

Rating Action: Moody's changes the outlook on Botswana's ratings to negative, affirms A2 ratings

29 May 2020

London, 29 May 2020 -- Moody's Investors Service, ("Moody's") has today changed the outlook to negative from stable on the Government of Botswana's issuer ratings and affirmed the A2 long-term local and foreign currency issuer ratings.

The negative outlook reflects increasing risks to Botswana's fiscal strength due to the severe shock to its growth and the government's revenue resulting from the coronavirus pandemic impact on the economy and the important diamond sector in particular. Significantly lower growth, much weaker government revenues and higher borrowing requirements will aggravate already deteriorating fiscal trends and risk accelerating the erosion of fiscal buffers. Furthermore, the disruptions caused by the coronavirus will likely slow progress in terms of fiscal consolidation and economic diversification, which are key to preserve the fiscal and external buffers in the longer term.

The coronavirus outbreak, deteriorating global economic outlook, falling commodity prices, and financial market turmoil are creating a severe and extensive economic and financial shock. Moody's regards the coronavirus outbreak as a social risk under its ESG framework. For Botswana, the shock transmits mainly through weaker growth and the loss in government revenue and exports caused by the drop in the demand for diamonds and cut in production in response. The government's fiscal, external and liquidity positions risk deteriorating to a level that would be consistent with a lower rating.

Botswana's A2 rating is supported by the government's still relatively strong, albeit deteriorating, fiscal metrics, in particular low debt level, high debt affordability and fiscal and external liquidity buffers that help mitigate the impact of the coronavirus shock. The current rating also reflects solid institutions and prudent policymaking that support macroeconomic stability and limited susceptibility to event risk.

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 CHANGE IN THE OUTLOOK TO NEGATIVE FROM STABLE

RISKS TO FISCAL STRENGTH HAVE INCREASED DUE TO THE CORONAVIRUS SHOCK AMID ALREADY WEAKENING BUFFERS

The negative outlook reflects the risk that lower growth, higher budget deficit and the resulting increasing borrowing requirements combined with the challenges the government already faces in resuming fiscal consolidation due to increased budget rigidity will result in fiscal metrics continuing to deteriorate to a level which is no longer consistent with the current rating.

The coronavirus shock has crystalized Botswana's vulnerabilities arising from the limited economic diversification given its heavy reliance on a single commodity for growth, exports and budget revenues, slow progress towards economic transformation, and an increasingly rigid expenditure structure in the budget.

Moody's expects real GDP to contract by around 7% in 2020, due to the sharp slowdown in domestic demand and the disruptive impact of the coronavirus on the mining sector (representing about 15% of GDP), in particular on the demand for diamonds and the decline in the tourism sector, which directly accounts for 4% of GDP, hit by the travel restrictions. The growth downturn is expected to be deeper compared to that experienced by most sovereigns in Sub-Saharan Africa. The authorities are preparing a fiscal stimulus package beyond the economic measures already announced to cushion the impact of the coronavirus shock on growth, supporting a recovery in activity later this year and next year as restrictive measures domestically and abroad are gradually lifted and mining activity recovers.

The conditions in the diamonds markets due to the impact on the coronavirus have deteriorated significantly

compared to Moody's previous assumptions for 2020, potentially magnifying some of the long-term challenges already faced by the industry, and weighing on Botswana's already weakening fiscal dynamics given the sovereign's high reliance on mineral revenue (accounting for about 30% of total revenue in recent years), which is expected to fall by about two thirds in fiscal 2020 that ends in March 2021 compared to the budget estimate.

Moody's expects that lower mineral (and particularly diamond) and non-mineral revenue and fiscal measures to contain the effect of the pandemic will contribute to the fiscal deficit widening to close to 10% of GDP in fiscal 2020 from an estimated 4% in fiscal 2019 and remaining close to 6% of GDP in fiscal 2021 as the impact of lower Southern African Customs Union (SACU) revenue materializes with a one year lag. Moody's expects the large shock to the revenue and stimulus policy response will lead a significant deterioration in fiscal metrics, jeopardizing the government's medium term fiscal consolidation plans and accelerating the already-evident erosion of the sovereign wealth fund.

Moody's assumes that the deficit will be financed mainly via domestic borrowing rather than through a drawdown of government fiscal reserves, although the government could also approach multilateral development banks for budgetary support as done in the past. While Botswana's domestic banking system has comfortably met government issuance in previous years, larger than projected government financing requirements in 2020 may pressure liquidity capacity within the relatively shallow system to absorb larger issuance of government securities. The rigid structure of the budget (particularly the large public sector wage bill) leaves limited room to accommodate the anticipated fiscal response without a significant increase in the deficit leading to higher government debt and erosion in fiscal reserves. As a result, Moody's projects government debt to increase to around 25% of GDP in 2020 from about 14% of GDP in 2019 and broadly stabilized thereafter.

External vulnerability risk is also increasing, albeit from a low level, as Moody's projected current account deficit -- already exceeding 7.5% of GDP in 2019 -- will likely widen due to the decline in diamond exports, leading to a further weakening of the foreign currency reserves buffer.

RATIONALE FOR THE RATING AFFIRMATION

The affirmation of the A2 ratings reflects Botswana's fundamental credit strengths including the government's still-strong fiscal metrics, supported by fiscal buffers (albeit declining) and prudent fiscal policy. Debt affordability metrics, with interest payments absorbing less than 2% of revenue, and the government debt burden, estimated at about 14% of GDP as of 2019, remain favorable compared with the median of the sovereigns rated A2 (4% of government revenue and 46% of GDP, respectively) although Moody's projects that debt to revenue will double in 2020. Furthermore, Botswana's sovereign wealth fund, the Pula Fund, at an estimated size of 24% of GDP as of March 2020, continues to provide a key fiscal and external buffer despite having weakened significantly in recent years.

Botswana's robust institutions and prudent policymaking also supports the current rating despite a mixed track record in terms of structural reform implementation to improve the business environment and promote economic diversification. The country ranks favorably according to the Worldwide Governance Indicators, in particular adherence to the rule of law and control of corruption, while a sound monetary policy has been conducive to price stability although the institutions and governance strength is weaker than the median of the A2-rated sovereigns.

The affirmation also reflects limited susceptibility to event risk given a track record of political stability and contained government liquidity and banking sector risks despite increasing (albeit from a low level) external vulnerability risk. Despite being on a declining trend, the reserves buffer remains solid - with foreign exchange reserves amounting to \$5.2 billion as of March 2020 or an estimated 32% of GDP, covering an estimated 9 months of imports of goods and services, while public external debt remains low (at about 8% of GDP at end-2019).

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Environmental considerations are relevant 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 0.53) lags compared to Botswana's relatively strong economic performance, in part reflecting dependence on the mining sector, limited

private sector job creation, and labor market distortions. Botswana has a history of relatively peaceful elections and minimal social unrest. Moody's regards the coronavirus pandemic as a social risk under its ESG framework, given the substantial implications for public health and safety. For Botswana, it mainly manifests in an economic shock and revenue deterioration that exacerbates existing pressures on fiscal strength.

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.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

An upgrade is unlikely in the foreseeable future given the negative outlook. Moody's would likely change the outlook to stable if the rating agency were to conclude that the deterioration of fiscal metrics caused by the coronavirus shock will likely be stabilized by credible fiscal measures aimed at rebuilding fiscal buffers in the long term and reduce fiscal vulnerabilities posed by the rigid budget structure. The decision to stabilize the outlook may also be supported by evidence of progress in implementing growth-enhancing reforms targeting an improvement in economic diversification and business environment.

Conversely, indications of challenges in halting the fiscal deterioration after the severe but temporary coronavirus shock suggesting a durable deterioration of fiscal strength will likely prompt a downgrade. An increase in financial support to state-owned enterprises that lead to a material weakening of the fiscal metrics would also likely result in a lower rating. Any signs that susceptibility to event risk has increased due to higher liquidity risk resulting from larger gross borrowing requirements or a further deterioration of the external position compared to current expectations will also increase the likelihood of a downgrade.

Given Botswana's strong dependency on the diamond industry for growth, exports and budget revenues, the sovereign is more exposed than peers at the current rating level to the risks associated with the coronavirus shock, this event prompted the publication of this credit rating action on a date that deviates from the previously scheduled release date in the sovereign release calendar, published on www.moody.com.

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 26 May 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 fiscal or financial strength, including its debt profile, has not materially changed. The issuer has become increasingly susceptible to event risks. Other views raised included: The issuer's institutions and governance strength, have not materially changed.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1158631. Alternatively, please see the Rating Methodologies page on www.moody.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.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: <https://www.moody.com/researchdocumentcontentpage.aspx?>

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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