MOODY'S
INVESTORS SERVICE

CREDIT OPINION
22 July 2022

Update

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Contacts

Samar Maziad +1.212.553.4534
VP-Senior Analyst
samar.maziad@moodys.com

Giovanni Pagan Velez +1.212.553.4515
Associate Analyst
giovanni.paganvelez@moodys.com

Mauro Leos +1.212.553.1947
Associate Managing Director
mauro.leos@moodys.com

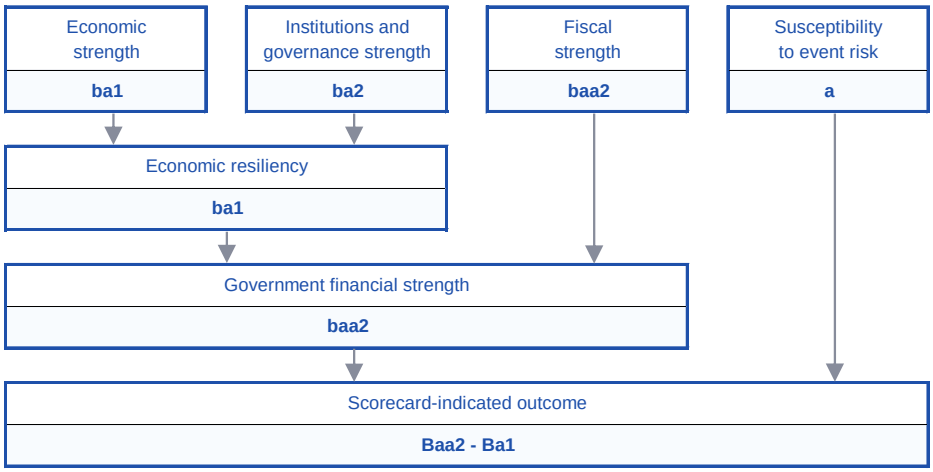
Government of Paraguay – Ba1 positive

Update following outlook change to positive from stable

Summary

The credit profile of Paraguay balances volatility in growth and relatively weak but improving institutions against a strong fiscal position and limited external vulnerability. In 2022, we expect the debt-to-GDP ratio to be 37% and interest-to-revenue to be 8%, both below the medians for regional peers and Ba-rated sovereigns. The main credit challenges include the economy's dependence on agriculture and weak governance indicators.

Exhibit 1
Paraguay's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

» Low government debt burden in absolute and relative terms

» Higher GDP growth than that of its peers and potential for economic diversification

» Track record of compliance with targets set in the Fiscal Responsibility Law

Credit challenges

» Agriculture-dependent economy subject to high growth volatility

» Lower government revenue than that of its peers

» Weak institutional strength indicators

Rating outlook

The positive outlook reflects a track record of solid growth and prudent fiscal policy demonstrated by debt metrics that compare favorably with Baa-rated sovereigns. The outlook also accounts for structural and fiscal reforms that will support institutional strength and governance.

Factors that could lead to an upgrade

The rating would be upgraded if structural reforms related to the civil service, public pension fund and public procurement were approved and implemented. These reforms would enhance the country's institutional and governance framework, improving Paraguay's overall credit profile. Changes to the fiscal rule, which would increase policy predictability in response to shocks and the materialization of robust investment and FDI inflows would also contribute to a higher rating.

Factors that could lead to a downgrade

The outlook could change back to stable if implementation of the structural reform agenda does not advance at a steady pace or if economic growth prospects come below our expectations, leading to an upward trend in debt metrics.

Key indicators

Paraguay	2016	2017	2018	2019	2020	2021	2022F	2023F
Real GDP (% change)	4.3	4.8	3.2	-0.4	-0.8	4.2	-1.0	5.0
Inflation (CPI, % change, Dec/Dec)	3.9	4.5	3.2	2.8	2.2	6.8	9.0	5.0
Gen. gov. financial balance/GDP (%)[1]	-1.1	-1.1	-1.3	-2.9	-6.1	-3.8	-3.2	-2.5
Gen. gov. primary balance/GDP (%)[1]	-0.5	-0.6	-0.6	-2.0	-5.1	-2.6	-2.0	-1.2
Gen. gov. debt/GDP (%)[1]	17.8	18.3	20.8	24.2	35.2	35.5	37.0	37.8
Gen. gov. debt/revenues (%)[1]	127.9	129.1	147.3	170.0	260.5	253.9	260.9	264.0
Gen. gov. interest payment/revenues (%)[1]	4.0	4.1	4.8	5.8	7.9	8.3	8.7	9.0
Current account balance/GDP (%)	4.8	3.5	-0.1	-0.5	2.1	-0.3	-3.5	-0.5
External debt/CA receipts (%)[2]	107.9	101.4	97.2	107.0	149.3	146.0	174.4	147.3
External vulnerability indicator (EVI) [3][4]	103.9	92.9	85.9	77.7	69.5	69.8	72.2	87.7

[1] Central Government
[2] Current Account Receipts
[3] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/Official Foreign Exchange Reserves
[4] Excludes total nonresident deposits over one year

Source: Moody's Investors Service

Detailed credit considerations

On 22 July, we affirmed Paraguay's Ba1 rating and changed the outlook to positive from stable. The key drivers were: (i) a track record of solid growth and prudent fiscal policy demonstrated by debt metrics that comparefavorably with Baa-rated sovereigns; and (ii) structural and fiscal reforms that will support institutional strength and governance.

We set Paraguay's **economic strength** score at "ba1" to reflect strong growth trends and reduced GDP growth volatility, with wealth levels only slight below that of its peers. These factors are partially offset by Paraguay's relatively small economy and reliance on agriculture.

Paraguay's nominal GDP of around $39 billion in 2021 is smaller than the $63 billion Ba median, while the GDP per capita (purchasing power parity basis) of $13,722 in 2021 was slightly below the Ba median of $16,161. Between 2010 and 2019, Paraguay's economy expanded at an average annual rate of 4% in real terms, above the average growth rate of 3.2% for the Ba median and the Baa median of 3.5%. Paraguay's economy contracted by only 0.6% in 2020, making it the Latin American economy with the least severe contraction, and recovered in 2021 with growth of over 4%. For 2022, we expect Paraguay's economy to contract by 1% in real terms

as severe drought conditions have impacted the agriculture sector and the hydropower sector, both of which accounted for 49% and 15% of total exports in 2021 respectively.

Although climate-related shocks and agriculture's significant contribution to output have historically resulted in some economic volatility, ongoing positive developments in economic diversification, particularly related to the efforts to increase the value add of agricultural exports and upgrading infrastructure through public investment, mean that volatility in economic output is diminishing. We expect a strong recovery in 2023 with real growth of 5%.

We set the score for **institutions and governance strength** at "ba2" to reflect Paraguay's weak, although improving, institutional framework. Our assessment also incorporates the Worldwide Governance Indicator scores for Paraguay (specifically, government effectiveness, rule of law and control of corruption), which are consistently at or below the 25th percentile of sovereigns that we rate and are weaker than the median for its peers with a Ba rating.

Nevertheless, Paraguay's institutional framework has improved with the passage of several laws, including the Fiscal Responsibility Law, the Law to Modernize the State's Financial Administration and the Public-Private Partnership Law. In recent years the government has also presented to Congress laws to address some of Paraguay's key institutional shortcomings. Structural reform proposals relate to the public procurement system, civil service, social security system and further enhancements to the fiscal responsibility law. In addition, the government's track record of sound fiscal management indicates a higher degree of government effectiveness than that suggested by the country's governance indicators alone.

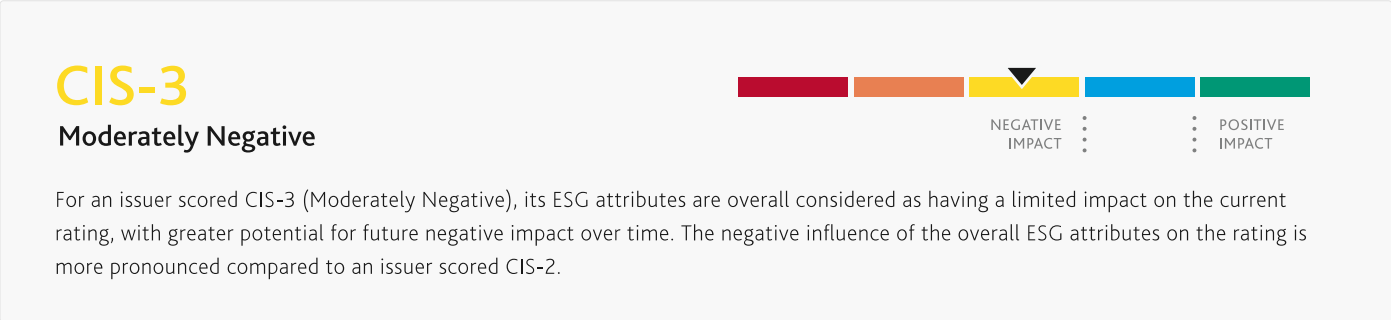
Our assessment of a "baa2" **fiscal strength** score reflects the country's favorable debt metrics compared with those of its peers in the Ba category. Debt increased to 35% of GDP in 2020 from 24% in 2019 because of an increase in borrowing to finance the response to the pandemic. Debt will increase to 37% of GDP in 2022 and stabilize at that level. Despite this increase in debt, Paraguay's debt-to-GDP ratio remains below the median of 54% for sovereigns with a Ba rating, as well as the median for sovereigns with a Baa rating of 58%. Paraguay's debt affordability, as measured by the ratio of interest payments to revenue, is very high, but has weakened over the past five years, with interest payments at around 8% of revenue in 2021, up from 1.3% in 2012, but still below the Ba median of 10% for 2021.

The **susceptibility to event risk** score is set at "a," driven by our "a" score for political risk, which reflects the fact that we do not expect political events to substantially affect the sovereign's credit metrics, lead to significant changes in economic policies or impair the government's willingness or ability to service debt. Our government liquidity risk score of "a" reflects a strong track record of narrow government deficits and low gross borrowing requirements. The banking sector risk score of "a" reflects the relatively small size of the banking sector, with banking sector assets at slightly less than 70% of GDP and Paraguayan banks' persistently high liquidity ratios, loan loss reserves and capitalization ratios. Finally, our external vulnerability risk score of "a" reflects Paraguay's low debt burden, adequate reserve buffer and flexible exchange rate. Despite the relatively high financial dollarization in Paraguay, we do not see significant vulnerability to external shocks.

ESG considerations

Paraguay's ESG Credit Impact Score is Moderately Negative CIS-3

Exhibit 3
ESG Credit Impact Score



Source: Moody's Investors Service

Paraguay's ESG Credit Impact Score is moderately negative (**CIS-3**) reflecting a relatively weak governance profile, despite broadly effective macroeconomic and fiscal policies. Social risks are moderately negative, and exposure to environmental risks is moderately negative, supported by strong resilience due to strong fiscal metrics.

Exhibit 4
ESG Issuer Profile Scores

Source: Moody's Investors Service

Environmental

We assess Paraguay's exposure to environmental risks as moderately negative (**E-3** issuer profile score) reflecting the risk of droughts and flooding on agricultural and hydroelectric generation, balanced against Paraguay's position as a producer and exporter of clean energy and limited reliance on hydrocarbon.

Social

Paraguay's exposure to social risks is moderately negative (**S-3** issuer profile score), balancing positive demographic trends with relatively weak educational outcomes that limit Paraguay's competitiveness.

Governance

The influence of governance on Paraguay's credit profile is moderately negative (**G-3** issuer profile score) reflecting the impact of relatively weak, but improving governance indicators related to corruption and rule of law. This is balanced against a track record of sound macroeconomic policies and strong fiscal metrics.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

All of these considerations are further discussed in the Detailed credit considerations section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

Recent developments

Real GDP will contract in 2022 due to prolonged drought

Since late 2018, Paraguay has experienced severe drought conditions caused by the La Niña atmospheric phenomenon. As a result, the yields of key agricultural exports such as soybeans have decreased, livestock has faced more difficult grazing conditions and record low water levels in rivers have made it harder to take goods to market and have reduced the energetic output of Paraguay's hydropower plants. The adverse climate conditions have impacted economy activity. In 2019, drought conditions caused a contraction of 0.4% while in 2021 the post-covid recovery (4.2%) was less than what it would have been otherwise. We expect that Paraguay's economy will contract in 2022 by 1% in real terms.

In the first quarter of 2022, real GDP fell by 2.1% quarter-on-quarter. The economic slowdown was caused by contractions in the agricultural sector (-12.6%), the hydropower sector (-8%), and to a lesser extent the livestock, forestry and fishing sector (-2%). Agriculture also fell by 22% in Q3 2021 and by 16% in Q4 2021, making this latest drought episode more severe than the 2018-19 period. Although GDP for the second quarter of 2022 is not available, the performance of the economic activity indicator (IMAEP) for the months of April and May indicate that the drought continues to have a negative impact.

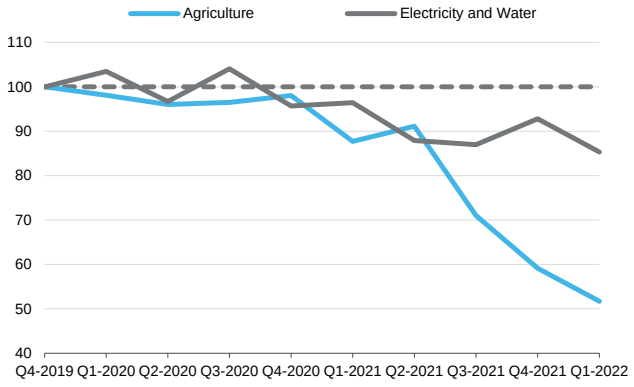
However, sectors that are not directly vulnerable to drought, such as construction, services and manufacturing have continued to expand and have supported economic activity. In Q1 2022, the construction sector expanded by 7% and the industry and mining sector by 3.5%. The dynamism of these sectors have helped sustain the economy since 2019. The construction sector has grown by 26% compared to 2019 levels, the industry and mining sector has grown by 7%, and the services and trade sector by 5%. This has helped sustain the economy even as the agricultural sector has contracted by 49% and the electricity and water sector has decreased by 15% over the period (see Exhibit 5).

As of the first quarter of 2022, Paraguay's GDP was about 1% below what it was at the end of 2019. However, GDP excluding hydropower and agriculture has grown by about 5% over the same period (see Exhibit 6). The resilience of other sectors even as agriculture is heavily impacted suggests that Paraguay will return to its previous growth trend once drought conditions fade. Moreover, investment over these last four years has remained strong – in 2021 it was 12% higher than in 2018 and contributed five percentage points to growth – suggesting that investors have not lost confidence on the growth potential. We expect a strong recovery in 2023 with real growth of 5%.

Exhibit 5

Agriculture and hydropower have been hit by severe drought conditions caused by La Niña…

Real GDP (Q4 2019 = 100)

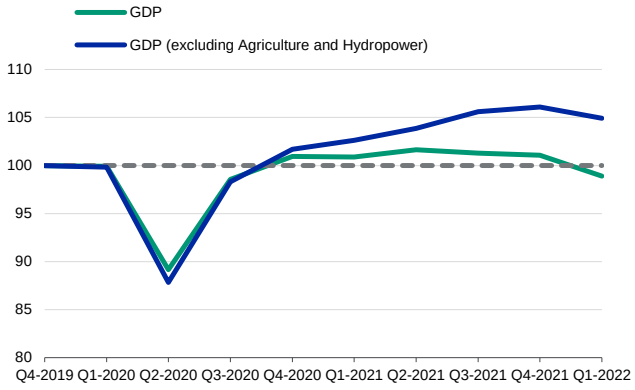


Sources: Haver Analytics and Moody's Investors Service

Exhibit 6

…while sectors that have not been exposed to drought conditions have supported economic activity

Real GDP (Q4 2019 = 100)



Sources: Haver Analytics and Moody's Investors Service

Central Bank of Paraguay increased policy rate to 7.75% in response to elevated inflation

On 21 June, the Monetary Policy Committee of the Central Bank of Paraguay voted unanimously to increase its monetary policy rate by 50 basis points, placing the policy rate at 7.75%. In its decision-making process, the central bank sought to balance elevated inflation of 11.4% annually in May 2022 with an adverse global economic environment and a domestic economy still strained by drought.

The central bank began its hiking cycle in August of 2021 with a 25 bps hike to 1% after maintaining its policy rate unchanged at 0.75% since May of 2020 – making it one of the first emerging market economies to begin its tightening cycle. Although the rate of hiking has slowed slightly since the Russian invasion of Ukraine (Caa3 negative) in March of 2022, the monetary authority has increased rates in all of its meetings since the hiking cycle began.

As a result of the pandemic-induced shock, inflation averaged 1.8% in 2020 and remained below the lower limit of the central bank's target (4% +/- 2 ppts) for most the year. In September 2021, inflation was above the upper bound of the target range for the first time since 2011 and ended the year at 6.8%. During the first half of 2022 inflation has averaged 10.4%, driven by volatile elements of the consumer basket, such as food and beverages (17% average inflation in the first half of 2022) and transportation (20%). Price increases are not limited to volatile sectors, as demonstrated by the fact that the core CPI was 8.4% in June 2022.

According to the latest central bank poll of economic participants in June 2022 inflation expectations for the end of 2022 stood at 8.2%. Despite higher inflation this year, inflation expectations over the monetary policy horizon remain anchored at 4.5% for 2023. Paraguay has had a credible inflation-targeting framework in place for over a decade, effectively maintaining stable inflation for the vast majority of this period. We forecast that inflation will be within the target range in 2023 as the combination of restrictive monetary policy and slowing global economic conditions will ease price pressures.

Paraguay $500 million global bond issuance partially used for liability management operation

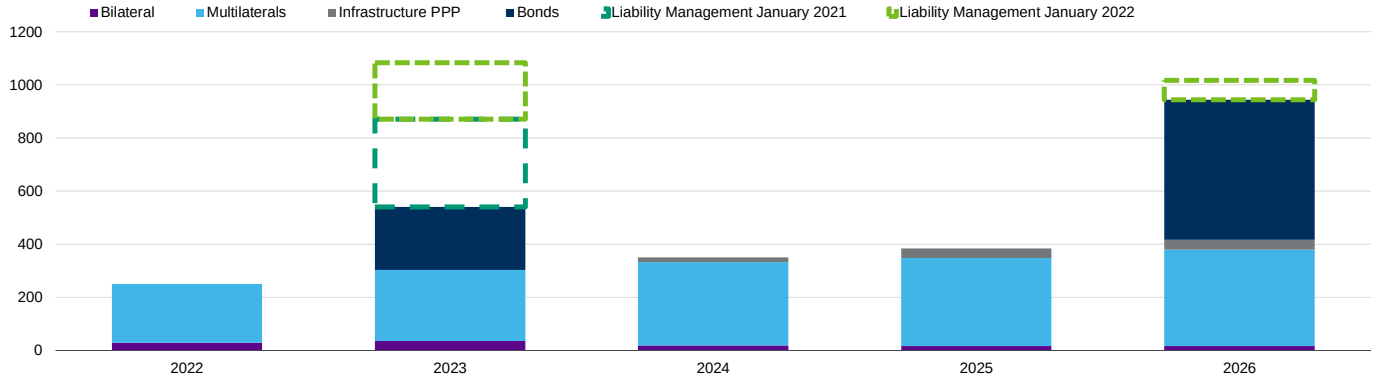
On 20 January, Paraguay issued $500.6 million in global bonds maturing in 2033 at a rate of 3.8%. From this issuance the government will use $199 million to meet part of its financing needs for the 2022 budget, while the remaining $301 million was dedicated to the second liability management operation in Paraguay's history. Of that, $221 million has been used to repurchase the upcoming 2023 sovereign bonds, reducing the principal payment to $238 million from $451 million before the operation. The remaining $79 million was used to repurchase sovereign bonds due in 2026, resulting in a reduction in principal payments to $527 million from $600 million.

Paraguay's global sovereign bond program is relatively new with its first global bond issued in 2013. As of May 2022, international bonds accounted for 42% of Paraguay's total government debt. In January 2021, following an issuance of $826 million, the Ministry of Finance conducted a similar bond repurchase of 2023 bonds reducing the principal amount by $330 million. If we combine both liability management operations, Paraguay has managed to prepay over 70% of the 2023 international bond maturities before they were due. These liability management operations have helped smooth the repayment schedule of Paraguay's external bonds and also limit external vulnerabilities (see Exhibit 7).

Exhibit 7

Liability management operations have helped smooth the repayment schedule over the coming years

External bond maturities in $ millions



Sources: Ministerio de Hacienda de Paraguay and Moody's Investors Service

Moody's rating methodology and scorecard factors: Paraguay – Ba1 positive

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial Factor Score	Final Factor Score	Weights
Factor 1: Economic strength				**ba1**	**ba1**	**50%**
Growth dynamics	Average real GDP growth (%)	2017-2026F	2.7	baa2		25%
	Volatility in real GDP growth (%)	2012-2021	3.0	ba3		10%
Scale of the economy	Nominal GDP ($ billion)	2021	39.0	ba3		30%
National income	GDP per capita (PPP, Intl$)	2021	13,722.4	ba1		35%
Adjustment to factor 1	*# notches*				0	max ±9
Factor 2: Institutions and governance strength				**ba2**	**ba2**	**50%**
Quality of institutions	Quality of legislative and executive institutions			ba		20%
	Strength of civil society and the judiciary			b		20%
Policy effectiveness	Fiscal policy effectiveness			ba		30%
	Monetary and macroeconomic policy effectiveness			baa		30%
Specified adjustment	Government default history and track record of arrears				0	max -3
Other adjustment to factor 2	*# notches*				0	max ±3
F1 x F2: Economic resiliency				**ba1**	**ba1**	
Factor 3: Fiscal strength				**ba2**	**baa2**	
Debt burden	General government debt/GDP (%)	2021	35.5	a1		25%
	General government debt/revenue (%)	2021	253.9	ba1		25%
Debt affordability	General government interest payments/revenue (%)	2021	8.3	a2		25%
	General government interest payments/GDP (%)	2021	1.2	aa2		25%
Specified adjustments	*Total of specified adjustment (# notches)*			-6	-3	max ±6
	Debt trend	2017-2022F	18.8	-1	0	
	Foreign currency debt/general government debt	2021	86.7	-6	-3	
	Other non-financial public sector debt/GDP	2021	3.9	0	0	
	Public sector assets/general government debt	2021	0.0	0	0	
Other adjustment to factor 3	*# notches*				0	max ±3
F1 x F2 x F3: Government financial strength				**baa3**	**baa2**	
Factor 4: Susceptibility to event risk				**a**	**a**	Min
Political risk				a		
	Domestic political risk and geopolitical risk			a		
Government liquidity risk				a	a	
	Ease of access to funding			a		
Specified adjustment	High refinancing risk				0	max -2
Banking sector risk				a	a	
	Risk of banking sector credit event (BSCE)	Latest available	ba2	ba1-ba2		
	Total domestic bank assets/GDP	2021	--	<80		
Adjustment to F4 BSR	*# notches*				0	max ±2
External vulnerability risk				a	a	
	External vulnerability risk			a		
Adjustment to F4 EVR	*# notches*				0	max ±2
Overall adjustment to F4	*# notches*				0	max -2
F1 x F2 x F3 x F4: Scorecard-indicated outcome				**Baa3 - Ba2**	**Baa2 - Ba1**	

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the scorecard-indicated outcome. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the scorecard-indicated outcome. For more information please see our Sovereign Ratings Methodology.

Footnotes: (1) Initial factor score: scorecard indicators combine with the automatic adjustments to produce an initial factor score for every rating factor, as detailed in Moody's Sovereign Ratings Methodology. **(2) Final factor score:** where additional analytical considerations exist, initial factor scores are augmented to produce a final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Ratings Methodology; details on country-specific considerations are provided in Moody's research. **(3) Scorecard-indicated outcome:** Factor 1: Economic Strength, and Factor 2: Institutions and Governance Strength, combine with equal weight into a construct we designate as Economic Resiliency (ER). An aggregation function then combines ER and Factor 3: Fiscal Strength, following a non-linear pattern where Fiscal Strength has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the government financial strength as given by combining the first three factors. **(4) There are 20 ranking categories for quantitative sub-factors:** aaa, aa1, aa2, aa3, a1, a2, a3, baa1, baa2, baa3, ba1, ba2, ba3, b1, b2, b3, caa1, caa2, caa3, ca and 8 ranking categories for qualitative sub-factors: aaa, aa, a, baa, ba, b, caa, ca **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's related publications

» **Outlook**: Global Macro Outlook 2022-23 (May 2022 Update): Price pressures and financial tightening slow global economic momentum, 26 May 2022

» **Sector In-Depth**: Macroeconomics – Latin America & Caribbean: Latin America will benefit widely from commodity price gains, 14 July 2022

» **Rating Methodology**: Sovereign Ratings Methodology, 25 November 2019

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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