Unveiling of Bahrain's Fiscal Balance Program on 4 October 2018 in Manama, Bahrain. Finance Ministers of Kuwait, Saudi Arabia and the UAE pledged to support the program with a $10 billion aid package.

Till Debt Do Us Part: Bahrain's Fiscal Position and Regional Lifelines

by Muizz Alaradi

In June 2018, Saudi Arabia, Kuwait and the United Arab Emirates announced that they were in talks with authorities in Bahrain to provide financial support which would "enable the kingdom of Bahrain to support its economic reforms and fiscal stability."[1] This announcement was prompted by a selloff of Bahraini government bonds by international hedge funds and investors and pressure on its dinar currency due to concerns about the country's rising public debt levels and weakened fiscal position.[2] This situation has been at least a decade in the making, first exposed by the 2008 global financial crisis and recession.

Looking back

Like its GCC peers, Bahrain's public revenues are primarily generated from hydrocarbons. Based on the Final Accounts between 2007-2017, oil and gas made up, on average, 82.9% of total government revenues.[3] However, unlike its peers, oil production is relatively small. During that same period, Bahrain's oil output mainly ranged between 180,000 - 200,000 barrels per day (bpd),[4] meaning that any fluctuation in international oil prices directly corresponded to movements in public income. It is also worth noting that approximately one quarter of the country's oil output (23% in 2017) is generated from its onshore

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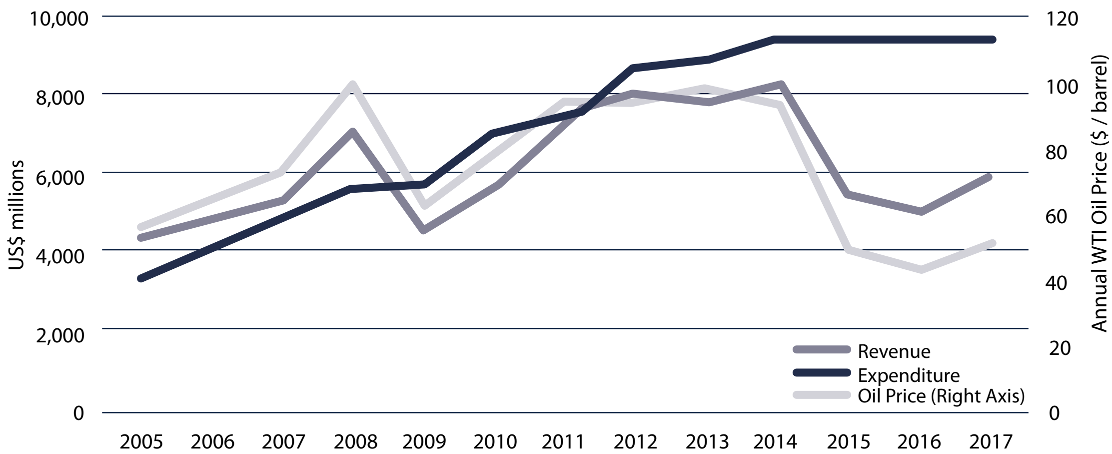
Bahrain field; the remaining 77% was from the Saudi Aramco-operated offshore Abu Saafa field,[5] via an equal production-sharing agreement between Bahrain and Saudi Arabia.

Prior to the Global recession, oil prices had steadily risen to reach an all-time peak of $147 per barrel in July 2008, boosting Bahrain's revenues and expenditures to new highs. However, within six months, oil prices plummeted, pulling revenues sharply down with them, as shown in Figure 1. Yet rather than adjust expenditures to this new low-revenue environment, spending continued to rise, now financed by public sector borrowing. The situation was further exacerbated by the protests that began in 2011, which, in part, fuelled even higher spending on security and social services. Despite gradually rising oil prices over the next several years and some financing from other GCC countries, Bahrain's debt-to-GDP ratio rose from 8% in 2008 to 41% in 2013.[6]

Figure 1: Bahrain Government Revenues and Expenditures (US Dollars)

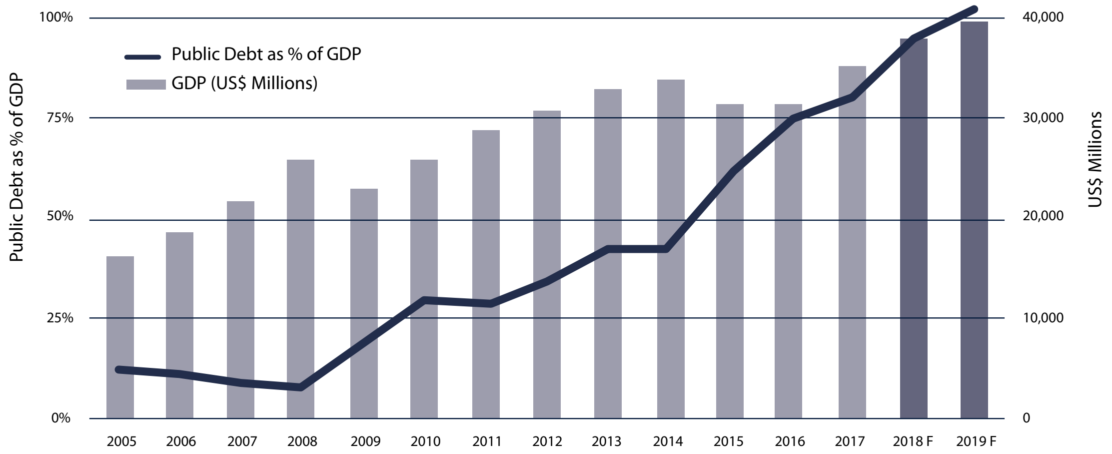


Data Sources: Kingdom of Bahrain Ministry of Finance; U.S. Energy Information Administration. Note: 1 USD = 0.376 BD.

In 2014, oil prices collapsed once again. This time around, however, expenditures were almost double their 2007 levels in Bahraini Dinar, meaning that the revenue collapse widened the deficit gap substantially. The country began enacting budgetary reforms, such as by removing or redirecting subsidies on fuel, meat and poultry,[7] raising the fees for public services and imposing excise taxes on soft drinks, energy drinks and tobacco. It has recently implemented a value-added tax (VAT) of 5 percent, similar to those implemented in Saudi Arabia and the UAE.

Despite these reforms, revenues still fell far short of expenditures. The International Monetary Fund (IMF) estimates that, since 2014, Bahrain has consistently needed an average oil price of well-above $100 simply to break-even on the national budget, compared to an actual average price of $59. That gap is likely to remain large through 2019.[8] The resulting deficits were financed with debt, translating to rising debt levels—debt-to-GDP is expected to top 100% by the end of 2019 (see Figure 2).[9] These increases have also prompted an increase in bond yields and thus debt service. As of April 2018, the majority (58%) of the debt was US Dollar denominated and the remainder was in Bahraini Dinars,[10] which is pegged to the US dollar at 0.376 Bahraini Dinars. Between 2019-2024, Bahrain will have approximately $3 billion in annual bond principal and interest due.[11]

Figure 2: Bahrain's Public Debt



Data Sources: Central Bank of Bahrain, International Monetary Fund. Note: 1 USD = 0.376 BD.

Looking ahead: regional support

Following the 2011 "Arab Spring" protests, the Gulf Cooperation Council (GCC) countries had announced a $10 billion GCC Development Fund aid package to Bahrain (as well as Oman),[12] which has helped support GDP growth over the past several years, despite leaving underlying core fiscal issues unresolved. The IMF's 2018 Mission to Bahrain noted that "notwithstanding notable measures implemented since 2015, a credibly large fiscal adjustment is a priority" and that "additional revenue measures—including consideration of a corporate income tax—would be welcome."[13] The latter advice is similar to that proffered to other GCC countries, though somewhat more acute.

In October 2018, the UAE, Saudi Arabia and Kuwait announced another $10 billion in financial support to Bahrain through "a long-term, interest-free loan."[14] This was soon followed by a new "Fiscal Balance Program" by the Bahraini government, which seeks to balance the public budget by 2022 through several initiatives, including cutting cash subsidies and improving efficiencies.[15] Although the upcoming aid package is expected to relieve immediate pressures, the moment presents an opportunity for long-term fiscal reform. Bahrain has already diversified its economy away from hydrocarbons—the "non-oil economy" made up 81.6% of the Kingdom's GDP in 2017,[16] though the fiscal income is somewhat less diversified. Moreover, to-date, diversification efforts have been largely reliant on government funds, with growth in the private sector still driven by government spending and transfers. For instance, over a third of the local workforce is employed in the public sector, placing a sizeable wage burden on the state.[17] Streamlining the state budget through the redistribution of subsidies and implementation of progressive corporate and personal income taxes would raise non-oil public revenues without placing a cost burden on lower-income earners. Shifting local employment towards the private sector could improve productivity levels and reduce the sizeable public wage bill.

Without tangible fiscal reform, Bahrain will continue being substantially exposed to market forces outside of its control. In the medium-term, as the expansion in the United States matures, the Federal Reserve is likely to return to its rate hiking path. Given its pegged exchange rate, Bahrain's central bank will likely follow suit, which could stifle its own growth. Conversely, if the global economy slows and oil prices were to substantially fall again, the Kingdom may be forced to borrow even further, which can become prohibitively expensive. In the 2018 and 2019 budgets, interest on debt alone was equal to more than 23% of public revenues,[18] a dangerous level and the highest in the GCC. Furthermore, over the next five years, the Kingdom has almost $6 billion of dollar-denominated bonds and sukuk maturing,[19] which will most likely need to be refinanced at higher costs than when they were issued.

In April 2018, the Kingdom did announce the discovery of large quantities of hydrocarbon deposits "amounting to at least 80 billion barrels, and deep gas reserves in the region of 10-20 trillion cubic feet."[20] However, the viability and recoverability of these reserves is yet to be determined, and production is likely to take at least five years—details on any royalties and distribution payments remain uncertain. Nonetheless, if realisable, these reserves could provide a boost to output and revenues, alleviating the pressure on public finances.

Bahrain's trajectory towards ever-higher levels of debt is clearly unsustainable. Although recent fiscal reforms have been in the right direction, more needs to be done at the structural level, and sooner rather than later. Continuing to move away from blanket subsidies to more targeted support to those who need it would reduce deadweight losses and improve efficiency, although care must be taken to avoid negative impacts on energy-intensive productive industries. Developing the private sector through workforce and enterprise development initiatives can also foster a more vibrant, self-sustaining non-oil economy. Increased transparency and public awareness are also necessary, as policies that raise the cost of living tend to be understandably unpopular. In the short term, the Kingdom's small size allows for continued support from its neighbours, but these may begin to come with increased conditions and stipulations. Implementing effective, sustainable reforms with broad-based equitable policies may prove difficult, but it is the only way forward.

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