

Rating Action: Moody's affirms Botswana's A2 rating; outlook stable

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London, 06 March 2020 -- Moody's Investors Service, ("Moody's") has today affirmed the Government of Botswana's A2 long-term local and foreign currency issuer ratings. The outlook remains stable.

The affirmation reflects Botswana's credit strengths and challenges captured at the A2 rating level. The low debt burden, strong debt affordability indicators and a sizeable sovereign wealth fund continue to support fiscal strength, despite the gradual erosion of fiscal buffers, while solid institutions and prudent policymaking support macroeconomic stability. A track record of political stability and modest government liquidity and banking sector risks limit event risk. Nevertheless, the economy's small size, slow progress towards diversification and long term structural challenges constrain economic strength, while a large public sector, heavy reliance on a single commodity for growth, exports and budget revenues, and an increasingly rigid expenditure structure, constrain fiscal flexibility.

The stable outlook reflects Moody's view that the balance of risks is unlikely to change over the next 12-18 months. Still-strong fiscal metrics underpinned by a sizeable sovereign wealth fund more than adequate to cover outstanding debt and prudent policies should help weather near-term uncertainties associated with potential global growth disruptions and any adverse impact on consumer demand for Botswana's diamond exports. Nevertheless, the slow progress in terms of fiscal consolidation and economic diversification risks eroding fiscal and external buffers over the longer term.

Botswana's local currency bond and deposit ceilings remain at Aa3, foreign currency deposit ceiling at A2/P-1, and foreign-currency bond ceiling at Aa3/P-1, all unchanged.

RATINGS RATIONALE

RATIONALE FOR THE AFFIRMATION

LOW DEBT BURDEN, STRONG DEBT AFFORDABILITY AND A SIZEABLE SOVEREIGN WEALTH FUND SUPPORT FISCAL STRENGTH, DESPITE GRADUAL EROSION OF FISCAL BUFFER

Botswana's fiscal strength assessment reflects the government's strong fiscal metrics and fiscal resilience, supported by large fiscal buffers and prudent fiscal policy. Government debt affordability metrics, with interest payments accounting for less than 2% of revenue, and the government debt burden, estimated at about 14% of GDP as of 2019, are stronger than the A-rated median (4% of government revenue and 38% of GDP, respectively). Furthermore, Botswana's sovereign wealth fund, the Pula Fund, which accounts for an estimated 27% of GDP as of the end of November 2019, remains a key buffer against potential shocks in government revenue.

While the availability of large sovereign wealth fund resources has provided the government with flexibility to implement moderately expansionary fiscal policy over the recent years, fiscal space has gradually narrowed and the government is now pursuing a gradual fiscal consolidation targeting a budget surplus in the medium term.

Moody's expects Botswana's budget deficit to narrow to 2.8% of GDP in 2020/21 from an estimated 3.9% of GDP in 2019/20 and gradually decline thereafter. The fiscal adjustment will occur through lower development expenditure while recurrent expenditure is expected to continue to increase. The government is adopting measures to improve the efficiency of development spending by enhancing public investment management. While the planned reduction in capital spending reflects the government's efficiency considerations, the resulting increase in budget rigidity reduces fiscal flexibility. It also poses a risk to the achievement of the envisaged deficit reduction, should mineral revenues underperform due to challenging conditions in the diamond industry and/or if lower than expected Southern African Customs Union (SACU) receipts materialize due to continuing weak economic performance in South Africa.

SOLID INSTITUTIONS AND PRUDENT POLICYMAKING SUPPORT MACROECONOMIC STABILITY

Botswana's solid institutions and governance strength supports the A2 rating. The country performs strongly in

Worldwide Governance Indicators, in particular adherence to the rule of law and control of corruption, robust monetary policy framework delivering price stability, and prudent policymaking that has resulted in a sound management of the country's natural resources.

These positive attributes of Botswana's institutional profile are balanced by capacity constraints that have resulted in a mixed track record in terms of structural reform implementation. For example, progress introducing reforms to improve the business environment and enable economic diversification has been very gradual, while public investment management and governance of state-owned enterprises (SOEs) continue to face challenges.

SMALL ECONOMIC SIZE, LOW DIVERSIFICATION AND LONG TERM STRUCTURAL CHALLENGES CONSTRAIN ECONOMIC STRENGTH

Botswana's A2 rating balances the relatively solid, albeit volatile, growth performance and its high per capita income with its relatively narrow economic base, heavy reliance on the diamond industry and on a large public sector. Despite diversification efforts, the mining sector, and in particular the diamond sector, remains a key growth driver and accounts for the vast majority of export proceeds, and more than one third of government revenue.

Moody's expects real GDP to grow by 3.9% in 2020, after expanding by an estimated 3.6% in 2019, driven mainly by the recovery of mining activity and improvement in the non-mining sectors supported by the accommodative monetary conditions and gradual reform progress to improve the business environment. However, risks to the growth outlook are tilted to the downside due to the challenging external environment, including sluggish growth in South Africa and risks to global consumer demand for diamonds associated with the increasingly challenging global conditions. Over the longer term, more expensive extraction of diamond resources and potential structural changes in the industry will challenge Botswana's growth model without material progress in economic diversification. The large public sector displays low efficiency levels and creates labour market distortions, while high unemployment and inequality pose additional structural challenges.

LIMITED SUSCEPTIBILITY TO EVENT RISK, GIVEN THE TRACK RECORD OF POLITICAL STABILITY AND MODEST GOVERNMENT LIQUIDITY AND BANKING SECTOR RISKS, AND STRONG, ALBEIT WEAKENING, EXTERNAL POSITION

Moody's decision to affirm Botswana's rating also reflects limited susceptibility to event risk due to its stable political system, modest government borrowing requirements, healthy banking system and the country's strong, albeit weakening, external position.

The re-election of the Botswana Democratic Party (BDP) -- the ruling party since independence -- under the leadership of President Masisi with a comfortable margin in October 2019 gives the new administration a strong mandate to deliver on economic transformation, and reconfirmed Botswana's track record of political stability. Moody's expects robust political institutions to continue to underpin its assessment of political risk.

Government liquidity risk is modest, reflecting low gross borrowing requirements and the government's reliable access to domestic capital markets to absorb local currency-denominated debt.

Botswana's banking system's financial profile is sound. Banks are on average well capitalized and the level of non-performing loans as a percentage of gross loans remains contained, at about 5% at the end of 2019.

External vulnerability has increased as the current account balance has shifted into deficit in 2019 and Moody's expects it to remain in negative territory in 2020 and 2021. However, the reserves position remains solid - with foreign-exchange reserves (excluding gold and special drawing rights) amounting to \$6.4 billion as of November 2019 or an estimated 34% of GDP - and public external debt is low, mitigating risks from external shocks stemming from the high reliance on the diamond industry.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects broadly balanced risks at this rating level. Moody's expects Botswana to embark on a fiscal consolidation path in the next fiscal year while fiscal and external buffers will support its shock absorption capacity. Moody's expects progress on economic transformation to continue, albeit at a gradual pace. Botswana's credit profile continues to balance sound fiscal metrics and prudent policies delivering macroeconomic stability with the challenges posed by the country's economic model reliant on the diamond industry and on the large role of the public sector. These challenges risk eroding its credit strengths over the longer term in the absence of material diversification progress.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Moody's takes account of the impact of environmental (E), social (S), and governance (G) factors when assessing sovereign issuers' economic, institutional and fiscal strength and their susceptibility to event risk. In the case of Botswana, the materiality of ESG to the credit profile is as follows:

Environmental considerations are somewhat material to Botswana's credit profile because the country is affected by water scarcity and vulnerable to recurrent droughts, despite relatively low economic reliance on agriculture compared to other Sub-Saharan African sovereigns.

Social considerations are relevant to Botswana's credit profile. Progress in reducing high unemployment, in particular among the youth, and high income inequality (with a Gini coefficient of 0.52) lags compared to Botswana's relatively strong economic performance, in part reflecting dependence on the mining sector, limited private sector job creation, and labour market distortions. Botswana has a history of relatively peaceful elections and minimal social unrest.

Governance considerations are material to Botswana's rating. Botswana performs strongly on the Worldwide Governance Indicators, and ranks highly among African countries according to the 2018 Ibrahim Index of African Governance as well as sound management of natural resources income, which it has invested to expand the country's social and physical infrastructure.

WHAT COULD CHANGE THE RATING UP

Upward pressure would arise in the presence of (i) structural reforms leading to tangible results in terms of business environment improvements and higher economic diversification, boosting Botswana's growth potential and (ii) an improvement in the composition and efficiency of expenditure that reduces fiscal vulnerability to sudden declines in SACU revenues and/or mineral revenues.

WHAT COULD CHANGE THE RATING DOWN

Conversely, downward rating pressure would likely develop due to limited fiscal consolidation, inability to contain recurrent expenditure and in the event of a negative shock to government revenue resulting in a significant erosion of fiscal reserves. A material increase in financial support to state-owned enterprises would also erode Botswana's fiscal buffers and put negative pressure on the rating. Lack of progress in terms of economic diversification, over the long term, would also exert downward pressure on the rating.

GDP per capita (PPP basis, US\$): 17,948 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 4.5% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 3.5% (2018 Actual)

Gen. Gov. Financial Balance/GDP: -4.6% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 2.1% (2018 Actual) (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: baa3

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 03 March 2020, a rating committee was called to discuss the rating of the Government of Botswana. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, have not materially changed. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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