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

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.

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.)
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.)

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.

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...
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 savings by 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.

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).

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**

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 propel 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 exorbitant 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.