Paraguay (/gws/en/esp/issr/88306070)

FitchRatings

Fitch Affirms Paraguay at 'BB'; Outlook Stable

Fitch Ratings-New York-16 December 2016: Fitch Ratings has affirmed Paraguay's sovereign ratings as follows:

--Long-term foreign and local currency Issuer Default Ratings (IDRs) at 'BB', Outlook Stable;
-- Issue ratings on senior unsecured foreign currency bonds at 'BB';
--Country ceiling at 'BB+';
--Short-term foreign and local currency IDRs at 'B'.

KEY RATING DRIVERS
Paraguay's ratings reflect a long track record of macro policy prudence, low fiscal deficits and debt levels, and increased resilience to external shocks. These are counterbalanced by constraining factors on creditworthiness including high output volatility due to weather related shocks and weak structural factors compared to peers such as lower per capita income, and weaker governance and social development indicators.

Paraguay's economy is becoming increasingly resilient to external shocks given an adequate level of international reserves, increased exchange rate flexibility and improved credibility of monetary policy. Fitch estimates real GDP growth at 4% in 2016 despite low commodity prices of key exports (soya and beef) and the fact that Paraguay's main trading partners - Brazil and Argentina - are in deep recession. Abundant rainfall benefitted both hydro-electric and agricultural production. Growth is expected to reach 3.5% of GDP in 2017 and 3.8% in 2018 driven by domestic demand. There are signs of economic diversification into higher value-added activities as well, which could over time reduce output volatility.

Inflation is expected to rise to an average of 3.6% in 2016, at the lower end of the central bank's 4.5% +/-2% inflation target. The central bank's monetary policy credibility has increased since its inflation targeting regime was introduced in 2011. It has broadly met the targets and kept inflation expectations anchored.

International reserve coverage, at 6.5 months of current external payments (CXP) has improved and remains adequate to mitigate risks related to commodity dependence and high financial dollarization. Furthermore, measures of external debt sustainability have improved sharply over the last decade; external debt represents 36% of CXR in 2016, down from 135% in 2007. A large part of the external debt is related to the Itaipu dam, jointly owned by Paraguay and Brazil.

Fitch expects the government to meet the 1.5% of GDP central government deficit target in 2016 as stipulated in the Fiscal Responsibility and Transparency Law, given buoyant revenue growth and current expenditure restraint. However, Fitch forecasts a central government deficit of 2% of GDP in 2017 due to a rise in government spending on salaries. The government is threatening to veto the 2017 budget recently passed by the Congress because it would lead to a deficit exceeding the 1.5% of GDP limit.

Given the continued difficult external environment and the country's significant infrastructure and social needs, the government is considering modifying the fiscal rule to target a structural fiscal balance based on economic growth potential, reducing the economic pro-cyclicality of the current fiscal rule. At the general government level, Fitch expects a fiscal deficit of 0.4% of GDP in 2016, which captures the surplus run by the public pension fund.

In order to boost infrastructure investment while preserving strong fiscal metrics, President Cartes' administration is focused on ramping up projects under the public-private partnerships (PPP) law. Paraguay's low level of infrastructure spending has been one of the country's key structural weaknesses but has been improving over the last three years.

Fitch estimates that the general government debt reached 23.7% of GDP in 2016 from 22.5% of GDP in 2015, largely as the result of the government's $600 million international bond issuance. Nearly 77% of Paraguay's debt is external, exposing the debt ratio to foreign exchange volatility. Debt/GDP remains less than half of the 'BB' median of 51%.

Structural factors remain Paraguay's major rating constraints, reflected in governance indicators which are well below those of the 'BB' median although improving. In an effort to increase transparency and reduce corruption, the government passed a law in 2014 that requires publication of all public sector salaries. Per capita income of below $4000 is well below the BB median of $5000.

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 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 QO, relative to rated peers, as follows:

--Macro: +1 notch, to reflect Paraguay's long track record of prudent, credible and consistent economic policies. The authorities continue to emphasize macroeconomic stability in their policy actions, which has contained macroeconomic imbalances despite volatile GDP growth.

Fitch's SRM is the agency's proprietary multiple regression rating model which 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.

RATING SENSITIVITIES
The main factors that could individually or collectively lead to a positive rating action are:

--A higher, less volatile growth trajectory that improves per capita income relative to peers while maintaining macroeconomic stability;
--Improvements in governance indicators.

The main factors that could individually or collectively lead to a negative rating action are:

--A prolonged terms-of-trade or weather-related shock that negatively impacts the country's economic prospects and external accounts;
-- A sustained fiscal deterioration and/or emergence of financing constraints;
--Increased macroeconomic instability, for example from substantial asset quality deterioration that impacts the financial sector.

KEY ASSUMPTIONS
--Fitch assumes that the Brazilian economy will grow modestly by 1.2% in 2017, after a deep recession in 2015-16 with a fall of over 3% in both years. Argentina is expected to grow by 3.2% in 2017 after a 1.7% fall in GDP in 2016;
--Fitch assumes that Paraguay will maintain access to external sources of financing and continue to attract FDI inflows.
--Fitch projects oil price average of USD45 in 2017 and USD55 in 2018.

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Applicable Criteria
Country Ceilings (pub. 16 Aug 2016) (https://www.fitchratings.com/site/re/885997)
Sovereign Rating Criteria (pub. 18 Jul 2016) (https://www.fitchratings.com/site/re/885219)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1016699&cft=0)
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