COUNTRY NOTE: PARAGUAY

October 2024

GlobalEvolution

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PARAGUAY

We conducted a due diligence trip to Asuncion in September '24, just six weeks after Moody's upgraded Paraguay's credit rating to investment grade (Baa3) for the first time. The upgrade was justified by Paraguay's strong structural reform agenda, improved governance, relatively high growth, and adherence to fiscal targets. We are confident that the country will continue its fiscal consolidation and achieve its 1.5% deficit target by 2026, as outlined in its Fiscal Responsibility Law. The President appears to be in a strong position to navigate the remaining four years of his term, with a solid majority in both houses. During our meetings in Asuncion, we noticed a renewed sense of determination and progress within the ministries. The purpose of our trip was also to assess the economy's vulnerability to weather-related shocks. Although improving, the still relatively undiversified economic base suggests boom-bust growth cycles remain a risk.

By Christian Mejrup, Deputy CIO EM Sovereign Debt

Politics: Presidential power

Paraguay stands out in Latin America for its strong government institutions. Successive governments have prioritized institutional improvement, and the present government led by President Santiago Peña and the Colorado Party is no exception.

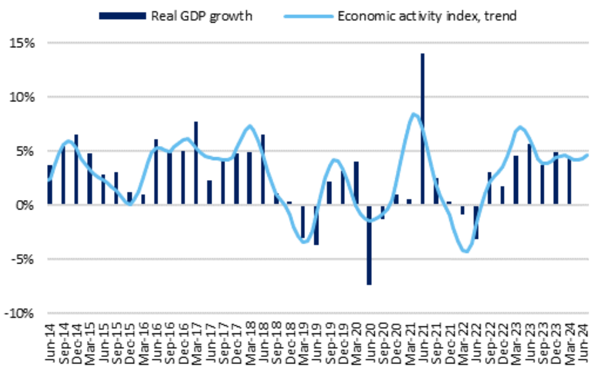
President Peña took office in August 2023 for a five-year term. His Colorado Party holds an absolute majority in both the Senate (24 out of 45 seats) and the Congress (48 out of 80 seats). This strong political position gives us confidence that the process of structural reforms will continue to make Paraguay's economy more resilient moving forward.

Economic growth outlook: Weather dependent

Over the past decade, Paraguay has maintained an average annual growth rate of 2.9%, primarily driven by agricultural production and hydroelectric power. However, growth stalled to just 0.2% y/y in 2022 due to severe drought, which reduced agricultural output, increased transportation costs due to low river water levels, and lowered hydroelectric power generation.

Paraguay experienced a strong recovery in 2023, with growth rebounding to 4.7% y/y. Economic activity in early 2024 remains above trend, with Q1:24 growth at 4.3% y/y. The economic activity index, a GDP proxy, showed 4.6% y/y growth as of July '24, making it likely that GDP growth will outperform the IMF's 2024 forecast of 3.4%. We expect medium-term growth to trend towards 3.0-3.5%, which aligns with Paraguay's potential growth level. While this may seem modest in a frontier market context, it is compelling compared to many of its regional peers.

Economic activity (YoY%): Above trend



Source: Haver, Global Evolution

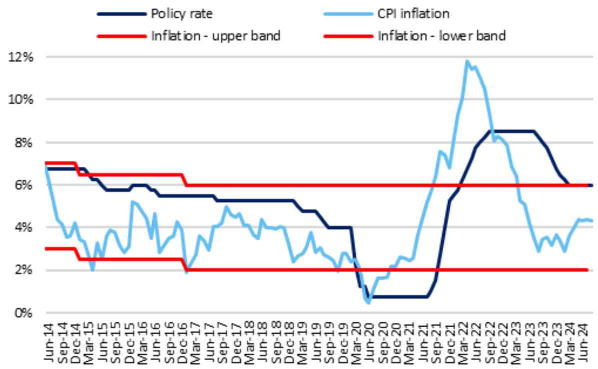
The Peña administration has made significant progress in advancing business-friendly initiatives and attracting foreign direct investments (FDI). A key part of his strategy is to diversify the economy to reduce its vulnerability to weather-related shocks via investment into physical infrastructure and human capital.

Several large projects are in the pipeline. These include Paracel, a USD4.0bn wood-pulp mill, the largest project in the country's history; the Omega Green biorefinery, Latin America's largest biofuel plant (USD1.0bn), which is set to produce 20,000 bpd of green fuels by 2025; and Silvipar, a USD300m forestry project investment.

Monetary policy: Neutral for now

The Central Bank of Paraguay (BCP) operates under an inflation targeting regime aimed at maintaining price stability within a range of 4.0% +/- 200bps.
After years of minimal inflationary pressure, the impacts of drought sent inflation to a high of 11.8% y/y in April '22. The BCP was able to prevent too many second-round effects and brought inflation back within the target range by April '23. In fact, from early 2021 through late 2022, fluctuations were mainly contained within food and transportation prices Inflation stood at 4.3% y/y in August '24, well within the BCP's target range.

CPI (y/y) and policy rate: At the target



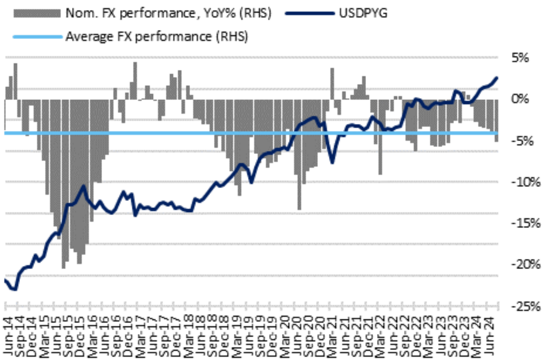
Source: Haver, Global Evolution

In response to the COVID-19 pandemic, the BCP reduced the policy rate to an extraordinary low of 0.75%. Following the inflation surge in 2021, the BCP raised rates over 14 consecutive meetings to 8.5% by September '22. With inflation back within target, the BCP initiated monetary easing in August '23, cutting the policy rate to 6.0% by March '24, where it has since remained. With a real policy rate of 1.7%, we do not expect imminent changes in monetary policy.

The Paraguayan Guarani (PYG) operates under a flexible exchange rate system, with the BCP occasionally intervening to smooth excess volatility or manage seasonal flows. The currency has served as an effective shock absorber during terms of trade shocks. The BCP has also allowed the PYG to depreciate by around 4.1% y/y against the USD over the last decade to maintain competitiveness.

Paraguay's banking sector remains relatively dollarized, with USD deposits comprising 40-48% of total deposits over the past decade, and a dollarized loan book largely reflecting the country's export-driven economy.

USD/PYG: Gradually weaker



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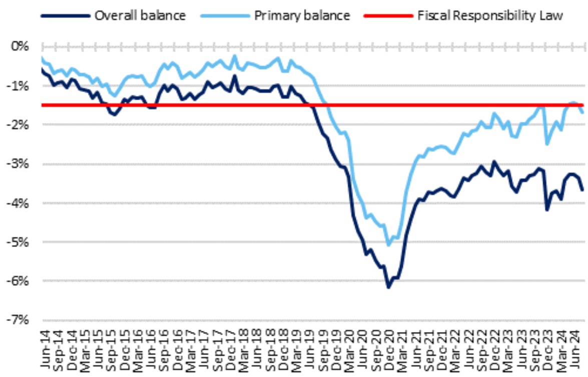
Fiscal policy: Consolidation ahead

The fiscal deficit widened to 6.2% of GDP in 2020, primarily due to COVID-related expenditure. However, it improved to 3.6% in 2021 and 2.9% in 2022. In 2023, the deficit rose to 4.2% of GDP, mainly due to the government's clearance of arrears from the previous administration. The deficit target for 2024 is 2.6% of GDP, which we believe will be met, supported by robust tax revenues and favorable base effects.

Budget balance (12m sum, %GDP): Twin surplus



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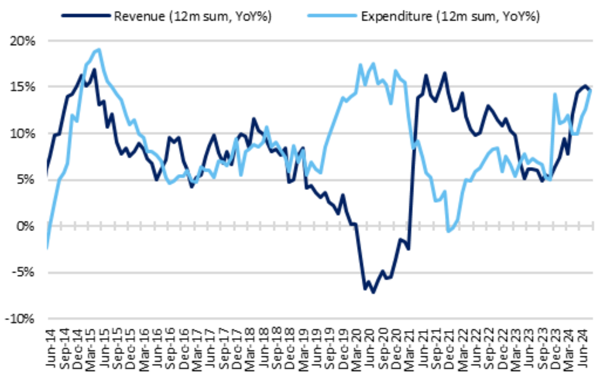
Paraguay suspended its Fiscal Responsibility Law, which limits the deficit to 1.5% of GDP and restricts real current primary expenditure to 4.0% y/y, due to COVID-19. The government aims to reduce the fiscal deficit to 1.9% in 2025 and return to compliance with the law by 2026.

The new administration has expressed a clear commitment to fiscal discipline without relying on tax increases or introducing new taxes. Instead, its focus is on improving revenue collection, managing expenditures, and addressing tax exemptions. However, from a long-term perspective, we believe it will be difficult for Paraguay to avoid raising taxes. At around 10.4% of GDP in March ’24, the tax-to-GDP ratio remains well below that of other Latin American nations and investment grade peers.

Revenue and expenditure: Both growing



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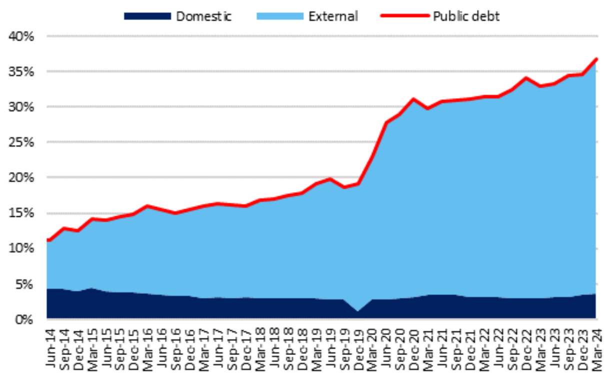
Paraguay and Brazil have agreed to raise the electricity tariff for the Itaipu binational hydroelectric dam for the period 2024-2026. The tariff will increase by 15.4% to USD19.28 per kW/month. Itaipu's contribution to the Paraguayan economy is vital, with an estimated impact of USD1.25bn in 2024, equivalent to around 2.7% of GDP. Despite the tariff increase, the 2024 windfall is only estimated to be only around USD300m compared to last year. Only around USD60.0m will go directly to the central government as roughly 80% of the additional revenue will be allocated to social investments managed by Itaipu. These investments will focus on child protection programs, citizen security, hospital construction, and general infrastructure improvements to support the country’s industrialization.

A key fiscal vulnerability is the public pension system, "Caja Fiscal," which is underfunded and runs an operational deficit of around 1.5% of GDP. The President has committed to reforming the pension system, which is crucial for long-term fiscal sustainability and could help deepen Paraguay’s domestic capital markets.

Public debt: Testing the ceiling

Paraguay’s public debt-to-GDP ratio has risen to from 19.2% in 2019 to 36.7% in March '24, due to fiscal pressures from COVID-19 and the 2021/22 drought. Paraguay’s Fiscal Responsibility Law sets a debt ceiling of 40% of GDP, which we do not expect to be breached, despite the challenges.

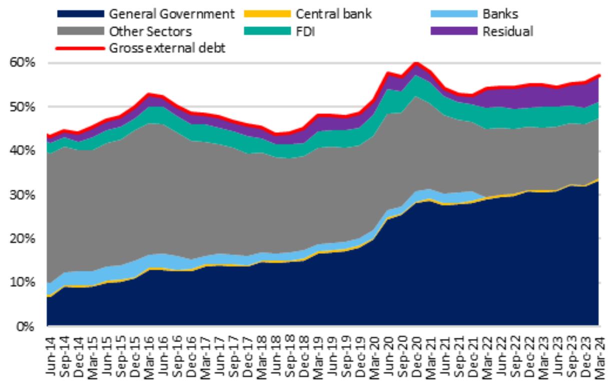
Public debt (%GDP): Significantly higher



Source: Haver, Global Evolution

We expect that a prudent fiscal trajectory and relatively high growth rates will help stabilize Paraguay's debt ratio over time. The external debt issued in early 2024 was primarily used to finance one-off arrears. Overall, Paraguay’s debt levels compare favorably with its peers. The implementation of the proposed pension reform is also crucial for maintaining debt stability. From a long-term perspective, we believe that the current debt ceiling is too restrictive and could hinder growth. We are comfortable with higher debt levels in Paraguay, provided the funds are invested wisely in infrastructure, human capital, and renewable energy projects.

Gross external debt (%GDP): Rising govt. debt



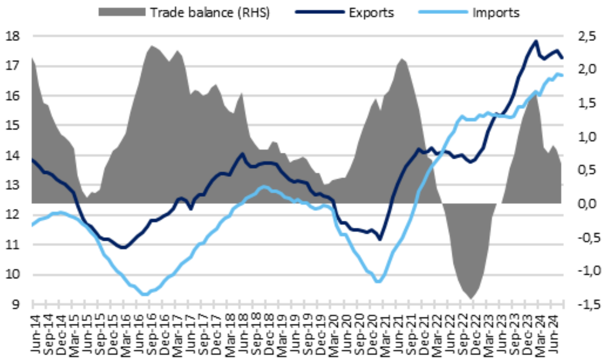
Source: Haver, Global Evolution

With public debt approaching the ceiling, we are concerned that the government may encourage state-owned enterprises (SOEs) to engage in external borrowing, which typically incurs higher costs than government borrowing. The state power company, ANDE, for example, is expected to explore a bond issue in the market in 2025.

Balance of payments: Back in black

Paraguay's external balance is highly vulnerable to weather shocks, particularly due to its reliance on soybean exports and hydropower generation. The 2021/22 drought severely impacted the trade balance, leading to a deficit of USD1.4bn by November '22. However, the balance quickly recovered in 2023, with a surplus of USD1.5bn by year-end as exports rebounded.

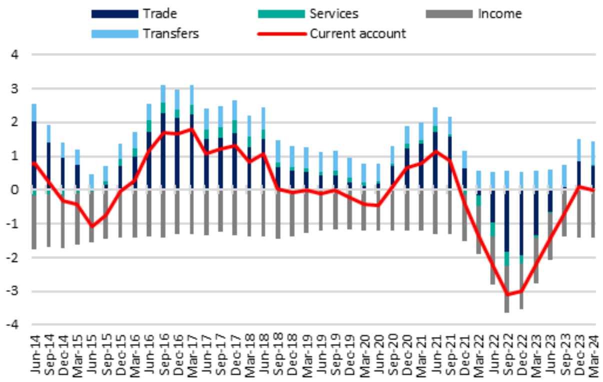
Trade balance (12m sum, USDbn): Positive



Source: Haver, Global Evolution

The current account (CA) balance mirrored this pattern, shifting from a surplus in 2021 to a deficit of USD3.0bn or 7.2% of GDP in 2022. As the trade balance recovered, the CA recorded a marginal surplus of USD0.1bn or 0.2% of GDP for 2023. We expect the CA to register a deficit of around 1.5% of GDP for 2024.

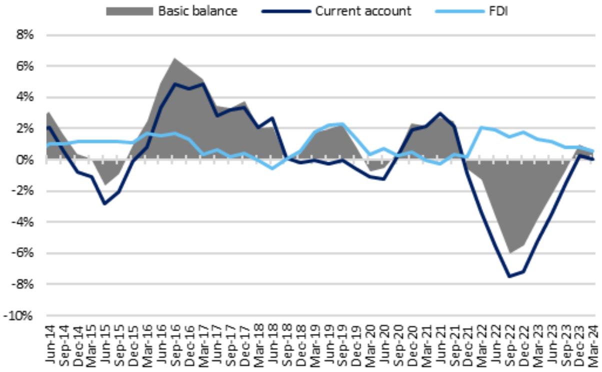
Current account (4q sum, USDbn): V-shaped



Source: Haver, Global Evolution

FDI has averaged 0.9% of GDP over the past decade but is expected to increase due to several large projects. Many of the large projects are confusingly recorded in the other investment item in the financial account, which has also registered solid positive inflows in recent years.

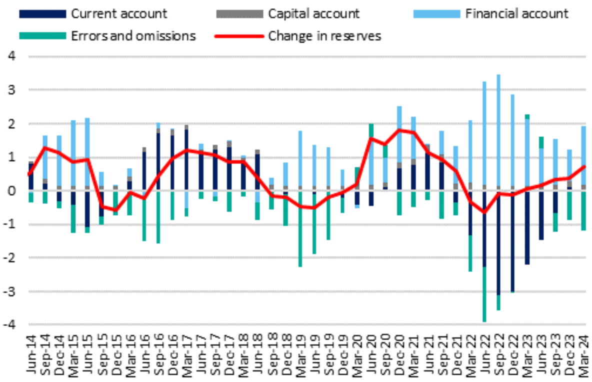
Basic balance (4q sum, %GDP): CA volatility



Source: Haver, Global Evolution

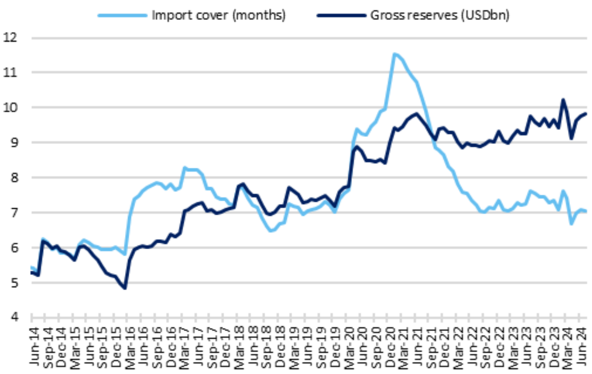
Overall, Paraguay's balance of payments has remained in positive territory over the last decade, except during severe weather shocks. The BCP has managed to gradually build FX reserves, which stood at USD9.8bn in July '24 or 22.5% of GDP, providing seven months of import cover.

Balance of payment (4q sum, USDbn): Up



Source: Haver, Global Evolution

FX reserves: Adequate



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