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February 7, 1985

To: Members of the Executive Board
From: The Secretary
Subject: Bahrain - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Bahrain, which has been tentatively scheduled for discussion on Monday, March 4, 1985.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Jakubiak (ext. 7109) or Mr. Borpujari (ext. 7143).

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INTERNATIONAL MONETARY FUND

BAHRAIN

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the
1984 Article IV Consultation with Bahrain

Approved by S.H. Hitti and J.T. Boorman

February 6, 1985

I. Introduction

The 1984 Article IV consultation with Bahrain was held in Manama during the period November 24-28, 1984. The Bahraini representatives included the Governor and the Deputy Governor of the Bahrain Monetary Agency (BMA), the Minister of Development and Industry, the Undersecretary of the Ministry of Finance and National Economy, and senior officials of these departments and of the Ministries of Commerce and Agriculture; Labor and Social Affairs; and Public Works, Power and Water; and the Directorate of Statistics. The staff representatives were Messrs. S. Hitti (Head), J.G. Borpujari, P. Clawson, and D. Noursi, Mrs. M. Schulze-Ghattas, and Mrs. J. Polk (secretary), all of the Middle Eastern Department.

Bahrain accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement on March 20, 1973.

II. Background

After a decade of vigorous expansion, the Bahraini economy experienced slower growth in the early 1980s largely as a consequence of more restrained public spending policies in response to the slack in international oil markets. The petroleum sector occupies a vital role in Bahrain's economy, providing about four fifths of exports and two thirds of budgetary receipts. The sector is composed of: (1) production from a small onshore field of 42,000 barrels per day (b/d) of crude oil and the energy equivalent of 80,000 b/d of natural gas; (2) a share in the revenue from an offshore field operated by Saudi Arabia, with Bahrain's portion being about 55,000 b/d; and (3) a 250,000 b/d refinery using domestic and imported crudes. However, about 80 percent of GDP originates in the non-oil sector reflecting the success of diversification policies through encouragement of export-oriented industries and services. Industrial development has centered on an aluminum smelter and several other large joint venture projects, in some cases in cooperation with government and private sector interests from neighboring countries. The Government has also given strong

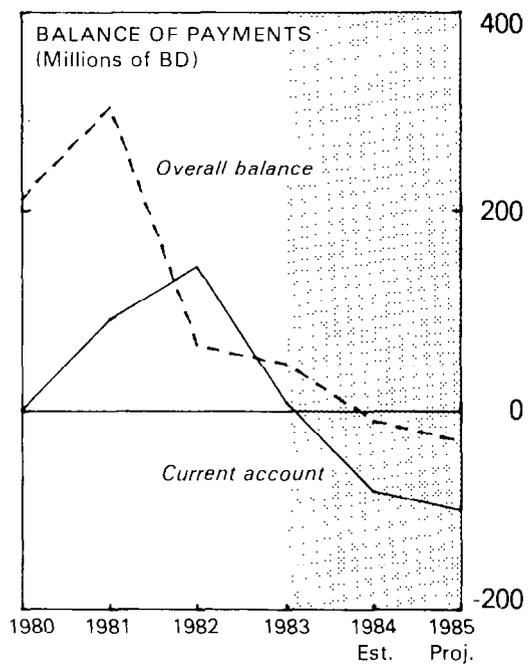
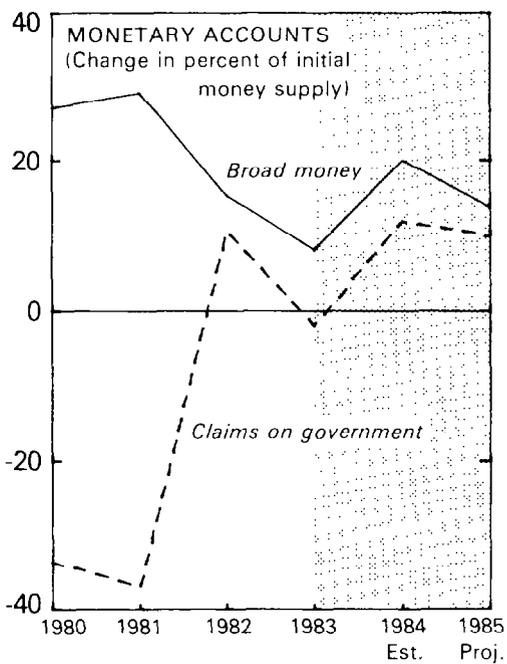
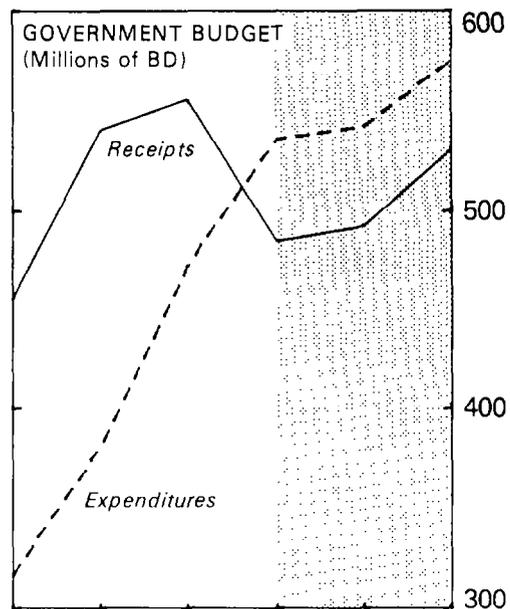
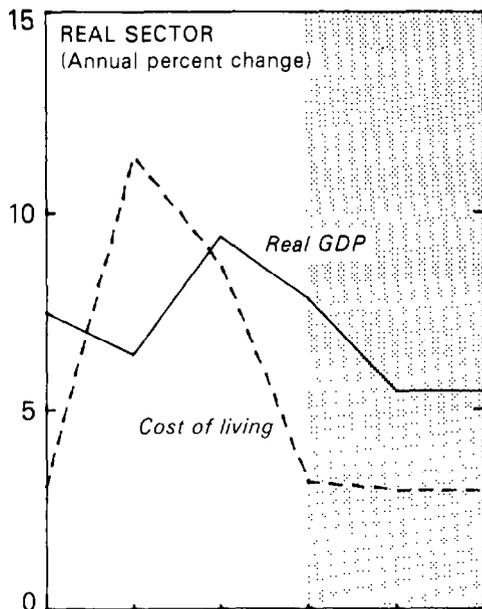
encouragement to private sector industry, which is primarily involved in the export-oriented manufacture of aluminum products. An important element in the economy's growth and diversification has been Bahrain's emergence as a major international financial center; 77 Offshore Banking Units (OBUs) with assets of approximately US\$60 billion contribute directly about 12 percent of GDP.

Relatively expansionary fiscal policies were pursued by the Government in 1980-82, a period of rising oil revenues. The Government adopted an ambitious Economic and Social Investment Program, directed considerable resources to upgrading housing, and increased substantially expenditures on basic infrastructural facilities such as power, water, and sewerage. Despite accelerated government expenditures, the overall fiscal accounts showed substantial surpluses in 1980-81. However, due to considerable extrabudgetary expenditures in 1982, a deficit equal to 5 percent of GDP was incurred. The rate of growth of domestic liquidity averaged 24 percent per annum in 1980-82, while price increases were contained to an average of less than 8 percent per annum (Chart 1).

Bahrain experienced a favorable balance of payments situation in 1980-82 resulting primarily from higher petroleum export earnings with an additional contribution from growing service receipts; the latter factor reflected a rising level of reserves, higher international interest rates, and the expansion of the export-oriented services sector. Bahrain maintains a liberal exchange and trade system. Customs duties are relatively low, except for selected consumer products, e.g., automobiles and tobacco products. In principle, the Bahrain dinar is pegged to the SDR; however, since December 1980 a stable relationship between the dinar and the U.S. dollar has been maintained. By November 1984, this had resulted in a real effective appreciation of the dinar by about 8 percent since the last consultation discussions (May 1983).

The timeliness of economic and financial data in Bahrain is generally good. The coverage as well as the currentness of data reported for inclusion in the International Financial Statistics (IFS) is on the whole satisfactory (see Appendix II). There are discrepancies between fiscal and monetary accounts and the net errors and omissions entry in the balance of payments statistics is large. The authorities are maintaining their efforts to improve the quality of the data.

CHART 1 BAHRAIN PRINCIPAL ECONOMIC TRENDS





III. Economic Policies and Prospects

1. Production and prices

Despite the slack conditions in the international oil markets in 1983-84, the Bahraini economy continued to experience relatively strong real growth, estimated at about 8 percent in 1983 and some 5-6 percent in 1984 (Table 1). The prospects for 1985 are for growth in real GDP at roughly the same rate experienced in 1984. The growth impulses emanated in part from increased activity in construction and non-oil manufacturing and, in addition, the Bahraini oil industry was comparatively little affected by the downturn in world markets. Oil production increased slightly due primarily to higher output in the offshore Abu Saafa field (controlled by Saudi Arabia) and a temporary halt in the declining production trend from the aging onshore field in 1984; refinery operations improved also after mid-1983. As regards the natural gas sector, production rose in 1983 and 1984 and, with the inauguration of several gas-using industrial facilities scheduled for 1985, further increases in output can be expected. Currently, natural gas prices in Bahrain are below the energy-equivalent price of crude oil. While continuing to increase the price charged industrial users of natural gas, the Government's policy is to maintain the price of natural gas at a level which permits the development of energy-intensive industry.

The non-oil sector continued to grow at a relatively brisk pace in 1983-84. Bahrain witnessed a substantial boom in both residential and office construction in these two years. Several major industrial projects begun in the early 1980s with financing primarily from the governments of Bahrain and of neighboring countries were under construction in 1983-84, including an aluminum rolling mill, an iron pelletization plant, and a petrochemical complex. The Bahraini authorities remain committed to the strategy of diversifying the economy, wherever possible taking advantage of opportunities presented through joint ventures under the aegis of the Gulf Cooperation Council (GCC). ^{1/} They consider, however, that the period ahead should be one of consolidation. The Bahraini representatives stated that in the future, industrial development strategy would focus on encouraging private sector initiatives in light manufacturing industries.

The authorities are giving close attention to the economic consequences for Bahrain of the opening of the causeway now under construction between Bahrain and Saudi Arabia. The causeway, 25 kilometers in length and costing US\$700 million, is being financed by Saudi Arabia and is expected to be completed in late 1985 ahead of schedule. In order to assess the likely impact of this historical event on the domestic economy, an interministerial committee is reviewing a number of issues including procedures for facilitating the movement of goods and people; the potential for greater economic links between Bahrain and eastern Saudi Arabia; the prevailing price differentials between the two countries; and the further opportunities for trade and provision of services that may open up for the Bahraini private sector.

^{1/} The members of the Gulf Cooperation Council are: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

Table 1. Bahrain: Principal Economic Indicators, 1980-85

	1980	1981	1982	1983	Staff Est. 1984	Staff Proj. 1985
<u>(Annual percentage change)</u>						
Non-oil GDP at constant prices	11.0	6.4	9.4	7.8	5.5	5.5
Oil production	-11.6	-5.3	-8.3	3.4	5.5	--
Consumer prices	3.1	11.4	8.7	3.2	3.0	3.0
Government budgetary receipts	49.6	18.8	2.9	-12.9	1.6	7.7
Government budgetary expenditure	24.6	20.3	23.9	13.2	1.3	6.1
Money and quasi-money	27.2	29.2	15.3	8.0	20.1	13.8
Exports <u>1/</u>	48.7	21.4	-11.6	-15.5	10.8	-11.5
Imports <u>1/</u>	40.9	18.8	-14.7	-5.6	17.7	-7.4
<u>(In percent of GDP)</u>						
Oil revenue	22.4	24.7	23.0	18.0	17.3	16.7
Non-oil revenue	5.5	5.2	5.6	6.0	5.8	6.6
Current budgetary expenditures	13.2	14.1	16.9	17.1	16.2	16.9
Capital budgetary expenditures	8.8	9.3	10.0	12.2	11.2	9.9
Budgetary balance <u>2/</u>	9.7	9.8	4.8	-2.8	-2.5	-2.1
Overall fiscal balance <u>3/</u>	9.7	12.2	-5.1	-5.6	-5.1	-4.5
Exports	90.7	97.2	79.5	64.4	66.1	54.1
Imports	87.7	92.1	72.6	65.7	71.7	61.5
Current account in balance of payments	0.1	5.6	8.2	0.4	-4.1	-4.7
Overall balance of payments	14.9	18.8	3.7	2.5	-0.5	-1.4
Gross reserves						
In millions of SDRs	832.7	1,373.3	1,421.0	1,413.7	1,470.0	1,390.0
In months of imports	3.2	5.7	5.9	4.7	5.0	4.4

Sources: Data provided by the Bahraini authorities and staff estimates.

1/ In Bahrain dinars.

2/ Including interest payments and grants receipts.

3/ The sum of the budgetary balance and net extrabudgetary operations.

Consumer prices rose 3 percent per annum in 1983-84. Continuing moderation of international inflation and effective appreciation of the Bahraini dinar, as well as slack demand conditions in the region, contributed to the relative stability of prices. These conditions are expected to persist in 1985, offering good prospects for maintaining the low inflation rate. In the area of administered prices, petroleum product prices were raised twice in 1983 increasing the price of gasoline, for instance, to the equivalent of US\$0.81 per gallon; as a result, the subsidies for local petroleum product sales fell from BD 18 million in 1982 to BD 8-9 million in 1984. Following the installation of new meters, water rates are expected to be increased substantially in 1985. Electricity tariffs have not been raised since 1981; however, the authorities noted that Bahrain is coordinating its pricing policy within the GCC, which recently recommended that electricity prices in the other member states be raised to the levels prevailing in Bahrain. Consideration is being given to gradual increases over a five-year period in the electricity and water rates so as to eliminate any form of subsidy to these two services.

2. Fiscal policy

The Bahraini authorities recognized in early 1983 the need for a more restrained fiscal policy given the less favorable outlook for oil revenues. Accordingly, they undertook measures to contain expenditure growth, the most important of which was the decision to stretch out the Economic and Social Investment Program to six years from four. The extension permitted the re-evaluation of the viability of investment projects, some of which were postponed. These actions had little effect on capital expenditures in 1983, however, because of the long lead time involved in planning and implementing projects. The growth of current expenditures, which averaged 23 percent in 1980-82, was curtailed to less than 6 percent in 1983 through a freeze on hiring new staff and more careful scrutiny of expenditure requests by government departments. At the same time, a number of measures were introduced to increase non-oil revenue, including higher duties on tobacco products, automobiles, and alcoholic beverages. Despite these efforts, the budget outturn for 1983 was a deficit of BD 50 million (Table 2), compared with a BD 83 million surplus a year earlier; the decline in oil revenues and in grants accounted for almost two thirds of the turnaround in the budgetary position. However, as the net deficit on extrabudgetary operations was reduced sharply in 1983, the overall deficit (i.e., the sum of the budgetary and extrabudgetary deficits) increased by only BD 14 million. The overall deficit ratio to GDP rose from 5.1 percent in 1982 to 5.6 percent in 1983.

Table 2. Bahrain: Summary of Financial Accounts, 1980-85

(In millions of Bahrain dinars)

	1980	1981	1982	1983	Staff Estimate 1984	Staff Proj. 1985
A. Government finances ^{1/}						
Revenues and grants	455.2	540.6	556.1	484.8	492	530
Expenditures	-317.2	-381.6	-472.7	-535.2	-542	-575
Budgetary surplus or deficit (-)	138.0	159.0	83.4	-50.4	-50	-45
Net extrabudgetary operations	-0.2	37.5	172.1	-52.0	-50	-50
Overall surplus or deficit (-)	137.8	196.5	-88.7	-102.4	-100	-95
B. Factors Affecting Changes in Domestic Liquidity						
Money and quasi-money	112.1	152.8	103.5	62.8	170	140
Net foreign assets	211.6	304.0	64.7	46.5	-10	-30
Net domestic assets	-99.5	151.2	38.8	16.3	180	170
Claims on Government (net) ^{2/}	(-137.9)	(-193.5)	(71.4)	(-15.4)	(100)	(95)
Claims on private sector	(59.1)	(52.6)	(57.2)	(60.7)	(65)	(80)
Other items (net)	(-16.7)	(-10.3)	(-89.8)	(-29.0)	(15)	(-5)
C. Balance of Payments						
Merchandise trade	42.9	83.6	120.3	-24.8	-110	-155
Exports	(1,294.2)	(1,570.6)	(1,388.6)	(1,172.9)	(1,300)	(1,150)
Imports	(-1,251.3)	(-1,487.0)	(-1,268.3)	(-1,197.7)	(-1,410)	(-1,305)
Services and private transfers (net)	-41.7	7.0	22.8	32.7	30	55
Current account balance	1.2	90.6	143.1	7.9	-80	-100
Capital account balance ^{3/}	210.4	213.4	-78.3	38.5	70	70
Monetary movements (increase -)	-211.6	-304.0	-64.8	-46.4	10	30

Sources: Ministry of Finance and National Economy, Bahrain Monetary Agency, and staff estimates.

^{1/} Estimates for 1984 and projections for 1985 provided by authorities.

^{2/} Excluding the deposits with the BMA of the Pension and Social Insurance Funds, which are in other items (net).

^{3/} Includes official transfers, counterpart items, and errors and omissions.

Government finances in Bahrain, in addition to transactions under the government budget, include extrabudgetary transactions covering the return on government foreign assets and on government domestic investments, such as in the oil refinery and the aluminum smelter, as well as the financing of investment in certain public enterprises and miscellaneous government expenditures. The Bahraini representatives explained that in 1982 there were certain large and nonrecurring extrabudgetary expenditures including the final repayment of a US\$300 million Eurodollar loan of 1980 related to the purchase of a 60 percent share in the oil refinery, and extraordinary expenditures for security. In the absence of such expenditures in 1983, the extrabudgetary position improved. The mission emphasized to the authorities the importance of integrating the extrabudgetary accounts, on both the expenditure and revenue sides, into the budget accounts in order to strengthen expenditure control and to facilitate the analysis of fiscal developments. The authorities intend to continue looking into this matter but feel that sensitive concerns need to be taken into consideration. 1/

Fiscal developments in 1984 reflected the continuing efforts of the authorities to curtail expenditures and to increase non-oil revenue. With regard to the outcome for 1984, estimates by the authorities based on nine months of actual data indicate that current spending rose by less than 3 percent. Expenditure-reducing measures included continuation of the freeze on the hiring of civil servants, elimination of purchases of automobiles and equipment, and imposition of stricter controls to ensure adherence to budgeted levels of spending. Capital expenditures are estimated to be 10 percent higher than approved in the budget but to have remained constant relative to their actual level in 1983. Non-oil revenue rose 5 percent, partly as a consequence of the full-year effect of the measures taken in 1983; in addition, the method of billing municipal rates was changed so as to increase revenue and to reduce the cost of the subsidies to municipalities. Grants from neighboring countries were 21 percent below the 1983 level and 34 percent below the budgeted level. The overall impact of these developments, as well as a relatively small increase in oil revenues, was to maintain the budget deficit constant at BD 50 million. Since net extrabudgetary operations are estimated to have been at approximately the same level as in 1983, the absolute level of the overall fiscal deficit is expected to have remained unchanged at BD 100 million but its ratio to GDP declined from the equivalent of 5.6 percent to 5.1 percent.

Under the biennial budgetary cycle, the 1985 budget was drawn up at the same time as the 1984 budget, but more up-to-date estimates by the authorities point to a likely emergence of a deficit resulting entirely

1/ The discrepancy between the monetary data and the fiscal results in 1983 was very large relative to those shown in earlier years. To a considerable extent this discrepancy resulted from BD 68 million in government deposits reclassified during the course of 1983 from an OBU account to a domestic bank account. See Bahrain: Recent Economic Developments (to be issued shortly), Section III.

from revenue shortfalls relative to the projections in the budget while expenditures are forecast to approximate the original allocations. With a small decline in capital spending from the 1984 level, all the expenditure growth is for current purposes. The projected higher rate of growth in current expenditures than in 1984 (12 percent compared to 3 percent) is primarily the result of an allocation for maintenance that had been frozen in 1984. With respect to revenues, the original budgetary estimates were made in relation to the 1984 budgetary forecast. As all revenue items in 1984 are expected to fall short of their targets, a similar scaling down for 1985 is in order. Nevertheless, an increase in gas use and higher prices is expected to result in the growth of oil and gas revenues and non-oil revenues are expected by the authorities to grow considerably over collections in 1984. The revised estimates result in a 1985 budget deficit of BD 45 million, and assuming that net extra-budgetary operations incur a deficit on the same level as in 1983-84, an overall deficit of about BD 95 million is projected (approximately 4.5 percent of GDP).

For the medium term, capital expenditures in 1986-87 are expected to decline considerably as major projects are completed while new projects continue to be limited to those included in the stretched out investment program. Moreover, the Bahraini authorities are considering a set of measures aimed at mobilizing non-oil revenue and controlling the growth of expenditure during the period 1985-91. A technical report is before the Council of Ministers. On the expenditure side, it proposes to limit the rate of growth of current spending to one half the anticipated rate of increase in real GDP, although the rate of growth in spending by ministries providing services to the public is to be limited instead to the rate of growth of the population. In addition, services provided by some ministries are to be evaluated with the aim of financing some through fees and contracting out others to the private sector. As for capital expenditure, annual re-evaluations would be conducted to ensure that the proposed projects remain appropriate. On the revenue side, consideration is being given to various fees and taxes along the lines proposed by a Fund fiscal technical assistance mission in February 1984, including a broad based tax on expatriate workers, an airport departure tax, and higher municipal rates. The impact by 1991 of the entire package under consideration is estimated at BD 53 million in reduced current expenditures and BD 85 million in additional revenue, for a combined effect equivalent to 7 percent of 1984 GDP.

3. Monetary and credit policies

Based on monetary data through June 1984 supplemented with estimates of the fiscal and balance of payments results for 1984, it appears that net domestic liquidity will grow at a considerably more rapid pace in 1984 (20 percent) than in 1983 (8 percent). However, various factors suggest that the developments in the two years 1983-84 can most meaningfully be analyzed for the two-year period as a whole, during which liquidity grew at an average annual rate of 14 percent. The Bahraini

representatives explained that some of the increase in the growth of net domestic assets, from BD 16 million in 1983 to an estimated BD 180 million in 1984, was the result of three extraordinary nonrecurring factors, which reduced asset growth in 1983 or increased it in 1984. First, a BD 68 million government deposit was reclassified in 1983 from an account with an OBU to an account with the domestic bank which was the OBU's parent. Since the corresponding assets could not be precisely identified, the Bahraini representatives stated that no retroactive adjustment could be made to the data. ^{1/} Second, other items (net) incurred a considerable turnaround due primarily to withdrawals in 1984 of deposits made in 1983 with the BMA on the part of a firm partly owned by the Bahrain Government. Third, the commercial banks increased their capital and reserves at a much slower rate in 1984. Extraordinary earnings in 1982 had permitted a rise in the capital/assets ratio to 11.2 percent at the end of 1983; the commercial banks therefore decided to distribute larger dividends in 1984 rather than to expand their capital base.

The indications are that the increase in net domestic assets in 1985 may be below the level of 1984. In light of the authorities' projections for the fiscal outturn, credit to the Government from the banking system is likely to be a little less in 1985 compared with 1984. Based on the continuing growth of the manufacturing sector, credit to the private sector is projected to increase at only a slightly faster rate in 1985 than in 1984. The outlook for domestic liquidity growth depends in part upon the expected balance of payments outcome. In the view of the staff, an overall deficit larger than in the preceding year is likely in 1985, although considerable uncertainty attends the estimates of flows of capital and official aid. Assuming that the capital account is much the same in 1985 as in 1984, domestic liquidity growth could approximate 14 percent in 1985 which is the 1982-84 average.

The considerable growth of domestic credit has contributed to the weakening of the external position. As the authorities will continue to target a moderate rate of growth in domestic liquidity while improving balance of payments performance, some restraints on the growth in domestic credit will be needed. In this context, the mission suggested that the tightened fiscal policy stance be supplemented with some steps to moderate the demand for credit by the private sector and that consideration be given to the appropriateness of interest rate policy, which in recent years may have stimulated demand for credit and led to placement of some capital overseas. Although the BMA lacks the authority to impose interest rate ceilings, its maximum recommended rates on deposits are in effect adhered to. The rates, which have been unchanged since January 1983, range from 6.5 percent to 8.5 percent. Recommended interest rates have been below those prevailing in international markets due to the authorities' concern that lending rates remain low so as to encourage economic development. Reflecting its concern about the impact of the differential

^{1/} In the absence of an adjustment for the amount in question, some caution is necessary in interpreting developments in foreign assets, credit to the Government, and possibly credit to the private sector.

between interest rates in the domestic market and world markets, the BMA issued a circular in 1984 asking banks not to extend credit for the purpose of interest rate arbitrage. The mission said that given the difficulties in ascertaining the end use of credit, such regulations tend to be much less effective than removing the incentive itself. The authorities' view is that the BMA interest rate policy is designed to strike a balance between domestic needs and balance of payments considerations. So far, with declining interest rates, the authorities did not believe that there was need for a change in their policy. However, they would consider a more active interest rate policy if capital flows necessitated moves in that direction.

Growth of the OBUs slowed noticeably in 1983-84, with total assets essentially stagnant from early 1983, subject to month-to-month fluctuations. The financial sector as a whole was influenced by the declining oil income in the region and the difficulties in international lending to less developed countries. Banking, including the OBUs, has become a mature industry in Bahrain and is unlikely to experience soon a return to the rapid growth rates of 1979-82. The authorities stated, however, that there is scope for increased contributions from nonresident banks to the GDP, employment, and the balance of payments, on the basis of the potential for expansion in investment banking and in fee income. The Bahraini representatives asserted that the authorities continued to apply high standards in licensing OBUs, and were exercising proper supervision over these units.

4. External sector policies

The overall balance of payments surplus shrank steadily from the 1981 record of BD 304 million, and approximate balance is estimated for 1984. In 1983 the surplus on the current account of the balance of payments virtually disappeared and in 1984 a considerable current account deficit is likely to have been incurred. The developments in 1983-84 were strongly influenced by a sharp decline in the merchandise trade balance, mainly as a result of the deterioration in the oil trade surplus, which was adversely affected primarily by lower export prices. The non-oil trade deficit also widened. Non-oil exports benefited from sales of aluminum stocks at the high prices prevailing on world markets in 1983-84. The principal factor in the trade balance decline was the growth of non-oil imports which was fueled in part by the increase in GDP. However, the rapid rate of growth in payments for imports in 1983-84 combined with declining import prices in terms of Bahrain dinars suggest that the volume of imports has grown at a faster pace than GDP, perhaps due in part to the appreciation of the dinar. The Bahraini authorities believe that increases in stocks were also an important factor in the rapid import growth. The current account balance did not weaken as much as the merchandise trade balance in 1983-84 partly due to the larger contribution from OBUs. The capital account balance has been influenced by the changes in international interest rates relative to those in Bahrain; the major factors in the capital account in 1983-84 were, however, official aid inflows and inflows of investment capital.

The Bahraini representatives stated that in view of the uncertainties regarding the exogenous factors that strongly influence the Bahrain economy, such as the world oil market, international industrial and economic activity, and the political scene in the region, it was difficult to make a balance of payments forecast for 1985. Should the current situation regarding these variables remain the same, the authorities expect a balance of payments outcome similar to that in 1984. The staff estimated that 1985 may see a further erosion in the current account balance, due primarily to a decline in non-oil exports with the exhaustion of aluminum stockpiles and a resumption in the decline in domestic production of crude petroleum. On the other hand, non-oil imports may fall in 1985, since the growth of such imports in recent years, as the authorities believe, may have contained additions to stocks which could not be expected to continue increasing. Moreover, the surplus on services and private transfers may also rise, reflecting partly an increase in receipts from the growing number of nonbank off-shore companies as well as a further decline in workers' remittance outflows. Overall, the staff concluded that a reasonable estimation of all these factors points to an increase in the current account deficit in 1985 to about BD 100 million. As noted earlier, considerable uncertainty is involved in the estimation of the capital account. In light of the authorities' expectation that official transfers in 1985 may equal those in 1984, it may be appropriate to assume that the capital account balance in 1985 could be similar to that in 1984, although such an hypothesis is highly tentative since the outcome will depend upon other capital flows which reflect such factors as changes in interest rates. If the capital account balance remains unchanged, the overall balance of payments outturn in 1985 would be a deficit of BD 30 million.

A qualitative assessment of the medium-term prospects for the balance of payments suggests the possibility of recouping the reserve losses that might occur in 1984-85. The main favorable element on the horizon relates to the impact of the Bahrain-Saudi Arabia causeway on Bahrain's earnings, but a quantification of this unique factor is not feasible currently. Moreover, the adoption and effective implementation of the fiscal package described above would strengthen Bahrain's demand management stance with a favorable impact on the external position.

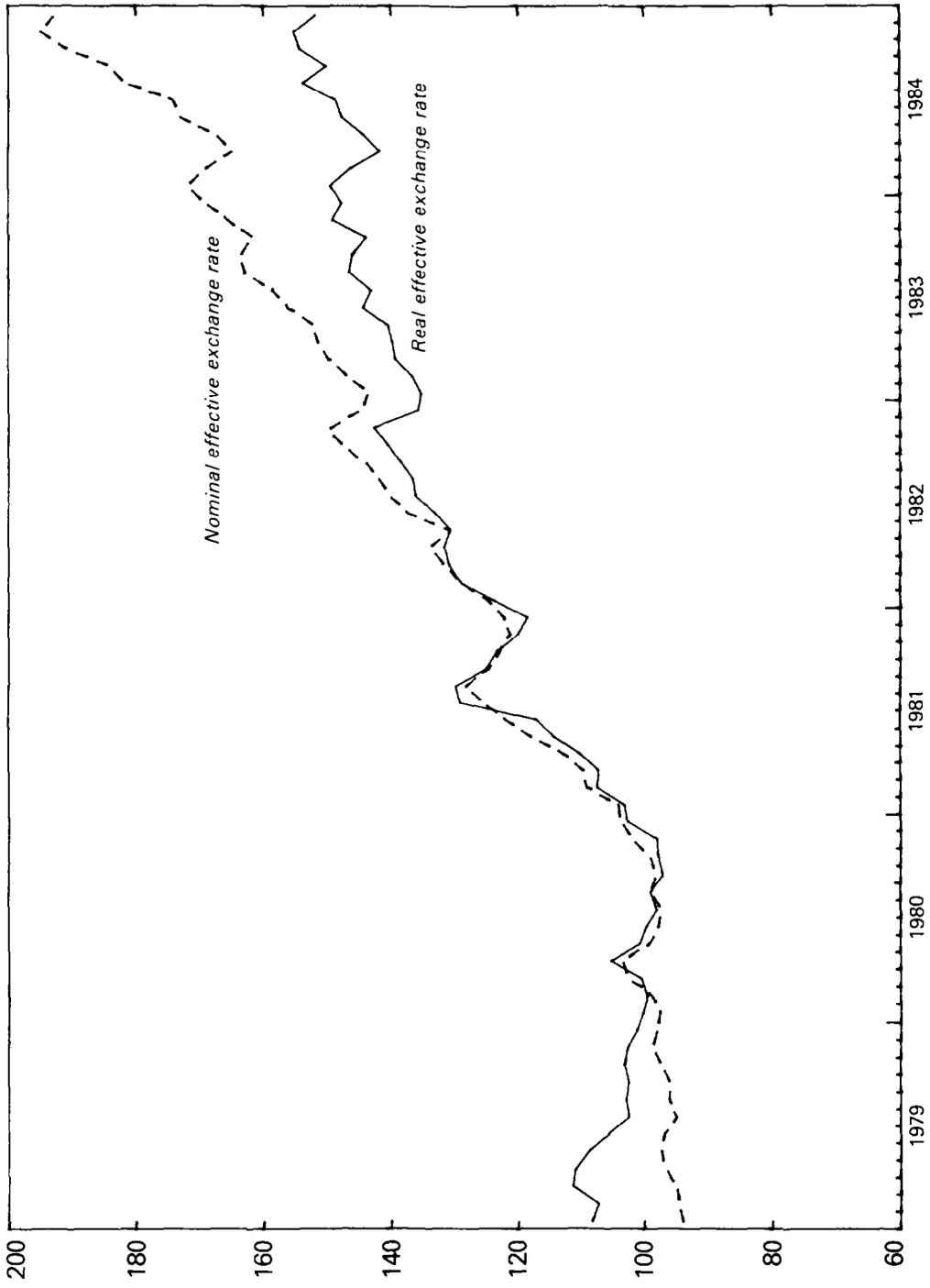
Gross official reserves at the end of June 1984 were equivalent to five months of total imports and nine months of non-oil imports at the estimated 1984 levels. Bahrain's external public debt, equivalent to 5 percent of GDP at the end of 1983, is small. Since the loans were obtained on concessional terms, debt service payments are less than 1 percent of export earnings.

In principle, the Bahrain dinar continues to be pegged to the SDR with 7.25 percent margins. In practice, despite the dollar's strength since 1981, the dinar/U.S. dollar rate has remained unchanged since December 1980. As a consequence, the dinar has remained outside the 7.25 percent margin of the peg to the SDR for three and a half years. The dinar's real effective exchange rate (on a non-oil import-weighted

basis) appreciated strongly since most of Bahrain's imports come from Western Europe and Japan (Chart 2). The appreciation was 1.8 percent in the year ended November 1984 and 52.2 percent from December 1980 to November 1984. While service receipts do not seem so far to have been adversely affected, the mission suggested a close monitoring of the effects of the exchange rate on the costs in export-oriented and import-substituting industries and services in order to ensure that the cost structure in Bahrain remains competitive. The Bahraini representatives stated that for the present a stable relationship of the dinar to the U.S. dollar was appropriate, but if it appeared that greater flexibility in setting the exchange rate was needed, this would be considered and adopted if circumstances warranted.

Trade policy is coordinated within the framework of the GCC. Tariffs on trade within the GCC on locally produced goods (those with local value added of 40 percent or more) were abolished in March 1983. A common external tariff, ranging from 4-20 percent for most commodities, is being introduced by the GCC over the next four years.

CHART 2
BAHRAIN
EFFECTIVE EXCHANGE RATES
(1980 = 100)





IV. Staff Appraisal

The Bahraini authorities have made strong and largely successful efforts over the last decade to broaden the economy's base and to reduce dependence on the oil industry. Earnings from petroleum and gas continue to dominate the fiscal and external trade accounts. Although these earnings have declined in recent years due primarily to lower prices, Bahrain has been less affected by the slack demand conditions that has led some neighboring countries to reduce their output substantially. Considerable progress has been achieved in diversification, including development of export-oriented industry and of services. Although the Government necessarily played the major role in the initial development of industry, the focus of the authorities' efforts currently is the encouragement of private sector activities. The economy experienced relatively strong expansion in 1984 with moderate price increases and the prospects for 1985 are about the same. Sustaining the momentum for economic expansion after 1985 will depend in part on the impact of the completion of the causeway linking Bahrain to Saudi Arabia and continued implementation of policies that would allow the private sector to take full advantage of the new opportunities.

Bahrain's fiscal position weakened in 1984 and the fiscal situation is likely to remain tight in 1985, largely as a result of the reduction in oil revenues which began in 1983. The authorities have taken a wide range of measures to adjust to the changed circumstances, particularly through curtailing the growth of expenditures. The increase in current outlays has been contained to modest levels. The stretching out of the Economic and Social Investment Program from four years to six will help reduce these expenditures in 1986-87. In addition to curtailing capital expenditures after 1985, the authorities have under consideration a package of measures including new taxes, raising charges and fees, eliminating subsidies, and limiting current expenditure growth. The staff is of the view that implementing the proposed package would represent a commendable effort to improve the fiscal situation, but its impact would be more effective if the pace of implementation is accelerated and if, to the extent possible, the introduction of measures is front loaded. Early action may well enable the authorities to curtail the 1985 fiscal deficit from its currently projected level.

With the sharp decline in the external surplus, the primary source of liquidity growth has been the large increase in domestic credit for both the public and the private sectors. The monetary authorities are concerned that some private credit was being utilized to take advantage of interest rate differentials. The staff believes that the financial position in 1985 may benefit from moderating private sector demand for commercial bank credit. In this regard, an adjustment in interest rates would be appropriate. In addition to eliminating the profitability of interest arbitrage, aligning Bahrain's interest rates more closely with those on world markets might help the balance of payments situation by reducing the relative attractiveness of depositing abroad.

Bahrain's overall external payments surplus has been declining and in 1984 approximate balance is expected. The prospects for the balance of payments in 1985 are clouded by uncertainties, including those related to developments in the international oil markets and the potential for changes in stocks of imports. The staff estimates, however, that the deficit in the current account is likely to widen and an overall deficit may emerge. Bahrain's external reserve position is relatively comfortable, which allows the authorities to focus on medium-term improvements in the balance of payments through furthering Bahrain's role as a regional services center and encouraging expansion of export-oriented private industry. In the framework of closer links within the GCC and after completion of the road connection to the mainland, Bahrain is likely to have the opportunity to strengthen external performance over the second half of the 1980s. For these favorable prospects to materialize in good measure, the authorities will need to ensure that the exchange rate is appropriate and that the private sector is well placed with an adequate competitive edge.

It is recommended that the next Article IV consultation with Bahrain be held on an 18-month cycle.

Bahrain: Fund Relations

(As of January 31, 1985)

I. Membership Status

- (a) Date of membership: September 7, 1972.
(b) Status: Article VIII.

A. Financial Relations

II. General Department

- (a) Quota: SDR 48.9 million.
(b) Total Fund holdings of Bahrain dinars: SDR 25.8 million or 52.8 percent of quota.
(c) Fund credit: None.
(d) Reserve tranche position: SDR 23.1 million.
(e) Current operational budget: Not included.
(f) Lending to the Fund: None.

III. Current Stand-by or Extended Arrangement and Special Facilities

None.

IV. SDR Department

- (a) Net cumulative allocation: SDR 6.2 million.
(b) Holdings: SDR 13.1 million or 211 percent of net cumulative allocations.
(c) Current Designation Plan: Not included.

V. Administered Accounts

- (a) Trust Fund loans: Not eligible for loans.
(b) SFF Subsidy Account: No transactions.

VI. Overdue Obligations to the Fund

None.

VII. Use of Fund Resources

None.

B. Nonfinancial Relations

VIII. Exchange Rate Arrangement

The Bahrain dinar (BD) is pegged to the SDR at $BD\ 0.476190 = SDR\ 1$ with margins of +7.25 percent. Since December 1980 the dinar/U.S. dollar rate has remained unchanged at $BD\ 0.37600 = US\$1$. As a result, the dinar/SDR exchange rate was $BD\ 0.36625 = SDR\ 1$ at the end of January 1985.

IX. Last Article IV Consultation

May 25-June 1, 1983. The Staff Report (SM/83/158) was discussed by the Executive Board on September 16, 1983. It was agreed that the next Article IV consultation be held on an 18-month cycle.

X. Technical Assistance

At present, one expert is assigned to the Bahrain Monetary Agency under CBD auspices and another to the Ministry of Finance and National Economy under FAD auspices.

XI. Resident Representative/Advisor

None.

Bahrain - Statistical Issues

1. Coverage, Currentness, and Reporting of Data in IFS

		<u>Latest Data in January 1985 IFS</u>
Real Sector	- National Accounts	n.a.
	- Prices	April 1984
	- Production	July 1984
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1982
	- Financing	1982
	- Debt	1982
Monetary Accounts	- Monetary Authorities	April 1984
	- Deposit Money Banks	April 1984
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	June 1984
	- Merchandise Trade: Prices	December 1983
	- Balance of Payments	1983
	- International Reserves	November 1984
	- Exchange Rates	November 1984

During the past year, the reporting of data for inclusion in the IFS has been infrequent and data have been updated in batches rather than on a regular basis.

2. Outstanding Statistical Issues

Prices

The consumer price index base is July 1975, and a new household survey to check the currentness of the basket could be useful. Quarterly data for 1982 and 1983 were revised, but corresponding revisions to monthly data were not provided.

Monetary Accounts

As of July 1984, a new set of monthly commercial bank returns was introduced which will have a substantial impact on the detail and quality of data available. The new returns provide a breakdown of the assets and liabilities of all banks (including OBUs) according to

resident/nonresident, dinar/other currency, and public/private classifications. A second set of returns compiles details on foreign transactions that affect foreign assets and liabilities. The returns provided information on credit to the public sector without distinguishing credit to the Government from credit to public enterprise.

Merchandise Trade

Monthly data for the period January-May 1983 have not been reported to I.F.S., which reduces the usefulness of the time series.

Balance of Payments

No data on stocks of external assets and liabilities have so far been reported. In December 1983, there was a technical assistance mission in balance of payments statistics. A report on the mission was sent on June 25, 1984, but so far the authorities have not commented on the report's recommendations.

Bahrain: Basic Data

Area	678 square kilometers
Population	397,000 (1983 estimate)
Total work force	140,150 (1982 estimate)
Of which: non-Bahraini	81,600 (1982 estimate)
Gross domestic product (current prices)	US\$4,847 million (1983 estimate)
GDP per capita	US\$12,209 (1983 estimate)

				Staff Est. 1984	Staff Proj. 1985
1980	1981	1982	1983		

(In thousands of barrels per day)

Petroleum production					
Onshore crude oil	49	47	44	41	...
Offshore crude oil <u>1/</u>	57	55	47	52	...
Refined products	240	258	195	175	...

(In millions of Bahrain dinars)

GDP at 1977 prices	897	922	981	1,051	1,107	1,160
Crude oil production	(176)	(155)	(142)	(147)	(154)	(154)
Non-oil sector	(721)	(767)	(839)	(904)	(953)	(1,006)

Monetary survey (end of year)

Money	192	233	267	250)	1,013)	1,153
Quasi-money	332	444	513	593))	
Net foreign assets	445	749	814	861	851	821
Of which: Government	[154]	[276]	[289]	[251]	[...]	[...]
Claims on private sector	435	488	545	605	670	750
Claims on Government (net)	-242	-436	-364	-380	-280	-185
Other items (net)	-114	-124	-215	-243	-228	-233

Government finances

Revenues and grants	455	541	556	485	492	530
Oil revenues	(320)	(399)	(402)	(329)	(340)	(354)
Other revenues	(78)	(84)	(98)	(109)	(115)	(140)
Foreign grants	(57)	(58)	(56)	(47)	(37)	(36)
Expenditures	317	382	473	535	542	575
Current expenditures	(188)	(228)	(295)	(311)	(319)	(359)
Capital expenditures	(126)	(150)	(174)	(222)	(220)	(211)
Interest	(3)	(4)	(4)	(2)	(3)	(5)
Surplus or deficit (-)	138	159	83	-50	-50	-45
Net extrabudgetary operations	--	38	-172	-52	-50	-50
Overall surplus or deficit (-)	138	197	-89	-102	-100	-95

Bahrain: Basic Data (concluded)

	1980	1981	1982	1983	Staff Est. 1984	Staff Proj. 1985
(In millions of Bahrain dinars)						
Balance of payments						
Trade balance	<u>43</u>	<u>84</u>	<u>120</u>	<u>-25</u>	<u>-110</u>	<u>-155</u>
Exports, f.o.b.	1,294	1,571	1,388	1,173	1,300	1,150
Petroleum	(1,206)	(1,460)	(1,182)	(972)	(1,100)	(1,000)
Other <u>2/</u>	(88)	(111)	(206)	(201)	(200)	(150)
Imports, c.i.f.	-1,251	-1,487	-1,268	-1,198	-1,410	-1,305
Crude oil	(-750)	(-935)	(-694)	(-536)	(-670)	(630)
Non-oil <u>2/</u>	(-501)	(-552)	(-574)	(-662)	(-740)	(-675)
Services and private transfers (net)	<u>-42</u>	<u>7</u>	<u>23</u>	<u>33</u>	<u>30</u>	<u>55</u>
Current balance	<u>1</u>	<u>91</u>	<u>143</u>	<u>8</u>	<u>-80</u>	<u>-100</u>
Official transfers (net)	<u>68</u>	<u>43</u>	<u>57</u>	<u>88</u>) <u>70</u>) <u>70</u>
Capital (net) <u>3/</u>	<u>-43</u>	<u>-11</u>	<u>5</u>	<u>2</u>))
Errors and omissions	<u>186</u>	<u>181</u>	<u>-140</u>	<u>-52</u>))
Overall balance	<u>212</u>	<u>304</u>	<u>65</u>	<u>46</u>	<u>-10</u>	<u>-30</u>

(In millions of SDRs)

SDR equivalents						
Exports, f.o.b. <u>2/</u>	2,637	3,543	3,344	2,918	3,372	2,983
Imports, c.i.f. <u>2/</u>	-2,550	-3,314	-3,055	-2,981	-3,658	-3,385
Current balance	2	205	345	20	-208	-259
Overall balance	432	686	157	114	-26	-78
International reserves (gross official, end of period)	833	1,373	1,421	1,414	1,470	1,390

(In SDRs per Bahrain dinar)

Exchange rates						
Period average	2.0380	2.2555	2.4090	2.4879	2.5940	2.7206
End of period	2.0853	2.2850	2.4110	2.5403	2.7206	2.7206

1/ Bahrain's half share in Abu Saafa field.

2/ Excludes goods transshipped through Bahrain.

3/ Includes counterpart items relating to SDR allocations, gold demonetization, and valuation changes.