Panama's unorthodox infrastructure finance model

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The Panamanian governments $15 billion public investment plan (PIP), when added to the countrys high-profile Canal expansion, constitutes a financial commitment of $20.25 billion, equivalent to over 75% of 2010 GDP.

It covers a new North Concourse (Muelle Norte) for the government-owned Tocumen International Airport, recently completed at a cost of $100 million, as well as the airports new South Terminal (Terminal Sur), estimated to cost over $650 million, which is set to begin construction in the coming months. The expansion recognizes the airports growth into the largest hub in Central America and one of the most important in Latin America. It includes the governments recent purchase of the Corredor Sur, which links the airport to Panama Citys centre, along with its sister toll Corredor Norte for a combined $1.1 billion. It encompasses the Panama City road improvement programme that has an all-in cost of $3.1 billion. It also features Line 1 of the first Metro system in Central America at a cost $1.8 billion. And it entails the Panama Canals $5.25 billion expansion, now more than half complete.

Budget and concession priorities

How has Panama managed to procure such a large number of expensive infrastructure projects? The government has striven to avoid over-extending its budgetary responsibility for project financing and worked to enhance its position in international capital markets, all while maintaining a culture of fiscal discipline.

Its unorthodox approach to public financing has raised eyebrows, as critics suggest that overheating, the crowding out of the private sector and the deferral of some liabilities, could be byproducts of this pro-cyclical fiscal stance (Panama grew at 10.7% in 2012). But proponents of the plan say that the government is focused on acting as a catalyst for development without dominating or hindering natural market processes, as well as maintaining its credibility with investors. In July 2012, Standard & Poors justified Panama´s rating upgrade to BBB thus: We expect Panamas GDP growth will remain strong over the medium term, boosted by the countrys high and diversified investments.

The evolution of countrys investment model can trace its roots to the privatisation efforts of the mid-1990s. Panama was able to attract multinational corporations such as Cable & Wireless and Gas Natural Union Fenosa by selling equity stakes of up to 49% in public utilities. These utilities became mixed corporations, with the government effectively retaining ownership but relinquishing control over day-to-day operations to private sector operators.

At this point, Panama also adopted the concession model in infrastructure development. The most prominent examples were the design-build-finance-operate-maintain contracts for toll highways and ports. In those years the country had no sovereign credit rating and had difficulty attracting foreign capital. As a result, these concession contracts were skewed in favor of the concessionaire and allowed them to keep the vast majority of any upside from the performance of concessions. The government benefited from state- of-the-art infrastructure developed with little or no risk or equity commitments, as well as the technology and knowledge transfer associated with, for example, the development of a port sector by foreign concessionaires such as Hutchinson Whampoa, SSA Marine and Evergreen.

Over the past 20 years, Panama learned much from the concession model: sound corporate governance; delegating management to the private sector; and witnessing how concessionaires tapped the international capital markets as a major source of funding. It also learned, however, that it had left a lot of money on the table while it made its way up the learning curve.

New administration, new plan

During the Torrijos administration (2004-2009) a Fiscal Social Responsibility Law passed that not only made each new administration commit to specific debt and deficit targets, but also required them to produce a five-year strategic development plan (SDP). When the current Martinelli administration took office, Alberto Vallarino, a former chief executive officer of a bank, became head of the Ministry of Economy and Finance (MEF).

In 2009, with a GDP of $24 billion, Panama launched its five-year, $15 billion PIP to expand and modernise the countrys infrastructure, as well as the Canal expansion project approved in 2007. It cast aside previous investment models in favour of a more direct and assertive approach. Government was calling for an average of roughly $3.0 billion in new capital expenditure per year over the next five-year period but its total revenue for 2008 was only $4.52 billion. Vallarino says: We needed to target the revenue side if we wanted to be successful at implementing such an ambitious investment plan. They have since increased to $6.58 billion, a 46% increase in four years*, on the back of fiscal reform, effective collection and a strong growth cycle.

As the government navigated the financial crisis and waited for its fiscal reforms to produce increased revenues, it turned to different financing mechanisms for its aggressive PIP. These mechanisms included project finance, securitization, 144A bonds, private placements, Japanese auctions, and other ways of deferring liabilities to years when government would, hopefully, have more fiscal room, most notably in procuring projects using turnkey contracts.

Vallarino quickly surrounded himself with young technocrats with experience in banking and finance, many of whom returned from abroad with MBAs and Masters in economics and finance. The MEF deployed these banking-trained technocrats to the various government entities executing large projects to advise on financial structuring and lead negotiations with external creditors, such as multilateral and private banking institutions. This ensured the best terms and conditions on financings, and that each financing plan fit in within the macro budgetary strategy.

A case in point is the acquisition of the Corredor Sur toll road from its private sector concessionaire in 2011. The transaction was financed with a small equity contribution from the government and two bond series that were marketed through a trust structure, one series principally to international investors and the other to domestic Panamanian investors. The proceeds paid off existing creditors and the concessionaire, while the bonds are serviced only from tolls and the roads related revenues, without any government guarantee. The bonds benefitted from the strong credit rating of the country, receiving investment grade ratings from Fitch and Standard & Poors. MEF personnel were intimately involved in the project, from conception through implementation.

Capping this evolution in financing techniques was meant to be a modern PPP law, based on international best practices and developed within the MEF. But the law failed to pass, amid exaggerated fears that it would lead to privatisation in the health care sector.

Capital markets access

Much of the success of the governments infrastructure plan would depend on Panamas access to international capital markets, so it moved to improve its standing in the international financial community. In 2009, it set up a commission made up of prominent private and public sector figures to look at how to improve its chances of becoming an investment grade credit. Panama is now several notches into investment grade.

The government has carefully built out its yield curve, both in the domestic and international debt capital markets, with benchmark issues along key points on the curve and an increasingly long-term progression in its domestic treasury issues. Most recently it has issued 40-year global bonds at an interest rate of 4.3%.

It also worked hard to make key projects financially self-supporting. Taking its cue from the Canal, which in 2008 closed on $2.3 billion in loans against its own balance sheet and future cash flows, and working alongside the International Monetary Fund (IMF), the government identified state enterprises that had robust cash flows and did not need subsidies and took them out of the non-financial public sector, meaning their assets and liabilities would not consolidate with those of the public sector. As a result, key institutions, managing key strategic assets (airport, toll highways, electricity transmission) no longer had to compete with education and health care for a share of the budget, but could instead go to the local and international capital markets to raise their own financing.

The government transferred the airport to a newly created, wholly-owned corporate entity with its own balance sheet. Financing for the South Terminal will come from revenues from the airports own operations and third-party financing that relies only on the corporations future cash flows, much as the Corredor Sur bonds did. The toll roads now owned by the government are managed through newly-created corporate entities headed by former private sector executives.

Each entity has raised financing against its own operations and without a government guarantee, but lenders know that those operations support the countrys overall strategic objectives. And the government, through MEF, has supported the financings with abundant technical expertise. The credit rating agencies speak in terms of an implicit government guarantee, which has no legal significance but refers to the importance of the projects to the host country, and that the government has communicated to the financial community that it wants the projects to succeed.

For now, the strategy seems to be paying off. Panama has averaged 8.7% real GDP growth since 2004, has been the fastest growing economy in Latin America over the past five years and its per capita GDP has more than doubled over the past decade. The three major rating agencies all rate it triple-B (Moodys Baa2), second only to Chile (double-A-) in Latin America. Unemployment is at an all-time low at 4%, and Panama has consistently ranked among the highest recipients of foreign direct investment on a per-capita basis in the region. And the allocation of the budget for capital expenditures has gone from 12% in 2000 to 35% in 2012. The IMF, which has expressed reservations about Panama´s pro-cyclical strategy in the past, admitted in its last yearly review of the Panamanian economy: Panamas economy continues to grow strongly, buoyed by the Panama Canal expansion and large public infrastructure projects.

Some in Panama contend that this growth is coming at the expense of the private sector (by crowding out its activities) and is debt financed. There is an argument that with 10% GDP growth rates and record levels of revenue, the government should not be running 2% deficits, as it is currently doing. The country´s current Vice Minister of Finance, Mahesh Khemlani, a former young technocrat at the MEF who had been an investment banker, responds: Panama is investing massively in productive infrastructure that will have a multiplier effect on GDP growth and on productivity. To accomplish this, we are running moderate deficits. During the last forty years, very little productive infrastructure was added to the economy. We are trying to change that by investing in roads and highways; airports and ports; hospitals and schools and public transportation. More importantly, we are doing it with fiscal prudence with 75% of investments being financed from current revenue and only 25% relying on debt. Panama has broken with macroeconomic orthodoxy by pursuing this markedly pro-cyclical fiscal policy.

Will it work in the longer term? The outcome cannot be predicted with certainty, but the current indications are that the government is getting it right. The government is planning for a wind-down of the infrastructure investment programmes. Panama is now banking on prudent fiscal management and increases in non-tax revenues and complementary activities such as mining. The government intends to step back and let the economy run on its own strength, enhanced by an integrated upgrade of its core infrastructure.

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*Because of a change to the way Panama reports its revenue figures, an earlier version of this article used incorrect numbers.

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