Macroeconomic outlook

# Bahrain: Non-oil sector continues to showcase resilience

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

> Nemr Kanafani
Senior Economist
+965 2259 5365, nemrkanafani@nbk.com

## 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

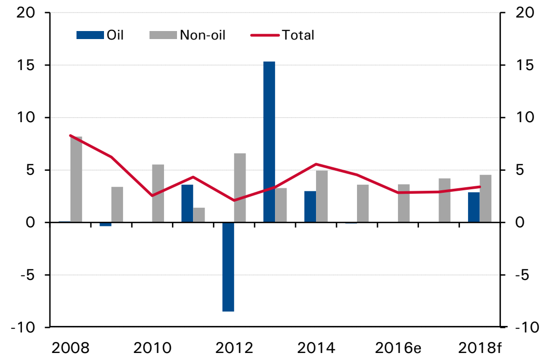
Inflation in the consumer price index (CPI) decelerated at the start of 2017 on declining food prices and softer housing inflation. (Chart 3.) In

Table 1: Key economic indicators

| | | Year | | | |
|---|---|---|---|---|---|
| | | 2015 | 2016e | 2017f | 2018f |
| Nominal GDP | USD bn | 32 | 32 | 35 | 38 |
| Real GDP | % y/y | 2.8 | 2.9 | 3.4 | 4.2 |
| - Oil | % y/y | -0.1 | 0.0 | 0.0 | 2.9 |
| - Non-oil | % y/y | 3.6 | 3.6 | 4.2 | 4.5 |
| Inflation | % y/y | 1.8 | 2.8 | 2.5 | 3.0 |
| Budget balance | % of GDP | -16.1 | -18.0 | -15.0 | -12.6 |

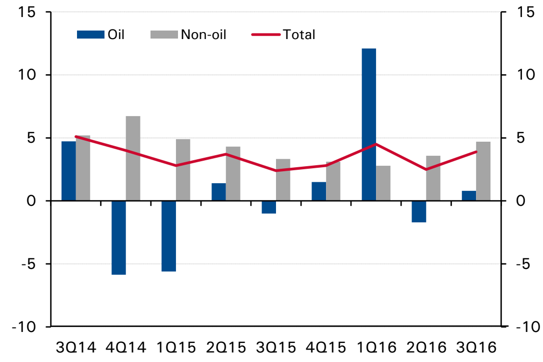
Source: Official sources, NBK estimates

Chart 1: Annual real GDP
(% y/y)



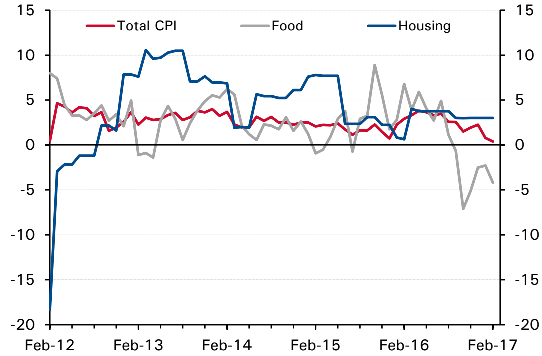

Source: Information & e-Government Authority, NBK estimates

Chart 2: Quarterly real GDP
(% y/y)




Source: Bahrain Economic Development Board

Chart 3: Consumer price inflation by sector
(% y/y)




Source: Thomson Reuters Datastream

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.

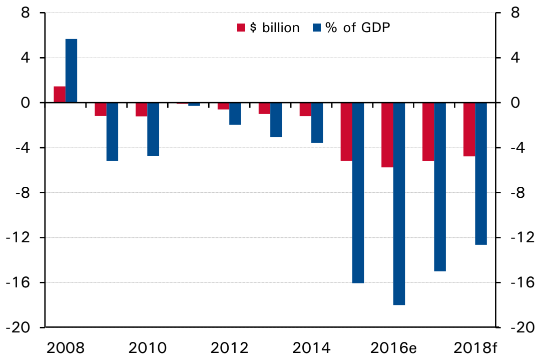
With the budget deficit expected to hover at stubbornly high levels, the nation is likely to continue to turn to domestic and international bond markets to plug its deficit. In 2015, Bahrain issued a total of $6 billion in bonds, $1.5 billion of which was in the international market. In 2016, the government 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

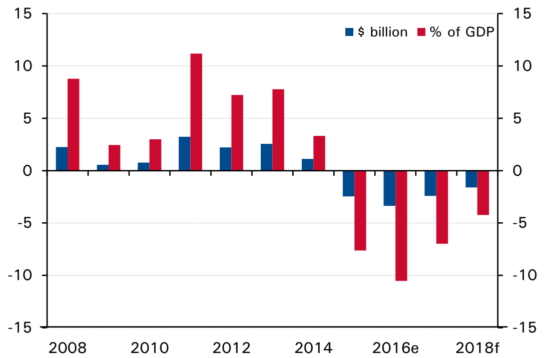
Growth in private sector borrowing slowed considerably in recent months. Data from the CBB showed private sector claims falling in January for the first time in years. The 1.5% y/y decline could be attributed to the 25 bps hike in the key policy rate that came into effect just the month before, after 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

**Chart 4: Budget balance**




Source: Bahrain Ministry of Finance, NBK estimates

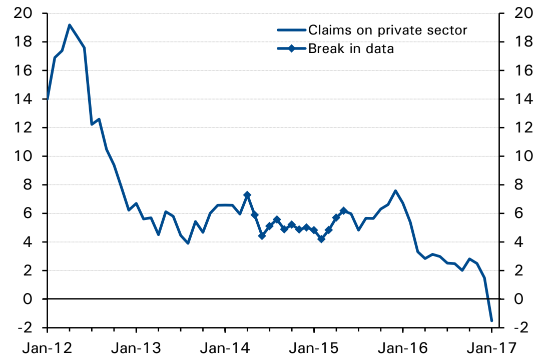
**Chart 5: Current account balance**




Source: Bahrain Ministry of Finance, NBK estimates

**Chart 6: Private sector claims**

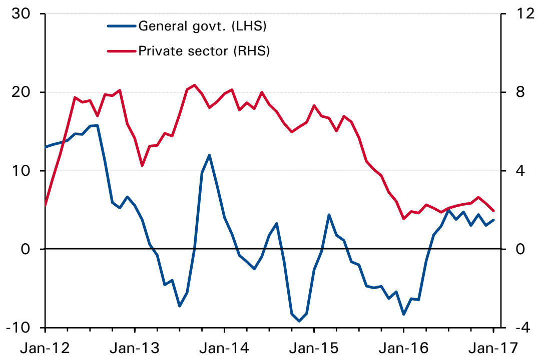
(% y/y)




Source: Thomson Reuters Datastream

**Chart 7: Deposits**

(3-month moving average % y/y)




Source: Thomson Reuters Datastream

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.

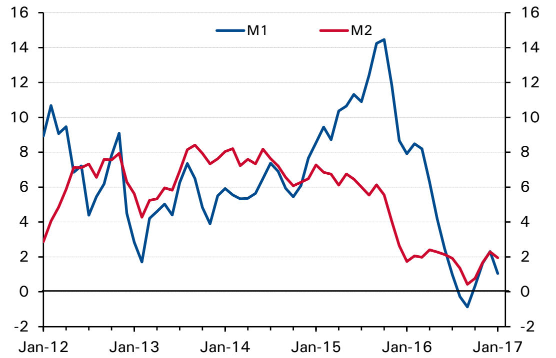
## Bahrain stock market rallied in the first quarter of 2017

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 optimisim 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.)

**Chart 8: Money supply**

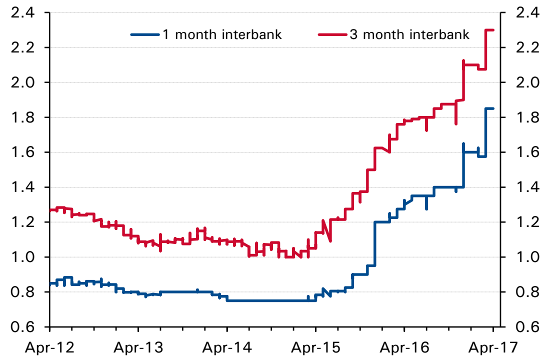
(3-month moving average % y/y)




Source: Thomson Reuters DataStream

**Chart 9: Interbank rates**

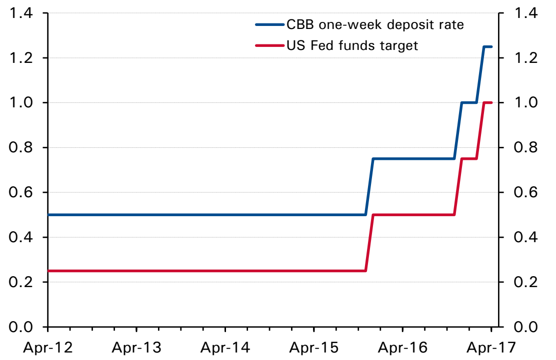
(%)




Source: Thomson Reuters Datastream

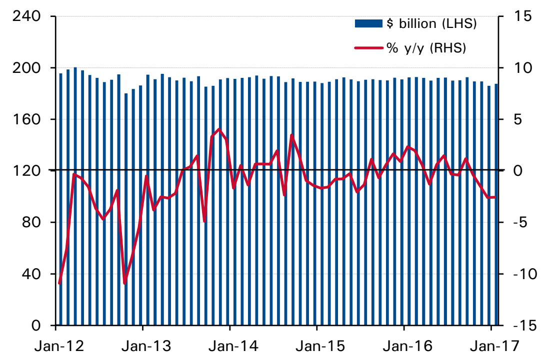
**Chart 10: Policy rates**

(%)



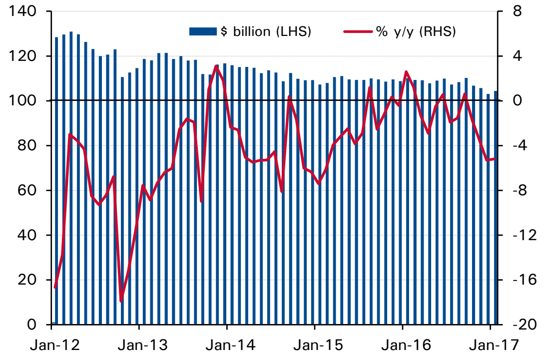

Source: Thomson Reuters Datastream

**Chart 11: Commercial bank assets**




Source: Central Bank of Bahrain

## Chart 12: Wholesale bank assets




Source: Central Bank of Bahrain

## Chart 13: Stock market index

(all share index)


Source: Thomson Reuters Datastream

## Chart 14: 5-year credit default swap

(basis points)


Source: Thomson Reuters Datastream

## Head Office

### Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City
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 Representative 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