Economic Update
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Macroeconomic outlook

Bahrain: Softer oil prices to weigh on growth and widen fiscal deficit in 2016

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Overview and outlook

- **Real GDP growth is expected below 2% in 2016 on depressed oil prices. We foresee a pick-up in 2017 on the back of a potential recovery in oil prices and as the non-oil sector gathers pace.**
- **Inflation is projected to come in higher in 2016 and average 2.5%, predominantly due to subsidy cuts.**
- **The budget deficit is set to widen further in 2016, to 17% of GDP, as oil revenues remain weak.**
- **The banking sector is expected to face some liquidity constraints until at least the end of 2016, on the back of tepid deposit growth.**

Real GDP growth to maintain downward trend in 2016

Economic growth is set to soften further in 2016 as lower oil prices continue to act as a damper on public expenditure and investment growth. We expect growth in real GDP to slow from an estimated 2.3% in 2015 to around 1.6% in 2016, before recovering in 2017 (Chart 1). Non-oil GDP is expected to decelerate to around 2.0% in 2016 as investor confidence remains sluggish. We see real growth in the non-oil sector rising to around 3.8% in 2017 on higher government spending and inflows of official GCC grants targeting housing and infrastructure developments.

Non-oil growth is poised to be bolstered by higher investment levels in the medium- to long-term. The GCC has pledged $10 billion in investment over ten years. Indeed, the airport expansion project is being launched with a $0.93 billion grant from the UAE. In addition to this, Bahrain's Economic Development Board (EDB) plans to invest over $20 billion in industrial and infrastructure projects over the coming years.

However, the strength of non-oil GDP growth remains suceptible to internal concerns, which have overshadowed business optimism in the past. While these concerns have subsided somewhat, they continue to hang over investor confidence and impede gains in the financial services, construction and tourism sectors.

Inflation expected to edge higher in 2016 on subsidy cuts

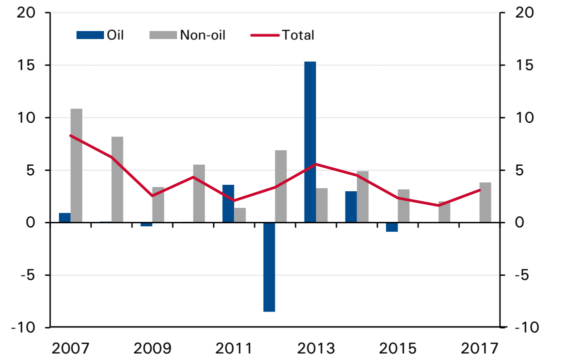
Inflation in the consumer price index (CPI) climbed higher for the most

Table 1: Key economic indicators

		Year			
		2014	2015e	2016f	2017f
Nominal GDP	USD bn	33.8	32.2	31.8	34.9
Real GDP	% y/y	4.5	2.3	1.6	3.1
- Oil	% y/y	3.0	-0.9	0.0	0.0
- Non-oil	% y/y	4.9	3.2	2.0	3.8
Inflation	% y/y	2.7	2.3	2.5	2.5
Budget balance	% of GDP	-5.6	-16.1	-17.2	-13.2

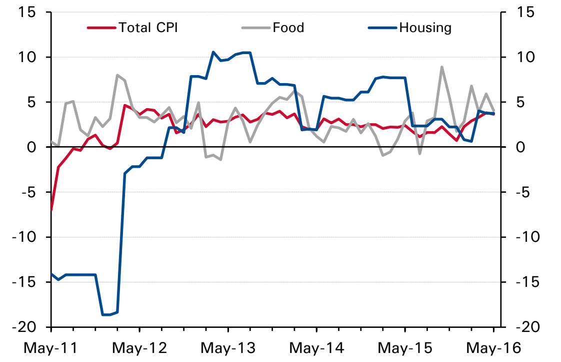
Source: Official sources, NBK estimates

Chart 1: Real GDP
(% y/y)



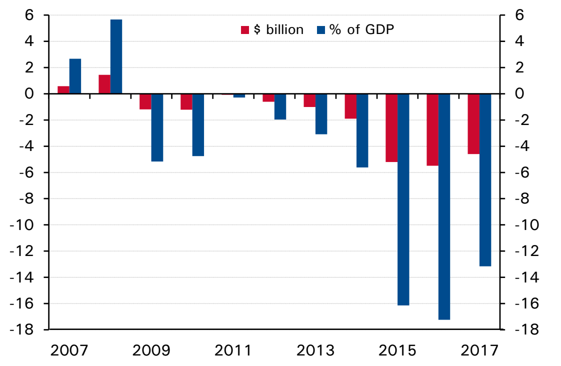
Source: Central Informatics Organization, NBK estimates

Chart 2: Consumer price inflation by sector
(% y/y)



Source: Central Informatics Organization

Chart 3: Budget balance



Source: Bahrain Ministry of Finance, NBK estimates part of 1H16, after subsidy cuts in the food and housing components drove the respective inflation rates higher (Chart 2). However, latest data showed headline inflation steadied at around 3.7% year-on-year (y/y) in May after inflation in food remained broadly unchanged and after housing inflation witnessed a notable slowdown, from 5.9% y/y in April to 4.1% y/y.

We expect inflation to edge slightly higher and average around 2.5% in 2016, following the rather strong inflationary gains in 1H16 and on the basis that there may potentially be further subsidy cuts, in a bid to shore up the nation's public finances.

Budget deficit to remain high on lower oil earnings and high spending

Bahrain is 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 oil prices remaining low, we expect the budget deficit to widen and come in north of 17% of GDP in 2016 before narrowing slightly to around 13% of GDP in 2017 (Chart 3).

Bahrain has vowed to embark on austerity measures in line with the IMF's recommendations to help plug its public deficit. Thus far, it has approved a plan to reduce government spending by 30%. Spending cuts have been concentrated on subsidies, while maintaining planned spending on infrastructure and development projects. 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 that will lower subsidy costs and better reflect price increases in other GCC states. In 1H16, it approved the removal of subsidies on utilities.

However, engaging in 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 total government spending.

Given that the budget deficit is expected to remain high in spite of recent and potentially further subsidy cuts, Bahrain will continue to tap into international bond markets in 2016 to help finance its deficit. In 2015, Bahrain raised $1.5 billion in bonds. In 1H16, the government of Bahrain reopened a two-tranche US dollar bond issue worth $600 million and apparently privately issued a $435 million three-year sukuk.

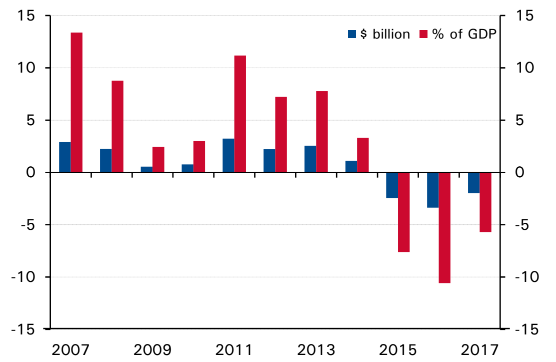
However, recent downgrades of the nation's long-term credit rating are likely to make any future bond deals more challenging. In June, Fitch, in line with the other two major rating agencies, downgraded Bahrain's long-term credit rating to below investment grade status, citing fiscal deficit concerns.

Banking sector liquidity conditions to remain tight

After remaining mostly steady in 2015, recent data show a slowdown in private sector claims growth (Chart 5). Growth slowed from 5.4% y/y in February to 3.3% y/y in March. We expect growth in this segment to ease further in the near- to medium-term amid tighter liquidity conditions.

Total deposit growth remains tepid mainly due to declining government deposits (Chart 6). Growth in government deposits continues to trend lower and remains in negative territory due to lower oil revenues and high levels of government spending. According to the latest data, government deposits fell by 6.3% y/y in March. Growth in private sector deposits also remained weak in March, after it came in unchanged from the previous month at 1.9% y/y. (The sharp drop in government deposit growth between August of 2015 and October 2015 can mostly be

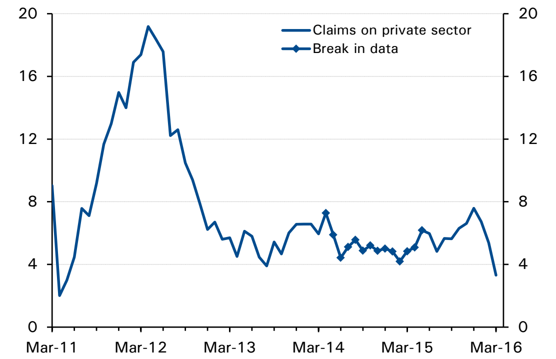
Chart 4: Current account balance



Source: Bahrain Ministry of Finance, NBK estimates

Chart 5: Private sector claims

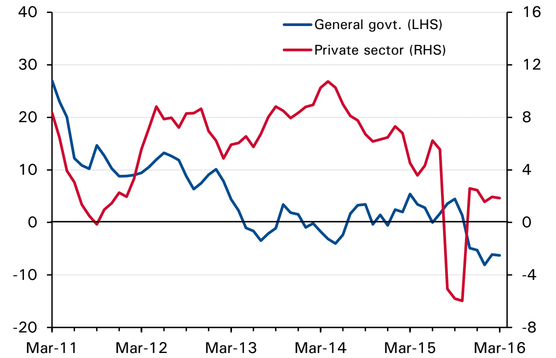
(% y/y)



Source: Thomson Reuters Datastream

Chart 6: Deposits

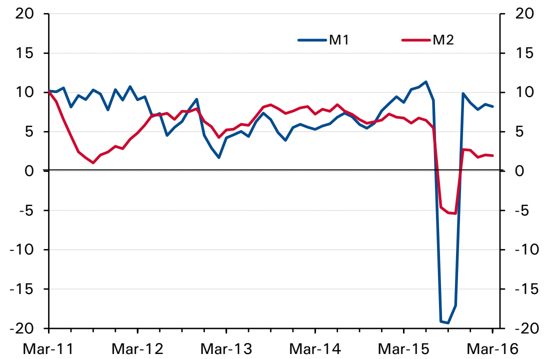
(3-month moving average % y/y)



Source: Thomson Reuters Datastream

Chart 7: Money supply

(3-month moving average % y/y)



Source: Thomson Reuters Datastream

attributed to a one-off outlier.)

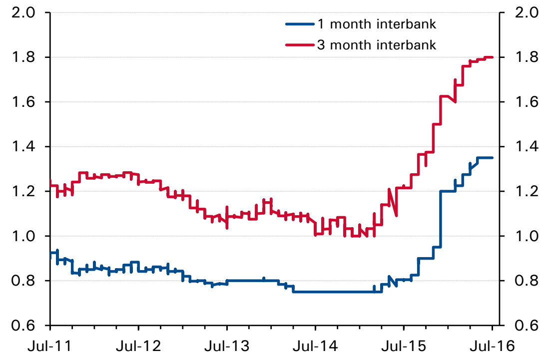
Growth in the broad M2 money supply remains weak on the back of lower oil prices. This, in turn, has pushed interbank rates higher. In March 2016, M2 money supply growth came in at a mere 2.0% y/y (Chart 7). Bahrain's one-month and three-month interbank rates witnessed steep increases in the first half of 2016. Both rates are due to continue to rise this year on the back of tepid deposit growth (Chart 8).

Bahrain stock market remains subdued

The Bahrain All Share Index continued to trend lower in 1H16, in tandem with most GCC and global markets. The oil price outlook remains one of the keys to investor confidence and thus market performance (Chart 9).

Chart 8: Interbank rates

(%)



Source: Thomson Reuters DataStream

Chart 9: Stock market index

(All Share Index)

Source: Thomson Reuters Datastream

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