Economic Update

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Bahrain outlook

Infrastructure investments drive growth amid an improving fiscal picture

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Highlights

- **Real GDP growth is expected to hold at around a healthy 3% over 2019-2020, supported by infrastructure spending, some of which may be financed by the recently announced GCC aid package.**
- **Inflation is expected to rise to 3.5% (avg.) in 2019, on the back of the introduction of the 5% VAT, before subsiding to around 2.0% in 2020, as the initial impact of the VAT ebbs away and as food and housing cost rises remain moderate.**
- **The budget deficit is forecast to gradually narrow from an estimated 8% of GDP in 2018 to around 4.6% of GDP by the end of 2020, on greater fiscal prudence and higher non-oil revenues.**
- **Credit growth is projected to continue its impressive recovery, mainly driven by heightened activity in the construction sector.**

Infrastructure spending supporting economic growth

Bahrain's economy is expected to continue being driven by the non-oil sector and underpinned by high levels of infrastructure spending, some of which will be financed by the recently announced $10bn GCC support package of loans, deposits and grants. These will be disbursed in installments over the next five years and may help finance major infrastructure projects such as the $1bn Bahrain International Airport expansion project, which will increase passenger capacity to support the tourism sector, the Bahrain national oil company modernization project and the Aluminum Bahrain (Alba) expansion project. These should yield both growth and employment dividends, offsetting some of the negative impact on domestic demand of the fiscal austerity measures.

By way of background, concerns about the kingdom's high debt level and ability to meet its financial obligations heightened last June amid a sell-off of government bonds, higher risk premiums and increased pressure on the Bahraini dinar in the foreign exchange market. As Bahrain faced the prospect of losing access to funding in the face of prohibitively high borrowing costs, Saudi Arabia, Kuwait and the UAE announced their intention to offer the kingdom an integrated financial support package, which helped to calm jittery markets.

As part of its plans to expand the oil sector, Bahrain and Saudi Arabia inaugurated a new 350,000 b/d offshore oil pipeline connecting the two kingdoms. The pipeline replaces the existing, ageing 230,000 b/d pipeline that supplies imported crude to the kingdom's 267,000 b/d Sitra refinery. The refinery's capacity is also being expanded, to 400,000 b/d, which should come on line by 2022.

Oil sector activity will also benefit from the creation in 2018 of a $1bn energy fund, with capital from local and international investors. This vehicle will invest in the country's oil and gas sectors, including its recently discovered tight oil and gas deposits. Real oil GDP could, therefore, expand by 1.4% and 1.6% in 2019 and 2020, respectively. Overall GDP growth should range around 3% in 2019-2020. (Chart 1.)

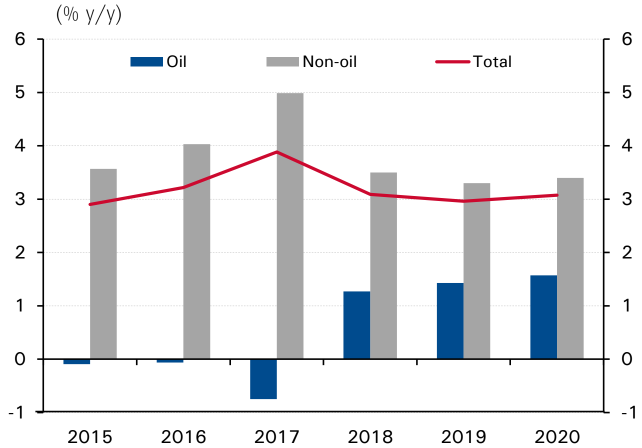
Table 1: Key economic indicators

		2017	2018e	2019f	2020f
Nominal GDP	USD bn	35	37	40	39
Real GDP	% y/y	3.9	3.1	3.0	3.1
- Oil	% y/y	-0.7	1.3	1.4	1.6
- Non-oil	% y/y	5.0	3.5	3.3	3.4
Inflation	% y/y	1.4	2.5	3.5	2.0
Budget balance	% of GDP	-11.6	-8.0	-5.9	-4.6

Source: Official sources, NBK estimates

Chart 1: Real GDP

(% y/y)



Source: Information & e-government Authority, NBK estimates

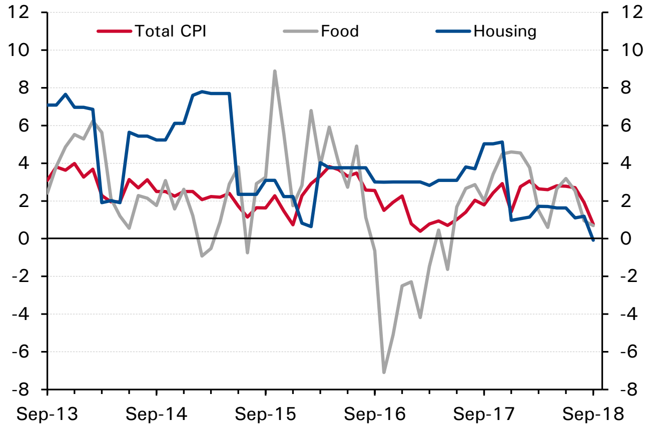
Furthermore, financial services, the second largest sector of the economy after oil, is expected to benefit from government initiatives and reforms, especially in the area of financial technology innovation. The cost of doing business in the sector is also low by regional standards—reportedly up to 40% lower than in Dubai—so the kingdom is well placed competitively. Real non-oil growth is forecast at 3.4% y/y on average during the next two years.

Inflation to rise in 2019 on VAT introduction

Consumer price inflation is expected to rise from an estimated 2.5% in 2018 to 3.5% in 2019. This is mainly due to the rollout next year of the value-added tax (VAT). After that, inflation should subside to 2.0% in 2020 as the initial impact of the VAT ebbs away. Food price and housing cost inflation is expected to remain moderate. (Chart 2.)

Chart 2: Consumer price inflation by sector

(% y/y)



Source: Thomson Reuters Datastream

Budget deficit to gradually narrow on fiscal prudence and higher non-oil revenue

The budget deficit is expected to gradually narrow, in-line with the kingdom's 'Fiscal Balance Program' (FBP), a series of reforms aimed at reducing by 2022 the fiscal deficit from the current estimate of 8% of GDP to zero and the public debt from around 90% of GDP to 82% of GDP.

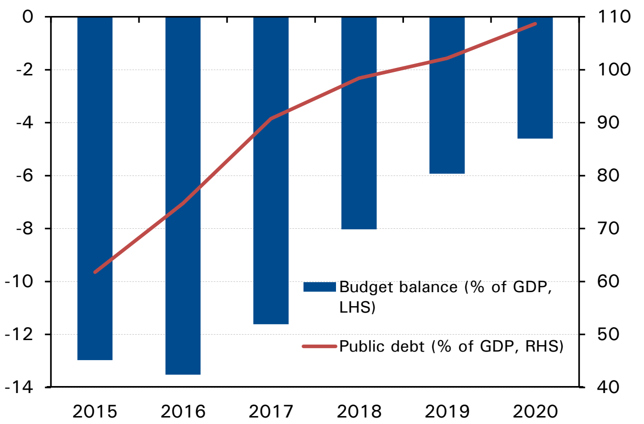
The FBP outlines six major initiatives to help generate BHD 800mn ($2.1bn) in savings over the next five years: i) reducing government operational expenditures; ii) introducing a voluntary retirement scheme for government authorities; iii) balancing the Electricity and Water Authority's expenditures and revenues by 2022 by adjusting tariffs; iv) streamlining the distribution of cash subsidies to low-to-middle income citizens; v) improving the efficiency of government spending; and vi) simplifying state processes, strengthening accountability within government departments and increasing non-oil revenues.

The program was launched immediately after the GCC announced its financial support package, so the provision of financial assistance appears to be conditional on fiscal consolidation. This should help expedite some of the previously delayed fiscal and economic reforms that had been proposed as part of the kingdom's Economic Vision 2030. Indeed, just days after the two announcements, the Bahraini legislature approved both the draft 5% VAT law and the amended pension law.

The sign-off on the 5% VAT bill paved the way for the tax to be levied for the first time at the start of 2019. The amended pension law should lead to the paring back of pension bonuses of government ministers, members of parliament and municipal councilors.

The FBP aims to increase non-oil revenues by 2-2.5% of GDP, not least through the introduction of the VAT. However, the VAT is not expected to generate more than BHD 188.5mn ($500mn) or around 1% of GDP, so the authorities will need to find other income sources to increase non-oil revenue. Nevertheless, the budget deficit should narrow, to 5.9% of GDP in 2019 and 4.6% of GDP in 2020. (Chart 3.)

Chart 3 : Budget balance & public debt



Source: Bahrain Ministry of Finance, IIF, NBK estimates

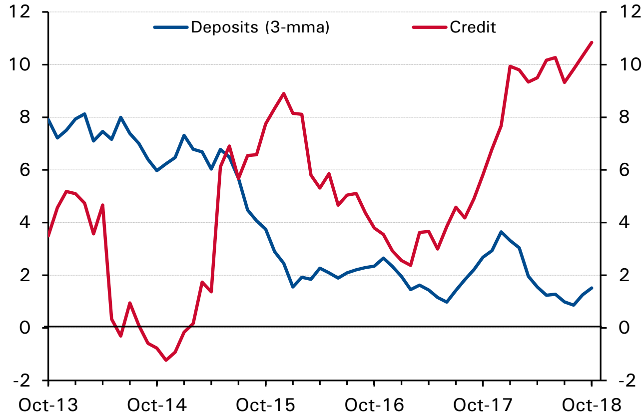
Robust private credit growth driven by business lending

Business credit has been growing strongly, at a rate of 12.3% y/y, in the year to October—much higher than the 4.1% y/y average growth that was logged in 2017. Momentum is mainly driven by increased lending activity in the construction and manufacturing sectors. Total private sector credit growth in turn, which includes personal lending, came in at more-than-a-six-year high of 10.8% y/y in October. (Chart 4.)

Private sector deposit growth has lagged credit growth, however. Having bottomed out in August, growth reached 1.5% y/y in October. (See chart 4.) Weak deposit growth has contributed to the decline in the money supply (M1) observed during most of 2018. Growth in M2 has trended downwards.

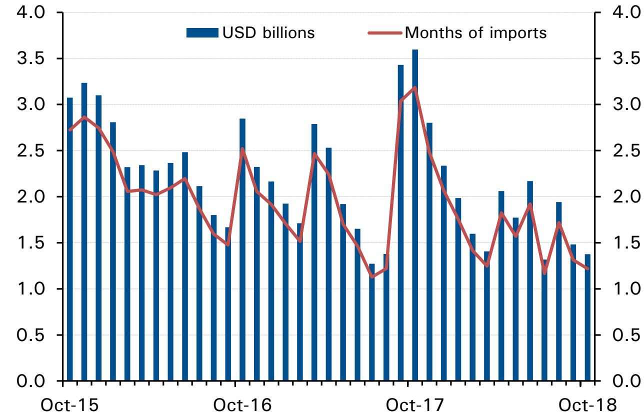
Chart 4: Private credit & deposit growth

(% y/y)



Source: Central Bank of Bahrain

Chart 5: Central bank foreign reserves



Source: Central Bank of Bahrain

Foreign reserves under pressure from large twin deficits

Large fiscal and external current account deficits continue to put downward pressure on international reserves. The current account deficit is currently estimated at around 1% of GDP for 2018. It is projected to remain in deficit in 2019, before witnessing a slight surplus in 2020 on the back of some improvement in non-oil activity. The kingdom's reserves slid from $1.5bn in September to $1.4bn in October (1.2 months of imports). (Chart 5.) Bahrain is set to receive up to $2bn of the $10bn GCC financial support package by the end of this year, which should help replenish some of its reserves and offer some fiscal relief.

At $10bn, the support package could cover most of the kingdom's external debt due to mature between 4Q18 and 2022, which is estimated at around $12bn. The government is, however, likely to continue to tap domestic and international bond markets to help plug the deficit. While the kingdom's sovereign rating is classified as below investment-grade by the major rating agencies S&P (B+), Moody's (B2) and Fitch (BB-), access to less costlier finance has improved in the months since the GCC financial package was announced as investors appear a little more confident about Bahrain's economic outlook. Indeed, Moody's recently upgraded its outlook on Bahrain from negative to stable on the back of the support package.

Having said that, borrowing costs are on the rise as the authorities follow the US Fed's lead. Bahrain raised its key policy rate by 25 bps to 2.75% in December. Interbank rates have also been rising on the back of the policy rate hikes over the past year. As of mid December, the 3-month rate was up 105 bps year-to-date.

Though risks remain, Bahrain's economic outlook is more encouraging

While the reforms proposed in the FBP and more broadly in the Bahrain Economic Vision 2030 are ambitious and socio-politically sensitive, indications are that the authorities are committed to forge ahead with the announced reforms. With disbursements of the GCC aid package likely to be tied to fiscal reforms and an improvement in the kingdom's financial metrics, there is less likelihood of backsliding on its reform efforts. Serious and front-loaded progress on these reforms will send positive signals to investors. The pace of reform implementation will need to be carefully managed, however, so as not to adversely affect domestic demand.

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