STRATEGY FOR THE MANAGEMENT OF PUBLIC DEBT IN PANAMA 2014 - 2018

Directorate of Public Financing
Ministry of Economy and Finance
Republic of Panama

Index

Public Debt Management Strategy in Panama 2014-2018

1. Strategy Objectives and Scope

The "Public Debt Management Strategy in Panama 2014-2018" is published in accordance with the provisions of Article 4 of the Executive Decree No.113 of November 28, 2003 relating to the role of Public Financing on recommending a national credit policy for consideration of the National Economic Council (CENA) and the Cabinet Council and the President of the Republic through faithful compliance with the laws and regulations that govern public financing , and, once this is coordinated, ensure and coordinate for its execution. In addition, it has other roles that would be directly related to the strategy, such as: the coordination of the execution of State securities in the international capital markets, and the organization of the State securities allocation system in the internal capital markets.

According to legal regulations, individual debt operations, such as the issuance of securities in the internal and external market and contracting loans, are performed through previously authorized decrees that are approved in the Cabinet Council. This document establishes political guidelines for these individual financing operations, which are necessary to contribute to build a portfolio of obligations with favorable financial terms and conditions, and that reflect the medium term public debt management objectives of Panama.

The objectives set by the Ministry of Economy and Finance (MEF) to manage public debt, through the Directorate of Public Financing, are: (i) meet the State's financing need; (ii) obtain the lowest possible financing costs without compromising the financial stability of the State; and (iii) promote the development of the internal debt market. So far, the search of these objectives has promoted a prudent management of the public debt that has contributed to fiscal sustainability.

The scope of this strategy includes the Non Financial Public Sector (NFPS)[1], which includes the public debt of the Central Government (CG) and the public debt of decentralized institutions (including some public companies such as the Institute of National Aqueducts and Sewage Systems).

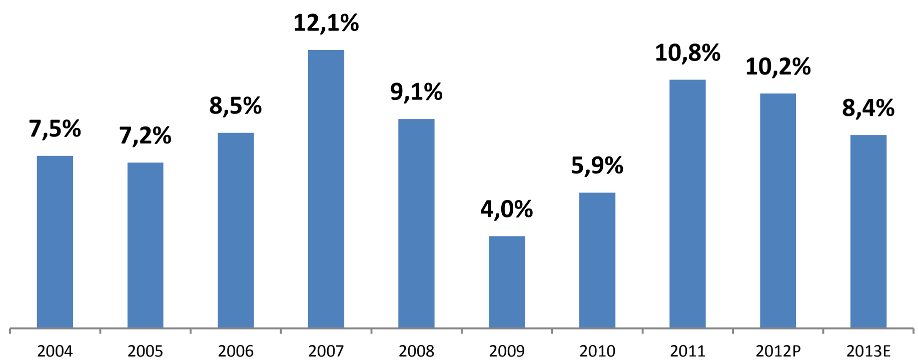
[1]Composed of all General Government entities and the Non-Financial Public Entities. It does not include financial public institutions that collect deposits, the Panama Canal Authority, Aeropuerto Internacional de Tocúmen, S.A. (AITSA), the National Motorways Company, S.A. (ENA) and the Electrical Transmission Company, S.A. (ETESA).

2. Public Debt and its Current Situation

The balance of the gross public debt reached US$15,683.6 million at the end of 2013, of which $12,230.7 million correspond to external debt balance (78.0% of total debt), and $3,452.5 million correspond to internal debt balance (22.0% of total debt).

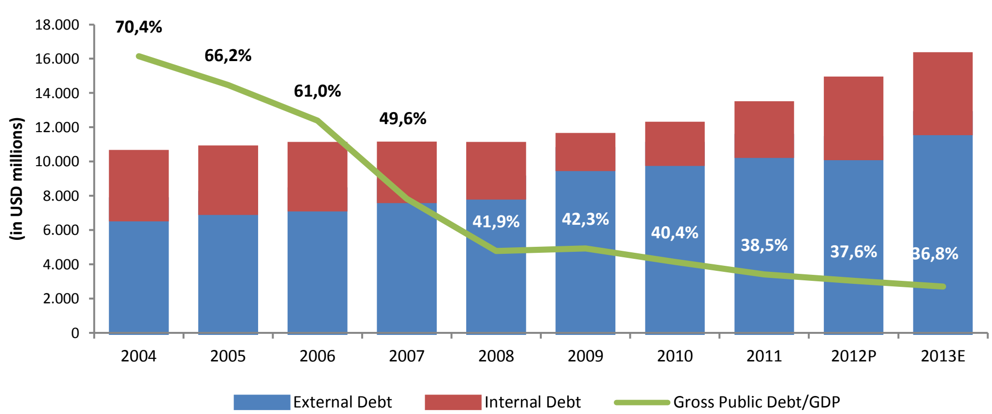
As a result of the growth of the national economy (see Graph No.1) and a prudent fiscal management by the Government, the gross public debt / GDP ratio has decreased steadily since 2004, from 70.4% to 36.8% at the end of 2013 (see Graph No.2).

Graph No.1
Growth of Real GDP (%)[2]



Source: Contraloría General de la República and MEF

Graph No.2
Evolution of Debt / GDP[3] Ratio



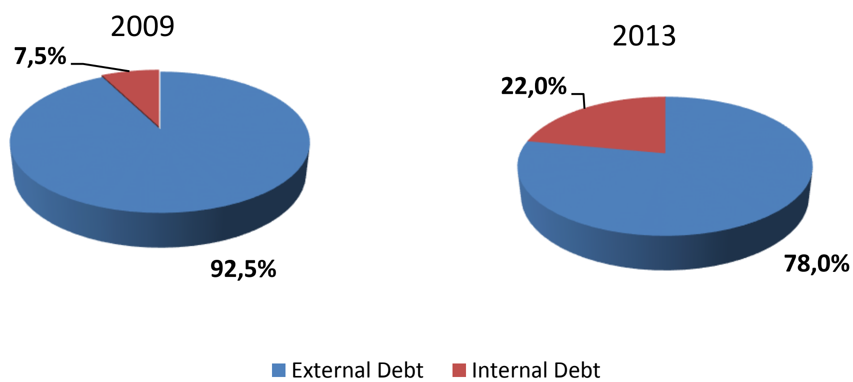
Source: MEF/Directorate of Public Financing

[2]Economic growth, until 2007, is measured at constant prices of 1996, from the year 2008 onwards at constant 2007 prices.
[3]Nominal GDP.

78.0% of the public debt's portfolio consists of obligations with the external sector. The main creditors of external debt come from the private sector. Bond holders, whose balance amounts to USD 8,307.1 million, represent 67.9% of the external debt; meanwhile, the portfolio with multilateral agencies represents 24.0% (USD 2,937.4 million). The rest of the external debt portfolio corresponds to bilateral agencies, 2.4% (USD 293.3 million), and commercial banking 5.7% (USD 693.3 million).

However, the participation of internal public debt has increased significantly since 2009. At the end of 2013, participation tripled, reaching a 22.0%, thus reflecting the commitment of the Government to promote the development of the internal capital market. (See Graph No. 3)

Graph No.3
Composition of the Public Debt by Jurisdiction of Origin



Source: MEF/Directorate of Public Financing

2.1 Current Cost and Risk

The implicit interest rate[4] of the external debt portfolio of the Republic of Panama, 6.25%, is higher than that of the internal debt, 4.57%, due to the larger share of instruments issued in the external market years ago when the interest rate level was higher.

The access to financing through multilateral and bilateral agencies has had a positive impact in the reduction of the weighted average cost of the public debt due to the benefits of this type of financing, in terms of cost and term, in comparison to the debt instruments issued in the local and international markets.

[4]Calculated using the payments of interest and commissions paid for a year as a percentage of the balance of the previous year's public debt (methodology used by various multilateral organizations such as the International Monetary Fund in its public debt sustainability analysis).

Chart No.1

Implicit Interest Rate of the Public Debt (as of December 31, 2013)

	Balance (in USD millions)	Implicit Interest Rate
According to original jurisdiction	**15,683.6**	**5.84%**
Internal Debt	3,452.5	4,57%
External Debt	12,231.2	6,25%
According to financing sources	**15,683.6**	**5.84%**
Treasury Bills	449.5	0.05%
Commercial Banking	693.3	5.74%
Private Financing	16.1	1.76%
Bilateral	293.3	1.50%
Multilateral	2,937.4	3.45%
Official Banks	500.1	5.10%
Treasury Bonds	1,464.0	5.63%
Treasury Bills	1,022.8	4.73%
Global Bonds	8,307.1	7.36%

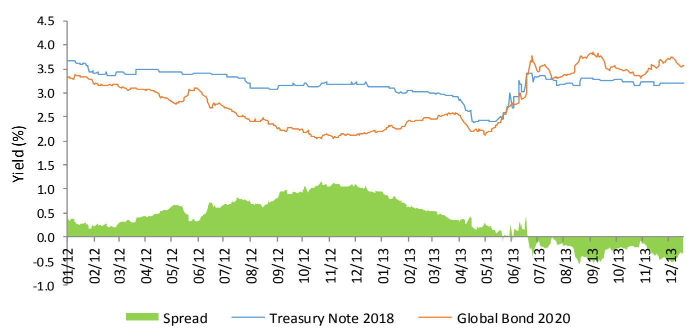
Source: MEF/Directorate of Public Financing

Currently, the internal securities market's financing costs tend to exceed those demanded in the international markets, in similar terms, mainly due to the fact that the liquidity premium and that of the first issuance required by the local market, is greater. A current estimate of this liquidity premium can be appreciated by comparing the performance on the secondary market of the Global Bond 2020 yield, which during much of 2013 had an outstanding balance of $1,000 million[5], with the Treasury Note 2018 (local), which has an outstanding balance of $993.8 million.

As it is presented in Graph No.4, this premium has been reduced from its highest point of 115 basis points, at the end of October 2012, to -35 basis points in December 2013.

Graph No.4

Evolution of Global Bond 2020 and 2018 Treasury Note yields



Source: MEF/Directorate of Public Financing

[5]As part of a liabilities management operation, there was a reopening of the Global Bond 2020 on November 21, 2013, raising its balance to US$1,500 million.

2.1.1 Exchange risk

As of December 31, 2013, 4.0% of the balance of the public debt corresponds to external debt in foreign currency, almost in its entirety (3.8%), in Japanese yen. A devaluation of the dollar against the yen of 10% [6] would increase the debt stock by USD 66.8 million, an amount that represents 0.2% of the GDP[7]. The dominant share of the dollar (96.0%) in the public debt portfolio, explains the low level of exposure of the portfolio to the currency volatility.

2.1.2 Refinancing risk

The public debt portfolio of the Republic maintains an extended redemption profile marked by the repayment of the Global Bonds and instruments issued locally. This structure has an Average Time to Maturity (ATM) of 11.4 years; 13.0 years for external debt and 5.7 years for internal debt. The market operation that produced a significant extension in the average time to maturity of the internal debt took place in 2012 with the launch of the 2022 Treasury Bond, which practically doubled the ATM of the internal debt from 3.9 years at the end of 2011 to 6.1 years at the end of 2012.

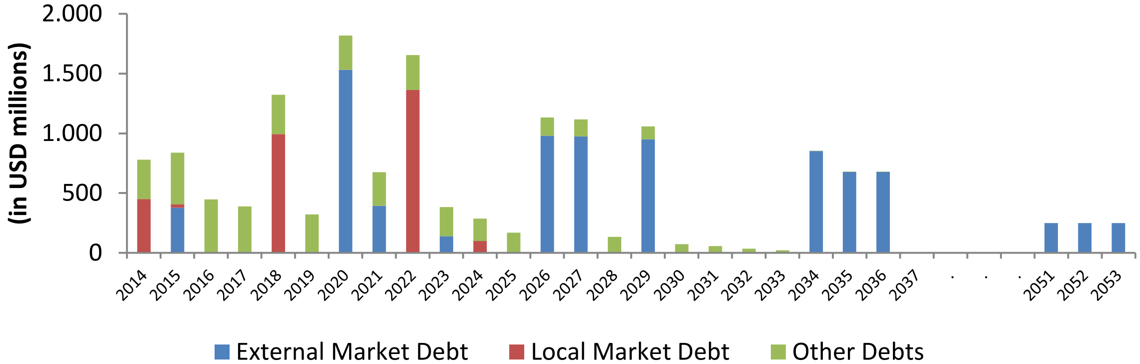
During the next five years, 24.1% (USD 3,778.6 million) of the public debt matures, amount that includes specific maturities of Treasury Notes in 2014 for USD 449.5 million, of the 2015 Global Bond for USD 378.8 million and from the 2018 Treasury Note for USD 993.9 million. The outstanding balance of the 2015 Global Bond in December 2011 was USD 1,471.0 million, but through two successful liability management operations in January 2012 and November 2013, this amount was reduced by 74.2% (USD 1,092.2 million). If that operation had not been performed, 31.0% of the debt would mature in the next five years; thus contributing to mitigate significantly the exposure of the public debt portfolio to refinancing risk.

While the redemption profile is favorable, it is important to highlight the importance of the execution of liabilities management operations in order to avoid the concentration of payments in specific years and mitigate the refinancing risk.

[6] USD/JPY exchange rate recorded at the end of 2013 = 104.92.

[7] 2013 estimated GDP = USD 42,648.1 million. Published by the National Institute of Statistics and Census (INEC) for the end of 2013.

Graph No.5
Public Debt Redemption Profile (as of December 31, 2013)



Source: MEF/Directorate of Public Financing

2.1.3 Interest Rate Risk

The exposure to interest rate risk comes from the obligations contracted in a floating rate, which represents 14.0% of the portfolio and mostly consists in loans with multilateral entities, and those contracted in a fixed rate that mature in the next fiscal year and must be refinanced, represent 4.2% [8] of the public debt. Together, these obligations represent USD 2,854 million, 18.2% [9] of the total balance of the debt. Accordingly, a widespread increase in the interest rates by 100 basis points in 2014, concerning current levels, would raise the payment of interests during the fiscal year 2014 by USD 21.9 million, which represents 2.0% of the NFPS debt service of the 2014 fiscal budget assigned to the payment of interests.

In the medium term, the exposure to interest rate risk measured by the average time to refixing of rates (ATR[10]), is located at 10.4 years at the end of 2013; 11.7 years for external debt and 5.5 years for internal debt. Positive evolution of this indicator, along with the ATM, are the result of the ongoing strategy in view of reducing risks in the Government debt portfolio.

The liabilities management operations performed show an appropriate and proactive debt management, which seeks to extend the redemption profile and keep debt maturities in the next five years in manageable percentages.

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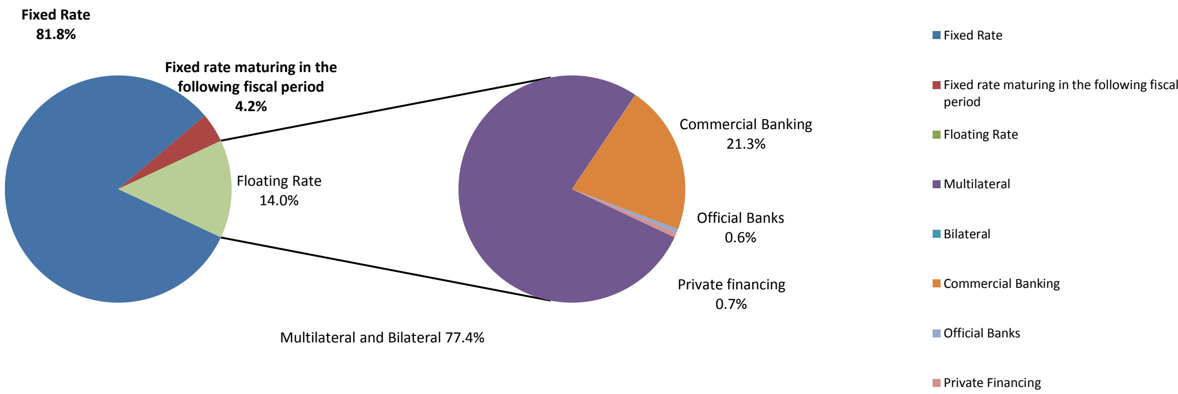
[8]Includes the following commitments made at fixed interest rate: USD 449.5 million of Treasury Bills maturing in 2014, USD 125.5 million of external debt and USD 85.5 million of another internal debt.

[9]Includes agreed commitments to fixed rate of previous footnote plus all the commitments made to floating interest rate amounting to USD 2,193.9 million.

[10]Average Time to Refixing is the average time in which all of the debt's portfolio principal payments flows will be subject to a new interest rate. If all debt were contracted at fixed rates, then the average time for re-fixation would be equal to the average time to maturity (ATM).

Graph No.6
Interest Rate Risk (as of December 31, 2013)



Source: MEF/Directorate of Public Financing

The favorable evolution of the main indicators of public debt risk can be seen in Chart No. 2.

Chart No.2
Public Debt Risk Indicators

Indicator **Refinancing Risk**	2011	2012	2013
Average maturity of External Debt	12.2 years	12.2 years	13.0 years
Average maturity of Internal Debt	3.9 years	6.1 years	5.7 years
Average maturity of Total Debt	10.9 years	10.7 years	11.4 years
Market Risk			
Average time to re-fixing of External Debt	11.2 years	11.0 years	11.7 years
Average time of re-fixing of Internal Debt	3.8 years	6.1 years	5.5 years
Average Time of Total re-fixing [1]	10.1 years	9.8 years	10.4 years
% of the debt that re-fixes rates in the following fiscal year	15.30%	16.80%	18.20%
% fixed-rate debt	89.4%	87.6%	86.0%
Exchange rate risk			
% of the debt in USD	93.40%	94.60%	96.00%

Source: MEF/Directorate of Public Financing

In conclusion, the exposure of the debt portfolio to exchange, refinancing and interest rate risks is limited, due to the larger share of the dollar, the extended and balanced maturity profile structure, and the coverage operations executed for those loans contracted in a floating interest rate.

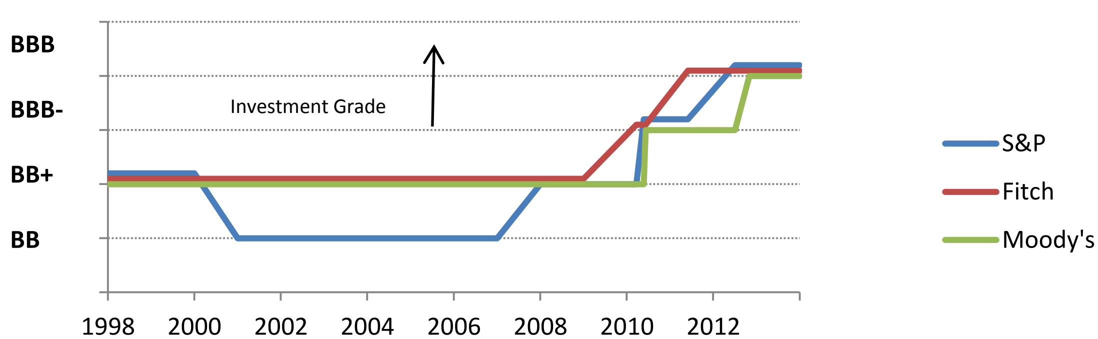
3. Financing Sources

Currently the Republic of Panama can have access to external and internal financing through the contracting of loans or through the issuances of securities.

3.1 External Sources

Since 2010, the Republic of Panama has an investment grade awarded by the three most prestigious rating agencies around the world, giving us a wide access to the international capital markets through instruments that can be issued with different modalities for its registration and liquidation. The sustained improvement in the risk rating (see Graph No.8) and the volume of allocations in the last year allow to foresee that the Government could timely place between USD 2,000 and USD 3,000 million a year[11], during the next 5 years, at interest rates that would have spreads over the references of the US Treasury which depend on the situation of the market. However, the potential high demand that may exist from international investors, the amounts to be allocated will be directly related to the State's financing requirements.

Graph No.8
Evolution of the Risk Rating of the Republic of Panama



Source: MEF/Directorate of Public Financing

Moreover, Multilateral Organisms comprise the second most important source of external financing; representing, at the end of 2013, 18.7% of total debt and 24.0% of the external

[11] In the most recent issuances of Global Bonds (April and November 2013), more than USD 6.0 billion were received in deals when combined indicative amounts were USD 1.2 billion.

debt. The composition by creditor of contracts made with the Multilateral Organizations is as follows: 55.2% is contracted with the Inter-American Development Bank (IDB), 22.6% with CAF- Development Bank of Latin America and 19.7% with the International Bank for Reconstruction and Development (IBRD).

The financial conditions of these loans compared with the cost that the Republic would face by issuing debt instruments in the international markets, at the end of 2013, are less by 391 basis points, as can be appreciated in Chart No. 3.

It should be noted that one of the competitive advantages of contracting loans with Multilateral and Bilateral Organizations is the access to technical assistance and follow-up in the implementation of investment projects of social interest.

Chart No.3
External Financing Sources

Sources	Instrument	Approximate cost in December 2013[12]	Grace Period	Term	Risks	Annual Volume Available (millions)
Multilateral						
IDB	Loans / Contingency Lines	Floating Rate: 3m LIBOR + funding margin + floating margin (0.84%)	1 to 5 years	10 to 30 years	Interest Rate Risk	USD 400.0
		Fixed Rate: 3.554% + margin variable				
IBRD	Loans / Contingency Lines	Variable Rate: 6m LIBOR + floating rate (0.27%)	1 to 5 years	15 to 25 years	Interest rate risk	USD 300.0
		Fixed Rate + variable margin				
CAF	Loans	6m LIBOR + 2.40%[13]	1 to 5 years	10 to 20 years	Interest rate risk	USD 300.0
		Fixed Rate: 2.925% + 2.40%				
IFAD	Loans	IFAD floating rate	10 years	16 to 18 years	Exchange rate risk (SDR) / Interest rate risk	USD 5.0
OFID	Loans	Fixed at 5.00%	1 to 5 years	20 Years	Availability of Funds	USD 50.0
Bilateral						

[12]It does not include commissions.
[13] CAF partially subsidizes the margin for a period established at the discretion of the Bank.

Sources	Instrument	Approximate cost in December 2013[12]	Grace Period	Term	Risks	Annual Volume Available (millions)
JICA	Loans	Fixed concessional rate between 0.01% and 1.20%	1 to 7 years	30 years	Exchange rate risk (JPY)	USD 50.0
Commercial banking						
Private Banking and ECA's [14] (COFACE, CESCE, among others)	Loans	3m Libor + 1.475%	1 to 3 years	12 years	Interest rate risk	Will depend on the negotiated amount
		Fixed 3.03% - 3.85%				
International Bonds						
Private	Global Bonds	Fixed between 4.30% to 10.75%	Bullet	10 to 40 years	Refinancing risk	USD 2,000.0 – USD 3,000
	Samurai Bonds	Fixed at 1.81%	Bullet	10 years	Exchange rate risk (JPY)	

Source: MEF/Directorate of Public Financing

3.2 Internal Sources

Although Panama has the possibility to meet its financing needs in the external market, the Ministry of Economy and Finance has strived to develop and stimulate the internal capital market with the launch of the Market Makers Program, with the dual objective of consolidating the advantages of the country as a financial center in the region and mitigating the risk of a sudden interruption of capital flows. Despite the fact that significant progress has been made in the development of the local market, a situation that has been recognized by the risk rating agencies and the International Monetary Fund (IMF) as an important element of diversification of financing sources and mitigation of exposure to external shocks, higher financing costs can be seen resulting from a local market that is less active and liquid in comparison with traditional sources of financing.

Chart No.4
Internal Financing Sources

Instruments	Approximate cost in December, 2013	Term	Risks	Annual volume (millions)
Private Financing				
Treasury Bills	Issued at discount, in reference to LIBOR	3 to 12 months	Refinancing risk	USD 450.0
Treasury Notes	Fixed between 3.5% and 5.0%	3 to 10 years	Refinancing risk	USD 1,000.0
Treasury Bonds	Fixed at 5.625%	More than 10 years	Refinancing risk	USD 1,500.0

[14] Export Credit Agencies.

Source: MEF/Directorate of Public Financing

The securities are issued through Primary Dealers, according to a program released in June 2011, called the Internal Public Debt Market Makers Program. The Government's commitment with the program is reflected in the increase of the participation of the internal debt in the portfolio from 7.5% in 2009 to 22.0% in 2013.

The major buyers of internal bonds are treasuries of commercial banks, the National Bank of Panama and the Caja de Seguro Social. Holdings of Government securities by private pension funds (PFA) and insurance companies are small, because there is not yet a developed investment fund industry in the country. Panama banks have about USD 90,000 million in liabilities, 60% of which are local deposits, but only one-fifth funds portfolio investments. The structure of its balance sheets makes banks natural buyers of Government securities at the short end of the curve and its demand should grow to the rhythm of the nominal GDP.

Table No.5
Holding of internal public debt instruments[15] (in USD millions)
As of December 31, 2013

Entity	Bonds	Notes	Bills	Total	%
Private Sector	**394.0**	**517.1**	**188.6**	**1,099.7**	**37.5%**
Private Banks	252.1	346.1	168.2	766.4	26.1%
Investment Administrators (SIACAP and PRAA)	57.3	118.2	6.9	182.4	6.2%
Pension Funds	6.3	-	-	6.3	0.2%
Investment Companies	3.2	1.2	-	4.5	0.2%
Corporations and Foundations	10.2	9.3	1.0	20.5	0.7%
Direct Foreign Investors	-	-	-	-	0.0%
Individuals	1.0	0.0	-	1.1	0.0%
Insurance Companies	44.8	27.5	7.5	79.8	2.7%
Trusts	3.7	0.5	-	4.2	0.1%
Brokerage Firms	15.3	14.2	5.0	34.5	1.2%
Public Sector	1,070.1	505.6	260.9	1,836.6	62.5%
Caja de Ahorros	78.1	32.5	-	110.6	3.8%
Caja de Seguro Social	31.8	57.9	-	89.7	3.1%
Banco Nacional de Panamá	960.1	415.2	260.9	1,636.3	55.7%
Total	**1,464.0**	**1,022.8**	**449.5**	**2,936.3**	**100.0%**

Source: MEF/Directorate of Public Financing

Although institutional saving in Panama is significant, only a small portion of these assets are invested in Government securities, with the exception of the Caja de Seguro Social. The PFA does not have an obligation to invest in Government bonds and there is no explicit "benchmark" [16] for the industry; which is expanding in average of 10.0% to 12.0% annually.

[15]By December 2013.
[16]Index that is used as a reference for assessing the management of an investment portfolio, under profitability and risk parameters.

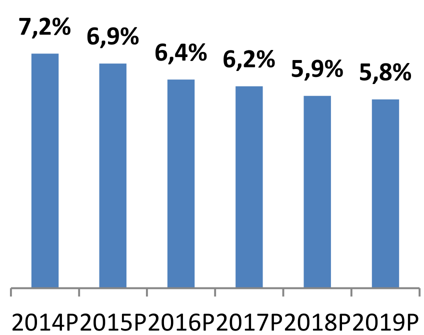
The National Banking System (SBN for its Spanish name), represented in Chart No.5 by private banks, Caja de Ahorros and the National Bank of Panama, possess 85.6% of the public debt instruments issued in the local market as of December 2013.

4. Macroeconomic Factors

4.1 Growth and Inflation

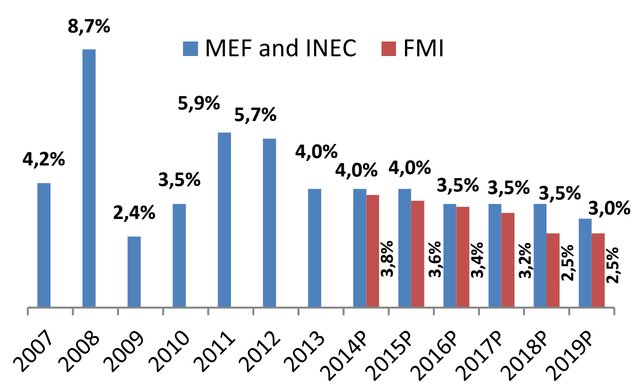
The Panamanian economy has experienced a fast growth in the last decade, derived mainly from high levels of investment, including the expansion of the Panama Canal and public and private investment[17]. The investment in capital has driven the strong activity in the transportation, trade, construction and communications sectors and has allowed Panama to duplicate the GDP per capita since 2006 and reduce unemployment to levels near to 4.0% between 2009 until 2013. According to the IMF World Economic Outlook report of April 2014, the Panamanian economy is expected to grow, on average, at a real rate above 6% over the next 5 years.

Graph No.9
Economic Growth Forecast



Source: IMF

Graph No.10
Inflation



Sources: MEF, INEC and IMF

The fast pace of the economic activity, especially after the international financial crisis in 2008, has produced an increase in inflation, which has stabilized at levels close to 4.0%, which was the average during 2013. This behavior is explained mainly by volatility in the prices of food and fuel used for transportation, resulting from the weakness of the dollar as a consequence of the expansionary monetary policies put in place by the Federal Reserve of the United States. Inflation is expected to stabilize in the medium term, with a downward

[17]In 2012, Panama was the country in Latin America with the highest investment as a proportion of GDP, 28.0%: public investment, including the Panama Canal represented little more than 12% of GDP, while private investment accounted for 16%. See figures in Panama 2012 IMF Article IV Consultation IMF Country Report No. 13/88, March 2013.

trend in later years, according to forecasts of the Medium-Term Fiscal Framework 2015-2019 and the IMF.

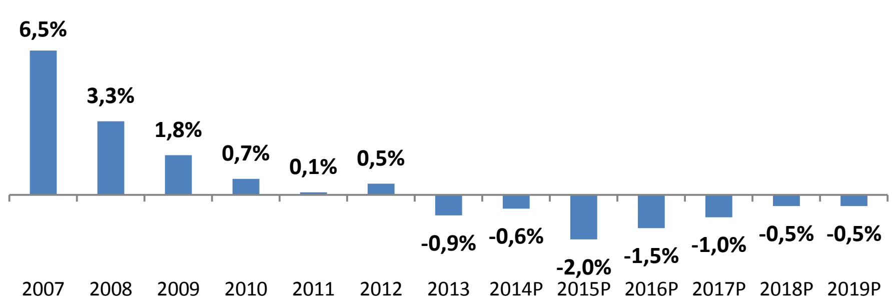
4.2 Financing Needs and Fiscal Policy

The high rhythm of growth and the high levels of consumption and investment have been supported by a prudent fiscal management. Since 2008, this management is governed by the Social Fiscal Responsibility Law (SFRL), which sets as objectives reducing the level of the net public debt [18] of the Non-Financial Public Sector (NFPS) to 40.0% of the GDP, and maintain the deficit of the NFPS below the annual limits established in this law.

The legal framework for the fiscal management was complemented in 2012 with the creation of the Sovereign Wealth Fund of Panama (FAP for its Spanish name), which will allow to accumulate additional income from the Canal expansion. The law that established the FAP modified the SFRL modifying the maximum limit of the deficit of NFPS up to the 2017 fiscal period.

The primary balance, which represents a more appropriate indicator to assess the fiscal discipline, is calculated by deducting from the fiscal balance the interest payments of the public debt. Graph No.11 illustrates the historical results and the forecasts of this indicator. It is estimated that for the period between 2014 and 2016, the primary balance will be negative, due to the commitments arising from the implementation of public infrastructure works and social interest projects.

Graph No.11
NFPS Primary Balance (% of the GDP)



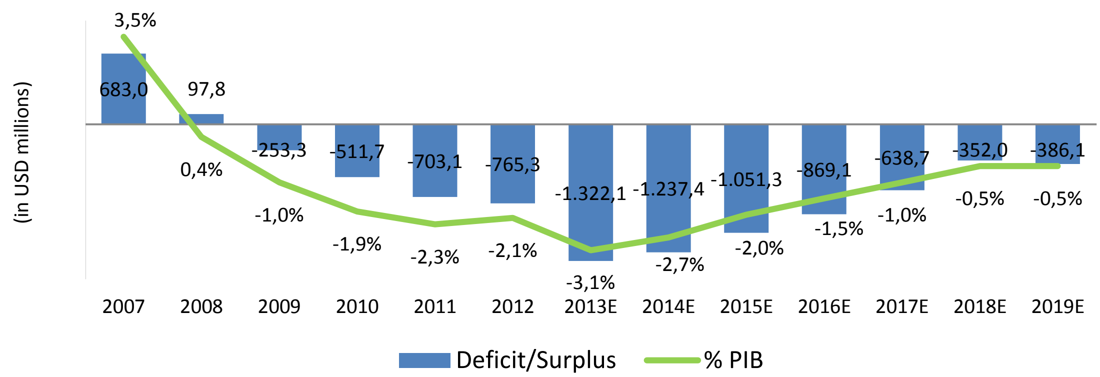
Source: INEC and MEF

The NFPS total balance sheet has shown moderate and manageable deficits since 2009, in direct connection with the implementation of the projects that make up the Strategic Plan

[18] It is defined as the sum of the external and internal debt, all entities of the NFPS, less the heritage of the Panama Savings Fund (US$ 1.2 billion according to the preliminary Financial Statements of 2013). At the end of 2013, this indicator stood at 33.9%.

of the current Administration and in compliance with the limits established in the Social Fiscal Responsibility Law, which ensures the sustainability of public finances.

Graph No.12
NFPS Total Balance (% of GDP)



Source: INEC and MEF

For the purposes of this strategy report, it is considered that the fiscal deficit of the following years complies with the limits established by law and that the Central Government deficit levels shall behave according to what was presented in the Medium-Term Fiscal Framework 2015-2019. Consequently, the financing needs of the Central Government are presented in Table No.6, adding to the fiscal deficit forecast the public debt maturities.

Chart No.6
Central Government Financing Needs 2014-2019[19]

Year	Amortizations (1)[20]	Balance[21] (2)	Total Financing Needs (3 = 1+2)	Nominal GDP (4)	% of GDP (5 = 3/4)
	(in USD millions)				
2014E	770.8	-1,528.8	2,299.6	45,829.0	5.0%
2015E	850.0	-2,188.0	3,038.0	52,565.0	5.8%
2016E	478.0	-2,029.0	2,507.0	57,941.0	4.3%
2017E	430.0	-1,399.0	1,829.0	63,867.0	2.9%
2018E	1,332.0	-1,089.0	2,421.0	70,399.0	3.4%
2019E	340.0	-1,280.0	1,620.00	77,225.0	2.1%

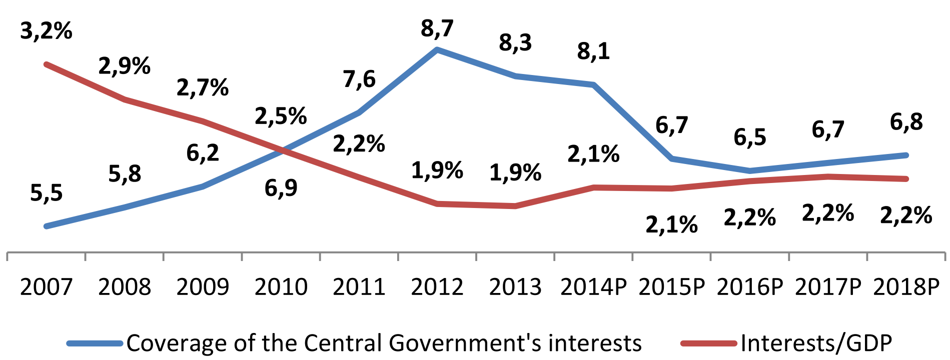
[19] Financing needs are composed by amortizations and the deficit. If there were a surplus, then the financing needs would simply be the amortizations.
[20] Amortization forecasts are based on Medium Term Fiscal Framework 2015 - 2019.
[21] The fiscal balance forecasts were taken from the Medium Term Fiscal Framework.

Source: MEF

In this regard, despite the financing need for megaprojects such as the Panama Metro, Sanitation of the City and the Bay of Panama, Road Rearrangement, expansion of the Pan American road Santiago - David section, among others, the gross financing needs as a proportion of the GDP, show a downward trend in the next years.

The Central Government, due to timely fiscal reforms and to the dynamics of the Panamanian economy, has strengthened its capacity to face the debt service as shown by the positive evolution of the indicators of coverage of interest payments and interests/GDP. In relation to the debt strategy, the strength of the fiscal accounts reflected in the declining trend of the gross public debt/GDP ratio gives future administrations the possibility to consider primarily the cost within the variables analyzed at the time of acquiring debt.

Graph No.13
Coverage of Central Government[22] interest payments and Interests/GDP[23]



Source: MEF

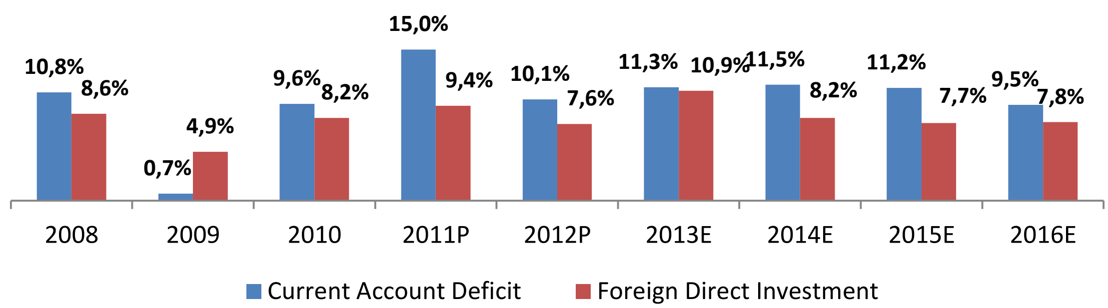
4.3 External sector

Panama has an open economy characterized by the export of services and the import of agricultural, energy and manufactured products. The high deficit in the current account in the past few years responds to the import of capital goods required by mega-projects such as the Canal expansion and has been financed, in its majority, by flows of Foreign Direct Investment (FDI).

[22]Current Income / Interest. The forecasts of the Medium Term Fiscal Framework were used for the years 2014 - 2018.
[23]The forecasts of the Medium Term Fiscal Framework were used for the years 2014 - 2018.

Graph No.14

Current Account Deficit and Foreign Direct Investment (%GDP)



Sources: INEC, IMF and World Bank

The external current account deficit will gradually converge from the 15.0% of GDP in 2011 to a lower level of around 9.5% of GDP in 2016, to the extent that the public investment cycle is complete. These deficits will continue to be financed, in large part, by the FDI flows which, as well as financial services revenues, should benefit from free trade agreements with trading partners such as the United States, Canada, the European Union, Central America, Mexico and Colombia, and also from tax information exchange agreements or to avoid double taxation[24] signed by the current Administration.

These forecasts from the balance of payments are also reinforced through evaluations of the exchange rate that show that despite a recent modest appreciation, the real effective exchange rate[25] is in line with macroeconomic fundamentals and does not reduce levels of competitiveness. In this regard, the present current account deficits, which express a high exposure to external demand that can increase the risk aversion of foreign investors is not considered.

4.4 Macroeconomic Risks

A significant proportion of the economic activity and revenues of the Government is associated to the transit operations through the Panama Canal[26], the movement of containers in the Colon Free Trade Zone (re-exports) and the banking services related to commercial activity. Consequently, the contraction of trade, caused by a reduction in

[24]The Trade Promotion Agreement (TPC) with the United States came into force in October 2012. In 2013, the FTA with Canada and the Association Agreement (AdA) between the European Union and Central America came into force. During 2014, FTA negotiations with Mexico and Colombia, Double Taxation Treaties (DTT) with Vietnam, Taiwan, Hong Kong and the Tax Information Exchange Agreement (TIEA) with Germany, Australia, India and Japan will continue.

[25]The real effective exchange rate is the relative price of the goods between different countries or the types of nominal exchange deflated by a weighted average of external prices in relation to the prices of the local economy.

[26]In the 2013 fiscal term, direct contributions from the Canal were equivalent to 2.3% of GDP.

economic activity in the United States and in the People's Republic of China could cause a drop in Canal traffic and a slowdown in the pace of economic growth, and consequently greater financing needs of the Government.

Panama, because of its tropical climate, is exposed to natural disasters, this being the second most important risk. The rainy season is long and covers between 8 and 9 months of the year. From 2010 to 2012, the country was affected by severe floods, whose reconstruction and rehabilitation costs rose to USD 150.0 million and USD 123.0 million, respectively, according to reports submitted before the Cabinet Council and the National Assembly. In order to deal with these contingencies, the Government was forced to request a temporary suspension of the fiscal deficit limits according to the SFRL.

Other catastrophic events could be added to the floods. Panama ranks No.14 among countries with greater exposure to multiple natural hazards according to its territorial extension. 4.4% of the national territory and 2.9% of the population are exposed at least to the three of the following threats: floods, earthquakes and landslides. These events could generate losses of between 5.4% and 9.0% of the GDP[27], impacting significantly the health of public finances.

A third risk of importance are the explicit contingent liabilities arising from arbitration and lawsuits against the State, which at the end of 2013, amounted to only USD 28.7 million, and other non-explicit contingent liabilities associated with the operation of the public companies which were excluded from the NFPS.[28]

Although the FAP and the contracted and current contingent credit lines with the IDB, and the IBRD[29] allow to mitigate the fiscal impact of natural disasters, the materialization of these risks would substantially increase the financing needs of the Government, requiring expedited access to various financing sources.

The diversification of financing sources is an important component for the public debt management strategy due to the fact that the vulnerability faced by Panama to external shocks and natural disasters is accentuated by a dollarized economy that reduces the degrees of freedom of the macroeconomic policy and places the weight of adjustments on the fiscal policy.

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[27]Natural Disaster Hotspots: A Global Risk Analysis (World Bank, 2005) and Panama: Indicators of Risk and Disasters and Risk Management (Inter-American Development Bank, 2010).

[28] The Law No.31 of April 5, 2011, which modified the SFRL excluded AITSA, ETESA and ENA, from the NFPS with the intention that these companies could leverage on their competitiveness, profitability, financial strength and potential generation of flows to undertake their investments and would not have to be restricted to the budgetary limits of the NFPS.

[29]The cumulative amount of the current credit lines is US$166 million (0.45% of GDP). The FAP on its part would provide coverage for natural disasters with costs above the 0.50% of GDP (US$ 181.2 million according to nominal GDP 2012).

5. Medium Term Strategy for Public Debt Management

The strategic guidelines for the management of the public debt in Panama reflect the preferences of the authorities in terms of cost and risk, the plans to develop the domestic market and the macroeconomic projections.

The existing portfolio presents moderate costs; moreover, it is essentially denominated in dollars, it has an extended repayment structure and a low exposure to refinancing, interest rate and exchange rate risks.

In the macroeconomic context, the decreasing trend of the gross public debt /GDP ratio will allows the Government to give greater emphasis to the reduction of financing costs. However, the vulnerability of the economy to external shocks and the materialization of contingent liabilities resulting from natural disasters, could increase the financing needs.

Therefore, although the composition of the existing portfolio and the expected debt levels are consistent with strategies based exclusively on external financing, macroeconomic risks indicate that it is convenient to diversify debt sources, strengthening the local debt market.

The lower liquidity of the securities in the local market increases financing costs, for which an evaluation of alternatives has been initiated, to allow to compensate this increase with the issuance of securities in shorter terms, the use of floating-rate instruments or the implementation of international settlement platforms to promote the participation of foreigners in the local market.

In this regard, this document provides guidelines for medium term debt with respect to the composition of the internal and external debt, the use of market instruments in the external debt, the use of floating-rate instruments in the external debt and the repayment profile of the internal debt.

To reach the proposed guidelines various financing strategies were explored, which were compared with the debt service forecasts under different exchange rate and interest rate scenarios. The baseline scenario, defined as the one with the greater probability of occurrence and the one that better reflects the current debt strategy, was used to calculate the expected cost of the different strategies. The risk was measured as the increase in the cost resulting from applying shocks to the market rates used in the base scenario, using two cost and risk indicators: total public debt/GDP and interests/GDP. Both were computed for the end of the fifth year of forecast, i.e. for 2018.

5.1 Strategic Guidelines

The strategic guidelines for public debt management of the Republic of Panama in the medium term are:

- Strengthen connectivity and complementarity between external and domestic markets.
- Deepen the domestic market of public debt through a liquid local curve.
- Maintain presence in international capital markets.
- Keep the currency exposure at current levels and balance the composition of fixed-rate and variable-rate debt to privilege a cost reduction target.

Panama has maintained its presence in the international markets, and in recent years, has strengthened its role as a catalyst for the development of the internal market through the Market Makers Program. The Government has promoted various initiatives to strengthen the complementarity between the internal and external markets, which would allow domestic securities to be liquidated through the major international clearing houses. In addition to the diversification of financing sources, the Government will seek to minimize the premium associated with the jurisdiction risk of the internal debt securities, which would result in the internal and external yield curves to converge.

The MEF has led along with Latinclear[30] the I-Link Panama project, which will allow securities registered in Latinclear to be cleared and settled in Euroclear's platform. Public and private Panamanian securities, duly registered with the Superintendence of the Securities Market and listed on the Panama Stock Exchange and that comply with international eligibility standards, to become "euroclearable" securities. It is estimated that in the middle of the second quarter of 2014 this platform will be running, which will complement the efforts of the MEF to develop the internal capital market, through the internationalization of local debt instruments which may be purchased and traded by foreign investors under local jurisdiction. In the face of a potential increase in the demand for locally-issued public debt securities, one might expect a reduction in spreads, compared with the Global Bonds.

The framework for action in the internal market will take place through the creation of points of reference ("benchmarks") distributed along the curve, including periods of 5, 7 and 10 years. To complement the issuances, the Government may, through liabilities management operations, perform or run reopenings, swaps and anticipated purchases of the debt instruments. Finally, the connectivity of the markets, the continuity of the Market Makers Program, the implementation of an electronic platform for trading securities in the

[30]Local private entity that provides services of custody, clearing, settlement and administration of securities.

primary and secondary market and the Investor Relations Program should contribute to the deepening of the internal market.

In the international market, the Government will seek to maintain a liquid long-term reference. That may mean the reopening of already existing bonds in the market, the launching of new points of reference through liabilities management operations or new issuances. In the Japanese market depending on the market conditions, the Government could maintain a liquid reference point, by means of eventual reopenings of the existing Samurai Bond or the issuance of a new reference point.

These strategic guidelines are expressed in the set of risk indicators presented below:

Chart No.7
Strategic Goals for the period 2014 - 2018

Indicator	Range
Domestic vs. external financing	
% of internal debt	18% - 30%
Refinancing Risk	
% of the debt that matures in the following year	< 10%
ATM of the internal debt	> 4 years
ATM of the total debt	> 8 years
Market Risk	
% of debt at a fixed rate	> 80%
% of debt in USD	90% - 97%

Source: MEF/Directorate of Public Financing

The medium-term strategy is in line with the policies that the Government has adopted since 2011 whose main guideline is the commitment to the development of the domestic capital market. Indicators are expressed in ranges and to show the commitment of the Government with the above guidelines, they leave a degree of flexibility so that the debt management adapts to changing economic and market situations. These goals should be checked by the Government if there are structural changes in the macroeconomic and financial situation of the country or internationally.

The Government will complement the process of transparency and governance in the management of the public debt of the Republic of Panama with the continuity of the Investor Relations Program, the publication of an annual debt plan, quarterly debt management reports, as well as the annual review of the medium-term strategy. The annual financing plan will detail the Central Government's financing plan for the year and will be developed under the guidelines of the medium-term strategy. The quarterly reports of debt management will be an instrument of accountability, where the year's debt management will be analyzed and their results compared to the goals defined in this strategy and the annual financing plan.