Macroeconomic outlook

Bahrain: Non-oil sector continues to showcase resilience

Overview and outlook

- Resilience in non-oil economy expected to continue to support overall GDP growth in 2017.
- GCC investments set to catalyze non-oil sector activity, particularly in the construction sector.
- Inflation to remain subdued in the near-to-medium term.
- The budget deficit is poised to remain large at around 15% of GDP in 2017 on counter-cyclical spending levels.
- Liquidity conditions in the banking sector are forecast to improve as deposit growth gradually recovers.

Real economy to be supported by healthy gains in the non-oil sector

Economic growth is projected to continue to gradually edge higher in 2017 thanks to a healthy pace of non-oil sector growth. Growth in real GDP is expected to rise from an estimated 3.0% in 2017 to 3.4% in 2018 (Chart 1). Whilst growth in real oil GDP is poised to come in unchanged in 2017 on the back of steady oil production levels, non-oil sector growth is forecast to continue to gather pace amid increases in investment levels, particularly in the construction sector.

According to the latest data from Bahrain’s Economic Development Board (EDB), real GDP growth accelerated to 3.9% year-on-year (y/y) in the third quarter of 2016 from 2.5% y/y in the previous quarter, as the non-oil sector maintained its healthy growth pace. (Chart 2) Growth in real non-oil GDP jumped from 3.6% y/y in 2Q16 to 4.7% y/y in 3Q16, its highest growth rate in over a year. In contrast, growth in real oil activity remained weaker at a mere 0.8% y/y during the same period.

Bahrain’s non-oil economy is envisaged to remain the main driver of growth in 2017, thanks to the faster than expected utilization of GCC grants, which has in turn helped prop up investment. The GCC pledged $10 billion in investment over ten years and Bahrain has allocated these funds to infrastructure and housing developments.

Inflation set to remain subdued in 2017 before picking up in 2018

Inflation in the consumer price index (CPI) decelerated at the start of 2017 on declining food prices and softer housing inflation. (Chart 3).

Table 1: Key economic indicators

<table>
<thead>
<tr>
<th>Year</th>
<th>2015</th>
<th>2016e</th>
<th>2017f</th>
<th>2018f</th>
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</thead>
<tbody>
<tr>
<td>Nominal GDP (USD bn)</td>
<td>32</td>
<td>32</td>
<td>35</td>
<td>38</td>
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<tr>
<td>Real GDP (y/y)</td>
<td>2.8</td>
<td>2.9</td>
<td>3.4</td>
<td>4.2</td>
</tr>
<tr>
<td>- Oil (y/y)</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>2.9</td>
</tr>
<tr>
<td>- Non-oil (y/y)</td>
<td>3.6</td>
<td>3.6</td>
<td>4.2</td>
<td>4.5</td>
</tr>
<tr>
<td>Inflation (y/y)</td>
<td>1.8</td>
<td>2.8</td>
<td>2.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Budget balance (y of GDP)</td>
<td>-16.1</td>
<td>-18.0</td>
<td>-15.0</td>
<td>-12.6</td>
</tr>
</tbody>
</table>

Source: Official sources, NBK estimates
February, it logged in a multi-month low of 0.4% y/y as food prices fell by 4.2% y/y and housing inflation steadied at 3.0% y/y and after the Central Bank of Bahrain (CBB) hiked its key policy rate by 25 basis points (bps) in December.

We expect inflation to edge up, albeit modestly, in the near-to-medium term as rising activity in the non-oil sector partly offset any further hikes in the key policy rate. As a result, we expect the annual average to only slightly come off the 2.8% annual average seen in 2016 to settle at or around 2.5% in 2017. In 2018, headline inflation is expected to see greater upward pressures, on the back of more solid gains in growth and especially if Bahrain becomes one of the first GCC nations to introduce a 5% value-added tax (VAT).

Budget deficit to narrow but remain high in 2017

Despite sizable fiscal consolidation measures, Bahrain is still forecast to log in one of the largest budget deficits in the GCC region. With the breakeven oil price estimated at around $120 per barrel and spending levels expected to remain fairly strong, the budget deficit is forecast to narrow slightly from roughly 18% of GDP in 2016 to around 15% of GDP in 2018 (Chart 4).

Bahrain remains determined to exercise more prudent fiscal policy measures in line with the IMF’s recommendations, in an effort to lower its public deficit and in turn make it more attractive in the eyes of investors. Fiscal reform has been centered on rationalizing subsidies. Meanwhile, public spending on infrastructure and development projects has remained untouched, as it is seen as an important driver of non-oil sector activity and a counterweight to the ongoing weakness in the oil economy.

There may be more subsidy cuts to come, but imposing further significant cuts in public expenditure levels remains a challenge, especially since the two politically sensitive areas of spending, namely subsidies and public wages, make up two-thirds of government spending.

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. In 2015, Bahrain issued a total of $6 billion in bonds, $1.5 billion of which was in the international market. In 2016, the government issued $3.4 billion in bonds, $2 billion of which was issued internationally. As a result, public debt has edged higher and currently stands between 70-80% of GDP.

Fiscal deficit and debt concerns have led to a series of downgrades of the nation’s long-term credit rating. In June 2016, Fitch Ratings, in line with the other two major rating agencies, downgraded Bahrain’s long-term credit rating to below investment grade. In early December that same year, S&P lowered Bahrain’s sovereign credit rating from BB to BB-, deeper into non-investment grade territory. The downgrades will make it more difficult for the government to negotiate better bond deals.

Lending activity to be supported by strength in non-oil sector

Growth in private sector borrowing slowed considerably in recent months. Data from the CBB showed private sector claims falling in January for the first time in years. The 1.5% y/y decline could be attributed to the 25 bps hike in the key policy rate that came into effect just the month before, after the US Fed hiked its policy rate by the same amount during the same period. (Chart 6) Whilst growth in private sector claims is expected to remain subdued in the first half of 2017, especially after the CBB took the decision to hike rates again by 25 bps in tandem with the US Fed in

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March, we expect growth in these claims to recover soon after, as higher oil prices act as a boon to consumer confidence and as credit demand in the non-oil sector, particularly in the construction sector, picks up. Total deposit growth is slowly but surely gathering pace as higher oil revenues help prop up government deposit growth (Chart 7.) This should help ease liquidity constraints in the banking system. According to the latest data, growth in government deposits rose from 3.0% y/y in December to 3.7% y/y in January. Growth in private sector deposits is also witnessing a recovery, albeit a tepid one. In January it came in at 2.0% y/y, still far lower than the rates seen prior to mid-2015.

Growth in the broad money supply (M2) continues to struggle to eke out healthy gains. In January it slipped to 1.9% y/y from 2.3% y/y in the previous month. The tepid growth in money supply has subsequently continued to push interbank rates to multi-year highs (Chart 8).

Bahrain’s one-month and three-month interbank rates continue to trend sharply upwards. Both leapt in the aftermath of the 25 bps policy rate hikes in December and in March, following similar hikes in the US federal funds rate. (Chart 10.) As of mid-April, they were up 20 bps and 25 bps year-to-date (ytd), respectively (Chart 9). With liquidity constraints set to ease in the near-to-medium term, we should see interbank rates gradually come off their multi-year highs.

Bank assets continue to undergo sluggish growth. Total commercial bank assets remained in decline in January after falling by 2.6% y/y mainly due to the ongoing decline in wholesale bank assets. (Charts 11 and 12.) Wholesale bank assets, which make up around 60% of total banks assets (as of 2016), contracted by 5.2% y/y during the same period. Asset growth among the more domestically-centered retail banks has also remained fairly subdued. In January it stood at 1.0% y/y.

Bahrain stock market rallied in the first quarter of 2017

Bahrain’s All Share Index was bouyed by better investor sentiment in early 2017, mainly thanks to positive corporate earnings. As a result, the market was up by 11%. (Chart 13.)

Whilst business optimism remains susceptible to internal political concerns, these concerns have largely subsided as reflected in the main credit default swap (CDS). The CDS, a good bellwether of the market’s perception of a country’s level of risk, has been trending lower. In mid-April, the CDS on five-year Bahrain debt was at 217 bps, considerably lower than the 353 bps around the same period last year. (Chart 14.)