

PANAMA'S COLON FREE ZONE

CHALLENGES AND OPPORTUNITIES OF A LOGISTICS HUB

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Panama's Colon Free Zone: Challenges and Opportunities of a Logistics Hub

Since the United States' completed the Panama Canal in 1914 linking the Atlantic and Pacific oceans, an independent Panama has been a hub for international trade. The Zona Libre de Colon (Colon Free Zone or CFZ) was established in 1948 adjacent to the Atlantic entrance to the Panama Canal. The CFZ which occupies approximately 600 acres near the Colon port facilities allows international companies to import goods and materials into the zone - add value through finishing or packaging - and re-exported without local custom duties, taxes or regulations.

According to Surse Pierpont, the President of the Colon Free Zone Users' Association, the CFZ imported \$14 billion worth of goods and sold \$15 billion in 2011, double what the zone handled only a decade ago with consistent growth projected in the coming years¹. Over 90% of sales were re-exported outside of Panama, largely to Latin America and the Caribbean.² The planned expansion of the Panama Canal and the size of the Free Zone itself in 2014 presents further opportunities and challenges for international traders considering use of the Colon Free Zone. This study will examine major areas of concern including geography and international trends and the business climate and infrastructure of Free Zone itself.

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Geography & International Trends

The Latin American and Caribbean economies have grown exponentially - although unevenly - since the push for democratization, liberalization and end to political violence in the region over the past few decades. Panama has been no exception - enjoying relative peace and prosperity since the 1989 ouster of Panamanian dictator Manuel Norriega by US forces. This prosperity is directly linked to Panama's position as a way station for trade both north-south and east-west. The high-value services sector, including logistics, shipping services, banking, and tourism, accounts for 75% of Panama's \$30 billion economy.³ Regional and international trends that impact the Colon Free Zone are largely advantageous but warrant close consideration especially considering the fallout from narco-trafficking, the rise of populist governments and systemic political and economic problems afflicting Latin America.

Shippers utilizing the Colon Free Zone prize one consideration above all others: geography. South and Central America are growing rapidly and for the first time in their history that growth is creating a new and large middle class. Depending on the estimate, the Latin American middle class comprises between 30% (150 million) and 50% (275 million) of the population.⁴ On the upper end, Latin America's consumer market rivals that of the US, China (~300 million middle class in 2012) and Western Europe in total consumers if not purchasing power. Access to this market represents a growth opportunity for many international corporations struggling to hold market share in developed markets. The strategic position of the CFZ allows for easy access to the South American and Caribbean markets via the Canal, overland via highway and rail, or by air from either Panama City or nearby France Field.

³ CIA World Factbook, 2011, Panama
<https://www.cia.gov/library/publications/the-world-factbook/geos/pm.html>

⁴ Economist, Latin America's Growing Middle,
<http://www.economist.com/news/americas/21565930-decade-social-progress-has-created-bigger-middle-class-but-not-yet-middle-class?zid=305&ah=417bd5664dc76da5d98af4f7a640fd8a>

¹ Product Directory and Catalog. Colon Free Zone - Panama. Vol.16 1998-99

² Interview with Surse Pierpont, by Eric Jackson,
http://www.thepanamanews.com/pn/v_18/issue_10/economy_01.html



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Geographically, Panama is a midpoint from transatlantic or transpacific goods heading either north to the US or south to Latin America's largest markets. Crucially, the CFZ is located directly on the Panama Canal so that imported or re-exported goods can reach markets on the Pacific or Atlantic coasts directly, without transferring cargo finished in the CFZ to another mode of transport.

The Colon Free Zone's major advantage is access to Latin America and the Caribbean. These remain emerging markets with high growth potential but continue to suffer from corruption, political instability, black market economies (especially drugs and drug-related financing), and rigid economic systems. Although liberalization and democratization of these political and economic systems has continued for the past two decades, the potential for political or economic disruption remains high. The Latin American and Caribbean region, despite the above mentioned challenges, grew by 5% in the five years from 2003-2008 according to OECD.⁵ Since that time, a number of economies including Panama have posted double digit growth despite the world financial crisis and recession. Brazil, Mexico, Chile, Colombia, Argentina and Venezuela have outstripped the global average GDP growth over the past decade, with Brazil's growth rate exceeding that of China and its total economy surpassing the United Kingdom in 2011.⁶

At the same time, the United States and Europe

“The Colon Free Zone's major advantage is access to Latin America and the Caribbean.”

have pursued efforts, directly and through international institutions, to strengthen political and economic foundations in Latin American countries. Despite the political upheavals and threats to liberalized economies, the Organization of American States (OAS), World Trade Organization (WTO), World Bank and International Monetary Fund (IMF) have

successfully mediated and moderated a number of domestic and international crises in the region. The United States, in particular, has used its historic ties to the region, foreign aid and strong domestic market to accelerate economic and political reforms. Notably, US anti-drug partnerships and trade agreements have been stipulated on greater transparency and respect for human rights.⁷

In addition to the CFZ's strategic location as a gateway to the Western Hemisphere, especially from North to South America, the CFZ enjoys growing importance as trade throughout the region is liberalized through Free Trade Agreements (FTAs) and Trade Promotion Agreements (TPAs). After the ratification of NAFTA, the United States and Latin American governments cooperated on the establishment of free trade zones across the region. The Caribbean Basin Initiative (CBI) took effect in the year 2000 including most Caribbean economies (except Cuba) and including Panama. The Central American Free Trade Agreement (CAFTA) took effect in 2009. Panama pursued a bilateral trade agreement with the United States which was ratified in 2011.⁸

Panama's Political and Economic Climate

Panama's economic growth in the last decade is a testament to the strength of the emerging Latin American markets discussed above. Domestically, Panama has also invested in improved infrastructure and enjoyed political stability and peaceful democratic transitions. Trade agreements and international pressure have improved transparency in some sectors and consecutive governments have remained consistent in their commitment to a business-friendly climate, especially on the Canal and CFZ. Despite these positive trends, challenges remain for Panama and the Colon Free Zone especially corruption, labor unrest and drug-related violence.

⁵<http://www.latameconomy.org/fileadmin/uploads/laeo/Documents/English%20miniflagshipLEO2012bis.pdf>

⁶ World Bank Data, accessed December 5, 2012; <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>

⁷ Office of US Trade Representative, Andean Trade Preference Act (ATPA), <http://www.ustr.gov/>

⁸ Office of US Trade Representative, CBI, CAFTA-DR, and Panama TPA, accessed December 5th 2012



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Free but Corrupt?

Relative to its South and Central American neighbors, Panama has consistently been ranked highly as a politically “Free” according to the international watchdog Freedom House.⁹ Heritage Foundation’s Index of Economic Freedom also ranks Panama above its regional peers at 65% for business freedoms, showing some improvement from 2008 to 2012.¹⁰ Heritage Foundation chief concern in Panama is echoed by Transparency International: corruption is pervasive. This corruption touched the Colon Free Zone, when in 2002 it came to light that a politician had bribed others to vote for an expansion of the CFZ.¹¹

The functioning democratic institutions of the National Assembly, the Presidency and judiciary are susceptible to this corruption according to international watchdogs. These scandals are counterbalanced by the relative freedom of elections in Panama and a vibrant democratic system – the presidency changed party hands peacefully three times in recent years. Furthermore, political overreach by the current president Ricardo Martinelli has been met with democratic opposition in the form of protests, and surprisingly, Martinelli and his allies amended the controversial laws to account for public opposition.¹²

Unrest and Inequality

This turbulent form of grievance resolution impacted the Colon Free Zone in late October 2012. President Martinelli and the National Assembly allowed the sale of some of the state-owned land in the CFZ to private entities with 65% of the revenues going to the national government and only 35% to the local investments. After violent protests, Martinelli repealed the law and offered to increase rents in CFZ and reinvest the

proceeds in the impoverished city of Colon adjacent to the Free Zone.¹³ The income disparities in Panama mark it as one of the least equal societies in the world, with 30% of its population below the poverty line and 17th most unequal country in the world – on par with Mexico, Chile and Brazil.¹⁴

When inequality and corruption are linked, as they were in January 2010, economic development projects are put at risk by large, disruptive protests. After wage discrepancies occurred in January 2010, Panama Canal expansion project workers went on strike. The international consortium relented and agreed to a wage bump after a week – to avoid costly delays on the billion-dollar project.¹⁵ The government’s response to such labor and civil unrest frequently starts with force, as the police crackdown on protesters, before ultimately relenting to their demands. This pattern suggests Panama’s leaders and people have little faith in one another and Panama’s relative stability is precarious.

Public safety also remains a concern in Panama, with a spike in violent and property crime observed between 2007 and 2011. Panama’s murder rate more than doubled fueled by drug-related violence. Compared to the region, Panama is still relative safe with a murder rate 20% lower than Mexico and Brazil’s and only a third as many robberies per capita as Mexico.¹⁶

Infrastructure Strength

One area where Panamanians enjoy consensus is over the importance of infrastructure for Panama’s economic well-being. Since the Canal Zone was formally ceded to the national government in 1999,

¹³ Panama Digest, October 24, 2012; <http://www.thepanamadigest.com/2012/10/martinelli-repeals-colon-land-sale/>

¹⁴ CIA World Factbook, 2012; <https://www.cia.gov/library/publications/the-world-factbook/geos/pm.html>

¹⁵ “Panama Canal expansion strike called off,” BBC News, January 22, 2010, <http://www.bbc.co.uk/news/world-latin-america-16674578>

¹⁶ United Nations, Crimes Statistics Survey, 2012, <http://www.unodc.org/unodc/en/data-and-analysis/statistics/data.html>

⁹ Freedom House, <http://www.heritage.org/index/country/panama>

¹⁰ Heritage Foundation Index of Economic Freedom 2012; <http://www.heritage.org/index/country/panama>

¹¹ Global Integrity Project, Panama 2004 Report, <http://back.globalintegrity.org/reports/2004/2004/country59d7.html?cc=pa&act=notebook>

¹² Freedom House, Panama, 201; <http://www.freedomhouse.org/report/freedom-world/2012/panama>



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Canal passage fees have represented a sizeable portion of government revenues. In 2006, a national plebiscite overwhelmingly passed authorizing the government to expand the Canal. The project will accommodate ships more than twice the size of the Panamax (ship size limitations in the current Canal) and twice the total traffic load. The Canal expansion is set to be opened late 2014 or early 2015.¹⁷

With the opening of expanded Canal, ocean freight traffic is likely to increase and costs for shipping to

“Ocean freight import rates into Panama from China, along with exports from Panama into Latin America and the Caribbean, average 30% less as compared with the United States as an origin or destination.”

fall with more goods passing through on larger vessels, faster. This is compounding the rapid growth in volume of freight in recent years. Panama's ports have grown from handling roughly 4 billion TEUs (TEU is ~1 standard container) in 2007 to handling nearly 6 million TEUs in 2010.¹⁸ Nelson Cabrera, Manager of Business Development at Lilly & Associates International, has seen the effect of Panama's prime geographic location, coupled with the amount of ships passing through the Canal, lowering the overall cost of ocean shipments to and from the region. Cabrera has witnessed “ocean freight import rates into Panama from China, along with exports from Panama into Latin America and the Caribbean, averaging 30% less as compared with the United States as an origin or destination.”

Direct rail and road traffic from the capital, Panama City, to the Colon Free Zone has been improved in the past decade with major upgrades to the rail tracks and

the opening of a new highway linking the two cities overland. The Colon Free Zone will also incorporate the Colon City airport or France Field, which is being upgraded to accommodate international flights. The total size of the duty-free zone will also expand to encompass seven square miles (1800 hectares).¹⁹

Economic Fundamentals

Panama's positive ratings as a business friendly locale have been consistently high for the past few decades, and with a strong consensus across the political spectrum that is unlikely to change. Panama is a fully dollarized economy. Although the official currency is the balboa, it has been pegged a 1:1 to the US Dollar since 1903. For US and international companies that do business in US dollars, this not only simplifies simple transactions, it mitigates risk against government induced devaluation or inflation. The stable currency gives Panama the best of both worlds: relative low inflation and high growth rates over the past decade.²⁰ Panama has also improved financial and banking transparency, and remains a financial hub for the region. Over two dozen international banks do business directly in the CFZ.²¹

¹⁷ “Panama Canal Expansion on Schedule,” Wall Street Journal, May 17, 2012; <http://online.wsj.com/article/SB10001424052702303448404577410131264191046.html>

¹⁸ World Bank, “World Economic Indicators - Container Port Traffic,” <http://data.worldbank.org/indicator/IS.SHP.GOOD.TU/countries>

¹⁹ “The Colon Free Zone Refines Its Strategy,” June 15th, 2012; <http://thebulletinpanama.com/colon-free-zone-refines-its-strategy>

²⁰ CIA World Factbook, 2012; <https://www.cia.gov/library/publications/the-world-factbook/geos/pm.html>; Panama's inflation has been slightly higher than US inflation rates, and appears to be especially vulnerable to energy price hikes

²¹ Interview with Surse Pierpont, by Eric Jackson, http://www.thepanamanews.com/pn/v_18/issue_10/economy_01.html



Labor Force Trends and Laws

Since the Colon Free Zone enables companies to add value to products without being taxed, labor costs are

“Colon Free Zone imports and exports grew by 56% between 2008 and 2011.”

a primary concern to operators in the CFZ. Labor costs are higher than the regional average with minimum wage in well over \$2.31 for most professions.²² This represents the bottom of

the scale, as many semi-skilled urban workers can expect higher than minimum wages.²³ This wage cost has to be balanced against other attendant costs, including compliance and transport costs, for offshoring to a lower wage destination. Rising wages in China have resulted in companies near-shoring production to Mexico for importation to the US market.²⁴ Panama's wages are comparable or slightly lower than Mexico's, so as the competitive advantage between China and Mexico shrinks, so it does with Panama. The trends are even more encouraging for Panama as wages have been mostly flat from 2000 to 2009, and are likely to track price inflation.²⁵ In contrast, China's manufacturing wages may triple from \$2 to over \$6 an hour in some regions from 2010 to 2015.²⁶ The stability of these costs and proximity of the Colon Free Zone to emerging markets in Latin America may outweigh any short term savings in lower labor costs elsewhere.

Labor productivity is also on the rise in Panama, according to a 2009 study by USAID. Labor productivity rose at a faster rate than the regional average, outpacing Chile.²⁷ In the urban and service sector economy, this growth trend is even more dramatic since agricultural productivity is growing at a slower rate. This growing productivity coupled with 10% GDP growth for 2011 and 2012 has led to rising wages and a shortage of labor in some sectors. President Martinelli observed in April 2012, “You can't hire a lot of workers in a lot of positions because there simply aren't the workers.”²⁸ Martinelli's concern about worker shortages has been a continually problem since Panama lacks a highly educated and skilled workforce. The US

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Department of Commerce described it as a “serious concern to both Panamanian and foreign investors. The problem with the lack of skilled Panamanian labor is compounded by the Panamanian law that mandates 90% of an employer's staff must be Panamanian. A recent study claimed that 80% of Panama's

management positions are held by non-Panamanians or Panamanians who studied outside of Panama.”²⁹ The difficulty of hiring, firing and recruiting workers earned Panama one of the worst ratings in the World Bank's “Employing Workers” index, 177 out of 183.³⁰

Labor law in Panama has traditionally been very restrictive with firing costs amounting to 44 weeks of a

²² <http://www.encuentra24.com/content/panama-en/general/view/minimum-wage-in-panama>

²³ “Investing in Panama,” Export.gov; <http://export.gov/panama/doingbusinessinpanama/investinginpanama/>

²⁴ “For Mexico, An Edge on China” Wall Street Journal, September 16th, 2012 <http://online.wsj.com/article/SB10000872396390444318104577587191288101170.html>

²⁵ International Labor Organization, 2010-2011 Report, http://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/@publ/documents/publication/wcms_145265.pdf

²⁶ Andres Oppenheimer, “China's rising wages may benefit Latin America,” Miami Herald, March 5, 2012, <http://www.mcclatchydc.com/2012/03/07/v-print/140827/commentary-chinas-rising-wages.html>

²⁷ USAID, Panama Economic Performance Assessment, January 2009

²⁸ Matthew Bristow and Eric Sabo, “Panama 10% Growth Forces Firms to Steal Workers, Martinelli Says,” Bloomberg News, April 16, 2012, <http://www.bloomberg.com/news/2012-04-14/panama-s-10-economic-growth-leaves-firms-scrumbling-for-workers.html>

²⁹ “Investing in Panama,” Export.gov; <http://export.gov/panama/doingbusinessinpanama/investinginpanama/>

³⁰ Ibid Export.gov



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worker's annual wage according to the World Bank, double the cost of nearby Nicaragua (22 weeks), but significantly lower than Honduras (95 weeks) and Colombia (59 weeks).³¹ President Martinelli sought to reform labor laws in a larger bill (Bill 30) which was met with labor strike actions and violent protests. The law was repealed and replaced with an individual bill more amenable to labor concerns. The Free Zone has its own labor code, considered less restrictive than Panama's national labor laws, but still rigid compared to the international norm. Furthermore, the complexity of the labor code has increased the informal workforce to over 40% and the use of temporary workers to circumvent the rigid laws.³²

Conclusion

Colon Free Zone imports and exports grew by 56% between 2008 and 2011, an astonishing figure amid a world-wide recession and continued lagging growth in the world's largest economy. This growth will likely be accelerated when the Panama Canal expansion is complete in 2014 and the CFZ upgrades are finalized, including an international airport. The emerging middle class in Latin America and globalized trade markets place Panama and the CFZ at a strategic crossroads. With relative political and economic stability, Panama is an appealing way station for multinational companies looking to access emerging markets at low risk.

Political and economic challenges including corruption and inequality remain causes for concern but not overriding ones, as Panama outperforms its regional peers in both stability and growth. Panama's infrastructure improvements and adherence to international norms under trade agreements position the Colon Free Zone as a dynamic center for Latin American and Caribbean trade in the coming decades.

³¹ World Bank, "World Development Indicators - Firing Cost (weeks of wages) 2012",

<http://data.worldbank.org/indicator/IC.EMP.FIRE.WK>

³² JF Hornbeck, "US Panama Free Trade Agreement," Congressional Research Service, November 8, 2012;

<http://www.fas.org/sgp/crs/row/RL32540.pdf>





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