Bahrain

Non-oil growth is expected to remain above 3% to 2021, with GCC investments supporting elevated infrastructure spending. This will offset continued oil sector weakness and keep headline growth at 2-3%. Inflation will moderate in 2019 as the VAT effect wears off, before rising next year. The budget deficit is projected to gradually narrow in line with reforms outlined in the Fiscal Balance Program. Adhering to this program will improve the external current account position and lessen the pressure on Bahrain's foreign reserves.

Infrastructure spending to remain supportive of growth

Bahrain's economy is projected to continue to grow at a decent 2.5-3% over 2019-2021. (Chart 1.) While real oil GDP growth is constrained by Bahrain's participation in the recently-extended OPEC+ oil production cut agreement, the non-oil economy is expected to hold firm at around 3% over the forecast period thanks to high levels of infrastructure spending and an increase in manufacturing output. The additional spending will likely be financed, at least in part, by the $10bn GCC support package announced in 4Q18, while manufacturing activity will be boosted by the $3bn expansion of the Alba aluminium smelter. This is one of the largest in the world, producing more than 2% of global output and 15% of Bahrain's GDP.

Consumer price inflation remains soft despite VAT levy

Headline inflation has so far surprised on the downside, with continued softness occurring across most subcomponents, including food. This softness can be attributed to a stronger US dollar against Bahrain's main trade partners' currencies, which has brought down imported inflation, and more than offset recent price rises in housing and in the retail sector more broadly following the implementation of the 5% VAT in January. (Chart 2.) We expect inflation to moderate in 2019 as the VAT effect fades, before picking up speed over 2020-21 on increasing demand. A potentially dovish Fed may also put downward pressure on the US dollar.

Fiscal position to gradually improve in-line with FBP

The fiscal deficit is projected to gradually narrow, as outlined in the kingdom's Fiscal Balance Program (FBP). A series of reforms were laid out in 4Q18 to balance the budget by 2022 from the current deficit of around 8% of GDP and reduce the public debt from the current 90% of GDP to 82% of GDP. (Chart 3.) Of particular note is the introduction of VAT in January. However, in its recent budget report, Bahrain signaled that it may take longer to balance the budget.

In a further bid to ease the pressure on public finances and spur foreign investment inflows, Bahrain has reportedly approved a law that would allow foreign companies to set up independent subsidiaries and for these subsidiaries to also own 100% of domestic oil and natural gas extraction projects.

Business lending holding firm

Growth in credit to businesses continues to hold firm, underpinned by robust lending activity in the construction and manufacturing sectors. (Chart 4.) Private sector deposit growth is catching up, likely thanks to the aid installments Bahrain has received so far, which were disbursed as loans, deposits and grants. As of 1H19, the kingdom has received almost half of the $10bn support package; another $2.3bn is due this year.

Foreign reserves remain under pressure

Given large fiscal and current account deficits, international reserves remain under pressure. Going forward, a gradual improvement in both the fiscal and current account positions and the $10bn GCC financial support package should offer foreign reserves some reprieve. Indeed, as of April, reserves were at $2.4bn (1.5 months of imports), up from $1.8bn at the start of the year and higher than the $1.7bn average in 2018. (Chart 5.)

Economic outlook hinges on FBP reforms

Soon after the announcement of the FBP, the kingdom's sovereign wealth fund issued a $600 million sukuk priced at 5.625%, 60 bps lower than what was expected. Bahrain is now in discussions to issue its first international bond since last year. However, the kingdom's economic outlook hinges on its execution of the FBP. Any further deviation from the balanced budget target would adversely affect investors' confidence, the level of reserves (which remain low by international standards), and the rate at which they can borrow in the future.

On the other hand, Bahrain's pledge to monetize newly-discovered hydrocarbon reserves of up to 80 billion barrels of tight shale oil and around 20 trillion cubic feet of tight natural gas within the next five years will improve its outlook.

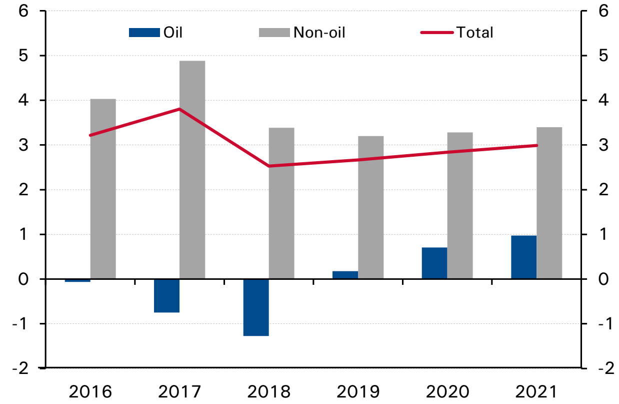
Table 1: Key economic indicators

		2017	2018	2019f	2020f	2021f
Real GDP	% y/y	3.8	2.5	2.7	2.8	3.0
- Oil	% y/y	-0.7	-1.3	0.2	0.7	1.0
- Non-oil	% y/y	4.9	3.4	3.2	3.3	3.4
Inflation	% y/y	1.4	2.1	1.5	2.0	2.5
Budget balance	% of GDP	-10.0	-8.3	-6.4	-4.8	-3.7
Current account	% of GDP	-4.5	-5.9	-4.4	-4.1	-3.8

Source: Official sources, NBK estimates

Chart 1: Real GDP

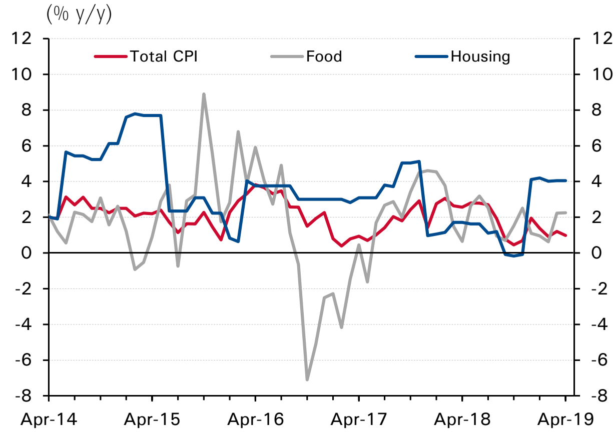
(% y/y)



Source: Information & e-government Authority, NBK estimates

Chart 2: Inflation

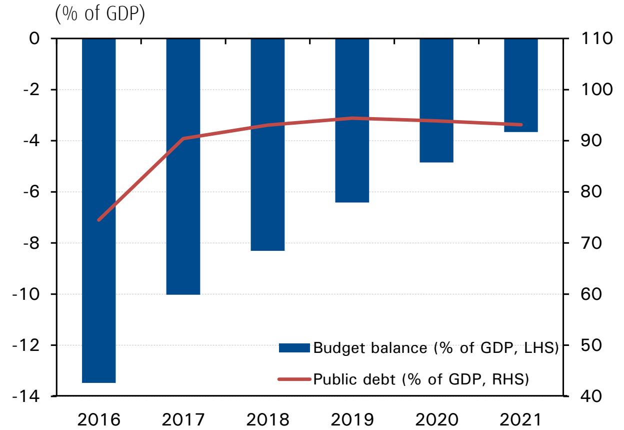
(% y/y)



Source: Refinitiv

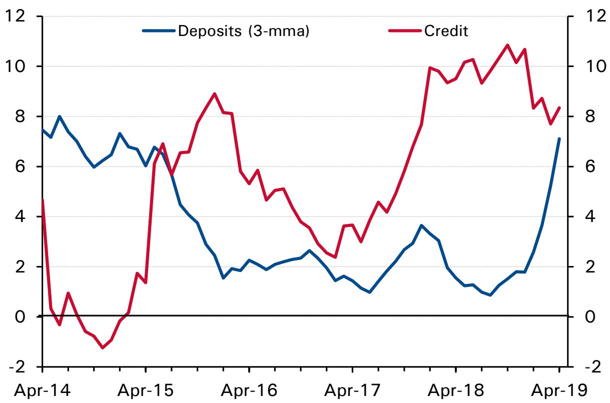
Chart 3: Budget balance & public debt

(% of GDP)



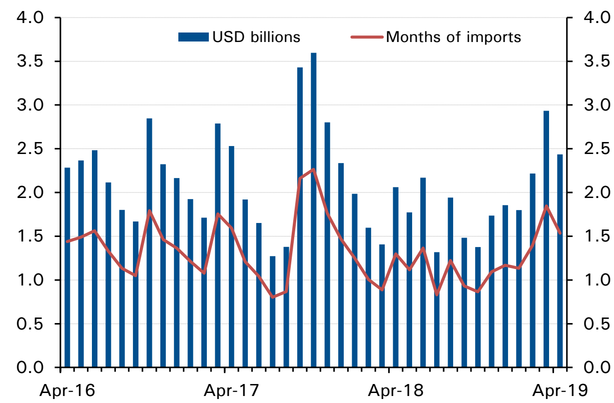
Source: Bahrain Ministry of Finance/ IIF / NBK estimates

Chart 4: Private credit & deposit growth



Source: Central Bank of Bahrain

Chart 5: Central bank foreign reserves



Source: Central Bank of Bahrain