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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/63-3

12:10 p.m., July 9, 2018

3. Kingdom of Bahrain—2018 Article IV Consultation

Documents: SM/18/165 and Correction 1, and Supplement 1

Staff: Joshi, MCD; Goodman, SPR

Length: 21 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
M. Mkwezalamba (AE)	
	M. Raghani (AF)
	D. Vogel (AG), Temporary
	G. Johnston (AP)
	P. Fachada (BR)
	K. Lok (CC), Temporary
	J. Rojas (CE), Temporary
	N. Feerick (CO), Temporary
	O. Bayar (EC)
	A. Castets (FF)
S. Meyer (GR)	
	M. Siriwardana (IN)
	T. Persico (IT), Temporary
	Y. Saito (JA)
J. Mojarrad (MD)	
H. Beblawi (MI)	
	V. Rashkovan (NE)
	K. Virolainen (NO)
	S. Potapov (RU), Temporary
H. Alogeel (SA)	
	H. Alias (ST), Temporary
M. Panek (SZ)	
	T. Hemingway (UK), Temporary
	S. Vitvitsky (US), Temporary

G. Bauche, Acting Secretary
S. Maxwell, Summing Up Officer
J. Acheson, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
European Central Bank: T. Persico. Information Technology Department: F. Gheriss. Middle East and Central Asia Department: A. Alreshan, B. Baltabaev, N. Ben Ltaifa, T. Callen, A. Husain, B. Joshi, E. Roos, S. Roudet, M. Zaher, L. Zhu. Strategy, Policy, and Review Department: M. Goodman, M. Saito. Alternate Executive Director: S. Geadah (MI). Senior Advisors to Executive Directors: W. Abdelati (MI), M. Choueiri (MI), Y. Danenov (SZ),

A. Tivane (AE). Advisors to Executive Directors: A. Abdullahi (AE), B. Alhomaly (SA), F. Al-Kohlany (MI), P. Al-Riffai (MI), F. Dogan (EC), T. Manchev (NE), M. Merhi (MI), H. Mori (JA), A. Park (AP), S. Bah (AF), A. Souza (BR).

3. KINGDOM OF BAHRAIN—2018 ARTICLE IV CONSULTATION

Mr. Beblawi and Ms. Merhi submitted the following statement:

The Bahraini authorities thank staff for the constructive and open dialogue in Manama. They appreciate staff's high-quality report and broadly concur with staff's assessment of the current economic conditions, as well as their policy recommendations. They also thank staff for the insightful analytical notes that covered relevant topics and were included as annexes in the report. They look forward to continuing the close engagement and candid policy dialogue with the Fund.

Economic Growth and Outlook

The Kingdom of Bahrain's economy registered a strong economic performance in 2017, with growth at 3.8 percent, exceeding expectations despite a contraction in the hydrocarbon sector. This resilience reflects the growth in the non-oil private sector—around 5 percent—which was led by the financial and logistics sectors. Growth also benefitted from GCC-funded infrastructure projects, as well as from regulatory reforms aimed at boosting foreign direct investment. The Bahrain Economic Development Board attracted a record of foreign investments, which also contributed to job creation.

While the authorities broadly agree with staff's economic outlook and macroeconomic projections, they are more optimistic about non-oil growth projections in the medium-term, on the basis of expectations for infrastructure projects, private sector activity, and growth in Saudi Arabia.

Fiscal Policy

The authorities are cognizant of the importance of reducing the fiscal deficit for putting public debt on a sustainable path. In addition to balancing the budget by 2022, they aim to lower the dependence of fiscal revenues on the hydrocarbon sector and to increase non-oil revenues. The authorities continued to undertake additional fiscal measures in 2017, yielding 1½ percent of non-hydrocarbon GDP in fiscal savings. These measures, as well as the concurrent increase in oil prices, helped to reduce the overall deficit to 14¼ percent of GDP, from 18 percent in 2016. On the expenditure side, the authorities contained current spending further than had been anticipated through additional cuts in energy subsidies and operating expenses. In early 2018, they introduced excise taxes on tobacco, and on energy drinks and carbonated drinks, and higher fees on government services.

Additional measures are being considered to increase non-oil revenues, further curtail spending, and improve the effectiveness and efficiency of government spending. The planned introduction of the VAT in 2019 will help to diversify the revenue base. Its implementation will be facilitated by planned consultations with businesses and communications with the general public as soon as the VAT legislation is finalized. There are also plans to further improve the targeting of subsidies and transfers, and to privatize some government services in health and education, which will help rein in public spending. These efforts will benefit from the recently announced commitments by Saudi Arabia, Kuwait and the United Arab Emirates to support Bahrain's economic reforms and fiscal stability by providing financing to complement the strong measures being taken by the authorities. The related discussions are ongoing and details of the agreement will be announced as soon as it is finalized.

The Ministry of Finance has recently established a debt management office to strengthen fiscal financing and debt management strategy. The authorities will continue working on developing the domestic bond market by expanding the investor base and deepening the secondary market for government securities.

Monetary Policy and Financial Sector Stability

The Central Bank of Bahrain (CBB) has effectively preserved financial stability. The exchange rate peg has served Bahrain well and has been an important element of stability for decades. The authorities recognize that fiscal consolidation is needed to support the peg. The CBB has adjusted its policy rates by 125 bps since 2017, following closely the increase in U.S. policy rates.

Bahrain has a 40-year history as a regional financial hub in the GCC. The banking system remains well capitalized, liquid, and profitable. Capitalization ratios are high by international standards, and NPLs, though higher among Islamic banks, continue to fall across both conventional and Islamic banks. The CBB relies on macroprudential tools to help safeguard the soundness of the banking system. The CBB is fully aware of the financial stability risks stemming from the real estate market and has taken measures to induce Islamic banks to reduce their exposure to real estate.

The regulatory and supervisory regime is robust. The authorities have made impressive progress in implementing the recommendations of the 2017 FSAP and plan to complete the remaining recommendations in a timely manner. In this regard, the CBB has enhanced its banking supervision capacity by increasing on-site bank inspections using external experts, and by extending inspection coverage to foreign branches. The CBB is working to develop a clearly defined emergency liquidity assistance framework and is also in the final process of forming a joint committee on crisis management with the Ministry of Finance. The establishment of the Real Estate Regulatory Authority (RERA) and its compilation of real estate and housing price data will help in effectively regulating the market through the effective macroprudential monitoring of household debt.

Bahrain aims to remain at the forefront of financial innovation in the Middle East and will continue to capitalize on the rapid expansion of Islamic finance. Significant progress has been made in fintech development. The CBB established a fintech and innovation unit responsible for regulating fintech, and it introduced an onshore fintech regulatory sandbox which is allowing new startups and traditional financial institutions to test innovations in a live environment. New regulations for crowdfunding platforms were announced last year. The launch of Bahrain Fintech Bay earlier this year, provides a collaborative platform for cooperation in the region. Building on this reform momentum, further regulatory reform as well as coordination with other regulators are expected to promote fintech innovation while mitigating its risks.

Structural and Regulatory Reforms to Boost Inclusive Growth

In line with the Bahrain Economic Vision 2030—which focuses on competitiveness and job opportunities for nationals—the authorities have taken measures to support private sector-led growth aiming to boost efficiency and productivity. These measures include initiatives to streamline regulations—including easing the process of starting a business and updating the insolvency framework, among others—allowing foreign ownership in several sectors, launching a business accelerator program, simplifying company registration, and lifting the minimum capital restrictions. The authorities also recently announced 10-year residence permits for foreign investors.

Recognizing the significant role SMEs have played in economic diversification, the Ministry of Industry, Commerce, and Tourism recently established an SME Development Board to create a conducive policy environment for the development of SMEs and boost their competitiveness. Furthermore, a national strategy for SME development was completed, that includes initiatives to improve access to finance, access to overseas markets, as well as to foster innovation and skill development. To further improve SMEs' access to finance, the authorities recently established the Bahrain Investment Market to help SMEs raise capital from the Bahrain Bourse at a lower cost.

Bahrain continues to make substantial investments in its modern logistics infrastructure to capitalize on the growth that is projected in the region. These investments include the airport expansion, the new causeway with Saudi Arabia, and the development of a strategic medical city, which will include training for medical students and centers for clinical research. The authorities are also continuing their efforts to reform the labor market and encourage employment of nationals in the private sector. In addition to the efforts undertaken by Tamkeen (the national labor fund) and the Bahrain Development Bank to improve job skills and provide advisory services to Bahraini professionals, the authorities have introduced a wage protection system and a "Flexi permit" system for expatriate labor that delinks residency in Bahrain from employment sponsorship by a specific employer.

Mr. Agung and Mr. Alias submitted the following statement:

We take positive note that the Bahrain economy is expected to grow at around 3.8 percent in 2018 underpinned by a recovery in oil production and implementation of GCC-funded projects. However, growth is expected to decelerate in the medium-term. Additional measures are needed to safeguard macroeconomic stability from downside risks—mainly interest rate and geopolitical risks. With large financing needs and high budget deficits, public debt is estimated to reach 120 percent of GDP by 2023 from 90 percent in 2017, with the external position expected to remain in deficit from rising borrowing costs. We therefore share staff's recommendation for the urgent implementation of a credible fiscal adjustment plan to strengthen fiscal and external sustainability. In addition, reforms to preserve financial sector resilience, and promote sustainable and inclusive growth should be completed in a timely manner. We thank staff for the well-written report and Mr. Bebalwi and Ms. Merhi for their informative buff statement. We would like to offer the following comments for emphasis.

Authorities' efforts aimed at increasing non-oil revenues, improving the targeting of subsidies and introducing VAT in 2019 are laudable. To stabilize the debt level and make debt service more manageable, staff proposed a fiscal consolidation of about 11 percent of non-oil GDP. Although the authorities do not intend to pursue revenue measures proposed by staff other than the new excise taxes introduced in early 2018, we appreciate that the authorities are taking steps in restraining public sector wage, subsidy and operating expenses to achieve a balanced budget by 2022. While we note that Bahrain has large revenue measures to maneuver as presented in page 12 of the staff report, we are inclined to support a gradual and well sequenced fiscal consolidation, with due consideration for the impact of these measures on economic activity and the protection of the vulnerable in society. Further, a well-communicated macro-fiscal framework strategy, supported by commitment at the highest leadership would help bolster economic activity and public support for fiscal reforms. We note that the establishment of independent revenue administration and crafting of a medium-term fiscal framework are on-going. We invite staff comments on how best to advance progress in this area. Given Bahrain's large fiscal financing needs, the recent establishment of the Debt Management Office tasked to develop prudent fiscal financing strategy is a welcome step. A well-developed domestic bond market would be integral to absorb market shocks and enhance investor confidence.

We concur with staff that the current exchange rate peg remains appropriate for Bahrain's economic structure. In addition, elimination of central bank lending to the government should be gradual and commensurate with reductions in fiscal deficits and financing needs. Being a regional financial hub in the GCC with a highly connected banking system, we encourage accelerated efforts in completing the remaining FSAP recommendations, particularly the emergency liquidity assistance framework and the strengthening of risk-based supervision of Islamic banks and the insurance sector. We welcome the progress made on Fintech, and emphasize that international co-ordination in managing risks and harnessing the benefits of Fintech is crucial to preserve domestic financial stability. We also note positively the efforts to strengthen the AML/CFT risk management framework, which should address the increasing sophistication in financial crime activities.

The focus on private-sector led development strategy envisaged in Bahrain Economic Vision 2030 is welcome. In promoting competition and improving delivery of public services, we commend the plan to privatize some government services in the education and health sectors. Could staff scope the privatization efforts in these areas and the safeguards to ensure these basic services continue to be affordable to the general population? We view reforms to improve the business environment, labor market and legal and regulatory frameworks as important to attracting foreign investment and further diversifying the economy. Continuing efforts to support SMEs are welcome as it could also help expand the productive sectors' economic value chains and promote financial inclusion.

With these remarks, we wish the authorities success in their endeavors.

Mr. Lopetegui and Mr. Vogel submitted the following statement:

We thank staff for the report and Mr. Beblawi and Ms. Merhi for their helpful buff statement.

We are encouraged by the authorities' awareness of the substantial challenges and risks Bahrain is facing and their firm willingness to address them. Amidst a period of lower oil prices, Bahrain, which has a strong reliance on oil receipts, has shown a deterioration in its fiscal and external accounts. Public debt has doubled over the past four years and its trend, in the baseline scenario, seems to be unsustainable. This situation has impacted the country's credit rating which has been downgraded to below investment grade. Meanwhile, the above-referred developments pose risks for the country's financial system. Therefore, we agree with the staff report's main advice which is related to the need to implement an urgent fiscal consolidation strategy which could take Bahrain back to a sustainable path.

We welcome Mr. Beblawi and Ms. Merhi's comments on the authorities' intentions to put public debt on a sustainable path and the envisaged plans to materialize this objective. A credible and much deeper fiscal strategy would not only improve the primary balance, but it would reduce the substantial burden of interest payments—according to the report, interest will reach 8 percent by 2023—and reinforce the possibilities of building a more vibrant non-oil sector with the consequent positive impact on the non-oil primary balance. While we consider that redoubling efforts on the fiscal front is essential, we would like to have further elaboration from staff on the likely social impact that the proposed adjustment (as set out on page 10 of the report) would have, considering that it would be a sizable one. Building sound institutions is critical for any country to underpin stability and growth in the medium-term and, in this regard, we welcome the establishment of a Debt Management Office to strengthen fiscal financing and debt management strategy.

We understand the authorities' position regarding their preference to preserve the currency peg. Fears of floating almost always have a rationale and, in this case, it is very well exposed in paragraph 22. Perhaps the least clear argument is related to the fact that "given Bahrain's economic structure—it exports commodities while its domestic absorption has high import content (including high expatriate labor content)—greater exchange rate flexibility would have limited impact on the current account through relative prices changes." While this is correct, sometimes institutions and policies (related to different exchange rate systems, among others) contribute to mold countries' economic structures and could incentivize diversification.

We welcome staff's assessment that the banking sector remains stable and on the progress in implementing recommendations posed in the 2017 FSAP. At the same time, Bahrain should urgently address movements observed over the past years that have driven to significantly increase sovereign-bank nexus, as explained in Box 1 of the report. In times where public debt is exhibiting a negative trend, this nexus could put the financial system at risk. We would appreciate if staff could elaborate further on the origins of this increasing nexus.

With these comments, we wish Bahrain and its people every success in their future endeavors.

Mr. Meyer and Mr. Maluck submitted the following statement:

We thank staff for an insightful report and Mr. Beblawi and Ms. Merhi for their helpful buff statement.

We agree with the thrust of the staff's appraisal. We welcome that the economic activity remained resilient and that growth 2017 was stronger than expected. At the same time, we highlight the vulnerabilities and the challenges the economy is facing on its way to a more diversified economy with more sustainable debt dynamics. Delays in implementing a credible fiscal consolidation strategy are worrisome and we encourage the authorities to swiftly follow the Fund's advice to speed up efforts in this regard.

The increased fiscal deficit and the deteriorated external position point to an urgent need for a bold policy package with a credible fiscal consolidation strategy at its centre. Tackling the sources of Bahrain's twin deficit is crucial. We agree with staff that the authorities must develop a credibly large adjustment plan that has to be based on revenue measures and spending cuts alike, including by a better targeted social safety net. Those measures are not only important to stabilise debt dynamics, but also a prerequisite for the stabilisation of the external position, i.e. to keep the peg and to rebuild foreign reserves. In this context, we also strongly support staff's call for unwinding of the CBB's credit to government.

On the revenue side, it is decisive to tackle the lack of a solid non-oil revenue base. Amid robust non-oil growth, fiscal indicators showed limited improvement, pointing to the need to further improve non-oil revenue sources. The authorities' commitment to introduce a VAT by 2019 is welcome and we encourage the authorities to follow up with the implementation of additional revenue options like recommended by staff. On the spending side, we encourage the authorities to fully implement the envisaged measures. We are encouraged by the commitment, also stated in Mr. Beblawi's buff statement, to balance the budget by 2022. However, we note staff's assessment that the currently planned measures would not be sufficient to stabilize debt levels and we urge the authorities to be prepared to implement additional measures if needed.

We take positive note that the banking sector is stable and we welcome the authorities progress in implementing the 2017 FSAP recommendations. It is encouraging that the CBB has increased its banking supervision capacity. The authorities should continue this path and develop a liquidity assistance framework and improve crisis management. We welcome Bahrain's aim to be at the forefront of financial innovation and we take note of the introduction of a regulatory sandbox for fintech. We thank staff for the very informative Annex on fintech and financial regulation and share the thrust of their appraisal on the identified policy priorities.

On structural reforms we see it a priority to diversify the sources of growth and to reduce structural vulnerabilities. The dependence on oil makes the economy vulnerable to shocks and we strongly agree that diversification is urgently warranted. Such a structural transformation is only possible if based on private sector development. Thus, we consider structural reforms to promote private sector-led growth important and we encourage the authorities to improve the business environment and investment climate, to develop privatisation plans, and to further reform the labour markets.

Mr. Saito submitted the following statement:

We thank staff for informative report and Mr. Beblawi and Ms. Merhi for their insightful statement. While economic activity in Bahrain has remained resilient supported by robust growth in the non-oil sector, the decline in oil prices since 2014 adversely affected Bahrain's fiscal and external position. Notwithstanding the recent higher oil prices and fiscal consolidation measures, the fiscal indicators showed limited improvement dragged by the increasing interest payment, and external position remains weak with significant current account deficit and low official reserves. In this situation, we agree with staff that a credibly large and comprehensive package of reforms are needed to ensure fiscal and external sustainability. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

Further fiscal consolidation is necessary to restore fiscal sustainability. We are concerned by the increasing public debt due mainly to the mounting interest rate payment, despite the authorities' efforts toward fiscal consolidation including subsidy reforms, non-oil revenue increasing measures and recurrent and capital spending cuts. Against this backdrop, further fiscal adjustment is inevitable. We welcome the authorities' plan to balance the budget on an above the line basis by 2022 with the introduction of a voluntary departure program for civil servants, continuous subsidy reforms and privatization of some government services. Authorities' commitment of introducing a VAT by 2019 is also encouraging. However, given the size of current fiscal and external imbalances, a wider range of fiscal reforms, striking a right balance between revenue and spending measures are needed. In particular, introducing a corporate income tax could raise the tax revenue significantly, given the solid performance of the non-oil sector. Such a credible fiscal reform is also important to rebuild reserves and preserve the currency peg, which has served well for the economic and inflation stability in Bahrain. While we note that authorities consider expenditure reforms are more feasible at this juncture, we would like to hear staff's view on the feasibility of tax reform including introducing a direct taxation system and the main impediments of introducing the corporate income tax.

Financial Sector Policies

Close monitoring is required to the rising personal loans. We welcome the authorities' efforts to implement the FSAP recommendations. We agree with staff that the developing a clearly defined emergency liquidity assistance framework should be the near-term priority. We note that personal loans have been increasing rapidly, tripled since 2006 and close monitoring is warranted although the current level is manageable. We would ask staff to elaborate more on the background of the rising personal loans and the necessary policy responses if the trend continues.

Optimizing benefits from fintech while minimizing risks are encouraged. Fintech in Bahrain has a potential to promote economic diversification and financial inclusion, given a favorable condition with a large financial sector connecting regional and global financial system. We commend the authorities for taking a balanced approach to promote fintech while containing risks. Especially, we positively note the recent efforts for cooperation among regional and global regulators including GCC fintech working group. We encourage the authorities to continue strengthening the effectiveness of regulation and supervision through coordination with other regulators. Could staff explain more about the activities of GCC fintech working group, and recent developments of the “global sandbox” proposal by the U.K. FCA and authorities’ interest in the initiative?

Structural Reform

Enhancing economic diversification through strengthening private sector is important for Bahrain. To this end, improving the business environment to attract foreign investment is key. We support authorities’ recent initiatives to streamline regulations including easing the process of starting a business, and increase access to finance for SMEs. It is also encouraging to see the progress in reducing gender inequality. We encourage further reforms in areas such as the labor market to promote higher labor market participation of female workers.

Regional Support

We welcome the recent statement by the three gulf states (Saudi Arabia, Kuwait and the UAE) that they commit to consider options to support Bahrain. We urge authorities to deepen discussions with these countries on the concrete policy packages and details of financial support and announce to the public as soon as when they are finalized. Does staff have any information on the details of ongoing discussions?

Mr. Alogeel and Mr. Alhomaly submitted the following statement:

We thank staff for an informative report and Mr. Beblawi and Ms. Merhi for their insightful buff statement. Bahrain’s economic performance remains generally strong, with non-oil sector growth about 5 percent in 2017, underpinned by, among others, the implementation of GCC-funded infrastructure projects. Going forward, we share the authorities’ view that non-oil economic activity would benefit from favorable spillovers from the ongoing reforms in Saudi Arabia, which are already yielding positive results. That said, additional fiscal measures and reforms are needed to ensure fiscal sustainability. Against this background, we are in broad agreement with staff's policy recommendations and would like to emphasize the following points.

We consider the authorities' plan to balance the budget by 2022 as appropriate. Here, we would like to note that Saudi Arabia, Kuwait and the United Arab Emirates are currently in close discussion with Bahrain to support the authorities' economic reform program. The program would aim to strengthen international reserves and ensure fiscal sustainability while accelerating structural reforms to buttress economic resilience to external shocks.

On the fiscal side, we take positive note of the implemented consolidation measures, including the recently introduced excise taxes on some harmful products. Looking ahead, while the authorities' plan to introduce VAT in 2019 is a step in the right direction, additional measures would be needed over the medium-term to further enhance domestic resource mobilization and streamline public spending, with the goal of ensuring debt sustainability. In this context, we are encouraged by the authorities' firm commitment to maintain fiscal prudence and ensure a steadfast implementation of the needed measures.

At the same time, we underscore the importance of adopting an effective communication strategy about future reforms and fiscal measures to help safeguard business momentum and enhance public awareness. Here, we welcome the authorities' plan to consult and communicate with businesses and individuals to facilitate the planned implementation of VAT. In addition, putting in place well-targeted social safety net is important to mitigate the impact of such reforms on the most vulnerable.

Given the structure of Bahrain's economy, we agree with staff and the authorities that the exchange rate peg has served Bahrain well and should be preserved. As staff has rightly noted, the exchange rate peg provides a credible monetary policy anchor to inflation expectations. Therefore, the focus going forward should be on implementing credible fiscal adjustment, coupled with growth-enhanced reforms, to maintain macroeconomic stability and promote competitiveness and diversification.

On the financial sector, we are comforted to note that the banking system remains liquid, profitable, and well capitalized, with declining NPLs. We welcome the progress made in implementing FSAP recommendations, particularly by forming a Financial Stability Committee at the central bank. On the same note, we are encouraged by the ongoing efforts to enhance supervisory and regulatory frameworks and to promote financial innovation through potential contributions of Fintech.

With these comments, we wish the authorities all the success.

Mr. Rashkovan and Mr. Manchev submitted the following statement:

We thank staff for the comprehensive report and Mr. Beblawi and Ms. Merhi for their informative buff statement. Economic activity in Bahrain remained resilient since the last Article IV consultation. Nevertheless, vulnerabilities continue to rise due to the sizable external and fiscal imbalances in an environment of global and domestic interest rates tightening and volatile oil prices. International reserves are low according to all adequacy metrics, the external position is weaker than implied by fundamentals and desirable policies, and the country continues to accumulate debt. On the positive side, the authorities have progressed with the implementation of the FSAP recommendations and the banking sector remains sound, well-capitalized and regionally interconnected. The regional Gulf Cooperation Council (GCC)-funded projects have also supported non-oil growth and further economic diversification. Since we broadly agree with staff's assessment and recommendations, the comments below are provided for emphasis.

Fiscal Policy

Further fiscal consolidation is warranted given the double-digit budget deficits in the recent years and evolving debt pressures. The authorities have already initiated some fiscal adjustment measures, which have helped to improve the 2017 fiscal performance, but more efforts will be essential. We commend the authorities for their plan to reach a balanced budget by 2022. However, in the current juncture, the consolidation needs to be faster, further reaching, and broader based. Growing regional and domestic challenges, together with Bahrain's exchange rate regime choice, call for building additional fiscal and foreign reserve buffers. In this regard, staff rightly emphasizes the necessity for additional growth-enhancing fiscal consolidation measures. Spending rationalization should advance the authorities' aim to achieve a more efficient current and capital budget. To mitigate possible risks from the public finance reforms, the additional expenditure measures need to be accompanied by a better-targeted social safety net system. As suggested in the staff report, the revenue mobilization should be streamlined through the new stable revenue sources to diversify the existing system. Introduction of the direct taxation would be beneficial and consistent with the suggested labor and structural reforms.

Bahrain should sustainably limit budget pressures arising from the domestic-global energy price gaps. International experience suggests that the energy price adjustments are successful if they are accompanied by frequent transparent communication between the government, businesses and households. The authorities may consider adopting a rules-based automatic price adjustment mechanism. Predictable energy price increases would allow consumers and producers to adjust their consumption and production. This should also help minimize the impact on inflation through anchoring expectations and sustainably guide the necessary social protection measures to the poorest people.

Debt Management

A transparent debt management and financing strategy is needed to rebalance the composition of the existing debt stock and underpin long-term debt sustainability. A proper strategy design can help develop the domestic bond market and facilitate liquidity management by the central bank (CBB). The widening of the current account deficit and rising debt service cost have prompted Bahrain's government to aggressively borrow from the CBB and domestic banking sector in recent years. The establishment of a Debt Management Office at the Ministry of Finance and decision to allow additional trades in government securities via the local stock exchange have been small steps in the right direction to support market developments and expand the investors' base. However, more action will be needed as the ratio of debt to GDP continues to increase, thus putting stress on debt sustainability. Could staff provide an update on the recent debt developments, structure of financing and use of the CBB overdraft account?

Financial Stability

We encourage the CBB to continue implementing the FSAP recommendations in a timely and decisive manner to preserve financial stability. Given that Bahrain has a large and regionally interconnected financial sector, the CBB has rightly focused the institutional development on enhancing supervisory capacity and increasing number of on-site bank inspections. The CBB should introduce clearly defined frameworks for emergency liquidity provisioning and crisis management. Bahrain's balanced approach to promote fintech innovations through regional cooperation agreements and the establishment of the collaborative ecosystem (BFB) can reap benefits, and we welcome the introduction of the CBB's regulatory sandbox in line with the best international practices for testing the fintech novelties in a controlled environment. Rising personal loans in Bahrain warrant continued close monitoring. We agree with staff that strengthening of the macroprudential policy framework should take higher priority and welcome the authorities' request for TA. Can staff brief the Board on the FATF's recent assessment on effectiveness of Bahrain's AML/CTF framework?

Structural Reforms and Sustainable Development

We urge the authorities to continue the structural reforms, enhance private sector development, and diversify the economy. The authorities have made welcome progress to reduce gender inequality, increase female labor participation, and introduce a system allowing migrants to work and live in Bahrain without employer sponsorship, but the labor market reforms should continue. Further steps to narrow the public-private sector wage gaps and skill-mismatches would be needed in line with staff's recommendations. Completion of the national strategy for SME development and the authorities' recent measures to implement it, especially through increasing their access to financing and overseas markets, would create a more conducive policy environment in the segment.

Finally, we strongly encourage the Bahrain authorities to consent to the publication of the report. Publication is an opportunity for the authorities to better explain the objectives of the needed fiscal and structural reforms, and particularly the necessity for a credible fiscal consolidation and deeper and further reaching labor market reforms.

Mr. Gokarn and Mrs. Dhillon submitted the following statement:

We thank staff for the excellent report and Mr. Beblawi and Ms. Merhi for their informative buff statement.

We positively note that Bahrain's economy registered a strong economic performance in 2017, with growth at 3.8 percent. Bahrain's growth uptick flows from robust non-oil growth, led by the financial and logistics sectors. We note that staff has projected economic growth to moderate over the medium term even as the authorities are more optimistic on the outlook. However, regardless of recently enacted austerity measures, Bahrain remains vulnerable in the face of lower oil and commodity prices. Large fiscal and current account deficits and heightened external vulnerabilities emerging from its limited buffers and sharply rising debt levels leave it exposed to financing risks. In response, the authorities have taken substantial steps and positive results are evident, including a record high level of foreign investments. We broadly agree with the thrust of staff's appraisal and limit our comments to the following.

Like staff, we too are convinced that fiscal consolidation program would require greater actions for boosting non-oil revenues and reducing the fiscal deficit and debt. To their credit, authorities have articulated the measures planned for this agenda, especially introduction of VAT, targeting of subsidies and privatizing some government services in health and education. On debt management, the newly created Debt Management Office is a welcome step. Beyond this, we would like to know more on the debt impact of the prospective financing commitments by Saudi Arabia, Kuwait and the United Arab Emirates and recent debt issuances internationally. Could staff elaborate? Further, to complement the strong measures on the expenditure front, we do feel that the revenue side too should be bolstered. However, staff has stated that, on the revenue side, measures such as the personal income tax are not currently under consideration. The staff has briefly discussed the challenges of progressive taxation for Bahrain in Annex XI. Could staff offer more details on the pros and cons of this transition, suggested timelines and compare it with the practices of Bahrain's GCC peers?

The Central Bank of Bahrain has effectively preserved financial stability and the banking system remains well capitalized, liquid, and profitable. We agree that the exchange rate peg has served Bahrain well. On the financial stability risks emanating from the real estate market, we note that authorities have taken measures to induce Islamic banks to reduce their exposure to real estate and established a Real Estate Regulatory Authority. The authorities have made impressive progress in implementing the recommendations of the 2017 FSAP and we expect the remaining recommendations to be implemented in a timely manner. Notably, new sources of growth are emerging in fintech and innovative financing instruments and significant efforts are being made by the authorities to this end. Has staff made an assessment on the potential GDP contribution from these areas in the medium term?

Finally, business confidence and growth momentum can benefit Bahrain as it makes a paradigm shift towards diversified private-sector led growth. The authorities have made considerable progress towards implementing a wide range of initiatives to streamline business regulation and improve the legal framework for private sector-led growth. Constructive initiatives to ease starting a business, updating the insolvency framework, allowing foreign ownership in several sectors, developing SMEs and lifting the minimum capital restrictions, are commendable. Going forward, we urge the authorities to continue addressing gender inequality, implement structural reforms and enhance private sector developments for inclusive growth.

With these comments, we wish the authorities the best in their endeavors.

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We thank staff for a well-written paper and Mr. Beblawi and Ms. Merhi for their informative buff statement.

Non-oil growth has been fairly resilient due to the implementation of GCC-funded infrastructure projects and regulatory reforms, but weak oil prices since 2014 (until recently) and limited policy response continue to be reflected in persistently large twin deficits, a substantial worsening of debt dynamics, and significant loss of foreign reserves despite external borrowing. The recent recovery in oil prices provides some relief, but elevated downside risks to the outlook leave no room for complacency. We are in agreement with the thrust of the staff appraisal and offer the following points for emphasis.

Fiscal consolidation is key to the sustainability of internal and external balances, and as highlighted by staff, the baseline scenario of limited fiscal adjustment still entails large financing needs and substantial weakening of debt dynamics and foreign reserves coverage over the medium term—even assuming a relatively favorable oil price scenario—thus affecting market sentiments at the time when international financial conditions and capital flows to emerging markets are expected to tighten. With interest cost exceeding 90 percent of non-oil revenue, we agree with staff that significant revenue mobilization over the medium terms has clear priority. We encourage the authorities to accelerate the introduction of VAT and excises and seriously consider introducing personal and corporate income taxes over the medium term in line with those in other GCC countries. Greater effort would also be needed to scale back the high government wage bill and cut the sizable budgetary subsidies and transfers, while ensuring social equity through better targeting. Fiscal reform plans should also include strengthening the fiscal framework, enhancing fiscal transparency, and keeping the public informed of the need for fiscal consolidation and the attendant risks of fiscal laxity.

We agree with staff that the currency peg has provided an important monetary anchor, delivered low inflation, and has been a source of confidence over the years, but its creditability hinges on sound macroeconomic policies built on solid fiscal correction that would also allow the Central Bank of Bahrain (CBB) to gradually reduce its substantial claims on government. The rapid increase in personal loans and the large exposure of banks to real estate also need close monitoring especially in an environment of rising interest rates. Would staff please comment on the apparent divergence of NPLs between retail and wholesale banks and between conventional and Islamic banking? We welcome the progress in implementing the 2017 FSAP recommendations—notably establishing a Financial Stability Committee, strengthening crisis management response, and intensifying bank supervision—and encourage the authorities to complete the remaining recommendations in a timely manner. The proliferation of fintech and its associated risks call for greater cross-border coordination and adoption of international best safeguard practices.

In an environment of fiscal constraint, supporting private sector activity is critical in maintaining the growth momentum and boosting efficiency and productivity. The recent streamlining of regulations, easing business starts, and allowing greater foreign ownership in several sectors were all steps in the right direction. Other important initiatives to consider include establishing a framework for public-private partnerships, particularly for infrastructure investments, and in social and housing projects that could also benefit from accelerated privatization. Also important are measures to increase labor market flexibility, encourage job creation for nationals by the private sector, and increase the labor force participation of women.

We wish the authorities success in their endeavors.

Mr. Johnston and Ms. Park submitted the following statement:

We thank staff for their comprehensive report and Mr Beblawi and Ms Merhi for their helpful buff statement. Lower oil prices have eroded Bahrain’s fiscal and external positions. This has meant a need for fiscal consolidation, and for a re-examination of the model that uses low tax, subsidies and generous public employment to help share the benefits of oil production across Bahraini citizens. Structural and regulatory reforms to promote private sector-led growth by attracting foreign investment and diversifying the economy are also important to support medium term growth.

A credible, and large, fiscal adjustment plan is needed to restore fiscal and external sustainability. Ongoing consolidation efforts are welcome, but more is needed. We agree that the focus should be on boosting non-oil revenue through the introduction of direct taxes, especially corporate and personal income taxes which are a staple of most other countries' revenue systems. The impact of these taxes on the most vulnerable could be lessened by ensuring that any personal income tax was progressive, and by the introduction of targeted social transfers. Broad-based, low-rate taxes are usually best, so we also support staff's recommendation to consider eliminating VAT exemptions.

With rising financing needs, Bahrain is vulnerable to a shift in market sentiment. We note recent press reports that several neighboring countries are in talks to finalize a support package for Bahrain. Are staff able to say at this stage how such a package would affect their assessment and recommendations?

We welcome work underway to implement FSAP recommendations necessary to bolster financial stability, and we encourage the authorities to make further progress. Developing a clearly defined emergency liquidity assistance framework is a near term priority, along with further enhancements to supervision, and monitoring of rising household debt.

Finally, we would encourage the authorities to agree to the publication of the staff report.

Mr. Virolainen and Mr. Slettvag submitted the following statement:

We thank staff for a well-written and concise report and Mr. Beblawi and Ms. Merhi for their informative buff statement. Bahrain has faced significant economic challenges after the sharp fall in oil prices eroded export earnings and government revenues. Growth picked up somewhat last year, but external and fiscal deficits remain high and have led to a rapid increase in public debt and decline in foreign reserves. Bahrain is very vulnerable to a tightening in global market conditions or a lower oil price, and we urge authorities to pursue all available options to prevent buffers from being depleted further. We broadly concur with staff's appraisal and encourage the authorities to consent to the publication of the article IV report. We offer the following comments on fiscal adjustment for emphasis.

The large twin deficits cannot be sustained indefinitely and recent sovereign credit downgrades and rising spreads illustrate the urgency for a sizable and frontloaded fiscal adjustment. There have been some improvements recently, mainly due to a higher oil price and progress on subsidy reform and spending cuts. Solid growth in the non-oil sector is also encouraging, but yields little revenue due to the no-to-low tax environment. In sum, the ongoing fiscal adjustment seems insufficient to halt the deterioration in the fiscal accounts. Public debt as a share of GDP has more than doubled in three years, to 89 percent in 2017, and we note that even with a full implementation of the announced measures, debt is estimated to increase further to 120 percent of GDP in 2023.

The staff's calculations show clearly that the introduction of a direct taxation system in some form has to be part of a sustainable reform package. We agree that coordinating measures with the GCC will be important to build public support, and note that all other GCC countries already have some form of corporate income tax (CIT) regime in place. Introducing a CIT consistent with existing frameworks, with low rates and limited exemptions, could yield substantial dividends for the Bahraini economy. In the longer term, the introduction of a progressive personal income tax (PIT) would also be a powerful tool in promoting both fiscal sustainability and efficient fiscal distribution. Given the many challenges in developing such tax systems, we ask staff to elaborate on the capacity requirements and a feasible time horizon for implementing CIT and PIT regimes in Bahrain.

Given the large adjustment needs, reforms should be underpinned by a transparent and credible medium-term fiscal framework with a coherent social protection strategy. A clearly communicated adjustment plan will help to reduce policy uncertainty, anchor reforms, and increase public support. The redistributive impact of fiscal policy could be enhanced by eliminating generalized price subsidies in favor of a well-targeted safety net. With one third of national employees being absorbed by the government, careful consideration must be given to how the reforms will affect employment. Policies focusing on increasing private investment and employment will play an important role, and we welcome initiatives to streamline regulations and improve access to finance for SMEs. Further efforts could be made in actively pursuing privatization plans, and encouraging nationals to seek employment in the private sector.

Mr. Castets and Mr. Chotard submitted the following statement:

We thank staff for a very clear and comprehensive report, as well as Mr. Beblawi and Ms Merhi for their insightful buff statement. Like many oil-exporting countries, Bahrain has suffered from lower oil prices over the last years, which led to large fiscal and external deficits. While the authorities initiated actions, a more comprehensive policy package remains to be implemented to address these issues, and efforts for the diversification of the economy should be pursued. We agree with the recommendations made in the staff report and make the following comments for emphasis:

Recent Macroeconomic Developments and Outlook

We welcome that the Bahraini economy proved resilient in 2017, thanks to the dynamism of the non-oil sector and notably robust implementation of GCC-funded project, but note that growth will slow down over the medium term, due to the need for further fiscal consolidation. Could staff however detail the oil prices with which this forecast was done and to which extent the recent increases in oil prices may impact it? In addition, we wonder to which extent Bahrain is impacted by recent U.S. taxes on aluminum, considering the importance of this sector in Bahrain's exports and the fact that the United States is an important client. The staff's comments are welcome.

Fiscal Policy

We share staff's view that a comprehensive fiscal adjustment strategy is needed to put public debt on a sustainable path. We welcome the authorities' efforts which, together with the increase in oil prices, led to a reduction of fiscal deficit of 3.75 points in 2017. Yet, the authorities did not yet engage on an ambitious enough fiscal adjustment plan, as public debt is projected to keep rising above 120 percent of GDP over the medium term under the baseline scenario. As a consequence, Bahrain, which is no longer rated as investment-grade, faces increasing financing costs. This situation calls for additional measures, as pointed out by staff. On the overall fiscal adjustment, while we share staff's objective to reach a balanced overall balance by 2023, we wonder to which extent the adjustment path proposed by staff, with a reduction of the primary balance of 5 percent of GDP in 2019, is realistic, and whether the adjustment path should not be more gradual. The staff's comments are welcome. In addition, could staff provide its preliminary assessment of the impact the GCC support announced at the end of June will have on the adjustment path?

As for the specific measures to feed the fiscal adjustment, we agree with staff that a mix between revenue and spending measures would be appropriate, and thank staff for recommending precise additional measures. On the revenue side, we welcome that the introduction of the VAT is expected in 2019. Could staff detail the additional revenues expected out of this measure? In addition, we strongly encourage the authorities to envisage implementing direct taxes and property taxes, which would entail a more efficient, progressive and fair taxation system. On the spending side, we encourage the authorities to consider additional savings measures, by accelerating subsidy reforms, progressing on their privatization plans and by addressing the current high wage bill. In the meantime, we call to preserve as much as possible public capital spending. Could staff detail its assessment of these privatization measures contemplated and the additional revenues it could provide?

Monetary Policy and External Sector

We share staff's view that the exchange rate peg to the dollar should be preserved, but that measures are needed to preserve it. In this regard, a comprehensive fiscal package is all the more necessary to rebuild reserves and preserve the credibility of the currency framework. In addition, we support staff's recommendation to gradually phasing out the central bank's lending to the government.

Financial Sector

We invite the authorities to pursue their efforts to implement 2017 FSAP recommendations. We positively note that the banking system remains well capitalized and that several recommendations from the latest FSAP have been implemented. Going forward, we share staff's views that focus should be on developing an emergency liquidity assistance framework, enhancing supervision of Islamic banks and monitoring more closely the upward trends in household debt. Lastly, we commend the authorities' efforts to strengthen access to finance to SME, and encourage them to continue in this direction.

Structural Reforms

We fully share staff's assessment that more efforts are needed to promote private sector development and diversification of the economy. We support every effort the authorities will take to further enhance the business environment, attract foreign investments and strengthen the functioning of the labour market, along the lines recommended by staff. We also thank staff for the assessment of gender inequality in Bahrain and encourage the authorities to pursue their efforts, notably to increase female labor participation.

Mr. Hurtado and Mr. Rojas Ramirez submitted the following statement:

After a period of low oil prices with high impact in its economy, the Kingdom of Bahrein is facing challenges in its economic stability, financial soundness, and sustainable economic growth. The authorities are committed to achieving fiscal consolidation, a sound debt administration framework, and preserving financial soundness. We welcome this and thank staff for its Article IV report and Mr. Beblawi and Ms. Merhi for their illustrative buff statement.

Despite the impact from low oil prices that is the primary source of fiscal revenues, the fiscal deficit declined in 2017, but still low oil revenues, external imbalances and high public debt pose challenges to Bahrain. The staff proposes a comprehensive reform by adopting a complete tax system reform by broadening the tax base and strengthening budget administration, as well as increasing revenues by enhancing tax administration, implementing VAT and improving budget administration taking expenditure measures aimed at rationalizing public wages, streamlining the wage bill, reforming the pension system, and minimizing fiscal pressures at the time accompanied by better targeted social safety nets.

Authorities are committed to policies aiming at stability and fiscal consolidation and have been implementing actions for strengthening the budgetary financing and debt management strategy, improving revenue administration by taxing tobacco, energy and carbonated drinks, implementing subsidy reforms specific to non-oil revenue measures and expenditure cuts. As stated in the risk matrix, we think delays in the fiscal consolidation can have serious consequences. The staff's comments are welcome.

The financial system prudential indicators are at stable levels of NPL but need some attention. Authorities are committed to preserving sector resilience by mitigating risks and preventing vulnerabilities by implementing an appropriate liquidity management framework, deepening interbank market and reducing exposure to government credit. We note a persistent current account deficit over the last two years along with outflow of capital. The Central Bank of Bahrain (CBB) has undertaken appropriate actions to preserve stability; nevertheless, further efforts are necessary. We commend authorities for implementing FSAP recommendations; prudential liquidity requirements continue enhancing prudential and regulatory and legal framework for safeguarding financial and external stability and developing the AML/CFT framework. Actions on FinTech initiatives and financial corporate leveraging leading to economic diversification and sustained, inclusive growth is appropriate in oil economies.

Structural reforms and economic diversification are essential for underpinning sustained, inclusive growth. We note measures for improving the business climate and attract foreign investments as enhancing regulatory environments and the initiatives to streamline regulations and credit procedures. We welcome actions aiming at the development of SMEs and reforms on the labor market.

Mr. Bayar and Mr. Dogan submitted the following statement:

We thank staff for their comprehensive report and detailed annexes. We also thank Mr. Beblawi and Ms. Merhi for their informative buff statement. Bahrain's economy has seen a continued, moderate recovery on the back of higher hydrocarbon prices and stronger non-oil economic activity, fueled by the implementation of GCC-funded infrastructure projects. However, legacies from the decline in oil prices in 2014 and inter-related structural weaknesses continue to weigh on economic activity. Going forward, elevated fiscal and external vulnerabilities, which could grow further should there be a delay in the implementation of the prudential measures and/or a lower-than-envisaged oil price path, could expose Bahrain's economy to the swings in the global market sentiment. In this vein, we are also concerned about the recent pressures facing Bahrain in the borrowing market. We, therefore, call on the authorities to firmly press ahead with the needed adjustments and reforms to improve fiscal sustainability, enhance financial sector resilience, and foster a more diverse and inclusive growth. We agree with the thrust of the staff assessment and will limit our comments to a few points for emphasis.

Credible fiscal consolidation is imperative. Despite the authorities' ongoing efforts and relatively higher oil prices, the fiscal deficit is still high and public debt is projected to increase under all staff scenarios. We, therefore, strongly encourage the authorities to embark on an additional, bold consolidation path that will comprise both revenue and expenditure measures. On the revenue side, we welcome the implementation of excises on tobacco, and energy and carbonated drinks. However, a renewed focus is needed on further broadening the tax base, possibly through introducing personal and corporate income taxes, and property taxation. We regret that the value-added tax reform was once again postponed, particularly in view of the need to enhance non-oil revenues. Could staff explain the reasons behind the delay and comment on the prospects of its introduction in the near future? On the expenditure side, the priorities should be streamlining inefficient subsides; containing current expenditure, particularly the high wage bill; and addressing pension system actuarial imbalances. Recognizing the importance of external support to the authorities' policy efforts and noting the reference in the buff statement, we would appreciate if staff could inform us about the recently announced financial aid program by some GCC countries, particularly its conditionality.

Inflation in Bahrain remained appropriately under control. Nevertheless, we note that the Central Bank of Bahrain's (CBB) financing of government operations through an overdraft account remain elevated and could pose risks to the price and financial stability going forward. In this vein, we positively note that the authorities agreed with staff to gradually unwind these operations. We underscore that the CBB should focus on its core mandate to maintain price and exchange rate stability. While we agree that the exchange rate peg is helping preserve financial stability, we are concerned about the low level of reserves. We, therefore, concur with the staff that a steadfast fiscal adjustment in Bahrain would also be essential to rebuild external buffers.

Preserving the resilience of Bahrain's financial sector is crucial. We welcome the authorities' continued efforts to improve the regulatory framework, including through implementing the Financial Sector Assessment Program's recommendations. In this vein, we see developing a clearly defined emergency liquidity assistance framework and further enhancing the supervision of Islamic banking and insurance industry as priorities. As staff highlighted, the recent accumulation of household debt could also pose risks that warrant closer monitoring. We appreciate the authorities' progress in upgrading their AML/CFT framework, and would welcome staff's comments on the initial insights from the recent assessment by the Financial Action Task Force.

We appreciate Bahrain's active role in developing Fintech issues. Bahrain has an important potential to improve Fintech and has taken significant steps in this regard, such as by establishing Bahrain Fintech Bay, and the Fintech and Innovation Unit. A developed Fintech ecosystem would present opportunities to advance the financial system in Bahrain and in the broader region, including through further cross-border integration, economic diversification, and financial inclusion.

Mr. Sun and Ms. Lok submitted the following statement:

We thank staff for the comprehensive report and Mr. Beblawi and Ms. Merhi for the helpful buff statement. While economic activity in Bahrain remained robust in 2017, the significant challenges lying ahead call for steadfast efforts to build fiscal and external buffers to strengthen the economy's resilience. We broadly agree with the thrust of staff's appraisal, and would like to make the following comments for emphasis.

A strong and credible fiscal adjustment is necessary for fiscal and external sustainability. The staff noted that the current measures planned for balancing the budget by 2022 would not be enough to stabilize debt levels and keep debt service manageable. We therefore take positive note from the fact that the authorities are considering additional measures to raise non-oil revenues, cut expenditures further, and enhance the effectiveness and efficiency of government spending. In face of risks including the tightening of global financial conditions and fluctuating oil prices, a credible and forceful fiscal strategy, supported by greater transparency and a medium-term fiscal framework, would help bolster economic resilience and boost market and investor confidence. Meanwhile, the prospective financing commitments from Saudi Arabia, Kuwait, and the United Arab Emirates could also potentially lend support to the economy, and we look forward to further details of the package.

We take positive note of the notable progress made in implementing the FSAP recommendations. Given Bahrain's role as a financial center for the Gulf Cooperation Council region, the stability of its financial system is of critical importance. We share staff's view that rising personal loans deserve close monitoring, and welcome the establishment of the Real Estate Regulatory Authority, which will provide the necessary data to facilitate the monitoring effort. We encourage the authorities to press ahead with the remaining FSAP recommendations and further strengthen the financial sector, especially in the areas such as macroprudential measures, crisis management and resolution, and the supervision of Islamic banks and insurers. Meanwhile, we welcome the authorities' promotion of financial innovation. As set out in Annex VIII of the staff report, the Central Bank of Bahrain has created a clear conceptual regulatory framework for fintech solutions. Given the ever-changing nature of technology, it is important to maintain a flexible regulatory approach that can adapt to latest developments.

We support efforts to promote private sector-led growth and economic diversification and welcome the authorities' efforts in this regard. In the process of doing so, it is vital to be inclusive and ensure that the vulnerable remains protected, particularly given that the economy is also going through fiscal adjustment. To this end, we encourage the authorities to further improve the targeting and efficiency of social transfers and welfare programs, while avoiding across-the-board subsidies that disproportionately benefit the more well-off segments of society.

With these remarks, we wish the authorities every success in their policy endeavors.

Ms. Pollard and Mr. Vitvitsky submitted the following statement:

We thank staff for the Article IV report and welcome its focus on Bahrain's very tenuous fiscal situation. We concur with staff that Bahrain urgently needs a large-scale fiscal consolidation to address domestic and external imbalances. Despite a stable banking system, we are also concerned over the significant increase in the government-banking sector nexus. We broadly agree with the recommendations laid out in the staff report and encourage authorities to consent to its publication.

Shortly after the completion of this Article IV, Saudi Arabia, Kuwait, and UAE announced a financial support package for Bahrain. Can staff provide additional information on the package they may have recently obtained?

We urge Fund staff, in future engagements with Bahrain and its partners, to stress the importance of addressing the structural components of its fiscal deficit, including the large government wage bill and inefficient subsidy spending. Given Saudi Arabia's successful, technocratic approach to subsidy reform, there is significant room for bilateral technical support. We also urge all parties to be fully transparent with Fund staff over the terms and conditions of the financial support package.

Separately, we concur with staff recommendations to implement structural reforms to support private-sector growth and diversification. Efforts to improve the business climate, enhance the legal and regulatory environment, and support access to finance for small and medium enterprises are all welcome. Given ongoing severe fiscal constraints, these efforts are particularly important to support sustainable and inclusive growth.

Finally, Bahrain remains one of the few IMF members that does not publish its Article IV report. We continue to find this lack of transparency unfortunate. Common arguments against publishing Article IV reports include the potential they are market sensitive, which is unconvincing—markets clearly already recognize Bahrain's vulnerabilities, with sovereign Eurobond spreads significantly widening in recent months. In fact, we believe publishing the report would help Bahrain and build confidence with investors by showing transparency.

Mr. Panek and Mr. Danenov submitted the following statement:

We thank staff for an insightful report and Mr. Beblawi and Ms. Merhi for their informative buff statement. Bahrain enjoyed strong growth and resilience last year. However, the decline in oil prices since 2014 has substantially weakened the fiscal and external positions, despite the recent upward trend in the crude markets and the authorities' consolidation measures applied. We share staff's recommendation on the need for a comprehensive package of reforms to ensure fiscal and external sustainability. As we concur with the general thrust of the report, the following remarks are offered for emphasis.

Larger fiscal consolidation is required to reduce the deficit and improve the external position. Despite the authorities' previous efforts to restore fiscal sustainability—including subsidy reforms, steps to increase non-oil revenue and the compression of capital spending—further fiscal adjustment is needed. We welcome the plan to introduce the VAT by 2019. A deep and gradual set of fiscal reforms will also be key to rebuild reserves, stabilize the external position and preserve the current exchange rate peg. We agree that the latter remains appropriate, given Bahrain's economic structure.

We welcome the progress in implementing the 2017 FSAP recommendations and the stability of the financial sector. The authorities are encouraged to continue to develop banking supervision capacity, improve crisis management and ensure well capitalized banking system with a low level of NPLs. We welcome the efforts to progress in fintech/financial innovations, and urge the authorities to ensure adequate supervision and compliance with AML/CFT standards.

Structural reforms to promote private sector-led growth are important for Bahrain. We encourage the authorities to implement their privatization plans, improve the business environment and labor market, and continue to support the development of SMEs. These reforms would contribute to the further diversification of economy that is needed to reduce its dependence on oil markets and, thus, its vulnerability.

We welcome the strengthening of regional cooperation. We positively note the perspectives of the recently announced commitments by Saudi Arabia, Kuwait and the United Arab Emirates to provide financing to support Bahrain's economic reforms and fiscal stability. Are there more details available on ongoing discussions on that matter? Also, given the stated important role of the GCC-funded infrastructure projects, could staff provide more information on these projects, especially on their sustainability and effects on growth?

Mr. Raghani and Mr. Bah submitted the following statement:

We thank staff for the well-written and Mr. Beblawi and Ms. Merhi for their informative buff statement.

Bahrain’s economy proved resilient notwithstanding the drop in oil prices in 2014-15, which had adversely affected the country’s fiscal and external position. The positive development in the non-oil sector that drove most of the GDP Growth is encouraging. Although the fiscal deficit remains high, the fiscal consolidation measures taken by the authorities have reduced it substantially from 18 percent of GDP in 2016 to about 14 percent in 2018. However, we note that public debt increased reaching 89 percent of GDP, and the external position weakened with gross official reserves covering less than 2 months of non-oil imports. The downgrading of Bahrain by credit agencies has led to a rise of the spreads on interest rates.

In this context, we welcome the authorities’ ongoing efforts to address imbalances and put the economy on a sustained growth path while increasing its resilience to external vulnerabilities. We agree with the thrust of the staff appraisal and would like to highlight the following points for emphasis.

In the fiscal sector, the authorities’ fiscal consolidation measures including subsidy reforms and cuts in recurrent and capital spending have improved the fiscal balance. In addition to balancing the budget by 2022, we agree that further measures and reforms to reduce the fiscal deficit over the medium term, put public debt on a downward path and create needed space for higher social and capital expenditure are key to ensure fiscal and external sustainability. We welcome the indication in Mr. Beblawi and Ms. Merhi’s buff statement that Bahrain’s neighbors Kuwait, Saudi Arabia and the United Arab Emirates are discussing with Bahrain on ways and means to support the Bahraini authorities’ economic reform program and strengthen the country’s fiscal stability. Furthermore, we see merit in increasing non-oil revenue by introducing corporate and property taxation while implementing, as planned, the value added tax (VAT). On the spending front, sustained measures to tackle the high wage bill and reform the pension system will be necessary. The introduction of an automatic fuel price mechanism will be helpful in accelerating the reform of subsidies. Finally, we agree that these adjustment fiscal measures should be accompanied by adequate actions aiming at protecting the most vulnerable population.

Regarding the country's public debt which is on a rising trend, we welcome the authorities' prudent debt management and financing strategy, including the establishment of a Debt Management Office at the Ministry of Finance. Moreover, to develop the domestic bond market, we encourage the authorities to expand the investor base and deepen the secondary market for government securities. In addition, a sustained implementation of the authorities' fiscal reform plan would help improve the spreads on Bahrain' interest rates in the international markets. The staff's comments on the financial implications of the projected rise of public debt above 120 percent of GDP over the medium-term will be appreciated.

With regard the monetary policy, the exchange rate peg continues to serve Bahrain well, the Central Bank of Bahrain (CBB) continuing to adjust interest rates in line with U.S. rates and preserving financial stability. The authorities' commitment to the ongoing fiscal consolidation is key to support the peg, strengthen the current account, and preserve reserve buffers.

We commend the authorities for their continued efforts to implement the FSAP recommendations which have helped the sector to remain stable. However, we note that banks' exposure to the government and households has increased and that the rising of personal loans outpaced the business loans. In their efforts to address this situation, the authorities' initiatives to contain credit risks and keep delinquency rates low are warranted. We also encourage them to ensure an effective macroprudential monitoring of household debt by using appropriate indicators under the Fund's technical assistance. Finally, we see merit in the ongoing assessment of the effectiveness of the AML/CFT framework whose recommendations will help adjust AML/CFT policies to address associated risks.

Diversifying the economy and boosting private investment are critical to promote long-term inclusive growth. The diversification of the production and export base would increase the Bahraini economy's resilience to vulnerabilities. To this end, further efforts are needed to advance structural reforms with a view to develop the private sector, attract foreign investment and facilitate Bahrain's integration to the global knowledge economy. The recent initiatives to improve the business climate, foster SME's access to finance are encouraging. We are also pleased to note the ongoing initiatives with regard fintech issues including the regulatory sandbox, as tools to promote economic diversification and financial inclusion in Bahrain as rightly indicated in the Annex VIII of the report. We also see merit in accelerating the authorities' privatization plans, as well as increased public-private partnership.

Finally, the reforms to the labor market should be pursued to make it more flexible and encourage the nationals' employment in the private sector.

With these remarks we wish the Bahraini authorities success in their future endeavors.

Mr. Beblawi made the following statement:

I would like to express the appreciation of the Bahraini authorities and my appreciation for Mr. Joshi and his team for their excellent work, constructive engagement, and valuable policy advice. I also thank Directors for their support to Bahrain and for their candid views, which I will convey to my authorities following this meeting.

The staff has addressed in writing most of the issues raised in the gray statements, and I thank them for that. I would like to focus on one main issue regarding the fiscal adjustment that was raised in most of the gray statements.

The authorities are aware of the substantial challenges that they are facing, and they agree with the staff that additional fiscal adjustment is needed to safeguard macroeconomic stability and put public debt on a sustainable path.

In addition to the introduction of the VAT, the authorities are considering additional measures to increase non-oil revenues while giving due consideration to the impact on the most vulnerable and on growth.

Moreover, the authorities are in discussions with Saudi Arabia, Kuwait, and the United Arab Emirates on how best to support their economic and fiscal reform program. The aim is to strengthen international reserves and ensure fiscal sustainability, as elaborated by Mr. Alogeel in his gray statement. Discussions are still ongoing; and as a result, we do not have further details that we can disclose at this stage.

Mr. Mkwezalamba made the following statement:

We thank the staff for the informative report and Mr. Beblawi and Ms. Merhi for their informative buff statement. We did not issue a gray statement but wish to make a few points.

First, we note that despite a contraction in the oil sector, growth of the non-oil sector lifted overall economic growth to 3.8 percent in 2017; inflation has moderated; unemployment is lower; and the overall deficit has declined, owing to improved revenue collection and spending cuts. However, the near-term growth outlook is subject to considerable risks, including uncertainty in oil price developments, worsening debt dynamics, and a challenging external position, which could undermine investment and lead to high fiscal deficits. In this context, we urge the authorities to be vigilant and to implement the needed reforms.

Second, we welcome the authorities' plan to balance their budget by 2022 through civil service reform, continued subsidy reform, and the privatization of some government services. Nevertheless, more needs to be done, particularly on the non-oil revenue side and in terms of further expenditure reductions. In this regard, the planned introduction of the VAT in 2019 should not be delayed any further. In addition, we agree with the staff that the establishment of an independent tax authority, and the introduction of a direct taxation system would help improve revenue collection.

On the expenditure side, while we appreciate the government's actions thus far, there will be a need to undertake energy and water subsidy reforms, undertake measures to contain the wage bill, and develop a strategy to deal with continued liabilities arising from the underfunded pension system. While recognizing that these reforms will be difficult and will need public support, we urge the authorities to take decisive and timely actions.

Third, given that public debt has doubled since 2014 and is approaching a dangerous level, we urge the authorities to take decisive steps to put public debt on a sustainable and downward path. To permanently change the current trajectory of public debt, the authorities will need to ensure that they swiftly undertake the current planned fiscal consolidation and consider further fiscal consolidation measures to stabilize debt levels.

Fourth, we note that the banking sector is stable and commend the authorities on the progress made in implementing the Financial Sector Assessment Program (FSAP) recommendations. In this regard, we encourage the authorities to implement the remaining recommendations, and agree with the staff that developing a clearly defined emergency liquidity assistance framework and further enhancing the supervision and regulation of Islamic banking and the insurance sector should be the focus.

We wish the authorities success.

Mr. Alogeel made the following statement:

We thank the staff for its work and Mr. Beblawi for his buff statement. We issued a detailed gray statement, so I will focus on a few issues for emphasis.

We take positive note of the recent robust growth and the progress made in enhancing the resilience of the financial sector. Given the structure of Bahrain's economy, we agree with the staff and the authorities that the exchange rate peg has served Bahrain well and should be preserved. The focus going forward should be on implementing credible fiscal adjustment, coupled with growth-enhancing reforms to maintain macroeconomic stability. In this regard, we commend the authorities for their ongoing consolidation efforts and agree on the need for a sizable fiscal consolidation to mitigate the fiscal risks and place public debt on a sustainable path. In this regard, we consider the authorities' plan to balance the budget by 2022 to be appropriate.

Finally, as Mr. Beblawi mentioned, there are ongoing discussions between my authorities, Kuwait, and the United Arab Emirates to support Bahrain's medium-term reform program, which aims to strengthen international reserves and ensure fiscal sustainability. The details of the program will be announced soon, when finalized.

Mr. Saito made the following statement:

We thank the staff for the comprehensive report, and Mr. Beblawi and Ms. Merhi for the informative statement. We thank Mr. Beblawi for his remarks. As we have issued a gray statement, we will limit ourselves to two comments for emphasis.

First, on fiscal policy, we are concerned about the increasing public debt due mainly to the mounting interest rate payments, despite the authorities' fiscal adjustment efforts. Against this background, further fiscal consolidation on both the expenditure and revenue sides is necessary to restore fiscal sustainability. To this end, we urge the authorities to introduce the VAT, as planned. At the same time, we encourage the authorities to seriously consider the other options, including introducing the corporate income tax. We positively note the staff's answer that corporate income tax in Bahrain is feasible since most other Gulf Cooperation Council (GCC) countries have taxes of some form on corporate income.

Second, on regional support, we welcome the recent statements by the three GCC countries that they have committed themselves to considering options to support Bahrain. We also welcome the comments by Mr. Alogeel in this regard. We encourage the authorities to deepen their discussions with these three countries on the concrete policy package, taking account of the policy recommendations by Fund staff.

The staff representative from the Middle East and Central Asia Department (Mr. Joshi), in response to questions and comments from Executive Directors, made the following statement:

The staff has provided written responses to the questions raised by Directors in their gray statements. I will take this opportunity to focus on a few key themes.

Fiscal policy was at the heart of our discussion with the authorities. There was recognition that more was needed on top of the measures taken since 2015. The authorities recognized that non-oil revenues have to be increased and that the fiscal gap remains large, leading to increased refinancing risks.

Our talks focused on identifying possible measures to fill this gap, the design of such measures to mitigate the impact on growth and on the most vulnerable, and the pace of such measures. In addition, we also engaged in extensive technical discussions, especially with teams at the Ministry of Finance, working on issues of value-added tax and enterprise taxation and operational matters.

As Directors have noted, the composition of adjustment matters, and the authorities are looking into these issues. In line with the staff's advice, the legislature and the government are currently discussing options to better target the subsidy regime and to reform the pension system to contain its actuarial deficits.

Turning to the recent announcement by Saudi Arabia, Kuwait, and the United Arab Emirates to consider options to support economic reforms and fiscal stability in Bahrain, Mr. Beblawi and Mr. Alogeel have already described the current status of these discussions. We remain in touch with the authorities and have shared with them our macro framework and our assessment of the fiscal gap, as well as estimated yields of various measures. We stand ready to provide further support, as needed.

Directors noted the key role played by the financial sector in Bahrain, a regional financial hub. Our discussions with the authorities focused on priority measures, as highlighted in the 2017 FSAP. In terms of the emergency liquidity assistance, progress is being made. Domestic systemically important banks are now required to have resolution and recovery plans, and all locally incorporated banks are required to have a recovery plan.

The background work on the Crisis Management Committee is also progressing and is at an advanced stage. Pending final legal review, a joint Ministry of Finance/Central Bank committee on this should come into operation soon.

Finally, there was broad agreement on the need for structural reforms. In the severely fiscally constrained environment, it was thought to be imperative that the private sector be given space to thrive in order to further develop the non-oil sector and to generate employment for nationals. This is being done by regulatory reforms, as well as reforms in the labor market, and improved access to finance by small- and medium-sized enterprises (SMEs).

As noted by a Director, the education and health care sectors will play a large role in this area. Encouraging the private sector to play a greater role while protecting the access of the most vulnerable to these services remains a priority of the government.

Economic reform remains a difficult process, and there is merit in efforts to build consensus around these issues. The authorities are cognizant of the challenges they face and the risks of inaction. We have offered our full support in this context to help ensure fiscal and external sustainability and to promote sustainable and inclusive non-oil growth.

In conclusion, on behalf of the Bahrain team, let me use this opportunity to thank the authorities for their constructive engagement and hospitality, as well as Mr. Beblawi and his colleagues for their support.

Mr. Beblawi, in a brief concluding statement, thanked the staff and remarked that the authorities' reforms, combined with support from Gulf countries, would address the challenges facing the economy, thereby safeguarding macroeconomic stability and putting public debt on a sustainable path.

The Acting Chair (Mr. Zhang) noted that the Kingdom of Bahrain is an Article VIII member and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the resilience of growth in Bahrain, while noting downside risks to the outlook stemming from the rise in fiscal and external vulnerabilities, tighter global financing conditions, delays in fiscal adjustment, and lower energy prices. Against this background, Directors called for additional sustained efforts to improve Bahrain's fiscal and external positions, preserve financial sector resilience, and support diversified, inclusive growth.

Directors welcomed the authorities' continued fiscal reform efforts, but observed that public debt is expected to increase further over the medium term and reserves are projected to remain low. In this regard, they agreed that a comprehensive package of reforms is needed to reduce fiscal deficits over the medium term. Directors welcomed the authorities' commitment to continue subsidy reforms, cut non-productive spending, and raise non-oil revenues by introducing a value-added tax by 2019. They considered that additional steps are needed to put public finances on a sustainable trajectory, striking the right balance between revenue and expenditure measures while protecting the most vulnerable. In this context, Directors emphasized the need to introduce direct taxation, including a corporate income tax, while containing the public wage bill and targeting subsidies to the poorest. They looked forward to the newly established debt management office developing a contingent financing strategy to mitigate financing risks and costs. Directors also encouraged the authorities to strengthen their macro-fiscal framework and increase fiscal transparency and accountability, securing public support and awareness, and enhancing market confidence.

Directors agreed that the exchange rate peg remains appropriate for the economy, and delivers a clear and credible policy anchor, keeping inflation low and stable. They underscored the importance of fiscal adjustment in supporting the peg and rebuilding international reserves, and ensuring external sustainability. In this context, Directors recommended gradually unwinding central bank lending to the government.

Directors welcomed the central bank's continued efforts to implement the 2017 FSAP recommendations to further strengthen the regulation and supervision of the financial sector. They emphasized the need to develop a well-defined emergency liquidity assistance framework, deepen the interbank market, and enhance the supervision of Islamic banks and insurance companies. Directors also encouraged close monitoring of the build-up of household debt. They welcomed Bahrain's initiatives to promote fintech, while underscoring the importance of monitoring risks. Continued efforts to strengthen the AML/CFT framework were also encouraged.

Directors commended the authorities' initiatives to streamline business regulations to promote private sector development, diversification, and job creation. They welcomed recent developments in enhancing SMEs' access to finance, as well as recent labor market reforms to increase flexibility and promote employment in the private sector. They called for further structural reforms to boost productivity and competitiveness through more privatization plans and public-private partnerships, and measures to strengthen the education system and support greater female labor force participation.

It is expected that the next Article IV consultation with the Kingdom of Bahrain will be held on the standard 12-month cycle.

APPROVAL: April 15, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***Could staff detail the oil prices with which this (medium term) forecast was done and to which extent the recent increases in oil prices may impact it?***

- The staff are using the latest global assumptions underpinning the forthcoming World Economic Outlook update. Oil prices assumed in staff's baseline remain very close to market projections as of July 5.

(US$/bbl)	2018	2019	2020	2021	2022	2023
APSP (July 5, 2018)	71.39	69.43	65.09	62.08	60.05	58.76
APSP (WEO, June 2018)	70.23	68.99	64.97	62.10	60.12	58.82

2. ***Could staff comment on the extent to which Bahrain is impacted by recent U.S. taxes on aluminum, considering the importance of this sector in Bahrain's exports and the fact that the U.S. is an important client?***

- Bahrain exported US$656 million of aluminum to the U.S. in 2017 (9½ percent of Bahrain's total non-oil goods exports; 2½ percent of total exports). Most of this is semi-finished product, used for infrastructure projects, or raw material used for further refinements.

- The staff understand that discussions are ongoing to get product exemptions from the U.S. Department of Commerce. Should such an exemption not materialize, and if the resulting decline in Bahraini aluminum exports cannot immediately be exported elsewhere, staff estimate a modest direct impact: a worsening of the current account by around 0.2 percentage points of GDP.

Fiscal Policy

3. ***Could staff comment on how best to advance progress in the establishment of independent revenue administration and the crafting of a medium-term fiscal framework?***

4. ***While we note that authorities consider expenditure reforms as more feasible at this juncture, could staff comment on the feasibility of tax reform including introducing***

a direct taxation system and the main impediments of introducing the corporate income tax?

- The authorities agree that non-oil revenue remains low, even by regional standards. As part of the GCC-wide initiative, they introduced excise taxes on certain products at the start of the year, and are committed to implement a value-added tax (VAT) by 2019. Collection of excise taxes since January have met expectations.

- As part of the legal framework to introduce the VAT, the authorities plan to establish an independent revenue administration authority. During the Article IV mission, staff delivered many presentations on the technical and operational aspects of tax administration. The Fund remains ready to provide further technical assistance in this area, and in the broader area of public financial management, as needed.

- During the mission, the authorities agreed that the fiscal gap remains large and noted their readiness to consider all alternatives. The staff presented options—amounting to more than the recommended consolidation—for the authorities to consider.

- In terms of policy measures, the authorities are keenly aware of the frameworks around the GCC region. Since most other GCC countries have taxes of some form on corporate income, it was felt that a corporate income tax in Bahrain could be feasible. Discussions with the business community also showed that they were not opposed to measures already implemented elsewhere. The main impediment is the absence of a robust revenue administration framework. The to-be established independent revenue authority should be able to provide a framework for additional efforts over time.

5. Could staff offer more details on the pros and cons of this transition (to progressive personal income tax), suggested timelines and compare it with the practices of Bahrain's GCC peers?

- With the background of large fiscal consolidation needs, staff offered many policy options to the authorities for their consideration. Regarding a personal income tax, in addition to highlighting its ability to raise needed non-oil revenue, staff also underscored the role of a progressively designed direct tax regime in more efficiently redistributing income.

- In terms of a redistributive impact of fiscal policy measures, staff noted that a progressive personal income tax might be better in that it directly takes account of the ability of households or individuals to pay. Implementing progressive income tax while expanding coverage can thus support redistributive policies, possibly garnering support for such measures, and minimize efficiency losses.

- Any move in this direction would take time: institutional capacity, including at the Ministry of Finance, would have to be built. While there is currently no regional example to pursue, as other GCC countries do not have personal income taxes either, Fund staff have provided similar advice to other countries in the region.

6. Given the many challenges in developing such tax systems, could staff elaborate on the capacity requirements and a feasible time horizon for implementing CIT and PIT regimes in Bahrain?

- Institutional underpinnings for the VAT could be used to develop a corporate taxation regime. The mandate of the independent tax administration authority could be expanded to collect such taxes. The Ministry of Finance already has a division dedicated to enterprise taxation issues.

- During the Article IV consultation, staff discussed initial steps that could be taken. For instance, if a CIT begins by covering the few big corporations listed at the Bahrain Bourse, institutional capacity requirements—as well as the feasible time horizon—should be minimal. In this regard, the authorities could benefit from the experience of other GCC countries, especially Oman which implements CIT on both domestic and foreign corporations.

- As for the PIT, the government could begin the process by targeting very high-income earners based on their contributions to the pension system.

7. Could staff detail the additional revenues expected out of the introduction of VAT?

8. Could staff explain the reasons behind the delay (in implementing VAT) and comment on the prospects of its introduction in the near future?

- Revenues from implementing the VAT are projected to increase gradually from 1 percent of GDP in 2019 to 1.8 percent in 2023, reflecting improvements in tax collection and coverage over time.

- The authorities are continuing to prepare for the introduction of the VAT, as part of their commitment in the GCC context. Work is ongoing to implement the tax by 2019: a VAT department has been created within the Ministry of Finance and staffed, a consultant is being appointed to review a draft legislation, and discussions are ongoing with the business community and public at large. During the Article IV mission, staff engaged in extensive discussions on the operational aspects of the VAT, sharing cross-country experiences (both within and outside the GCC) with its design and implementation. Successful examples of Saudi Arabia and the United Arab Emirates, which introduced the VAT in 2018, provide models for Bahrain.

9. Could staff detail its assessment of privatization measures contemplated and additional revenues they could provide?

- Other than some services in the health and education sectors, significant privatization is currently not under consideration, and hence no significant impact is anticipated.

- The staff pointed to some government assets which, if privatized, could help contain the rise in public indebtedness and reduce financing risks. Bahrain's Sovereign Wealth Fund, for instance, had assets of about US$10.4 billion (over 30 percent of GDP) at end 2017, invested primarily in domestic companies. The staff also noted that privatization, if implemented, should be done transparently to maximize returns to the government.

10. Could staff provide an update on recent debt developments, structure of financing and the use of the CBB overdraft account?

- The government has issued US$8.3 billion in debt over the first five months of this year, of which US$1.5 billion was issued externally in U.S. dollars (including a US$500 million private placement) and the rest was placed domestically and was denominated in Bahraini Dinars.

- Of domestic issuances (of US$6.8 billion), majority were treasury bill rollovers (US$5.9 billion).

- The central bank claims on the government increased by US$1.4 billion in the first quarter in 2018, before falling to the end-2017 level (of US$2.8 billion) in May, in part due to the external debt issuance.

11. As stated in the risk matrix, we think delays in the fiscal consolidation can have serious consequences. Could staff comment?

12. Could staff comment on the financial implications of the projected rise of public debt above 120 percent of GDP over the medium-term?

- As staff show in the baseline scenario, the authorities' current and planned fiscal measures are not sufficient in stemming the upward trajectory of public debt, with debt rising to 120 percent of GDP by 2023. Assuming that the government's ability to borrow—domestically as well as internationally—remains unimpaired, its gross financing need would increase from 28 percent of GDP in 2018 to 34 percent in 2023. The interest payment on public debt would jump from 4 percent to 8 percent of GDP, exceeding government's total non-oil revenue by about 2 percentage points of GDP. This could have an adverse impact on growth, and crowd out the private sector.

- Under such circumstances, access to market financing could become prohibitively expensive. Yields on the 10-year government bond, maturing in 2022, rose by 300 bps between end-April and the pledge of support by regional partners on June 26. Market pressure has since eased and the yield has declined by 70 bps from its highest point to 8.3 percent as of July 5. Interest rates on domestic debt also rose significantly: the 3-month treasury interest rate increased by 100 bps relative to its end-2017 level, to 3.93 percent as of July 2. These recent developments point to risks faced should fiscal consolidation be delayed.

13. Could staff comment on the extent to which the adjustment path proposed by staff, with a reduction of the primary balance of 5 percent of GDP in 2019, is realistic, and whether the adjustment path should not be more gradual?

- A large fiscal consolidation is not unusual in GCC countries; such adjustments have historically been implemented in response to fiscal pressures stemming from declines in oil prices. The non-oil primary balance declined, between 2014 and 2017, by 27 percentage points of non-oil GDP in Kuwait, 32 percentage points in Oman, and 26 percentage points in Qatar and in Saudi Arabia.

- The adjustment in 2019 includes the impact of the VAT (one percent of GDP) as well as other tax and spending measures, as detailed in the adjustment scenario (Annex V).

- Given the fiscal challenges, a sizable fiscal adjustment is urgently needed to put public finances on a more sustainable footing and to reassure markets to help contain the rising costs of public borrowing.

14. Could staff further elaborate on the likely social impact that the proposed adjustment (as set out on page 10 of the report) would have, considering that it would be a sizable one?

- Any impact would depend on measures adopted by the authorities, and their implied progressivity. Options were discussed during the consultation, based on the framework outlined in Annex XI.

- The staff advised, instead of subsidies, means-tested direct transfer mechanisms to compensate low-income earners and to support the social safety net. Discussions are continuing in Bahrain in this regard, in the context of a joint parliamentary-government high-level committee.

- The staff also recommended that measures be implemented gradually (as noted in 17 of the staff report), initially capturing only the highest income brackets by using high thresholds.

Regional financial support

15. ***Does staff have any information on the details of ongoing discussions (between the gulf states and Bahrain on financial support)?***

16. ***Could staff provide additional information on the package they may have recently obtained (from regional partners)?***

17. ***Are there more details available on ongoing discussions on that matter (of financial support) from regional partners)?***

18. ***Could staff inform us about the recently announced financial aid program by some GCC countries, particularly its conditionality?***

19. ***Could staff provide its preliminary assessment of the impact the GCC support announced at the end of June will have on the adjustment path?***

20. ***Are staff able to say at this stage how such a package (of financial support from neighboring countries) would affect their assessment and recommendations?***

21. ***Could staff elaborate on the debt impact of the prospective financing commitments by Saudi Arabia, Kuwait and the United Arab Emirates and recent debt issuances internationally?***

- On June 26, three GCC countries—Saudi Arabia, Kuwait, and the United Arab Emirates—announced that talks were ongoing with Bahrain and confirmed “their commitment to consider all options to support the kingdom of Bahrain and to finalize an integrated program that will soon be announced to enable the kingdom of Bahrain to support its economic reforms and fiscal stability.”

- As noted by Mr. Alogeel and Mr. Ahlomaly in their Gray, such a program would aim to strengthen international reserves and ensure fiscal sustainability, while accelerating structural reforms.

- Discussions are continuing. Within Bahrain, on June 28, the Prime Minister established a high-level committee, chaired by a Deputy Prime Minister (who is also the head of the Ministerial Committee for Financial Affairs and Rationalizing Expenditure) and comprising the Minister of Finance and Governor of the Central Bank of Bahrain, to identify needed economic measures while keeping in mind the impact on growth.

- Details of these discussions, including on support conditions if any, are not yet forthcoming. The authorities have promised to keep staff abreast of developments.

- The staff welcome the financial support, which will enable Bahrain to undertake the needed fiscal adjustment.

- The announcement of the intent to support has alleviated market pressures. Most analysts (and rating agencies) have underscored that the details—of the authorities' program as well as the proposed support—would underpin future developments in market sentiment.

22. Given the stated important role of the GCC-funded infrastructure projects, could staff provide more information on these projects, especially on their sustainability and effects on growth?

- The GCC development fund, announced in 2011, comprised grant disbursements of US$10 billion over a decade. The funding is in the form of project finance.

- Overall, 46 projects were committed for an amount of US$7.3 billion. Of this,6 projects have been completed and 20 more are currently ongoing. The remaining are in various planning stages and are expected to be implemented in the coming years: the value of certified projects planned for 2018 and 2019 amount to about US$2 billion.

- The projects have mainly been in the areas of housing (US$2.4 billion); infrastructure, mainly roads (US$1.4 billion); airport expansion (US$1 billion); and electricity and water (US$1.5 billion).

Financial Sector, Monetary and Exchange Rate Policies

23. Could staff elaborate further on the origins of this increasing (sovereign-bank) nexus?

- Banks hold public debt mainly for liquidity management and investment purposes.

- The interbank market is underdeveloped, and systemic excess liquidity is usually high due to oil related inflows. To reduce excess liquidity, banks purchase treasury bills.

- Government bonds have been an attractive investment option, given their relatively favorable regulatory risk weight and high yields. Moreover, the volume of government borrowing has increased over time while the corporate bond market is small and private-sector credit demand remains subdued.

24. Could staff elaborate more on the background of rising personal loans and necessary policy responses if the trend continues?

- The rise in personal loans reflects improved access to credit for households—it rose from a low initial level and its current level is still low relative to advanced economies. Therefore, staff have recommended that the authorities closely monitor its development.

- Should the trend continue, with risks becoming higher, staff have discussed with the authorities options to expand the debt-service-to-income ratio caps, currently implemented on bank loans, to cover consumer credits from non-bank financial institutions.

25. Could staff comment on the apparent divergence of NPLs between retail and wholesale banks and between conventional and Islamic banking?

- The difference in NPLs between retail and wholesale banks and between conventional and Islamic banks is driven by differences in their balance sheets. Specifically, wholesale conventional banks hold 90 percent of their assets outside Bahrain, and hence the performance of their assets is not correlated with that of retail conventional banks, which hold most of their assets in Bahrain.

- Most of the NPLs in Islamic banks and retail conventional banks are related to real estate and construction. Therefore, the different paths of NPLs between them are driven by the different paths of exposure to real estate and construction sectors.

- On the one hand, Islamic banks are much more exposed to real estate and construction sectors, and hence have higher NPLs than retail conventional banks. On the other hand, Islamic banks have been reducing their large exposure to these sectors, resulting in their NPLs declining over time; retail conventional banks' exposure to real estate and construction sectors has not declined as it is still considered manageable.

26. Could staff explain more about the activities of the GCC fintech working group, and recent developments of the "global sandbox" proposal by the U.K. FCA and authorities' interest in the initiative?

- The authorities informed staff, during the Article IV mission, that a GCC fintech working group had recently been established, and had had its first meeting. The group plans to meet at a quarterly frequency, covering issues such as a possible GCC-wide regulatory sandbox. Though it remains to be seen how the group will evolve, staff welcome this regional initiative in promoting and regulating fintech.

- The "global sandbox" proposal was made by the U.K. FCA in February 2018, and is still at an idea stage. According to the U.K. FCA, the global sandbox "could potentially allow firms to conduct tests in different jurisdictions at the same time and allow regulators to work together and identify and solve common cross-border regulatory problems, through tests." The U.K. FCA has been asking firms, regulators, and consumers around the world for their views and suggestions on the proposal. The Bahraini authorities expressed their openness to this idea, noting at the same time the need to ensure Anti-Money Laundering (AML) and Know Your Customers (KYC) compliance standards related to cross-border activities.

27. Have staff made an assessment of the potential GDP contribution from these areas (of fintech and innovative financing instruments) in the medium term?

- The staff's baseline does not incorporate the potential impact of fintech and innovative financing instruments on GDP, and staff are not aware of such an assessment for other countries.
- These developments, however, represent an upside to staff's baseline projections. Fintech could potentially contribute to GDP growth in the medium term both directly, through growth in the financial sector, and indirectly, by providing alternative (and possibly cheaper) forms of financing and increasing efficiency of financial services.

28. Can staff brief the Board on the FATF's recent assessment on effectiveness of Bahrain's AML/CTF framework?

29. Could staff comment on the initial insights from the recent assessment by the Financial Action Task Force?

- The FATF Plenary met during the last week of June and discussed the joint FATF-MENAFATF mutual evaluation report of Bahrain, which set out the level of effectiveness of the country's AML/CFT system and its level of compliance with the FATF Recommendations.

- Overall, Bahrain's AML/CFT framework was assessed as being moderately effective, including for the supervision of financial institutions and the misuse of legal persons and arrangements for criminal purposes. Owing to the ratings, the MENAFATF has placed Bahrain under its enhanced follow-up procedures, and requested Bahrain to submit a follow-up progress report in November 2019. The mutual evaluation report will be published by September 2018.

Structural Reforms

30. Could staff scope the privatization efforts in these areas (education and health

sectors) and the safeguards to ensure these basic services continue to be affordable to the general population?

- In both education and health sectors, the government plans—over time—to assume more the role of a regulator, enabling private-sector participation and competition. Resulting efficiency gains are expected to bring down costs of services.

- Education and health sectors currently comprise over 30 percent of the public wage bill. Inefficiencies are estimated to be high; for instance, the cost per student remains large and not matched by outcomes. Reforms being contemplated would continue to provide support for low-income families.

- Steps are being taken: the government has permitted private sector entry in medical tests, resulting in cost and time savings. The recently enacted medical insurance law will be complemented by a fund to provide cash to beneficiaries that covers the projected cost of private medical insurance.

- The government continues—as part of its reform endeavors—to examine costs of its various services.