Macroeconomic outlook

Bahrain: Non-oil growth supported by elevated project spending

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Overview and outlook

- Non-oil growth will remain resilient in 2018 and 2019, with GCC investments keeping infrastructure spending levels elevated. This will help offset continued oil sector weakness and keep overall growth close to a reasonable 3.0%.
- Inflation will rise to 2.5% in 2018 on the planned VAT as well as firmer housing and food inflation. The VAT is expected to add some 2% to the overall inflation rate.
- The budget deficit is forecast to gradually narrow, but remain high at 8-10% of GDP. Public spending levels will stay elevated to support infrastructure projects.
- Weaker foreign reserve levels are applying pressure on the currency peg to the US dollar. But we expect the government to remain committed to the peg.

Resilient non-oil sector keeps overall growth at solid levels

Growth will continue at a decent pace of around 3% in 2018 and 2019, as resilience in the non-oil economy continues to offset weakness in the oil sector. (Chart 1.) Oil sector output is set to be flat in 2018 given Bahrain's participation in the OPEC/non-OPEC oil production cut deal, now extended to the end of 2018. With an average compliance rate of only 54% so far in 2017, Bahrain could potentially cut oil output further in 2018. However, given that its share of overall production cuts is very small, it may not be pressured to more fully comply with the deal. As a result, we see Bahrain likely keeping oil output levels broadly steady. In 2019, we expect oil activity to pick up and grow by 1.4% as the production deal unwinds and on the back of a new 350,000 b/d offshore oil pipeline connecting to neighboring Saudi Arabia.

The new pipeline is part of Bahrain's plans to expand its refinery capacity. It will replace the 230,000 b/d pipeline, which the government-run Bahrain Petroleum Company was forced to temporarily close in November after an explosion the government claims was carried out by terrorists. Officials say production was restored within a couple of days.

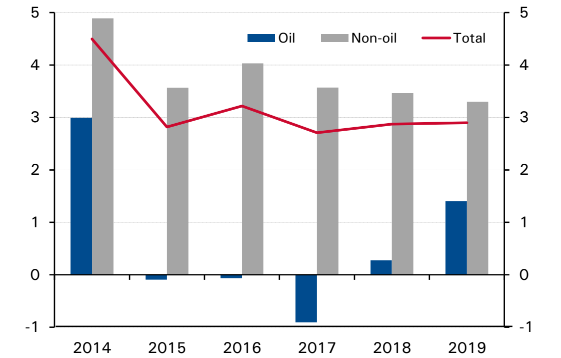
Table 1: Key economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	USD bn	32	34	36	38
Real GDP	% y/y	3.2	2.7	2.9	2.9
- Oil	% y/y	-0.1	-0.9	0.3	1.4
- Non-oil	% y/y	4.0	3.6	3.5	3.3
Inflation	% y/y	2.8	1.0	2.5	2.5
Budget balance	% of GDP	-13.5	-12.1	-9.7	-8.0

Source: Official sources, NBK estimates

Chart 1: Real GDP

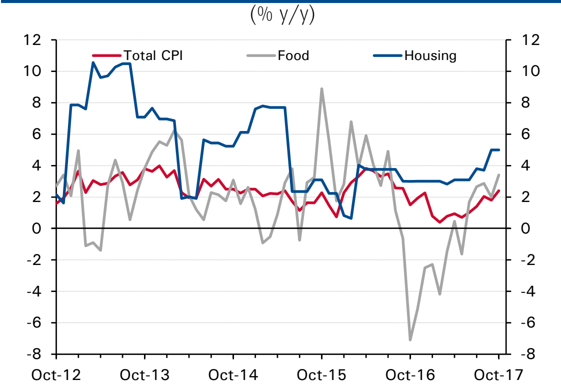
(% y/y)



Source: Information & e-Government Authority, NBK estimates

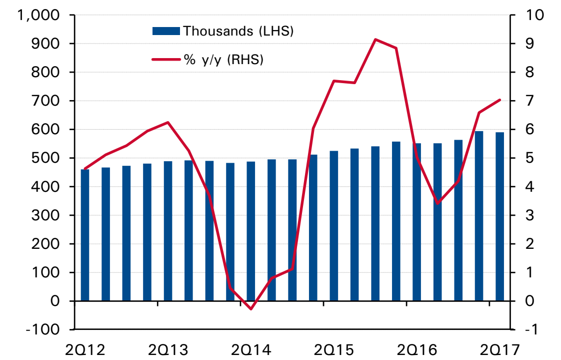
Chart 2: Consumer price inflation by sector

(% y/y)



Source: Thomson Reuters Datastream

Chart 3: Total employment



Source: Information & e-Government Authority

Bahrain produces around 200,000 b/d of oil, most of which is from the Abu Safa field shared with Saudi Arabia. Bahrain is looking into expanding output from its domestic field by tapping into unconventional gas.

To expand its energy mix, the nation is building its first liquefied natural gas (LNG) terminal. It is expected to be completed in 2019 and will allow the import of up to 0.8 billion cubic feet of gas per day for domestic use. There is talk that Saudi Aramco could link up the terminal with other GCC countries. If so, this would in effect turn Bahrain into a hub for LNG imports for the region. Bahrain is also reportedly in talks with Kuwait's PIC about setting up a petrochemicals plant.

Non-oil sector growth, meanwhile, is projected to hold between a decent 3.0 and 3.5% in 2018 and 2019, mainly on the back of elevated levels of infrastructure spending.

Over the past few quarters infrastructure spending has been bolstered by 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 MEED pointed to an impressive 20% y/y increase in executed projects in October. Key areas of project activity include the aluminium sector, an airport expansion, social housing, utilities, roads, renewable energy and telecoms. There are also plans for a second causeway linking Bahrain and Saudi Arabia, connecting Bahrain to the GCC rail network.

Non-oil growth has also been supported by healthier gains in the financial services sector, which averaged at an impressive 6.4% y/y over the first three quarters of 2017, much higher than the 3.6% y/y average recorded during the same period in 2016. Similar trends are being witnessed across most other non-oil sub-sectors, including the transportation & communications and social & personal services sectors, which were up an average 7.7% y/y and 11.6% y/y, respectively, during the same period. Growth in manufacturing activity was more muted in 2017 due to some production disruptions at the Alba aluminium smelter (one of the largest in the world). With these disruptions resolved, growth in manufacturing activity should recover in the near-to-medium term.

The pace of employment growth has been strong if volatile since 2H14, helped by solid economic growth including a pickup in activity in the construction sector. (Chart 3.) In 2Q17, employment grew by a robust 7.0% y/y, up from 6.6% y/y in the previous quarter.

Inflation to rise in 2018 before steadying in 2019

Consumer price inflation is expected to rise in 2018, mainly on the back of a planned value-added tax (VAT) as well as firmer housing and food inflation. Latest figures showed inflation gaining momentum, reaching an over one-year high of 2.4% y/y in October (Chart 2). After falling sharply in 4Q16 as the initial impact of subsidy cuts petered out, food price inflation returned to positive territory in mid-2017 and is expected to rise further on the back of planned excise duties on tobacco and soft drinks.

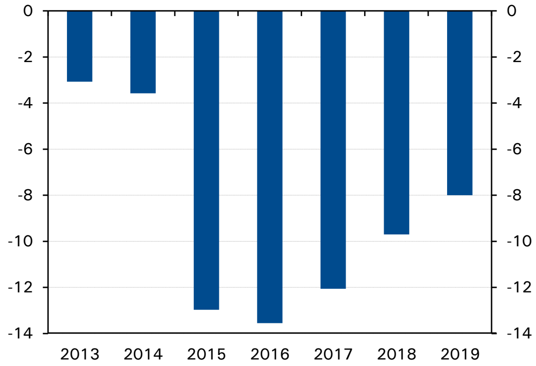
At 5%, the VAT – which we assume will be introduced in the second half of 2018 – is projected to add around 2% to the overall inflation rate for one year. We see inflation rising from around 1% in 2017 to 2.5% in 2018. We expect inflation to remain at or around that rate in 2019, given the economy's decent underlying growth performance.

Budget deficit to gradually narrow but remain very high

The budget deficit is expected to gradually narrow given ongoing fiscal consolidation efforts as well as some improvement in revenues. But the deficit will remain worryingly large at around 9.7% and 8.0% of GDP in

Chart 4: Budget balance

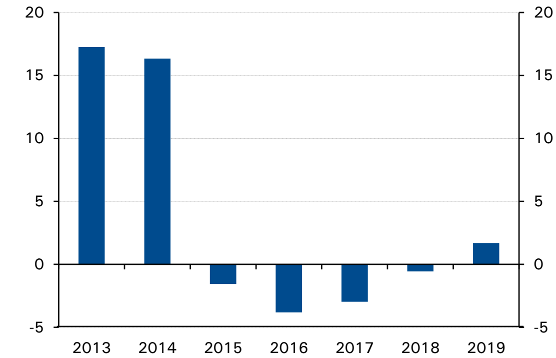
(% of GDP)



Source: Bahrain Ministry of Finance, NBK estimates

Chart 5: Current account balance

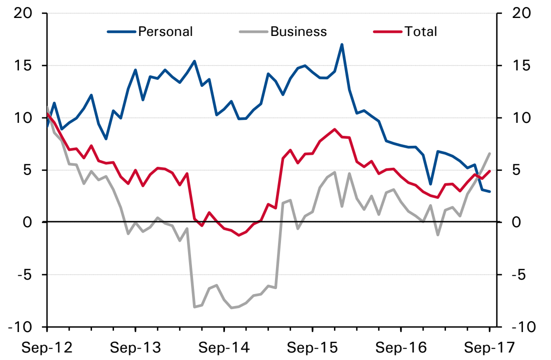
(% of GDP)



Source: Central Bank of Bahrain, NBK estimates

Chart 6: Credit growth

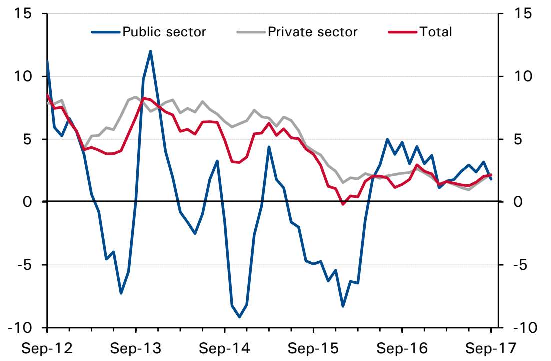
(% y/y)



Source: Central Bank of Bahrain

Chart 7: Deposit growth

(3-month moving average % y/y)



Source: Central Bank of Bahrain

2018 and 2019, respectively (Chart 4).

Fiscal reform has so far 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. But unlike other GCC countries, government spending in Bahrain is virtually unchanged from 2014 levels, highlighting the challenges in cutting areas such as salaries and subsidies. The VAT should raise around $0.3 billion (approximately 1% of GDP) in additional tax revenue per year.

Following a 4.4% y/y estimated rise in public spending in 2017, the state budget pencils in a 2.9% y/y decline for 2018, on the back of a drop in current expenditures. Capex growth is expected to be supported by GCC grants and come in at around 2-3% y/y in 2018 and 2019. With the cumulative sum of GCC grant allocations currently standing at less than $1.3 billion year-to-date, according to the Economic Development Board, active projects are projected to continue to grow at healthy rates. Major current projects include Alba's $3 billion expansion project, a $1.1 billion airport expansion and a gas plant project worth $355 million.

With the budget deficit hovering at high levels, the government will continue to look to domestic and international bond markets to plug the shortfall. The latest issue came in late 2017 with a $3 billion three-tranche bond, at comparatively high premiums of 5-8% and maturities ranging between 7-30 years. Assuming an average interest rate on government debt of around 5%, this implies debt interest payments of around 2-3% of GDP. Government debt now stands about 10% points higher at around 90% of 2017 GDP. This figure is expected to rise to above 100% of GDP by 2019.

Fiscal deficit and debt concerns have led to a series of downgrades of the government's credit rating, the most recent being in early December, when S&P downgraded the long-term issuer rating by one notch from BB- to B+, placing it deeper in non-investment grade territory. However, despite 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 end of November, yields on five-year government debt were at 4.9%, around 50 basis points lower than at the start of 2016.

Business lending gains traction after prolonged period of weakness

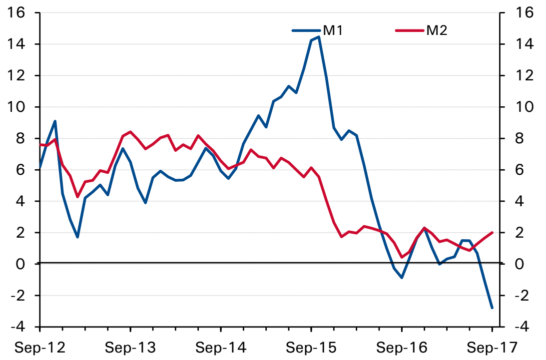
Growth in credit to businesses is expected to offset the continued weakness in personal loans growth, thanks to an ongoing pickup in lending activity in the construction sector. Growth in personal loans has been on a downward trend since early 2016 – albeit from a strong starting point – easing to 2.9% y/y in September. (Chart 6.) However, 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, thanks in part to a continued recovery in credit to the construction sector.

Deposit growth is forecast to remain limited, with government deposits capped by the low oil price environment. Growth in government and private sector deposits stood at 1.8% y/y and 2.2% y/y, respectively, in September. (Chart 7.) With deposit growth muted, both the narrower measure of the money supply (M1) and the broader measure (M2) continue to struggle to eke out gains. In September, M1 declined 3.5% y/y and M2 growth stood near a multi-year low of 2.1% y/y. (Chart 8.)

Interest rates are expected to continue to rise, reflecting in part rises in official policy rates. The policy rate, currently at 1.75%, is expected to increase by a further 50 bps in 2018 and in 2019, in tandem with hikes in the US federal funds rate. Interbank rates jumped following the policy

Chart 8: Money supply growth

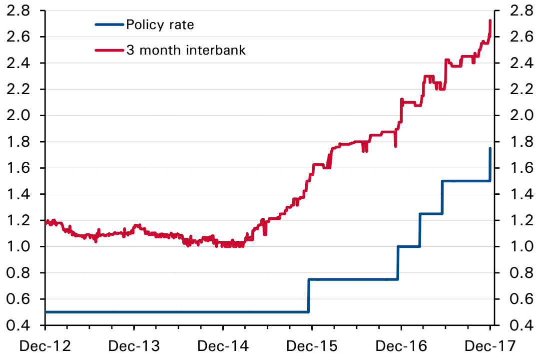
(3-month moving average % y/y)



Source: Thomson Reuters Datastream

Chart 9: Interest rates

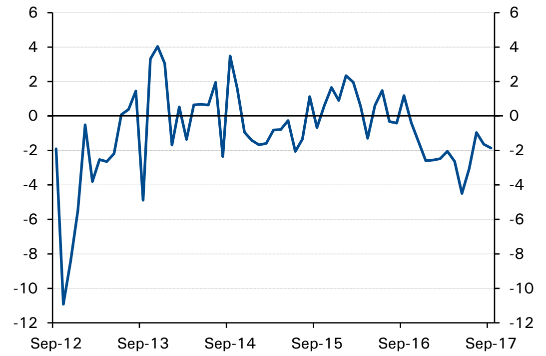
(%)



Source: Thomson Reuters DataStream

Chart 10: Total bank assets*

(% y/y)



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

Chart 11: 12m forward FX rate

(BHD per US$)

Source: Thomson Reuters Datastream

rate hikes of the past year – in March, June and December. As of mid-December, the 3-month rate was up 63 bps year-to-date (chart 9). Whilst lending activity may come under some pressure from higher rates, the underlying strength in lending to the business sector is expected to offset some of that downward pressure and support overall credit growth.

Total commercial bank assets remained in decline in September, falling at a faster pace of 1.9% y/y mainly on the back of a continued decline in wholesale bank assets (chart 10). These assets, which make up around 60% of total bank assets (as of 2016), fell by 5% y/y. In contrast, asset growth among the more domestically-centered retail banks rose for the third straight month, but still remained fairly subdued at 2.3% y/y.

Reserves and currency to remain under pressure

Given large fiscal and external deficits (charts 4 and 5), international reserves remain under pressure. The 12-month forward foreign exchange rate recently hit a one-year high (implying a new low against the US dollar), 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. (Chart 11.) Indeed, the proceeds from the $3 billion bond in September helped the central bank's international reserves jump 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. A positive response to the request would improve the government's immediate financial position, though the prospect of such a 'bailout' may still not be viewed favorably by investors.

Bahrain stock market rally subsides in 2017

Bahrain's All Share Index moved lower through most of 2017 broadly in line with regional trends, though as of early December was actually up 3.6% year-to-date, outperforming other GCC markets. (Chart 12.) The recent climb in oil prices to above $60/bbl helped by the extension to the oil production cut deal had little visible impact, limited perhaps by continued moderate economic growth in the Gulf region, as well as geopolitical concerns including the fallout from the Qatar crisis.

Chart 12: Stock market index

(all share index)

Source: Thomson Reuters Datastream

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