



The Upgrade Race! – Colombia versus Panama

Coca and coffee are to Colombia what the Canal is to Panama, but in the past decade or so these neighbours have made significant strides and have evolved far beyond these old associations. LATAM emerging market gurus know this well and following Brazil's much anticipated recent upgrade, are anxiously awaiting and hotly debating the next upgrade. Judging from most analysts' comments, Panama and Colombia are the next most likely contenders.

Both countries are assigned the same rating at this point in time by Standard and Poor's, BB+ / Stable / B. What exactly does this rating mean? Please refer to Box 1 for an excerpt from the S&P website explaining what 'BB' and the rating one notch above, 'BBB' mean.

Box 1

S&P Definitions:

"The 'BB' range, the highest in what is commonly referred to as the speculative-grade category, reflects significantly more political risk, with political factors possibly disrupting economic policy. Income is low to moderate, and lack of diversity and structural impediments may restrain economic growth. As at higher levels, the central bank pursues sustainable monetary and exchange rate policies, but market-oriented tools are not well developed. The financial sector is likely to come under stress when economic growth slows, and capital markets have a short track record. Debt and debt service are usually high and variable.

And one notch above, "The 'BBB' range is the lowest within what the investment community commonly refers to as the investment-grade category. In Standard & Poor's opinion, the cushion supporting timely debt service is not as large as at higher rating levels. Political factors play a larger role here than at higher levels, but orthodox market-oriented economic programs are generally well established. 'BBB' rated sovereigns tend to be the most heavily immersed in economic reform and liberalization (as are many lower rated sovereigns), and are at an earlier stage in the reform process than their more highly rated peers. Median per capita GDP is about US\$5,000, far below the 'A' median's US\$11,000. Debt may be high, and there is likely to be greater reliance upon short-term debt and debt indexed to, or denominated in, a foreign currency than at higher rating levels. Capital markets are less developed, and the financial sector may be small and/or encumbered by weak economic performance and supervisory shortcomings.

A Standard & Poor's rating outlook assesses the potential direction of a long-term credit rating over the intermediate term (typically six months to two years). In determining a rating outlook, consideration is given to any changes in the economic and/or fundamental business conditions. An outlook is not necessarily a precursor of a rating change or future CreditWatch action.

- *Positive means that a rating may be raised.*
- *Negative means that a rating may be lowered.*
- *Stable means that a rating is not likely to change.*
- *Developing means a rating may be raised or lowered.*

In determining whether a country is due for a change in its credit rating, we can analyze from a fundamental standpoint and focus on social, economic and political statistics. We can also analyze from a technical standpoint, focusing on the data of the country's S&P credit rating history.

Technicals

TABLE 1	Colombia	Panama
What was the highest Foreign Currency rating? (since 1997)	BBB- (1997-1999)	BB+ (1997-2000, 2008)
What was the lowest?	BB (2000-2006)	BB (2001-2007)
How does that relate to the current rating?	Current is one notch above their lowest	Current is one notch above the lowest
How long ago was the last revision?	Mar-07	Feb-08
How many upgrades in how many years?	One upgrade in 11 years	One upgrade in 11 years
How many downgrades in how many years?	Two downgrades in 11 years	One downgrade in 11 years
Is a revision overdue or "under-due"?	"over-due"	"under-due"

Examining the breakdown of the S&P credit ratings history in Table 1 will reveal that there are many similarities, but a few essential differences:

1. Panama's ratings history is more stable than Colombia's
2. Colombia was once investment grade, but both are now one notch below investment grade
3. Panama was upgraded very recently – in February 2008 – less than 6 months ago.

Given the foregoing, particularly points 2 and 3, it is apparently more likely – fundamentals permitting – that Colombia would be upgraded sooner than Panama. Conquering uncharted territory is usually more difficult than re-visiting a previous home, and Panama could have more of a challenge accomplishing this for the first time than Colombia should in regaining prior levels of performance. Also, according to S&P, Colombia is one of the few Latin American countries that have not defaulted since 1939 (unlike Brazil, Costa Rica, Peru, and Panama, which all defaulted in the 1980s).

Fundamentals

Now, let's examine on a fundamental basis, those factors which determine a country's credit rating.

In terms of political risk, Colombia has made significant improvements to its military and security arrangements over the past four years, which have lessened overall political risk. Colombia's major weaknesses in this regard are the guerilla groups and the illicit drug trade. The major guerilla unit, the FARC, has suffered major setbacks recently – high profile

hostages have been captured from the guerillas and released, senior FARC members have been captured or killed, and Venezuela's President Hugo Chavez has apparently changed his perspective and has called for FARC rebels to disarm, while he previously (allegedly) provided financial support. According to S&P "Colombia's ongoing internal conflict places pressure on fiscal accounts that is absent in Panama and other 'BB' rated peers, though the country's institutional strengths partly mitigate this." According to Transparency International, Panama's public sector is more corrupt than Colombia's. The former has a rank of 94 on the corruption perceptions index while the latter ranked 68, where the most corrupt is 179. In terms of the transfer of political power between the major parties, Colombia and Panama are on par.

The fact that Panama is dollarized means that monetary and exchange-rate policy are not available as tools to manage the economy. As it should, Panama has however been able to exercise fiscal discipline as reflected by lower debt levels and fiscal deficits than similarly rated countries, indicating that there is sufficient fiscal flexibility to mitigate the absence of monetary policy options. Panama's average net general government debt / GDP ratio is 30%, only slightly lower than that of Colombia at 32%. Also similar is the level of fiscal flexibility as demonstrated by interest burden versus revenue at around 13% for both countries. Colombia usually records higher fiscal deficits, but greater general government revenue / GDP ratios.

Panama is a clear winner when it comes to GDP growth, and per capita GDP. Colombia's GDP per capita is expected to reach roughly US\$4,500 this year, while Panama's is expected to come in just over US\$6,500. According to the World Bank, the Gini coefficient which measures the inequality of income distribution is only slightly higher for Colombia at 57.6 than Panama at 56.4. Future growth in Panama is highly dependant on external factors – international trade and demand for shipping services, and the level of FDI particularly as it relates to the expansion of the Panama Canal. The final deadline for the Panama Canal project which is estimated to cost US\$5.25bn is still on track for 2014, and is designed to increase the capacity, depth and width of the canal, opening the waterway up to larger ships (carrying 10,000 containers versus the current maximum of 4,000 containers) and increased volumes of traffic. The project is much needed as the canal is already operating at over 90% of its capacity. At present, the canal handles approximately 5% of global trade and is mainly used by the United States, China, Japan and Chile - all major export nations. Given that international trade with China is expected to continue to soar, increased pressure will be put on the Canal's capacity. Similarly, Colombia's growth prospects are tied to higher FDI flows and an expected uptick in exports. A free trade agreement with the US is unlikely to be ratified neither with Colombia nor with Panama until 2009 after general elections are held.

What will make the difference to S&P?

For Colombia, the major factors to watch according to S&P in terms of a change in credit rating are - further tax reform which could lead to rapid improvement in the government's fiscal prospects and alleviate the debt burden, and of course, any major change in the national security situation. For Panama, the major factors appear to be the canal expansion, and the possible effects of changes to the original plan, and the maintenance of fiscal discipline.

Given that more time has passed since Colombia's last upgrade, there have been more developments there (mostly positive) especially as it relates to national security. Inflation has been a major concern for both countries. Colombia has intervened in the foreign exchange market to slow the appreciation of its currency which should help boost exports and the Canal project is on track in Panama. These conditions and developments would lead one to conclude that Colombia is the more likely candidate for an upgrade from Standard and Poor's. Any bets?

FINANCIAL & ECONOMIC INDICATORS

As at 10 July, 2008

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	107.08	106.74
Euro	1.58	1.57
Jamaica	72.28	72.02
Guyana	204.70	204.40

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	141.65	145.29
Natural Gas (US\$/mmbtu)	11.83	13.01
Gold (US\$/Troy Ounce)	947.66	934.54

Eurobond Indices (Return % YTD, as of 10-July-08)

Lehman Brothers Global Aggregate Index	4.34
JP Morgan EMBI+ (percentage change)	24.40
CMMB Eurobond Index	n/d

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	2.00	1.50
Euro Zone	4.00	4.00
Japan	0.51	0.50
Brazil	12.25	12.25
Trinidad	8.25	8.25
Jamaica	13.50	13.50
Barbados	4.50	4.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	1.64	1.82
US 10-Yr Treasury	3.80	3.98
3-month UK Libor	5.84	5.91
Japan 90-day T-Bill	0.53	0.53
Brazil 90-day T-Bill	13.08	12.88
TT 90-day T-Bill	7.17	7.17
Jamaica 90-day T-Bill	14.19	14.19
Barbados 90-day T-Bill	4.16	4.16

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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