

Macroeconomic outlook

Bahrain: Resilient non-oil sector helps economy weather low oil prices

> Dana Al-Fakir

Economist

+965 2259 5373, danafakir@nbk.com

> Nembr Kanafani

Senior Economist

+965 2259 5365, nemrkanafani@nbk.com

Overview and outlook

- Real GDP growth poised to hold in 2016 on signs of resilience in the non-oil economy. We expect growth to pick up in 2017 on a potential recovery in oil prices and as the non-oil sector gathers momentum.
- Inflation is projected to end 2016 up, to average 2.5%, mainly due to lower subsidies, and to hold steady in 2017.
- The budget deficit is set to widen further in 2016 to 17% of GDP as oil revenues remain weak.
- The banking sector continues to face liquidity constraints, on subdued deposit growth.

Real economy expected to hold thanks to a resilient non-oil sector

Economic growth is set to hold steady in 2016, as a resilient non-oil economy helps weather some of the on-going weakness in the oil sector. We foresee growth in real GDP to hold at around 2.9% year-on-year (y/y) in 2016, before climbing to around 3.4% y/y in 2017 on stronger non-oil growth. (Chart 1.) Growth in real oil GDP is set to remain flat in 2016 and 2017 amid steady oil production levels. Real non-oil growth is expected to remain broadly stable at a relatively solid 3.6% y/y in 2016 before edging up towards 4% y/y on high levels of investment.

In the first quarter of 2016, real GDP growth recovered relative to 4Q15 and accelerated to 4.5% y/y. However, the acceleration was mostly attributed to a one-off jump in real oil GDP growth. (Chart 2.) Indeed, growth in real GDP slowed once again to 2.5% y/y in 2Q16, after real oil activity contracted by 1.7% y/y.

In contrast, growth in real non-oil activity climbed from 2.8% y/y to 3.6% y/y during the same period, helping shore up some of the weakness in oil activity. Non-oil GDP recorded its highest growth rate in a year in 2Q16, thanks to faster than expected utilization of GCC grants, which helped prop up investment. The GCC pledged \$10 billion in investment over ten years which Bahrain has vowed to devote to infrastructure and housing developments.

Inflation expected to come in slightly higher in 2016 on subsidy cuts

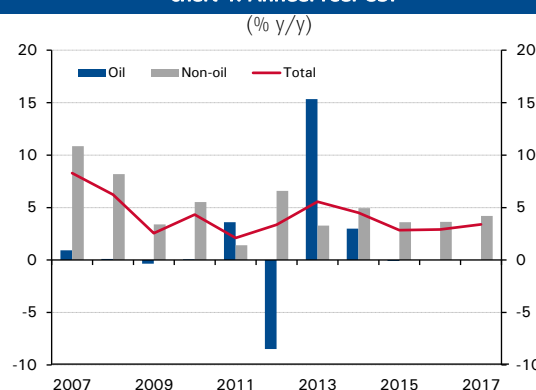
Inflation in the consumer price index (CPI) rose for the most part of 1H16,

Table 1: Key economic indicators

		Year			
		2014	2015e	2016f	2017f
Nominal GDP	USD bn	33.8	32.2	31.9	34.6
Real GDP	% y/y	4.5	2.8	2.9	3.4
- Oil	% y/y	3.0	-0.1	0.0	0.0
- Non-oil	% y/y	4.9	3.6	3.6	4.2
Inflation	% y/y	2.7	1.8	2.5	2.5
Budget balance	% of GDP	-3.6	-16.1	-17.1	-14.1

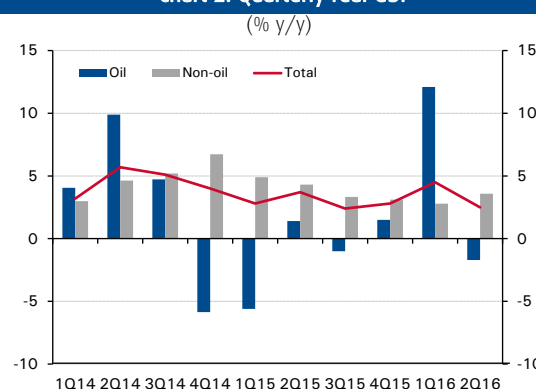
Source: Official sources, NBK estimates

Chart 1: Annual real GDP



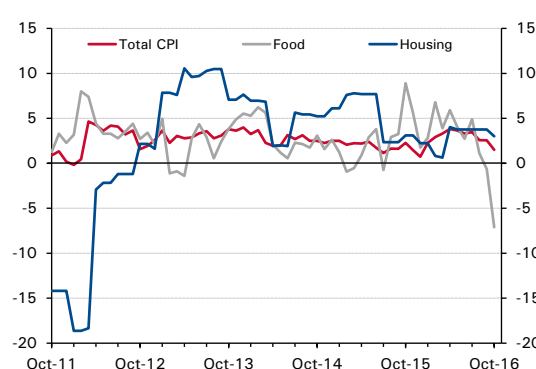
Source: Central Informatics Organization, NBK estimates

Chart 2: Quarterly real GDP



Source: Economic Development Board

Chart 3: Consumer price inflation by sector



Source: Central Informatics Organization

after subsidy cuts in the food and housing components led the respective inflation rates higher (Chart 3). However, the initial impact of the subsidy cuts appears to have waned; CPI inflation peaked at 3.8% y/y in April and as of October, stood at 1.5% y/y on the back of a slowdown in inflation in the housing component and a decline in food prices.

Despite the ongoing ease in the overall inflation rate, we expect inflation to still edge up slightly and average around 2.5% in 2016, following the multi-month high readings recorded in 1H16.

Budget deficit to widen on lower oil receipts and high spending

Bahrain is forecast to see one of the largest budget deficits in the GCC region. With the breakeven oil price estimated at around \$120 per barrel amid a weak oil price environment, the budget deficit is expected to expand to roughly 17% of GDP in 2016 before narrowing to around 14% of GDP in 2017 (Chart 4).

Bahrain remains adamant about imposing fiscal reforms in line with the IMF's recommendations to help shore up its public deficit. So far, it has agreed to cut government expenditures by 30%. Spending cuts have been concentrated on subsidies; public spending levels on infrastructure and development projects have remained broadly stable. In August 2015, the government lifted subsidies on meat products. In December 2015, the cabinet approved a new pricing system for diesel, kerosene and jet fuel to reduce subsidy costs and better reflect price increases in other GCC states. In 1H16, it approved the removal of subsidies on utilities.

However, engaging in further significant cuts in public spending remains a challenge, especially since the two politically sensitive areas of spending, namely subsidies and public wages, make up two-thirds of total government spending.

Given that the budget deficit is expected to remain high in spite of subsidy cuts, Bahrain will continue to turn to both domestic and international bond markets, to help finance its deficit. In 2015, Bahrain issued a total of \$6 billion in bonds, \$1.5 billion of which was in eurobonds. So far in 2016, the government of Bahrain has issued \$3.4 billion in bonds, \$2 billion of which was issued externally. Subsequently, the debt to GDP ratio is projected to remain at around a high of 60% of GDP in 2016.

Fiscal deficit and debt concerns have led to a bout of downgrades of the nation's long-term credit rating. In June, Fitch, in line with the other two major rating agencies, downgraded Bahrain's long-term credit rating to below investment grade status. The downgrades have no doubt made it more difficult for the government to negotiate better bond deals.

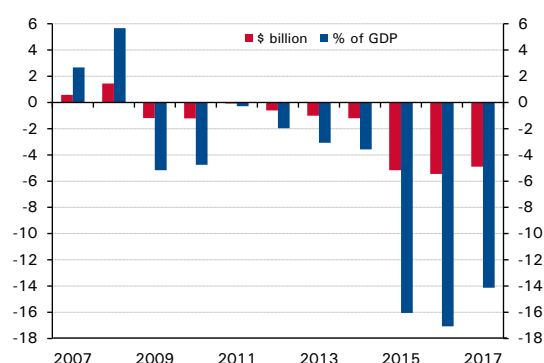
Banking sector liquidity conditions remain constrained

After remaining mostly steady in 2015, latest data reveal a slowdown in private sector claims growth (Chart 6). Growth slowed from 5.4% y/y in February to 3.3% y/y in March. We expect growth in this segment to have eased further in 2016 amid tighter liquidity conditions.

Total deposit growth has been weighed down by an ongoing decline in government deposits (Chart 7). Government deposits have continued to contract on lower oil revenues and high levels of government spending. According to the latest data, government deposits fell by 6.3% y/y in March. Growth in private sector deposits also remained weak during the same month, after it came in unchanged from February at 1.9% y/y.

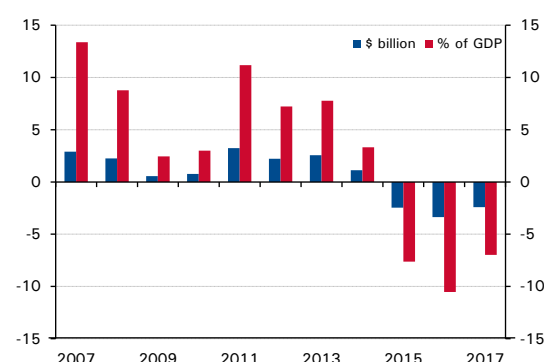
Growth in the broad M2 money supply remains weak mainly on tepid growth in quasi-money supply. This, in turn, has continued to push

Chart 4: Budget balance



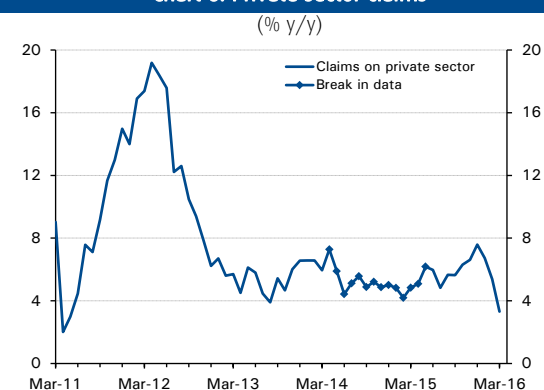
Source: Bahrain Ministry of Finance, NBK estimates

Chart 5: Current account balance



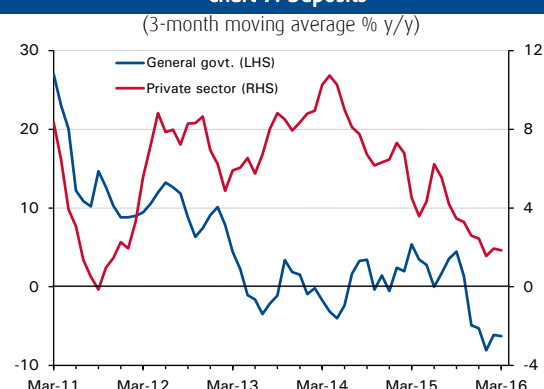
Source: Bahrain Ministry of Finance, NBK estimates

Chart 6: Private sector claims



Source: Thomson Reuters Datastream

Chart 7: Deposits



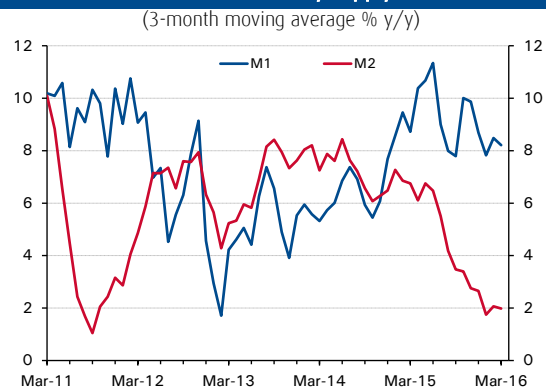
Source: Thomson Reuters Datastream

interbank rates higher. In March 2016, M2 money supply growth came in at a mere 2.0% y/y (Chart 8). Bahrain's one-month and three-month interbank rates witnessed sharp increases in 2016. As of the end of November they were up 20 basis points (bps) and 27 bps year-to-date, respectively (Chart 9).

Bahrain stock market quelled by low oil price environment

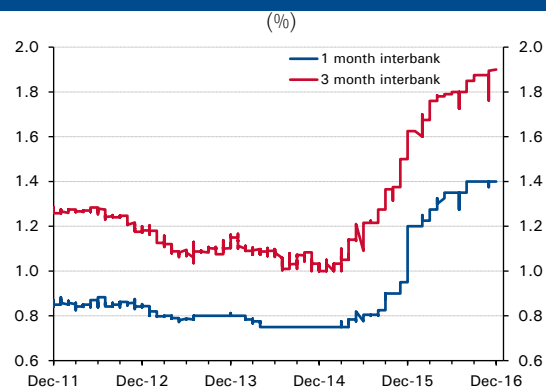
In tandem with regional markets, the Bahrain All Share Index has been weighed down by depressed global oil prices. The weak oil price outlook continues to act as a damper on investor confidence and thereby market performance (Chart 10).

Chart 8: Money supply



Source: Thomson Reuters DataStream

Chart 9: Interbank rates



Source: Thomson Reuters Datastream

Chart 10: Stock market index



Source: Thomson Reuters Datastream

Head Office

Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567, Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait
(International) Plc
Paris Branch
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Representative Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0352