SUMMARY

NON-OIL STRENGTH DEFINES 2016

The continued resilience of the non-oil economy allowed Bahrain to achieve a slight improvement in its headline growth in 2016 in spite of historically subdued GDP figures in the region. The near-term outlook remains one of relative continuity.

✦ The Bahraini economy expanded by 3% in 2016. This marked a slight acceleration over the 2.9% pace posted in 2015 and was achieved thanks to stronger momentum in the non-oil sector. By contrast, oil sector GDP came in flat as a result of a Q4 drop in output due to seasonal maintenance

✦ Non-oil momentum drivers point to relative continuity. Even as ongoing region-wide fiscal consolidation will somewhat dampen Bahrain’s growth momentum, the ongoing implementation of the infrastructure pipeline will serve as a strong countervailing force. Major projects such as Alba Line 6, the airport expansion, and the LNG terminal will support activity across the non-oil economy

✦ Regional non-oil growth set to accelerate. Even though regional growth will be depressed by slower growth in the oil sector (due to the OPEC quotas), the non-oil economy is showing encouraging signs of adjusting to the new economic realities. Business confidence has generally strengthened across the region and should further benefit from a more positive oil price outlook, even allowing for bouts of volatility

✦ A slightly brighter global outlook. After a long period of record low interest rates and subdued growth, the outlook for the global economy has become somewhat brighter. A combination of pro-growth policies in the US and stimulus measures in China are among the main factors underpinning this optimism. However, structural weaknesses still entails risks concerning the pace and magnitude of this recovery

Bahrain economic outlook

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Source: Bahrain Economic Development Board
GLOBAL ECONOMY

CAUTIOUS OPTIMISM

After a lengthy period of subdued global growth, signs are multiplying of a slight improvement in the prospects of a number of key economies. Economic activity has been generally strengthening somewhat since the second half of 2016 and some key economies – most notably the US and China – are expected to resort to further stimulus measures this year. While the global outlook hence appears more benign, unusual uncertainties continue to cloud the prospects for the global economy. There is concern about the outcome of the impending elections in Europe and policy uncertainties in several other countries, while somewhat tighter monetary conditions in the US can be expected to test capital flows to the emerging markets. More generally, there is mounting concern over the medium- to long-term impact of increasingly numerous steps away from economic integration and broader protectionism in several countries. For instance the US administration is keen to renegotiate parts of NAFTA to reduce immigration into the US. It is also contemplating a controversial border tax measure. Among other things, these trends are curbing the growth of international trade, which slowed down to some 1% over the past year.

The International Monetary Fund (IMF) estimates global growth of 3.1% in 2016. Growth is projected to accelerate to 3.4% this year and 3.6% in 2018. Growth in the advanced economies is expected to strengthen somewhat from this year’s 1.9% to 2.0% in 2018. Emerging market growth is expected to rebound quite strongly from an estimated 4.1% in 2016 to 4.5% in 2017 and 4.8% in 2018.

Global growth prospects (real growth in major economies, %)

Source: International Monetary Fund, World Economic Outlook, January 2017 update
The cost of capital edges up

Recent months have seen a clear adjustment in market views regarding global and especially US monetary policy. After a lengthy period of near-zero rates and repeatedly thwarted expectations of policy normalization, the US Federal Reserve made its first rate increase since the onset of the global financial crisis in December 2015. Since then, two further hikes have ensued, in December 2016 and on 15 March 2017. The Federal Funds Rate now stands in the range of 0.75 to 1%. This is the first time since 2008 the target range has hit 1%.

Two more hikes are now seen as likely during the remainder of 2017, on current expectations most probably in June and December. Further tightening could materialize as a result of potential steps by the Fed to reduce its balance sheet, albeit probably not before the end of the year. The median projection sees the policy rate continuing to edge up 1.4% by the end of the year. Three rate hikes are, similarly, seen as likely in 2018.

The Fed currently bases its policy plans on relatively cautious macroeconomic projections in spite of the plans by the Trump administration to stimulate growth through a variety of mechanisms. The Fed expected growth to reach 2.1% this year and in 2018, followed by a slight moderation to 1.9% in 2019. Unemployment is expected to plateau at 4.5% this year, as compared to 4.7% at present. According to Open Market Committee (OMC) Chair Janet Yellen, the Fed has not formally mapped out the possible impact of the Trump administration’s proposed fiscal measures.

Although the near- to medium-term outlook for US monetary policy remains one of gradual tightening, this may not ultimately result in a very significant paradigm shift as far as financial market conditions are concerned:

- While acknowledging that rates in the US remain below what is seen as the neutral rate (trend GDP growth in combination with stable inflation), Yellen suggested that they are close to it. As a sign of continued caution, she underscored that the OMC would consider financial market and international developments in connection with its rate decisions. The market reaction to the Fed’s announcements was positive as they were seen as signalling a measured approach to policy tightening.

- A new Fed research paper argues that the central bank should tolerate inflation of up to 3% during periods of faster growth in order to achieve its average target of 2% inflation over the cycle. The average measure of inflation over the past decade has been 1.6% (personal consumption expenditure index) while it claims that the 2% inflation target is symmetric. This suggests that the Fed could tolerate increased prices pressures for a while instead of seeking to curb them through immediate rate increases.

- The Fed remains unique among major central banks globally in contemplating near-term tightening. The continued absence of new inflationary pressures in other advanced economies is likely to change this state of affairs in the foreseeable future. This may check the Fed’s willingness to tighten monetary conditions in the US in order to contain Dollar appreciation.

In general, the markets have to date taken the prospect of gradual US tightening in their stride. The mounting conviction about rates remaining lower for longer has boosted market confidence.
This view has received further support from indications by President Trump that he does not wish to see a strong Dollar and that interest rates should remain low. Under the circumstances, most key equity market indices continued to advanced to historic highs during the first quarter of the year.

Global equity market performance (Jan 2015 = 100)

Source: MSCI

OPEC vs. Shale

The decisions by OPEC and other major producers to impose output quotas at the end of last year has had a pronounced impact on oil prices which have risen significantly from their early 2016 lows. While the overall price outlook for the near- to medium-term has improved, the upward momentum of prices in March came to be tested by a combination of factors, some of them seasonal. As so often before, the market has once again come to be characterized by a tug of war between the desire of conventional producers to eliminate a persistent glut, on the one hand, and a robust supply response to higher prices by the US shale sector, on the other:

✧ OPEC and its partners have achieved a high degree of compliance with their agreed-upon cuts, reportedly 95% in February. However, historically high global stockpiles along with growing North American output in March brought oil prices to their lowest level since November. Refinery maintenance and slower than expected demand growth in Q1 have further perpetuated the glut. In response, there were growing indications that OPEC stood ready to extend its output cuts by another six months. In particular, Saudi Arabia and Kuwait have indicated that they would like to see inventories fall back to their five-year average. They are currently some 285mn barrels above that level. If extended, the planned output cuts should eliminate the surplus by the end of Q3

✧ US output levels have been rebounding fairly consistently in response to the more optimistic price projections. According to Baker Hughes data, the number of oil rights in the US rose to 652 in the third week of March, their highest level since September 2015 and more than
double the total recorded in May 2016. The overall rig count rose to 809. US output rose to 9.13 mbd by mid-March, up from 8.5 mbd in October. The EIA now projects US output of 9.73 mbd by 2018

While the interruption of the positive price dynamics is seen as potentially casting doubt on the effectiveness of the output deal, there are indications that the market may be normalizing more sustainably:

- A number of seasonal or short-term factors have depressed prices in Q1. These include somewhat more subdued global growth than is expected for the year as a whole. Similarly, refinery maintenance has cut demand. In many countries, the onset of the summer season, including the American “driving season,” should help revive demand

- The shale sector is undergoing a major shake-up with many of the smaller operators facing financial difficulties. Geographically, there has been a refocusing on the most accessible, lowest-cost deposits, specifically the most cost-competitive Permian basin. The USD28bn spent by the five top majors in 2016 was more than three times the 2015 level. The Permian rig count reached 276 in January, twice the May 2016 trough of 137 but still far short of the November 2014 peak of 565. US share production has crept up from 4.72 mbd in September to 4.75 mbd in January. The EIA expects this to rise to 4.87 mbd in March with 2.25 mbd to come from the Permian, which would mark a 270,000 b/d YoY gain

- The shale sector has benefited from significant efficiency gains and cyclical declines in input prices since 2014. Many of those gains have been large exhausted and in some cases are now being reversed and higher activity levels are pushing up operating costs. Most Permian wells are reportedly being completed with delays and budget overruns

Ultimately, shale oil is likely to be an enduring part of the new global energy landscape and to exert a significant impact on the oil market dynamics. Just as OPEC has shown its willingness to promote market stability be containing price corrections that can jeopardize investment, it is widely expected that shale oil will place a de facto ceiling on the sustainable price range. Some recent OPEC statements suggest that USD50-55 a barrel would be a comfortable output level.

The near-term outlook for the oil market is generally benign. The improved prospects for the global economy should underpin continued demand growth, which is put by OPEC at 1.3 mbd this year and should take the total to 96.3 mbd. The demand for OPEC crude is expected to increase from 31.6 mbd in 2016 to 32.4 mbd in 2017. The IEA projects global demand growth of 1.4 mbd to an average of 96.5 mbd. It expects non-OPEC output growth of 0.4 mbd to 57.7 mbd.

Subdued investment is likely to remain a long-term challenge for the oil market. In spite of a pick-up in North America, the global oil majors are on track to undertake further investment cuts this year, making this a fourth straight year of retrenchments. The five largest companies are expected to reduce investment by 3% in 2017. While the drop looks small compared to the estimated 24% fall in 2016, it continues a trend of historically record-low investments.
Monthly average crude oil prices (USD/barrel)

Source: US Energy Information Administration

Global oil demand and supply dynamics (mbd)

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<td>2017 Global oil demand (mbd)</td>
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<td>Non-OPEC</td>
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Implications for Bahrain

The combination of a generally more benign near-term global growth outlook and renewed indications of US reluctance to see rapid monetary tightening is likely to have mainly predominantly positive implications for Bahrain:

✨ The prospect of greater oil price stability with a moderate upward bias would be beneficial from the business confidence and fiscal perspective
More measure Dollar appreciation would contain real exchange rate appreciation and the relative attractiveness of emerging market assets
THE GCC REGION

SIGNS OF GROWING NON-OIL CONFIDENCE

The GCC economies are continuing to adjust to the new realities of relatively low oil prices and ongoing fiscal reform efforts. This is likely to deliver another year of modest GDP gains as the role of the historically important growth drivers of oil and government spending will likely remain well below their long-term trend. Nonetheless, the disruptions caused by this ongoing economic paradigm shift are likely to be markedly less pronounced than last year. In spite of continued volatility, the OPEC interventions in the market appear to have created an acceptable floor for oil prices while governments, companies, and consumers alike have had time to adjust to the new economic realities. Moreover, further fiscal consolidation steps are generally expected to be smaller in magnitude than those seen in 2015-2016.

The growth rates of the GCC economies have converged markedly over the past couple of years with the more diversified economies generally proving more resilient in the face of oil price gyrations. This is likely to be of particular importance this year as oil production levels across the region are expected to be at best in line with the 2016 totals.

Real GDP growth rates among the GCC economies are estimated to have varied in the range of 1.4% to 3.6% in 2016. The outlook for 2017 is broadly comparable with a projected range of 0.4% to 3.4%. This will likely mark the low point of the current cycle as the expected rebalancing of the global oil market as well as gradually strengthening non-oil drivers should deliver stronger growth figures by 2018.

GCC real GDP growth, %

![GCC real GDP growth chart]

Source: International Monetary Fund
Business confidence is strengthening

The most widely used leading indicator of economic activity in the region, the Emirates NBD Purchasing Managers’ Indices for Saudi Arabia and the UAE, point to progressive consolidation of non-oil activity in the region. The average reading of the UAE index rose to 55.8 in Q1 in a clear improvement from 54.2 in 4Q16. This was the highest quarterly average since 3Q15. In particular, the output index has improved sharply, to a reading of 62.7 in March, the highest figure recorded in over two years. New orders, similarly, advanced to a high of 59.9. By contrast, job creation still remains relatively subdued with a reading of 51.5 in 1Q17.

The average reading of the Saudi Arabia PMI was 56.7 in 1Q17 as compared to 54.6 in 4Q17. The February reading of 57.0 represented an eighteen-month high for the index. Although business activity is accelerating, job creation remains relatively stagnant with an average reading of 50.5 in Q1, which in fact marked a small decline from 4Q16.

**Emirates NBD Purchasing Managers’ Index**

While the regional outlook is clearly improving, the impact of fiscal consolidation on growth in the short term has been palpable. Aggregate government spending in the GCC has fallen by 18% in real terms since 2015. This has pushed down GCC-wide real growth from the neighbourhood of 3.5% in 2015 to just over 2% in 2016. The region’s largest economy, Saudi Arabia, saw its headline growth decelerate from 3.6% in 2015 to 1.4% in 2016. Even the more diversified UAE economy experienced a deceleration from 3.8% to the neighbourhood 3.0% over the same period.

In general, intermediate economic data from the region points to relative continuity with some strengthening of non-oil activity. While business confidence has proven resilient and liquidity conditions have improved in Saudi Arabia, other indicators still point to a mixed picture. Consumer spending has been fairly stagnant and for instance cement production during the opening months of 2017 declined in YoY terms.
While the positive trend has been more pronounced in the UAE, even there the picture remains somewhat mixed. The Emirates NBD Dubai Economy Tracker Index in March rose to 56.6 from a February reading of 56.2. The 1Q17 average was 56.7, the highest reading in two years. The trade sector has been the strongest performer but also construction recorded an improvement led by a pronounced increase in new orders. By contrast, employment growth has remained subdued with a March reading of 50.7 as higher input costs are continuing to put pressure on company margins. In spite of the positive trends, business confidence appears somewhat fragile. The proportion of non-oil companies expecting an output increase over the coming year fell from 47% in February to 30% in March.

For the UAE as a whole, the non-oil GDP is estimated to have grown by 2.8% in 4Q16, down marginally on 3% during the preceding quarter, according to the Central Bank’s Economic Composite Indicator Index. By contrast, overall growth appears to have accelerated from 2.8% in Q3 to 3% in Q4 led by increased oil production. Headline real oil GDP growth in 2016 was estimated at 2.4%, a figure that is projected to decline to 0.8% this year due to a 139,000 b/d output cut pledge. Non-oil GDP in 2016 is estimated to have expanded by 2.7%, which is projected to accelerate to 2.9% this year and 3.8% in 2018. This should leave overall headline GDP growth on a broadly positive trajectory. Having increased by an estimated 2.6% in 2016, it is set to rise by 2.3% this year, and 3% in 2017-2018.

The IMF estimates that the Saudi economy expanded by 1.4% in 2016 and it expects this rate to further moderate to 0.4% this year because of lower oil production. In 2018, by contrast, growth is projected to rebound fairly markedly to 2.3%. The projection for Kuwait is a deceleration from estimated 3.6% growth in 2016 to 2.6% in 2017-2018. Qatari growth decelerated from 3.5% to 2.2% in 2016 but is expected to rebound this year.

**Waiting for VAT**

In spite of a clear improvement in oil prices, 2017 is likely to be characterised by continued fiscal consolidation across the region. In general, however, the emphasis of these measures is expected to shift from expenditure cuts toward revenue diversification. In this regard, the region-wide agreement to introduce a value added tax (VAT) as of next year will be of particular importance. According to estimates by Moody’s Investor Services, this will help reduce the regional fiscal gap from some 7.5% of GDP this year to 4.9% in 2018. It will also begin to contain the growth of public debt which is set to reach 31.6% of GDP next year, as compared to 10.5% in 2014.

As of February, all the GCC governments had signed the Unified VAT Agreement, which sets out the general principles for the tax across the region. Individual national governments will then draft their own legislation in keeping with these principles. The regional countries have agreed to introduce VAT with a base rate of 5% VAT while coordinating excise duties on products such as high-sugar soft drinks and tobacco already last year. The flat VAT rate will be applied to goods and services that are not exempt or zero-rated. A 0% rate is expected to be applied to exports outside the region, international transportation, education, healthcare, and new residential properties. Exempted goods and services are expected to include certain types of financial services, residential real estate, undeveloped land, and local passenger transport. This should significantly limit the inflationary impact of the new tax.
Economically, VAT is likely to be less disruptive than direct taxes. It has the advantage of being broad-based and expanding to tax base to most economic activity. Thanks to a heavy reliance on self-assessment, it is relatively easy to administer, a major consideration in a region with a modest starting point in terms of tax administration. Its revenue impact, even with the internally low rate, is likely to be substantial. In the OECD, where VAT rates are much higher (an average of 19%), the tax receipts equal roughly 6.5% and approximately a third of the total tax intake. In the GCC as a whole, the tax is likely to equate to approximately 1.4% of GDP. The UEA reportedly expects a VAT intake of AED12bn in 2018 followed by AED20bn in 2019.

In spite of its relative economic advantage, the introduction of the VAT will mark a paradigm shift requiring a far greater emphasis on proper accounting as well as further increasing the importance of productivity at companies and the broader economy. Apart from its costs, the tax is also likely to support new economic activity in sectors such as business services and ICT where the regional economies are in a strong position to capitalize on their advanced infrastructure. VAT may also have an impact on consumer spending by bringing forward expenditure ahead of the introduction.

Apart from fiscal consolidation efforts, the regional governments are increasingly looking to involve private capital in activities traditionally undertaken by the public sector. After a relative lull during the years of high oil prices, the regional public-private partnership market is clearly entering its next significant phase of development. Not only is the use of PPP being scaled up but they are also being applied in new areas beyond the traditional core of independent water and power projects. Among other things, Saudi Arabia has indicated that it is seeking to finance transportation projects on a PPP basis. These include urban rail projects in Dammam, Jeddah, Makkah, and Medina. Qatar is reportedly considering ways to use PPP structures for investments linked to the 2022 World Cup. Oman’s looking to apply the model to affordable housing, as well as education and healthcare. Also elements of the 2,177 km Gulf railway network are expected to utilize private funding. The target completion date for the project is 2021. Kuwait has already announced plans to structure parts of its railway investment on a PPP basis. Governments are also looking for ways to upgrade the regulatory framework for private investment. Kuwait and Dubai have existing PPP laws and Qatar and Oman are also expected to adopt relevant legislation soon.

The Kuwait cabinet in late January approved the FY2017-18 budget (with the financial year running from April to March) which is expected to see an 18.4% contraction in the deficit to KWD7.9bn on the back of a projected 30% increase in revenues, in large part thanks to a higher intake from oil. The budget uses a USD45 oil price assumption, up from USD35 in FY2016-17. The projected output of 2.8 mbd is in line with last year’s output. There is a small projected spending increase to KWD19.9bn (USD76.4bn). Capital expenditure will account for KWD3.4bn of the total. Subsidies are still estimated to cost KWD3.1bn. The Kuwaiti Government is planning USD100bn of spending under its Kuwait 2035 Vision. USD15bn of strategic project spending is foreseen in FY2017-18.

The hydrocarbons sector adapts to new realities

Following a record breaking year in 2016, the GCC oil sector is likely to be characterised by at best minimal output growth in 2017. This change is likely to be particularly pronounced in Saudi Arabia where oil production was officially reported at 10.46 mbd in 2016, a figure that translated into a 12.8% increase on 2015. At the same time, domestic refining capacity has risen by 2.9 mbd and for
instance products exports to Europe rose by 37% during the first 11 months of 2016. Overall exports of crude and refined products rose by an annual 6.4% to a new record of 9.03 mbd. Crude exports alone were up by 3.4% to 7.65 mbd.

Saudi Arabia has indicated its willingness to bring production below 10 mbd, potentially by more than its formal commitments would suggest. Some industry estimates indicate that Saudi Arabia may cut production to below 9.80mn b/d in order to ensure that the OPEC targets are met, with Kuwait and the UAE reportedly going below 2.70mn b/d and 2.85mn b/d respectively. Oman is committed to producing 970,000 b/d in 1H17 as compared to its target of 1 mbd.

But in spite of the expected slowdown in oil production and in contrast to the rest of the world, hydrocarbons investment has held up relatively well in the GCC region. In 2016, it was only some 10% down on the levels recorded in the peak years of 2012-13. Also, the regional rig count has remained fairly constant with a single-digit drop since early 2014, as compared to a global contraction by a third. The GCC Countries ran a monthly average of 295 active rigs in 2016 with both Saudi Arabia and Abu Dhabi achieving new records. Most regional economies are working to increase capacity.

**Monthly oil production by Saudi Arabia ('000 b/d)**

![Monthly oil production by Saudi Arabia](source: Joint Organisations Data Initiative)

Indeed, moving forward, the relative importance of gas extraction and further downstream activity is expected to increase in the broader hydrocarbons sector. According estimates by the Arab Petroleum Investments Corporation (Apicorp), Middle East energy investments are expected to reach some USD622bn over the coming five years, some USD207bn of this in the power sector. Some USD195bn is projected to go into the oil sector and a nearly comparable USD159bn into gas. For instance, Saudi Aramco has ambitions increase the production of the country’s gas network from 12bn cfd to 23bn cfd, some of which may involve investment in shale gas in the north of the Kingdom. The interest in gas is expanding also elsewhere, not least because reduced oil output will depress associated gas production.

Having been a key driver of growth during the past year, the regional oil sector is likely to see some output declines due to the OPEC deal.
Crude oil production in other GCC countries, ‘000 b/d

Source: Joint Organisations Data Initiative

Renewed inflationary divergence

Consumer price pressures in the region have generally continued to wane due to a combination of factors:

- The subsidy reforms that were implemented in 2015-2016 initially pushed up inflation but have had minimal secondary effects. Due to the base effect, the YoY change in prices in segments such as food, utilities, and energy has become minimal or even turned negative.
- The recent strength of the US Dollar has reduced imported inflation thanks to the Dollar pegs of the regional currencies.
- Housing costs have been subdued because continued increases in supply along with more measured demand growth. Several regional markets have experienced price corrections.
- There have not been major weather or logistics-related disruptions in the soft commodity market.
- Inflationary expectations are generally well anchored and the ability and willingness of companies to pass on the costs beyond the initial round has been further reduced by the relative slowdown in the non-oil economy across the region.

Thanks to the base effects from the subsidy effects wearing off, Saudi inflationary actually turned negative in YoY terms in January with a reading was -0.4%. Also Qatari inflation has in recent months fallen below 1%. Kuwaiti inflation has tended to be higher by relatively flat, just above 3%. By contrast, Oman and the UAE are seeing some renewed prices pressures. In the UAE, following an average annual rate of 1.8%, consumer price inflation rebounded to 2.8% due to higher fuel costs.

While consumer price pressures are generally subdued, some regional economies are seeing a renewed pick-up in inflation due to subsidy cuts.
Consumer price inflation, %

Sovereign borrowing needs continue to dominate the financial landscape

Liquidity conditions in the region have remained tight by historical standards. Most regional economies have seen stagnant or negative deposit growth along with a gradual deceleration in bank lending. In several regional economies, growth in lending to Government and other public sector entities has tended to outpace private sector credit growth. For instance in Kuwait, credit to the private sector grew at an average rate of 6.4% in 2016 but decelerated to 2.5% in December and 2.7% in January.

The only regional economy to see some improvement in domestic lending in recent months was Qatar where the YoY growth rate in total domestic credit slightly exceeded 14% in February. Also Kuwait saw an increase to 9.5% in February. Most of the region has witnessed a consistent, albeit typically fairly gradual, decline in the pace of credit growth. The annual pace of new lending in the UAE has fallen below 5% while Oman has seen a comparable trend. The deceleration in credit growth has been most pronounced in Saudi Arabia where the annual pace of increase in lending to the private sector and public sector enterprises was only very narrowly positive in February.
Following a strong oil-fuelled rally at the end of 2016, the regional equity market put in a mixed performance in Q1 of this year. Of the seven regional bourses, two – Kuwait and Bahrain – advanced while others posted declines. Kuwait was the region’s strongest performer with a 22.3% gain during the first three months of the year, followed by an 11.1% increase in Bahrain. The other exchanges were largely flat with small losses. Oman declined by 4%, Saudi Arabia’s Tadawul by 2.9%, and Abu Dhabi by 2.3%. Dubai shed 1.4% and Qatar 0.4%.

**GCC equity market indices (January 2015=100)**

IPO activity in the region was subdued by historical standards in spite of growing interest. Qatar Exchange saw the only primary offering when the Investment Holding Group came to the market in January. The construction company offered 60% of its shares to Qatari citizens in a roughly QAR500mn placement. This was the first Qatari IPO since 2014. QE is expecting three more IPOs,

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Please refer to the disclaimer at the end of the document.
including two exchange traded funds this year. In Saudi Arabia, the Al Jazira Mawten REIT Fund was IPOed in late January and listed on 15 February. The fund offered 11.8mn units at SAR10 each.

Continued an established pattern, capital market activity was heavily tilted toward sovereign borrowing. GCC sovereign borrowers raised USD35.5bn on global debt markets in 2016, more than ten times the amount borrowed the previous year.

✎ Kuwait issued its inaugural USD8bn international bond offering in March. This was the third-largest regional offering during the current period of low oil prices. The offering attracted USD29bn in bids and achieved a yield of 2.8% for the USD3.5bn five-year tranche and 3.62% for the USD4.5bn ten-year tranche

✎ Oman returned to the international markets in early March with USD5bn worth of bonds broken down into three tranches of five, ten, and 30 years. This was broadly in line with the OMR2.1bn of international borrowing stipulated in the 2017 national budget. The Central Bank has also issued OMR150mn of domestic debt this year. Oman expects to post an OMR3bn deficit this year

✎ Saudi Arabia returned to the global fixed income market in April with USD9bn sukuk. Bids for the offering exceeded USD33bn. A USD4.5bn tranche was due to mature in 2022 and a similar one in 2022

Also the corporate bond and sukuk market is showing signs of becoming more active. Banks remain active issuers with Bahrain-based Gulf International Bank, Dubai Islamic Bank, and Ahli Bank all coming to the market in Q1. Kuwait’s Warba Bank placed a USD250mn sukuk in mid-March. Other issuers included Abu Dhabi Commercial Bank, Qatar National Bank, and National Bank of Abu Dhabi.

Implications for Bahrain

With the regional growth prospects looking historically modest and liquidity conditions fairly tight, the regional spill-overs are unlikely to make much of a positive contribution to growth in Bahrain:

✎ Regional visitor flows are unlikely to grow rapidly, although Bahrain can continue to capitalize on its location, connectivity, and cost competitiveness. In some cases, these factors seem to be working to Bahrain’s benefits as regional tourists refrain from more long-distance travel

✎ While the more benign outlook for oil prices should benefit trade and investment flows in the region, continued fiscal consolidation will curb the rate of improvement. This is unlikely to result in substantial near-term increases in either area, although both areas do appear fairly resilient
**BAHRAIN**

**NON-OIL CONTINUITY DELIVERS A GROWTH GAIN**

Activity in Bahrain's non-oil economy was characterized by a high degree of continuity in the closing months of 2016. The YoY growth rate of the non-oil sector in 4Q16 was 3.9%, below the 4.6% peak achieved in Q3 but nonetheless high and reflective of the continued strong momentum generated by infrastructure investment. By contrast, the oil sector contracted sharply in Q4, posting a 10.5% YoY drop in real value added. This left the annual increase in the overall GDP growth rate at 1.1%, the lowest quarterly reading posted in 2016. In quarter on quarter terms, this oil sector reversal meant that the economy contracted by 2.7%, the first drop after four consecutive quarters of accelerating growth.

In spite of the reversal in the oil sector growth momentum in the second half of the year, Bahrain experienced a slight acceleration in its headline growth during 2016 taken as a whole. Overall, the economy expanded by 3.0% in 2016 as compared to 2.9% in 2015. Growth in the non-oil economy accelerated from an annual 3.6% to 3.7% over the same period. The oil sector posted a small 0.1% drop in 2015 and 2016 alike. Nominal growth accelerated from -6.8% in 2015 to 2.4% in 2016.

This track record of resilience in the face of an unusually challenging regional economic environment highlights the strength of the structural as well as counter-cyclical growth drivers in the Kingdom. The unprecedented infrastructure investment, in particular, has been a key source of continuity at a time of low oil prices and fiscal consolidation.

**Real GDP growth**

![Real GDP growth chart](chart.png)

*Source: Information & e-Government Authority*
Economic activity in Bahrain is likely to be underpinned by relative continuity in the near- to medium-term. Even as ongoing fiscal consolidation will test the established business models of companies, it will also fuel new investments in greater productivity which counter some of this effect in the short term and boost the productive potential of the non-oil sector in the future.

The large pipeline of infrastructure projects will serve as an important source of continuity and should ensure continued non-oil growth momentum of close to 3% in the medium term. By contrast, we expect more or less flat output levels in the hydrocarbons sector, which should leave headline real growth in the range of 2-2.5%.

Inflationary pressures are likely to be minimal in the near term. However, the implementation of VAT in 2018 should push them up somewhat for a while, as happened with past subsidy reforms.

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**Forecasts: Some growth moderation likely in the medium term**

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*Source: Central Bank of Bahrain, Ministry of Finance, Information & e-Government Authority, Economic Development Board forecasts*
The non-oil sector posts another strong quarter

The breakdown of the real GDP increment in Bahrain points to a high degree of continuity in Q2-4 of 2016. The non-oil private sector contributed 2.8 percentage points of overall growth in Q3 and an almost comparable 2.6 percentage points in Q4. The contribution of Government Services was 0.4 percentage points in both quarters. Oil was the main differentiator, contributing 0.7 percentage points in Q3 and -2% in Q4.

Real GDP growth composition

[Graph showing real GDP growth composition]

Source: Information & eGovernment Authority

Within the non-oil economy, growth remained fairly broad-based, much in line with the pattern observed during the preceding two quarters. With the exception of a small drop in manufacturing, all key sectors of the non-oil economy posted growth of 2.7% or more. The fastest growing sector was once again Social & Personal Services, which expanded by an annual 7.7%. Financial Services grew by an annual 6.3%. The positive momentum of the non-oil economy continued to be underpinned by the Construction sector which expanded by an annual 4.5%. Trickle-down effects from infrastructure investments are likely to account for much of the healthy 4.3% YoY growth seen in Trade and the 4.1% recorded for Real Estate & Business Services.

During the 2016 as a whole, Social & Personal Services was the fastest growing sector. Its 9.1% YoY growth rate attests to the continued strong momentum within private education and health care services within the Kingdom. Social & Personal Services has consistently been one of the most dynamic sectors of the economy and in fact saw an acceleration in its growth rate from 6.9% in 2015. The second fastest growing sector was Construction which expanded by an annual 5.7%. This was comparable to the 6.4% pace recorded in 2015. Financial Services emerged as the third most dynamic sector with 5.2% growth in a marked acceleration over the 1.7% pace recorded in 2015.
Oil production rebounds in Q1

After an unusually weak last quarter of 2016, mainly because of maintenance on the Abu Sa’afah field, oil production normalized in Q1 of 2017. In particular, offshore production rebounded from an average of 129,851 b/d to the above-capacity reading of 157,070 b/d. Production from the onshore Bahrain Field moderated somewhat from 47,421 b/d in Q4 to 45,456 b/d in Q1.

Oil production during 2016 taken as a whole averaged 202,063 b/d. The aggregate output was hence virtually unchanged from 2015 with a small 601 b/d – or 0.3% – gain. Offshore production from Abu Sa’afah field increased by an annual 1.8% to an average 153,538 b/d. By contrast, the Bahrain Field saw a 4.0% drop in its output to 48,525 b/d.
Infrastructure investment delivers continuity

Infrastructure investment is set to remain a leading driver of economic activity in Bahrain over the near- to medium-term. The overall pipeline of projects, as estimated by MEED, stood at some USD69.7bn in mid-March, down 4.4% YoY, but nonetheless an extraordinary pipeline equal to more than twice the Kingdom’s nominal GDP. At the core of this overall total is more than USD32bn worth of priority projects, which are deemed strategically significant in terms of their economic impact, including employment. These project are primarily funded by private investors with the rest coming from a combination of quasi-government funds and the GCC Development Fund. In all cases, project implementation has accelerated over the past year.

In particular, the GCC Development Fund has seen the volume of active projects double from USD1.6bn in 1Q16 to USD3.2bn in February 2017. The aggregate cumulative value of tendered projects has risen from USD4.8bn to USD4.3bn over the same period. The positive momentum is expected to continue during the remainder of 2017 with the year-end total of tendered projects expected to be USD740mn higher than the February reading. The value of awarded projects is set to increase by just over USD1bn.

Housing projects currently account for 29% of the total GCC Fund spending. Electricity and water projects make up 20% and roads 16%. The USD1.1bn airport modernization program alone represents 13% of the total. The first GCC-funded project to have been completed to date is the USD14mn Isa Town boys’ primary school, which was handed over in October 2016. Some 31 other projects are currently underway at various stages of completion.
As in the rest of the region, public-private partnerships are likely to increase in importance for funding and managing projects in order to achieve speedier implementation at a time of fiscal consolidation. Saudi Arabia and Bahrain are reportedly considering the PPP model for the planned King Hamad Causeway, which would constitute the second overland connection between the two countries. A technical and financial feasibility study for the project was completed last year. The proposed causeway is of particular importance because of the GCC rail network which would use it for its link to Bahrain. Bahrain is also planning a light rail network with a consultancy study due to be completed in September.

Another project funded on the basis of the PPP model will be the planned Al Dur 2 water and power project (IWPP). This follows the first phase of the project which was, similarly, structured as an independent water and power project and commissioned in 2012. Al Dur 2 is expected to have a power generation capacity of 1,200-1,500 MW and desalination capacity of some 50mn imperial gallons a day. Power demand in the Kingdom is projected to grow at around 6.4% a year up until 2020. The value of the first Al Dur project was USD2.2bn and the project had a power generation capacity of 1,234 MW along with 181,700 cu m/d of water desalination. Bahrain already produces the vast majority of its power and desalinated water through IWPPs.

The Ministry of Housing and the state-owned Eskan Bank are launching USD3.5bn worth of PPP projects for social and affordable housing. The first two of the planned four projects are breaking ground this year. Additionally, the Ministry of Works has received proposals from six groups for a consultancy contract for the planned expansion of the Tubli sewage treatment plant, which is also expected to be a PPP project.
Several other key infrastructure projects are making headway and include:

- Among key real estate projects, Diyar al Muharraq is due to tender some BHD40mn worth of new infrastructure and housing works over the coming year. The main contract for the Marassi Galleria Mall is to be awarded by the middle of the year.
- Dilmunia Island has awarded the construction contract for its Mall of Dilmunia
- The main building works tender for the Bahrain Fairmont in Salam Beach is expected in Q3

Several projects were tendered during Q1. These include the following:

- Ministry of Housing: a USD150mn construction award for the Al Ramli housing contract and a USD70mn award for infrastructure works for the East Sitra project
- Eskan Bank made a USD50mn award for the construction of the Danat al Lawzi real estate development
- Private real estate projects: a USD50mn construction award for the Waterfront Villas of Dilmunia Health Island, a USD50mn construction award for Sun Tower 2 of Shams al Manama
- Amlak Real Estate awarded a residential project in Umm al Hassam
- Airport modernisation: a USD70mn award for ICT systems, the design and supervision of the air traffic control systems.

**The value of exports increases**

Bahrain’s export trade has posted fairly steady growth over the past half a year. The aggregate value of exports and re-exports rebounded from USD468.8mn in September 2016 to USD627.3mn in January and USD596.6mn in February. The value of exports of Bahraini origin rose from USD376.7mn in September to USD510.7mn in January USD472mn in February. The positive trend is reflective both of increased volumes and of a price recovery in key export products such as aluminium and aluminium products. The price dynamics in the commodities market have benefited from resilient growth in China as well as greater optimism regarding US growth.

Import values have manifested greater volatility. They stood at USD923mn in September, USD1bn in January and USD885.8mn in February.
Economic diversification continues apace

Bahrain has been a regional pioneer of economic diversification, setting up the region’s first oil refinery already in the 1930s. Bahrain became a regional hub for trade and travel by the 1960s. A more structured diversification strategy has been pursued since the 1960s, with the establishment of Aluminium Bahrain (Alba) a key landmark. The creation of a diversified financial centre in the 1970s constituted another major landmark.

The diversification process has also continued to make substantial headway since the turn of the millennium. The share of oil and gas extraction in Bahrain’s real GDP has fallen from 43.6% in the year 2000 to 19.3% as of 2016. Four sectors of the economy – hydrocarbons, Financial Services, Manufacturing, and Government Services – now each generate more than 10% of GDP. Collectively, their share stood at 63.2%. The aggregate share of these four leading sectors was 78.4% at the turn of the millennium and 67.3% a decade ago, in 2006. Apart from the relatively flat hydrocarbons sector, the other three have been important contributors to growth, each growing at a compound average annual rate of more than 5% since the year 2000.

**Source:** Information & eGovernment Authority, preliminary data from Customs Affairs

**80.7% of Bahrain’s real GDP is now generated by the non-oil sector**
As shown above, while the largest sectors have been instrumental in reshaping the Bahraini economy, it is clear that the diversification story in the Kingdom is increasingly shaped by a group of highly dynamic medium-sized sectors. In particular, Social & Personal Services as well as Construction have both posted double-digit compound annual average growth rates during the new millennium. Transportation & Communications has had an annual average pace of 8% over the same period, nearly matched by Hotels & Restaurants at 7.9%. These four sectors taken together have sharply increased their GDP share from a collective 9.8% in the year 2000 to 18.1% in 2006 and 22.8% in 2016. Apart from their dynamism, all four sectors – with the partial exception of construction – are characterized by relatively limited direct or indirect dependence on oil. Rather, their growth is linked to demographic, regulatory, and infrastructure/connectivity drivers.
Bahrain’s real GDP composition, %

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Source: Information & eGovernment Authority

Minimal consumer price pressures

Inflationary pressures in Bahrain have continued their downward trend during the opening months of the year. This is partly reflective of base effects wiping out the impact of the one-time price increases triggered by a range subsidy reforms a year or more ago. However, consumer prices have also benefited from minimal imported inflation, party thanks to the continued strength of the US Dollar, and partly due to a lack of significant market or trade disruptions. The relative stability of the local real estate market has kept housing cost inflation at bay.

The Consumer Price Index in Bahrain, having increased by an average 2.7% in 2016, rose by an annual 0.8% and just 0.4% in February. Food inflation has turned negative as the relevant subsidy reforms happened more than a year ago and new price pressures have been absent. Housing costs have continued to increase at a steady annual pace of 3%. Even transportation costs, which were the key driver of inflation last year, have turned mildly negative. This is primarily reflective of the wearing off of the price boost created by subsidy reforms a year ago.
New loan growth moderates

The growth of bank credit in Bahrain slowed down during the closing months of 2016. While a reduction in the outstanding credit to the public sector was initially the main source of this decline, also private sector credit growth displayed a fairly consistent downtrend since August. Overall, outstanding retail bank credit at the close of 2016 was 2.8% higher than at the end of 2015. The subdued trend was very much in line with developments in elsewhere in the region. Overall lending growth by domestic retail banks further moderated to an annual pace of 2.7% in January 2017.

Year-on-year credit growth to the private sector and government (BHD mn)

Source: Central Bank of Bahrain
Deposit growth has been subdued in line with regional trends. As of December, total bank deposits were up by an annual 1.3%. This accelerated to 2.4% in January.

Deposit liabilities to non-banks (BHD mn)

![Graph showing deposit liabilities to non-banks from 2015 to 2017]

Source: Central Bank of Bahrain

In general, however, the liquidity situation in the banking system remains favourable. As of September 2016, the overall loan-to-deposit ratio of the banking system was 67.9% and liquid assets stood at 22.8%. The capital adequacy ratio of the banking sector as a whole was 19.2% and that of retail banks 19.6%.

The cost of credit has remained fairly stable with some increase seen following the December rate rise. This trend can be expected to continue at a measured pace. Following the most recent rate increase by the US Federal Reserve, the CBB increased its key policy rate on the one-week deposit facility from 1.00% to 1.25%. The overnight deposit rate rose from 0.75% to 1.00%. The one-month deposit rate rose from 1.50% to 1.75% while the lending rate was increased from 2.75% to 3.00%.
Average rate of interest on credit facilities (conventional retail banks)

Source: Central Bank of Bahrain

Bourse recoups losses in Q4

During a mixed quarter for the regional stock exchanges, the Bahrain Bourse was among the stronger performers with an 11.1% gain. This marked a clear acceleration from the largely flat performance during 2016 as a whole. The Bahrain Islamic Index advanced by 14.6% during the quarter.

Bahrain All Share Index and Bahrain Islamic Index

Source: Bahrain Bourse

The performance of most sector indices was positive, with the Industrial index leading the way thanks to a 24.6% gain during the quarter. The Investment sub-index rose by 14% and the Commercial Banks by 12.7%. The Insurance index gained 3.4%.
In a major new initiative, Bahrain Bourse on 26 March launched its new Bahrain Investment Market (BIM). This is a separate listing platform designed for growth companies which can list through a simpler and more cost-effective mechanism than that available on the main market. In order to list, companies must appoint a qualified sponsor which will help them meet the admission and financial disclosure requirements. Two advisory firms have so far been approved as sponsors. Moreover, the national Labour Fund Tamkeen has agreed to support companies seeking a listing by covering some of the associated costs.

In the fixed income space, Bahrain in February launched a USD600mn tap of its 2028 international bond with the pricing set at 6.65%. Short-term issuance by the CBB has continued in line with previous quarters.

**Source: Bahrain Bourse**
### Issue, Value, Maturity, Average interest/over-interest, Average price, Over-subscription

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<th>Issue</th>
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*Source: Central Bank of Bahrain*

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**Job growth remains historically high**

Employment growth in the Kingdom has remained robust in line with the large infrastructure project pipeline. Total employment rose by 8.6% in Q4, the fastest pace during the year. The total number of jobs in the country reached 787,190.
External assessments

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<th>Global rank</th>
<th>MENA rank</th>
<th>Key strengths highlighted</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Human Development Index</strong> by United Nations Development Program</td>
<td>A composite statistic of life expectancy, education, and per capita income indicators that is used to rank countries into four tiers in terms of human development</td>
<td>47 (out of 188)</td>
<td>4</td>
<td>Bahrain is ranked in the “high human development category.” Bahrain ranks above the GCC average in education and healthcare</td>
</tr>
<tr>
<td><strong>Financial Attractiveness Index</strong> by AIRINC (Associates for International Research, Inc.)</td>
<td>As part of its Global 150 Cities ranks 150 cities as places to settle in. These are evaluated in terms of salary levels, the cost of living, and taxes</td>
<td>1 (out of 150)</td>
<td>1</td>
<td>Manama classified as the most attractive city to settle in, followed by Georgetown (Cayman Islands), Zurich, and Geneva</td>
</tr>
</tbody>
</table>
KEY SECTORS

TECHNOLOGY DRIVES CHANGE

Bahrain is working to embrace disruptive technological change on multiple levels in ways that can leverage its competitive strengths in the areas of human capital and connectivity. Work is progressing in terms of creating a comprehensive ecosystem for the development of financial technology (FinTech), while a number of new initiatives are designed to support technology start-ups.

Creating the regulatory foundation for FinTech

A key element of Bahrain’s emerging FinTech ecosystem will have to be a conducive regulatory framework that encourages and enables the kind of creative risk-taking the sector requires. With this in mind, the CBB in March presented its white paper for a regulatory sandbox for FinTech companies.

The White Paper recognises the speed with which new technology start-ups have challenged incumbents in financial services. The White Paper defined the proposed regulatory sandbox as “a safe space in which businesses can test innovative products, services, business models and delivery mechanisms without immediately incurring all the normal regulatory and financial consequences of engaging in the activity in question.” This allows new ideas and innovations to be tested without formal licensing requirements.

Successful innovators can apply for a license and leave the sandbox. For others, their participation is expected to be finite in duration. The sandbox will be open to existing licensed financial institution as well as complete newcomers. These can be financial institutions as well as tech or telecommunications companies. It allows them to offer services to customers in an environment where risks are clearly defined and mitigated.

The CBB is hoping to use the virtual centre to foster competition, technology innovation, better service standards, and financial inclusion. In order to qualify for inclusion in the virtual space, companies are required to offer truly innovative solutions or ones that are significantly different from those currently available in the marketplace. They should also offer demonstrable benefits to consumers. Participants must present developed plans for testing their product and ensure appropriate safeguards to protect customers against risks that in turn must be explicitly outlined. Participants are expected to report to the CBB on their progress and must show can they can deploy the technology in Bahrain or the broader region.

The Government has also been working to expand its regulatory framework more generally in ways that will give companies more flexibility to operate in the FinTech space. A new Investment Limited Partnership (ILP) Law was unveiled this year, the first instance of a GCC country introducing such a law as part of its national legal system, as opposed to free zones. By recognizing new legal structures, the law is expected to support the development of real estate funds, private equity funds, venture capital and technology funds, start-ups, and captive insurance. In formal terms, the law covers the activities of collective investment undertakings, private investment undertakings,
Bahrain has become the first regional economy to introduce an Investment Limited Partnerships Law as part of its mainstream legal system.

The efforts to foster the creation of a comprehensive innovation ecosystem has spawned new accelerators and events.

The law defines investment limited partnership with distinct legal persons and allows investors to contribute to such vehicles without taking an active management role or assuming legal liabilities exceeding their contribution to the fund. This function is to be fulfilled by a general partner which can be a bank of a Category 1 or 2 investment company, which obviates the need to create a separate legal entity for the purpose.

The ILP law is part of a broader financial regulatory reform program which to date also includes a Protected Cell Companies Law and a new Trusts Law. It aligns Bahrain’s legislation in these areas with international best practice.

**ICT entrepreneurship ecosystem takes shape**

Putting in place the key elements of a technology start-up ecosystem has been identified as a key policy goal in the Kingdom and good progress is continuing to be made in this direction with the launch of a new batch of companies at the CS accelerator as well as the establishment of a new accelerator with plans pending for up to three others.

Bahrain is hosting the 10th MIT Enterprise Forum Arab Startup Competition winners in an award ceremony on 27 April. The competition is being held in partnership with Community Jameel, Zain Group, and Tamkeen. 74 semi-finalists from 11 Arab countries are competing for cash prizes in access of USD160,000. The group of contestants will undergo a round of training and present to a jury of prominent regional business leaders and investors. The three tracks have different juries composed of representatives of leading regional and international organizations. The final round of the event was preceded by training and preparatory activities in Egypt, Jordan, and the UAE. The competition originally attracted some 8,272 applications, which marked a 39% increase on the year before. The largest number of applications were received from Egypt, Morocco, Libya, and Saudi Arabia while the most popular sectors were software, education, healthcare, and creative industries.

**Industrial investments advance**

A number of flagship projects in the manufacturing sector are making progress and should be a key driver of economic activity over the coming years:

- Alba has completed its financing for Line 6 with commitments from export credit agencies – a total of some USD700mn. Production is expected to start in 2019. Once fully operational, the new extension will boost capacity by 540,000 tonnes a year, which would make Alba the world’s largest single-site smelter with a total capacity of 1.5mn tn/y. The project includes an approximately 1,800 MW power station which will significantly increase the efficiency of gas utilisation. The company is currently in the front-end engineering and design stage of the project. Most contractors are expected to be on site by June. The project is projected to boost employment by 400-500 people.
In the oil sector, work on the LNG terminal has commenced whereas the recommendation for contract award for the Bapco Modernization Program are expected by the middle of the year. During Q1, Bapco awarded a USD83mn projects for fire protection systems and USD80mn for site preparation.

The growing role of culinary tourism in Bahrain

Bahrain has long been known as an exceptional culinary destination in the region. The Kingdom boasts a wide – and rapidly expanding range of options – in the food service sector. This include a number of unique home-grown options alongside recognized international brands. Food and beverage outlets have become an increasingly important element of the Hotels & Restaurants sector which has shown consistent annual growth reaching 3% and 2% in 2015 and 2016, respectively.

Developers continue to have a strong interest in further expanding the restaurant offerings in Bahrain with sustainable and competitive brands. New food service projects include dedicated restaurant complexes as well as mixed-use developments with a large mix of leasable space devoted to food service. Some of the projects which are contributing to the rise in Bahrain’s restaurant segment include The Terminal (Edamah), El Mercado (First Bahrain), Marina Promenade (Albilad Real Estate), Harbor Row (GFH), and The Avenues (KFCDC).

Also a number of new international brands are interested in exploring the Bahraini market. The Kingdom will welcome an array of well-known brands such as Wildside Texas BBQ, Angelina Paris, and Hakkasan; offering Bahrain’s visitors and residents a further diversified mix of cuisines. Regional favourites such as Reem Al Bawadi and Fire Grill have also taken advantage of Bahrain’s position in the GCC with recent and future openings in the market.

The Bahrain Tourism and Exhibition Authority aims to attract 15mn tourism visits by 2018. The outcome of this increase in tourism arrivals will have a healthy impact on restaurant demand. In addition to tourism arrivals, Bahrain’s population continues to grow with a majority of the population between the ages of 20–39, a typical age demographic that looks for food and entertainment options in the local market. There are several new locations available to restaurant concepts and operators in Bahrain, all offering distinctive advantages. This sector will continue to provide a growth opportunity for the country.
Visitor arrivals by port of entry

Source: Ministry of the Interior – Nationality, Passports & Residence Affairs
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