FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Paraguay at 'BB+'; Outlook Stable

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Fitch Ratings - New York - 30 Nov 2021: Fitch Ratings has affirmed Paraguay's Long-Term Foreign Currency 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

Paraguay's ratings reflect its track record of prudent and consistent macroeconomic policies anchored by a floating currency, an inflation-targeting regime and a fiscal responsibility law (FRL). The ratings also reflect a general government debt level that is still relatively low despite a steep rise in 2020 and a projected upward trend, along with robust external liquidity relative to 'BB' peers. Its ratings are mainly constrained by weak governance indicators and a shallow local capital market that narrows fiscal financing flexibility.

Paraguay had the shallowest contraction among Fitch-rated Latin American sovereigns in 2020 (0.8%) despite the pandemic, although in part due to base effects from a drought-induced recession in 2019. Fitch forecasts a strong recovery of 4.5% in 2021, led by services, construction and manufacturing. Vaccination has picked up pace in recent months despite a slow start earlier in the year. A historic drought has affected agriculture and the waterways that are the main transit routes for exports as well as hydroelectricity exports, but rain in key regions during the soy planting season has improved prospects for the 2021-2022 harvest.

Fitch forecasts 4% growth in 2022. Announcement of a large project in the pulp sector, expected to be the largest investment in Paraguay's history, should support favorable growth in the coming years.

Fiscal consolidation is on track this year following a suspension of the FRL in 2020 to facilitate pandemic response measures and use of the escape clause in 2019 due to drought. The government expects a 4% of GDP central government deficit in 2021, down from 6.1% of GDP in 2020, but could be even lower given the positive trend so far in the year (3.6% of GDP in the 12-months through October). Tax revenue rose 19.2% in 10M21 compared with 10M20, and now exceeds pre-pandemic levels, helping to offset lower fiscal revenue due to the historic drought that has reduced hydroelectricity exports. Additional social transfers introduced last year are being wound down this year. Public investment is being reduced gradually from high levels to avoid damaging the recovery.

The government aims to gradually return to compliance with the FRL central government deficit limit of 1.5% of GDP by 2024. The authorities project a 3% of GDP deficit in 2022 and 2.3% of GDP in 2023, broadly in line with Fitch's forecasts. The 2022 budget does not propose new structural revenue-enhancing measures to underpin consolidation, although the 2019 tax reforms are expected to gradually generate 0.7% of GDP in revenue, with potential upside. Fitch expects that meeting fiscal targets in 2023 and 2024 could be harder to achieve, and could rely on the authorities' willingness to use capex as the adjustment variable.

Paraguay's intention to renegotiate some parts of the Itaipu Dam Treaty with Brazil could pose some upside to hydroelectricity export revenue and fiscal revenues in the medium term, but the potential magnitude is uncertain and subject to talks that could take some time. By default, the prices at which Itaipu sells electricity to each of its member countries will fall when debt is paid off in 2023. If current prices are maintained, Paraguay could receive up to USD1 billion per year in additional fiscal revenues.

The government has made efforts to develop the local capital market by issuing domestic guarani-denominated debt more frequently and at longer tenors, although it remains shallow, limiting financing options for the government, and the foreign currency share of debt has been increasing. The government is exploring ways to further develop the local market, including by attracting non-resident investors to the local market, but this could be difficult. The local investor base is small. Public sector pension funds are forbidden from investing in government domestic debt. A reform intended to create a pension regulator failed in 2020 that could have changed the prohibition.

General government debt to GDP is one of the lowest in the 'BB' category at 30% of GDP in 2020 compared with the current 'BB' median of 59%, although has risen sharply from 20% of GDP in 2019 and remains on a gradual upward trend. Nearly 90% of Paraguay's debt is in foreign currency, exposing it to FX rate volatility.

Reform momentum is weak, reflecting the challenges the Abdo administration faces in securing political support and the upcoming electoral cycle, with internal elections in the ruling Colorado Party due in 2022 and presidential elections in 2023. Changes to the FRL proposed earlier this year are stuck in Congress and are unlikely to proceed before the 2023 elections, along with reforms to public procurement and the civil service. Pension reform is also on the agenda but will likely be pushed to the next administration as well. The pension system could put pressure on public finances in the medium term without changes to the parameters. The public pension system retains a surplus given favorable demographics, but this is diminishing, and the teacher and military pension regimes are already in deficit.

Structural features are weak compared to peers, particularly governance indicators despite gradual improvement in recent years. High levels of corruption combined with an ineffective judicial system means many crimes result in impunity. An ongoing AML/CTF review by GAFILAT highlights international concerns in this area.

Inflation has risen above the target range, driven by food and energy prices, reaching 7.6% yoy in October. The central bank has responded with cumulative YTD hikes of 325 bps in the policy rate, and signalled an additional hike of 125 bps in December.

Paraguay remains in a favorable external position, with significant international reserves and a current account surplus. Fitch estimates the current account surplus to reach 1.8% of GDP in 2021, down slightly from 2.3% in 2020 due to a record soy harvest. Reserves were up to USD9.9 billion in November 2021, or 9.4 months of current external payments (CXP) compared to a 'BB' median of 5.6 months in 2020. Net external debt at 8.9% in 2020 remains low relative to the 'BB' median (14.9%).

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 39th 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: Strengthening of fiscal financing flexibility through development of the local capital market; fiscal consolidation that ensures preservation of low debt/GDP levels.

-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.

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

-Public Finances: A perceived deterioration in fiscal policymaking, such as a failure to achieve consolidation that stabilizes debt/GDP at low levels.

- 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.

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

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

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

-Macroeconomic: +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. 26 Apr 2021) (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, v3.12.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Sovereigns Latin America Paraguay
