Economic and Financial Reform in Panama: Challenges and Opportunities to 2025

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This paper begins with a brief review of Panama's vital statistics and some past and recent economic and political highlights. Panama, a small tropical country located in a politically and economically challenged region, is poised to assume a larger and more prominent role in the 21st-century global economy because of its strategic position between the Atlantic and Pacific Oceans. Using a well-known framework to assess the performance of a national economy within the context of the wider global economy, I identify the strengths and weaknesses of the Panamanian economy, that, in turn, need to be exploited or addressed to the end of enhancing the performance of the economy and future living standards.

INTRODUCTION

While the EU and the US economies continue to heal in the wake of the Great Recession, Latin America experienced impressive growth for the decade ending in 2013, with only a brief downturn in 2009 (United Nations, 2013). This is most likely the result of "more pragmatic policies, including flexible exchange rates, inflation targeting by more or less independent central banks, more responsible fiscal policies, and tighter regulation of banks, as well as social policies aimed at the poor" (Reid, 2010, p.3).

The favorable international economic environment until 2008 -- in particular the double digit GDP growth in China -- along with more responsible economic policies and/or improvements in the legal and tax environments for business in some countries in Latin America, i.e., Brazil, Chile, and Peru, resulted in higher economic growth rates and improved living standards. The ten years to 2013 were Latin America's best since the 1960s and 1970s, with economic growth averaging 4% per year and inflation in single digits (United Nations, 2013). However, slowing growth in China and continued weakness in Europe, Japan, though less so in the US, has put the region's decade-long boom at risk (Rathbone, 2014).

This paper begins with an overview of Panama's vital statistics that provide some measures of the nation's relative material wellbeing as compared with some of its regional neighbors. In addition, I review the historical political landscape that influenced the creation of some of the unique attributes that characterize Panama, the current -- both domestic and international -- political environment that affects the performance of the Panamanian economy, and then some of the major economic and political events of the last few years that have shaped the country's economic and financial policies. Part 2 provides a review of some recent research regarding some of the "ingredients" judged to be important for a well-performing national economy that is participating in the wider global economy in the second decade of the 21st century. These "ingredients" are used in the next section to assess the current state of the Panamanian economy -- both its strengths and weaknesses. I conclude by examining ways that the country can draw on its strengths to reinforce and expand its adhesion to the global economy to the end of improving the performance of its economy and increasing living standards for all segments of the population.

PART 1. VITAL STATISTICS, THE (PAST AND PRESENT) POLITICAL LANDSCAPE, RECENT ECONOMIC AND POLITICAL HIGHLIGHTS, AND A BRIEF SURVEY OF THE REGION

Vital Statistics

Panama, a tropical country located on the eastern end of the isthmus of Central America that forms a land bridge between North and South America, controls the Panama Canal that links the Atlantic Ocean through the Caribbean Sea to the Pacific Ocean. The country is bordered by Costa Rica to the northwest and Colombia to the southeast and lies mostly between 7-10 degrees north of the equator, and has a total area of 75,515 square km, slightly smaller than the US state of South Carolina. In 2013, Panama's population was approximately 3.6 million people, its population growth rate was estimated at 1.4% per annum (p.a.) -- a shade below the Latin America average of 1.6% p.a. but significantly below the average in Central America -- and while the country historically registers net out-migration, in recent years because of the growing economic and political stress in Venezuela there has been an influx of almost 500,000 mostly middle-class Venezuelans seeking jobs and greater economic and political security in Panama.

Life expectancy in 2013 was reported at 78.3 years, about the same as in the United States, and the infant mortality rate in Panama was 11.01 per 1000 live births, compared to 6.06 in the US. Almost three-quarters of Panamanians live in urban areas, the most urbanized country in Central America. The country's ethnic breakdown is 70% mestizo, 14% Amerindian and mixed (West Indian), 10% white, and 6% Amerindian. Panama registers greater than 94% literacy for those 15 years and older, and in 2011 the country spent 3.5% of its GDP on education, compared with 6.3% in neighboring Costa Rica. The World Bank classifies Panama as a middle-income country, and per capita GDP in 2013 was estimated at \$16,500 US on a purchasing power parity (ppp) basis (Central Intelligence Agency, 2014).

Concerning the composition of GDP in 2013, agriculture accounted for 3.7% of GDP (but employed 17% of the approximately 1.54m people in the labor force); industry for 17.9% of GDP; and services for approximately 78.4% of GDP. In 2013, official unemployment was 4.5%, and Gross Fixed Investment as a percentage of 2013 GDP was reported at 28.2%, a rate that would be consistent with the large number of ongoing public works projects (United Nations, 2013). (More about this below).

The Past and Present Political Landscape

In 1502, Christopher Columbus became the second recorded European to visit the isthmus of Panama. One year earlier Rodrigo de Bastidas sailed from Venezuela in search of gold. Even in the early 1500s, Vasco Nuñez de Balboa demonstrated that the isthmus was the critical path between the Atlantic and Pacific Oceans, and this stretch of land quickly became "the crossroads and market place of Spain's empire in the New World. Gold and silver were brought by ship from South America, hauled across the isthmus, and loaded aboard ships for Spain" (http://en.wikipedia.org/wiki/Panama, pages 3-4).

From 1538-1821, Panama was part of the Spanish empire, and already during this time period Panama's identity -- "its geographic destiny" -- was forged, and "its fortunes fluctuated with the geopolitical importance of the isthmus" (http://en.wikipedia.org/wiki/Panama, p 4).

With the ascendency of the Dutch and British maritime presence in the Caribbean region in the late 17th and early 18th centuries, in 1717 the isthmus of Panama was placed under the jurisdiction of the newly created vice-royalty of New Granada, administratively seated in Santa Fé de Bogotá (today, Colombia's capital). This is the root of Panama's centuries-old uneasy relationship with Colombia that will be revisited below.

By the middle of the 18th century, with advances in shipping and navigational technology and the general decline in Spain's global reach, the importance of Panama as a transport hub similarly declined as newer and larger vessels increasingly used the longer -- but less costly and more secure -- southern route around Cape Horn to transport goods to the Pacific and back.

After securing independence from Spain like most of Latin America in the first three decades of the 19th century, Panama voluntarily became a department of Colombia at the end of 1821 for the next 80 years despite several failed attempts to secede. After the Colombian Senate rejected the Hay-Herrán Treaty in 1903 that would have permitted the United States to acquire a canal zone, the US threw its weight behind Panama's independence movement and, in the same year, Panama declared its independence from Colombia and concluded the Hay-Bunau-Varilla Treaty with the US that granted the US sovereignty over a zone 10 miles wide and 50 miles long where the US would build a canal -- linking the two oceans -- that was completed in 1914.

From 1903 until 1968 Panama's political scene was dominated by a small, commercially oriented oligarchy as in many other Central American and Caribbean countries. Populist politicians often surfaced such as Amulfo Arias Madrid, who, between 1940 and 1968, was elected president three times, only to be ousted from office each time.

While there were differences over many social and economic issues among the various factions of Panamanian society during this period, there was near universal agreement in Panama over what was perceived as the unfair terms forced on Panama by the 1903 Canal Treaty, specifically regarding canal sovereignty and the amount of annual income transfers to Panama that prompted two treaty revisions in 1936 and 1955. Both the revisions were judged inadequate that provoked violent protests in 1964, leading to a rupture of diplomatic relations with the US that eventually culminated in the Robles-Johnson Treaty (actually, a three-in-one treaty) which was agreed and announced in 1967 that was underscored by the paucity of the treaty's details.

Simultaneously, the simmering political instability both inside Panama and throughout the region during these years -- that was extended to South America in the early 1970s -- led to a military coup in October 1968, the first against a civilian government in Panama. In 1977, after 13 years of negotiations, Panama reached agreement with the US for the return of sovereignty over the Canal Zone by December 31, 1999.

Even though successive military governments operated with the tacit approval of the US for more than two decades, and over the years various positive reforms to restore democratic institutions were implemented -- political parties were permitted in 1978 and direct presidential elections resumed in 1983 -- the military continued to dominate the political scene leading to the ascension of General Manuel Noriega as head of the National Defense Force in 1983.

However, by 1987, figures in both Panama and the US accused General Noriega of engaging in drug-trafficking and money-laundering. The US suspended economic aid, two US grand juries indicted him on drug charges, and the US demanded Noriega's departure from office.

The May 1989 presidential elections were won by Guillermo Endara Galimany, but, under the influence of General Noriega, the results of the election were annulled by the military to the displeasure of other Latin American countries and the US. A few subsequent provocations -- real or imagined -- led to a US invasion of Panama on December 20, 1989.

The US invasion ended 21 years of military dictatorship that has been followed by five sets of free elections, the last of which took place in May 2014, with the election of Juan Carlos Varela, the vice-president in the previous administration, who took office on July 1, 2014. Like its western neighbor Costa Rica, since 1994 Panama is constitutionally enjoined from maintaining a standing army.

Recent Economic and Political Highlights

As a result of the favorable global economic environment during the decade since Panama took full control of the canal until 2008 -- the beginning of the Great Recession -- overall canal traffic expanded by one-third and the number of containers conveyed through the canal tripled, in large part explained by China's integration into the world economy and the ongoing powerful technological advances in shipping.

To accommodate the next generation of very large vessels -- called post-Panamex ships (four football fields long, 160 feet high, with each capable of carrying 13,200 containers, 2 1/2 times the current capacity) -- at the end of 2006 then-President Martín Torrijos secured a mandate through a referendum to widen and deepen the canal, a project that began in late 2007 and that is now expected to be completed in early 2016. The project, that was originally budgeted at $5.25bn and that includes building a third set of locks, is expected to double the canal's capacity. Canal revenues in 2013 were about 10% of Panama's GDP (Schipani and Wright, 2013), and approximately 5-6% of world trade currently passes through the canal which is expected to increase to 10% after the expansion of the canal is completed (O'Grady, 2012). (The effects of the canal expansion project on Panama's GDP and its contribution to poverty reduction in the country is discussed in Part 3, below).

Though the canal expansion project is without question the major economic event of the last decade in Panama, other significant public works projects initiated by former President Ricardo Martínelli (2009-14) at a total cost of $13bn, half of Panama's GDP, include the construction of Central America's first metro system in Panama City at a cost of $2bn that was inaugurated in April 2014 and is expected to be extended in the Varela administration; a major upgrade and expansion of the international airport; and a new "toll-road" linking the capital with Colón, the Atlantic terminal of the canal.

It is not unusual for a large infusion of public works projects to be accompanied by (at least) accusations of corruption, and the Martínelli administration had its share. In a poll taken in August 2013, more than two-thirds of the respondents surveyed said they would not vote for the incumbent president even were he allowed to stand for reelection, which, according to the Constitution, he cannot (EIU,2013). Many attribute the success of President Varela in the recent national elections to his ability to project himself as an anti-corruption and pro-transparency candidate. (More about this below).

Panama is making steady progress in cleaning up its banking system and its reputation as a haven for tax-evasion and money-laundering is receding as the country, which is "dollarized", has bank secrecy, and is a magnet for "shell companies" with its lax corporate laws, is slowly forging the necessary tax-information exchange treaties to comply with the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes on the exchange of account information.

Central America: A Brief Survey of Panama's Neighborhood

The data presented in Table 1, below, provide a snapshot of Panama's relative position with respect to its regional neighbors for some generally accepted indices of "quality of life" and economic well-being.

According to The Economist (2011a), the isthmus of Central America is the "most routinely murderous region on earth". Living in a "bad neighborhood" has significantly increased Panama's homicide rate, reported at 21.6 per 100,000 of population, about four times the US rate, which itself is four times the rate in Western Europe (UN Office on Drugs and Crime, 2010). To be sure, the July 2014 crisis caused by the influx of almost 60,000 illegal migrant children into the US, mostly from Central America, confirms this perception (Davis and Shear, 2014).

Natural disasters are also part of the landscape. Four of the seven countries in the region have been classified as among the most vulnerable in the world to destructive weather or other acts of nature including hurricanes, floods, landslides, earthquakes, and volcanic eruptions (The Economist, 2011a).

Then, of course, there is the human condition illustrated by the data in Table 1, where, clearly, Panama appears to be much better off, judging by its respective poverty rate and physician density rates as compared to the rest of the region. Panama has better "vital statistics" than most of the other Central American countries in part because it has historically had much stronger ties -- for better or for worse -- with the US because of the importance of the canal to US interests.

Civil wars plagued many Central American countries during the 1970s and 1980s that were linked to the then ongoing Cold War between the US and the Soviet Union with the dictators being backed by the former, and the guerrillas supported by the Soviet Union and its regional proxy, Cuba. Panama, with 21 years of military dictatorship rule -- underwritten by the US -- from 1968 to 1989, serves as an example of this.

TABLE 1
CENTRAL AMERICA: A SNAPSHOT OF THE REGIONa

Country	GDP per Capita (2013 US$, ppp)	Population (Millions, 2013)	Population Below Poverty Line (% of Population)	Education Expenditures (% of GDP)	Physician Density Rate (per 1000 Population)	Homicide Rates (per 100,000 Population)
Belize	8,800	0.3	41.0	6.6	0.83	41.4
Costa Rica	12,900	4.8	24.8	6.3	1.32	10.0
El Salvador	7,500	6.1	36.5	3.4	1.60	69.2
Guatemala	5,300	14.7	54.0	3.0	0.93	38.5
Honduras	4,800	8.6	60.0	NA	0.37	91.6
Nicaragua	4,500	5.9	42.5	4.6	0.37	12.6
Panama	16,500	3.6	26.0	3.5	1.50	21.6

a. Latest available data
Source: Central Intelligence Agency (2014), UN Office on Drugs and Crime (2010)

Over the last few decades, Central America has been in the frontline of the drugs trade and organized crime since it is wedged in between the world's largest cocaine-producing countries (Colombia, Peru, and Bolivia) and the world's largest consumer market for cocaine, the United States. Along with the increased violence and insecurity that accompanies the drugs trade, according to the World Bank, the economic cost imposed on the economies of the region by the drug-related crime and violence has been estimated at approximately 8% of the region's GDP, about twice the relative cost of the US's annual defense budget (The Economist, 2011a). Panama did not escape the "curse" of the drugs trade considering the charges of drug-trafficking and money-laundering brought by the US against General Noriega in 1987, as mentioned above.

PART 2. THE METHODOLOGICAL FRAMEWORK

Before discussing the areas in which reform will be needed to improve the long-term performance of the Panamanian economy to the end of raising living standards, it is worthwhile reviewing some of the alternative "paths to prosperity" that have been proposed by the leading development experts -- individuals and institutions -- over the last half century.

The ideas of Raúl Prebisch (1959) and Hans Singer (1964) provided the intellectual firepower for the development blueprint anchored in "import substitution" because their thesis was based on the declining terms of trade for primary products and the dynamic benefits to the economy of a vibrant manufacturing sector. These concepts became operational policy in most of South America in the 1960s-70s, ensuring a large and growing role of the state in the economy through supportive taxes and subsidies if not direct ownership of productive capacity.

The role of state involvement in the economy for development purposes that is a corollary of the Prebisch-Singer thesis was actually the foundation of the work proposed earlier by Paul Rosenstein-Rodan (1943) and P.C. Mahalanobis (1955), which stressed increasing returns to scale and kick-starting growth through large-scale investments, and accelerating economic development by government encouragement of heavy industry, respectively.

These "inward" winds of economic development shifted in favor of more "outward" and "market-oriented" strategies that were advanced during the 1970s by Balassa (1971), Bhagwati (1978), Krueger (1978), and Little, Scitovsky, and Scott (1970). The "market-based" approach to improving the performance of the economy and to enhancing living standards reached its zenith with the views of a group of Latin American economists and policymakers, the World Bank (1991), and various academic and "think tank" development experts such as John Williamson (1994) with the so called "Washington Consensus" of the 1990s.

For example, in its 1991 World Development Report, the World Bank articulated four broad requirements that characterize a national economy as "battle ready" to meet the challenges of the fiercely competitive world economy. They included:

- A stable macro-economy characterized by both fiscal and external balance and low and stable inflation;
- the adoption of a competitive micro-economy that includes a substantial reduction in state ownership and management of productive assets and the elimination of price distorting subsidies and taxes;
- strong global linkages that include adherence to GATT (now the WTO), low and uniform tariff rates, absence of non-tariff barriers, a uniform and market-determined exchange rate, a liberalization of the rules governing capital flows and direct foreign investment, and;
- an active government policy that promotes social and economic investment, especially in the areas of education, infrastructure, and health.

In its 1997 World Development Report (World Bank, 1997), the Bank expanded the reach of the fourth requirement to include the promotion and enforcement of property rights, reducing the level of corruption in the country, and ensuring a reliable legal system -- some of the so-called “second tier” reforms.

The “Washington Consensus” (WC), which was originally compiled in 1990 and published by John Williamson (1994), enumerated a list of desirable conditions that, if adopted and adhered to, would, over time, put reforming countries on the path to success in the global economy. (Please see Table 2, below, for a list of its main points). Since the late 1990s, because of its alleged failure to address the issue of poverty reduction directly, the Washington Consensus was subjected to heated intellectual debate within academia and the major international organizations such as the World Bank (Beattie, 2000). Nevertheless, this framework continued to assume a central role in the debate on development strategies for low- and middle-income developing countries during the first decade of the 21st century. (Readers interested in this debate are referred to Rodrik (2010) for a recent review of this subject).

In light of the experience of the late 1990s (increasing poverty rates and stalled economic growth due to an adverse external environment), proponents of the Washington Consensus amended the original framework to ensure that fiscal policy is counter-cyclical to support economic growth in an economic downturn, and to focus on reducing income inequality by ensuring that the poor have access to assets, i.e., education, land titling, micro-credit and land reform, that will enable them to work themselves out of poverty (Williamson, 2003).

While the “reform decade” of the 1990s did restore growth in GDP and GDP per capita in Latin America when compared with the “lost decade” of the 1980s -- growth in GDP and GDP per capita from 1991-98 was 3.5% and 1.7% p.a., respectively compared with 1.0% and -1.0% p.a. in the 1980s (United Nations, 1998) -- many observers of Latin America contended that the “neo-liberal” reforms of the 1990s have not only “failed to deliver sustained growth, but have made the region more vulnerable and increased unemployment, poverty and inequality. As a result of all this, some political pundits asserted that Latin America was sinking back into populism and/or anti-market leftist nationalism” (The Economist, 2003). At the end of 2014, this last statement is borne out for many countries in South America, in particular Argentina, Bolivia, Ecuador, and Venezuela.

In a review article of economic development blueprints, Dani Rodrik (2010) reviewed the experience of China, which over the last three decades arguably has had the most successful growth and poverty reduction program in recorded history, and notes that there does not appear to be any single orthodox Western economic plan that was adhered to by Chinese economists and policymakers.

TABLE 2
MODIFIED "WASHINGTON CONSENSUS"

- Fiscal and monetary discipline
- Redirection of public expenditure priorities towards health, education, and infrastructure
- Tax reform and improved tax administration
- Unified and competitive exchange rates
- Modernization of government and "quasi" government institutions
- Deregulation
- Trade liberalization and regional integration
- Privatization
- Elimination of barriers to direct foreign investment
- Banking reform and financial liberalization

Rodrik also observed that even in (now prosperous) Chile -- which was recently admitted to the Paris-based club of “rich” countries, the Organization of Economic Cooperation and Development (OECD) -- during the 1970s-80s a strict universally scripted development plan was abandoned and a more heterodox (and indigenously articulated) strategy was adopted even during the tense Pinochet era.

It now appears, according to Rodrik, that a more fruitful approach to prescribing a successful path to economic growth and development is one that is based on “diagnostics’, as proposed recently by Hausmann, Rodrik, and Velasco (2008) and Hausmann, Klinger, and Wagner (2008). In place of a “boiler plate” set of rules and a rigid, unyielding approach to growth these development economists propose to identify a country’s binding constraints and then prioritize the policy reforms given the political and social realities of the country involved. These authors argue that the earlier, carefully scripted paths to growth and development have not lived up to their expectations:

> “The currently prevailing view, as reflected in the World Bank’s (2005) report on the lessons from the 1990s or by the blue-ribbon Commission on Growth and Development (2008), accepts the importance of outward orientation but places much less emphasis on trade liberalization and is much more willing to condone a measure of industrial promotion in order to achieve and sustain high growth” (Rodrik, 2010; p. 40).

Rodrik praised China’s so-far successful development approach of grafting a market system on top of a heavily regulated state sector (that was the orthodoxy of an abandoned Communist economic system) with China’s development plan evolving over time as their binding constraints change: first in agriculture; then in industry; then in foreign trade; and eventually in finance, the environment, and pension reform.

It is important to note that despite its impressive poverty reduction cum economic growth program now in its fourth decade, China enjoys enormous leverage in the world because of its population of 1.4bn people -- almost 20% of the world’s population -- that is increasingly willing and able to become “21st century consumers”. China’s voracious appetite for fuel and nonfuel minerals (Sohn, 2008a; Sohn, 2008b), “first world” foods and diets, electricity and other infrastructure goods, along with its abundant and still relatively inexpensive labor force provides it with enormous “monopoly-like” and “monopsony-like” power on world resource, factor, and product markets. For example, China’s policy regarding “local content” requirements for equipment used in the production of wind energy, the “Notice 1204” directive, was certain to be in violation of World Trading Organization rules. The directive has since been revoked, but not before its major objectives were achieved (Bradsher, 2010). The market access that it provides for the goods and services of global companies confers on China tremendous leverage regarding the terms it dictates for foreign (inward and outward) investment, the aid programs it operates, its carefully-controlled foreign exchange and capital account regimes, and, above all, its (lightly criticized and) stunted state of political and human rights best exemplified by the official treatment of Chinese dissident Liu Xiaobo, the 2010 recipient of the Nobel Peace Prize.

To be sure, particularly in the wake of the 2008-9 global financial crisis and the need for substantial global rebalancing, China's trade, savings, investment, capital account, and exchange rate policies are exacerbating the adjustments that are needed and increasing the political and diplomatic tensions in the world. The jury is still out whether China's one-party political system can be maintained in light of ongoing globalization and technological change.

Nevertheless, over the last few years, after a prolonged internal debate, even the thinking of the International Monetary Fund, in juxtaposing the harsh economic and financial consequences of the 1997-98 Asian crisis with the relative calm in China in the aftermath of the 2008-09 global financial crisis, has evolved on the need for, and desirability of, capital account liberalization as the complement of already liberalized current accounts for developing countries. This new 'institutional view' recognizes that liberalizing "developing countries capital accounts before they have reached a certain level of financial and institutional development is highly risky" (Plender, 2012).

Recently, Daron Acemoglu and James Robinson argued in favor of the critical role played by economic institutions in explaining the enormous differences in living standards across the world (Acemoglu and Robinson, 2012). They contend that these institutions determine the economic incentives and the resulting allocation of resources, investment, and innovations needed for growth. Ultimately, it is politics that shape these institutions and their evolution. It will, of course, be interesting to track, during the next few decades, the evolution of China's political system, and if the changes that are introduced support the "right" economic institutions as argued by Acemoglu and Robinson.

In the next section -- which takes the measure of the Panamanian economy -- I rely heavily on the "ingredients" prescribed in the market-based and outward-looking approach to economic growth and development noted in the above-mentioned World Bank reports, while at the same time being mindful to incorporate the contributions made by those advocating a more tailored approach to development that identifies binding national constraints and priorities in the quest for economic modernization over the next two decades, in addition to the important role of institutions as stressed by Acemoglu and Robinson (2012) that was discussed above.

PART 3. THE STATE OF THE PANAMANIAN ECONOMY: STRENGTHS AND WEAKNESSES

Macroeconomic Stability

With a view towards improving the performance of the Panamanian economy during the next decade it is useful to take the measure of the current state of the economy following the World Bank's "recipe" articulated in the early 1990s and described in Part 2, above. The first of the four broad requirements needed for a well performing national economy is macro-economic stability, generally characterized by both fiscal and external balance, low and stable inflation, and high levels of employment.

It would be of interest to examine these macro-variables over the last five years, that is, how the Panamanian economy performed over the 2009-13 period. According to the data reported by the United Nations (2013), real GDP growth peaked in 2011 and 2012 at almost 11% p.a., driven by the large-scale investment projects cited above, and, in 2013, GDP growth slowed to its 2010 rate, still a very impressive 7.5%, as these projects approach their completion. Over the 2015-18 interval, growth is projected to decline to a respectable 5% p.a (EIU, 2014).

The gradual increase in Panama's ratio of Gross Fixed Capital Formation to GDP from 23.4% in 2009 to 28.2% in 2013, three to five percentage points above the Latin American average for those years, is further evidence of the role played by these outsized investment projects in igniting economic activity. It is expected that this ratio will decline in the 2015-18 interval as this "bulge" in construction-related activities winds-down.

Another important macro-economic variable that lends additional support to the critical role the canal expansion and upgrade project and other ongoing infrastructure works -- such as the newly inaugurated Panama City subway system -- are having on the rate of economic growth is the rock-bottom urban unemployment rate reported for Panama relative to the Latin America average. Panama's urban unemployment rate is about 20-25% below the Latin American average over the 2011-13 interval in which GDP growth in the region averaged around 4% p.a.

According to the United Nations (2013), real average wages in Panama over the five-year interval ending in 2013 increased by only 2.5% p.a. To be sure, economic logic would suggest that a tightening labor market -- characterized by an unemployment rate that steadily declined from 2009 -- would be accompanied by higher labor costs and increasing rates of inflation as wage increases push up costs and prices.

Panama's inflation rate, as measured by the change in annual consumer prices over the 2009-13 interval, averaged 4.3% p.a., as compared with an annual inflation rate of 6.2% p.a. for the region as a whole (Table 3, below), but was much higher than the US inflation rate over the period, and it is important to note that since Panama is a "dollarized" country, it does not have an independent monetary policy. Consequently, Panama imports loose monetary policy from the US, complicating the efforts of policy-makers to contain inflationary pressures.

In the case of Panama, during the 2012-13 interval, moderating inflationary pressures despite the low unemployment rate could be explained partly by the steady influx of many Venezuelans fleeing the increasing economic and political instability back home seeking jobs (see Part 1, above), often in the informal booming construction sector.

This additional (informal) supply of labor could explain the lack of wage pressures in certain sectors, while the decline in consumer price inflation can be attributed to the recent deceleration in international oil and food prices. Higher inflation in the larger Latin American countries -- especially in Argentina and Venezuela -- explains the higher average rate of consumer price inflation for Latin America as a whole. (See Table 3, below).

Examining some of the other macroeconomic components in Table 3 reveal some of the problems that need to be addressed by Panamanian political leaders and policy-makers. For example, to address its chronic -- and growing -- fiscal deficits and the resulting increase in external indebtedness during the 1990s, the Social and Fiscal Responsibility Law (SFRL) was introduced in 2002 to mitigate these dual problems. The 2008 law mandated that the annual non-financial public sector deficit should not exceed 2% of GDP in any given year and the ratio of external public debt to GDP be brought down to 35% by 2017. However, throughout the 2000s, as a result of domestic political concerns, the fiscal "straightjacket" has been at times suspended, modified, or "bent", endangering the government's reputation for fiscal responsibility. Since the 2008-09 Great Recession the central government (primary and the overall) fiscal deficits have been increasing, though the 2013 deficit was, according to the IMF(2014), below the ceiling permitted by Panama's adjusted SFRL. Successive adjustments to the Law that raised the mandated target level of the deficit have run the risk of undermining confidence in the public finances and, according to the IMF (2013) the credibility of the fiscal anchor, and increases the risk of the economy to over-heat. Fiscal policy is still considered to be pro-cyclical, and since Panama's output gap is closing, fiscal policy should be tightened if inflationary pressures build, either from external sources (such as higher international fuel and/or food prices) or domestic sources (such as a tighter labor market).

A new stabilization instrument became operational in December 2012 to address emergency situations created by nature such as floods, and economic slowdowns caused by the normal turns in the business cycle and/or shocks imported from abroad. This mechanism, the Sovereign Wealth Fund (or FAP, its Spanish abbreviation) also creates a long-term state-owned savings account. After receiving an initial infusion of $1.2bn from a precursor institution in 2012 that has since been shuttered, starting in 2015 annual contributions from the Panama Canal Authority (ACP) to the budget of more than 3.5% of GDP will be transferred to the FAP (IMF, 2013). While the motive for establishing this instrument is palpable, the danger lies with the politicians legislating ad hoc laws and/or modifying the rules governing the use of these funds instead of appropriating them for normal budgetary purposes. If the Fund's administrators are able to resist the likely entreaties by Panama's politicians to make claims on the Fund's resources, by 2025 the Fund is projected to have assets equivalent to approximately 9% of GDP (IMF, 2013).

TABLE 3
RECENT MACROECONOMIC DATA: PANAMA AND LATIN AMERICA, 2009-2013

Macroeconomic Variable		2009	2010	2011	2012	2013
Gross Domestic Product (annual % change)						
	Panama	3.9	7.5	10.9	10.8	7.5
	Latin America and Caribbean	-1.6	5.8	4.3	3.1	2.6
Gross Fixed Capital Formation (% of GDP)						
	Panama	23.4	24.3	26.2	27.5	28.2
	Latin America and Caribbean	20.6	21.5	22.4	22.3	23.0
Central Government Balance (% of GDP)						
	Panama	-1.5	-2.5	-3.5	-3.5	-4.4
	Latin America and Caribbean	-3.4	-2.6	-2.5	-2.6	-2.5
Consumer Prices (annual % change)						
	Panama	1.9	4.9	6.3	4.6	3.9
	Latin America and Caribbean	4.6	6.5	6.8	5.6	7.1
Urban Unemployment Rate (avg. annual %)						
	Panama	7.9	7.7	5.4	4.8	4.7
	Latin America and Caribbean	8.1	7.3	6.7	6.4	6.3
Employment Rate[a] (average annual rate)						
	Panama	59.9	59.4	59.1	60.8	61.5
	Latin America and Caribbean	54.4	55.0	55.5	55.9	na

a. Employed population as a percentage of working age people
Source: United Nations (2013)

Another area of concern in the macro-economic accounts is the excessively large current account deficit which is expected to be above 8% of GDP in 2014 and 2015. To be sure, the deficit is being driven by spending on the construction equipment and materials needed for the array of public and private infrastructure projects discussed above. In the short-term these deficits have been offset by large inflows of foreign direct investment, especially into the transport and leisure sectors. (More about this below). As the large investment projects are completed, it is expected that the current account deficit will recede to about 6.5% by 2018 (EIU, 2014). Panama's external public debt, estimated in 2013 at about 39% of GDP is projected to decline to 32% of GDP by 2017 (EIU, 2013), in line with SFRL requirements, as the large investment projects' cash-flow profile begins to turn positive.

The Adoption of a Competitive Microeconomic Environment

According to the World Bank (1991), improving the microeconomic foundation of the national economy includes, among other things, a substantial reduction in state ownership and management of productive assets, and the elimination of price distorting subsidies and taxes.

The government of Panama privatized many sectors of the economy in the mid-1990s, such as the hydroelectric plants -- which, according to the US Department of Energy (www.eia.gov), provided 53% of electricity used in the country in 2011; telecommunications; and the ports. However, the government has retained non-controlling 49% ownership stakes in the electricity generation and telecommunication assets, and a 10% ownership share in the ports. In addition, the electricity transmission company, ETESA, remains an entirely state-owned entity.

Since it is a public-sector enterprise it is important to mention the administrative authority that plays an oversized role in Panama's economy -- the Panama Canal Authority (ACP). The ACP took full control of the canal in 2000. During the transition the Authority sold-off its cargo ships, its railway, and other non-core assets, such as the ports on both ends of the canal, to concentrate on its core business: moving traffic through the canal quickly, safely, and efficiently. As one observer remarked, the Authority has become "a model of well-run public-sector enterprise in a country and a region where bad examples are more frequent" (Lapper and Thomson, 2007).

Over the last two decades there has been a lull in privatization activity, though strong candidates for privatization in the future include the water authority; the convention center, and some parts of the public health system, and, less likely, COTEL, the postal system. Because of domestic political opposition these privatizations were blocked in 2012, and in 2013, a proposal that would have allowed the sale of the remaining state shares in the partially privatized enterprises had to be withdrawn, and even a draft law intended to regulate public-private partnerships was scuppered. The Varela administration, which took the reins of government on July 1, 2014, may attempt another sale of some (or all of these) state-owned assets in the coming years. Another casualty of violent demonstrations in recent years was the repeal of a law that would have allowed the sale of public land in the Colón Free Zone (IMF, 2013). Finally, all of Panama's media-outlets are privately owned except one state-owned television network (of which there are six), and one radio station (of which there are about 100).

In Panama subsidies are primarily targeted at the transport, electricity, and food sectors. Buses and the newly inaugurated Panama City metro system are the main recipients of government subsidies in the transport sector. These subsidies, especially those for the new metro system, add additional pressure to Panama's budget stress and complicate the government's ability to comply with the mandated SFR Law to the end of reducing the non-financial public sector deficit. In 2011, total energy subsidies accounted for approximately 1% of GDP (IMF, 2013).

Subsidies for food -- which comprises 33% of the consumer price index -- and for electricity, along with the transport subsidies, generate a downward bias of the true rate of inflation. Even before assuming office in July 2014, President Varela, because of rising food prices, threatened to impose price controls on food (The Economist, 2014a) that not only adds uncertainty to Panama's true inflation rate, but also risks opening up a Pandora's Box of future food shortages and "black markets" à la Venezuela.

From 2010 to 2012, tax collection in Panama averaged about 18.2% of GDP, about 2% below the Latin American average for 18 countries, while the average rate for 34 rich OECD countries was approximately 34% of GDP (EIU, 2014). This below average rate is partly explained by the relatively large informal sector in Panama.

However, it is important to remember that -- like Egypt and its Suez Canal revenues and Chile and its revenues from Codelco, the Chilean state-owned mining company -- Panama's canal tolls are a significant and, as a result of the modernization project nearing completion, a growing source of non-tax government revenue. The other important source of non-tax government revenue -- that will decline over the medium-term -- is the tariff revenue on imports, as the various free trade agreements are phased in over the next decade. (More about this below).

Improving the country's tax administration would also help to keep Panama's fiscal deficits at or close to the mandated SFR Law targets. To this end, the Large Taxpayers Unit (LTU) was formed to improve tax collection primarily among 72 large corporations whose tax payments comprise approximately 25% of total income tax collected (IMF, 2013).

Since 2002, Panama has implemented three tax reforms (in 2002, 2005, and 2009-10) that, together, have lowered tax rates on income, increased value-added taxes (VAT), and broadened the tax base by closing loopholes and enhancing tax compliance. Nevertheless, VAT rates and VAT revenue-to-GDP ratios in Panama remain well below those of the region as well as below the average for middle-income countries. More generally, according to the IMF (2013), Panama still lags behind its region and its peer group (middle-income countries) in its "tax effort" score -- the difference between its estimated tax collection capacity and its actual tax revenue collected: 48% for Panama and 78% for its peers. The country's tax system still suffers from an array of exemptions on custom duties, corporate income taxes, property taxes, and VAT, though the decade of tax reform has reduced the losses from 15% to 4% of tax revenue (IMF, 2013).

To shore-up weaknesses in Panama's financial sector, the 2011 Financial Sector Assessment Program recommended a number of steps to that end. The reforms that have been or are being implemented include new regulations to reduce risks to banks that are focused on better banking supervision by overhauling capital requirements and reporting standards for banks, and improved oversight of insurance companies and the securities markets. In addition, as Panama continues to anchor itself more firmly into the global economy, the subject of the next section, the authorities are developing the nation's capital market by building a single yield curve across domestic and global bonds by dual listing and extending market making to global bonds (IMF, 2013). Furthermore, in the World Bank's recent Doing Business survey (www.doingbusiness.org), which regularly collects information from entrepreneurs and managers operating in a large set of countries about the costs of doing business there, in 2013 Panama ranked the "lowest cost" country in Central America and the fifth "lowest cost" country in Latin America behind Chile, Peru, Colombia, and Mexico (Monge-Naranjo, 2014).

To conclude this brief review of Panama's competitive position, according to the International Monetary Fund, the reforms implemented through 2012 have improved Panama's ranking in various competitiveness surveys, and, according to the World Economic Forum, Panama is now considered the second most competitive economy in Latin America, after Chile (IMF, 2013).

Global Linkages

Adhesion of the national economy to the larger global economy is becoming indispensable to improving a nation's material well being. It is without doubt that the successful development model implemented by China over the last three decades is, in part, due to China's reengagement with the world economy after decades of economic autarky. Consumers benefit from liberalized trade by having more choice of goods, often at lower prices and/or with higher quality. More competition faced by domestic producers from imported goods reduces domestic producers' pricing power, and provides crucial incentives to enhance efficiency and productivity. The prospects of higher exports (in part to pay for increased imports) raise both national employment and income.

Liberalization of the capital account, provided the domestic banking system is sufficiently strong, along with a unitary and market-based exchange rate, can confer benefits to both borrowers and investors alike. Lower interest rates for borrowers, and improved risk/reward tradeoffs for investors, as well as greater discipline on the public finances imposed by these open capital markets complement the benefits provided by a liberalized trade account. It is important to note that policy experts are still debating the cost/benefit calculus for developing countries of full capital account liberalization in light of the Asian financial crisis at the end of the 1990s and the financial meltdown in the US and Europe a decade later (Beattie, 2011; Plender, 2012). Finally, providing a "state-of-the-art" legal, tax, and regulatory environment for foreign investment is critical for attracting and maintaining much-needed financial capital, new technology, and managerial talent for the national economy.

As it enters its second century of service to the global economy it would not be inaccurate to say that the canal is Panama's most valuable asset. Because of its geopolitical importance in providing a sea-link between the Atlantic and Pacific Oceans, however paradoxical it appears, since 1994, Panama has eliminated its standing army through a constitutional ban, recognizing that the United States will defend the canal -- and Panama's sovereignty -- in light of America's far-reaching national security and commercial interests. Approximately 5% of world trade is currently transported through the canal, and once the expansion project is completed, global seafaring cargo is projected to double to 10% (O'Grady, 2012).

The expansion and upgrade of the canal and its ancillary infrastructure began in 2007 and is now expected to be completed in early 2016. The centerpiece of the project is the construction of a third lane of locks that would permit the transit of post-Panamex ships, which are too large to use the existing locks. Readers interested in the engineering details of the construction project -- its scale, duration, materials, cost estimates, etc. are referred to (Lapper and Thomson, 2007; Bussey, 2011).

In recent years, Guatemala and Honduras have announced plans to build massive land bridges between the Atlantic and Pacific coasts, and a Chinese company is conducting a feasibility study for building a parallel canal in Nicaragua that is projected to cost $40bn (The Economist, 2014b). Needless to say a project of this size and complexity would have major geopolitical implications for both China and the United States. Panama is closely following these developments since annual canal revenue from tolls, according to the Panama Canal Authority (http://www.githy.com/?action=page&id=1575), was approximately $2.5bn, about 6% of annual GDP in 2013, and the increase in future tonnage that is expected to transit the canal is expected to significantly increase revenue from tolls, assuming Panama's canal monopoly continues (Financial Times, 2014). Among the important new uses for the canal is the expected shipment of large quantities of liquefied natural gas from the US to Asia by 2020 (Molinski, 2014).

The array of completed, in-progress, and future infrastructure projects --not limited to the canal-- demonstrate Panama's quest to develop the country into a regional logistical hub. To this end the country has been expanding the largest free trade zone in the western hemisphere (the Colón Free Trade Zone), forging Free Trade Agreements (FTAs) with its major trading partners, and is aggressively courting foreign direct investment, offering light regulatory burdens and a favorable tax environment to attract foreign businesses. For example, because of its favorable shipping regulations, there are more ships registered in Panama than in the US and China, combined (http://www.bbc.com/news/world-latin-america-28558480).

The Colón Free Trade Zone (CFTZ, or ZLC in Spanish) accounts for almost all of Panama's exports and almost two-thirds of its imports. The zone has attracted more than 2,000 companies, among them names such as Proctor and Gamble and SABMiller. The enterprise was established in 1948 to modernize the economy's service sector and to streamline regional commerce on a large scale. The imports and exports entering and leaving the CFTZ are directed toward a market of more than 525m consumers (www.colonfreetradezone.com).

Supporting this venture are many transport links including COPA, increasingly recognized as the "Lan Chile of Central America", that contributes 4% to Panama's annual GDP (Rathbone, 2012); six airports; five state-of-the-art ocean ports; modern container terminals; the Pan-American Highway that originates in Alaska; the Trans-Isthmus Highway that extends from the Caribbean Sea to the Pacific Ocean; a Trans-Isthmus railway; and, of course, the canal itself.

In addition, of the more than 92 banks that operate in Panama City's International Banking Center -- the heart of Panama's financial system -- more than 20 of them participate in the financial activity of the CFTZ from their offices in the Zone's commercial center. The Banking Center, itself, developed out of a 1970 banking law permitting offshore operations that are conducted under tight confidentiality and with minimal financial regulation (EIU, 2008; EIU, 2013). In recent years, financial groups from South America have been increasing their regional presence in Panama, especially Colombian banks who control nearly 25% of total bank assets (EIU, 2013).

The fiscal advantages to the companies operating in the Zone are enticing: a zero percent tax rate on profits from re-exports; a zero percent duty and no quotas on imports or exports; and a zero percent tax on billings (www.colonfreetradezone.com).

Liberalized trade and investment regimes have played a critical role in Panama's successful growth strategy over the last decade. An FTA with the US, historically Panama's most important commercial partner, was signed by Panama in 2007, and after some delays by the US due to domestic political differences over some of the agricultural aspects of the agreement, the FTA was ratified by the US Senate and signed into law by President Obama in October 2011. The treaty, which became operative a year later, stipulates that 87% of US exports of consumer and industrial products became duty-free immediately, and the remaining tariffs will be phased out over the next 15 years (IMF, 2013).

Almost simultaneously, an FTA was agreed with Canada, which was as comprehensive and inclusive as the agreement with the US, comprising goods, services (including telecoms and finance), investment flows, and government procurement bids (IMF, 2013). Also, in 2013, the Economic Partnership Association Agreement came into force. This agreement with the European Union (EU), which was jointly negotiated with the other Central American countries, should, as a result, contribute to region-wide growth. The EU agreed to eliminate tariffs on most agricultural and manufactured goods immediately, and the remainder by 2020. Negotiations on additional FTAs are ongoing with European Free Trade Association countries and some Caribbean island-states.

With a view towards Asia -- the engine of growth in the first two decades of the 21st century -- and Pacific South America, FTAs already exist with Chile, Peru, Taiwan, and Singapore, and an agreement is expected soon with South Korea. Panama's regional Pacific FTAs are part of a more embracing strategy to enhance ties with important trading partners in the region through the Pacific Alliance, which Panama is in the process of joining (EIU, 2014).

Officially, the balboa is Panama's currency unit, but in 1904 it was fixed at parity with the US dollar, and today the balboa is issued only as coinage. Since all commercial transactions are conducted in US dollars, the country is effectively "dollarized". However, interest rates are historically above those in the US, reflecting structural weaknesses in the economy and credit risks associated with Panama's "neighborhood". Panama has no currency controls so there are no restraints on foreign companies' repatriation of profits from their operations in Panama.

During the economic recovery in the 1990s that included the privatization of many state-owned enterprises discussed above, Panama, besides liberalizing trade, opened the economy to foreign direct investment (FDI), particularly in transport infrastructure and the utilities sector. Since the mid-2000s there has been a large increase in FDI in the financial services sector that was highlighted by HSBC's takeover of Panama's largest bank, Banistmo.

As was discussed above, Panama's outsized current-account deficit in recent years that was triggered by infrastructure related construction imports for the canal and other projects is easily being accommodated by strong FDI inflows, powering the impressive GDP growth rates observed over the last decade. In addition, the array of FTAs agreed and implemented over the last five years that was discussed earlier all incorporate components to liberalize FDI (IMF, 2013).

With a view towards opening the country to the wider regional and global economy, Panama has attracted many foreign companies and banks who operate in the country. At the end of the last decade concerns were raised regarding Panama's lax corporate laws -- ownership was demonstrated by "bearer shares" without revealing the corporation's "beneficial owner" -- and, as a result, the country became a magnet for "shell companies", and, along with a real-estate boom, the country became a safe-haven for tax evasion, money laundering, and terrorist financing (The Economist, 2009). At that time, Panama still needed twelve Tax Information Exchange Agreements with other jurisdiction to comply with the standards set by the Organization for Economic Cooperation and Development's (OECD) Global Forum on Transparency and Exchange of Information for Tax Purposes. According to the OECD (www.oecd.org/tax/transparency/), in July 2011, after signing an agreement with France, "Panama moved to the list of jurisdictions considered to have substantially implemented the standard for exchange of information", and was taken off the OECD's "grey list". As of this writing (July 2014), Panama has an "exchange of information upon request" relationship with 25 jurisdictions, a lower bar of compliance than the "automatic exchange of information" relationship.

Finally, with the adoption of tougher laws to combat tax evasion by US taxpayers (citizens and others), the US -- Panama's largest and most important commercial partner -- has implemented the Foreign Account Tax Compliance Act (Fatca) that requires internationally domiciled banks to strengthen their capabilities to prevent tax evasion by US taxpayers or face fines and/or sanctions. At this writing, the consequences of the new reporting regime on Panamanian banks has not yet been assessed.

An Active Government Policy to Promote Social and Economic Investment

The last of the four World Bank "ingredients" to be included in a well-managed national economy is an active government policy that promotes social and economic investment, especially in the areas of poverty reduction, health, education, and physical infrastructure, including transport, telecommunications, and energy. Globally, during the 1960s and 1970s rapid economic growth increased living standards that -- in addition to rising per capita income -- was manifested through marked improvements in nutrition, greater access to health care and education, and, as a result of all-of-the-above, significant increases in life expectancy and reductions in infant mortality rates.

In its most recent Human Development Report, the United Nations Development Program (UNDP, 2013) ranked Panama 59th out of 185 reporting countries in its key metric, the Human Development Index. Panama's score was above the regional average and first in Central America, ahead of Costa Rica. The index measures the average achievement in three basic dimensions of human development: life expectancy; education levels; and the standard of living (measured by GDP per capita). According to the World Bank's Worldwide Governance Indicators (WGI) that report country percentile rankings against the world for six measures of "good government": voice and accountability; political stability and absence of violence; government effectiveness; regulatory quality; the rule of law; and control of corruption. In all the above categories Panama's ranking is below -- and for some, significantly below -- its Costa Rican neighbor, which is perceived to have the highest regional marks for "good government" (http://info.worldbank.org/governance/wgi/index.aspx#countryReports).

Panama, a small and extremely open economy, needs to exploit its niche in the global transport sector by providing transport services at an efficient and competitive level. Hence the importance of enhancing productivity in its large service sector . To this end, Panama has a critical need to improve the quantity, quality, and accessibility of its education programs -- that also extend to its under-served rural areas. (More about this below).

It is well known that Panama's shortage of IT workers and English speakers restrained efforts to attract FDI before the large surge in infrastructure projects began, forcing some foreign firms to locate in Costa Rica and Asia (EIU, 2008). According to the IMF, medium-term growth is already being adversely affected by the scarcity of educated and trained workers, particularly in services and construction (IMF, 2013).

While the country boasts near universal primary school enrollment, according to the World Economic Forum's Global Competitiveness Report 2012-13, Panama ranked 115 of 144 countries in terms of the quality of its primary education, with neighboring Costa Rica ranked 21st in overall educational quality (EIU, 2013), and according to the OECD's PISA study that ranks 65 countries' education systems based on the test results of 15-year olds, Panama ranked 63rd (The Economist, 2011b).

The government has responded to these shortcomings with cash incentives to families if their children attain certain attainment levels, a program that extends to over half a million students. Finally, improving the quality of its education programs is not limited to enhancing teacher quality but also modernizing physical educational infrastructure from schools to computers if Panama's skills mismatch is to be redressed (The Economist, 2012).

On the important subject of physical infrastructure, since Panama aspires to become the "hub of the Americas" upgrading and expanding rail, road, and port capacity to accommodate continued growth in world trade and the national economy is a "front-burner", "must-do" issue. To that end, in 1998 the Panama Canal Railway Company -- a joint venture between two US companies (Kansas City Southern Railways and Mi-Jack, a terminal operator) -- won a 50-year concession to rebuild and operate the railway that runs parallel to the canal between Panama City and Colón. The rebuilt railway provides an inter-modal link between the Pacific and Atlantic ports and adds another "layer of transport" infrastructure to complement the canal, the CFTC, the port terminals, and the roads and airports to improve the movement of cargo nationally, regionally, and internationally (IMF, 2013).

The rise in living standards over the last 15 years has increased automobile ownership appreciably in Panama exacerbating an already challenging problem of road congestion. Along with new and upgraded roads, Panama has begun to rationalize its urban transport system by improving its bus network and opening Central America's first metro system that was discussed above. Also, the long awaited toll road linking Panama City to Colón has finally been completed. The other critical infrastructure components -- the ports, energy, and telecoms -- were discussed above.

According to the World Bank the percentage of the population living below the poverty line in Panama fell from 38% in 2006 to 26% in 2011, with 6.6% living in extreme poverty, i.e., on less than US$1.25 per day (http://data.worldbank.org/indicator/SI.POV.NAHC/countries/PA?display=graph). However, in the rural areas, in 2006, 46% of the population was living below the poverty line of US$ 2 per day, and for those living in the indigenous areas, where 12.5% of population lives, 81% of the population was living in poverty (EIU, 2008).

The impressive reduction in the percentage of the population living below the national poverty line can be attributed to strong economic growth over the last decade and the successful government program mentioned above -- the Red de Oportunidades -- that was initiated in 2005 and provides monthly cash payments to families living in extreme poverty if their children meet commitments on school attendance and medical checkups.

It is normal in developing countries to have large disparities in living standards between the urban and rural areas, but in Panama this gap is even more pronounced as a result of the large amount of public works projects being carried out in Panama City and its suburbs (where more than 60% of Panama's population lives) to the neglect of the rural -- and especially the indigenous -- areas, where low-productivity and labor-intensive agriculture is the principal economic activity. The government recognizes the need to invest in modern agricultural technology and infrastructure to increase labor productivity and living standards, and to reduce poverty rates in these areas of the country (EIU,2014). Of course, higher productivity in agriculture will release labor that will need to be absorbed in other sectors of the economy, a problem that is already appearing on government "radar screens".

CONCLUSION

Over the last quarter century political leaders and policymakers in virtually every country in the world have been confronted with the same question: In the wake of widespread political, technological, and institutional change around the world, what changes must be introduced into the economic and financial architecture of a country's economy that is firmly anchored in the world economy of the 21st century that will lead to improvements in the nation's material well-being? From China to Brazil, from Russia to South Africa, from Japan to Australia, from India to North Africa, and, most recently from the United States to Western Europe, all have struggled, or are struggling, with this "existential" problem.

The objective of this paper has been to describe the predicament of Panama, a small country of less than 4m people, that is located in a politically and economically dysfunctional region of the global economy. Panama is a country with undeveloped deposits of copper, silver, gold, and molybdenum but without an economically viable manufacturing sector that produces durable consumer goods. So, how does Panama arrange its "assets" -- its geography, its climate, and its human capital -- to improve the standard of living of its population within the framework of the fiercely competitive global economy?

The first step is to identify the country's strengths and weaknesses, and then, through the political process and in collaboration with its business leaders and policymakers, to develop and implement the necessary policies to reduce or eliminate these weaknesses on the one hand, and to nurture and provide the necessary incentives to exploit the country's strengths, on the other hand.

This paper has emphasized the need for Panama to address its education shortcomings, the skills deficit of its labor force, the disparity in living standards that exists between the urban and rural areas (and, in particular, the unresolved problems with its marginalized, impoverished indigenous groups), and the intractable issues of widespread corruption and rising inequality of income. While it is not yet an imminent threat to the government's annual cash flow, a decision by Nicaragua and China to build a parallel canal would be a fiscal "game-changer" for Panama's economy. However, in the short- and medium-term, the completion of the canal upgrade will enhance government revenue, some of which can be allocated to addressing some of the above listed weaknesses. Also, as a services-based economy Panama is nurturing the development of its tourism sector, which is the largest source of income from services after its canal revenue. In 1987 the country had 1,400 hotel rooms, which grew to 15,000 in 2013, and in 1999, Panama attracted 457,000 tourists, while in 2013 that figure rose to 1.4m (Neville, 2013).

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