Macroeconomic outlook

Bahrain: Project spending to continue to support non-oil growth in 2018

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Overview and outlook

- The non-oil economy continues to display surprising resilience and will support overall GDP growth in 2017 and 2018. This assessment is based upon GCC investments continuing to boost infrastructure projects, in turn propping up activity in the non-oil sector.
- Inflation softened in 1H17 mainly due to base effects in food inflation, as the initial impact of the subsidy cuts wore off. We expect inflation to gather pace in late 2017 and into 2018, as housing inflation remains solid, food inflation recovers and VAT is introduced in 2018.
- The budget deficit is set to remain worryingly large at 12% of GDP in 2017, narrowing slightly to 10% in 2018. Despite some fiscal consolidation, public spending levels are being kept high by wide-ranging infrastructure investment.
- Liquidity conditions remain constrained by higher interest rates and sluggish deposit growth. The latter continues to struggle with oil revenues weighed down by the low oil price environment.

Non-oil economy boosted by infrastructure projects

The economy will continue to register moderate growth of around 3% per year in 2017/18, with a resilient non-oil sector offsetting virtually stagnant output in the oil sector (Chart 1). Oil production – currently around 11% of the economy – remains depressed by capacity constraints and declining output at the onshore Bahrain field. Non-oil growth will be steady at a respectable 3-4% per year thanks to elevated investment spending, particularly benefitting the construction sector.

Key to the strength of the non-oil economy in recent quarters has been the allocation of funds under the Gulf Development Program – a pledge by Bahrain's neighbors in 2011 to provide $10bn in grants over 10 years to boost investment in infrastructure and housing. Data from the Economic Development Board (EDB) suggests that project commencements saw a step-change in 2016, and were still up 20% y/y in Q2 2017. Key areas of project activity include the aluminum sector, an airport expansion, social housing, utilities, roads, renewable energy and

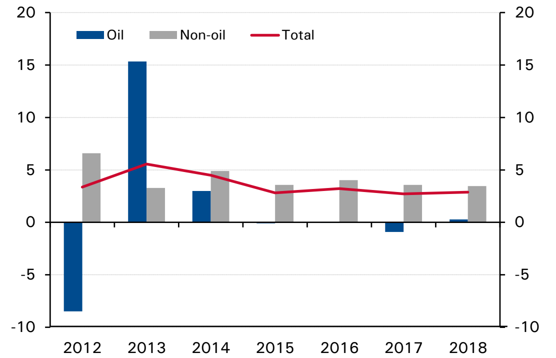
Table 1: Key economic indicators

		Year			
		2015	2016	2017f	2018f
Nominal GDP	USD bn	31	32	34	36
Real GDP	% y/y	2.8	3.2	2.7	2.9
- Oil	% y/y	-0.1	-0.1	-0.9	0.3
- Non-oil	% y/y	3.6	4.0	3.6	3.5
Inflation	% y/y	1.8	2.8	1.0	2.5
Budget balance	% of GDP	-13.0	-13.5	-12.1	-9.9

Source: Official sources, NBK estimates

Chart 1: Annual real GDP

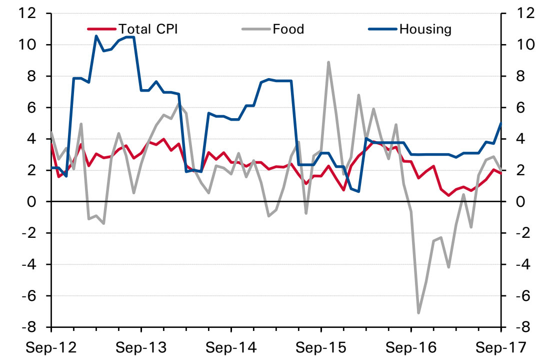
(% y/y)



Source: Information & e-Government Authority, NBK estimates

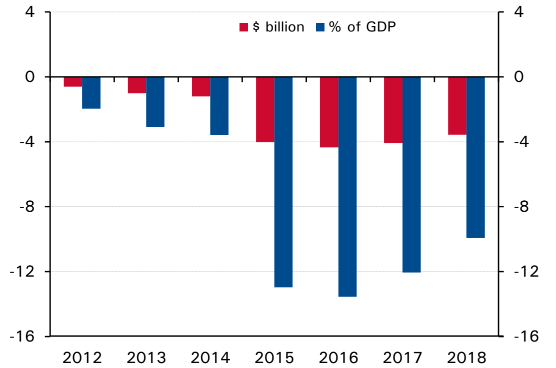
Chart 2: Consumer price inflation by sector

(% y/y)



Source: Thomson Reuters Datastream

Chart 3: Budget balance



Source: Bahrain Ministry of Finance, NBK estimates telecoms. There are also plans for a second causeway linking Bahrain and Saudi Arabia, connecting Bahrain to the GCC rail network.

The latest official figures show real GDP easing slightly from a revised 3.5% y/y in 1Q17 to 3.3% y/y in 2Q17, as oil sector activity remained in decline. However, growth in the non-oil sector remained robust at 4.3% y/y as the transportation & communication, hotel & restaurant and trade segments witnessed strong gains. This leaves Bahrain with the fastest growing non-oil economy in the Gulf, according to data so far this year.

Inflation to strengthen in late 2017 and into 2018

After softening in the first half of 2017, latest figures show consumer price inflation gaining some momentum on the back of some upward correction in food prices and stronger housing inflation. Inflation stood close to a multi-month high of 1.8% y/y in September (Chart 2). Food prices fell sharply in 4Q16 mainly due to base effects, as the initial impact of subsidy cuts wore off. But food price inflation returned to positive territory in mid-2017.

Upward price pressures from the food and housing components will likely be compounded by the introduction of a value-added tax (VAT) sometime in 2018, as well as an excise duty on tobacco and some soft drinks (possibly sooner). At 5%, the VAT is projected to add some 2% to inflation for one year. In this setting, we expect average inflation to rise from 1.0% y/y in 2017 to around 2.5% y/y in 2018.

Budget deficit to remain high in 2017 and 2018

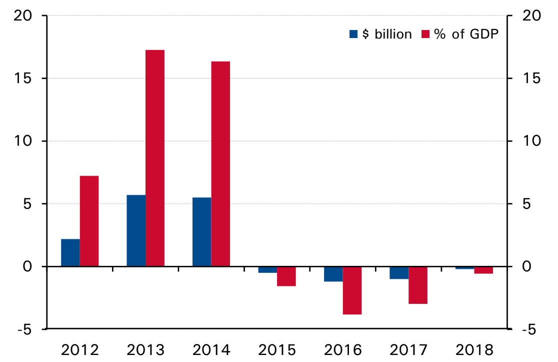
Despite some fiscal consolidation, Bahrain is still forecast to log one of the largest budget deficits in the GCC region this year. With the breakeven oil price estimated at around $120 per barrel and spending levels expected to remain counter-cyclical and fairly strong, the budget deficit is forecast to narrow to around 12% of GDP in 2017 from 13.5% last year, then to around 10% of GDP in 2018 (Chart 3).

Fiscal reform so far has been centered on rationalizing subsidies. In 2015, the government lifted subsidies on meat products and approved a new pricing system for fuel to reduce subsidy costs. In 2016, it approved the removal of subsidies on housing utilities. Next year, Bahrain is set to levy a 5% VAT on selected goods and services. Assuming that the tax will be levied by the second half of 2018, it is expected to raise around $0.3 billion (approximately 1% of GDP) in additional tax revenue per year.

After easing over the past two years, growth in overall public spending is slated to pick up in 2017. Whilst the state budget projects a 4.4% y/y rise in public spending, we expect public spending to rise at a slower pace of 1% y/y in both 2017 and 2018, mainly on the back of comparatively weak public revenues. However, support for spending is still expected from the GCC grants. According to the EDB, Bahrain is on track to witness a rise in the level of active projects this year. Major current infrastructure activities include Aluminium Bahrain's (one of the largest aluminum smelters in the world) $3 billion expansion project, a $1.1 billion airport expansion project and a gas plant project worth $355 million.

With the budget deficit expected to hover at stubbornly high levels, the nation is likely to continue to turn to domestic and international bond markets to plug its deficit. The latest issuance came in late 2017, when the government issued a $3 billion three-tranche bond, with comparatively higher premiums ranging between 5 and 8% and maturities ranging between 7 and 30 years. Although its debt is classified as below investment-grade by the three major rating agencies, investor demand for the multi-tranche bond still topped an impressive $15 billion,

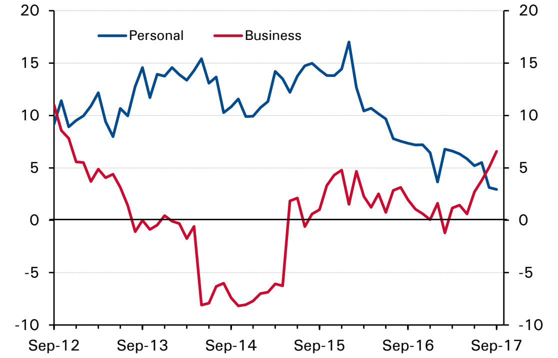
Chart 4: Current account balance



Source: Bahrain Ministry of Finance, NBK estimates

Chart 5: Credit growth

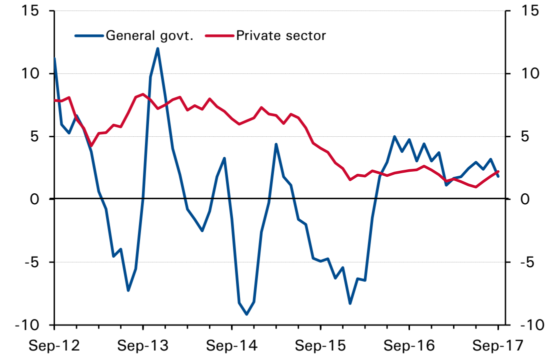
(% y/y)



Source: Bahrain Ministry of Finance, NBK estimates

Chart 6: Deposit growth

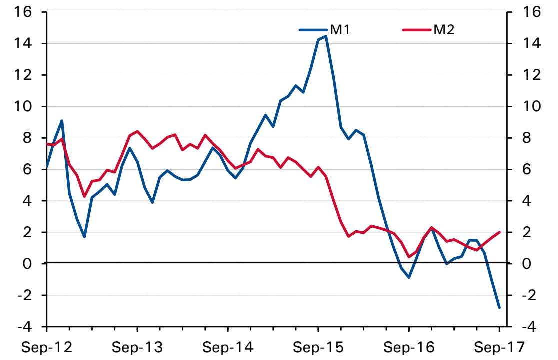
(3-month moving average % y/y)



Source: Thomson Reuters Datastream

Chart 7: Money supply growth

(3-month moving average % y/y)



Source: Thomson Reuters Datastream

thanks in part to its more attractive premiums. Including the new issue, government debt now stands about 10 percentage points higher at around 90% of forecast 2017 GDP. Assuming an average interest rate on government debt of around 5%, this implies debt interest payments of around 2-3% of GDP.

Fiscal deficit and debt concerns have led to a series of downgrades of the government's credit rating, the most recent being in July, when Moody's downgraded the long-term issuer rating by two notches, from Ba2 to B1, deeper into non-investment grade territory. However, inspite of the downgrades, yields on five-year government debt have come off the highs witnessed in early 2016 thanks partly to a recovery in oil prices. As of early October, yields on five-year government debt were at 4.5%, almost 200 basis points lower than at the start of 2016.

Lending activity continues to face some downward pressures

Despite fairly robust economic growth trends, the bank lending picture has been mixed. Growth in personal loans has been on a downward trend since early 2016 – albeit from a strong starting point – and eased to 2.9% y/y in September. But credit to businesses – weak in recent years – has picked up of late, climbing above 6% y/y in September for the first time since 2012. (Chart 5.) The acceleration was in part due to a continued recovery in credit demand in the construction sector. Modest lending growth overall partly reflects tougher funding conditions since the drop in oil prices, higher interest rates and more stringent lending rules.

Indeed, deposit growth remains tepid, especially as government deposits continue to struggle to eke out gains amid low oil revenues. (Chart 6.) Growth in government and private sector deposits came in at 1.8% y/y and 2.2% y/y, respectively, in September. Meanwhile, growth in the broad money supply (M2) remains near multi-year lows; in September it stood at 2.1% y/y. (Chart 7.)

Interest rates continue to rise, partly reflecting rises in official policy rates. Interbank rates jumped in the aftermath of 25 bps policy rate hikes in December, March and June, following similar hikes in the US federal funds rate. As of end of October, the 3-month rate was up 40 bps year-to-date (chart 8). Interbank rates are set to continue to rise on the back of at least two more rate hikes over the next year. The main policy rate now stands at 1.50%.

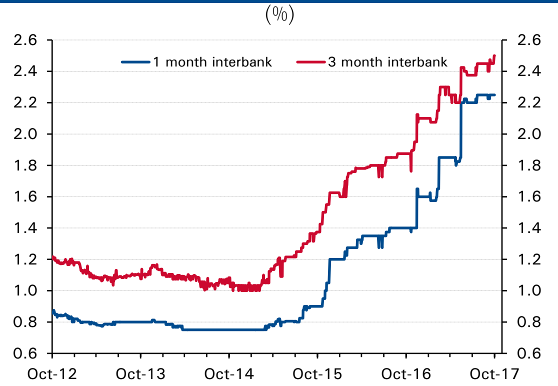
Given large fiscal and external deficits, international reserves remain under pressure. But the government has vowed to maintain the dinar's peg to the US dollar, being one of the key planks of economic and financial stability. Indeed, to ease pressure on reserves the government issued a $3 billion three-tranche bond in September. Subsequently, international reserves jumped to a more than two-year high of $3.4 billion from $1.4 billion in August. Furthermore, the government has reportedly asked for financial assistance from Saudi Arabia, the UAE and Kuwait to help replenish its reserves.

Bahrain stock market rally subsides in 2H17

Bahrain's All Share Index was bouyed by better investor sentiment in early 2017, mainly thanks to positive corporate earnings, as well as stronger economic growth. But the rally subsided in 2Q17 and 3Q17, broadly in line with regional trends. (Chart 11.)

Chart 8: Interbank rates

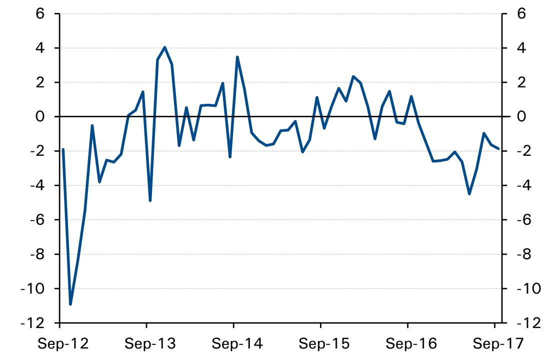
(%)



Source: Thomson Reuters DataStream

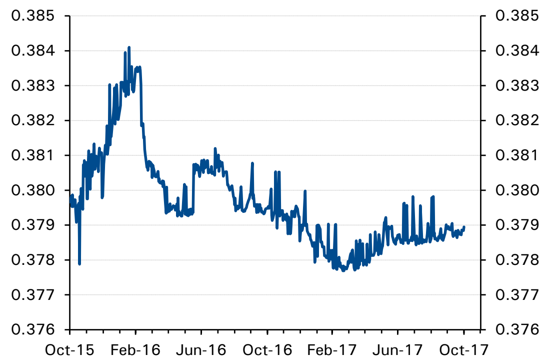
Chart 9: Total bank assets*

(% y/y)



Source: Central Bank of Bahrain; * Retail and wholesale bank assets

Chart 10: 12m forward FX rate (BHD/USD)



Source: Thomson Reuters Datastream

Chart 11: Stock market index

(all share index)

Source: Central Bank of Bahrain

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