Economic Insight
28 July 2026

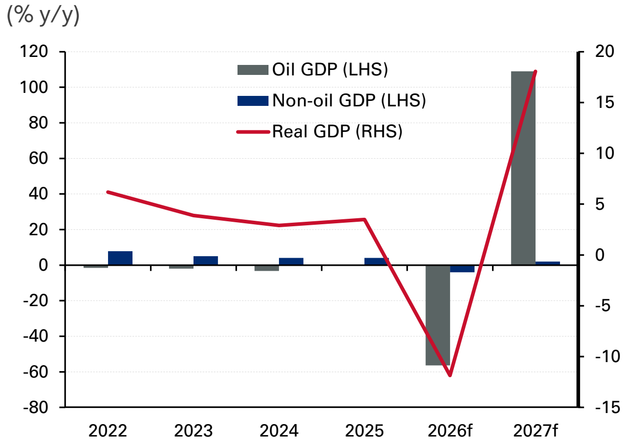
Bahrain: War spillovers deepen fiscal strains and test reform momentum

Bahrain's economy has come under significant pressure in 2026 as the regional conflict and the closure of the Strait of Hormuz disrupt energy production, trade flows and business activity over the last five months. While higher global oil prices may offer partial revenue support, the sharp decline in hydrocarbon output and weaker non-oil activity are likely to widen fiscal deficits and push public debt to even more elevated levels. Limited fiscal space constrains the government's ability to provide large-scale economic stimulus, compelling the authorities to rely mainly on liquidity support and targeted financial relief measures. At the same time, the conflict is expected to slow the pace of fiscal consolidation and delay parts of the December 2025 reform package. Despite these challenges, Bahrain is likely to continue benefiting from GCC financial backing, particularly from Saudi Arabia, while maintaining its longer-term focus on economic diversification under Vision 2030 and the Economic Recovery Plan.

Economy faces a sharp slowdown amid regional conflict

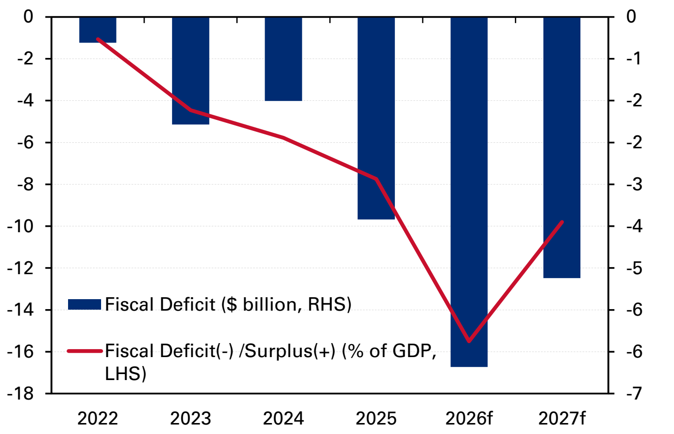
Bahrain's economy is expected to feel the full impact of the regional conflict in 2026, with real GDP projected to contract by around 12% in our alternative scenario amid the continued regional conflict. The downturn is primarily driven by a steep decline in oil production following the closure of the Strait of Hormuz, alongside weaker investment activity, lower export volumes and broader regional uncertainty. The oil sector is expected to bear the brunt of the shock, with oil-related activity projected to contract by around 56% y/y in 2026 due to field shut-ins caused by disruptions at the Strait of Hormuz. (Chart 1.) The non-oil sector, meanwhile, should fare better but also contract, by around 4% y/y, amid weaker tourism, manufacturing,

Chart 1: GDP growth



Source: MoFNE, NBK forecasts

Chart 2: Fiscal balance



Source: MoFNE, NBK forecasts

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logistics, trade and financial activity. At the same time, higher global energy prices are expected to generate renewed inflationary pressures. Average annual inflation is projected to rise to 1.7% in 2026 from a mild deflation rate of 0.1% in 2025, driven mainly by higher fuel and imported goods costs.

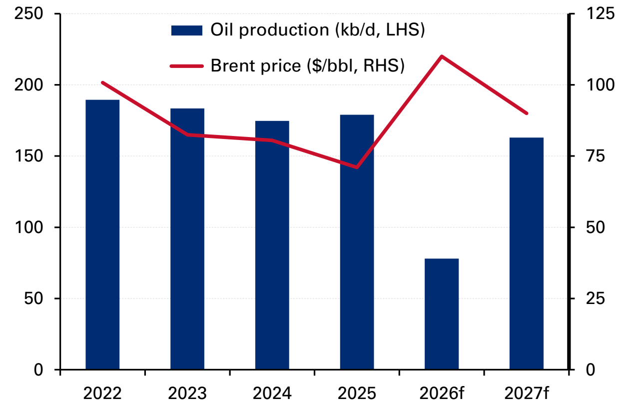
Fiscal pressures intensify despite higher oil prices

The conflict is expected to significantly worsen Bahrain's fiscal position—elevated oil prices provide little benefit given Bahrain's inability to export oil—highlighting the kingdom's continued vulnerability to external shocks and oil market volatility. We now project the fiscal deficit to widen to 15.5% of GDP in 2026, compared with a pre-conflict estimate of 8.5% and an estimated 7.7% in 2025. (Chart 2.) Fiscal deficits are expected to remain elevated in 2027 despite easing to 9.8% of GDP, reflecting persistent pressure on both hydrocarbon and non-hydrocarbon revenues. The deterioration in public finances is mainly linked to disruptions in hydrocarbon exports and refined petroleum products, which together account for roughly 63% of government revenues. Ongoing security risks and the closure of the Strait of Hormuz have led to temporary field shutdowns and lower production volumes. As a result, Bahrain's crude oil output is now expected to decline by 56% y/y in 2026, compared with pre-conflict expectations of nearly 10% growth. Higher oil prices—Brent is projected to average $90 in 2026 compared to our previous assumption of $65/bbl—could partially offset some of the revenue losses resulting from lower production and exports. (Chart 3.)

Non-oil revenues have come under pressure

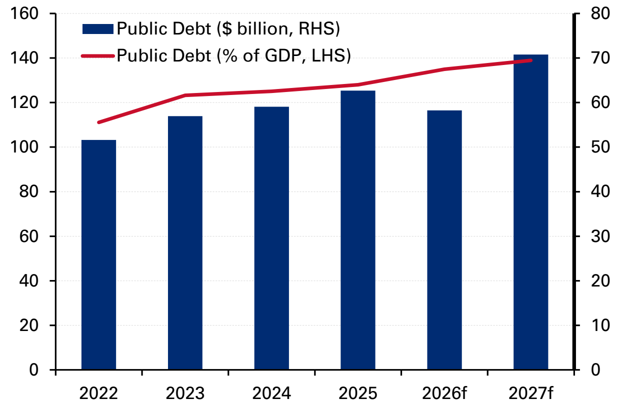
Government non-oil revenues are likely to have weakened materially as the conflict has disrupted tourism, aviation, trade and financial services activity. Non-hydrocarbon revenues are projected to decline by 36% y/y in 2026, a sharp reversal from pre-conflict expectations of 28% growth. The aluminum sector, which represents nearly 40% of Bahrain's non-oil exports, has struggled amid the closure of 3 smelting lines constituting 19% of ALBA's capacity. These pressures have necessitated stricter government fiscal discipline, a challenge without amplifying social and economic stress. In fact, authorities have already delayed parts of the December 2025 fiscal reform package, particularly the monthly fuel price increases that had been planned to reduce subsidy spending. Elevated global energy prices have made further subsidy reforms more difficult in the near term.

Chart 3: Crude oil production



Source: Haver, NBK estimates/forecasts

Chart 4: Public debt trajectory



Source: MoFNE, Haver, NBK estimates/forecasts

Limited fiscal space restricts government support measures

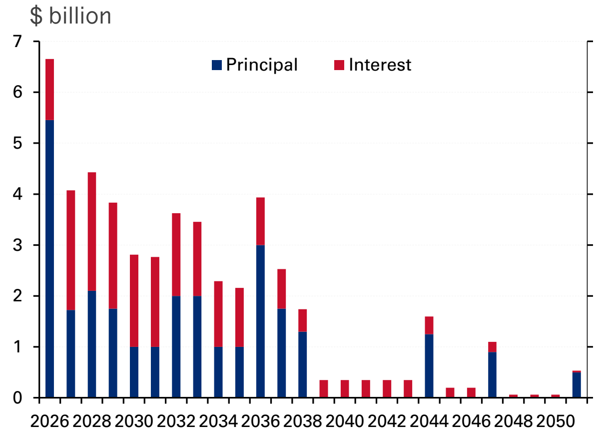
The government had limited fiscal flexibility coming into the conflict, which restricted its ability to deploy large-scale fiscal stimulus measures to support economic activity. Public debt already stood at around 128% of GDP in 2025, the highest level in the GCC region and among the highest in the world, and foreign currency reserves remained relatively low at $5 billion as of April 2026. (Chart 4.) Against this backdrop, the authorities are expected to avoid any meaningful expansionary fiscal spending but slow the implementation of some planned fiscal consolidation measures. Instead, policymakers are likely to rely more heavily on non-fiscal support tools to cushion the economic fallout and preserve financial stability. On April 13, the Central Bank of Bahrain introduced a temporary package of loan relief and liquidity support measures, including repayment deferrals, temporary easing of capital adequacy requirements and additional liquidity support for banks. These measures are likely to be extended or expanded further. If households and businesses remain unable to service debt obligations over time, banks could face rising non-performing loans.

The banking sector started to show early signs of stress in March at the height of the conflict, particularly evident in the decline in private sector foreign currency deposits, which fell by $189 million (-2% m/m) and the drop in non-resident foreign currency deposits by $1.3 billion (-9% m/m). The latter, though, eased somewhat in April while private sector foreign currency deposits reversed course and increased by $740 million (+9% m/m). In both March and April, the government stepped in to offset outflows with deposit placements of about $1.2 billion in commercial banks, which helped to stabilize the overall banking system deposit base. As a result, total deposits remained broadly stable despite mounting financial stress.

Rising debt servicing costs add to fiscal vulnerabilities

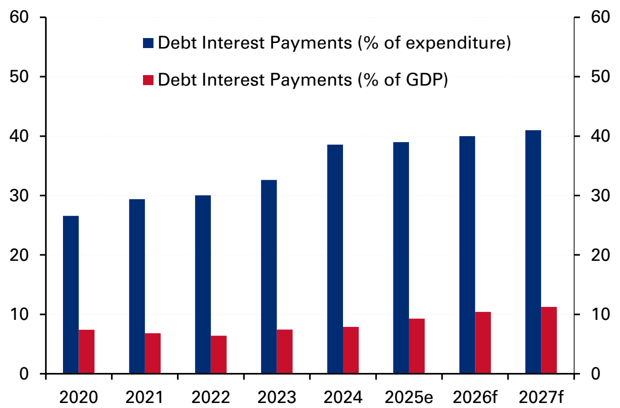
The government's already elevated debt burden is expected to continue rising over the coming years as larger fiscal deficits and higher borrowing costs place additional pressure on public finances. Interest payments alone already account for nearly 24% of total government expenditure and are projected to rise from 5.6% of GDP in 2025 to 6.6% in 2026. (Chart 6.) High debt servicing costs are expected to absorb a growing share of fiscal resources, limiting the government's ability to redirect spending toward growth-supportive initiatives.

Chart 5: Bahrain public debt profile



Source: LSEG

Chart 6: Size of Interest payments



Source: MoFNE, Haver, NBK estimates/forecasts

Consequently, government debt is projected to increase further from 128% of GDP in 2025 to around 135% in 2026. On a positive note, while Bahrain's public debt remains exceptionally high, its composition provides some important buffers against immediate financial stress. Nearly 79% of government debt is long-term, reducing refinancing risks and limiting near-term funding pressures. (Chart 5.) Furthermore, around 75% of total debt is denominated in US dollars, the same currency to which the Bahraini dinar is pegged. This minimizes foreign exchange risk and protects the public finances from adverse currency movements. Consequently, the primary challenge facing Bahrain is not the structure of its debt, but rather its overall size and the government's ability to gradually stabilize the debt trajectory over time.

Financial market indicators have also started to reflect mounting concerns over Bahrain's macro-fiscal outlook. One of the clearest signs of rising stress has been the sharp increase in sovereign borrowing costs. The yield-to-maturity (YTM) on Bahrain's 3-year Eurobond, issued in January 2026 before the outbreak of the war, has climbed to 8.1%, compared with 5.6% at issuance. At the same time, Bahrain's 5-year credit default swap (CDS) spread has widened to around 300 bps, well above its three-year average of 200 bps, although it has eased from its March peak of 337 bps, reached during the height of Iran's attacks on Bahrain.

In April, Moody's revised Bahrain's outlook from stable to negative, citing concerns that the regional conflict could further weaken the kingdom's already strained fiscal and debt metrics, potentially leading to a deterioration in its credit profile. Bahrain currently holds a sovereign credit rating of "B2" from Moody's and "B" from both S&P Global Ratings and Fitch Ratings, while the latter two agencies have so far maintained stable outlooks.

Long-term financial stability can be helped by reform momentum and GCC Support

Looking beyond the immediate impact of the conflict, Bahrain is expected to face growing pressure to strengthen its fiscal position while preserving social and economic stability. This suggests that fiscal consolidation will likely remain gradual, with policymakers seeking to balance debt sustainability objectives against social considerations. At the same time, authorities are expected to maintain their commitment to Economic Vision 2030 and the Economic Recovery Plan, accelerating efforts to diversify the economy, expand private sector participation and reduce dependence on hydrocarbon revenues. While the elevated government debt burden and limited external buffers leave it vulnerable to prolonged regional disruptions, continued financial support from GCC partners, particularly Saudi Arabia, should provide an important stability anchor. Ultimately, Bahrain's long-term economic resilience will depend not only on external support, but also on the success of its fiscal reforms and its ability to accelerate non-oil growth, strengthen investor confidence and place public debt on a more sustainable trajectory.

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