FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Paraguay at 'BB+'; Outlook Stable

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Fitch Ratings - New York - 01 Nov 2023: Fitch Ratings has affirmed Paraguay's Long-Term (LT) Foreign Currency (FC) Issuer Default Rating (IDR) at 'BB+' with a Stable 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 broadly prudent and consistent macroeconomic policies, low government debt relative to rating peers despite an increase in recent years, 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.

New Administration Faces Policy Challenges: The administration of President Santiago Peña took office in August, signaling broad economic policy continuity under the Colorado Party, which also won majorities in both houses of congress. The administration has touted a business-friendly, green agenda aiming to increase the role of the private sector in the economy and boost formal employment, and has already made progress with some initiatives (e.g. a carbon credits law). It also plans to continue with reforms in the Policy Coordination Instrument (PCI) agreed with the IMF, including creation of a pension regulatory body and reform of the public sector pension system (Caja Fiscal), however, these have faced resistance and could be difficult to advance despite Peña's strong support in the legislature. The incoming government also faces the challenge of implementing a credible fiscal consolidation, which would be needed to stabilize debt/GDP and bolster fiscal policy credibility after deterioration over the past five years.

Growth Rebounds: Fitch expects the economy to rebound by 5.2% in 2023, driven primarily by the recovery of the agriculture and hydroelectricity sectors, after a severe drought in 2022 reduced growth to just 0.1%. Fitch forecasts growth to remain robust at 4.5% in 2024 and 2025, supported by a pipeline of large investment projects in pulp (i.e. Paracel), green hydrogen, and biofuels. These investments, coupled with gradual growth in the maquila sector, are supportive of Paraguay's economic diversification efforts, which could help mitigate vulnerability to climatic shocks that have become more frequent and severe in recent years.

Arrears Delay Fiscal Consolidation: A significant amount of arrears (USD600 million, 1.1% of GDP) were reported this year, reflecting unrecorded expenditure commitments related to health and public works that have accumulated over the past few years. The new administration intends to include the arrears in a revised 2023 budget, which foresees a deficit of 4.1% of GDP, compared to an original target of 2.3% of GDP. This revision reflects a full recognition of the arrears (1.1% of GDP) but also a weaker underlying deficit position (about 3% of GDP).

Fiscal Risks, Credibility Erosion: The 2024 budget will target a fiscal deficit of 2.6%, and the revised fiscal consolidation path envisions a deficit of 1.9% in 2025 and a return to the fiscal responsibility law (FRL) limit of 1.5% in 2026. The new government has eschewed any tax increases, aiming instead to rely primarily on greater spending efficiency, improved tax administration, and higher growth. The authorities have yet to clearly outline the measures to support fiscal consolidation, however. In addition to the impact of payment arrears, Fitch notes that the higher deficit and longer fiscal consolidation path follows several relaxations in the FRL in recent years, which have weakened Paraguay's fiscal anchor. In Fitch's view, the government's capacity to outline and implement a realistic fiscal consolidation strategy will be key to restore fiscal policy credibility and avoid downward pressure on the sovereign rating.

Public Sector Pension Pressures: Achieving these fiscal goals will also require an additional effort to offset the erosion in the public-sector pension system (Caja Fiscal). The overall balance is in deficit (0.5% of GDP in 2022) and deteriorating by 0.1% of GDP per year, which will deplete the system's reserves in about three years, after which period government transfers will be required. A law to create a high-level commission of experts was submitted in July, tasked with formulating reform proposals, which would only yield savings in the medium term. Passage of reform could face political resistance despite the government's strong support in congress.

Consolidation to Stabilize Debt: Fitch forecasts government debt to rise to 35.5% of GDP in 2024, from 33.8% in 2022. Achievement of fiscal consolidation targets should stabilize debt/GDP around this level, absent any unexpected shocks to growth or the exchange rate. Debt remains lower than the 'BB' median of 52.8% but has risen sharply since Paraguay's upgrade in 2018 (17.8%). The interest burden is expected to increase to

1.6% of GDP in 2023 from 1.1% in 2021, and from 6.4% of revenues to 9.6%, thus exceeding the 'BB' median (9.2%) for the first time.

Efforts to Deepen Domestic Debt Market: The government is trying to deepen the local currency securities market, which is shallow and a key constraint on financing flexibility and creditworthiness. In June, a non-resident investor became the first to purchase local-currency bonds. The government intends to increase the amount of local market issuance to finance the 2024 budget, targeting up to USD350 million equivalent (versus an average of about 140 million in recent years), of which about 30% of demand is expected from non-resident participants. Greater local borrowing could gradually reduce the foreign currency share of debt, although this is set to remain among the highest in the 'BB' category (91% in 2022 versus a BB median of 52%).

Pension Oversight: As part of reform efforts agreed under the PCI, a draft law to establish a pension superintendency has been submitted to congress, with approval targeted in 1H24. The reform seeks to set up a regulatory body for the currently unsupervised pension system. The new body would also have the authority to change regulations that currently prevent pensions from investing in local government securities, a significant constraint on Paraguay's local capital market development. Chances of approval are bolstered by the new administration's political capital early in the term, although it has already faced some opposition.

Current Account Recovers: Fitch forecasts the current account to move into surplus (0.6% of GDP) in 2023 from a large deficit (6.7%) in 2022, due to the improvement in agricultural exports after last year's severe drought. Fitch forecasts the current account to return to a slight deficit in the coming years as imports increase to support the pipeline of capital-intensive investment projects. International reserves are forecast to remain above six months of coverage of current external payments (CXP), well above the 'BB' median of 4.4.

Inflation Anchored: Inflation has fallen sharply this year (3.5% as of September), driven primarily by lower fuel and food prices. Fitch forecasts average inflation of 4.8% in 2023, down from 9.8% in 2022. The central bank gradually cut policy rates, from a peak of 8.5% to 7.75% in October. Inflation expectations are well anchored (4% at 12 and 24-month horizons), reflecting the central bank's prudent management and well-entrenched credibility.

Country Ceiling Upgrade: Fitch has upgraded Paraguay's Country Ceiling to 'BBB-' from 'BB+'. Paraguay's +1 notch uplift from the IDR reflects our view that risks of FX controls are mitigated by robust external liquidity, a floating exchange rate, sound macroeconomic policies and institutions, and efforts to diversify the economy and attract FDI. The upgrade places Paraguay more in line with similarly rated 'BB' peers in the region.

ESG - Governance: Paraguay's scores for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption 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: Failure to implement a credible fiscal consolidation plan sufficient to stabilize debt to GDP.

Macro: Deterioration in the credibility of macroeconomic policymaking, which could lead to the removal of one +1 notch on Macro.

Macro: Materialization of a shock, such as an adverse weather event, that negatively impacts growth, fiscal and external metrics.

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 development of the local capital market and/or buildup of fiscal saving buffers that improve financial flexibility.

Macro: Higher economic growth (in the context of macro stability) that increases prospects for GDP per capita convergence with higher-rated sovereigns, and/or evidence of economic diversification that reduces Paraguay's exposure to extreme weather events.

Structural: Sustained improvement in governance indicators, via 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 LT FC IDR scale.

Fitch's sovereign rating committee adjusted the output by +2 notches from the SRM score to arrive at the final LT FC IDR of 'BB+' by applying its QO, relative to SRM data and output, as follows:

- Macro: +2 notches. One notch to reflect Paraguay's track record of prudent and consistent macroeconomic policies that include a floating FX regime and inflation targeting. Fitch has added an additional +1 notch which it views as temporary to offset the deterioration in the SRM output driven by volatility from shocks, including on GDP growth and inflation.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred 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.

COUNTRY CEILING

The Country Ceiling for Paraguay is 'BBB-', 1 notch above the LT FC IDR. This reflects strong constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of +1 notch above the IDR. Fitch's rating committee did not apply a qualitative adjustment to the model result.

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.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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	BBB-	Upgrade	BB+
senior unsecured	LT	BB+	Affirmed	BB+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Sovereign Rating Criteria (pub. 06 Apr 2023) (including rating assumption sensitivity)

Country Ceiling Criteria (pub. 24 Jul 2023)

APPLICABLE MODELS

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

Country Ceiling Model, v2.0.0 (1)

Debt Dynamics Model, v1.3.2 (1)

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

Sovereign Rating Model, v3.14.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Paraguay	EU Endorsed, UK Endorsed

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European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. Sector-specific best- and worst-case scenario credit ratings are listed in more detail at https://www.fitchratings.com/site/re/10238496

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