Economic Update

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Bahrain outlook

Economy remains supported by resilience in non-oil growth

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Highlights

- **Non-oil growth is holding up well on the back of elevated levels of infrastructure spending; we expect growth to average 4.6% over 2018-2019.**
- **Inflation is expected to be higher in 2018 and average around 2.5%, amid upward pressures from the housing and food components.**
- **The budget deficit is forecast to gradually narrow, but remain high at 8-9% of GDP; public spending levels will stay high to support infrastructure projects.**
- **Credit growth is recovering mainly on the back of heightened business credit.**

Elevated spending on infrastructure underpins economic expansion

Thanks to continued output gains in the non-oil sector, real GDP growth accelerated in 2017 to 3.9% from 3.2% in 2016. The services sector—financial and social & personal services especially—and the construction sectors were major contributors to the non-oil sector's impressive growth of 5.0% last year, the highest in the GCC. (Chart 1.)

We expect non-oil growth to average 4.6% over 2018-19, underpinned by government infrastructure spending on a record $8 billion worth of projects—the kingdom's largest ever pipeline. Capital spending spans a variety of projects in transportation, water and power, and housing sectors.

Such spending has been bolstered over the past few quarters by the allocation of funds under the Gulf Development Program—a pledge by Bahrain's neighbors in 2011 to provide $10 billion in grants over 10 years to boost investment in infrastructure and housing.

Burgeoning non-oil activity also helped offset some of the contraction in the oil sector due to the OPEC+ production cut agreement, in which Bahrain is a participant. Oil sector output is expected to fall slightly in 2018 as Bahrain adheres to its OPEC+ quota obligations and as oil field output is affected by lingering maintenance issues.

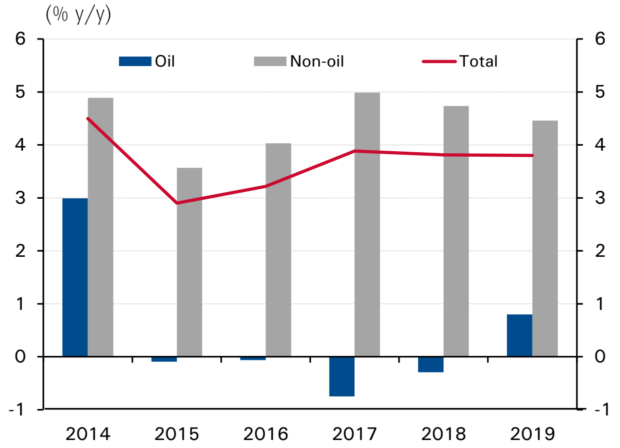
Table 1: Key economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	USD bn	32	35	38	40
Real GDP	% y/y	3.2	3.9	3.8	3.8
- Oil	% y/y	-0.1	-0.7	-0.3	0.8
- Non-oil	% y/y	4.0	5.0	4.7	4.5
Inflation	% y/y	2.8	1.4	2.5	3.5
Budget balance	% of GDP	-13.5	-11.6	-9.3	-7.6

Source: Official sources, NBK estimates

Chart 1: Real GDP

(% y/y)



Source: Information & e-government Authority, NBK estimates

However, the expected winding down of the production cut agreement from mid-2018 onward should allow Bahrain to ramp up to full output capacity, likely in 2019, boosting real oil GDP by 0.8%.

The kingdom is also in the process of upgrading its oil infrastructure, including the ageing oil pipeline from Saudi Arabia and the expansion of the Sitra refinery that will see refining capacity increased by almost 50 percent. The latter is expected to boost state revenues by about $1 billion, according to official sources.

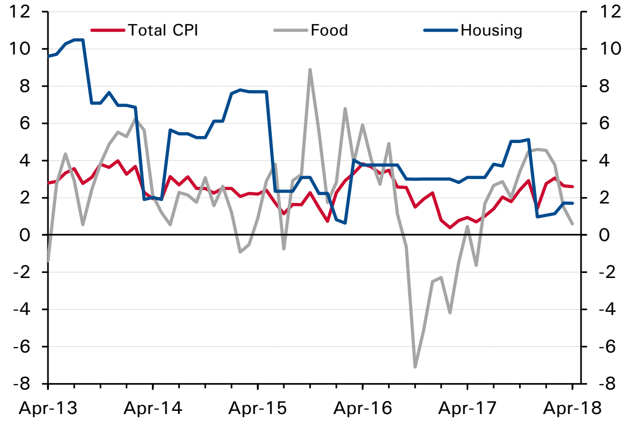
Moreover, in April, Bahrain announced that it had discovered up to 80 billion barrels of shale oil and around 20 trillion cubic feet of natural gas in offshore deposits. (The kingdom currently produces about 44,000 b/d from its own field and shares the revenues from a 300,000 b/d field owned by Saudi Arabia.) It hopes to monetize these new reserves within the next five years with the help of international oil companies. To this end, the government recently launched an energy fund that aims to raise $1 billion from local and international investors. Monetizing these new energy resources could ultimately restore investor confidence and reduce the country's fiscal deficit and high public debt levels—Bahrain is currently rated at below investment grade by major rating agencies S&P (B+), Moody's (B1) and Fitch (BB-).

Inflation to rise in 2018 and in 2019

Consumer price inflation is expected to rise from 1.4% in 2017 to 2.5% this year and then further to 3.5% in 2019 on the back of a planned value-added tax (VAT) and higher housing and food costs. Latest figures showed inflation averaging 2.8% y/y in 1Q18—higher than the 0.7% y/y average recorded during the same period last year—after excise duties were levied on tobacco and soft drinks. (Chart 2.)

Chart 2: Consumer price inflation by sector

(% y/y)



Source: Thomson Reuters Datastream

The introduction of a 5% VAT, now expected in 2019, is projected to add initially around 2% to the overall inflation rate.

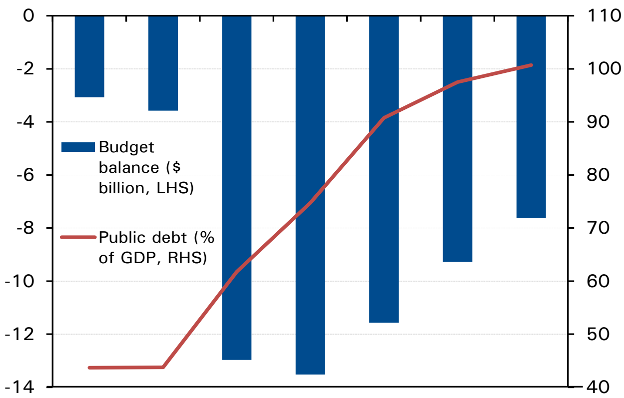
Budget deficit to gradually narrow but remain high

The budget deficit is expected to gradually narrow, given ongoing fiscal consolidation efforts and some improvement in revenues. While the VAT should raise around $300 million (approximately 1% of GDP) in additional tax revenue per year, the deficit will remain large at around 9.3% and 7.6% of GDP in 2018 and 2019, respectively. (Chart 3.)

The government will therefore have to continue to look to domestic and international bond markets to plug the shortfall. The latest issue came in March 2018, a 7-year $1 billion Sukuk at 6.875%, higher than the 5.25% on Sukuk issued in late 2017.

The hike in pricing reflects investors' concerns over the fiscal position and rising debt (which is expected to top 100% of GDP by 2019) as well as higher short-term rates.

Chart 3 : Budget balance & public debt



Source: Bahrain Ministry of Finance, IIF, NBK estimates

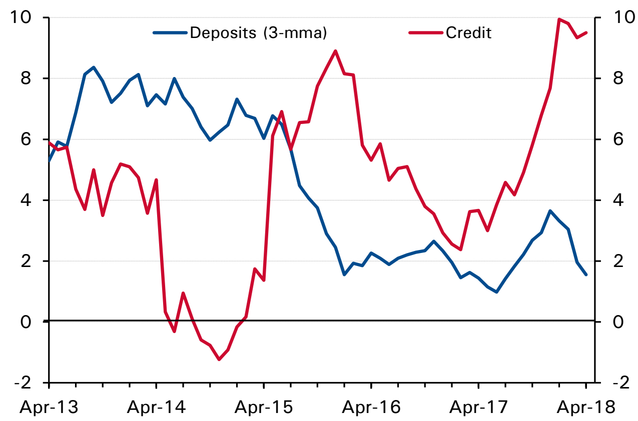
Credit default swaps (CDS), which tend to be good bellwethers of sovereign risk, spiked to near multi-year highs around mid-May amid growing concerns about Bahrain's large fiscal deficit and mounting debt burden. As of 5 June, the CDS on five-year government debt was at 383 bps, up 92 bps year-to-date, while yields on five-year government debt stood near record highs at 7.32%.

Business lending remains in recovery mode

Growth in credit to businesses continued to climb in 1Q18, thanks to the ongoing gains in lending activity in the construction sector. This has helped push total private credit growth higher, averaging an impressive 9.7% y/y in 1Q18, which is much higher than the 2.9% y/y recorded in 1Q17. (Chart 4.)

Chart 4: Private credit & deposit growth

(% y/y)



Source: Central Bank of Bahrain

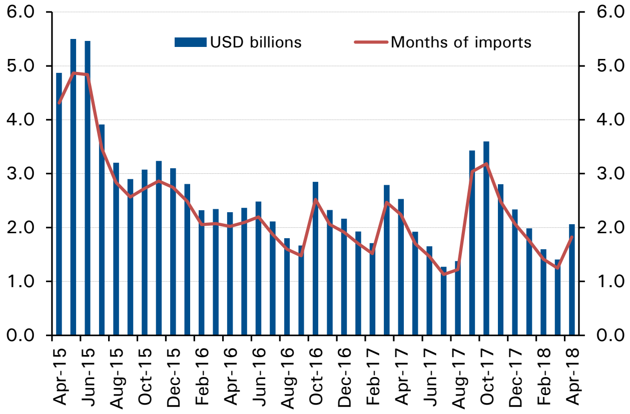
In contrast, private sector deposits grew by 2.8% y/y in 1Q18, higher than the 1.7% y/y average of 1Q17. With deposit growth subdued, M1 and M2 declined in April by 4.0% y/y and 1.4% y/y respectively.

Following the US Fed's move in June, Bahrain raised its key policy rate by 25 bps to 2.25%. Interbank rates have been edging higher in tandem with the policy rate hikes over the past year. As of early June, the 3-month rate was up 49 bps year-to-date. While lending may come under pressure from higher rates, the business sector is expected to continue to support overall credit growth.

Foreign reserves remain under pressure

Given its large fiscal (and external deficits), Bahrain's international reserves remain under pressure. In April, the central bank's international reserves stood at $2.1 billion, covering a mere 1.8 months of imports. (Chart 5.)

Chart 5: Central bank reserves



Source: Central Bank of Bahrain

Bahrain stock market weighed down by fiscal, debt concerns

After rallying briefly towards the end of 2017 and at the start of this year, Bahrain's All Share Index moved lower in 2Q18, weighed down by fiscal and debt concerns. (Chart 6.) However, a more encouraging economic outlook and higher oil prices should offer the market some support going forward.

Chart 6: Stock market index

(all share index)

Source: Thomson Reuters Datastream

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