

Rating Action: Moody's downgrades Botswana's ratings to A3, changes outlook to stable

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London, 23 April 2021 -- Moody's Investors Service ("Moody's") has today downgraded the Government of Botswana's long-term local and foreign currency issuer ratings to A3 from A2 and changed the outlook to stable from negative.

The downgrade to A3 reflects the deterioration in fiscal strength exacerbated by the shock induced by the coronavirus pandemic. As a result, Botswana's fiscal buffers have been eroded, reducing the government's fiscal space to absorb future shocks, to which the country is more exposed than most of its A-rated peers. At the same time, Botswana's credit profile continues to be supported by robust fiscal metrics, in particular a low debt level and high debt affordability.

The stable outlook balances Moody's expectations that Botswana's credit metrics will remain commensurate with the A3 rating, notwithstanding the risks posed by the evolution of the pandemic and a potentially weaker than currently expected recovery in the demand for diamonds. The stable outlook also reflects Moody's expectations that prudent macroeconomic policies will continue, helping Botswana to navigate the challenges stemming from the country's economic model reliant on the diamond industry and on a large public sector.

Concurrent with today's rating action, Botswana's local-currency country ceiling has been lowered by one notch to Aa3 from Aa2. The three-notch gap to the sovereign rating reflects predictable institutions and government actions, low political risk and external imbalances balanced against the government's significant footprint in the economy and reliance on a single revenue source. The foreign-currency country ceiling has been lowered by one notch to A1 from Aa3. The one-notch gap to the local currency country ceiling reflects moderate policy effectiveness and low external indebtedness that point to limited transfer and convertibility risks.

RATINGS RATIONALE

RATIONALE FOR DOWNGRADE TO A3

DETERIORATION IN FISCAL STRENGTH AND REDUCED CAPACITY TO ABSORB FUTURE SHOCKS DUE TO EROSION OF BUFFERS

The fiscal measures to cushion the effect of the pandemic and the large shock to revenue, primarily due to a reduction in mineral revenue, led to a deterioration in fiscal metrics and accelerated the erosion of the government's fiscal reserves which have been almost depleted.

Moody's estimates the fiscal deficit to have reached 9% of GDP in fiscal 2020 (ending on 31 March 2021), compared with a deficit of 5.6% of GDP in fiscal 2019. The government financed the 2020 deficit mainly by drawing down fiscal reserves and to a lesser extent by issuing domestic debt. As a result, Moody's expects government debt (excluding guarantees) to have only increased to about 19% of GDP in fiscal 2020, up from 14.7% of GDP in 2019. However, the fiscal reserves in the Government Investment Account (GIA), which represents the government's share of foreign exchange reserves in the Pula Fund and Liquidity Portfolio, declined by about 80% since the onset of the shock, to 1.9% of GDP at the end of 2020 from 9.3% of GDP as of March 2020, exacerbating a marked downward trend from a level equivalent of 17.1% of GDP in 2017 and 24.3% of GDP in 2015.

The erosion of fiscal buffers reduces the government's capacity to absorb future shocks to which the country is more exposed than most of its peers in the A rating category due to relatively weaker economic resilience, mainly reflecting a lower level of income and economic diversification. This is exacerbated by significant reliance on volatile sources of revenue, with mineral and Southern African Customs Union (SACU) revenue accounting for more than half of total revenue pre-pandemic. In addition, expenditure composition is sticky given the high wage bill representing about 40% of total expenditure.

Fiscal consolidation challenges persist, suggesting that the erosion of the fiscal strength will be long-lasting.

The adjustment envisaged under the 2021 budget relies on a significant increase in revenue rather than on reducing expenditure given limited flexibility. At the same time, lower SACU revenue, which accounted for over a quarter of total revenue over the past five years, will also materialize this fiscal year and next as a result of the delayed impact of the coronavirus shock on distributions to member states. Support for SOEs significantly affected by the pandemic poses an additional source of risk.

Botswana's external buffers are also weakening, although from a strong level. The current account position has worsened in recent years, driven by the deterioration of the trade balance. In 2019, the current account balance shifted into a large deficit and Moody's estimates that the deficit widened further to around 10 % of GDP in 2020 and foreign-exchange reserves declined to \$4.8 billion (equivalent to about 13 months of non-diamond imports or 9 months of total imports) at end-2020, down from \$6.0 billion at end-2019.

WEAKER ECONOMIC RESILIENCE THAN MOST A-RATED PEERS EXACERBATED BY THE PANDEMIC

The coronavirus pandemic has also exposed the structural limitations of Botswana's growth model, characterized by the large presence of the public sector and exposure to fluctuations in global demand for diamonds, which accounts for 15% of GDP and around 90% of goods exports.

After expanding by 3% in 2019, real GDP contracted by 7.9% in 2020, a deeper contraction than for most Sub-Saharan African sovereigns and A-rated peers, as a result of the restrictions imposed on economic and social activity to contain the spread of the virus and the fall in global demand for diamonds and subsequent production cuts. Moreover, travel restrictions significantly affected Botswana's tourism sector, which contributed 5% of GDP directly pre-pandemic.

Moody's forecasts the economy to recover in 2021, with real GDP expanding by 6.2%, mainly driven by the rebound in mining industry and gradual normalization of domestic economic activity. Prolonged containment measures to contain the spread of the virus or a slow vaccine rollout could impede the pace of the recovery, while the evolution of the pandemic will continue to influence the developments in the diamond market.

Moreover, long-term challenges are likely to become more acute in absence of effective progress on economic diversification and improvement in the business environment, that are key to promoting balanced growth, generating revenue and rebuilding fiscal and external buffers in the longer term. While the government has reaffirmed its commitment to economic diversification with the adoption of the Economic Recovery and Transformation Plan (ERTP) presented in 2020, the mixed track record on implementing structural reforms suggests that progress will likely remain very gradual.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects broadly balanced risks at this rating level. Despite the downside risks to the post-pandemic fiscal consolidation path, Moody's expects that Botswana's financial strength will remain commensurate with the A3 rating in the near to medium term. Moody's also expects that susceptibility to event risk will remain contained given low political risk, limited government liquidity and external vulnerability risks and a stable banking sector despite the expected deterioration in asset quality. Moody's expects that solid institutions will continue to pursue prudent policies delivering macroeconomic stability and helping with the challenges posed by the country's economic model reliant on the diamond industry and on the large role of the public sector. However, over the longer term, the absence of material diversification progress risks eroding Botswana's credit strengths.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Botswana's ESG Credit Impact Score is moderately negative (CIS-3), balancing moderate exposure to environmental risks and high exposure to social risks against relatively sound governance profile, moderate wealth levels, and relatively strong fiscal metrics that provide some fiscal space to respond to E and S risks.

Botswana's credit profile is moderately exposed to environmental risks as reflected in its E-3 issuer profile score. Botswana is affected by water scarcity and vulnerable to recurrent droughts, despite relatively low economic reliance on agriculture compared to other Sub-Saharan African sovereigns. A significant share of the population also does not have access to safe drinking water.

Exposure to social risks is highly negative (S-4 issuer profile score), as progress in reducing high unemployment, in particular among the youth, and high income inequality lags compared to Botswana's historically strong economic performance and sound institutions, in part reflecting dependence on the mining sector, limited private sector job creation, and labor market distortions. Outcomes in terms of health, and to a

lesser extent education, are not commensurate to the level of income and social spending.

Botswana has a G-2 issuer profile score. Botswana is characterized by good governance and prudent macroeconomic policy. Sound management of the natural resources income has supported the expansion of the country's social and physical infrastructure, its education sector and the government's institutional capacity. Nevertheless, efficiency of spending remains low.

GDP per capita (PPP basis, US\$): 18,572 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 3% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.2% (2019 Actual)

Gen. Gov. Financial Balance/GDP: -5.6% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -7.6% (2019 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 20 April 2021, a rating committee was called to discuss the rating of the Botswana, Government of. The main points raised during the discussion were: The issuer's fiscal or financial strength, including its debt profile, has materially decreased. Other views raised included: 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 susceptibility to event risks has not materially changed.

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

Upward pressure would arise from improved resilience to shocks supported by higher buffers or reduced vulnerabilities of the budget structure to sudden declines in SACU revenues and/or mineral revenues. Evidence that measures to increase economic diversification and improve the business environment are effective in materially reducing economic and fiscal reliance on the mineral sector would likely support a higher rating.

Conversely, a marked deterioration of fiscal metrics beyond Moody's current expectations due to fiscal consolidation challenges, a significant increase in financial support to state-owned enterprises or markedly weaker growth outlook, would likely lead to a downgrade. Any signs that susceptibility to event risk has materially increased due to a deterioration of the external position or to higher liquidity risk could also lead to a downgrade.

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?docid=PBC_79004.

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