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Ratings

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Research Update:

# Paraguay 'BB/B' Ratings Affirmed; Outlook Remains Stable

**May 18, 2022**

## Overview

- Policies that sustain macroeconomic stability should support Paraguay's GDP growth prospects, despite the temporary shock this year.
- The intense drought will take a toll on the economy, weaken the current account balance, and delay fiscal correction, but damage to Paraguay's economic fundamentals should be limited.
- We affirmed our 'BB/B' long- and short-term sovereign credit ratings on Paraguay.
- The outlook is stable, reflecting strong medium-term growth prospects, fiscal prudence, weak but slowly maturing institutions, low per capita income, and high vulnerability to droughts and volatile commodity prices.


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## Rating Action

On May 18, 2022, S&P Global Ratings affirmed its 'BB/B' long- and short-term foreign and local currency sovereign credit ratings on Paraguay. The outlook remains stable. Our transfer and convertibility assessment remains 'BB+'.

## Outlook

The stable outlook indicates our view that economic growth prospects for the coming years should remain strong, despite damage caused by the recent drought. Both fiscal and external balances will suffer from the weather shock this year, but the government's commitment to fiscal consolidation should limit the impact and prevent a deterioration of Paraguay's external profile and its government debt burden.

### Downside scenario

We could lower the rating over the next six to 18 months if worse-than-expected economic performance or an unexpectedly poor policy response undermines Paraguay's long-term GDP growth trajectory and significantly worsens its fiscal and external profiles. Large and persistent fiscal deficits financed by external debt could increase the country's narrow net external debt and raise its vulnerability to external shocks, leading to a downgrade.

### Upside scenario

We could raise the rating over the next 12-18 months if stronger resilience to external or climate shocks translates into faster-than-expected economic growth. Stronger growth could help the government to achieve its ambitious fiscal correction path while tackling its long-standing infrastructure needs. At the same time, a consistent reduction in the level of dollarization of the financial system could improve monetary flexibility, leading to an upgrade.

## Rationale

Our ratings are based on Paraguay's limited fiscal and external imbalances and a still-low, though vulnerable, debt burden. The ratings also incorporate weaknesses such as low GDP per capita and weak institutions. That said, predictability of economic policy has been better in recent years, as seen in a track record of macroeconomic stability despite repeated external shocks (falling commodity prices, pandemic, and drought) and political tensions between the executive and legislative branches of government.

### Institutional and economic profile: Political stability and continuity in economic policies over the next three years should contribute to a fast economic recovery after recent shocks

- We expect a severe drought will set back economic recovery, with GDP contracting 1% this year.
- Favorable commodity prices should contribute to stronger growth in the next couple of years, boosting GDP per capita to around $6,500 by 2025.
- We expect Paraguay to maintain macroeconomic stability during and after national elections in 2023.

Paraguay's economic performance is vulnerable to weather-related risks and commodity prices, despite progress in diversifying the economy over the last decade. A significant hit to the agriculture and energy sectors will set back the rapid recovery of 2021. We expect a contraction of 1%, down from 4.2% GDP growth in 2021. The drought that lingered through the critical soy season in the last quarter of 2021 caused significant damage to crops. Paraguay is one of the largest soybean exporters in the world (soybeans and subproducts make up 10% of GDP and 30% of exports). The drought has also affected the electricity and water sectors, which account for nearly 8% of GDP.

GDP is likely to expand 5% in 2023 thanks to rebounding agricultural output and continued high prices. Moreover, public and private investment projects should enhance Paraguay's economic prospects. We expect growth to average 4% and GDP per capita to reach $6,500 by 2025. Per capita income and living standards have improved significantly over the past decade or so, partly owing to a commodity boom. However, periodic external shocks have resulted in currency depreciation, dampening the per capita income metric measured in U.S. dollars.

Paraguay's government has been dominated by the Colorado Party, which has held the presidency since 2013 (and during 1954-2008). We expect broad continuity in fiscal, monetary, and other economic policies following the national elections in 2023. The country's governing institutions have slowly matured in recent years, with greater predictability and continuity in economic policies across changes in administration. Moderate economic management has supported sustained growth, low government debt, and a strong external profile.

Moreover, legislation passed over the last decade, such as the Fiscal Responsibility Law, has helped institutionalize those practices. Sovereign debt management has also improved since the issuance of Paraguay's first international bond in 2013. However, Paraguay ranks poorly in terms of economic and human development. Almost 27% of the population lives in poverty, and over 70% of workers are in the informal sector. The country's physical infrastructure is weak, and the level of perceived corruption is high.

## Flexibility and performance profile: Moderate fiscal deficits will be mostly funded by external lending, slightly deteriorating Paraguay's external profile

- Economic recovery and the withdrawal of pandemic support measures cut the fiscal deficit in 2021, but we expect fiscal consolidation to be gradual in the coming years.
- The economic downturn caused by drought will weigh on 2022 fiscal and external balances.
- Monetary policy and the flexible exchange rate should help absorb negative shocks.

We expect the general government deficit to gradually decline and average 2.6% of GDP in 2022-2025, from 3.5% in 2021. The strong economic recovery in 2021 helped the government to lower the fiscal deficit even more than targeted last year. However, the economic downturn will limit space for further consolidation this year.

The drop in production of the binational hydroelectrical companies that operate two massive dams is hurting royalties that they pay to the government. Nontax revenues--which generally average 15% of central government revenues--fell 12% through April. Additionally, following a strong performance during the first quarter of 2022, tax revenues will likely decelerate in the coming months due to the economic downturn. Extraordinary relief measures introduced during the pandemic have been almost fully retired. As a result, it could be difficult for the government to make further cuts in spending. Over the last five years, Paraguay has been increasing its public works to tackle long-standing infrastructure needs.

Any increases in government revenues are likely to come from efficiency gains and broadening of the tax base rather than tax increases in the coming couple of years. However, the government could gain revenue from the renegotiation of the Itaipu dam treaty with Brazil in 2023. The negotiations could result in lower power tariffs, which could improve the financial health of government-owned electricity company ANDE (Administracion Nacional de Electricidad). As a result, we expect the change in net general government debt to average about 3.4% of GDP in 2022-2025, narrowing from the average 7.3% temporary increase in 2020-2021 (this assumes no meaningful increase in royalties).

Net general government debt could rise to 26% of GDP in 2022 and stabilize below 30%. We do not incorporate central bank debt in our calculation of general government debt. The government's growing issuance of foreign currency debt has increased its exposure to exchange-rate movements, as about 87% of the public sector's debt stock is denominated in foreign currency. The currency exposure is only partially mitigated by dollar-denominated royalty inflows from the two large hydroelectric dams. Furthermore, a significant share of external debt is held by nonresidents, adding further risk to potential sudden changes in investor confidence and capital outflows.

The combination of external debt issuance and lost soybean exports is likely to worsen Paraguay's external metrics. We expect narrow net external debt to rise to about 40% of current account receipts (CAR) in 2022, from 22% in 2020-2021. However, gross external liquidity ratios have remained strong and stable, with gross external financing needs estimated at 77% of CAR and usable reserves, given that much of external debt has long maturities or is owed to official creditors. Paraguay has boosted international reserves through debt issuances. Such external assets now reach about $9.9 billion, about 25% of GDP.

The current account deficit will likely grow to 3.9% of GDP, from less than 1% in 2021, given the collapse in soy exports and import price increases. Paraguay is a net importer of oil, with imports representing 3.5% of GDP. Moreover, higher logistical costs and fertilizer prices will boost imports. That said, we expect a strong rebound in exports as weather conditions improve and prices are expected to remain high during 2023.

Monetary policy reforms and Paraguay's flexible exchange rate have helped to absorb negative external shocks and gradually boost the country's economic resilience. The central bank occasionally intervenes in the foreign exchange market to dampen volatility without targeting the exchange rate. Since the adoption of the inflation-targeting regime in 2011, Paraguay has kept inflation in line with the central bank target and has slowly strengthened its supervision of the financial system. However, food and oil price increases have affected inflation recently, which has remained above the bank's target of 4% plus/minus 2%. The central bank has raised interest rates 600 basis points since August 2021. We expect inflation to decelerate toward the end of the year and average 6% for 2022 before declining to the target of 4% by 2024.

## Key Statistics

Table 1

### Paraguay--Selected Indicators

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022f | 2023f | 2024f | 2025f |
|---|---|---|---|---|---|---|---|---|---|---|
| **Economic indicators (%)** | | | | | | | | | | |
| Nominal GDP (bil. LC) | 204,647.27 | 219,122.28 | 230,576.48 | 236,681.50 | 239,914.73 | 264,103.00 | 277,149.69 | 308,467.61 | 333,638.56 | 360,863.47 |
| Nominal GDP (bil. $) | 36.09 | 39.00 | 40.23 | 37.93 | 35.43 | 38.99 | 40.08 | 44.15 | 47.24 | 50.47 |
| GDP per capita ($000s) | 5.3 | 5.6 | 5.7 | 5.3 | 4.9 | 5.3 | 5.4 | 5.8 | 6.2 | 6.5 |
| Real GDP growth | 4.3 | 4.8 | 3.2 | (0.4) | (0.8) | 4.2 | (1.0) | 5.0 | 4.0 | 4.0 |
| Real GDP per capita growth | 2.8 | 3.3 | 1.8 | (1.8) | (2.2) | 2.8 | (2.3) | 3.6 | 2.6 | 2.6 |
| Real investment growth | (5.6) | 11.1 | 14.8 | (6.7) | (4.7) | 26.2 | (1.5) | 5.0 | 4.5 | 4.5 |
| Investment/GDP | 20.5 | 22.0 | 25.6 | 24.7 | 20.2 | 21.8 | 22.3 | 22.3 | 22.4 | 22.5 |
| Savings/GDP | 25.3 | 25.5 | 25.5 | 24.2 | 22.3 | 21.2 | 18.4 | 22.5 | 22.5 | 22.5 |
| Exports/GDP | 37.2 | 38.4 | 36.9 | 36.2 | 33.6 | 36.5 | 33.2 | 37.3 | 37.9 | 38.0 |
| Real exports growth | 9.2 | 8.5 | (0.4) | (3.4) | (9.0) | 2.2 | (9.9) | 18.0 | 5.9 | 4.2 |
| Unemployment rate | 6.0 | 5.2 | 5.6 | 5.7 | 7.2 | 6.8 | 6.7 | 6.4 | 6.1 | 5.7 |

Table 1

## Paraguay--Selected Indicators (cont.)

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022f | 2023f | 2024f | 2025f |
|---|---|---|---|---|---|---|---|---|---|---|
| **External indicators (%)** | | | | | | | | | | |
| Current account balance/GDP | 4.7 | 3.5 | (0.1) | (0.5) | 2.1 | (0.6) | (3.9) | 0.2 | 0.1 | (0.0) |
| Current account balance/CARs | 11.9 | 8.4 | (0.3) | (1.3) | 5.6 | (1.5) | (10.7) | 0.4 | 0.2 | (0.1) |
| CARs/GDP | 40.0 | 41.4 | 40.5 | 40.1 | 36.8 | 39.7 | 36.6 | 40.8 | 41.4 | 41.3 |
| Trade balance/GDP | 5.9 | 4.3 | 1.4 | 0.5 | 3.5 | 1.4 | (2.5) | 1.5 | 1.3 | 1.2 |
| Net FDI/GDP | 2.3 | 2.4 | 0.3 | 0.9 | 0.2 | (0.2) | 0.3 | 0.3 | 0.3 | 0.3 |
| Net portfolio equity inflow/GDP | (0.2) | 0.0 | (0.0) | (0.2) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Gross external financing needs/CARs plus usable reserves | 74.7 | 73.2 | 76.7 | 76.9 | 69.7 | 71.3 | 77.5 | 75.8 | 76.0 | 76.6 |
| Narrow net external debt/CARs | (0.9) | (2.3) | 5.5 | 12.2 | 17.9 | 26.3 | 39.8 | 37.5 | 38.8 | 39.5 |
| Narrow net external debt/CAPs | (1.1) | (2.5) | 5.5 | 12.0 | 18.9 | 25.9 | 35.9 | 37.7 | 38.9 | 39.4 |
| Net external liabilities/CARs | 78.4 | 65.8 | 68.6 | 73.3 | 78.8 | 71.3 | 87.7 | 76.0 | 73.8 | 71.2 |
| Net external liabilities/CAPs | 88.9 | 71.8 | 68.4 | 72.4 | 83.5 | 70.2 | 79.2 | 76.3 | 74.0 | 71.1 |
| Short-term external debt by remaining maturity/CARs | 12.4 | 9.0 | 9.1 | 10.3 | 10.9 | 9.8 | 11.0 | 11.3 | 10.1 | 10.4 |
| Usable reserves/CAPs (months) | 4.7 | 4.9 | 5.1 | 5.3 | 6.5 | 6.6 | 6.2 | 5.6 | 5.4 | 5.3 |
| Usable reserves (mil. $) | 6,022 | 6,961 | 6,869 | 6,649 | 8,671 | 8,371 | 8,337 | 8,724 | 9,226 | 9,926 |
| **Fiscal indicators (general government; %)** | | | | | | | | | | |
| Balance/GDP | (0.4) | (0.4) | (1.0) | (2.4) | (5.7) | (3.5) | (3.4) | (2.8) | (2.3) | (1.9) |
| Change in net debt/GDP | 1.0 | 0.9 | 2.4 | 3.6 | 8.1 | 3.4 | 3.8 | 3.1 | 2.7 | 2.3 |
| Primary balance/GDP | 0.2 | 0.1 | (0.3) | (1.6) | (4.7) | (2.4) | (2.3) | (1.7) | (1.2) | (0.8) |
| Revenue/GDP | 17.9 | 17.6 | 17.5 | 17.7 | 16.9 | 17.3 | 17.1 | 17.3 | 17.5 | 17.7 |
| Expenditures/GDP | 18.2 | 18.1 | 18.5 | 20.1 | 22.6 | 20.8 | 20.5 | 20.0 | 19.8 | 19.6 |
| Interest/revenues | 3.1 | 3.3 | 3.8 | 4.7 | 6.3 | 6.5 | 6.7 | 6.2 | 6.2 | 6.1 |
| Debt/GDP | 13.6 | 14.1 | 16.2 | 19.2 | 29.3 | 30.1 | 32.5 | 32.3 | 32.5 | 32.4 |
| Debt/revenues | 76.0 | 80.1 | 92.4 | 108.4 | 173.3 | 174.1 | 190.3 | 187.2 | 185.6 | 182.8 |

Table 1

## Paraguay--Selected Indicators (cont.)

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022f | 2023f | 2024f | 2025f |
|---|---|---|---|---|---|---|---|---|---|---|
| Net debt/GDP | 5.2 | 5.8 | 7.9 | 11.3 | 19.2 | 20.9 | 23.6 | 24.4 | 25.2 | 25.6 |
| Liquid assets/GDP | 8.4 | 8.3 | 8.3 | 7.9 | 10.1 | 9.3 | 8.8 | 7.9 | 7.3 | 6.8 |
| **Monetary indicators (%)** | | | | | | | | | | |
| CPI growth | 4.1 | 3.6 | 4.0 | 2.8 | 1.8 | 4.8 | 6.0 | 6.0 | 4.0 | 4.0 |
| GDP deflator growth | 4.1 | 2.2 | 2.0 | 3.1 | 2.2 | 5.6 | 6.0 | 6.0 | 4.0 | 4.0 |
| Exchange rate, year-end (LC/$) | 5,766.90 | 5,590.48 | 5,960.54 | 6,453.14 | 6,916.81 | 6,879.11 | 6,950.00 | 7,025.00 | 7,100.00 | 7,200.00 |
| Banks' claims on resident non-gov't sector growth | 3.5 | 4.9 | 14.1 | 9.8 | 8.7 | 10.9 | 9.7 | 12.2 | 9.1 | 9.0 |
| Banks' claims on resident non-gov't sector/GDP | 41.5 | 40.7 | 44.1 | 47.1 | 50.5 | 50.9 | 53.2 | 53.7 | 54.1 | 54.6 |
| Foreign currency share of claims by banks on residents | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Foreign currency share of residents' bank deposits | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Real effective exchange rate growth | (3.5) | (0.8) | 3.2 | (3.0) | (1.2) | (1.0) | N/A | N/A | N/A | N/A |

Definitions: Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid claims on nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. f--Forecast. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

# Ratings Score Snapshot

Table 2

## Paraguay--Ratings Score Snapshot

| Key rating factors | Score | Explanations |
|---|---|---|
| Institutional assessment | 4 | Long-standing commitment to macroeconomic stability and fiscal prudence have been key to promoting balanced growth. We perceive a higher level of policy predictability. Checks and balances have been gradually improving. Political tensions are less likely than before to constrain overall policy implementation and effectiveness. |
| Economic assessment | 5 | Based on GDP per capita ($) as per Selected Indicators in table 1. |
| External assessment | 2 | Based on narrow net external debt and gross external financing needs/(CAR plus usable reserves) as per Selected Indicators in table 1. |

Table 2

## Paraguay--Ratings Score Snapshot (cont.)

| Key rating factors | Score | Explanations |
|---|---|---|
| Fiscal assessment: flexibility and performance | 3 | Based on the change in net general government debt (% of GDP) as per Selected Indicators in table 1. |
| Fiscal assessment: debt burden | 3 | Based on net general government debt (% of GDP) and general government interest expenditures (% of general government revenues) as per Selected Indicators in table 1. |
| | | Over 50% of gross government debt is denominated in foreign currency. |
| | | Nonresidents are estimated to hold over 60% of government commercial debt. |
| Monetary assessment | 5 | The guaraní is crawl-peg arrangement, and the central bank intervenes only occasionally in foreign exchange markets. |
| | | The central bank has some operational independence and uses market-based instruments to conduct its policy. The track record of inflation targeting monetary policy is still short. CPI is as per Selected Indicators in table 1. The central bank has the ability to act as lender of last resort for the financial system. Depository corporation claims on residents in local currency and nonsovereign local currency bond market capitalization combined amount to about 50% of GDP. |
| | | Resident deposits in foreign currency have fluctuated around 50% of the total. |
| Indicative rating | bb | |
| Notches of supplemental adjustments and flexibility | 0 | |
| Final rating | | |
| Foreign currency | BB | |
| Notches of uplift | 0 | Default risks do not apply differently to foreign- and local-currency debt. |
| Local currency | BB | |

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

## Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

## Ratings List

| **Ratings Affirmed** | |
|---|---|
| **Paraguay** | |
| Sovereign Credit Rating | BB/Stable/B |
| Transfer & Convertibility Assessment | |
| Local Currency | BB+ |
| Senior Unsecured | BB |