MOODY'S

Rating Action: **Moody's downgrades Panama's rating to Baa3, changes outlook to stable**

31 Oct 2023

New York, October 31, 2023 -- Moody's Investors Service (Moody's) has today downgraded the Government of Panama's long-term issuer and senior unsecured ratings to Baa3 from Baa2, and the senior unsecured shelf rating to (P)Baa3 from (P)Baa2. The outlook was changed to stable from negative.

The ratings downgrade to Baa3 reflects Moody's view about Panama's lack of an effective policy response to structural fiscal challenges that have been rising over time, a condition that denotes weak governance and reduced fiscal policy effectiveness, a governance-related element under Moody's analytical framework. Moody's considers these pressures will persist leading to a deterioration of Panama's overall fiscal strength with the authorities' practice of relying on one-off revenue measures proving insufficient to reverse underlying trends.

The stable outlook reflects Moody's expectation that robust economic growth prospects will continue, allowing Panama's debt burden to remain aligned with that of its rating peers. Additionally, Panama continues to benefit from moderate-to-low susceptibility to event risk, which reflects in part the role of dollarization that mitigates the potential of sudden changes in its key credit metrics.

Panama's foreign-currency country ceiling was lowered to A2 from A1. In the context of full dollarization, Panama does not have a local currency country ceiling. In assigning a four-notch gap between the foreign-currency ceiling and the sovereign's ratings, Moody's considers that Panama's government has a relatively low footprint in the economy and financial system. The predictability and reliability of institutions and government actions is adequate and political risk is moderate. In the context of dollarization, the risks derived from external imbalances are low and Panama is not exposed to a single commodity or productive sector. Additionally, given the long track record of dollarization, there are minimal transfer and convertibility risks.

RATINGS RATIONALE

RATIONALE FOR RATING DOWNGRADE TO Baa3

The reduction of Panama's fiscal deficit has been supported by strong economic growth and a series of one-off measures, without the authorities having materially addressed structural fiscal challenges that continue to be present on the spending side, nor those derived from Panama's very narrow revenue base. In a social-political context characterized by heightened tensions, as evidenced by the large protests that have taken place over the past year, Moody's considers that Panama's credit profile will continue to be undermined by persistent pressures.

Expenditure challenges relate to a large wage bill that represents over 30% of government spending and will continue to grow in line with GDP driven by law-mandated salary increases. Additionally, to address social discontent, the government has extended subsidies and transfers that had risen initially in response to the pandemic, and the government passed a law this year increased spending earmarked to the education sector taking it to 7 % of GDP from the previously mandated level of 6% of GDP. Combined, these features and policies contribute to an increase in the rigidity of the government's spending structure and limit the adjustment capacity amid a narrow revenue base.

Tax revenue had been declining since 2017, to 7.6% of GDP in 2018-22 on average. This has been partially compensated by transfers from the Panama Canal Authority (ACP), increasing the government's dependence on the ACP, with transfers representing over 25% of central government revenue in recent years. Government revenue recovered in 2022-23 thanks to robust economic growth, but remained below budget targets despite one-offs, including $500 million (0.6% of GDP) received from the sale of land to the ACP.

In 2023, Moody's considers the government would be able to comply with the 3% of GDP deficit limit set in its fiscal rule thanks to the approval of a new mining contract that would generate $770 million (0.9% of GDP) this year and provide $375 million (0.4% of GDP) annually in royalties in the coming years. Moreover, given recent protests, the contract will be submitted for approval in a referendum that would take place in December 2023. Importantly, this additional revenue will not be sufficient to address higher fiscal pressures stemming from a larger interest burden and the ongoing deterioration of the finances of the social security.

Prospects of continued deterioration of debt affordability through 2024 will weigh on Panama's fiscal strength despite a stable debt-to-GDP ratio. Moody's expects the interest burden will rise to about 3% of GDP in 2024 representing over 15% of government revenue, almost double the Baa median of 8%, and for it to remain high in subsequent years.

Moreover, the Caja de Seguro Social (CSS), Panama's social security entity, defined-benefit program (IVM) continue to consume its reserves and Moody's estimates that, absent a major overhaul, partial measures will prove insufficient to address the growing IVM deficit placing the next government in a difficult position as it will have to confront increase pension-related spending projected to amount some 1% of GDP by 2025.

Given full dollarization, fiscal policy is the government's most important tool to respond to macroeconomic shocks. To anchor fiscal management Panama adopted a fiscal rule compliance with which has had a mixed track record to date. Changes to the fiscal rule approved in 2018 strengthened its framework, but weak compliance remains the norm as well as recurrent use of one-offs. For instance, in 2022 the deficit fell below the limit set in the fiscal rule due to a swap operation that allowed the government to reduce interest payments such that the deficit came at just below the 4% limit. Additionally, the government has not complied with fiscal rule-related mandates involving transfers to the sovereign wealth fund with payments due accumulating over $900 million between 2018 and 2022. Under-reporting of arrears by outgoing administrations have led to material revisions of fiscal outcomes, and the lack of multiyear fiscal frameworks undermine the predictability of fiscal policy. Overall, Panama's inability to effectively address fiscal challenges, coupled with limited transparency on the direction of medium-term fiscal management, denotes the presence of weaker institutions and governance strength than peers.

RATIONALE FOR STABLE OUTLOOK

Robust GDP growth prospects over the coming years with annual rates in the range of 4%-5% provide key support to Panama's credit profile. This feature, along with comparatively high GDP per capita PPP, will sustain Panama's economic strength in Moody's opinion. Favorable growth dynamics will help keep the debt burden stable and may potentially accommodate a gradual decline of the debt-to-GDP ratio, which will remain in line with the Baa median of about 55% of GDP in 2023.

Dollarization will continue to support Panama's credit profile by limiting its exposure to external shocks derived from volatile global financial conditions, shielding the government's balance sheet from exchange rate risks that affect its emerging market peers. Similarly, banks' balance sheets do not face currency mismatches, and their ample liquidity position significantly reduces risks that could result given the absence of a lender of last resort.

Given these credit features, at the Baa3 level Panama's rating appears very resilient and, in Moody's opinion, material downward pressures would only emerge if severe economic and/or fiscal shocks were to be experienced.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Panama's CIS-3 credit impact score reflects its moderate exposure to social risks related to income disparities and the potential for social unrest; environmental risks mainly related to climate risks that affect water availability, in particular to the Panama Canal; and a moderate institutional framework and challenges related to fiscal policy effectiveness.

Panama's E-3 issuer profile score reflects the country's exposure to weather events like excessive rains or droughts. While this has not led to significant disruptions, it can reduce the availability of water resources in the main urban areas, and for the agricultural sector and the Panama Canal. Given the importance of the canal for the economy and fiscal accounts, mitigation of water-related issues will remain a key challenge.

Moody's scores Panama's exposure to social risks at S-3. Panama has favorable demographic dynamics, but spending pressures stemming from the social security's defined benefit program will create fiscal constraints. Additionally, despite having one of the highest per capita GDPs on a PPP basis in Latin America, Panama has high income inequality, which is particularly significant between urban and rural areas. Challenges related to the provision and quality of education also pose risks because of the shortage of skilled labor that weighs on productivity growth.

The influence of governance on Panama's credit profile is reflected in a G-3 issuer profile score. The country has a moderate institutional framework, although it lags in terms of control of corruption and weakening of the rule of law. Although dollarization has supported broad macroeconomic stability, transparency challenges and a mixed track record of compliance with the fiscal rule has weighed on fiscal policy credibility and effectiveness.

GDP per capita (PPP basis, US$): 39,397 (2022) (also known as Per Capita Income)

Real GDP growth (% change): 10.8% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.1% (2022)

Gen. Gov. Financial Balance/GDP: -3.9% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: -3.9% (2022) (also known as External Balance)

External debt/GDP: 48.2% (2022)

Economic resiliency: baa2

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 27 October 2023, a rating committee was called to discuss the rating of the Government of Panama. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have materially decreased. The issuer's governance and/or management, have materially decreased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer has become increasingly susceptible to event risks.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

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Upward rating pressure would emerge if a material strengthening of Panama's fiscal policy framework enhanced the credibility of the fiscal rule as a policy anchor. Increased transparency related to fiscal policy planning and the management of arrears would also be credit positive. Policy measures that proved effective in addressing fiscal pressures stemming from a narrow tax base, the upward trend in debt affordability and the persistent financial deterioration of the social security's defined-benefit program would bolster Panama's credit profile.

FACTORS THAT COULD LEAD TO A DOWNGRADE OF THE RATINGS

Downward pressure on the rating would stem from a material shock that would prevent a gradual decline of the government's debt ratio, as currently contemplated in Moody's base scenario. Along with the ongoing weakening of debt affordability, i.e., increased interest-to-revenue ratio, these conditions would result in a larger-than-anticipated deterioration of the sovereign's fiscal strength. Lack of policy measures to address the weakening financial standing of the social security system would also contribute to an accelerated deterioration of Panama's credit profile.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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At least one ESG consideration was material to the credit rating action(s) announced and described above. Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1355824.

The Global Scale Credit Rating(s) discussed in this Credit Rating Announcement was(were) issued by one of Moody' affiliates outside the EU and UK and is(are) endorsed for use in the EU and UK in accordance with the EU and UK CRA Regulation.

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