Economics in Focus
NBK Economic Research Department I 5 November 2018

Bahrain

GCC pledges $10bn in financial support as kingdom unveils fiscal reforms

> Dana Al-Fakir
Economist
+965 2259 5373, danafakir@nbk.com

> Omar Al-Nakib
Senior Economist
+965 2259 5360, omarnakib@nbk.com

Highlights

- GCC governments pledge $10bn in financial aid to help shore up Bahrain's finances and restore market confidence.
- Bahrain unveils its Fiscal Balance Program (FBP), an ambitious yet achievable package of cost-cutting and other reform measures that target by 2022 a balanced budget and a reduction in public debt to 82% of GDP.
- Parliament signaled acceptance of the FBP and approved the draft VAT and pension law ahead of the November elections.
- The reform measures cap a tense few months during which government bonds were sold-off, CDS spreads widened and the currency came under pressure.
- The economic outlook should improve, with growth supported by a recovery in oil production and investment in development projects.

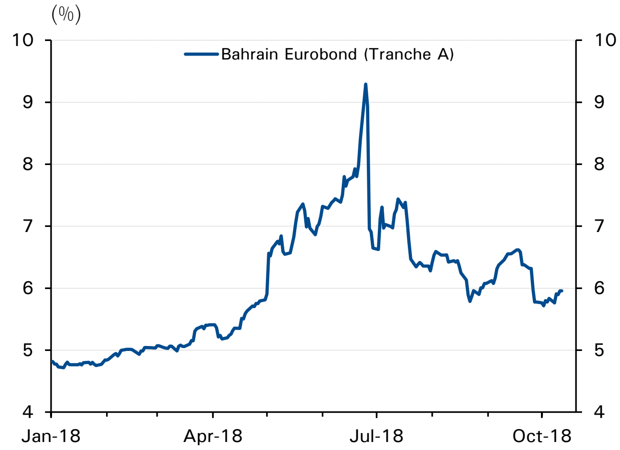
Bahrain outlook improves on GCC aid and fiscal reforms

After months of discussions, Saudi Arabia, UAE and Kuwait agreed to provide Bahrain with $10 billion in financial support over five years to help shore up the kingdom's finances and restore investor confidence. The aid appears to be contingent on the kingdom enacting measures to cut high public spending and raise non-oil revenues. For soon after the announcement, the government unveiled its 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. While the FBP's targets of reining in public spending and lowering the kingdom's public debt are ambitious and challenging, the outlook for Bahrain has improved as Investors will be reassured by the recent approval by parliament of a draft value-added (VAT) law and an amended pension law, which highlights the determination and urgency with which the authorities are approaching matters.

Markets had questioned Bahrain's fiscal sustainability amid high debt levels and thinning external buffers

Concerns about the sustainability of the kingdom's high debt level and ability to honor its financial obligations came to a head last June amid a sell-off of government bonds, higher risk premiums and increased pressure on the Bahraini dinar in the foreign exchange market. Yields on five-year government debt, already rising since April in response to the US Fed's monetary tightening program, spiked to above 9% in late June (see Chart 1.), as investors grew concerned about the government's high public debt of around 90% of GDP following several years of double-digit fiscal deficits.

Chart 1: 5-year government bond yield

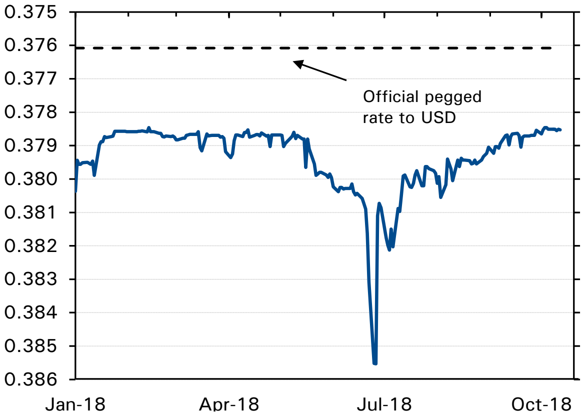


Source: Thomson Reuters Datastream

Investors' concerns about Bahrain's ability to defend its fixed exchange rate peg were amplified amid further thinning of the kingdom's external reserves. The 12-month Bahraini dinar forward rate against the US dollar hitting a seventeen-year low of 0.382 (compared to the official pegged rate of 0.376 Bahraini dinar per dollar). (Chart 2.)

Chart 2: Bahrain 12-month forward FX rate

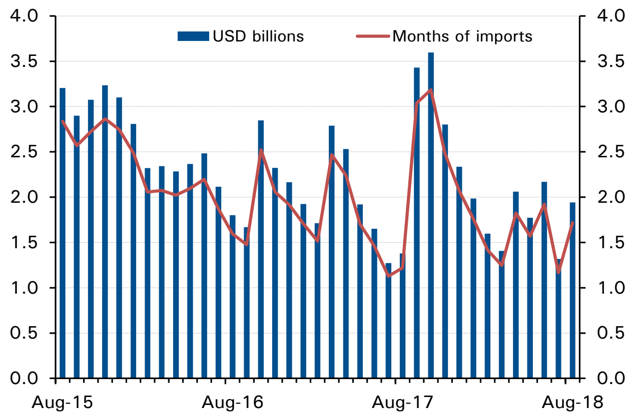
(BHD per USD)



Source: Thomson Reuters Datastream

The kingdom's foreign reserves, which had been steadily decreasing since 2014 after oil prices collapsed, fell to $1.32 billion in July, which is not far off the sixteen-year low of $1.27 billion the kingdom's reserves dropped to a year earlier and barely enough to cover forty days of imports. This is much lower than the minimum of ninety days of imports that the IMF considers desirable. (Chart 3.)

Chart 3: Foreign exchange reserves



Source: Central bank of Bahrain

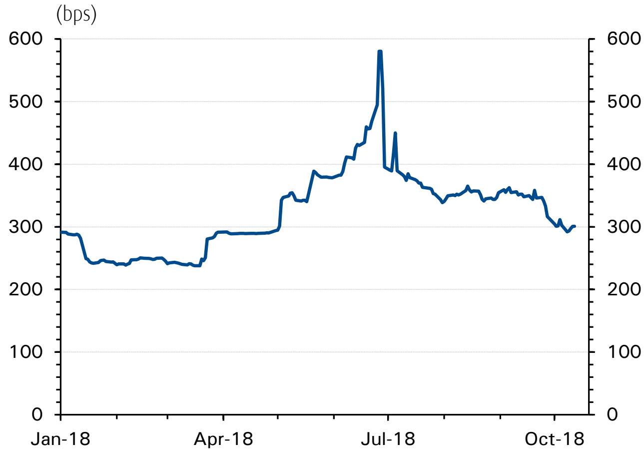
Meanwhile, Bahrain's main credit default swaps (CDS) on five-year government debt, which tend to be bellwethers of a sovereign's level of risk, jumped 290 bps year-to-date, to levels not seen since the financial crisis of 2009. (Chart 4.)

On reflection, there were signs as early as March that markets were beginning to be uneasy about the state of the kingdom's finances and pricing in the additional risk. There had been little traction on reforms and the promised rollout of the VAT as part of a GCC-wide agreement had yet to materialize.

There had also been little movement on the reported request by the authorities for additional financing from the GCC outside of those funds already earmarked for infrastructure and housing projects under the umbrella of the Gulf Development Program, a $10 billion aid package offered to Bahrain and Oman in 2011 to help the two countries deliver on public promises—and which has been a key driver of non-oil growth in Bahrain.

Chart 4: 5-year credit default swap (CDS)

(bps)



Source: Thomson Reuters Datastream

In such an environment, Bahrain was forced to shelve plans for a conventional bond and a longer-tenor sukuk sale after investors sought very high yields; instead, the sovereign issued a 7-year, $1 billion sukuk, priced at 6.875%—higher than the 5.25% the kingdom was able to offer on an $850 million, 8-year sukuk sold in December 2017. A plan by the Bahrain National Oil and Gas Authority (NOGA) to issue $1 billion of debt was also cancelled, due to low investor interest. With its debt classified as below investment-grade by major rating agencies S&P (B+), Moody's (B2) and Fitch (BB-), the government was unable to negotiate better rates.

The GCC steps in to calm the markets with the offer of financial support to Bahrain

As Bahrain faced the prospect of losing access to funding with borrowing costs turning prohibitively high, Saudi Arabia, Kuwait and the UAE announced their intention to offer the kingdom an integrated financial support package. Details were not disclosed at the time, but the GCC's intervention was crucial, helping to calm jittery markets and provide the kingdom with much-needed breathing space.

Some details have since been fleshed out. The sum of $10 billion was announced on 4 October, with the package likely to be a mix of loans, deposits and grants, to be disbursed in installments over five years. The first payment of up to $2 billion is due before the end of the year. It is believed that Bahrain's access to additional tranches will possibly be contingent on the passage of certain reforms.

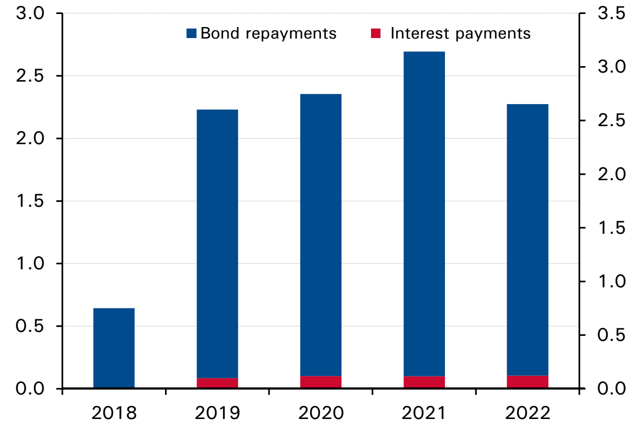
At $10 billion, the support package would cover most of the kingdom's external debt due to mature between 4Q18 and 2022, which is estimated at around $12 billion. (Chart 5.) The first of these obligations is a $750 million sukuk repayment due in November. Doubts about Bahrain's capacity to cover this near-term debt obligation was one of the catalysts in the June sell-off.

Nevertheless, the GCC's timely intervention had the intended result—allaying investors' fears and restoring Bahrain's access to the markets. Since peaking in June, Bahrain's five-year CDS have fallen by 280 bps, government bonds have rallied, with the yield on five-year government debt falling by just over 3 percentage points, and pressure on the currency peg has also eased. (See Charts 1, 2 and 4.)

But the real achievement of the support package could be in encouraging Bahrain to expedite some of the delayed fiscal and economic reforms that had been previously proposed as part of the kingdom's Economic Vision 2030.

Chart 5: External debt service

(USD billions)



Source: Thomson Reuters Datastream, NBK estimates

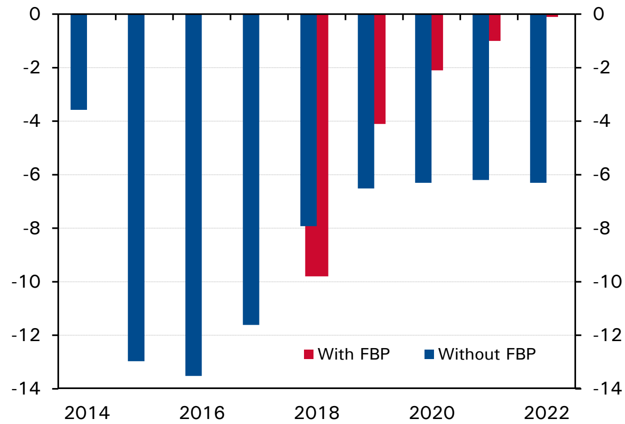
Bahrain unveils ambitious package of measures to balance the budget and reduce public debt

The kingdom subsequently released a 33-page 'Fiscal Balance Program' (FBP) report immediately after the GCC announcement, leading many to postulate that the offer of financial assistance is indeed linked to implementation of the FBP. In it, the authorities intend to both balance the budget and reduce the public debt to 82% of GDP by 2022. (Charts 6 and 7.)

They outline six major initiatives through which they intend to generate BHd 800 million ($2.1 billion) in savingsby 2022: i) reducing government operational expenditure; ii) introducing a voluntary retirement scheme for government employees; 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 establishment of new procurement and debt management units within the Finance Ministry, are also in the program.

Chart 6: Budget balance

(% of GDP)

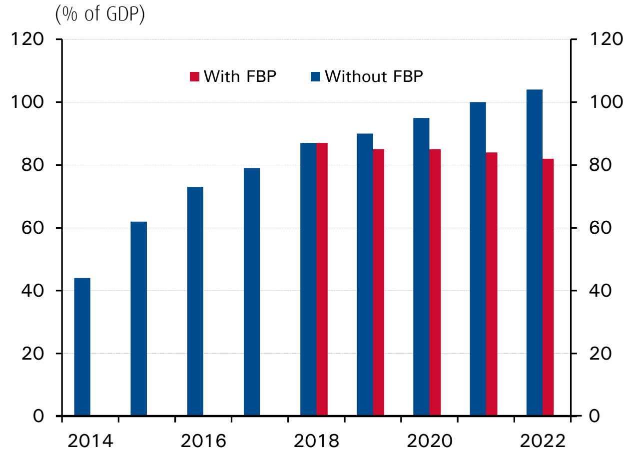


Source: Bahrain Ministry of Finance, NBK estimates

The central argument of the FBP is that non-oil revenues have not kept pace with economic diversification. Between 2002 and 2007, while the non-oil sector's share of GDP increased from 58% (BHD 3.5 billion) to 82% (BHD 10.2 billion) as the kingdom pursued diversification, the contribution of non-oil revenues to total government revenues actually shrank from 33% (BHD 0.33 billion) to 25% (BHD 0.55 billion).

Chart 7: Public debt

(% of GDP)



Source: Bahrain Ministry of Finance

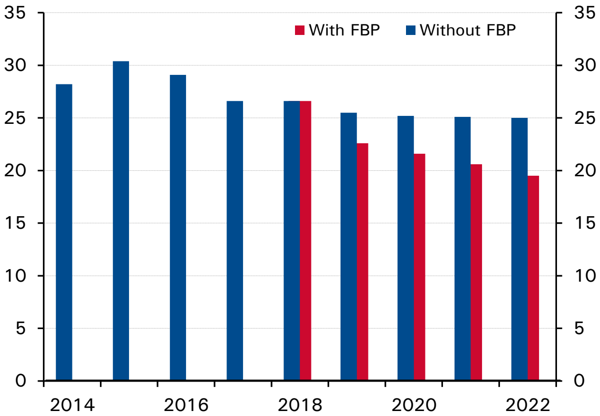
The increasing dependence on oil revenues and the low growth rate of non-oil revenues has, the authorities noted, led to fiscal deficits every year since the financial crisis. And the deficits recorded over the past couple of years were among the largest in the GCC region.

Realizing the goals of the FBP will be a challenge...

Chief among these will be the target of cutting government expenditures by BHD 800 million by 2022, or from 26.6% of GDP in 2018 to 19.5% of GDP in 2022. (Chart 8.)

Chart 8: Government spending

(% of GDP)



Source: Bahrain Ministry of Finance

While government spending has been on a downward trajectory since peaking at 30.4% of GDP in 2015 on the back of some limited subsidy cuts and pullbacks in capital expenditures, further savings will need to be made for the authorities to reach their target. And cuts of around 11% in nominal terms to current expenditures, which include politically sensitive items such as wages and subsidies, have been proposed. Cuts in wages, which make up the bulk (around 40%) of total recurrent spending, may prove to be very difficult to implement.

Moreover, there are risks to domestic demand and consumer confidence of an acceleration in the pace of austerity. A reduction in spending as a share of GDP by 7 percentage points over a span of just four years is not insignificant. Proposed cuts to capital spending of 38% in the FBP could also be too steep, with negative impact on medium-to-long term productivity growth. However, it is hoped that with such measures, foreign investors will be more positive about the outlook and the private sector would more than compensate for the retreat of the public sector. Bahrain also approved a law that would allow foreign companies to set up independent subsidiaries in the kingdom, to ultimately support foreign investment inflows, create more jobs and prop up growth.

Furthermore, questions also remain about the feasibility of Bahrain's revenue-generating plans. The FBP program aims to raise non-oil revenues by 2-2.5% of GDP, not least through the introduction of a 5% VAT from the start of next year. However, the VAT is not expected to generate more than BHD 188.5 million ($500 million), or around 1% of GDP, so the authorities will need to secure alternative sources of non-oil income in the near future to augment their existing revenue streams.

...but not an insurmountable one

While major challenges exist, opportunities for a reversal of the recent trend abound. For a start, the government appears to have secured the buy-in of parliament, at least for the spirit of the FBP if not all the details at this stage. Having been recalled from recess on October 7 for an 'extraordinary' session, the Bahraini legislature approved both the draft 5% VAT law and the amended pension law. The sign-off on the VAT bill paves the way for the tax to be levied for the first time in 2019, while the passage of the amended pension law will now see pensions and the pension bonuses of government ministers, members of parliament and municipal councilors pared back. So additional savings and revenues are potentially on the cards.

The approval appears to have been expedited ahead of the parliamentary elections scheduled for November 24, perhaps in an effort to secure the GCC aid package sooner. Granted, some opposition groups had boycotted this session, but the fact that some political and presumably popular support could be secured so quickly is an important step, and one that demonstrates the government's commitment to the reforms outlined in the FBP.

The latest measures are not isolated incidents, though, and fit into a broader narrative of reform that appears to have accelerated in 2018, making the challenges less onerous. The start of the year, for example, saw the government levy excise duties on tobacco and soft drinks (also as part of a wider GCC agreement), in a bid to increase non-oil revenues.

The authorities then followed this up by launching an energy fund to invest in and develop Bahrain's upstream, midstream and downstream oil and gas sectors. $1 billion in capital was raised from local, regional and international investors. The fund will also tap into Bahrain's recently discovered tight oil and gas deposits. It was announced back in April 2018 that up to 80 billion barrels of shale oil and around 20 trillion cubic feet of natural gas in offshore deposits had been discovered. The intention is to monetize these new reserves within the next five years with the help of international oil companies. Monetizing these new energy resources would be a further boon to investor confidence and help ease the country's financial constraints.

Good implementation of Bahrain's Economic Vision 2030, which comprises over $32 billion worth of priority development projects, in both the oil and non-oil sectors, will strengthen and diversify the economy, create more jobs and attract more foreign investments.

One promising sector that should contribute significantly to Bahrain's diversification and reform efforts is the financial sector. It is the second largest sector of the economy after oil and is set to make some headway, too, especially in the area of financial technology innovation. Relative to the other major financial hubs in the region, Bahrain has sizeable cost advantages. Indeed, according to Bahrain's Economic Development Board, the cost of doing business in the kingdom's financial sector is up to 40% lower than it is in Dubai.

Back in February of this year, the Bahrain FinTech Bay was established to support start-ups and attract global companies. Thanks to a promising outlook and cost advantages, the hub has already attracted almost half of its target number of companies. Furthermore, with the establishment of a dedicated FinTech Unit in the central bank in the pipeline, the sector should be well positioned to keep abreast of the digital transformation in the global banking industry.

GCC financial support and reforms will foster Bahrain's long-term economic vision

The GCC financial package should provide welcome support to the government's infrastructure program, which envisages investment by the private sector and GCC investors as well as the government. Some of the major projects include: (i) the expansion of Bahrain's International Airport ($1 billion), which will increase passenger capacity to support the tourism sector; (ii) Bahrain's national oil company modernization project; and (iii) an expansion project by Alba to lift aluminum production by more than 50%. These projects will help boost growth and create jobs, compensating for some of the negative effects on growth caused by the fiscal measures.

We are now more optimistic about the economic outlook for Bahrain, though risks remain. For sure, the reforms proposed in the FBP and more broadly in the Bahrain Economic Vision 2030 are ambitious and socio-politically sensitive. But the indications so far are that the authorities are committed. 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. The pace of reform execution will need to be carefully managed, however, so as not to impinge on domestic demand.

Serious and front-loaded progress on the announced measures will send positive signals to investors that the government intends to forge ahead with its economic reform program and will alleviate some doubts about what is perceived to be overly ambitious goals.

Head Office

Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait
(International) Plc
Paris Branch
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353