TRIP NOTE: BAHRAIN

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GlobalEvolution

GLOBAL EVOLUTION TRIP NOTE

We visited Bahrain as part of a longer GCC trip, which also included visits to Qatar and Oman. The day in Bahrain included meetings with the Central Bank, The Economic Development Board, a local bank and members of the US embassy. The timing of the trip was good, as the political scene in the whole region is undergoing changes, which has had a spillover effect on GCC markets in general.

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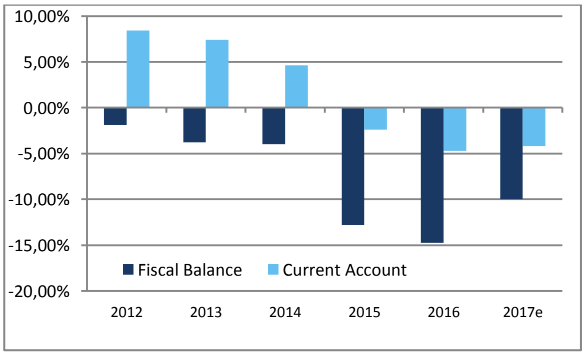
Fiscal Pressure

Double digit deficits, high debt-to-GDP and low reserves spells trouble.

Bahrain has had double digit deficits since 2014, as a direct impact of lower oil prices, and oil related revenues. The effect of this, alongside external pressure from a current account deficit, has been the depletion of reserves and an accumulation of debt. Fiscal deficit for the year will most likely be just under 10% of GDP, as it has benefitted from increasing oil prices. This will lead Debt-to-GDP to top 80% at the end of 2017.

Chart 1: Effect of drop in oil prices on fiscal balance and current account as % of GDP



Source: Haver Analytics & Central Bank of Bahrain

Bloomberg recently reported that reserves were only at USD 1.39bn in August, down 75% since 2014, and covering less than 1 month of imports, quoting official data. The Central Bank disputed this number, and claimed that the real number in August was 2.1bn USD, and 4.1bn after Bahrain issued Eurobonds in September, as the government covered it's arrears to the central bank. The central bank sees the crucial lower limit for reserves at USD 1.8bn, and if this point is reached they are open to raising rates and selling assets, but they will not touch the peg.

Fiscal Consolidation:

Fiscal numbers have improved, on the back of stronger oil prices, but a real fiscal plan is still needed

So it's clear that Bahrain needs a plan to consolidate its fiscal position in order to rein in debt and reduce the focus on dwindling reserves. The government is aiming for a balanced budget within 4-5 years, but the only specific fiscal measure being implemented is the VAT and the "sin-tax" (tax on tobacco and soft drinks). "Sin-tax" and VAT is part of a broader GCC agreement, and will, when fully implemented, reduce the deficit by 2-2.5pp. VAT is set to be implemented by 1 January, 2018 throughout the GCC, but it will be delayed in Bahrain. There are no good explanation for the delay, but officials say VAT should be implemented between mid-2018 and early 2019. The rest of the fiscal consolidation between now and 2022 should come via an expansion of the oil sector. The revenue ramp up in the oil sector is primarily thought to be supported by the expansion of the Bapco refinery capacity and an expansion of the Alba pipeline. The pipeline expansion is coming on line in 2019, while the refinery expansion is unsure, as the project contract has yet to be rewarded. Both projects will help the fiscal position of Bahrain via dividend payments from Bapco, but since the projects are financed by debt, the amount of free cash flow for dividend will be limited in the short/medium term as the combined capex is estimated to be USD 8bn.

So, the fiscal takeaway from Bahrain was that the government is reluctant to put additional pressure on the public and the plan to have a balanced budget within 5 years is unrealistic if no additional steps are taken. Also, the officials see a likely scenario for oil prices at USD 80/bbl in the coming years, plus they are budgeting for 2018 with USD 55/bbl as opposed to the rest of the GCC where budgets are based on $45/bbl. This make for a significant downside risk for Bahrain if oil prices were to decrease.

Saudi Put and Saudi Risk:

Saudi put is still in place, but the uncertainty is growing

It cannot be disregarded; Bahrain is viewed as somewhat of a Saudi Arabian province. On the back of this, the market has priced that Saudi Arabia will be the real lender of last resort for a government with a deteriorating fiscal position and weak reserves.

For Saudi Arabia and its allies, especially the UAE, it would make sense to financially support Bahrain due to its geopolitical position close to both Qatar and Iran. Also, if Bahrain were to de-peg its currency, it would put pressure on the rest of the GCC currencies which are all pegged to the USD. A possible bailout or financial support from UAE and Saudi Arabia would be relatively easy due to the large differences in scale between Saudi/UAE and Bahrain. The debt stock of Bahrain is equal to 2.31% of GDP for Saudi Arabia and UAE combined.

The recent developments in Saudi Arabia have created doubts about the Saudi Arabia put for Bahrain as the new crown prince, Mohammed bin Salman (MBS), is trying to consolidate power and push through reforms. The decisiveness of MBS, and the purge in the royal family in Saudi Arabia have made for increased uncertainty in the region, which also spills over to Bahrain as people question MBS's view on Bahrain and how hard a stance he is going to take in a possible bailout. It also seems increasingly unlikely that Saudi Arabia and the UAE will deliver a blank check to Bahrain as they themselves have imposed stricter fiscal discipline than Bahrain. So a possible bailout will most likely be conditional on a stricter fiscal discipline.

A smaller step than direct financial support could come in the form of the split from the Abu Sa'fah field. The Abu Sa'fah field is Bahrain's largest oil field, but it is shared with Saudi Arabia. The official split is 50/50, but as a measure of support Saudi Arabia could allow for a more uneven split in favor of Bahrain, even a 100% allocation. This has been done before in the early 2000's.

The government in Manama indicated that they are sure that Saudi Arabia will come to the rescue in the 11th hour and that they are hoping for a statement of support in the coming weeks.

Conclusion:

We entered the trip being negative on the Bahrain due to double digit deficits, debt-to-GDP above 80% and dwindling reserves. The trip didn't change our view on the country even though the fiscal situation will be better this year due to the increase in oil prices. Bahrain's current debt numbers combined with the government's lack of willingness to tackle hard issues and introduce further austerity measures will likely result in an unsustainable fiscal situation. This leads to possible GCC support which in our mind has become a bit more uncertain with the changes in Saudi Arabia and a general feeling in the GCC that Bahrain should have done more to tackle its issues.

Another issue for Bahrain is security concerns as the majority of the population is Shia Muslims while the power is centered with Sunni Muslims. In recent months there have been small attacks around the country even on the main pipeline between Saudi and Bahrain.

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