FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Paraguay at 'BB+'; Outlook Stable

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Fitch Ratings - New York - 22 Nov 2022: Fitch Ratings has affirmed Paraguay's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB+' with a Stable Rating Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Ratings Affirmed, Stable Outlook: Paraguay's ratings reflect its track record of prudent and consistent macroeconomic policies, low government debt relative to rating peers, and robust external liquidity. Its ratings are mainly constrained by weak governance indicators, a shallow local capital market that narrows fiscal financing flexibility, and vulnerability to adverse climactic shocks reflected in high GDP volatility.

Severe Drought Affects Growth: A historic drought during the 2021-2022 agricultural harvest severely impacted soy production (a 60% loss). This led to a sharp downward revision in our 2022 growth forecast, from 4% at end-2021 to -0.3% currently. The monthly economic activity index has started to show positive figures (4% yoy as of September). Fitch expects increased hydroelectricity generation, higher water levels for transport, and expectations for a more normal harvest in 2022-2023 to drive strong recovery in the second half of the year.

Large Investments Support Rebound: Fitch forecasts growth of 5.8% in 2023, absent a renewed drought in the 2022-2023 growing season. Large investment projects, such as the Paracel pulp mill (the nation's largest ever investment at more than USD3bn), will support growth in 2023-2024. The maquila sector also continues to demonstrate rapid growth (25% annually), supporting an important diversification of the economy, especially as droughts may become more frequent and severe in the future as a result of climate change.

2023 Election Likely to Reflect Continuity: Paraguay will hold presidential elections in April 2023. Fitch broadly expects policy continuity regardless of the outcome and a relatively prudent fiscal stance to be preserved. Recent U.S. government blacklisting of key political players in the Colorado Party for alleged corruption has upended the election cycle, removing one of the main contenders. However, thus far this does not seem to have led to a general backlash against the Colorado party nor presented governability challenges.

IMF PCI to Support Reform Agenda: The outgoing government reached a staff-level agreement with the IMF in October on a two-year non-financing Policy Coordination Instrument (PCI), which could serve as an anchor for structural reforms. A procurement law was recently approved by Congress, while reforms to the civil service, pensions and the Fiscal Responsibility Law are pending. Paraguay's relatively long transition period next year (elections take place in April with new government starting in August) could open a window of opportunity for advancement. Reforms to the 'Caja Fiscal' (the pension system for public employees) are becoming more urgent, as this is a growing source of pressures on the fiscal deficit.

Fiscal Consolidation Continues: Fitch forecasts a deficit of 3.2% of GDP in 2022, slightly above the 3% target but down from 3.6% in the 12 months through October. Revenue growth has been strong (10% through October), supported by strong tax collections reflecting high inflation and further yields from a 2018 tax reform. Current spending has faced upward pressure (up 8% through October) due to hikes in salaries and a higher interest burden. Capital expenditure remains above pre-pandemic levels and could be the adjustment variable in the final months of the year to reach the fiscal deficit target.

Convergence to Fiscal Target: The government targets a 2.3% of GDP deficit in its proposed 2023 budget and intends to return to the 1.5% of GDP deficit limit set in its Fiscal Responsibility Law by 2024. Achieving this is likely to rely on cuts to capital spending, given limited appetite for further tax reforms, salary pressures, and higher borrowing costs. Fitch views returning to the fiscal rule as important for preserving fiscal credibility, which has been undermined somewhat after several years of deviation from the rule both before and after the pandemic. Fitch does not presently expect any windfall profits for the government in its forecasts from renegotiation of Annex C of the Itaipu Treaty, which determines the dam's electricity sale price scheme, in 2023.

Financing Strategy Shifts Towards Multilaterals: The government relied more heavily on multilateral borrowing to finance the 2022 deficit. The government has been proactive in reducing amortization of its 2023 bond (its first Eurobond to mature) from a USD780 million original amount to USD238 million currently, through two liability management operations in 2021 and in 2022. Fitch expects Paraguay to retain favorable market access in 2023, but it will come at a significantly higher cost given higher rates.

Local Market Issuance Stalls: High local interest rates and the availability of lower cost multilateral financing has challenged further development of the small local capital market, although progress could resume when global rates normalize. The absence of a long-term institutional investor base remains a challenge to market development. As a result, the already high share of foreign currency debt has been rising (Fitch projects 91% in 2022). Fitch expects debt to GDP to reach 31.8% in 2022, well below the 'BB' median of 54%, and stabilize thereafter as the deficit falls and growth normalizes.

Inflation Continues Downward Path: Inflation has been falling since June, reaching 8.1% as of October from a peak of 11.8% in April. The central bank was proactive in increasing interest rates well ahead of the Fed, starting its hiking cycle of 775 bps in August 2021, with the policy rate reaching 8.5% in September 2022.

Wide Current Account Deficit in 2022: Fitch forecasts the current account deficit to widen to 4% of GDP in 2022 from 0.9% in 2021, driven primarily by a large increase in imports (20% yoy through October) from higher fuel and fertilizer prices and the post-pandemic recovery in domestic demand. Exports declined by less than expected (2% yoy through October) despite the shock to soy exports, in part offset by a historic corn crop (up 57% over 2021). Fitch forecasts the current account to remain in deficit but narrow in the coming years, as soy production recovers but capital imports related to Paracel and other large infrastructure projects increase. International reserves have declined somewhat in 2022 as the central bank has intervened in FX markets to manage the effects of the drought but remain at favorable levels in terms of CXP coverage (6.3 months).

GAFILAT Evaluation Passed: Paraguay passed the Financial Action Task Force of Latin America (GAFILAT)'s evaluation of AML/CTF issues this year, avoiding the so-called 'grey list' and associated reputational risks and reflecting positively on institutional capacity despite lingering governance challenges.

ESG - Governance: Paraguay has an ESG Relevance Score (RS) of '5' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model.

Paraguay has a medium WBGI ranking at the 36th percentile, reflecting a recent track record of peaceful political transitions, a moderate level of rights for participation in the political process, weak institutional capacity, weak rule of law and a high level of corruption.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Public Finances: A trend increase in debt to GDP ratio due to failure to achieve fiscal consolidation.

Macro: Deterioration in the credibility of macroeconomic policymaking, or a shock that worsens economic prospects and external accounts - for example, due to a fall in commodity prices or adverse climate conditions.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Public Finances: Strengthening of fiscal flexibility through expansion of the revenue base and lower debt/GDP ratio and/or greater financing flexibility through development of the local capital market and/or buildup of fiscal saving buffers.

Macro: Higher economic growth (in the context of macro stability) that increases prospects for GDP per capita convergence with higher-rated sovereigns.

Structural: Sustained improvement in governance indicators - for example, as a result of the government's efforts to combat corruption and strengthen public institutions.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Paraguay a score equivalent to a rating of 'BB-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

In accordance with its rating criteria, Fitch's sovereign rating committee decided not to adopt the score indicated by the SRM as the starting point for its analysis because the SRM output has migrated to 'BB-', but in our view this is potentially a temporary deterioration. Consequently, the committee decided to adopt 'BB' as the starting point for its analysis, unchanged from the prior committee.

Fitch's sovereign rating committee adjusted the output from the adopted SRM score to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Macro: +1 notch, to reflect Paraguay's track record of prudent and consistent macroeconomic policies that include a floating FX regime, inflation targeting and a fiscal responsibility law.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Paraguay has an ESG Relevance Score of '5' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Paraguay has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Paraguay has an ESG Relevance Score of '5' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Paraguay has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Paraguay has an ESG Relevance Score of '4' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. As Paraguay has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Paraguay has an ESG Relevance Score of '4' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Paraguay, as for all sovereigns. As Paraguay has a fairly recent restructuring of public debt in 2004, this has a negative impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores,visitwww.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Paraguay	LT IDR	BB+ Rating Outlook Stable	Affirmed	BB+ Rating Outlook Stable
	ST IDR	B	Affirmed	B
	LC LT IDR	BB+ Rating Outlook Stable	Affirmed	BB+ Rating Outlook Stable
	LC ST IDR	B	Affirmed	B
	Country Ceiling	BB+	Affirmed	BB+
senior unsecured	LT	BB+	Affirmed	BB+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 11 Jul 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.13.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Paraguay	EU Endorsed, UK Endorsed

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