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Research Note

Balance of Payments Issues in Panama and their Relation to its Status as an Offshore Financial Centre †

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Abstract: This paper discusses balance of payments issues in Panama with relation to its status as an Offshore Financial Centre. "Balance of Payments" statistics record a country's or an area's foreign economic relations systematically in both "real" terms and "financial" terms. On the one hand, Panama's weak manufacturing creates a large trade account deficit and the Panama Canal creates a large service account surplus. On the other hand, although there is a tremendous international movement, Panama's function in international finance is not the ultimate source of international capital movement, but acting as an "international intermediary." In making analytic views, we can generalize Panama's case. The first point is this status reflects not only financial terms, but also real terms in foreign economic relations. The second point is whether the country or area can be the ultimate source of international capital movement with relation to its settlement system.

Keywords: offshore financial centre, tax haven, balance of payments, capital movement, currency

JEL Classification Numbers: E42, E51, F65, G21

1. Introduction

Panama is one of the most famous countries in the world. Panama lies between the Pacific and Atlantic Oceans, or between North and South America. Panama has the Panama Canal and is an international financial centre (Offshore Financial Centre or Tax Haven). Hence, Panama has been an important location as regards economy, politics, and military affairs. Recently, Panama has come under the spotlight due to the "Panama Papers" and "Mossack Fonseca."

In the modern world, the topic of Offshore Financial Centres and Tax Havens is important. Because many scholars argue on this topic, the studies accumulate. For example, Strange (1998, Chap.7), Palan, Murphy, and Chavagneux (2010), and Shaxson (2011) discuss Offshore Financial Centres and Tax Havens in detail. Recently, Obermayer and Obermaier (2016) trace the "Panama Papers."

Japanese scholars started arguing about the topic of Offshore Financial Centres and Tax Havens at an early date. Nagakawa (1985) and Kyuno (1986) published a detailed study on Offshore Financial Centres in the 1980s. In the argument on the transnational corporation sphere, Sekishita (2002), Nakamura (1995, 2010), and Konishi (2017) discuss Offshore Financial Centres and Tax Havens with relation to transnational corporation networks. In the argument of the international currency sphere, Yamamoto (2002, Chap.6) discusses the Offshore financial centres' function in international capital flow.

In this paper, we discuss balance of payments issues in Panama with relation to its status as an Offshore Financial Centre.[1] Preceding studies do not always use "Balance of Payments" statistics. However, the characteristics of the "Balance of Payments" statistics are very important in the analysis. "Balance of Payments" statistics record a country's or an area's foreign economic relations systematically in both "real" terms (current account) and "financial" terms (financial account).[2] Therefore, we discuss Panama's foreign economic relations in real terms (Section 2) and financial terms (Section 3).

This study covers the period 2010-2017. This period includes two moments. The first one is the recovery of world economy after the financial crisis due to Lehman's collapse. The second moment is "Panama Papers" problem in 2016. We should especially note the second moment.

2. Panama's foreign economic relations in real terms

In real terms, the service sector in relation to the Panama Canal is at the centre of Panama's economy. There are two primary points: the strong service sector and weak manufacturing.

The first point is the strong service sector in relation to the Panama Canal. The Panama Canal has played a major role in the balance of payments. According to table 1, the balance on services, especially transport services ended with a large surplus. The surplus was \$3 billion (in 2010-2011), \$5 billion (in 2012), and \$7 billion (in 2015 and 2016). In spite of the "Panama Papers" problem, a large surplus remains.

In order to consider transport services, some facts about the Panama Canal are important.[3] Because of the Panama Canal, the history of Panama after the 2nd World War included the battle against the United States of America (USA). The USA began building the Panama Canal in 1904 and dominated its operation. The USA operated the Panama Canal without an emphasis on profit. Hence, Panama was ruled by the USA and/or gained some benefits.

On the other hand, Panama fought very hard to reclaim the Panama Canal. Because of this history, the Panama Canal has been governed under Panama since 1999, with emphasis on profit. Under this situation, the fee for using the Panama Canal and the volume of sea transport freight have increased. Recently, the Panama Canal was expanded in order to solve capacity problems. These facts have contributed to a large surplus in the balance on services.

The second point is weak manufacturing. In contrast to the service sector, manufacturing plays a minor role in the balance of payments. According to table 1, although the volume of trade in itself is very large, the balance on trade is a large deficit. There are two reasons for this.

"Colon Freetrade Zone (CFZ)" is one reason.[4] The CFZ has worked as an international logistics centre because of the tax-free activity as well as Panama's location. Trade goods are imported to the CFZ, and exported from it. On the one hand, these activities increase the volume of trade. On the other hand, because the main activities are mere storage of goods or easy operations, Panama cannot obtain added-value from the CFZ. As a result, the CFZ does not develop Panama's manufacturing.

Local manufacturing is the other reason mentioned.[5] Panama's manufacturing industry is very small. It cannot produce intermediate goods or capital investment goods. It can only produce consumption goods for the domestic market; therefore, Panama does not produce strong export goods. In addition to this, even if domestic production is conducted, the import of intermediate goods and capital investment goods is still necessary. As a result, Panama's trade structure is exporting primary commodities or low added-value goods and importing industrial goods.

Table 1. Panama's balance of payments (in millions of US dollars)

	2010	2011	2012	2013	2014	2015	2016	2017 (Q1-Q3)
Current account	**-3,113**	**-4,523**	**-3,735**	**-4,084**	**-6,677**	**-4,274**	**-3,160**	**-3,370**
Goods	**-4,564**	**-6,585**	**-6,640**	**-6,890**	**-8,942**	**-6,565**	**-5,843**	**-5,952**
Exports	14,146	19,076	21,122	19,603	16,841	15,913	14,665	10,172
Imports	-18,710	-25,662	-27,762	-26,493	-25,783	-22,478	-20,507	-16,124
Services	**3,624**	**3,806**	**5,559**	**5,658**	**6,497**	**7,056**	**7,863**	**6,474**
Transport	1,894	1,818	2,445	2,757	3,312	3,482	3,737	3,284
Travel	1,347	2,014	2,649	2,671	2,788	2,894	3,483	2,798
Other services	383	-26	465	230	397	680	643	391
Primary income	**-2,311**	**-1,914**	**-2,738**	**-2,907**	**-4,354**	**-4,659**	**-5,023**	**-3,797**
Investment income	-2,321	-1,938	-2,768	-2,945	-4,456	-4,738	-5,097	-3,849
Compensation of employees	10	24	30	37	102	79	74	53
Secondary income	**138**	**171**	**84**	**56**	**122**	**-106**	**-157**	**-95**
Capital account	**43**	**22**	**17**	**26**	**24**	**27**	**24**	**16**
Financial account	**-2,803**	**-4,864**	**-3,282**	**-4,939**	**-4,996**	**-3,877**	**-5,336**	**-4,324**
Net acquisition of financial assets	**5,178**	**5,736**	**3,723**	**3,705**	**8,272**	**8,257**	**1,376**	**-1,833**
Direct investment(assets)	143	1,419	-103	563	855	1,091	954	870
Portfolio investment(assets)	898	760	131	823	1,108	1,562	213	979
Other investment(assets)	3,870	3,881	3,587	1,932	5,128	5,679	-258	-3,012
Financial derivatives (Net)	-45	-70	71	-13	-42	2	-142	51
Reserve assets	312	-253	37	401	1,222	-78	609	-721
Net incurrence of liabilities	**7,981**	**10,601**	**7,005**	**8,644**	**13,267**	**12,133**	**6,712**	**2,491**
Direct investment(liabilities)	2,549	4,396	3,382	3,799	4,984	5,058	5,995	4,832
Portfolio investment(liabilities)	1,588	1,658	502	1,177	2,075	1,778	282	1,490
Other investment(liabilities)	3,844	4,547	3,121	3,668	6,208	5,298	436	-3,831
Net errors and omissions	**267**	**-364**	**437**	**-882**	**1,657**	**371**	**-2,200**	**-969**

Note 1: In "Financial account", positive figures (+) show an increase in assets or liabilities; negative figures (-) show a decrease in assets or liabilities.

Note 2: Because of unavailable data, the 2017 column is not for the full year, but the sum of three quarters (from January to September).

Source: Created based on data from International Monetary Fund.

Thus, Panama has a large trade account deficit owing to weak manufacturing and a large service account surplus thanks to the Panama Canal.

3. Panama's foreign economic relations in financial terms

In financial terms, international capital movement is a key point.

Panama became an international financial centre for two reasons.[6] The first reason is a Cabinet decree that took place in 1970. By this law, Panama supplies the duty of secrecy and preferential taxation, and has a liberalized financial system. In the 1970s, developed countries restricted financial activity relative to the current situation at the time. Hence, free financial activity is a source of superiority. In other words, Panama has aspects of a "Tax Haven." In this context, recently, Panama has come under the spotlight because of the "Panama Papers" and "Mossack Fonseca." The second reason is Panama's currency system, which is called the "Dollarization" Policy. Based on a monetary agreement with the USA, Panama has used the US dollar as a legal currency since 1904. Hence, US dollar - based financial transactions can be done in Panama.

First of all, we investigate the international capital movement around Panama, using Balance of Payments and International Investment Position statistics.

According to table 1, inward capital flow (Net incurrence of liabilities) was about $8 billion (in 2010), $10 billion (in 2011), and $13 billion (in 2014). Outward capital flow (Net acquisition of assets) was $5.2 billon (in 2010), $5.7 billion (in 2011), and $8.2 billion (in 2014). However, because of the "Panama Papers" problem, in 2016, both the inward and outward flow decreased. This trend continues in 2017. Especially, "other investment (assets and liabilities)" have become negative. This shows capital flight.

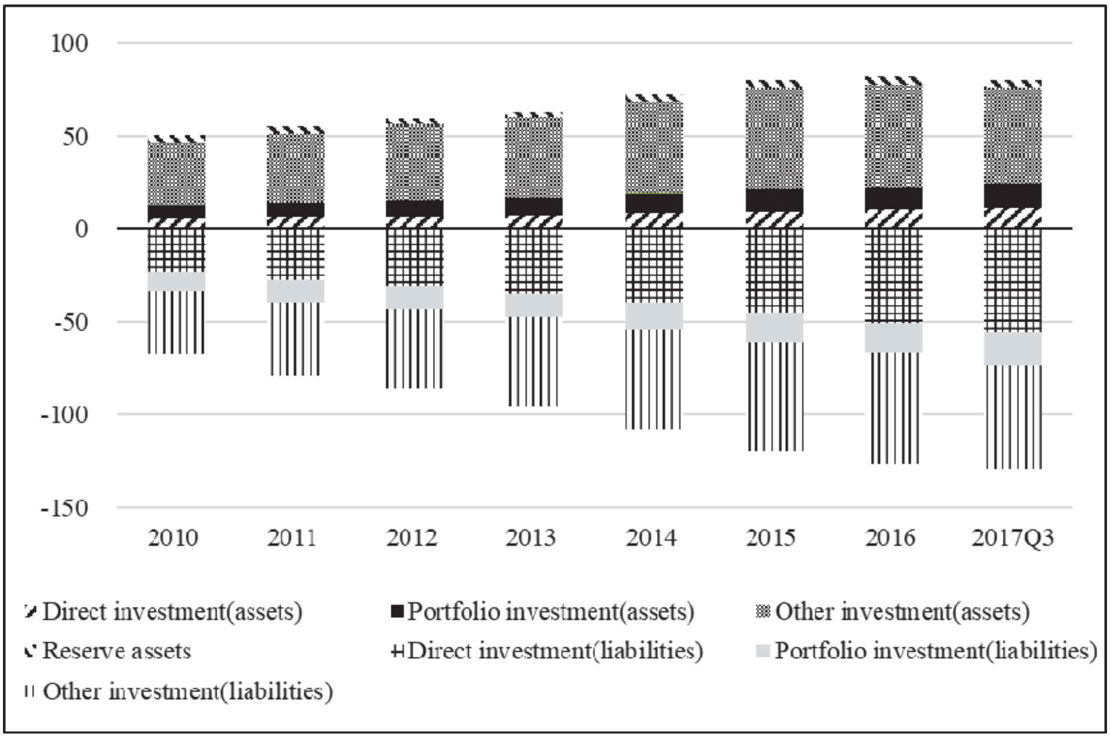
On the other hand, although Panama is a small country, the international capital movement around Panama is very large. According to graph 1, in stock terms, both assets and liabilities remain large. Further, according to table 1, "Direct investment (liabilities)" is about $4 billion (in 2011-2014), $ 5 billion (in 2015), and about $6 billion (in 2016). In spite of the "Panama Papers" problem, "direct investment (liabilities)" was greater in the past.

This shows two things. The first thing is that Panama has not only foreign liabilities, but also foreign assets, in spite of holding a net foreign debt position. The second thing is that, even after the "Panama Papers" problem, international financial assets and liabilities remain in Panama.

Next, we discuss Panama's situation in international finance. There are three main points.

The first point is "direct investment (liabilities)" relating to transnational corporations. In order to utilize Panama's hub function, such as the Panama Canal and CFZ, transnational corporations invest in Panama. On the other hand, reinvestment of earnings is also an important point. The IMF Balance of Payments and International Investment Position Manual Sixth Edition (p.135) states that "it is the direct investor's share of the retained earnings or net saving of the direct investment enterprise, before reinvested earnings payable are deemed distributed." Applying this explanation to Panama, Panama has the function of pooling profits for transnational corporations.

Graph 1. Panama's international investment position (in billions of US dollars)



Note 1: Positive figures (+) show assets, negative figures (-) show liabilities.

Note 2: Because of unavailable data, 2017 is end of September.

Note 3: Because financial derivatives(assets) and financial derivatives(liabilities) are very small, these items are not shown in Graph1.

Source: Created based on data from International Monetary Fund.

The second point is Panama's role in international finance. As we mentioned above, Panama has both foreign assets and liabilities. This shows that Panama attracts international capital and then reinvests it.[7] In the context of Panama, banks located in Panama attract international capital by "other investment (liabilities)," and reinvest in "other investment (assets)." The reason for this trend is the duty of secrecy, preferential taxation, the liberalized financial system, and the "Dollarization" policy in Panama. As a result, Panama functions as an "international intermediary."

We should note Panama's role in international finance. Historically, Despres, Kindleberger, and Salant

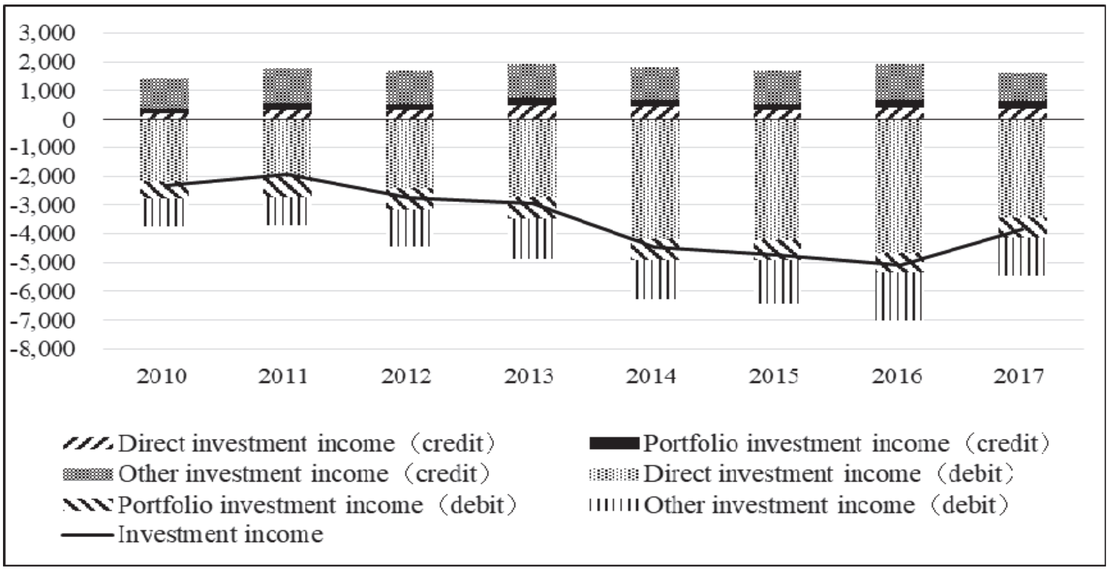
(1966), IMF (1997, pp. 2-3), and Gourinchas and Rey (2005) suggested the role of the USA as an "international intermediary." However, actually, this view is appropriate to Panama, not the USA.

The most fundamental thing is that the ultimate source of international capital movement in US dollar is the USA.[8] The US dollar international currency exists as US dollar deposits located in the USA. In using Fedwire, which is a USA settlement system, US dollar deposits are transferred through the Federal Reserve Bank deposit. This is a basic characteristic for the US dollar. Therefore, the USA is not an "international intermediary," but creates net international currency.

In other words, even if Panama is under the "Dollarization" policy, Panama does not have a US dollar settlement system. It is true that Panama has a "US dollar payment system" in the National Bank of Panama and a clearinghouse in Telered, S.A. Panama, but the settlement of the US dollar as an international currency is only done in the USA. Hence, the "US dollar denominated deposit" in Panama is "Panama's domestic currency.[9]" Thus, Panama is never the ultimate source of US dollars or international capital movement.

The third point is financial revenue. How does Panama earn through being an "international intermediary?" This issue is shown by "investment income" in table1 or graph 2. The total investment income is a deficit. "Portfolio investment income" and "other investment income" are expanding in both credit and debit, but these items are not in a large surplus in net terms. Furthermore, "direct investment income" is a deficit. Therefore, Panama cannot earn investment income.

Graph 2. Panama's investment income (in millions of US dollars)



Note: Because of unavailable data, 2017 is not a full year, but the sum of three quarters (from January to September).

Source: Created based on data from International Monetary Fund.

Thus, Panama has the function of "direct investment (liabilities)" relating to transnational corporations, and "international intermediary." On the other hand, Panama is not the ultimate source of US dollars and international capital movement, and cannot earn investment income.

4. Conclusion

In this paper, we discussed Panama's foreign economic relations. On the one hand, Panama's weak manufacturing creates a large trade account deficit and the Panama Canal creates a large service account surplus. On the other hand, although there is a tremendous international movement, Panama's function in international finance is not "international credit creation" (the source of US dollars), but acting as an "international intermediary."

According to Panama's case, we can generalize the balance of payments issues with relation to its status as an Offshore Financial Centre. The first point is this status reflects not only financial terms, but also real terms in foreign economic relations. The second point is whether the country or area can be the ultimate source of international capital movement with relation to its settlement system. These analytic views are important when discussing Offshore Financial Centres.

[†] The views expressed in this paper are those of the author and are not necessarily those of Cabinet Office.

Notes

[1] We have already discussed such issues in Hoshino (2018, Chap.4). Hoshino (2018, Chap.4) discusses Panama's foreign economic relations in the context of the "Dollarization" Policy and until 2016. We revise Hoshino (2018, Chap.4). In this paper, we discuss focusing on Tax Havens and extend the time series to 2017. The "Panama Papers" problem occurs in 2016. Hence, on considering the impact of the "Panama Papers" problem, the period 2016-2017 (discussed in this paper) is important.

[2] Matsumura (2010, pp.266-267) notes this point.

[3] On considering the Panama Canal, we refer to Ozawa (2006, pp.3-6, pp.10-12 and pp.14-15), Kawai (1980), Kobayashi (2000), Kunimoto, Kobayashi, and Ozawa (2004), and Zimbalist and Weeks (1991, Chap.3), Embassy of Japan in Panama Website.

[4] On considering the issue of CFZ, we refer to Kawai (1980, pp.169-171), Kunimoto, Kobayashi, and Ozawa (2004, pp.27-28), and Kobayashi (2007, p.154 and pp.175-178).

[5] On considering the issue of Panama's manufacturing, we refer to Kunimoto, Kobayashi, and Ozawa (2004, Chap.4 and Chap.51), and Kobayashi (2007, pp.152-164), Ministry of Foreign Affairs of Japan Website.

[6] On considering the issue of international financial centres, we refer to Eskelinen and Ylönen (2017, pp.638-640), Johnson (1972, pp.223-228), Moreno-Villalaz (1999, pp.426-427), and Zimbalist and Weeks (1991, Chap.4), Nagakawa (1979).

[7] On considering this issue, we refer to IMF (1997, pp.2-3).

[8] On considering this issue, we refer to Yamamoto (2002, Chap.6).

[9] We discussed "Panama's domestic currency" in Hoshino (2018, Chap.2 and Chap4).

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