Bahrain’s current fiscal situation is evidence that sometimes, even with the right policy mix, generating growth can be difficult.

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Bahrain’s current fiscal situation is evidence that sometimes, even with the right policy mix, generating growth can be difficult. The six states of the Gulf Cooperation Council entered the current low oil price environment and corresponding economic slowdown in very different fiscal positions, and on very different economic growth trajectories.

Accordingly, as has become clear both in the economic downturn and the current political discord within the GCC, there are significant differences. Despite their shared geography and history, their fiscal administration, domestic political constraints, and economic fundamentals are extremely diverse. While the general advice from multilateral organizations to the Gulf states to reduce government energy subsidies and public sector wages is sound, the ability to transform traditionally state-driven economies to a model less reliant on the state and more dynamic in private sector growth will take bespoke strategies.

Analysts reflecting on the October release of the most recent International Monetary Fund “Regional Economic Outlook” have made the point that the reform agenda will have stops and starts, and unique challenges in each country. The reform agenda might also gain momentum as these states compete with each other for access to international capital. And even with abundant access to international debt markets, it may not be enough to maintain current monetary policy, especially for the states with smaller, weaker economies.

Bahrain has come under recent pressure because of its dwindling foreign reserve assets, or, more accurately, its pattern of debt-fueled deposits to the Central Bank of Bahrain that are then quickly depleted. Foreign reserves were at $1.4 billion in August, or sufficient for one month’s import cover. In September, after the government’s record $3 billion bond issue, the reserves increased to $3.4 billion, Bahrain’s highest level since mid-2015. Moreover, the investor appetite for Bahrain’s debt remained very strong, with the most recent bond oversubscribed and some would-be buyers (including Qatar) turned away. So, while this pattern of debt-fueled spending is feasible, in the long term it is not very sustainable. The most immediate threat is to the sustainability of the currency regime, in that the Central Bank of Bahrain guarantees the convertibility of the local currency to the U.S. dollar at a rate of 0.376 dinars to 1 U.S. dollar.

The Central Bank’s reporting indicates that debt obligations have increased to 87 percent of gross domestic product as of September. Like its neighbors, Bahrain has faced fiscal deficits for the last two years, and that is expected again for the close of 2017. Its 2017 deficit is predicted at 8.3 percent of GDP, according to Standard Chartered analysts. (HSBC predicts a double-digit deficit.) To create bridge funding, Bahrain has tried to reduce government expenditure while also borrowing on international capital markets and tapping its reserves. Bahrain is now in a cycle of debt-fueled expenditure, one that will be difficult to break. With parliamentary approval, the government raised its debt ceiling in June to 13 billion Bahraini dinars (nearly $34.5 billion), close to 100 percent of GDP.

Bahrain has historically relied on Saudi Arabia and the United Arab Emirates for both formal financial support, as it did in 2011 with the Gulf infrastructure support fund, and more informal transfers. In fact, much of the recent growth in the country can be directly related to infrastructure expenditure funded by the UAE and Saudi Arabia. The Bahraini economy expanded 3.7 percent in the second quarter of 2017, year on year, according to research by Standard Chartered, an enviable figure in a slow growth environment in the Gulf. However, this growth has been driven not by manufacturing or the oil sector, but by infrastructure spending. Without the infrastructure financing from its neighbors, the growth story would be very different. The bad news is that relying on transfers from neighboring Gulf states is also unsustainable.

Growth across the GCC states is stalled, and for different reasons. Saudi Arabia’s real GDP has suffered from a slowdown in the oil and gas sector, due mostly to self-imposed production cuts, which have reduced investment and growth in the sector. The UAE has fared better as its economy is more diversified, but its own exports have not been so robust. Qatar’s current political isolation from the GCC has created a number of obstacles to growth, and created a fiscal prioritization of capitalization in the bank sector, largely drawn from reserves and transfers from the Qatar Investment Authority, the sovereign wealth fund. Oman’s struggles are most similar to Bahrain’s, as dwindling reserves and new debt meet demands of government expenditures. A small boost from increased airport and marine port activity with Qatar has not been enough to change the direction of economic activity. Kuwait’s falling private consumption and public investment point to a domestic slowdown. In short, this is a period of economic contraction; where there is growth in the region, it is largely still driven by government projects (domestic or regionally funded).

Bahrain’s Economic Reform Path: Cogent Policies, but Challenges Remain

Bahrain’s path from oil dependency to a diversified economy has been difficult, partly because of its limited resources and the timing of Bahrain’s entry into international oil markets. Bahrain has a long history of efforts at diversification, and has been on the declining oil revenue diet for much longer than its neighbors. Oil production peaked in Bahrain in 1977. Bahrain’s early trajectory for oil-fueled economic growth did not coincide with recent periods of international high oil prices. It missed the record wealth creation of the second oil boom of the 2000s, as its capacity has diminished since the early days of exploration. Bahrain has the advantage, however, of decades of experimentation with developing alternative sectors, like finance, tourism, and some manufacturing. Bahrain also has the benefit of a highly skilled pool of local talent in technocrats, businesspeople, and policymakers.

However, Bahrain’s government still heavily relies on its oil production as a key source of revenue, made more difficult in that its production is controlled largely by Saudi Arabia in joint fields. New plans to build an additional pipeline between Saudi Arabia and Bahrain, linking to Bahrain’s refinery and a liquefied natural gas facility to import gas domestically, would strengthen Bahrain’s ability to serve domestic markets and develop related products. A new causeway to Saudi Arabia is in the works to expand tourism and trade.

Bahrain’s early efforts to create a financial center provided a road map for the region, in iterations like the Dubai International Financial Center. Bahrain remains a major regional financial hub, especially for Islamic finance.

Bahrain was the first Gulf state to create a national airline of regional and international prominence. Gulf Air was part of the first initiatives of economic integration in the Gulf in 1974, when it became jointly owned by Oman, Bahrain, Qatar, and the United Arab Emirates. Since 2007, it has been wholly owned by the sovereign wealth fund of Bahrain.

Its commercial agency structure is comparatively liberal by Gulf standards, allowing 100 percent foreign ownership across the country in most sectors, not just in free zones.

In labor policy, Bahrain’s efforts to make employment markets more mobile, and empowering workers to move between employers without new contracts, is a model for reform of the kafala system in the entire GCC. The Labor Market Regulatory Authority has made efforts to streamline visa applications, deter the black market of visa trading, as well as provide more transparency on labor demographics.

In women’s economic inclusion, Bahrain leads the region with its proportion of female citizens in the workplace, though most are in public sector jobs.

In attracting foreign investment, Bahrain has recently shown impressive negotiating skills competing with richer, more powerful neighbors to land new business. Amazon Web Services opened in early 2017 in Bahrain, signaling the country’s ability to foster a technology ecosystem.

It seems Bahrain has all of the right ideas, at least as they are now popularized in economic vision documents across the region by consultancies and governments. But, the fundamentals of the Bahraini economy have limitations. Bahrain is small and it exports few manufactured goods. Its public sector is still the preferred employer for most citizens. Its ports and logistics hub is not competitive with its neighbors for its location and island geography. It is reliant on Saudi Arabian visitors for its tourism industry, such that a downturn in Saudi spending habits directly impacts Bahrain. Moreover, a redirection of Saudi spending habits internally will impact Bahrain. And its domestic political conflicts since 2011 have tarnished its international reputation and dampened prospects for growth.

Those challenges aside, in a recent conversation Bahraini Minister of Industry, Commerce, and Tourism Zayed Alzayani gave a cogent strategy for Bahrain’s economic survival, exemplified in the airline business. “We want to be the Southwest of the Gulf airlines,” he said. (Alzayani is also the chairman of the board of directors of Gulf Air.) As Southwest, a low-cost carrier in the U.S. air travel market seeks to do, Bahrain will have to compete with larger, better-funded regional rivals by providing a different kind of service or product. This is the marketing equivalent of pitching Bahrain as the no-frills Gulf business destination.

Bahrain has the potential to be a disruptor to other regional industries as well, offering niche services in a competitive environment. The difficult fact is that Bahrain will have to work harder for foreign investment, to diminish dependency on regional support in cash transfers, and to compete in a region in which growth is stagnant.

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