Macroeconomic outlook

Bahrain: Economy to be supported by resilience in non-oil sector

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Overview and outlook

- **GDP growth is set to be propped up in 2017 and through 2018 by the resilience in the non-oil economy.**
- **Non-oil growth to gather momentum on higher investment levels, particularly in the construction sector.**
- **Inflation to hold steady in 2017 before rising again in 2018.**
- **The budget deficit is set to narrow but remain high at 15% and 13% of GDP in 2017 and 2018, respectively, on solid levels of public spending.**
- **Liquidity constraints in the banking sector are poised to gradually ease as growth in deposits recovers.**

Real economy set to gradually pick up as non-oil sector holds strong

Economic growth is poised to gradually edge up in 2017 and 2018 on solid levels of activity in the non-oil economy. Growth in real GDP is envisaged to rise from an estimated 2.9% in 2016, to 3.4% and 4.2% in 2017 and 2018, respectively (Chart 1). Growth in real oil GDP is projected to remain flat in 2017 amid steady oil production levels, especially following the recently announced production cuts by OPEC producers. We expect growth in this sector to gather some pace in 2018 as production picks up. Non-oil growth is forecast to gradually rise from around 3.6% in 2016 to 4.2% in 2017 and 4.5% in 2018 on higher investment levels, particularly in the construction sector.

In the first quarter of 2016, real GDP growth recovered relative to 4Q15 and accelerated to 4.5% y/y. However, the acceleration was mostly attributed to a one-off jump in real oil GDP growth (Chart 2). Growth in real GDP slowed once again to 2.5% y/y in 2Q16, after real oil activity contracted by 1.7% y/y.

In contrast, growth in real non-oil activity climbed from 2.8% y/y to 3.6% y/y in 2Q16, helping shore up some of the weakness in oil activity. Non-oil GDP recorded its highest growth rate in a year in 2Q16, thanks to faster than expected utilization of GCC grants, which helped prop up investment. The GCC pledged $10 billion in investment over ten years; Bahrain has vowed to devote these funds to infrastructure and housing developments.

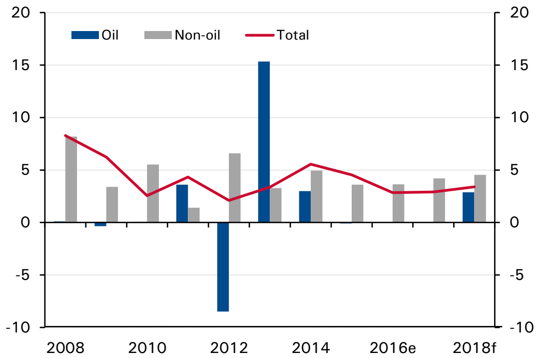
Table 1: Key economic indicators

		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	2.5	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

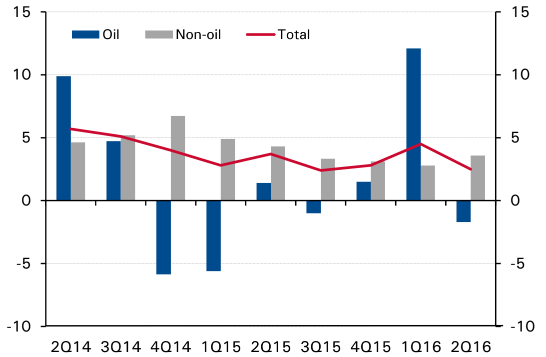
(% y/y)



Source: Central Informatics Organization, NBK estimates

Chart 2: Quarterly real GDP

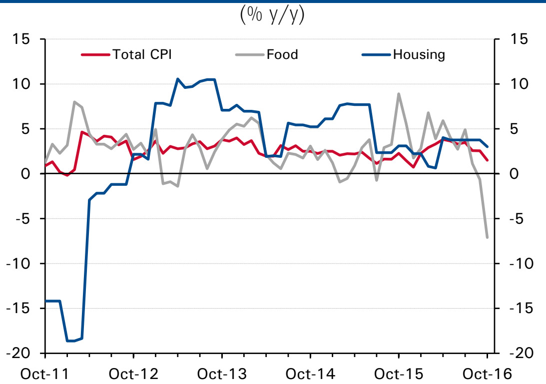
(% y/y)



Source: Economic Development Board

Chart 3: Consumer price inflation by sector

(% y/y)



Source: Central Informatics Organization

Inflation expected to hold steady in 2017 before rising in 2018

Inflation in the consumer price index (CPI) rose for most of 1H16 after subsidy cuts in the food and housing components led the respective inflation rates higher (Chart 3). However, the initial impact of the subsidy cuts appears to have subsided on the back of a slowdown in inflation in the housing component and a decline in food prices; CPI inflation peaked at 3.8% y/y in April and, as of October, stood at 1.5% y/y.

Despite the cooling inflation rate, we expect inflation to still edge up slightly and average around 2.5% in 2016, following the higher readings recorded in 1H16. We foresee the annual average inflation rate remaining at around the 2.5% mark in 2017 as both housing and food inflation stay in check. In 2018, headline inflation is expected to face some upward pressures, especially on the back of a planned introduction of a value-added tax (VAT) across the GCC region.

Budget deficit to narrow but remain high in 2017 and 2018

Bahrain is forecast to see 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 solid, the budget deficit is forecast to narrow slightly from roughly 18% of GDP in 2016 to around 15% and 13% of GDP, respectively in 2017 and 2018 (Chart 4).

Bahrain remains intent on imposing fiscal reforms in line with the IMF's recommendations to help shore up its public deficit. Spending cuts have been concentrated on subsidies, whilst public spending levels on infrastructure and development projects have been counter-cyclical and have thereby remained broadly stable. In August 2015, the government lifted subsidies on meat products. In December 2015, the cabinet approved a new pricing system for diesel, kerosene and jet fuel to reduce subsidy costs and better reflect price increases in other GCC states. In 1H16, it approved the removal of subsidies on utilities.

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

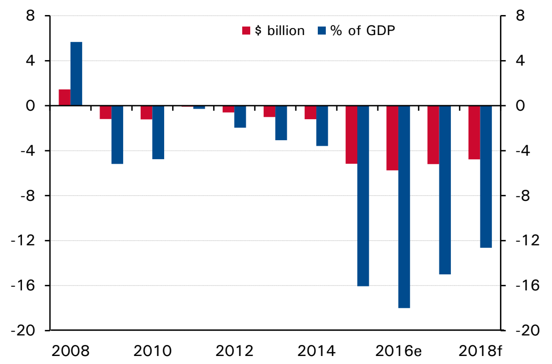
Given that the budget deficit is expected to remain high in spite of subsidy cuts, Bahrain may continue to turn to both domestic and international bond markets, to help finance its deficit. In 2015, Bahrain issued a total of $6 billion in bonds, $1.5 billion of which was in the international market. In 2016, the government of Bahrain issued $3.4 billion in bonds, $2 billion of which was issued externally. Subsequently, debt is projected to remain steady at around 60% of GDP.

Fiscal deficit and debt concerns have led to a bout of downgrades of the nation's long-term credit rating. In June, 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, S&P lowered Bahrain's sovereign credit rating from BB to BB-, deeper into non-investment grade territory. The downgrades have made it increasingly difficult for the government to negotiate better bond deals.

Banking liquidity poised to improve over the next two years

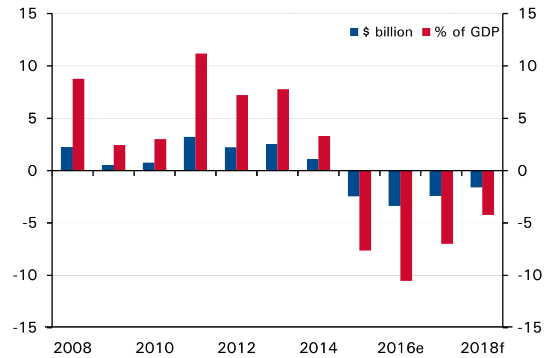
After recently starting to publish data again, the latest data from the Central Bank of Bahrain (CBB) showed growth in private sector claims softening for during most of 2016, against a backdrop of weak oil earnings (Chart 6). In October, it stood at a multi-year low of 2.8% y/y.

Chart 4: Budget balance



Source: Bahrain Ministry of Finance, NBK estimates

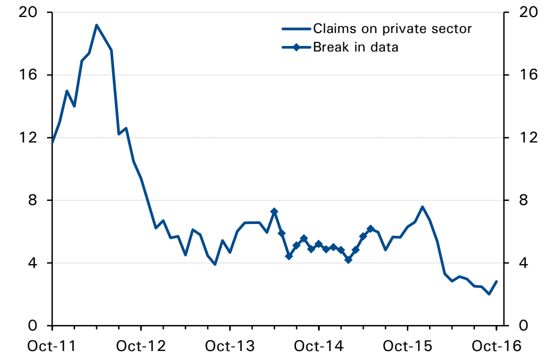
Chart 5: Current account balance



Source: Bahrain Ministry of Finance, NBK estimates

Chart 6: Private sector claims

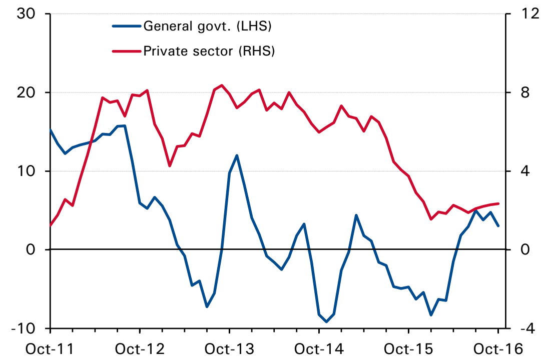
(% y/y)



Source: Thomson Reuters Datastream

Chart 7: Deposits

(3-month moving average % y/y)



Source: Thomson Reuters Datastream

However, we expect growth in this segment to improve during the course of 2017 and 2018 on the back of a recovery in oil prices and as credit demand, particularly in the construction sector, picks up.

Total deposit growth has been weighed down by an ongoing decline in government deposits (Chart 7). Government deposits have been hammered by lower oil revenues and high levels of government spending. According to the latest data, growth in government deposits slowed from 4.8% y/y in September to 3.0% y/y in October. At 2.3% y/y, growth in private sector deposits also remained relatively tepid. However, total deposit growth is expected to recover in the medium term, amid a recovery in oil revenues as well as bond issuances. This in turn should help ease liquidity constraints in the banking system.

Growth in the broad money supply (M2) witnessed a slowdown in 2016 and remained rather sluggish in 4Q16. This has pushed interbank rates to multi-year highs over the course of 2016. In October, M2 money supply growth was at an almost seven-year low of 0.8% y/y (Chart 8).

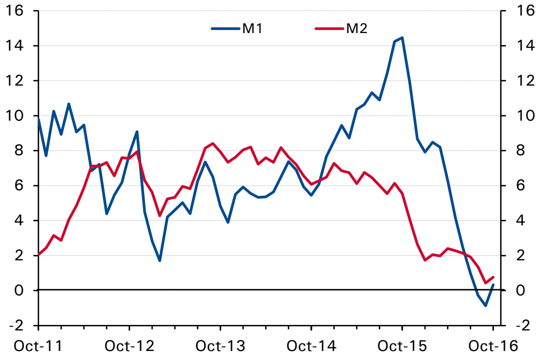
Bahrain's one-month and three-month interbank rates witnessed sharp increases in 2016, especially in the aftermath of the 25 basis points (bps) hike in the US federal funds rate in December, which led to a 25 bps hike in the CBB's key policy rate. As of mid-December, they were up 50 bps and 45 bps year-to-date, respectively (Chart 9). However, with liquidity constraints set to ease over the next two years and the initial impact of the policy rate hike set to subside in the near term, we should see interbank rates gradually come off their multi-year highs.

Bahrain stock market improves slightly on oil price recovery

In tandem with regional markets, the Bahrain All Share Index witnessed some higher gains towards the end of 2016, on the back of a recovery in global oil markets as well as greater business confidence (Chart 10).

Chart 8: Money supply

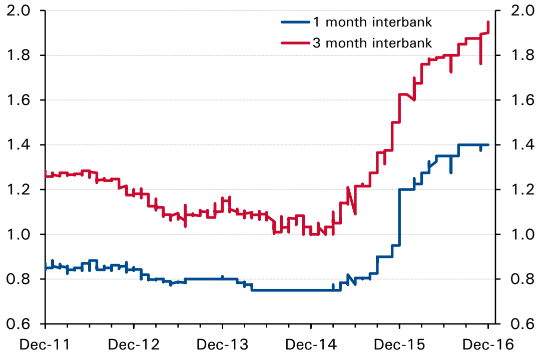
(3-month moving average % y/y)



Source: Thomson Reuters DataStream

Chart 9: Interbank rates

(%)



Source: Thomson Reuters Datastream

Chart 10: Stock market index

(all share index)

Source: Thomson Reuters Datastream

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