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KINGDOM OF BAHRAIN

SELECTED ISSUES

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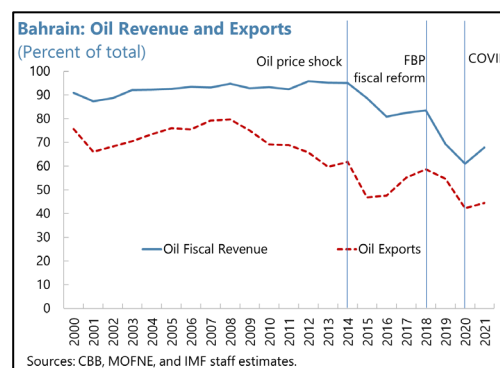
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BUILDING A LONG-TERM FISCAL POLICY FRAMEWORK¹

The Bahraini authorities are committed to implementing fiscal reforms to address large fiscal and external vulnerabilities, high debt, and reliance on oil revenue. However, medium- and long-term fiscal benchmarks, as well as unfavorable starting conditions for net financial wealth, call for ambitious fiscal efforts that should be embedded in a credible, well defined fiscal framework. The authorities launched the revised Fiscal Balance Program (FBP) that aims at achieving a fiscal surplus by 2024 and could deliver most of the needed post-crisis adjustment. This paper proposes a gradual transition from the current high-adjustment needs phase to a long-run steady state consistent with fiscal sustainability.

A. Introduction

1. Managing Bahrain's oil wealth is a central policy priority. Bahrain's economy is one of the most diversified in the GCC region with hydrocarbon extraction contributing approximately 30 percent to Bahrain's real GDP. However, hydrocarbon revenues play a central role in both fiscal revenue and current account inflows. Oil fiscal revenue hovered around 90 percent of total revenue until the 2014 oil price shock, and, in more recent years, it declined to around 70 percent following the reforms introduced by the fiscal balance program (FBP) such as the introduction of VAT and excise taxes. The investment and redistribution of oil wealth in Bahrain allowed the rapid improvement of living standards, the development of a vibrant nonoil private sector, and the achievement of "high income" economy status.

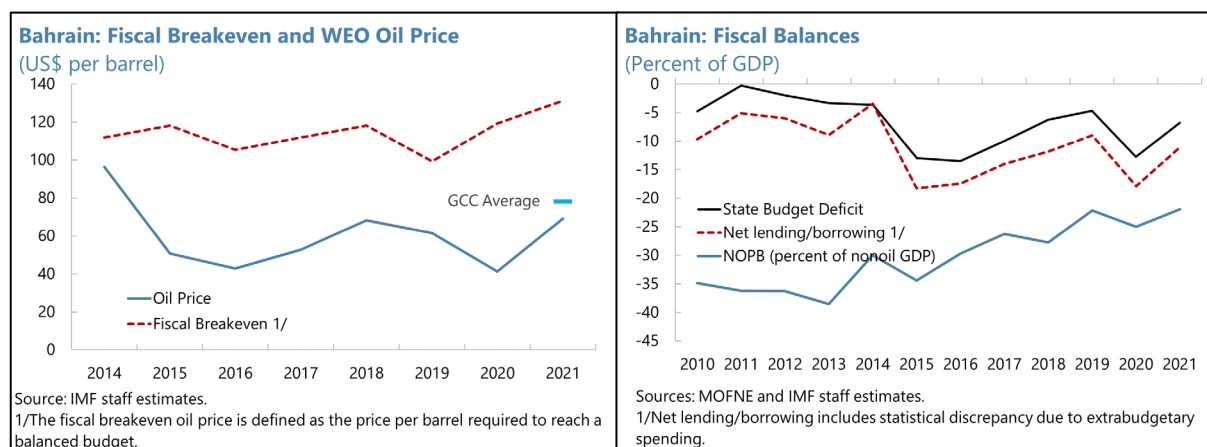


2. Fiscal policy plays a key role in oil wealth redistribution and savings decisions. In the current oil sector set up, all revenue generated by the hydrocarbon sector accrues to the state monopolist—the National Oil and Gas Authority (NOGA), which oversees oil extraction, oil refining, and sets domestic prices of hydrocarbons. Each year, NOGA transfers directly into the budget what becomes the year's oil revenue. Through the Budget Law, the Ministry of Finance and National Economy (MOFNE) allocates oil revenues to savings for future generations and expenditures. Oil revenue redistribution to citizens over the years has been achieved through large public sector employment, a generous subsidy system, and significant capital expenditure (see IMF 2020a).

3. Bahrain's fiscal position deteriorated sharply with the 2014-15 oil-price shock and more recently with the COVID-19 pandemic. Oil revenue in 2015 plummeted to 13.8 percent of GDP from 21.4 a year earlier and, with a mostly inelastic expenditure side, the fiscal deficit reached

¹ Prepared by Giovanni Ugazio.

and remained in double-digit levels almost every year until 2021. The fiscal breakeven for Bahrain shows that for the given level of expenditures and nonoil revenues, the gap between realized oil prices and those needed to balance the budget remains wide. The authorities began commendable adjustment efforts with the FBP that launched in 2018, which included various measures starting in 2019 and, prior to the COVID crisis, successfully reduced the fiscal breakeven despite marginally lower oil prices. Together with efforts to boost nonoil growth, the reforms have contributed to a significant improvement of the nonoil primary balance (NOPB) over the past years, which stood at around -20 percent of nonoil GDP in 2021, compared with -35 percent in 2010. However, progress was hindered by the twin COVID and oil price shocks in 2020, which derailed the fiscal progress causing a large increase in the deficit and debt.



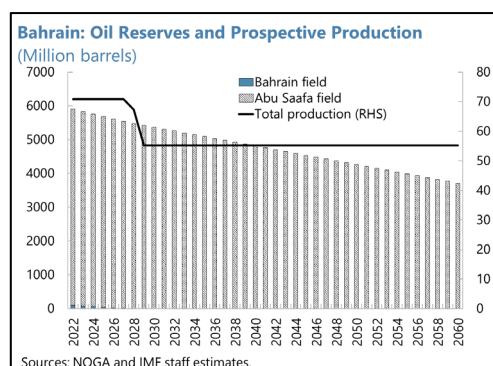
4. Global mitigation actions to tackle climate change will further exacerbate long-term fiscal sustainability challenges linked to oil exhaustibility. Further pressures on future oil revenues and on the viability of hydrocarbon extraction—including the newly discovered hydrocarbon resources—will emerge in the medium-long-term as oil importing economies gradually implement measures to reduce fossil fuels consumption and transition to renewable energy sources (see IMF 2020b and IMF 2022). This trend calls for conservative long-term fiscal targets to ensure sustainability and intergenerational equity.

5. Against this background, this paper proposes a fiscal framework for Bahrain to ensure long-term sustainability beyond the post-crisis adjustment. The paper builds on the post-COVID adjustment recommendations of the 2021 Article IV Consultation (see SM/21/23) and the IMF's framework for Resource Rich Countries (see IMF 2012) to propose alternative long-term paths to fiscal sustainability. Section B provides a context by looking at Bahrain's public sector savings and net wealth, as well as discussing Bahrain's hydrocarbon reserves. Section C estimates a set of long-term benchmarks for the NOPB that would be consistent with long-term solvency and different measures of intergenerational equity. Section D proposes the gradual phasing-in of a fiscal rule that would transparently transition Bahrain from an initial adjustment period to a long-term sustainable equilibrium. Finally, section E concludes with a summing up of policy recommendations.

B. Oil Wealth in Bahrain and Intergenerational Savings

6. Bahrain's oil extraction wealth and income derive from two different oil fields. The

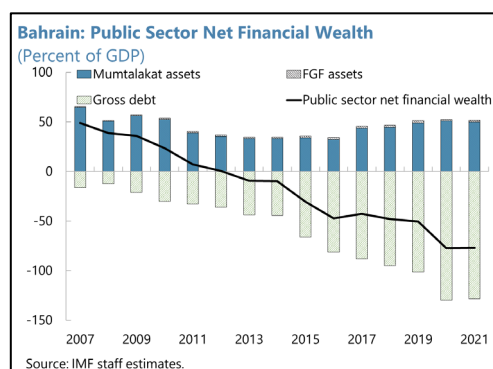
onshore Bahrain field produces approximately 50 thousand barrels/day, and at current extraction rates is expected to be depleted by 2028. Bahrain also shares with Saudi Arabia the production of the offshore Abu Saafa field and has a share of production of approximately 150 thousand barrels/day. The offshore field has enough reserves to keep producing at this rate for the next century. Moreover, Bahrain announced in 2018 the discovery of a new oil field with potentially 80 billion barrels, which could boost its production



capacity and increase its net wealth considerably. Bahrain is developing the new field through foreign partnerships. Due to uncertainty surrounding both the timeline and the future production capacity of the new fields, these are not included in the analysis presented in this paper. Finally, although potential future access to these reserves could provide a boost to oil revenue, policies aiming at economic diversification and reducing oil dependence should remain a priority.

7. Despite the hydrocarbon windfalls, Bahrain's public sector has a negative net financial wealth since almost a decade. Due to data

limitations, the analysis of financial wealth only considers on the assets side the two main savings and investment vehicles—the Future Generations Fund (FGF) and Mumtalakat—and on the liabilities side, the budgetary central government's (i.e., MOFNE) total gross debt. The net financial position of Bahrain's public sector is estimated to have turned negative in 2013 and has been declining since then to an estimated -75 percent of GDP in 2021.



8. Bahrain established the FGF to strengthen long-term fiscal management. The FGF was established in 2006 with a mandate to preserve its capital and to invest in low-risk liquid foreign financial assets. Since its establishment, the MOFNE has been funding it by transferring US\$1 for each barrel of exported oil, equivalent to approximately US\$50 million (0.2 percent of GDP) per year. Total assets at end-2019 stood at an estimated BD345 million (US\$900 million or 2.5 percent of GDP) but have since declined to an estimated BD242 million at end-2021, due to a one-off withdrawal of US\$450 million to help finance the emergency fiscal package during the COVID crisis.

9. To help replenish the withdrawn funds, the authorities will increase the contribution rate starting in 2023. Recognizing the need to rebuild fiscal buffers and boost almost-depleted intergenerational savings, new legislation coming into force in 2023 amended the contribution rates to the FGF, doubling (tripling) the rate when the price of exported oil is above US\$80 (US\$120) per

barrel. However, even at currently higher oil prices, the revised contribution rate is expected to replenish the fund only gradually.

10. Bahrain’s public sector also owns the holding company “Mumtalakat”, which channels and oversees sovereign investments. Mumtalakat’s has a different mandate than the FGF and holds both foreign and domestic participations in controlled companies. Total assets at end-2020 stood at BD7 billion (US\$18.9 billion or 50 percent of GDP). Mumtalakat’s portfolio pays a regular annual dividend into Bahrain’s state budget, which in 2020 amounted to BD30 million. Among others, Mumtalakat holds the Bahraini government’s participation in National Bank of Bahrain (NBB), Gulf Air, and Aluminum Bahrain (ALBA).

C. Long-Term Fiscal Sustainability

11. Adhering to a fiscal framework consistent with long-term sustainability is key to ensure the government’s solvency and the effectiveness of fiscal policy and, ultimately, protecting intergenerational equity. To estimate this framework a few key issues must be considered:

- **Exhaustibility of oil revenues:** at the current status quo, Bahrain field is set to cease production in 2028, reducing oil production and revenue by about 20 percent. In addition, price pressures may emerge in the medium-long-term due to reduced oil demand related to climate change and oil importing economies seeking to transition out of fossil fuels (see IMF 2020b).
- **Negative net financial wealth:** to put debt on a firm downward path and to leave a positive net financial wealth to future generations in the long term, Bahrain’s fiscal strategy should address the highly negative starting condition for net financial wealth which resulted from several years of significant fiscal dissaving.
- **Transition phase:** in the absence of fiscal buffers that could be used in the transition towards a long-term sustainable fiscal position, Bahrain’s large adjustment needs in the short and medium terms result in a trade-off between the speed of adjustment now versus the overall adjustment size required to achieve a permanently sustainable NOPB and a sufficiently positive net financial wealth in the future.
- **Fiscal rules to insulate the budget from short-term oil price volatility:** Bahrain could consider introducing a fiscal rule to target a sustainable overall primary balance (OPB) on average, which can be calibrated to yield a sustainable net wealth.

12. The Permanent Income Hypothesis (PIH) framework is used to derive different target options for fiscal sustainability. Based on net financial wealth as of 2021, the present value of future oil production, and other long-term macroeconomic assumptions (see box 1), the paper estimates two NOPB targets consistent with different definitions of PIH.

- **Constant perpetuity payout:** this scenario estimates that a constant NOPB of -0.6 percent of nonoil GDP would maximize Bahrain’s net assets in the long-term while being sustainable

indefinitely throughout the projection horizon. Although achieving this target in the short term would not be feasible (or desirable), the scenario represents the benchmark around which the paper examines different paths to achieve long-term sustainability. Given the initial condition for net financial wealth, even in this scenario with large and upfront theoretical adjustment, it would take until 2028 for net wealth to reach zero percent of GDP, and approximately 40 years to reach steady state net financial wealth at around 150 percent of nonoil GDP.

- **Constant *real* perpetuity payout:** a different approach to a long-term sustainable target is to assume oil wealth pays a constant transfer in real terms, resulting in larger disbursements at the beginning of the projection horizon. This scenario derives an initial NOPB that increases over time at the inflation rate and that stabilizes net assets in the long run. This approach would internalize the higher wealth for future generations generated by the expanding nonoil sector over time and, accordingly, frontloads the disbursement of oil wealth. Under this approach, the target NOPB for 2022 is estimated at -5.9 percent of nonoil GDP, lower (larger deficit) than under the constant perpetuity and increasing over the projection horizon. In this scenario wealth grows much more gradually and turns positive in 2039, eventually converging to approximately 35 percent of nonoil GDP after 40 years.

Box 1. Bahrain: Long-Term Macroeconomic Assumptions

Oil revenues

- *Oil production* is projected assuming the authorities continue producing at maximum capacity in both the onshore and offshore fields. It remains constant throughout the horizon.
- *Oil reserves* are estimated for 2021 at 122 million barrels for the Bahrain field and at 5.9 billion barrels for the Abu Saafa field.
- *Oil price* follows the IMF World Economic Outlook forecast until 2027. For years after 2027, it is assumed constant in real terms (i.e. grows in line with US inflation).

Macroeconomic variables

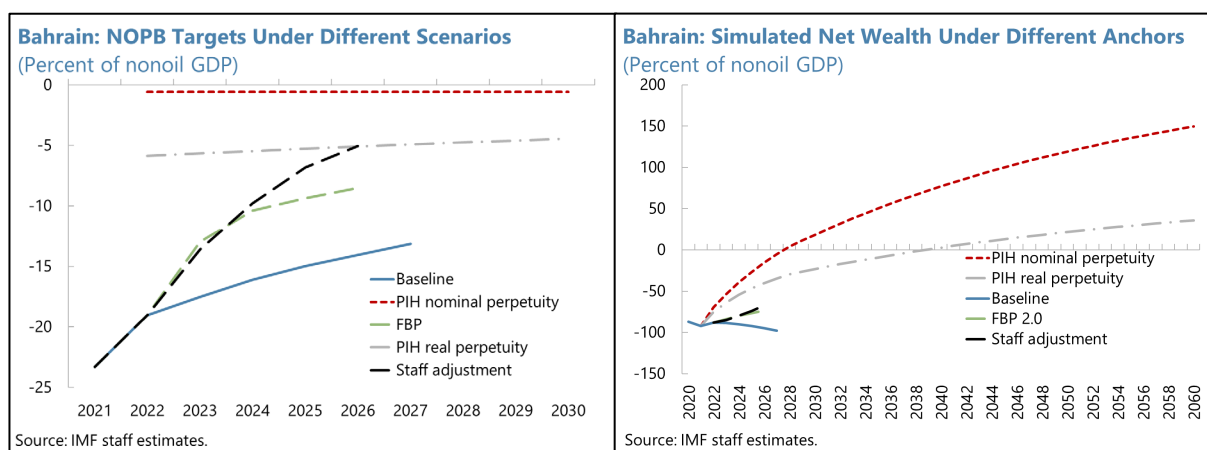
- *Inflation*, given the US dollar peg, is projected to converge to US long term inflation of 2 percent.
- *Nonoil GDP* is projected to grow in the long term at 3.6 percent.
- *Real interest rate* is assumed at 4 percent in the long-term.

13. Although different PIH benchmarks result in different targets, the analysis points in all cases to substantial fiscal consolidation needs. In the baseline scenario at current policies the NOPB improves too slowly over the projection horizon and net wealth drops to -100 percent of nonoil GDP by 2027 from -92 percent in 2021. Further postponing a significant adjustment,

therefore, would cause a significant deterioration of initial conditions, leaving Bahrain exposed to the uncertainty related to the outlook for oil markets as the global economy moves to a low carbon future and possibly forcing a very large correction in a short period of time if fiscal solvency is no longer ensured.

14. Medium-term adjustments proposed by staff and in the revised FBP (see Box 2) would go a long way to achieve long-term sustainability. At current oil prices, staff-proposed medium-term adjustment would bring the NOPB to around -5 percent of nonoil GDP by 2027, consistent with the real perpetuity target. The measures in the revamped FBP, if implemented and legislated as in the current plan, would instead deliver a NOPB of -8.5 percent by 2027, below but not very far from the real perpetuity target.

15. After the initial adjustment phase, additional fiscal efforts would be determined by the selected long-term PIH target. Selecting the NOPB target involves a trade-off between achievable savings and the size of fiscal adjustment. Under the staff adjustment scenario, the authorities could either opt for capitalizing on the achieved adjustment and remain at or above the real PIH level or, more prudently, they could gradually set a more ambitious target to create a large enough buffer and mitigate downside risks to future oil prices and possibly to nonoil growth. For instance, an extra adjustment beyond 2027 totaling about 4 percent of nonoil GDP over two years would bring the NOPB in line with a constant PIH target recalculated at that time and would achieve a net wealth of zero by 2035 (instead of by 2039 in the real PIH model) and stabilize net wealth at around 100 percent of nonoil GDP in the long run (compared with 35 percent of nonoil GDP in the real PIH model). However, under the revamped FBP scenario, an additional adjustment of at least 3.5 percent of nonoil GDP is needed beyond 2027 to achieve long-term sustainability in line with the minimum real PIH target.



16. The PIH targets and projections are sensitive to oil prices calibration. Given the long-term horizon, changes to assumed oil prices will significantly affect projected wealth at the end of the projection horizon. Table 1 illustrates the endpoint projection for net wealth depending on the NOPB target chosen by the authorities. The large uncertainty surrounding the long-term projection and the negative wealth starting condition call for a conservative approach in selecting the NOPB target.

Table 1. Bahrain: Projected 2060 Net Financial Wealth at Different Oil Prices
(percent of nonoil GDP)

	Oil Price Assumption (constant real price after 2028)							
	30	40	50	60	70	80	90	100
Nominal PIH	56	78	101	124	146	169	192	214
Staff adjustment then nominal PIH	2	25	48	71	94	117	141	164
Staff adjustment then real PIH	-106	-79	-53	-26	0	27	53	80
Real PIH	14	19	25	30	36	41	47	52

Source: IMF staff estimates.

D. Transitioning to a Long-Term Framework Using Fiscal Rules

Structural Rules

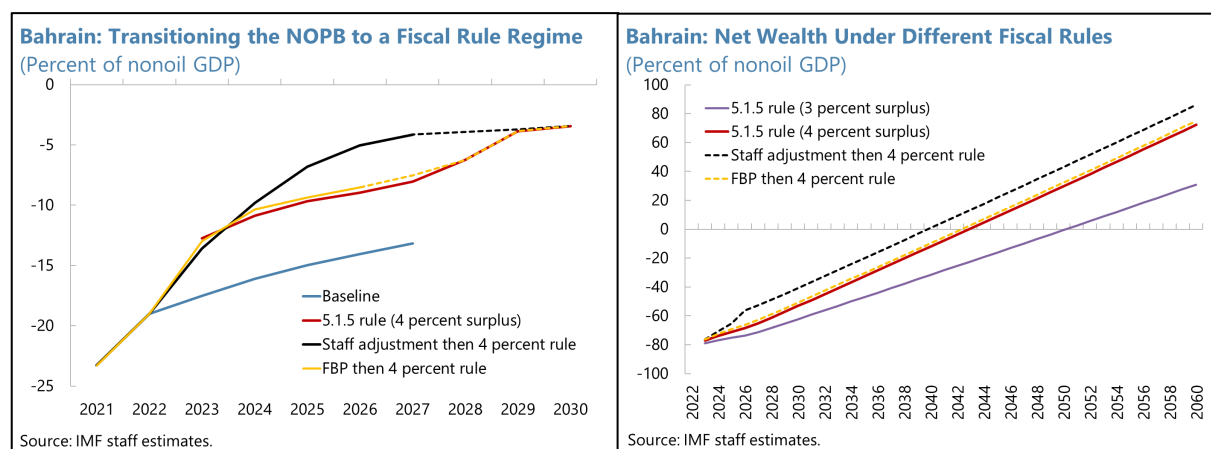
17. An alternative approach to long-term sustainability could be to establish a structural fiscal rule that would yield enough savings to be PIH-consistent. Structural fiscal rules embed a tradeoff between their sensitivity to oil price volatility and the amount of fiscal volatility they absorb. During high volatility episodes, a more rigid fiscal rule will allow the authorities to maintain their fiscal expenditure and will use saving (borrowing) to absorb the excess (shortfall) in revenue. This approach to sustainability could help fiscal transparency by using a published target that is simple and easy to communicate, while at the same time insulating fiscal policy from short-term oil price volatility.

18. A structural fiscal rule could be calibrated to generate savings broadly in line with long-term sustainability. The proposed fiscal rule is based on “structural” revenue, which is estimated using an eleven-year symmetric moving average for oil prices (5.1.5 rule). This average is calculated as the simple average of oil prices in the past five years, the current year, and the forecast for the next five years.

19. Permanently targeting a four percent structural primary surplus would generate savings consistent with the PIH by 2060. The PIH calculations showed that under a constant perpetuity target, net financial wealth would be about 150 percent of nonoil GDP by 2060. In contrast, following a more gradual adjustment, as in staff’s recommended approach before reaching the PIH target, would lower savings to 100 percent of nonoil GDP. The simulated outcome of immediately introducing a credible 5.1.5 rule with a 4 percent of GDP structural primary surplus target would generate 70 percent of nonoil GDP in savings, below the constant PIH but higher than the real PIH. In comparison to staff-proposed fiscal reform, based on recent and forecasted oil price developments, the rule would imply a similar one-off adjustment in 2023 followed by a more gradual effort starting in 2024, resulting in a smaller primary surplus target by approximately 3.5 percent of nonoil GDP in 2027. In contrast, the adjustment measures proposed by the FBP, if legislated in full, would imply an adjustment path in line with the 4 percent structural target rule until 2026. The main advantage of the staff adjustment scenario over the rule is that the additional fiscal effort during 2024-2026 provides long-term dividends by effectively insulating the fiscal

balance from long-term oil price developments, while both the FBP and the introduction of the rule without first finalizing the medium-term adjustment rely more on (and are more sensitive to) long-term oil revenue to build the target savings.

20. A strategy that combines the transparency and simplicity of the fiscal rule with frontloaded ambitious fiscal reform could be to transition from the staff adjustment in the medium-term to the structural fiscal rule starting in 2027. This scenario would allow for a more frontloaded adjustment focused on the nonoil components of the budget, thereby addressing Bahrain's main fiscal challenge to promote lower reliance on oil revenue at inception of the strategy and, importantly, allowing the authorities to capitalize on the currently favorable near-term outlook for oil prices by saving a good part of oil revenue to rebuild the fiscal buffers that were drawn down during the COVID crisis. The transition would involve achieving the medium-term reform targets and then adopting the structural fiscal rule of a 4 percent of GDP overall primary surplus with the 2027-28 Budget cycle, which would keep the target NOPB below the PIH level for a long time but without losing much in forecasted net wealth over the next two decades.



21. The simulated net wealth is sensitive to the selection of primary balance target, but the structural rule helps insulate the fiscal stance from excessive short-term oil price volatility. Like PIH-based targets, long-term projections for fiscal rule-based targets are also sensitive to parameter selection. Sensitivity analysis in Table 2 shows that small changes to the rule target are likely to have large impacts on fiscal sustainability and long-term solvency. Selecting a large enough primary balance target would therefore be a necessary condition. At the same time, reducing reliance on oil revenue remains key to ensure durable fiscal sustainability and to avoid generating large adjustment needs in the future should oil prices decline.

Table 2. Bahrain: Projected 2060 Net Financial Wealth Under the 5.1.5 Rule
(percent of nonoil GDP)

	Oil Price Assumption (constant real price after 2028)							
	30	40	50	60	70	80	90	100
0 percent OPB	-109	-105	-101	-98	-94	-90	-87	-83
2 percent OPB	-26	-22	-19	-15	-11	-8	-4	0
4 percent OPB	57	60	64	68	71	75	79	82
6 percent OPB	140	143	147	151	154	158	162	165

Source: IMF staff estimates.

Structural and Expenditure Rules

22. The structural balance rule could be supplemented by an expenditure growth rule to limit procyclicality during episodes of unexpectedly high windfall. While the purpose of the structural fiscal rule is to ensure average alignment of expenditures and revenues by smoothing oil revenue windfalls, the rule's slow-adjusting moving average for oil prices may be ineffective at absorbing unexpectedly large revenue windfalls. To obviate this design shortcoming, several countries have opted to combine fiscal balance rules with rules that explicitly limit expenditure growth (see Cordes et al. 2015).

23. Bahrain's existing budget process includes a benchmarked oil revenue that could be used to design an expenditure growth rule. Under this framework, all (or most) oil revenue above the benchmark legislated in the budget would automatically be saved or used to retire debt preventing procyclical increases in expenditure during periods of unexpectedly high revenue windfall. Alternatively, other rules to limit expenditure growth during windfall periods could include directly capping expenditure nominal or real growth at a level at or below GDP growth.

24. Finally, legislation is already in place to shield essential government spending during periods of collapsing oil prices. Under existing law, the MOFNE can appropriate an extra budget allocation of up to 3 percent of total expenditure without amending the Budget Law to boost discretionary spending during emergencies. This "escape clause" was last successfully used during the 2020 oil price and COVID twin shocks to finance health-related expenses and part of the fiscal support package.

Expenditure Rules

25. A simpler fiscal rule could comprise a growth ceiling for expenditures. In this setting, fiscal expenditure growth after the post-crisis adjustment is completed could be constrained in either nominal or real terms, for instance by linking it to economic growth. Advantages of adopting this rule over the structural fiscal rule include a stronger decoupling of expenditure from oil prices and ease of communicating the target to the public. Disadvantages, instead, include a disincentive to mobilize revenues when nonoil revenue is comparatively low as in the case of Bahrain, as well as the fact that they may induce lower level of capital spending (see Eyraud et al. 2018).

26. Capping real expenditure growth at GDP growth would deliver a net wealth consistent with the real PIH. Staff simulated a few expenditure rules which could be introduced starting in 2027 after the post-crisis adjustment is finalized. While results are sensitive to parameter selection, the simulation in Table 3 shows that, if no new revenue measure is introduced in the forecast horizon, real expenditure growth should be capped at real GDP growth or below to deliver a positive net wealth. Given that staff long-term forecast features constant inflation (see Box 1), the target could also be set in nominal terms without affecting the results. However, in this setting, realized deviations of inflation from the forecast would have to be absorbed with lower real expenditure growth, potentially boosting the countercyclical property of this rule but exposing it to implementation feasibility risks during periods of high inflation periods.

Table 3. Bahrain: Projected 2060 Net Financial Wealth Using Expenditure Rules
(percent of nonoil GDP)

Rule (Real Expenditure Growth Capped at:)	Oil Price Assumption (constant real price after 2028)							
	30	40	50	60	70	80	90	100
Nonoil growth (≈3.6 percent)	-186	-160	-133	-107	-80	-54	-28	-1
GDP growth (≈3.1 percent)	-92	-65	-39	-12	14	40	67	93
Zero real growth	266	293	319	346	372	399	425	452

Source: IMF staff estimates.

E. Conclusion

27. Achieving long-term fiscal sustainability will require ambitious fiscal savings. The paper used different definitions of the PIH as well as structural fiscal rules to estimate long-term sustainable fiscal targets. Under all scenarios examined by the paper, the starting conditions for both financial wealth and the NOBP require substantial efforts in the coming years to reverse the unfavorable dynamics and ensure fiscal solvency. The efforts would also go a long way in preserving a share of oil wealth for future generations.

28. In the medium-term, fiscal adjustment proposed by the 2021 Article IV remains appropriate. Given higher than expected oil prices compared to the 2021 Article IV discussion and the firming up of the economic recovery, this paper recommends proceeding with ambitious fiscal reforms in the medium term. Specifically, the plan would continue improving the NOPB without substituting nonoil measures with the additional oil revenue windfall. The latter could instead be used to replenish fiscal buffers and partially reverse the negative trend for net financial wealth.

29. The revised FBP's overall fiscal targets are close to staff's proposed strategy, but some additional nonoil revenue reform is needed to reach long-term sustainability beyond 2026 and to insulate the budget from oil price developments. While the FBP's target of a balanced state budget in 2024 is above the four percent primary surplus in staff's long-term fiscal rule proposal, the FBP proposes achieving the target in overall as opposed to structural terms. Therefore, it is vulnerable to substituting nonoil reform with higher-than-forecasted oil revenues if a reform

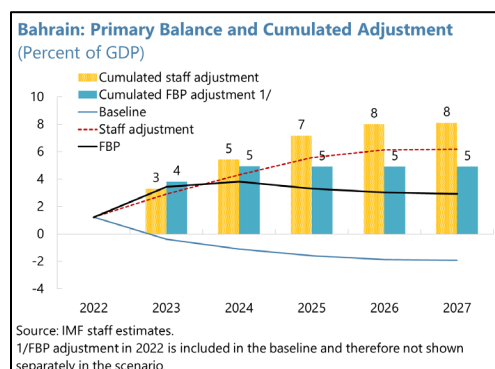
shortfall emerges. An additional risk to the FBP plan stems from the possibility that delays or other unforeseen impediments during the legislative process reduce the incisiveness of some of the initiatives.

30. In the long-term, fiscal targets could be underpinned by a structural fiscal rule. During 2022-24, the authorities have committed to an ambitious adjustment effort in the context of the FBP, and staff proposed a more ambitious yet gradual adjustment lasting until 2026. Following this effort, the NOPB is forecasted to be consistent with (or close to) the real PIH annuity and the implied level of a structural fiscal rule targeting a 4 percent of GDP overall primary surplus. Starting in 2027, fiscal policy should be anchored in a credible fiscal framework based on a long-term sustainable target. The fiscal target will go a long way to achieving fiscal sustainability and, importantly, determining the desired amount of fiscal saving for future generations. An option could be to commit to a fiscal rule of a four percent structural primary surplus. If the medium-term adjustment is implemented according to plan, transitioning to the rule will require no additional short-term consolidation (in the staff scenario) or some additional effort (in the FBP scenario), and would provide a transparent and simple fiscal target for communicating fiscal goals to the public.

Box 2. Bahrain: Summary of Staff-Recommended Adjustment and FBP Measures

Staff Adjustment

- Staff proposed a two-phase adjustment during the 2021 AIV Consultation (see SM/21/23). The first phase consisted of savings of up to 4 percent of GDP using readily available measures within the existing Budget Law during the years 2021-22, while the second phase would include more ambitious reforms for a total of 8 percent of GDP over four years.
- The authorities planned and implemented fiscal reforms in 2021-22 (e.g. VAT rate hike, elimination of EWA deficit) resulting in an estimated adjustment of 3 percent of GDP. Among the measures proposed by staff (see 2022 AIV Staff Report text), the plan to successfully complete the second phase over the next 5 years, for a total of 8 percent of GDP, could include a mix of (i) introducing a corporate income tax (CIT—up to 3.5 percent of GDP); (ii) reducing VAT exemptions (up to 1.5 percent of GDP depending on the rate applied); (iii) reducing wages (0.5 percent of GDP); (iv) discontinue extrabudgetary expense (4 percent of GDP); and (v) finalize subsidy reform (0.5 percent of GDP).



Revised FBP Adjustment

- The authorities are introducing fiscal adjustment through the revised FBP, which aims at achieving a balanced state budget by 2024, excluding extrabudgetary spending and assuming oil prices at US\$60 per barrel.
- Like staff advice, the revised FBP is also structured in two phases. The first phase of the FBP includes measures implemented during 2022, including the doubling of the VAT rate. The second phase is composed of a very ambitious adjustment of 5.2 percent of GDP in 2023-24, though some measures are not yet identified. The adjustment is composed of several reforms on both the revenue (60 percent of estimated adjustment) and the expenditure (40 percent) sides. Although not part of the current plan, the FBP document mentions the potential introduction of a CIT, which if implemented could broadly align the grand totals of fiscal reforms proposed by staff and those in the revised FBP.

Bahrain: Fiscal Reforms Measures (Percent of GDP)		
	Staff ¹	FBP ²
Revenue	up to 5	1.3
Remove all VAT exemptions except food	up to 1.5	n.a.
Introduce corporate income tax (CIT) of 15%	up to 3.5	n.a. ³
Increase domestic oil revenue	n.a.	0.2
Increasing dividends from SOEs	n.a.	0.3
Introducing new government fees	n.a.	0.8
Expenditure	up to 5	2.3
Reducing wages ⁴	0.5	0.5
Reducing other current expenditure	n.a.	0.6
Finalize subsidy reform ⁵	0.5	0.7
Cut extrabudgetary spending ⁶	up to 4	n.a.
Reduce capital expenditure	n.a.	0.4

Sources: MOFNE and IMF staff estimates.
1/Staff measures illustrate the proposal for the authorities to achieve the adjustment targets and are not meant to be all implemented. Measures with "n.a." are not part of the staff proposal.
2/FBP measures exclude those already in the baseline as well as measures yet to be identified. FBP yields are MOFNE estimates.
3/The FBP does not yet include a CIT, but the authorities have committed to implementing the OECD framework on minimum global CIT at 15 percent.
4/Staff estimate based on capping wage bill at 2022 nominal value for 5 years.
5/Staff estimate based on discontinuing the food and rent subsidies.
6/Based on staff baseline forecast for extrabudgetary spending.

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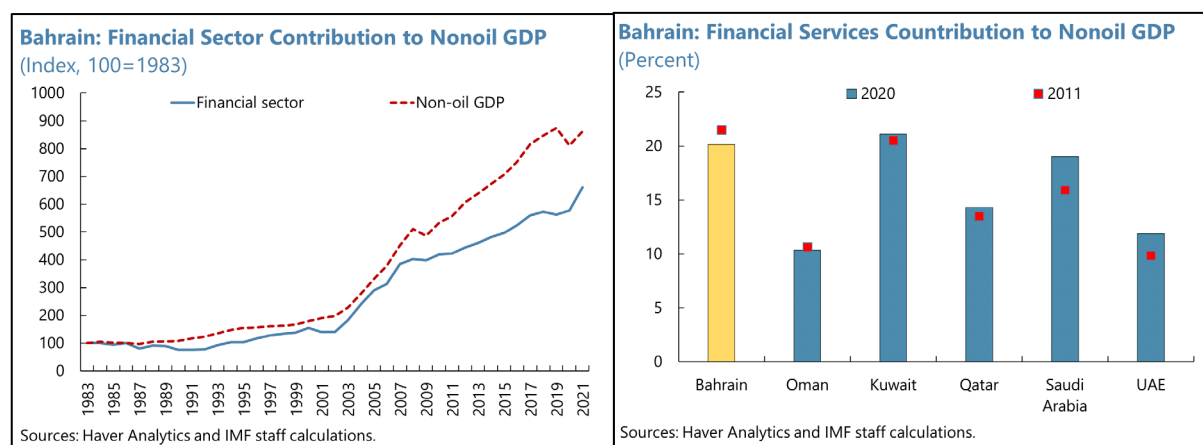
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POLICY SUPPORT MEASURES AND THE BANKING SYSTEM¹

Bahrain's large banking sector has been a critical asset in the country's diversification drive into nonoil sectors. During the twin COVID and oil price shocks of 2020, banks were instrumental in the delivery to the real economy of the authorities' comprehensive policy response, while also benefiting from regulatory easing. Although banks entered the pandemic with solid fundamentals, the extraordinary measures might have masked some vulnerabilities that may increase financial stability risks. This paper discusses these vulnerabilities and suggests an appropriate policy response.

A. Introduction

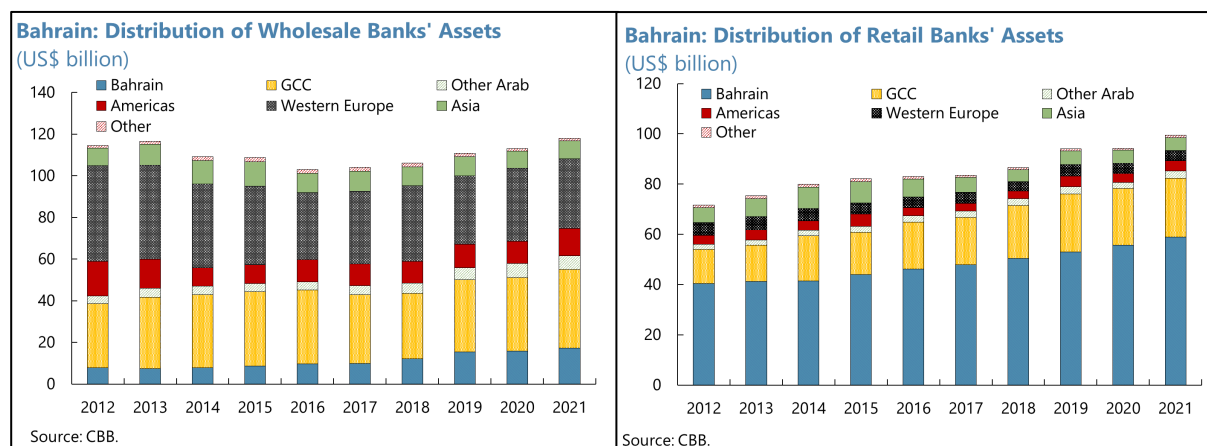
1. The banking sector is critical to Bahrain's economic growth model beyond credit intermediation. The financial sector is one of the largest contributors to Bahrain's nonoil GDP representing around 18 percent of total GDP in 2021. It employs over 13,500 individuals of which around 70 percent are Bahraini nationals. Within the financial system, the banking sector has been dominant with total assets equivalent to 626 percent of GDP and a share of approximately 70 percent of financial sector assets. Bahrain has long been a regional financial hub and the Central Bank of Bahrain (CBB) continues to enhance infrastructure and financial regulation to attract more financial institutions to Bahrain.



2. Retail banks perform most of domestic credit intermediation and are the focus of the CBB's banking supervision. There are two distinct types of banking licenses in Bahrain, retail and wholesale. Moreover, within the scope of these two licenses, a separate regulatory regime exists for Islamic banks. Retail banks account for 45 percent of total banking sector assets, and their activities cover Bahrain and the GCC region. There are 30 retail banks of which 13 are locally incorporated, including retail subsidiaries of foreign banks, while the remaining are branches of foreign banks. The wholesale segment includes 61 banks that are mostly members of international financial groups and

¹ Prepared by Shafiq Ghawi.

use Bahrain to manage their regional financial activities and to book assets generated abroad, taking advantage of its advanced infrastructure and favorable tax regime. Wholesale banks face several restrictions in transacting with domestic residents and are less relevant to credit intermediation in the domestic economy. As a result, they have a small domestic footprint of 15 percent of their total assets mainly through holdings of government securities and interbank operations but have no access to CBB liquidity facilities and are not required to hold reserves.



B. The CBB's Policy Action in Response to the Pandemic

3. The CBB introduced extraordinary measures to support borrowers at the onset of the pandemic. The package included a blanket six-months deferral of loans' principal and interest repayments at no additional cost to the borrowers. It also altered accounting standards on nonperforming loans (NPL) recognition and halted legal action against defaulting borrowers. As the pandemic evolved, the package was subsequently modified and extended several times and is currently due to expire at end-June 2022. The modified loan moratorium became optional for borrowers and carried a significant cost, as interest on both the full outstanding amount and on deferred interest itself (i.e., interest-on-interest) has been continuously accruing. At the end of 2021, deferred loans were about 25 percent of total domestic private sector loans.

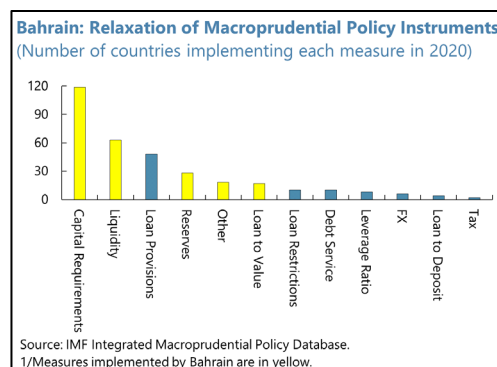
4. The CBB eased its macroprudential policy stance to sustain credit growth. To support credit intermediation during the pandemic and preserve financial stability, the CBB relaxed macroprudential instruments targeting liquidity, capital, and credit supply. On the liquidity side, reserve requirements were reduced from 5 to 3 percent, while the minimum liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) were both lowered from 100 to 80 percent. On the capital side, the risk weight of loans to small and medium enterprises (SME) was lowered from 75 to 25 percent. Finally, to boost credit provision, banks were allowed to increase the loan to value ratio (LTV) for new residential mortgages.

5. Bahrain was among many countries that eased macroprudential policy. The effects of the pandemic and the limited fiscal and monetary space resulted in macroprudential policy being central to the policy response in several jurisdictions. The IMF's integrated macroprudential policy database (iMaPP) indicates that 99 out of the participating 134 countries used one or more

macroprudential policy instruments in 2020. Like Bahrain, most used liquidity and capital adequacy instruments.

6. Finally, regulatory reporting was relaxed to help banks deal with operational challenges. Staff

falling sick, an abrupt move to remote work environment and a surge in the use of electronic channels by clients left many banks dealing with operational challenges. The CBB sought to provide relief by extending the submission deadline of some regulatory requirements like the annual certification of the financial crime systems and controls and postponing the implementation of some new regulations.



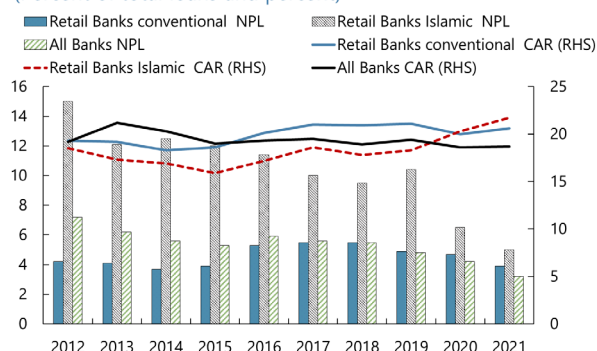
C. Banking Sector Health Pre- and Post- Pandemic

7. Despite the challenging economic environment between 2014 and 2019, banks entered the pandemic with solid capital and liquidity buffers. The aggregated capital adequacy ratio (CAR) for the entire banking sector was 19.4 percent at end of 2019. The CAR diverged across bank types and was 21.1 percent for conventional retail banks and 18.3 percent for Islamic retail banks. Banks also had a good liquid position, the upside of having built up a substantial portfolio of government securities of around 17 percent of their total assets.

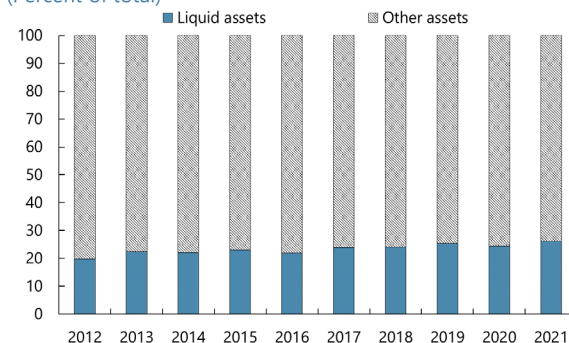
8. Nevertheless, real sector weakness may have caused some vulnerabilities since before the pandemic's onset. The extended period of low oil prices leading to large fiscal and current account deficits, as well as sluggish real GDP growth in 2018 and 2019, increased retail banks' exposure to sovereign risk and slowed private sector credit growth. NPLs for the banking sector were somewhat elevated in 2019 at around 4.8 percent and the ratio was significantly higher for Islamic retail banks at 10.4 percent. The low interest rate environment that prevailed since the financial crisis also affected banks' profitability. In 2019, return on assets (ROA) for the aggregated banking sector stood at around 1.1 percent but was much lower for retail Islamic banks at 0.4 percent. In addition, retail banks had sectoral concentration to real estate (including commercial) and construction. On the borrowers' side, corporate balance sheet indicators deteriorated in 2020, with corporate profitability declining from a ROE of 5.4 percent in 2019 to 3.7 percent in 2020 and leverage increasing to 23 percent of equity in 2020 from 18 percent in 2019 but remaining well below regional and emerging markets average.

Figure 1. Bahrain: Selected Banking Sector Indicators**Nonperforming Loans and Capital Adequacy**

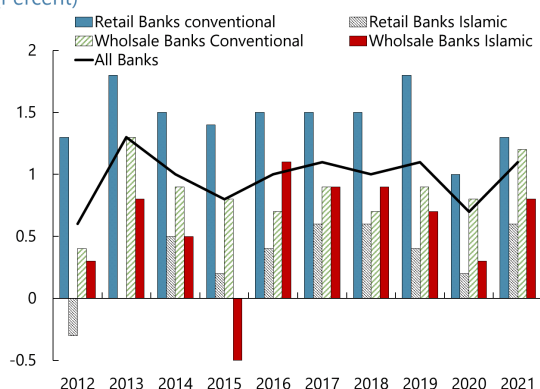
(Percent of total loans and percent)

**Liquid Assets**

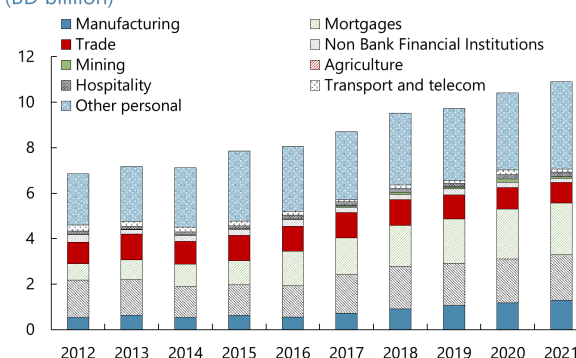
(Percent of total)

**Return on Assets**

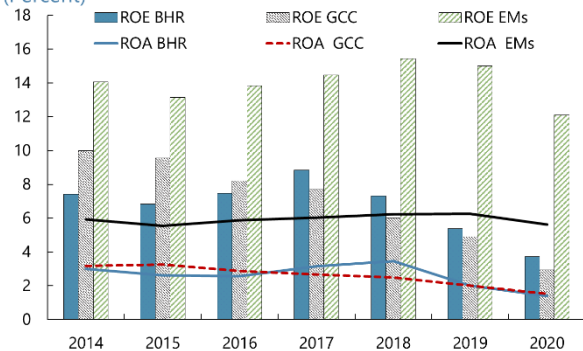
(Percent)

**Bank Credit by Sector**

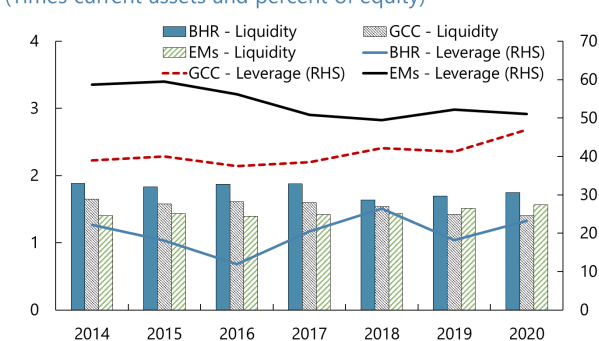
(BD billion)

**Corporate Sector Profitability**

(Percent)

**Corporate Liquidity¹ and Leverage Ratios**

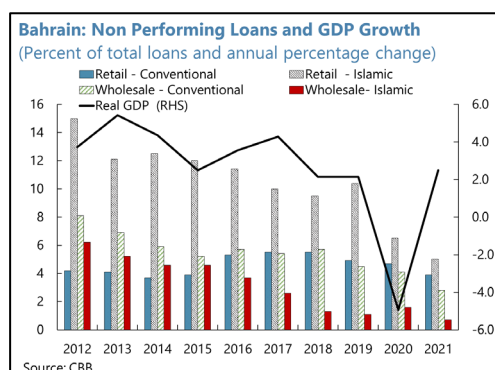
(Times current assets and percent of equity)

¹Liquidity ratio calculated as current assets divided by current liabilities.

Sources: Central Bank of Bahrain, S&P, and IMF staff calculations.

9. As a result of the crisis and the extraordinary measures, banks' balance sheets might harbor unrecognized NPLs.

Looking at past cycles, NPLs tend to be countercyclical and fluctuate inversely with the oil price and business cycles, as borrowers' ability to service their debt depends on the prevailing economic conditions. However, this was not observed during the pandemic, as the impact of containment measures and the oil price decline led to a large recession. Economic activity declined by 4.9 percent in 2020 and is estimated to recover only gradually by 2.2 percent in 2021. However, in the same period, the NPL ratio featured a steady decline from 4.8 percent in 2019 to 4.2 percent in 2020, and to 3.2 percent in 2021. Staff estimate that this unusual behavior is to be directly connected to the loan moratorium and the resulting delay in NPL recognition.



10. Banks' CARs might be overstated, especially those of retail Islamic banks. Provisions required against impaired assets reduce retained earnings and thus Tier 1 capital. Therefore, a strong capital position provides a cushion against unexpected losses and allows banks to absorb NPLs and continue to intermediate credit. However, unrecognized NPLs and risk weights below standard artificially increase the CAR. This is likely the case for the aggregated banking sector given the modest impact on CAR during the crisis. In the specific case of retail Islamic banks, the CAR unexpectedly increased during the crisis possibly indicating excessive use of flexibility embedded in CBB support measures to defer loans that might have already been nonperforming before the crisis.

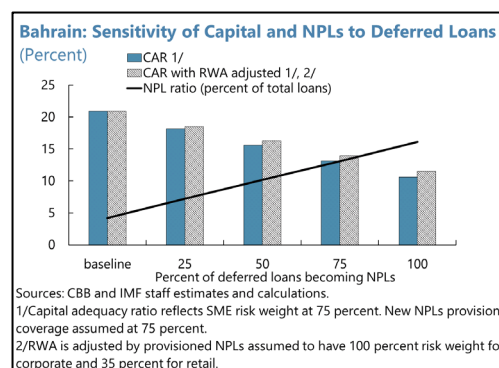
11. A more accurate assessment of CARs would require reversing the impact of the crisis measures. Staff estimate a counterfactual scenario in which CARs are recalculated after accounting for the impact of some deferred loans becoming NPLs. Due to data limitations, the scenarios are based on a few simplifying and conservative assumptions (Box 1), which may impact accuracy but not the broad picture. After applying these assumptions, the results of multiple simulations for retail banks' CAR based on different percentages of deferred loans becoming NPLs show that the impact could be significant in a severe case, but banking system capital remains adequate.

12. The unwinding of crisis measures will turn some deferred loans into NPLs, but aggregate capital is expected to remain adequate. During phases 2 to 5 of the pandemic support package, borrowers were provided with the option to opt in the deferral program. If they chose to opt in, installments were deferred, and loan tenors extended without an increase to the installment amounts to make up for the lost income. Moreover, interest continued to accrue on the full outstanding amount as well as on the deferred interest itself. Given the comparatively high economic cost of adhering to the optional deferral, borrowers opting in might have weaker capacity to repay, implying higher than usual NPLs within this subset of loans.

Box 1. Counterfactual Analysis Assumptions

- **Deferred loans are only held by retail banks.** All deferrals amounting to BD3.1 billion are assumed to be on the balance sheet of retail banks given that only around 4 percent of wholesale banks total assets are to the private sector in Bahrain.
- **Provisioning level is assumed to remain constant in the staff scenario.** The level of provisions for new NPL is assumed at 75 percent, above the 67 percent prevailing provision to NPL ratio for retail banks in 2021 and closer to the GCC (ex-Kuwait) average of 86 percent.
- **The SME risk weight is increased in the staff scenario.** The counterfactual analysis includes raising the SME risk weight to 75 percent according to international standard, compared to the 25 percent implemented as part of the crisis package.
- **RWA is not reduced by impairments in the counterfactual scenario.** The staff scenario does not reduce RWA when deferred loans are provisioned, partly to accommodate growth in the loan book. However, a separate upside is also estimated to mitigate the impact on CARs assuming corporate deferred loans carry a risk weight of unity and retail loans of 35 percent.

13. The economic recovery path will have a significant impact on the deferred loans outcome. While a favorable macroeconomic outlook with accommodating policy is likely to support the recovery and mitigate the percentage of deferred loans that become NPLs, a protracted recovery on the other hand will see more deferred loans turn into NPLs. The unique nature of the COVID-19 shock and the fact that many countries are still in the process of exiting support measures, means that the likely NPLs in the deferred loan portfolio are difficult to estimate. However, recent literature (see IMF 2019) on the dynamics of NPLs during banking crisis observed that, on average, NPL ratio reaches 22 percent and, in a few exceptional cases, exceeds 50 percent. It also concluded that higher NPLs from a crisis relates to weak macroeconomic, corporate, and banking sector conditions in the period leading up to the crisis. The staff scenario shows that should 25 percent of the deferred loans become NPLs, the NPL ratio would increase from 4.2 to 7.2 percent and the CAR decline to 18.2 from 20.9 percent, remaining well above regulatory minimum. However, a more extreme scenario with half of the deferred loans becoming NPLs would increase the NPL ratio to around 10 percent and significantly lower aggregate CAR.



14. Distributing the aggregated banking system to individual banks highlights pockets of vulnerabilities. To assess the impact of deferred loans becoming NPLs on individual banks, the counterfactual scenario impact is distributed to the balance sheet of the seven largest retail banks in Bahrain, that together account for over 95 percent of total retail banks assets. Due to data

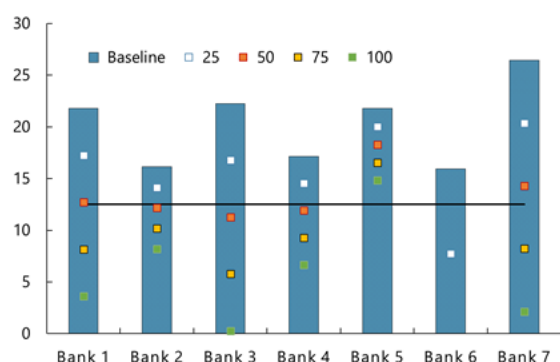
limitations, we use public data for these banks available through Fitch analytics and allocate deferred loans to individual banks using two approaches:

- **Bank-level NPLs share in total NPLs:** each bank's share of the NPL in the banks' total is assumed to remain constant after the increase generated by the counterfactual. This approach assumes that banks with existing high NPL levels have a lower quality loan portfolio and therefore a likely bigger share of deferred loans.
- **Bank-level share in total assets:** each bank's share in retail banks' assets is used to distribute the NPLs increase. This approach assumes that banks with a larger loan portfolio will have larger NPLs and that, therefore, asset quality deterioration during COVID was not necessarily related to pre-crisis loan portfolio quality.

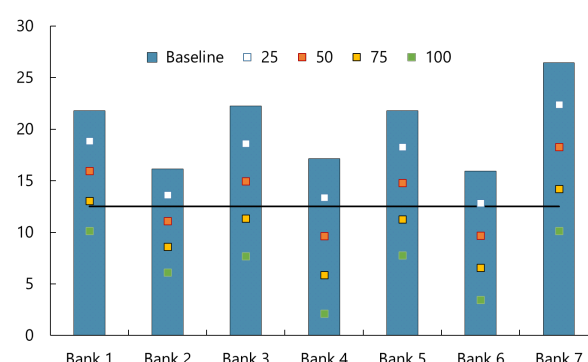
15. The impact on individual banks is divergent, and some banks are more likely than others to experience capital stress. The distribution exercise for the counterfactual simulates capital adequacy for each bank under four different deferred loan to NPLs conversion ratios (25, 50, 75 and 100 percent). To avoid rewarding under provisioning, the analysis assumes that the new NPLs are conservatively provisioned at 100 percent across all banks, but separate scenarios are also run to keep the existing bank level coverage ratio unchanged and applying the average system wide provisioning ratio respectively. In this setting, the impact depends on the initial CAR, each bank's share of deferred loans, the share of deferred loans that become NPLs, and the level of provisioning applied. Although results are sensitive to the many assumptions used, the exercise highlights that, depending on the assumed increase in NPLs, capital shortfalls might emerge in weaker institutions.

Figure 2. Bahrain: Simulated Capital for Deferred Loans Scenarios¹

Deferred Loans Allocated by Share of Current NPLs (Percent)



Deferred Loans Allocated by Share of Total Loans (Percent)



Sources: Fitch data analytics, Central Bank of Bahrain and IMF staff estimates.

¹/Central Bank of Bahrain set minimum capital adequacy ratio at 12.5 percent.

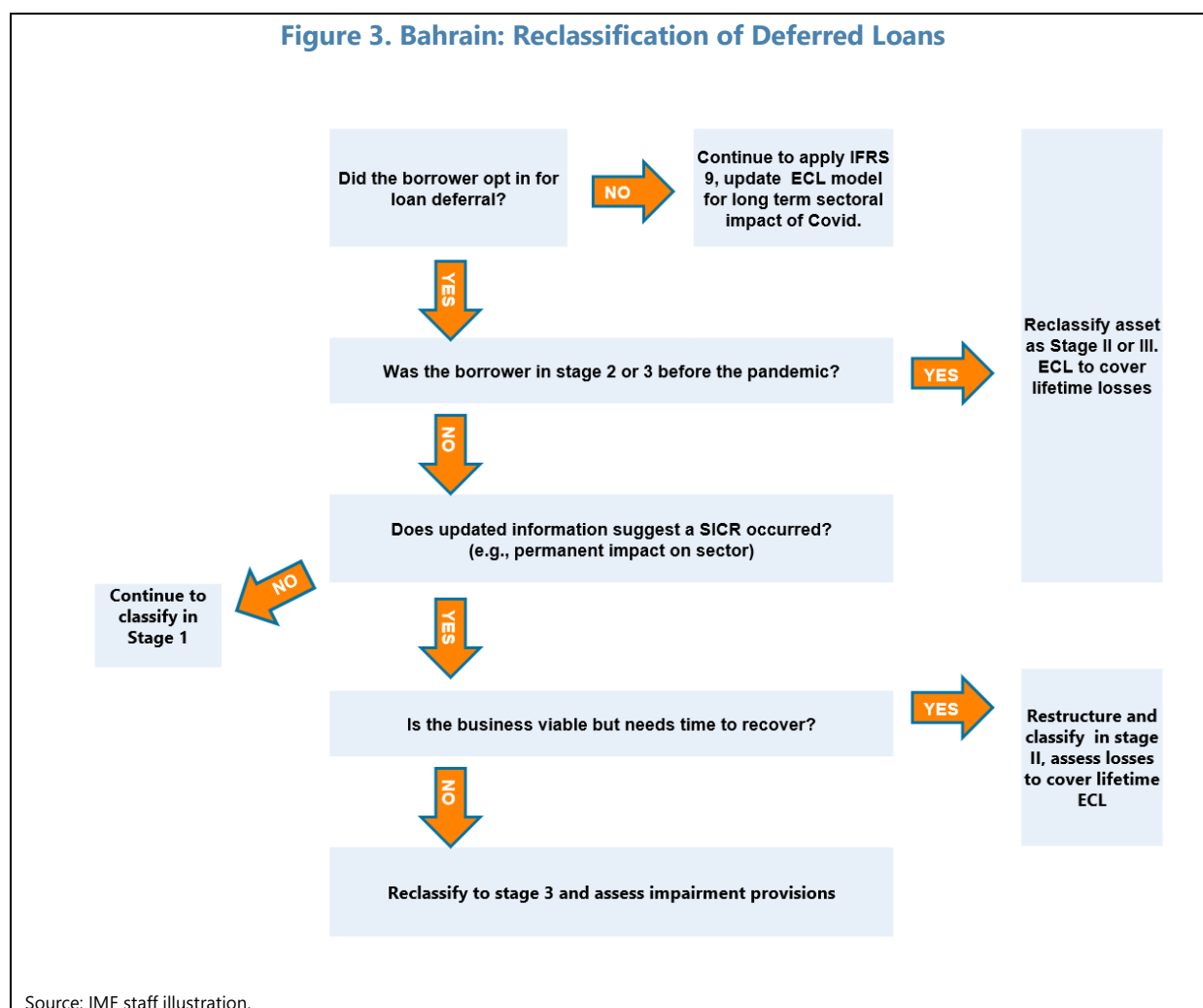
16. The quality of banks' liquid assets and loan book might have deteriorated. HQLA allows banks to meet unexpected outflows from liabilities and off-balance sheet items without impacting

their ability to provide credit or needing to dispose of assets at depressed prices (fire sale). The currency composition of HQLA should also broadly match the currency of the liabilities to guard against outflows from foreign currency liabilities. The decrease in the regulatory requirements for the LCR, NSFR and mandatory reserves freed up liquidity at banks and supported credit growth, but might have generated excess liquidity with LCR reaching 380 percent up from 323 percent in 2020. Banks are likely to compete to deploy the freed-up liquidity in loans and high yield securities to increase return on assets (ROA), which may lead to lower underwriting standards and higher NPL in the future. While the CBB does not mandate an LTV ratio, it instructed the banks to lower internal LTV as part of the support package, which could also increase the loss given default and lower the quality of the mortgage book over time.

D. Exiting Extraordinary Support and Normalizing Macroprudential Policy

17. The CBB should prepare a strategy to unwind the loan moratorium and NPLs forbearance measures. Some policy measures adopted by the authorities such as loan moratorium and delayed NPLs recognition are not part of a standard macroprudential policy tool kit. Their use was exceptional, prompted by the unprecedented nature and severity of the pandemic. Such extraordinary measures, if allowed to continue now that the recovery is well underway, could lead to misallocation of financial resources to unviable activities, create moral hazard, and disincentivize debt repayment.

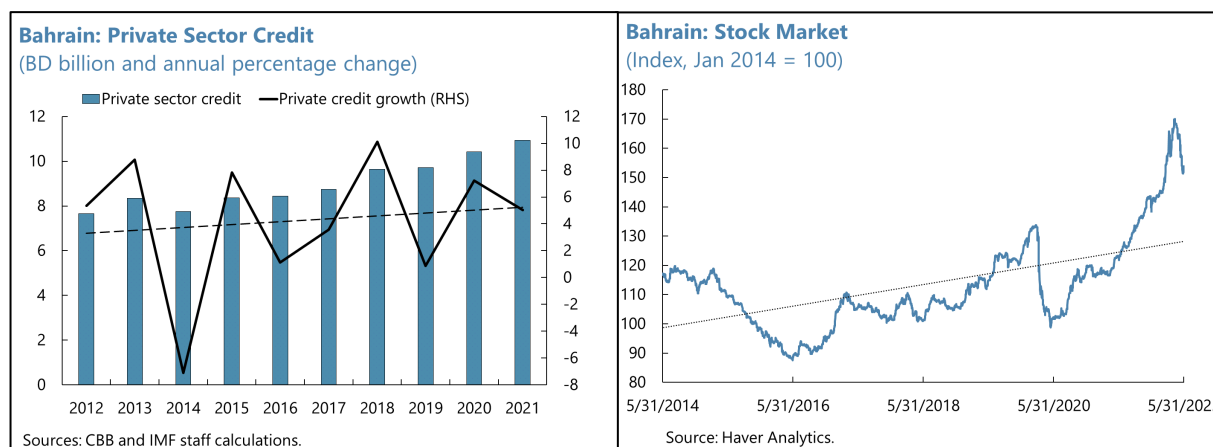
18. The blanket moratorium should be phased out and replaced with measures targeted at viable borrowers. Safely existing extraordinary measures requires a detailed assessment based on timely, granular, and accurate information about the quality of deferred loans, the capital position of banks and the state of the economy. Deferred loan customers should be classified into three groups, (i) borrowers that were likely unviable or struggling before the pandemic; (ii) viable borrowers that need more time to fully recover; and (iii) borrowers that became unviable due to the pandemic and are now unlikely to recover. The classification should be consistent across banks and driven by CBB guidance to consider factors such as the economic sector in which the borrower operates, adoptability of the business, banks' exposure and exit strategy. The classification of borrowers will also help to better target remaining policy support, including fiscal support, while guiding loan restructuring for sectors that became unviable.

Figure 3. Bahrain: Reclassification of Deferred Loans

19. The withdrawal strategy should be informed by credit focused supervisory reviews, followed by a capital remediation plan, if required. The authorities should limit the impact of exiting extraordinary measures by providing sufficient notice to banks, conducting onsite thematic inspections and forward-looking stress testing, and considering requiring banks to take preemptive actions such as restricting dividend payments, divestment of assets, mergers, or capital raising. As recommended in the 2017 FSAP, the authorities should continue to strengthen the recovery and resolution framework to be prepared to deal with the unlikely scenario of bank failure. The application of insolvency and bankruptcy laws should provide viable businesses with the means to restructure, and accelerate an orderly exit for unviable firms.

20. The normalization of macroprudential policy should not be delayed beyond the economic recovery and should consider credit and asset prices growth. The literature on calibrating macroprudential instruments (see IMF 2014a and IMF 2014b) provides guidance on the transmission channels, effectiveness, and useful indicators of macroprudential policy. Documented use cases are to control excessive credit growth, address asset price bubbles—in particularly real estate—and increase banking sector resilience in an economic downturn. In Bahrain, credit growth

was about 5 percent in 2021, which is in line with its long-term average and does not appear excessive. Real estate and the stock market made substantial gains in 2021 and might create vulnerabilities should the upwards trend continue. Given high level of capital and liquidity in the banking system, macroprudential instruments should be carefully tightened to their neutral stance considering the effects of withdrawing the loan deferrals and the changes to NPLs recognition criteria as well as the impact of tightening monetary and fiscal policies in the short-term.



21. Macroprudential instruments also serve micro-prudential objectives and current calibration is below international benchmarks. Although the normalization of macroprudential instruments may come after the withdrawal of loan deferrals, still, it should not be delayed because currently banks might be more vulnerable in a downturn than they were before the pandemic, especially banks operating close to regulatory minimums. While macroprudential policy is guided by indicators of vulnerability such as financial asset prices or excessive credit growth, micro-prudential policy is concerned with the soundness of individual banks. International standards on capital and liquidity published by the Basel Committee of Banking Supervision (BCBS) provide recommended levels for LCR (100 percent), NSFR (100 percent), and SME risk weight (75 percent) which should serve as neutral calibration of macroprudential instruments. A neutral level of LTV should be introduced and calibrated conservatively considering the historical volatility of the real estate market. A comprehensive macroprudential policy framework is useful to instill discipline, reduce political pressure and perform macroprudential surveillance, especially if the authorities intend to actively use macroprudential policy as part of their macrofinancial policy toolkit going forward.

E. Policy Considerations and Concluding Remarks

22. The banking sector weathered the Covid 19 crisis, but financial stability risks might increase. The unprecedented economic impact of the pandemic and the policy support measures that followed such as deferral of loan repayments, delayed NPL recognition, and easing of macroprudential instruments helped cushion the pandemic's impact on the real economy but may have left the banking sector vulnerable to future downturns. Some groups of banks appear to be more vulnerable than others, for example the increase in retail Islamic banks' CAR might reflect an

excessive use of CBB support measures. The authorities should prepare an exit strategy to withdraw pandemic measures that considers these risks while preserving financial stability.

23. The CBB should take advantage of the current economic environment to exit extraordinary measures. The favorable outlook for oil prices and for the post-pandemic recovery presents an opportunity to gradually unwind the pandemic measures. The starting point should be to replace the blanket moratorium with more targeted measures that will allow efficient allocation of financial resources to viable firms. The alteration of NPLs recognition and their accounting treatment during the crisis should be phased out to provide transparency and remove moral hazard. Adequate preparation is essential and requires granular information, a clear communication strategy and enhanced supervisory oversight. The use of stress testing can help estimate the effect of different tightening scenarios on individual banks and inform discussions with banks to agree on a remediation plan.

24. The CBB should not delay rebuilding banking sector buffers and continue to update its macroprudential policy framework. Leaving macroprudential instruments below their recommended micro-prudential levels (neutral state) for an extended period might weaken the banking sector and increase financial stability risks. The LCR, NSFR, SME risk weights and reserve requirements should be tightened gradually now that the economic recovery is well underway. The authorities should continue to update the macroprudential policy framework by finalizing the implementation of the 2017 FSAP recommendations, expanding financial stability indicators to include a real-estate index and adding macroprudential instruments such as LTV, countercyclical capital buffer and FX targeting instruments.

25. Finally, further enhancing the CBB's recovery and resolution powers would strengthen the authorities' toolkit to deal with the unlikely situation of bank failure. While all efforts should be made to safely exit the pandemic support policies, it is always prudent to be prepared for a bank failure. Ensuring that necessary powers are available to the CBB to deal with struggling or unviable banks is necessary to limit damage to financial stability. Requiring all banks to produce recovery plans, contingency funding plans and living wills can help the authorities and the banks navigate through difficult times. Given the significant presence of foreign bank branches in Bahrain, international cooperation between CBB and the home jurisdictions, should also be a priority.

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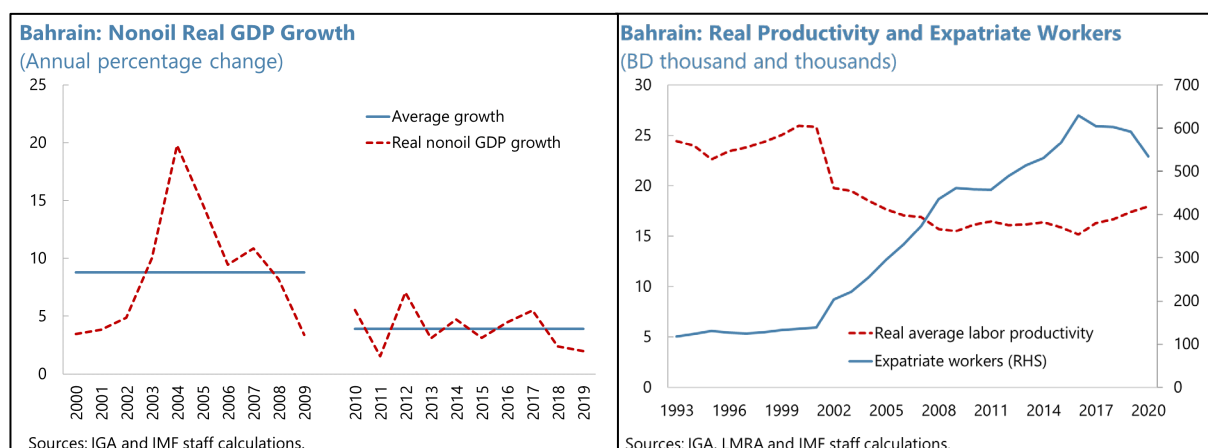
REFORMING THE LABOR MARKET¹

Despite a vibrant and diversified private sector, the Bahraini economy has been facing declining productivity in the recent decade and was recently hit by the COVID pandemic. Reforming the labor market has the potential to revive nonoil growth, improve the attractiveness of private sector jobs, and create opportunities for Bahrain's young and growing population. In line with the authorities' revived employment program, this paper argues that addressing labor market bottlenecks would require a comprehensive strategy to better align wages and productivity, address skills mismatches with training programs, and improve labor market flexibility.

A. Introduction

1. Bahrain experienced a productivity decline in the last two decades that resulted in lower nonoil growth. In addition to global factors such as weaker investment and policy uncertainty (IMF, 2017), the decline in productivity and the resulting growth decline were driven by the expansion of sectors employing mostly low-skilled workers and carrying limited productivity gains, such as tourism, social and personal services, retail and wholesale trade, and construction. Staff estimate that real productivity measured as real GDP per employee declined by about 30 percent during 2000-2019.

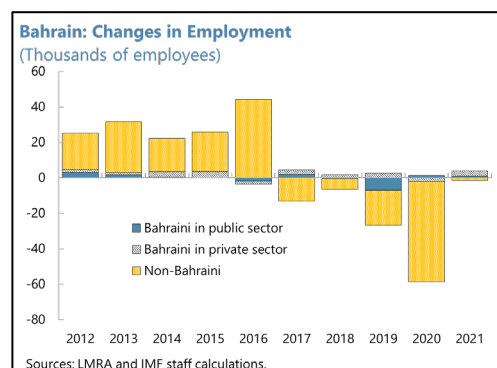
2. The private sector has relied on expatriate labor to expand. Expatriate workers in Bahrain form a large part of the labor force and, especially in the low-skilled segments, outnumber Bahraini employees (De Bel-Air, 2015). This is the result of a liberal expatriate labor market policy allowing firms in the private nonoil sector to hire expatriate workers on comparatively lower wages and more flexible contracts (Sassanpour et al., 1997). The lower production costs associated with the contracts offered to expatriates supported the nonoil sector's competitiveness and allowed it to swiftly adjust to terms of trade shocks in a pegged FX regime (Fasano & Goyal, 2004).



¹ Prepared by Haytem Troug.

3. Creating high quality private sector jobs for Bahrainis has long been a key policy priority.² In the next 5 years, approximately 70 thousand Bahrainis will enter the working-age population. Considering the replacement of retirees (approximately 3 thousand a year) and the prevailing participation rates, staff estimate that at least 32 thousand jobs will need to be created in the next 5 years to accommodate the increase in the labor force. At the prevailing pre-pandemic job-creation trends of around 1.5 thousand jobs a year for Bahrainis, the labor market will face difficulties absorbing these new entrants. In addition to the necessity of creating more jobs for the young, private sector opportunities will still be needed to attract civil servants and Bahraini women to the private sector. Therefore, improving the private sector's labor market prospects is important to avoid rising unemployment and, ultimately, that Bahrain misses the productivity potential of the country's most educated generation.

4. The COVID pandemic caused a sharp decline in private sector jobs. Although the employment of Bahrainis was protected by the crisis package that supported private sector salaries, significant job losses were experienced in the construction and trade sectors. Moreover, data show that, as in other Middle Eastern and North African (MENA) countries (IMF, 2021), public sector hiring was used as a countercyclical employment vehicle. Expatriate workers, given their large exposure to high-contact sectors and the flexibility of their employment contracts, suffered more significant job losses, with employment at end-2021 still 10 percent below its pre-pandemic level. While this decline may be temporary, it could disrupt the post-pandemic recovery and adversely affect growth potential in the medium term. For instance, labor shortages caused recent delays in the modernization program of Bahrain Petroleum Company, aiming to increase the refinery's production capacity and improve its energy efficiency.



5. Against this background, this paper discusses labor market challenges and proposes policies to address them. Section B analyzes Bahrain's labor market structure, section C identifies some of its main bottlenecks, and section D concludes by presenting some policy proposals to address them.

B. Labor Market Structure

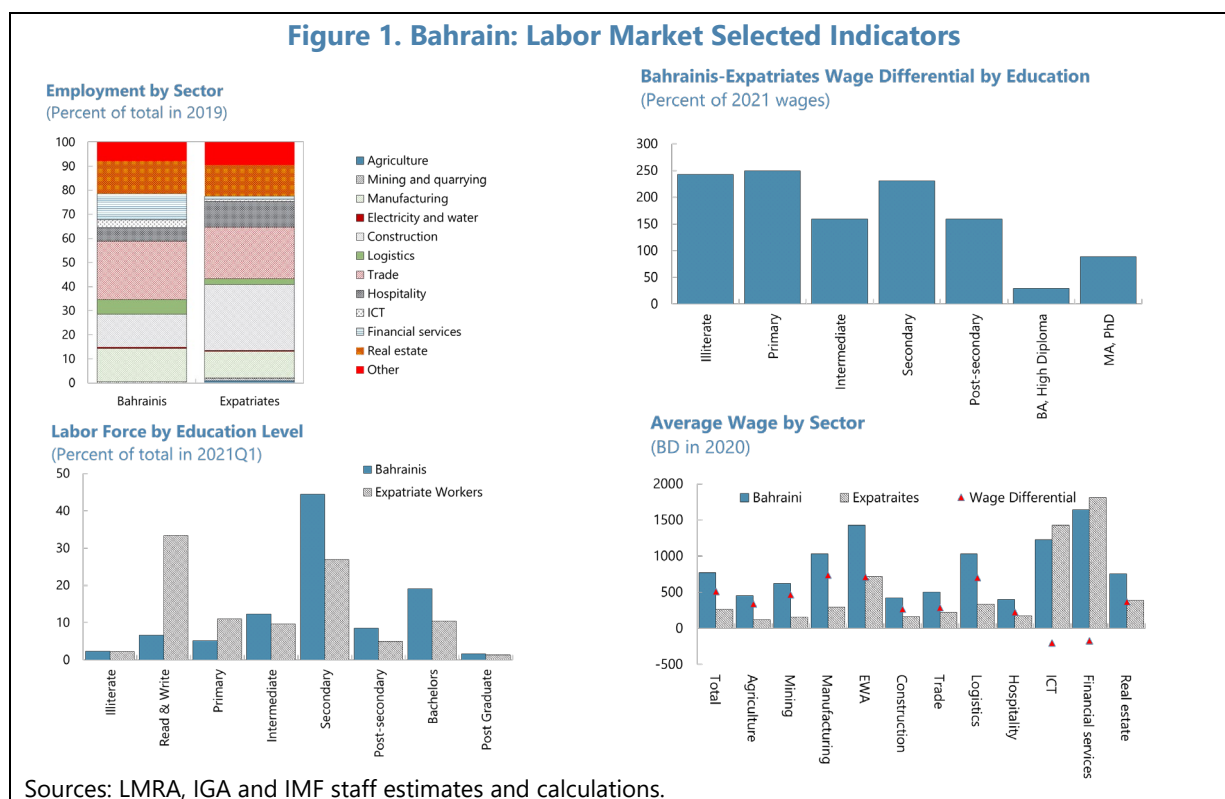
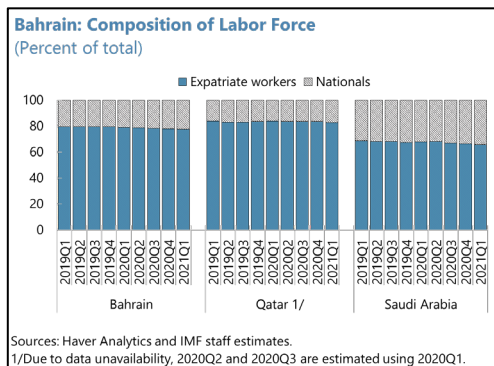
6. Bahrain's labor market presents some segmentation. Although 66 percent of the workforce is employed in the private sector, Bahraini nationals mostly work in the public sector, which remains a very attractive career path (IMF, 2018). Using education attainment as a proxy for skill level, expatriate workers are mostly unskilled and constitute 77 percent of Bahrain's labor force (83 percent of the private sector labor force). To better illustrate the segmentation, about 140,000

² In this paper the government sector is defined as all jobs in government services, whereas the private sector includes all other establishments regardless of ownership (including if fully government owned).

private sector jobs were created during 2010-19, but only 12 percent of these were filled by Bahraini nationals. Despite this fragmentation, Bahrain fares better than other GCC countries in terms of the share of nationals that work in the private sector (IMF, 2013).

7. Bahraini nationals are paid higher wages.

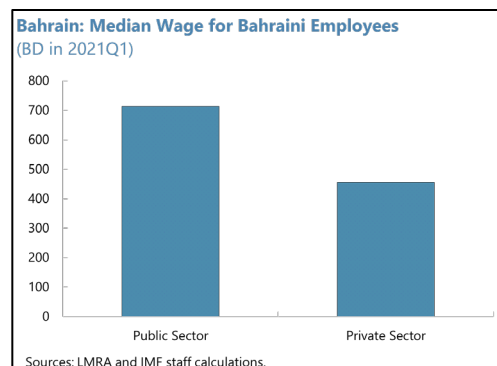
Staff estimates show that the private sector wage of Bahraini nationals is on average three times higher than that of expatriate workers in the same position. Looking at individual sectors, the differential is higher in low and medium-skilled jobs, proxied by the level of education, especially among males. In these sectors, the differential is driven by the large inflow of expatriate workers that caused downward pressure on private-sector salaries, making these professions unattractive to Bahrainis and disincentivizing most employers from hiring Bahrainis. However, the wage differential is less clear in higher skilled professions such as ICT and financial services. One explanation could be that in high productivity sectors the relative scarcity of job seekers ensures that competitive wages are paid to all employees.



8. Bahraini nationals also enjoy better benefits across all sectors. In addition to higher wages, Bahrainis in the private sector have access to unemployment benefits that last for nine months, conditional on attending training, while expatriates' access to unemployment benefits is conditional on their residency status. Finally, expatriates are not included in the state's pension

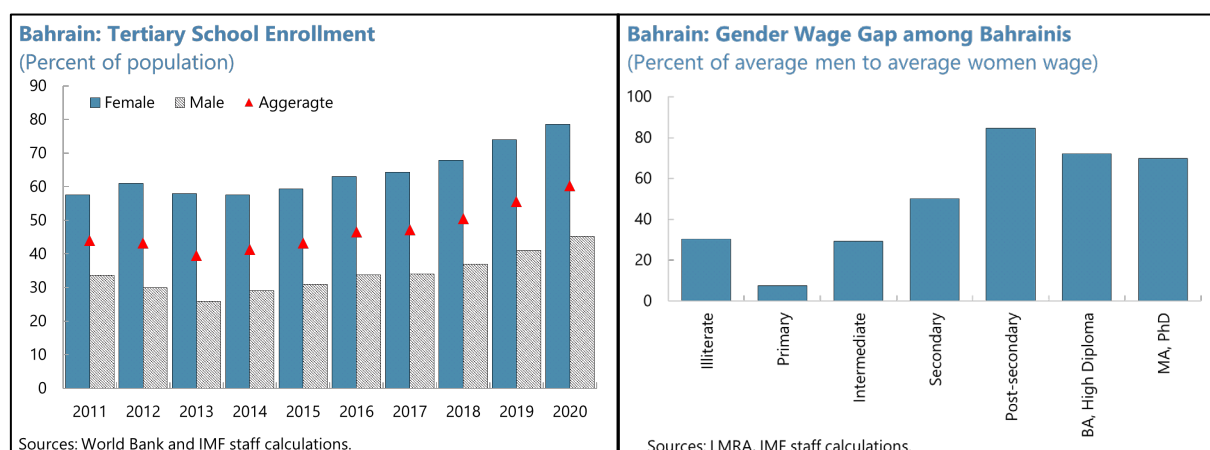
system and universal health coverage, but they have access to subsidized basic health treatment and are entitled to an end-of-service payment in lieu of the state pension.

9. Public sector employment is better remunerated than the private sector. Another key driver of the wage differential between Bahrainis and expatriates is the role of the public sector as a high compensation and benefits employer for Bahrainis, which increases reservation wages needed for private sector jobs to become attractive and distorts incentives leading to labor mispricing and labor market fragmentation (IMF, 2018). Among other benefits, civil servants in Bahrain also enjoy access to preferential bank-financing terms. The large wage differentials between private and public sector jobs and between Bahrainis and expatriates in the private sector suggest that the substitutability between Bahraini and expatriate workers, particularly in low-skilled occupations is very low.



10. Expatriate workers contracts are more flexible than Bahrainis. Panel regression analysis shows that employment of expatriate workers is highly responsive to changes in sectoral output, with a coefficient close to unity, and that expatriates' lower wages are a key driver of their employment in the country (Appendix 1). On the other hand, the results show that employment of Bahrainis is not as responsive to overall GDP growth. Finally, the results confirm the pandemic's disproportional effect on the employment of expatriate workers.

11. Women's participation in the workforce improved significantly in recent years but is still lagging that of men (Box 1). Overall women's participation in the labor market stood at 45 percent in 2019 against 87 percent for men, while the participation rate for Bahraini women was



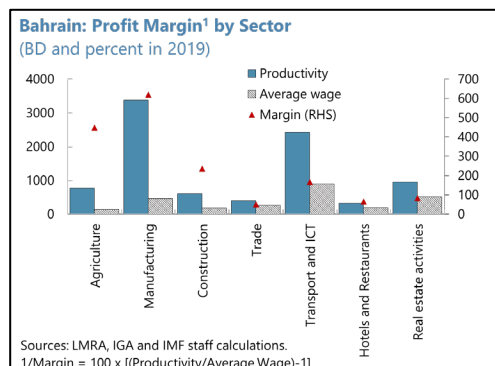
lower at around 30 percent. Low labor market participation contrasts with higher educational enrollment for women compared to men. Moreover, Bahraini women are paid comparatively less than their male counterparts in similar roles. This earning differential between Bahraini women and

men is positively correlated with the level of education and represents a disincentive to both labor market participation and upskilling. However, during the last couple of years, the government passed welcome reforms to incentivize women's participation in the labor market (Box 1).

C. Labor Market Bottlenecks

12. High profit margins may suggest a misalignment between wages and productivity.

High margins in some sectors might be an indication that wages are too low, perhaps compressed by significant hiring of low-skilled expatriate workers whose wage might lie significantly below their marginal product. Still, mid- and high-skilled sectors also show margins that indicate below-optimal wages. A possible explanation could lie with the large accumulation of fixed capital that boosts labor productivity. In comparison to peers, the nonoil profit margin in Bahrain stood at an average of 433 percent in 2019, approximately 5 times that in European countries with comparable income levels³. Moreover, in the manufacturing sector, hydrocarbon subsidies contribute to higher profit margins. While lower costs boost profits, excessively low wages negatively affect productivity growth given their adverse effect on skill development and innovation, as well as deterring the employment of Bahraini nationals in the private sector. Finally, besides being an indicator of labor market frictions, high rent margins might also point to lack of competition in the product market (Callen et al. 2014).



Labor Mobility

13. The hiring process for expatriate workers limits their mobility across jobs. The requirement for expatriate workers to work for 12 months with their first employer to be eligible for unconditional transfer represents a motive for firms to favor expatriate workers, as it leads to less bargaining power for expatriate workers, and it pushes wages downwards. In turn, this discourages low-skilled Bahraini workers from pursuing jobs in the private sector. Since the implementation of the 12-month requirement in 2011, the wage gap between Bahrainis and expatriate workers started to grow significantly (Alkhowaiter, 2021).

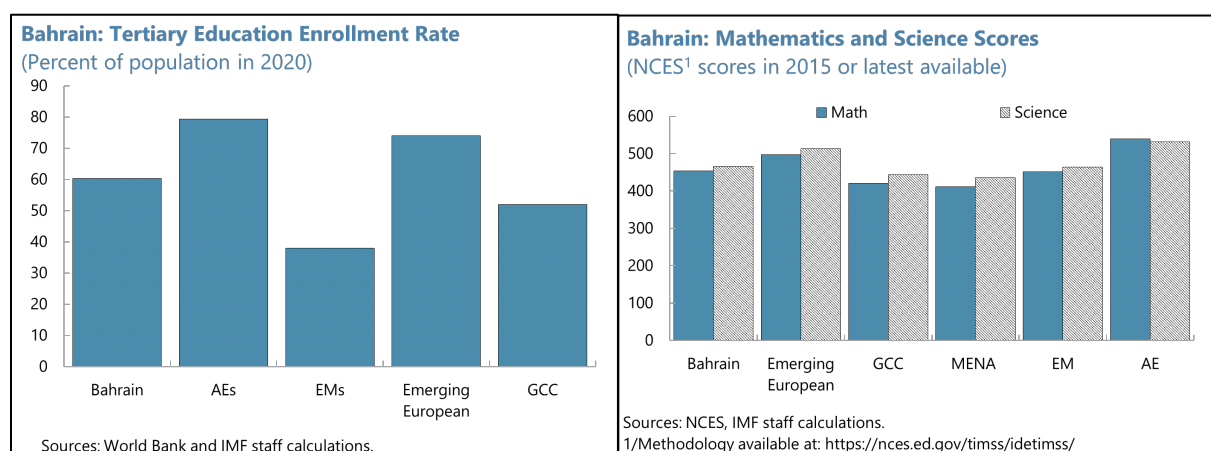
14. Labor immobility disincentivizes upskilling and might undermine sectoral labor reallocation. Limited mobility eliminates market incentives, such as promotions and higher wages, which disincentivizes expatriate workers from upgrading their skill set to acquire better-paid jobs, causing stagnation in productivity growth in the nonoil sector. While the authorities tried to

³ Eurostat's AMECO database available at: https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/macro-economic-database-ameco/ameco-database_en

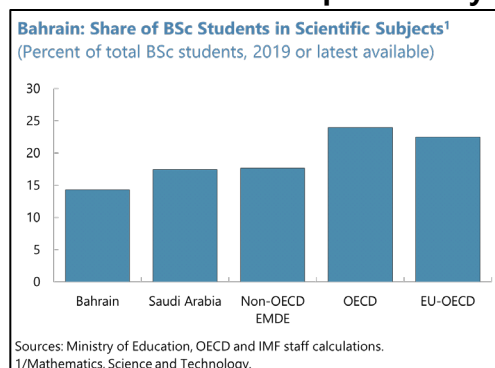
facilitate sectoral reallocation during the pandemic, low-skilled workers in high contact sectors shouldered most of job losses given the low likelihood of finding on-site jobs during the pandemic.

Skills mismatch

15. Bahrain's educational attainment and the quality of the education system are above regional peers but lag those of emerging Europe and advanced economies. Although the country has made significant strides in advancing education, tertiary education enrollments and the quality of education are still below those of advanced countries and European economies with similar income level to Bahrain. Increasing educational attainment rates and further improving the education system in Bahrain will prove crucial for transforming the Bahraini economy into a knowledge-based, private sector-driven economy.



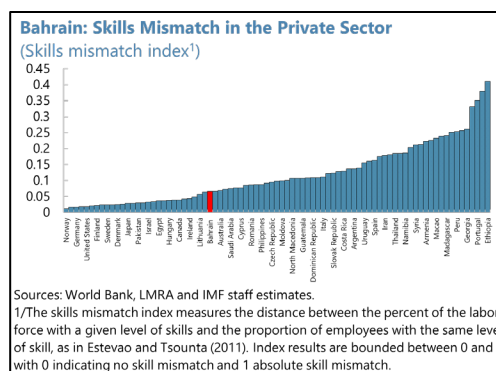
16. However, the educational achievements are yet to translate into faster productivity growth. The current educational choices by Bahrainis are directed mostly toward humanities and business administration instead of science and technology. Like in other countries in the region, the education system should continue to further develop the tools needed to equip students with skills required in the private sector, such as improving critical thinking abilities and developing leadership skills within collaborative work arrangements (Arezki et al., 2018).



17. Bahrain's labor force presents some mismatch with labor demand. To quantify the gap between demand and supply, staff estimated a skills mismatch index (SMI) for Bahrain. The SMI measures the distance between the percent of the labor force with a given level of skills and the proportion of employees with the same level of skill.

18. Nevertheless, Bahrain's labor market features a relatively low skills mismatch. In a sample of 83 countries for which the SMI was calculated, Bahrain's ranks 29th (Appendix 2). The SMI calculation shows two sources for Bahrain's skills mismatch. First, 66 percent of the skills gap in the aggregate labor market is driven by the mismatch between demand and supply in medium-skill

positions. Second, focusing on Bahraini nationals only, the mismatch is mainly driven by the differences in demand and supply for high-skill positions, highlighting the need for labor force upskilling. With the country's aspiration to move to a more knowledge-based economy, the SMI results could be considered as a floor for the skills needed in Bahrain's labor market, as the growth of digital-intensive sectors will require more reskilling and upskilling.



D. Policy Recommendations

19. To address labor market challenges, the authorities recently launched the National Employment Program (NEP 2.0) (Box 2). The program mainly focuses on extending wage support to subsidize Bahraini nationals employed in the private sector to make them a more attractive option for employers, increasing expatriate fees for employing expatriate workers, and further improving training programs. The program addresses some of the bottlenecks highlighted in this paper, but additional complementary measures (as described below) would reinforce its effectiveness.

20. Better aligning public and private sector wages with productivity would improve the attractiveness of private sector jobs. Containing public sector wages and grounding them on performance and productivity would help in increasing the relative attractiveness of private jobs by reducing the reservation wage for Bahrainis. Aligning private sector wages to productivity will likely translate in lower rent margins for most firms in the short term. Nevertheless, productivity gains in the medium term will compensate for short-term losses.

21. The basic and professional trainings under the NEP could be better integrated. Adopting a dual-education system, in cooperation with all stakeholders, that combines vocational training in education with an apprenticeship in firms would help in bridging the skills gap. To achieve this, the NEP's basic and professional trainings should be integrated into a comprehensive system that combines teaching with on-site training. Also, continued efforts to improve the quality of educational institutions would help in bridging the skills gap in the labor force, so as to encouraging young Bahrainis towards technology and science-related majors.

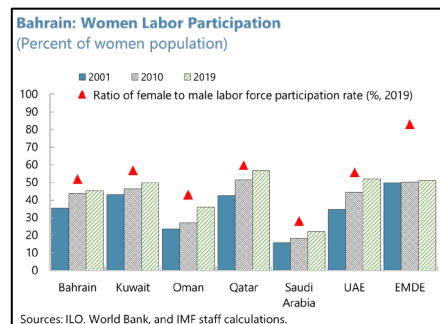
22. Policies to improve labor market mobility for expatriate workers would boost productivity and attract high-skilled expatriate workers. Improving labor mobility and adopting a more open migration policy would activate market incentives (promotions and higher wages) across the labor market and improve competition between Bahraini and expatriate workers. This would incentivize upskilling and attract more mid to high-skilled expatriate workers leading to higher productivity gains. Mobility-enabling policies would also facilitate sectoral reallocation that supports economic recovery and promote structural transformation towards a knowledge-based economy.

23. Finally, the authorities should continue reforms to promote women's participation in the labor market. While the government made significant progress in the last two years, renewed policy actions to enable Bahraini women in the labor market could include improving access to finance for female entrepreneurs, mentoring and supporting talented Bahraini women to support their progress towards senior positions, and encouraging firms to exploit digital solutions to increase flexibility in work schedules and locations.

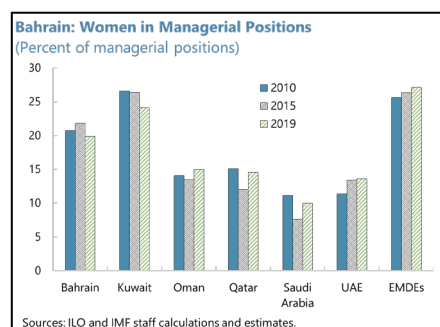
Box 1. Empowering Bahraini Women in the Labor Market

1. Similar to other GCC countries, female participation in Bahrain's labor market

showed marked improvement. Over the last two decades female participation grew by 10 percentage points, owing mainly to expansion in the services sector, improvement in educational attainment among Bahraini women, demographic changes, and a range of regulatory reform measures and government initiatives. For instance, the provision of two non-national permits for each female Bahraini hired. Another is a job-sharing program that allows two female employees to work part-time by sharing one full-time position.



2. However, women participation remains low at less than half of that of men. The participation gap is in contrast with education enrollment rates that show Bahraini women surpassing Bahraini men across all education levels. Although in line with the regional average, the ratio of female-to-male participation lags those in Emerging Market and Developing Economies (EMDE), where the ratio exceeds 80 percent. Moreover, the share of Bahraini women in managerial positions has remained subdued over the last two decades.



3. The government has adopted a series of measures in 2020 and 2021 that aims to facilitate greater participation of Bahraini women in the labor market¹:

- In 2021, the private sector Labor Law was amended, canceling Articles No. 31 and 32, which had prohibited women from working in some activities or night work. A second paragraph was also added to Article (39) of the same law, which prohibits wage discrimination.
- The mandatory retirement age for men and women with full benefits has been aligned.
- Through the CBB regulatory power, the authorities introduced the right to nondiscrimination based on gender in access to finance.
- Periods of childcare are explicitly counted for in pension benefits.

4. The Ministry of Labor and Social Development (MLSD) is promoting flexible working arrangements. Changes in working arrangements during the pandemic present a great opportunity to further boost female participation in Bahrain. For instance, telework and flexible work arrangements have the capabilities of enabling Bahraini women to advance professionally while maintaining a healthy work-life balance.

¹ Government efforts to empower women in the last two years are starting to pay off, as the World Bank's Women, Business and Law 2022 report shows that Bahrain's index jumped from 40 in 2019 to 65 in 2022.

Box 2. National Employment Program 2.0

The second version of the NEP was launched in 2021 to further boost employment of Bahrainis in the non-government sector. NEP 2.0 mainly focused on extending wage support to cover all Bahraini citizens working in the non-government sector, increasing expatriate-related fees and upgrading upskilling and training programs. With an annual target to employ 25,000 and train 10,000 Bahrainis during 2021-2024, The reinvigorated program's main features consist of:

- **Imposing quotas on the employment of expatriate workers.** The quota system imposes a minimum Bahrainization ratio across all institutions. The ratio also varies by sector, activity and size of institution. Firms must comply with the quota scheme to qualify for government tenders. Firms that do not abide by the quota scheme are also subject to an additional fee in accordance with the parallel Bahrainization scheme (see below).
- **Incentivizing hiring of Bahrainis over expatriates.** The authorities extended the existing three years wage subsidy scheme to cover all Bahrainis and increased work permit-related fees for expatriate workers.
- **Training and upskilling programs for job seekers.** Under the NEP 2.0, two other training programs were added to the initial training scheme provided by the MLSD, namely on-the-job training (Fouras) and training with an employment guarantee program (Dhaman).
- **The unemployment insurance scheme.** With a nine-month duration, unemployment compensations are provided to all registered jobseekers in the country, conditional on compliance with the attendance and training requirements of the labor services office. Expatriate workers' access to unemployment compensation is conditional on visa status.
- **Preserving the flexibility of the labor market.** In its effort to maintain the flexibility of the labor market, the authorities have put in place alternative employment schemes for expatriate workers, i.e., the parallel Bahrainization scheme and the flexible employment scheme. Fees for both permits have been increased to 500 BHD in the NEP 2.0.
- **Organizing job fairs.** The Labor Market Regulatory Authority (LMRA) started in 2016 organizing job fairs to facilitate the recruitment process for Bahraini jobseekers. This initiative aims to inform jobseekers of job opportunities and benefits in the private sector.
- **Automating the recruitment scheme.** The automated system developed by the LMRA aims to facilitate job matching between Bahraini job seekers and firms.
- **Advertisement of job openings in newspapers.** To provide more job opportunities for Bahrainis, the NEP 2.0, at the beginning of 2021, included an initiative for firms, that apply to recruit workers from abroad, to advertise vacancies in local newspapers for a period of three weeks before they get the approval to recruit expatriate workers.

Appendix I. Panel Regression Estimations

1. In this exercise, we run a panel regression for 7 sectors in the Bahraini economy¹. The model includes employment per sector, output per sector, and we control for aggregate growth in the Bahraini economy to also capture the spillover effect of aggregate growth on sectoral employment. We also add an interaction variable (Gap) which is a product of sectoral growth and the wage gap in each sector. This exercise is conducted to capture the effect of the wage differential on employment of Bahrainis and expatriate workers. The panel regression takes the following form:

$$\log(E_{i,t}) = \alpha_i + (\beta_{1,i} + \beta_{2,i} \text{Gap}_{i,t}) \log(Y_{i,t}) + \beta_{3,i} \log(Y_t) + \beta_{4,i} D_t$$

2. Where ($E_{i,t}$) is employment in sector (i), ($Y_{i,t}$) is output in sector (i), (Y_t) is Aggregate output, and $\text{Gap}_{i,t}$ is the wage differential between Bahrainis and expatriate workers in each sector. A dummy variable is also included in the analysis to capture the pandemic's effect on the labor market.

Growth, job Creation and the Role of Wages						
Dependent Variable:						
Employment	Bahrainis			Expats		
	1B	2B	3B	1E	2E	3E
Sectoral Growth	-0.21 (0.20)	-0.19 (0.21)	-0.05 -0.26	0.27** (0.11)	0.19** (0.09)	-0.22 (0.11)
Sectoral Growth x Wage Gap		0.000 (0.01)	0.003 (0.02)		0.07*** (0.01)	0.06*** (0.01)
Aggregate Growth			-0.83 (0.57)			1.21*** (0.24)
COVID Dummy			-0.05 (0.07)			-0.15 (0.03)
Constant	9.63*** (0.94)	9.57*** (0.97)	15.54*** (3.92)	9.29*** (0.53)	9.05*** (0.46)	1.44 (1.72)
Sector Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Observation	252	245	245	252	245	245
Sectors	7	7	7	7	7	7
R-Squared	0.80	0.80	0.39	0.46	0.31	0.41
Standard errors are in parantheses.						
Significance levels: ***p<0.01, **p<0.05, *p<0.1.						
Source: IMF staff estimates.						

¹ The exercise was conducted on 7 sectors in Bahrain (Manufacturing, construction, trade, transportation and ICT, hospitality, and real estate activities). With the exception of agriculture, these sectors are the main targeted sectors for employment of Bahrainis in the Economic Recovery Plan (ERP).

3. The first specifications of the model (1B & 1E) show how sectoral growth affects sectoral employment. The results show that employment of Bahrainis is not sensitive to sectoral growth, while employment of expatriate workers is responsive to short term sectoral growth. The second specification sets (2B&2E) introduce the interaction term (Gap), which is a product of sectoral growth and the wage differential between Bahraini and expatriate workers in each sector. The results show that the wage gap has significant, positive effect on the employment of expatriate workers.

4. The last specification sets (3B & 3E) show that the spillover effect of aggregate growth on employment of expatriate workers is positive and significant, while the effect on Bahraini workers is statistically insignificant. The specifications also reaffirm how disproportionately the pandemic affected the employment of expatriate workers. The analysis reveals the asymmetric effect of the pandemic on sectoral employment and the employment of Bahrainis versus expatriate workers. Employment of expatriate workers in the transportation sector was the most affected by the pandemic. Other than hospitality and real estate, the pandemic had a significant adverse effect on employment of expatriates across all sectors. On the other hand, employment of Bahrainis, was mostly not affected by the pandemic, except for employment in the construction sector, thanks to the widespread coverage of the government's wage support scheme

The Pandemic's Effect on the Sectoral Employment

Sector	Bahrainis	Expats
Manufacturing	-0.0015 (0.02)	-0.09 *** (0.03)
Construction	-0.047 ** (0.02)	-0.08 ** (0.03)
Trade	0.005 (0.01)	-0.03 ** (0.01)
Transportation and ICT	-0.091 (0.07)	-0.20 *** (0.07)
Hospitality	-0.169 (0.13)	-0.05 (0.17)
Real Estate and Business	-0.0445 (0.06)	-0.06 (0.10)

Standard errors are in parantheses.

Significance levels: ***p<0.01, **p<0.05, *p<0.1.

Source: IMF staff estimates.

Appendix II. Skill Mismatch Index

1. Following the work of Estevao and Tsounta (2011), we compute the skill mismatch index for Bahrain and use it to compare it with 82 other countries. The skills mismatch index measures the distance between the percent of the labor force with a given level of skills and the proportion of employees with the same level of skill. Index value ranges between 0 and 1, with 0 indicating no skill mismatch and 1 absolute skill mismatch. To ensure consistency, Bahrain's 2021 results were mapped back to 2014 to match them with other countries.

2. On the supply side of labor, the labor force is divided into three categories: (a) low skilled (Primary education or lower), (b) medium skilled (Secondary education), (c) high skilled (Above secondary education). On the demand side, sectors are divided into: (a) low-skilled sectors (agriculture, mining and construction), (b) medium-skilled sectors (manufacturing, trade, transportation and utilities, hospitality, and other services), (c) high-skilled sectors (ICT, financial activities, education and health care, professional and business services). The index is computed as the sum of the squared distances for the three skill levels for each country and over time:

- $SMI_{it} = \sum_{j=1}^3 (S_{ijt} - M_{ijt})^2$, where j = skill level, S_{ijt} = percent of labor force with skill level j at time t in country i , and M_{ijt} = percent of employees with skill level j and time t in country i .

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