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Fitch Affirms Paraguay's FC IDR at 'BB'; Outlook Stable

Fitch Ratings-New York-27 January 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 and local currency bonds at 'BB';
--Country ceiling at 'BB+';
--Short-term foreign currency IDR at 'B'.

KEY RATING DRIVERS

Paraguay's ratings balance a long track record of fiscal prudence through different economic and political cycles, strong fiscal solvency indicators and increased resilience to external shocks against constraints on creditworthiness that include high output volatility due to weather-related shocks, a low tax revenue base and comparatively weak structural factors in terms of investment rates, institutional quality and social development indicators.

Paraguay has demonstrated improved capacity to manage external shocks without destabilizing effects for external accounts or macroeconomic stability. Adequate international reserves, increased exchange rate flexibility and improved credibility of monetary policy allow Paraguay to absorb multiple external pressures derived from lower commodity prices (soy and beef), economic underperformance in key trading partners (most notably deep recession in Brazil) and increased financial market volatility.

International reserves' coverage, equivalent to 5.8 months of current external payments (CXP) or 22% of GDP, remains adequate to mitigate risks related to commodity dependence, downside risks for the Brazilian economy and high financial dollarization. Moreover, the guarani has depreciated by 23% in 2015 without creating risks for financial or macroeconomic stability.

Growth slowed to an estimated 3% in 2015 as the external environment worsened, but medium-term growth drivers are intact. Although growth could slow further to 2.5% in 2016 as Brazil will likely remain in deep recession and commodity prices will stay weak, Fitch expects it to accelerate in 2017 in line with a less adverse external environment, recovery in large neighbouring economies and the execution of infrastructure projects.

Inflation averaged 3.1% in 2015, well below the central bank's target of 4.5+/-2%. Food inflation has remained under control, and depreciation against the USD dollar has not been accompanied by similar depreciation vis-a-vis trade partners (Argentina and Brazil). Core inflation, though, moved up to 3.7% in December 2015. This development and increased volatility in global financial markets prompted the central bank to increase its policy rate by 25bps increase to 6% in January, reinforcing its commitment to keep inflation in check in spite of more subdued economic activity.

The current account deficit rose to an estimated 1.8% of GDP in 2015 and could remain above 2% over the forecast period, balancing a weaker export outlook against reduced price of oil imports and slower economic activity. Fitch expects the deficit, which will remain below 'BB' peers, to be financed by FDI. The sovereign will maintain access to external sources of financing such as multilaterals and external capital markets.

The central government deficit reached 1.8% of GDP in 2015, up from 1.1% in 2014. At the general government level, Fitch estimates that the deficit (2.2% of GDP) remained below the 'BB' median and was the lowest among peer commodity exporters. Nevertheless, the government missed the deficit ceiling of 1.5% of GDP under the 2013 Fiscal Responsibility and Transparency Law (LRTF).

The LRTF continues to face challenges to establish its role as an appropriate institutional anchor for fiscal policy. In contrast to previous practice, the 2016 budget approved by Congress made minimal changes to the proposal submitted by the Ministry of Finance targeting a deficit of 1.5% of GDP. Nevertheless, revenue projections could prove hard to achieve in the context of subdued growth, expenditure related to flooding and continued focus on public investment by the current administration. Hence, Fitch expects the central government deficit to increase to 2.2% in 2016.

Fitch estimates that general government debt rose to 21.5% of GDP in 2015, from 18.1% in 2014, driven by the guarani depreciation. Debt levels remain less than half the 'BB' median of 44%. Paraguay last accessed external bond markets in 2015, and the sovereign could return to the external markets (the 2016 budget authorises USD700 million in issuance) in the event of favorable conditions.

Given the deteriorating external environment and significant infrastructure and social needs, authorities are currently exploring changes to the fiscal rule to make it more responsive to economic cycles and reduce its pro-cyclicality by targeting a structural rather than a nominal balance. In Fitch's view, the potential changes to the fiscal responsibility law will be analysed in the context of improvements to fiscal policy predictability and flexibility, development of a track record and their impact on Paraguay's public finances, presently a key rating strength.

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

Positive:
--Higher growth trajectory including higher investment levels and maintaining macroeconomic stability;
--Strengthening of external liquidity in relation to 'BB' peers;
--Structural improvements in public finances in terms of revenue base, expenditure rigidity and a continued moderate debt burden.

Negative:
--Commodity production shocks or severe export price falls that materially impair external and fiscal solvency ratios;
--Sustained fiscal deterioration in the context of financing constraints.

KEY ASSUMPTIONS
--Fitch assumes that Brazil will remain in recession (-2.5%) in 2016, after contracting by an estimated 3.7% in 2015. Recovery in Brazil and in Argentina will likely only materialize in 2017.
--Fitch assumes that Paraguay will maintain access to external sources of financing and continue attracting FDI inflows.
--Fitch oil prices average USD45 in 2016 and USD55 in 2017.

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Applicable Criteria

Country Ceilings (pub. 20 Aug 2015)

Sovereign Rating Criteria (pub. 12 Aug 2014)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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