDP, and intend to pursue a policy of keeping payables to suppliers to a level of 90 days. An additional 0.6% of GDP was disbursed to clear accounts payable to the Caja del Seguro Social (CSS, Panama's Social Security Institution).

The government modified its fiscal responsibility law (LRSF) in late 2019 to widen the non-financial public sector (NFPS) fiscal deficit targets to 3.5% of GDP in 2019, 2.75% in 2020, 2.5% in 2021 and 2.0% thereafter. The upward revision to deficit targets by the new administration recognizes a weaker starting point for the planned fiscal consolidation, an outcome related to weak fiscal policy credibility under past governments, and an issue previously highlighted by Fitch. Improving the strength and credibility of the fiscal framework strength is particularly important to the rating in the absence of independent monetary policy.

Modifying the fiscal rule's deficit ceiling follows a decade-long pattern of postponement of consolidation goals and failure to stabilize government debt in spite of high growth. Adjustments to widen the fiscal deficit ceiling come only one year after a similar relaxation of spending constraints in October 2018.

Fitch estimates Panama's NFPS deficit rose to 3.1% of GDP, below the modified fiscal targets. A larger-than-budgeted deficit reflects government revenues contraction through the year, reflecting weaker growth and persisting structural issues, while expenditure continued to increase. Fitch expects the NFPS deficit to gradually decline to 2.75% of GDP in 2020 and 2.5%, in line with the gradual consolidation path set by the new deficit ceilings. The bulk of the consolidation effort will likely rely on reduction of capex and tax collection improvement efforts, given low appetite for a tax reform to increase revenues, and its conservative growth projections imply limited revenue gains. Risks around the fiscal consolidation target include an increase of the pension-related liabilities, lower-than-expected economic growth and continued underperformance of tax collections.

Gross government debt rose to 46.4% of GDP in 2019 from 39.4% in 2018. General government debt (net of the social security government debt holdings) increased to 40.2% in 2019 from 34.7% in 2018, nearly converging with the 'BBB' median. The fiscal rule sets a limit of 40% of GDP for net debt, defined as gross debt minus assets in the sovereign wealth fund and those held for pre-financing purposes. However, this is only an indicative threshold which was breached by YE 2019 as it reached 42.6% of GDP.

Fitch projects the debt burden will continue to rise, albeit gradually over the forecast period and reach 42.5% by 2021. Failure to meet the new fiscal targets would lead to a further rise in debt and risks to the sovereign rating. Panama's debt and interest burdens as a share of revenues are already well above the 'BBB' medians and rapidly rising, highlighting its low and falling revenue base.

Pension liabilities-related risks are also a challenge to the fiscal outlook. The unfunded defined benefit component of Panama's mixed pension system is entering into a cash deficit. Reserves could be depleted by 2023 absent any parametric reform, according to the latest actuarial estimates. However, estimates are based on unreliable information given data deficiencies at the CSS. The authorities intend to overhaul the current database system, which could take up to 18 months, prior to presenting a reform proposal in Congress.

Lower economic growth compared to historical averages could exert additional pressure on sovereign credit metrics. Economic growth softened to 2.7% in 3Q19 (cumulative terms), and Fitch estimates 3.0% growth for the year as a whole, as completion of infrastructure projects and a softer real estate market have contributed to an ebb in the construction cycle, and retail commerce has seen a slump. Unemployment increased to 7.1% by August 2019 (latest available data) from 6.0% in 2018, resulting in a drag on private consumption. Macroeconomic imbalances, however, remain low reflected by low inflation (0.8% in 2019) and a current account deficit (estimated at 7.0% of GDP in 2019) fully funded by robust FDI inflows (8.5% of GDP).

Fitch projects real GDP growth at 4.0% in 2020 and 2021. Economic activity is expected to improve as the new mining operation ramps up to full production through 2020. Copper production could contribute 1pp to growth, according to authorities. The construction sector, a key economic driver in the past, could continue to be a drag on performance given indications of over-supply. The government currently projects to lower on-budget capital investment to below USD3 billion in the coming years (4.5% of GDP), below the averages seen over the past decade. Private-public partnerships could complement government infrastructure projects under the recently approved law to create these regimes. The government expects USD2 billion in investments under this regime; however, these might experience delays as the framework is implemented.

Panama held general elections in 2019. Laurentino Cortizo from the center-left Partido Revolucionario Democratico (PRD) was elected president and sworn into office on July 1 for a five-year term. The election outcome denotes broad policy continuity as the campaign focused on corruption and transparency rather than macroeconomic policy. Legislative elections resulted in a congressional majority for the new administration; however, support for legislation is not assured, as demonstrated by the recent submission and retraction of a constitutional reform initiative.

Despite government progress in strengthening its Anti-Money Laundering and Combating the Financing of Terrorism framework, shortcomings in its effectiveness resulted in Panama being placed back on the FATF's "gray list." Deficiencies do not relate directly to the banking sector, and there has not been a discernible macroeconomic impact so far as a result of the most recent inclusion. Panama did not exhibit an extended macroeconomic impact when placed on the "gray list" in 2014.

Panama's ratings are supported by its strong and stable macroeconomic performance, which has driven a sustained rise in per capita income and reflects policies and a strategic location and asset (Panama Canal). This is counterbalanced by a relatively narrow government revenue base and an uneven track record of meeting fiscal consolidation targets that has kept the government debt burden on an upward trend.

Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns Panama a score equivalent to a rating of 'BBB-' on the Long-Term Foreign Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

- Public Finances: +1 notch, to reflect that the SRM classifies public debt as fully denominated in foreign currency due to Panama's use of the U.S. dollar, but the well-entrenched dollarization regime fully mitigates FX risk on the sovereign balance sheet.

The committee removed the -1 notch in Macroeconomic Performance and Prospects, which had reflected an uneven track record of compliance with its fiscal targets, which undermined policy credibility. Higher deficits and government debt projections due to historical revisions and continued relaxation of fiscal targets embedded in the SRM now captures this fiscal weakness. Nevertheless, the Negative Outlook on the IDR reflects persisting downside risks to meeting the new fiscal targets that could hinder a sustained improvement in policy credibility and predictability.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main factors that could individually, or collectively, lead to a downgrade include:

--Greater-than-anticipated increased in public debt ratio led by failure to reduce the fiscal deficit, lower economic growth, pension imbalances or crystallization of additional contingent liabilities (eg arrears);

--Reduced confidence in the government's fiscal consolidation strategy i.e. through revision of established fiscal targets;

--Sustained deterioration in medium-term growth prospects relative to Fitch's current economic projections.

The Rating Outlook is Negative. Consequently, Fitch does not currently anticipate developments with a high likelihood of leading to a positive rating change. However, the main factors that could lead Fitch to Stabilize the Outlook include:

--Increased credibility and predictability of the fiscal strategy leading to an improvement of debt dynamics over the medium term;

--Sustained improvements in tax collection that enhances fiscal policy flexibility.

Key Assumptions

The global economy performs largely in line with Fitch's Global Economic Outlook (December 2019).

ESG Considerations

Panama has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as World Bank Governance Indicators have the highest weight in the SRM and are relevant to the rating and a rating driver.

Panama has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are relevant to the rating and a key rating driver with a high weight.

Panama has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight.

Panama has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver as for all sovereigns.

For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
Panama	LT IDR BBB Affirmed	BBB
	ST IDR F2 Affirmed	F2
	LC LT IDR BBB Affirmed	BBB
	LC ST IDR F2 Affirmed	F2
	Country Ceiling A Affirmed	A
senior unsecured	LT BBB Affirmed	BBB

Additional information is available on www.fitchratings.com

Applicable Criteria

Sovereign Rating Criteria (pub. 26 May 2019)
Country Ceilings Criteria (pub. 05 Jul 2019)

Additional Disclosures

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