FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Paraguay at 'BB+'; Outlook Stable

Tue 22 Oct, 2024 - 14:15 ET

Fitch Ratings - New York - 22 Oct 2024: 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 appears at the end of this rating action commentary.

KEY RATING DRIVERS

Ratings Affirmed, Stable Outlook: Paraguay's ratings reflect its history of generally prudent and consistent macroeconomic policies, low government debt compared to similarly rated peers despite an increase in recent years, and robust external liquidity. Its ratings are constrained by weak governance indicators, a low revenue base, a shallow local capital market that narrows fiscal financing flexibility, and vulnerability to adverse climactic shocks.

Resilient Growth: We anticipate growth will remain robust, reaching 4.5% in 2024, slightly down from 4.7% in 2023. While growth in 2023 was driven by a post-drought rebound in agriculture and electricity production, in 2024 it has been driven by the manufacturing and services sectors. Fitch forecasts growth to remain robust at 4.5% in 2025 and 2026. Growth prospects will benefit significantly from the Paracel pulp mill project, the country's largest private sector investment to date totaling USD 4 billion (8.7% of GDP), and the ATOME fertilizer project, valued at approximately USD 2 billion (4.4% of GDP), assuming they move forward over the coming years.

Vulnerability to Climate Shocks: Large investments support Paraguay's economic diversification, which could help mitigate climate vulnerability. The "maquila" manufacturing activity tied to Brazil has grown significantly by an average of 10% over the past five years. Manufactured industrial goods represent about 14% of total exports, but Paraguay's economy remains vulnerable to climatic shocks, such as the droughts in 2019 and 2022. The water levels in the Paraguay River are at record low levels, increasing logistics costs for exporters and posing risks of transport bottlenecks. These risks are exacerbated by the potential increase in frequency and severity of extreme weather events due to climate change.

Improving Fiscal Position: We forecast the central government deficit to narrow to 2.6% of GDP in 2024, aligning with the authorities' relaxed target due to discovered arrears. The fiscal balance will improve this year with rising revenue and settlement of pandemic-related arrears (estimated at 1.1% of GDP). Tax collections increased 21% in the nine months through September 2024 yoy due to administrative efficiency gains from a merger of tax collection entities and a stronger Argentine peso that has prompted a shift of consumption back into Paraguay. The authorities aim for a 1.9% deficit in the 2025 budget and a return to the fiscal responsibility law limit of 1.5% by 2026. Fiscal consolidation will focus on spending efficiency and improved tax administration as the new administration has eschewed tax increases.

Itaipu Renegotiation: In May, Paraguay and Brazil agreed to a 15.4% increase in electricity tariffs at the Itaipu Dam that the two countries share, raising tariffs to USD19.28/kW for three years and generating an estimated USD650 million in additional annual revenue. We expect this measure to be neutral for fiscal consolidation, as most revenue will remain with Itaipu or go to state electricity utility ANDE for investments. However, it will reduce the government's need for capital expenditure cuts in order to comply with the fiscal rule, while addressing infrastructure challenges. The additional revenue will be temporary for the three-year deal, as a permanent agreement on the tariff under Annex C of the Itaipu Treaty is expected by December 2024.

Stable Government Debt: Fitch forecasts government debt to increase to 35.5% of GDP in 2024 from 33.6% in 2022. Achievement of fiscal consolidation targets should stabilize debt/GDP at this level and result in a slight decline beginning in 2026. Debt remains lower than the 'BB' median of 52.8%, but has risen sharply since Paraguay's upgrade in 2018 (17.8%). The domestic market remains relatively shallow given a narrow investor base and restrictions on public pension funds from holding government paper.

Paraguay successfully sold its first international offering of a local currency bond in February, raising G3.64 trillion (USD500 million). This lowered the share of foreign-currency debt to 87.5% as of August, although this remains one of the highest in the 'BB' category.

Reform Agenda: The government has announced a reform agenda aimed at enhancing institutional efficiency, ensuring transparency, and combating corruption. A key priority this year is to approve a civil service law designed to establish greater meritocracy within public service. The government is also setting up a superintendency for pensions, approved last year to address long-standing issues in the pension system. By the end of the year, the government plans to present a comprehensive reform of the regulatory framework governing the land property registry.

Efforts to tackle corruption are also a priority, with policies set to strengthen the general comptroller and legislative initiatives to create an autonomous entity dedicated to combating corruption. However, congress is also considering a controversial reform that increases oversight of nongovernmental organizations, which may weaken protections for freedom of association and expression.

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: 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: Expansion of the revenue base and debt/GDP reduction that strengthen fiscal flexibility, and development of the local capital market and/or buildup of fiscal saving buffers that improve financing 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 exposure to extreme weather events.

Structural: Sustained improvement in governance 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 Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output by +1 notch 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: +1 notch, to reflect Paraguay's track record of prudent and consistent macroeconomic policies, including a floating FX regime and inflation targeting, that have helped manage shocks from recurring droughts and are not fully captured by the low governance scores feeding into the SRM score. Fitch removed the additional +1 notch that had been added to offset the deterioration in the SRM output from volatility in macroeconomic variables, as this effect is subsiding.

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.

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 nonresident 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 and 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. Given that Paraguay has record of 20 years without a restructuring of public debt, which is captured in our SRM variable, this has a positive 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 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-	Affirmed	BBB-
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, v2.0.2 (1)

Debt Dynamics Model, v1.3.2 (1)

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

Sovereign Rating Model, v3.14.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Paraguay	EU Endorsed, UK Endorsed

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