SUMMARY

NON-OIL GROWTH REBOUNDS IN Q2

The summer months have been characterized by relative continuity for the global economy while the GCC region has faced renewed oil price volatility and fiscal consolidation efforts. While this has exerted some downward pressure on growth, the non-oil drivers appear generally resilient and several indicators point to some increase in activity.

✧ Bahraini growth normalizes in Q2. In Q2, growth was once again led by non-oil sector whereas the oil sector actually experienced a small 1.7% YoY contraction. This followed an unusual Q1, when growth was to a large extent attributable to one-off oil output gains. Headline growth in Q2 was 2.6%, down from the oil-led 4.5% in Q1. This translated to 3.5% YoY during 1H16 as a whole.

✧ Non-oil growth picks up significantly. The pace of growth in the non-oil economy accelerated markedly from 2.7% YoY in Q1 to 3.6% in Q2. This figure was ahead of the preceding three quarters and reflective of the continued activation of a large infrastructure pipeline. The fastest growing sectors in Q2 were Social and Personal Services, Construction, and Financial Services.

✧ Regional growth subdued as fiscal consolidation progresses. Growth in the GCC region has been adversely affected by renewed oil price volatility which in turn has triggered further fiscal consolidation efforts. 2016 may well end up posting the slowest headline growth figures during the current cycle, with region-wide unlikely to be much ahead of 1.5% before a rebound in 2017.

✧ Oil prices have remained volatile as the market rebalances. Following a sustained recovery in the late spring, oil prices manifested renewed volatility during much of the summer as oversupply concerns alternated with speculation about output cuts. The outlines of a deal eventually emerged in late September.

Bahrain economic outlook

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Source: Bahrain Economic Development Board
GLOBAL ECONOMY

MORE OF THE SAME

The performance of the global economy has continued to follow a well established pattern of bouts of volatility followed by a reversal to fairly modest trend rate of growth. At the same time, in an ultra-loose monetary policy environment, the performance of asset markets has been characterized by a search for yield which has driven valuations toward, or even beyond, record levels.

While markets have been rocked by shocks ranging from the Brexit vote in the UK to the abortive coup in Turkey, the global repercussions of such events have tended to be relatively limited in duration. Even as downside risks have proven generally manageable, the long-awaited strengthening of growth drivers has proven elusive. Nonetheless, the current bull run in equity markets has now become one of the longest on record.

The International Monetary Fund (IMF) in its July World Economic Outlook projected global growth of 3.1% this year followed by 3.4% in 2017. Both figures involve a small 0.1 percentage point revision to the previous (April) forecast. Growth is the advanced economies is expected to remain at 1.6% throughout the period, short of the 1.9% pace seen in 2015. Growth in emerging markets, by contrast, is projected to accelerate from 4.2% this year to 4.6% in 2017. This compared to 4.0% in 2015.

Global growth prospects

The elusive prospect of interest rate normalization

Following the interest rate increase by the US Federal Reserve last December, financial markets this year have been periodically disrupted by speculation of another hike. In response to such instability, which has tightened monetary conditions by strengthening the Dollar, the Fed has
invariably retreated. Global risks and weaker-than-expected performance of the US economy in the first half of the year have further justified such decisions. For instance, Q2 growth was revised down to an annual 1.1% in spite of robust consumption growth.

While the case for another rate increase seems to be strengthening once again, expectations regarding the future trajectory of rates continue to be scaled down. Some Fed officials have suggested that after the next increase, rates might remain on hold throughout 2017 and 2018. Even Open Market Committee Chair Janet Yellen recently indicated that the current rate cycle might peak at no more than 2% and suggested that the monetary accommodation inherent in the current stance is small. This marks a sharp contrast to the projections of four interest rate increases that were made in December 2015.

The Federal Reserve has linked interest rate increases to a “strong” economy and the 2% inflation target being met. The fundamental challenge facing policy makers in the US and beyond is stagnant productivity and a global savings glut. The Fed in September modified its GDP growth rate for this year from 2% to 1.8%, a figure that is also expected to be the trend rate going forward. Inflationary pressures are set to remain below the 2% target this year and next. Also labor market slack is seen as persisting for longer than expected.

Following a slew of mixed economic data in August, the Fed Open Markets Committee in September voted once again against a rate hike. For instance, US job creation slowed down sharply from 271,000 new jobs reported in July to 151,000. Also wage data was subdued and retail sales fell short of expectations. However, the Committee signalled that the case for a rate increase had strengthened and was generally thought to have left open the possibility of a rise before the end of the year. The Fed’s median rate forecast for 2017 now centers at 1.125%, followed by 1.875% in 2018 and 2.625% in 2019.

Global equity market performance

Across the developed world, economic growth has remained disappointing, while inflationary pressures appear minimal. Under the circumstances, most other central banks have signalled a
bias toward further easing. For instance, Bank of Japan (BoJ) Governor Haruhiko Kuroda has repeatedly underscored his determination to loosen policy until the Bank’s 2% inflation target is met. The bank in September set a 0% cap on 10-year bond yields. Policy rates currently stand at -0.1%. BoJ has been pursuing quantitative easing since 2013. Similar, the European Central Bank remains committed to a permissive policy, but quantitative easing has raised concern over a growing shortage of investable assets.

Volatility returns to oil markets and helps trigger a deal

Oil prices rallied sharply during the spring months with Brent rising from its January low of USD27.88/barrel to a peak of USD52.51 on 8 June. Since then, the price has fluctuated between just under USD42 and USD52 per barrel in reflection of conflicting market drivers. This renewed volatility ultimately helped trigger an agreement among OPEC in late September to cap total output at 32.5-33 mbd, a figure comparable to production in January. While the details of implementation remain to be worked out, the Algiers agreement offers a real prospect of curbing production at a time when it was beginning to look like the supply glut in the markets could persist past 2017.

The renewed focus on controlling supply is reflective of growing concern over the strength of global demand growth. After some downward revisions in September, the International Energy Agency (IEA) expects global oil demand to grow by 1.3 mbd this year, followed by 1.2 mbd in 2017. At the same time, a number of key market players, led by Saudi Arabia, have continued produce at close to their historic record levels. Global oil production in August reached 96.9 mbd, some 300,000 b/d down YoY. OPEC production reached 33.19-33.47 mbd in August, at least 150,000 b/d more than in January and up nearly 1 mbd YoY. Saudi Arabia’s output has exceeded 10 mbd for 17 straight months, reaching a record 10.67 mbd in July. Concurrently, Iran has been fairly consistently ramping up production toward pre-sanction levels. While this has delayed market rebalancing, it also appears to have allowed OPEC to make headway toward its stated goal of reclaiming market share form unconventional producers. OPEC’s global market share now stands at just under 42%, its highest level in over four decades, and is expected to rise further. For instance, the IEA project non-OPEC output growth to cover less than a third of the projected demand increase next year.

Non-OPEC production has remained under fairly sustained downward pressure and is expected by the IAE to fall by 840,000 b/d this year. Notably in the US, production has contracted from its April 2015 record of 9.69 mbd to 8.46 mbd in August following a 52% drop in investments in the shale sector over the past two years. However, the stabilization of oil prices has slowed down the US retrenchment and some shale producers are estimated to be able to sustain production with prices of USD45-55 per barrel. This may help sustain US production even in the face of a major debt crisis. There has been a fairly steady increase in the rig count from a trough of 316 in May to 418 in late September, although the figure is still far short of the peak of 1,609 in October 2014. The US Energy Information Administration (EIA) expected US crude production of 8.77 mbd this year, down on 9.42 mbd last year. The projection for 2017 is 8.51 mbd. Also China has seen output falling as work on mature fields has wound down. By contrast, however, countries such as Norway and Brazil are...
ramping up production while Phase I of Kazakhstan’s much delayed Kashagan Field is due to begin production this year. The IEA projects a 380,000 b/d rebound in non-OPEC production next year.

Even within OPEC, countries such as Venezuela, Nigeria, Libya, and Algeria have struggled to maintain output levels. For instance, Venezuela’s output in July was 2.27 mbd, the lowest since April 2011. Nigeria posted a 30-year low of 1.4 mbd in May, down by a third from its 2015 peak. In cases where this has been due to internal strife, any resolution to such conflicts remains an upside risk on new supplies. Something of a rebound now appears to be underway in Libya.

With the prospect of more formal output control by OPEC, oil prices are generally expected to continue to edge up in the coming months. However, the multitude of uncertainties overshadowing the market suggests that significant volatility may well persist for a considerable period. Beyond this, sharp investment cutbacks are fuelling concern over the longer-term outlook. Upstream capital investment globally fell by 25% to USD583bn last year, a figure that compared to USD777bn in 2015. The IEA projects a further USD42bn drop this year. Overall, global oil and gas investment has been cut by nearly USD300bn (41%) and rig counts have dropped by 37% since the 2014 peak.

Monthly average crude oil prices (USD/barrel)

Source: US Energy Information Administration
Global oil demand and supply dynamics (mbd)

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<th>IEA</th>
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Implications for Bahrain

The relative continuity in the global economic conditions should entail little change in the external backdrop shaping the performance of the Bahraini economy.

❖ The cost of borrowing is unlikely to increase significantly in the months ahead even if the Federal Reserve does hike rates before the end of the year

❖ Any sustained departure of oil prices from their current range looks unlikely in the short term, which underscores the continued need for fiscal rebalancing even as prices edge up
Economic growth in the GCC has shown continued resilience this year. However, it is becoming increasingly evident that the continued oil price correction and the ongoing fiscal re-engineering efforts by the regional governments have weakened some of the key traditional growth drivers and tested sentiment. In general, growth across the region is expected to fall clearly short of last year’s levels before rebounding somewhat in 2017. For instance, the latest IMF projection for Saudi growth put the headline figure for this year at 1.2%, followed by 2.0% in 2016.

The IIF expects non-oil growth in the GCC to decelerate from close to 3% in 2015 to less than 1.5% this year before rebounding to the neighbourhood of 2% in 2017. Saudi headline growth is projected at 1% this year and 1.2% next year, whereas the corresponding figures for the UAE are 2.2% and 2.7%.

**GCC real GDP growth, %**

![Graph showing GCC real GDP growth from 2010 to 2017. GDP and Non-oil data are plotted.](source: Institute of International Finance)

### Structural growth drivers remain robust

Intermediate data for the individual GCC economies points to continued general weakening of the non-oil growth momentum. Economic growth in the region’s largest economy, Saudi Arabia, declined to an annual 1.5% in Q1 and marginally further to 1.4% in Q2. Growth in Q1 was above all due to the oil sector where record output levels fuelled a 5.1% YoY expansion. The main negative on growth was a decline in the government sector which pulled the overall non-oil growth rate to -0.7% YoY. By contrast in Q2, the non-oil sector expanded by 0.4 with the non-oil private sector posting a small 0.1% gain. Oil sector growth moderated to an annual 1.6%.

Indicators of Saudi economic activity in recent months have been mixed with a sharp drop in consumer spending in the summer, although employment levels are moving up with 201,500 new
jobs created in net terms during the first half of the year. Import volumes have remained on a fairly consistent downtrend in recent months, dropping by an annual 24% in July. Non-oil exports have been more mixed but nonetheless recorded a fall of 10% YoY in July.

In the UAE, the Central Bank projects real growth of 2.8% this year followed by 3.0% in 2017. This represents a deceleration from 4.0% in 2015. Non-oil growth is projected to remain fairly steady: 3.5% in 2016 and 3.6% in 2017, down marginally from 3.7% in 2015. The Emirates NBD Dubai Economy Tracker points to a slight pick-up in economy activity, although the August reading of 55.7 marked a slight drop from 2016 high recorded in July. Overall, economic activity in the summer looked brisker than during the first half of the year. The output index was above 60 for the second consecutive month. Sales are continuing to grow, albeit partly due to price discounting.

The Qatari economy expanded by an annual 1.1% in real terms during Q1. The Mining and Quarrying sector (mainly hydrocarbons) contracted by 3.0% whereas the non-oil economy grew by 5.5%. Revised estimates by the Ministry of Development Planning and Statistics show that real growth of the Qatari economy reached 3.6% in 2015 and an average (CAGR) of 4.2% in 2011-2015. Qatari growth is expected to strengthen to over 3% for the year as a whole and close to 4% in 2018. Investment spending, partly in preparation for the FIFA World Cup will be an important source of momentum.

The Kuwaiti economy posted 1.8% real growth in 2015 in an increase from 0.5% in 2014. High levels of investment were a major contributor to this expansion and rose by 13%. Non-oil growth was estimated at 1.3% whereas the oil sector shrank by a real 1.7%. Growth is expected to remain on a positive trajectory this year with a continued pick-up in the implementation of projects under the current economic plan.

In line with the relative resilience of non-oil activity, the scale of infrastructure investment in the region has remained broadly stable. The aggregate value of the GCC project pipeline according to MEED was just over USD2.82trn in mid-September, almost exactly equal to the reading a year earlier. While Saudi Arabia has seen a small 3.2% YoY drop in its pipeline to USD1.17trn, the UAE experienced a 3% increase to USD866.2bn. The sharpest YoY drop was registered in Qatar: by 6.9% to USD268.4bn. By contrast, Oman saw the largest increase, by 15.8% to USD196.8bn. All other regional economies posted YoY gains.

Also forward-looking indicators of economic activity in the region point to generally firmer confidence in recent months. The Emirates NBD Purchasing Managers’ Index (PMI) for Saudi Arabia reached a reading of 56.6 in August, the highest in a year. Although, it subsequently relapsed to 55.3 in September, the quarterly average for July-September (56) was ahead of 1H16 (53.4). By contrast, the UAE index has shown somewhat greater volatility, declining to 54.1 in September as compared to a 2016 high of 55.3 in July. In both economies, new orders, especially exports, remain the main area of weakness.
In spite of significant steps toward fiscal reform, the budget deficits across the GCC look likely to be broadly comparable to last year’s levels. The IIF projects an overall deficit of 11% of GDP for the regional as a whole. In a departure from last year, a greater proportion of the shortfall is expected to be financed through foreign borrowing, partly to protect domestic bank liquidity, partly avoid having to draw down fiscal buffers. The IIF expects foreign borrowing to total USD50bn this year and USD40bn in 2017.

At the same time, the regional economies are continuing with their structural reform efforts to reduce government expenditure and to diversify their revenue bases. A GCC ministerial meeting in June approved in principle regional value-added tax (VAT) and excise duty treaties. National legislation on VAT is expected to be implemented as of January 2018.

But also a range of other measures are being pushed through. Saudi Arabia is reportedly considering plans to cancel more than USD20bn worth of projects and to cut ministry budgets by a quarter. A range of Government fees and fines have been increased. In late September, the Saudi Government reduced public sector bonuses and benefits. Ministerial salaries were cut by 20% and allowances of the Shoura Council members by 15%. The Saudi National Transformation Plan has set a goal of reducing public sector salaries from the current 45% to 40% of budget by 2020. It also seeks to save USD53bn on subsidies by 2020. Saudi Arabia is projecting a budget deficit of USD87bn this year, down from USD98bn in 2015. As a percentage of GDP, the deficit is set to contract from 15.9% to 13%.

The Kuwaiti Government presented plans to raise gasoline prices by 42-83% (depending on the grade) in September. This step is estimated to reduce government spending on subsidies by 22.1% and constitutes part of a broader overhaul. The budget law puts the cost of subsidies this year at KWD2.9bn, or 15% of total spending. Kuwait last year posted a deficit of KWD5.5bn, much lower...
than projected but up sharply on KWD2.31bn in FY2014/15, which the first deficit since FY1999/2000. The deficit this year is expected to reach KWD7bn (USD23bn). Projected spending is KWD18.9bn.

While a range of reforms are generally beginning to put the fiscal situation across the region on a more positive trajectory, some of the measures are having broader economic implications. Among other things, more market-based pricing for goods that were previously subsidized is curbing consumption. For instance, Saudi Arabia saw a small decline in the domestic demand of gasoline, kerosene, and other refined products in H1. Saudi Electricity Company in September reported the first drop in power demand since its formation 15 years ago.

### Energy diversification gathers momentum

Investments in renewable energy are emerging as an increasingly important theme in the region as the costs of solar energy hit new record lows and subsidies on hydrocarbons are modified. All the regional economies are now exploring alternatives, above all solar power, to help address their rapidly growing power needs.

Large-scale solar generation in the GCC was pioneered by Abu Dhabi which launched its 100 MW Shams concentrated solar power plant in 2013. Abu Dhabi is now planning a 350 MW solar PV plant at Sweihan. The facility will be developed as an independent power project and is due to begin operations in Q4. ADWEA recently announced that the levelized cost of electricity of the six bids it had received for the project ranged from AED0.089/kWh to AED0.133, ie 2.42-3.63 US cents, which sets a new record.

Dubai completed its first, 13 MW solar PV facility in 2013 – the first phase of a planned 5 GW Mohammed bin Rashed al Maktoum Solar Park at Seih al Dalal. By its projected completion in 2030, the part is expected to draw total investments of AED50bn. DEWA this year selected a consortium led by Masdar to build the 800MW third phase of the project with a planned 2020 launch date. The project will be developed as an IPP and the winning bid was based on a record 2.99 cents/kWh life cycle cost. In a sign of the speed with which costs are declining, this was only 51% of the winning bid for the 200 MW second phase, which is due to be operational next year.

DEWA has also launched a new Shams Dubai scheme to encourage the installation of rooftop solar panels which are estimated to generate up to 1.5GW of power by 2030. Dubai Municipality has announced plans for the region’s largest, 60 MW waste-to-energy plant at Warsan. It is expected to have capacity to process close a third of the emirate’s solid waste. Plans for three similar facilities are under consideration. Dubai is planning to generate a quarter of its electricity from renewables by 2030 and 75% by 2050. Also FEWA, which produces power for the northern emirates, has announced plans for 200 MW of solar capacity. Apart from solar power, the UAE has 5.6GW of nuclear power capacity under development along with 5.1GW of coal-fired capacity.

The Saudi Government has set a renewables capacity target of 3.45 GW by 2020, followed by further expansion to 9.5 GW by 2030. This compares to current solar capacity of 25 MW. Saudi Electricity Company (SEC) has approved plan for solar and wind projects with a combined capacity of 300MW. Projects planned by Saudi Aramco would take the current pipeline to 483 MW. Saudi
Arabia is also planning to leverage solar energy to improve the efficiency of combined cycle power plants through ISCC technology.

**Record-breaking oil production**

In line with OPEC’s policy of boosting its markets share, the regional economies have been posting record oil output levels in recent months. Saudi Arabia turned out an all-time high of 10.67mn b/d in July, according to official figures, followed by a comparable 10.63 mbd in August. This followed a H1 average of 10.29 mbd. Saudi Arabia’s capacity to export has further benefited from the increased use of gas following the launch of the 1.7bn cfd Wasit gas plan in March. Saudi crude burn in H1 was down 0.9% in YoY terms at 474,000 b/d. Saudi Arabia plans to boost its gas production capacity to 17.8bn cfd by 2020, a figure that compares to 11.6bn cfd last year.

Also the other regional producers have been operating near record output levels. Kuwait produced 2.99 mbd in August and is planning to hike its output to around 4 mbd by 2020, while the UAE extracted 3.15 mbd and is planning to increase its crude capacity to 3.5 mbd by 2018. Oman’s crude oil and condensate production averaged 1 mbd in 1H16, a record high over a six-month period and up from 970,000 b/d YoY. Exports averaged 901,000 b/d.

At the same time, the regional economies are continuing to invest heavily in downstream. For instance, Saudi Arabia’s National Transformation Program 2020 foresees an increase in the Kingdom’s refining capacity from 2.9 to 3.3 mbd by 2020. This will be reached once the 400,000 b/d Jazan refinery becomes operational. Saudi refineries saw a 17.6% YoY output increase in H1 to 2.764 mbd. Saudi product exports have more than doubled since late 2011 to 1.4 mbd and now total some 16% of overall hydrocarbons exports (crude and products) of the Kingdom.

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

![Monthly oil production by Saudi Arabia](image-url)

*Source: Joint Organisations Data Initiative*
Crude oil production in other GCC countries, ‘000 b/d

Source: Joint Organisations Data Initiative

Renewed inflationary convergence

Inflationary pressures across the GCC have increased somewhat over the past year or so as regional economies have sought to rationalize their subsidy regimes. In general, however, the impact of such measures has been fairly muted. In no regional economy has the annual rate of inflation exceeded 5%. Moreover, any spikes caused by subsidy reform or other factors have been limited in duration with the headline readings typically beginning to decline again within months. This underscores the high degree to which price expectations are anchored in the region and the limited pass-through of higher consumer prices through second round effects. The fixed exchange rate regime is likely to have served as an important source of this stability.

In general, consumer price trends across the region have shown signs of converging in recent months. The highest readings in Saudi Arabia have come down fairly clearly from their 4.2% peak in the spring. Conversely, Oman, which for a while recorded minimal price pressures, has seen the pace of consumer price inflation pick up fairly consistently. Consumer prices in Oman rose by 1.3% YoY in August, which compared to 0.1% a year earlier but was still, albeit very marginally, the lowest reading in the region. The average rate of inflation in the GCC (ex. Bahrain) was just over 2.5% in July.
Consumer price inflation, %

Financial market activity dominated by sovereign issuance

Bank lending across the Gulf region has continued to hold up well, even if a growing number of institutions have had to turn to new, mainly foreign funding sources as deposit growth has remained fairly subdued. It varied between -3.1% YoY in Saudi Arabia and 9.8% in Qatar as of July. Omani deposits contracted by 1.6% (June) while the UAE saw 3.5% growth. The YoY pace of expansion was 4.6% in Kuwait. Moreover, in much of the region, domestic debt issuance has drained liquidity. For instance, Saudi banks have increased their holdings of government bonds more than threefold over the past year to more than SAR160bn as of July.

In response to the liquidity pressures, the Saudi central bank SAMA in late September revealed plans to deposit SAR20bn with Saudi commercial banks along with the introduction of new money market instruments – notably seven and 28-day repurchase maturities – to counter liquidity constraints in the system. Saudi bank credit in July fell for the first time since December 2014 in MoM terms, by 0.3%.

More generally, the YoY pace of credit growth has tended to edge down gradually across the region, although it remains comfortably above 5% everywhere. In the summer, the YoY pace of credit growth varied between approximately 6% in the UAE and some 15% in Qatar. The other regional economies saw more or less comparable rates of expansion between 8 and 9% YoY.

Source: National statistical agencies
The performance of the regional stock markets has reflected the volatility in the oil markets as well as the impact of fiscal consolidation. In spite of some improvement in the underlying trend, the regional exchanges posted a mixed Q3. Dubai, Kuwait, and Qatar posted gains at 4.9%, 0.6%, and 5.6%, respectively. By contrast, Saudi Arabia shed 13.5%, Oman 0.9%, and Abu Dhabi 0.5%. The year-to-date performance of the indices has reflected these divergent trends. Gains have been led by the UAE exchanges and Oman. Dubai rose by 10.3% during the first three quarters of the year, followed by a 5.9% gain in Oman and 3.9% increase in Abu Dhabi. Qatar posted a small 0.1% gain. By contrast, Saudi Arabia declined by 18.6% and Kuwait by 3.9%.

Debt capital markets have remained the most dynamic segment of the regional financial sector, led by substantial sovereign borrowing requirements. Issuance in this has been overwhelmingly...
conventional while the sukuk segment of the market has been under downward pressure. This has reflected a global trend with overall sukuk offerings during the first eight and a half months of the year reaching USD39.3bn, as compared to USD48bn a year earlier. In the GCC, sukuk issuance has been on a consistent downtrend since 2013. Total YTD issuance as of mid-September was USD9.5bn, down on USD13.1bn a year earlier. S&P Global expects the year as a whole to see GCC sukuk offerings of USD13.5bn, which compared to USD17bn in 2015 and the 2013 peak of USD26bn.

By contrast, GCC conventional bond issuance YTD reached USD51.4bn as of mid-September, up sharply on USD27bn a year earlier. The projection for the year as a whole is USD73bn, which would compare to last year’s record of USD58bn set last year. In a challenging fiscal situation, conventional issuance appears to benefit from shorter structuring times, lower costs, and a broader range of investors on the demand side.

The conventional space has continued to be dominated by sovereign issuance. Qatar Central Bank in September placed QAR1.975bn (USD543mn) of government bonds with tenors of three to 10 years. This followed the placement of QAR4.6bn (USD1.3bn) in August along with a QAR1.6bn sukuk. Kuwait is planning to raise some KWD5bn (USD16.7bn) from domestic and international this year. Roughly KWD3bn is expected to be international borrowing.

Also regional banks remained active issues, an example being Qatar National Bank’s recent USD1bnn five-year offering. Similarly, energy companies have sharply increased issuance. For instance, Saudi energy companies have borrowed USD23.1bn in the last 18 months, almost as much as the USD23.4bn they took in all of the previous eight years.

**Implications for Bahrain**

While the relative cooling down of the regional economy will inevitably result in some negative spill-overs, available evidence points to an at most muted impact to date:

- Bahrain is continuing to show resilience in the area of tourism because of its central location, easy overland connectivity for regional tourists, and competitive costs as compared to the rest of the region
- While investors may be more cautious in general, Bahraini projects are continuing to benefit from attractive valuations and good returns
NON-OIL GROWTH ACCELERATES IN Q2

After a strong start to the year with 4.5% YoY growth in Q1, real GDP growth in Bahrain reverted closer to its recent norm with a 2.5% headline rate of expansion in real terms during Q2. This equated to 1.2% in QoQ terms, which marked a continued acceleration in growth since the last quarter of 2015. The composition of growth was sharply reversed from the opening months of the year. The oil sector posted a small 1.7% YoY contraction, having expanded by 12.4% in Q1. By contrast, momentum in the non-oil economy rebounded markedly from 2.7% in Q1 to 3.6% in Q2. This was only marginally short of the 3.9% non-oil growth seen during 2015 as a whole. The positive trend is likely to be at least partially linked to a significant build-up in infrastructure investments over the past couple of quarters.

Real growth during the first half of the year taken together was 3.5% YoY. The non-oil economy expanded by just under 3.2% while the oil sector, thanks to its strong rebound in Q1, expanded by 4.8% even allowing for the Q2 drop. These figures are largely in line with the rate of growth recorded in 2015.

Real GDP growth

The non-oil sector returns to the fore

Following a somewhat atypical period in terms of the composition of growth in Q1, the non-oil private sector once again reasserted its position as the leading force of economic expansion in Q2. It contributed virtually the entire GDP increment during quarter, with Government Services and the oil sector largely cancelling each other out.
Projected real GDP growth contribution (%)

Economic growth in 2016 is expected to come close to matching the 2015 level. Some moderation is likely thereafter as Bahrain, along with the rest of the region, will continue to reform its fiscal system. While this will ultimately support investor confidence, it will curb Government expenditure and will result in some moderation of private sector activity. Similar efforts across the rest of the region are likely to have a moderately negative effect on economic activity in Bahrain through negative spillovers. Nonetheless, GDP growth will continue to be underpinned by strong structural drivers. In particular, the accelerated implementation of major infrastructure projects will counter much of the adverse impact of fiscal consolidation on growth. At the same time, infrastructure investment can be expected to have strong positive linkages to other sectors of economy.
The fastest growing individual sector during the quarter was Social & Personal Services, a category dominated by private education and health care. It has been consistently one of the most dynamic sectors of the economy in recent years and grew by an annual 9.9% in Q2. This figure in fact marked a slight acceleration from the 8.4% pace recorded in Q1.

The Construction sector expanded by an annual 5.9% in a slight pick-up from 5.4% in Q1, as could be expected in view of increased project activity. The Financial Services sector has continued to perform well with a 4.0% pace of real growth in Q2. This was ahead of the 3.1% YoY rate seen in Q1 but also well above the 1.7% observed for 2015 as a whole. The Manufacturing sector expanded by 3.3% in Q2 in a near-tripling of the pace seen in Q1. For instance, the petrochemicals company GPIC achieved its highest ever output in September.

### Real GDP growth composition

![Real GDP growth composition chart]

**Source:** Information & eGovernment Authority

The growth of the non-oil economy was led by private education and health care, construction, and financial services.

<table>
<thead>
<tr>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>YoY growth</strong></td>
<td><strong>Annual</strong></td>
</tr>
<tr>
<td>Crude Pet. &amp; Nat. Gas</td>
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</tr>
<tr>
<td>Manufacturing</td>
<td>4.1%</td>
</tr>
<tr>
<td>Construction</td>
<td>6.4%</td>
</tr>
<tr>
<td>Trade</td>
<td>1.7%</td>
</tr>
<tr>
<td>Hotels &amp; Restaurants</td>
<td>3%</td>
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<tr>
<td>Transp. &amp; Comm’s</td>
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</tr>
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</table>
Oil output remains robust

The oil sector continued its strong performance in the late spring with Q2 almost comparable to Q1 in terms of the output level. Total production reached 209,105 barrels a day in Q2, which marked a slight decline from the 211,256 b/d rate observed in Q1. The growth contribution of the oil sector in YoY terms was negative because the Q2 totals fell short of the very high rate of 212,273 b/d seen in Q2.

Both the offshore Abu Sa’afah field and the onshore Bahrain field saw some moderation in their rate of production in Q2. The Bahraini half of Abu Sa’afah’s extraction came to 160,454 b/d in Q2, down very marginally – 0.3% – on the level seen during the opening months of the year. Nonetheless, the figure was well above the standard capacity share of 150,000 b/d. Bahrain field production dropped by 3.4% in QoQ terms, although it was up 0.8% over 2Q15.

Source: Information & e-Government Authority
The implementation of GCC-funded project has accelerated sharply and the active pipeline is now nearing BHD4bn

Project implementation accelerates

The pick-up in non-oil growth in Q2 is likely to have been at least partially reflective of a significant build-up of the project pipeline funded by the GCC Development Fund. The total cumulative value of the projects tendered as of August was just over USD4bn. Nearly USD3.8bn worth of projects have been awarded and just over USD3.7bn worth actually commenced. A year earlier the value of active projects was only a third of this (USD1.2bn) by comparison. The aggregate value of active, GCC-funded projects is expected to exceed USD4bn by the end of the year.

As of now, 36% of the projects are in housing, 21% in electricity and water, and 12% in roads. The airport modernization accounts for 16% of the total. The initial preparatory infrastructure work for the airport project has now been completed.

Source: National Oil and Gas Authority

Crude oil production, b/d

<table>
<thead>
<tr>
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<td>150,000</td>
<td>200,000</td>
<td>250,000</td>
<td>200,000</td>
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<tr>
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<td>250,000</td>
<td>200,000</td>
<td>250,000</td>
<td>200,000</td>
</tr>
</tbody>
</table>

Source: National Oil and Gas Authority
GCC Development Fund project pipeline, USD mn (cumulative totals)

The manufacturing project pipeline is dominated by Alba Line 6 and the Bapco Modernization Program

Source: Government sources

Also other projects, most of them private or linked to government-related funds, are seeing good momentum:

- The aluminium smelter ALBA recently announced that it had received financial commitments of USD1.5bn from banks for the Line 6 project. In August, it awarded the construction of a 1,792 MW fifth captive power station to a consortium of GE and Turkey’s Gama Power Systems
- Work has begun on a new Deerat al Oyoun development which is part of the Diyar al Muharraq island development
- Work on a new central market is to commence in Muharraq. Muharraq will also be the site for a new BHD45mn Sa’ada multi-purpose development that will connect the old souq with the waterfront
- Japan’s JGC won a USD98.7mn contract for a gas pipeline system and storage facilities, awarded by the Bahrain National Gas Expansion Co., a subsidiary of nogaholding. The venture constitutes the second phase of the Bahrain Gas Plant project. Upon completion, the combined processing capacity of BNGEC and Banagas will increase to 653mn cfd. The work is expected to be completed by the end of 2018

Overall, Bahrain saw an 11% YoY increase in the number of construction permits issued during the first eight months of the year. A total of 7,447 projects with an aggregate value of BHD1.3bn were approved since January. The Ministry of Works, Municipalities, and Urban Planning issued 685 permits for investment projects over the same period.

The total infrastructure project pipeline was put by MEED at USD72.5bn in mid-September. This marked a 1.7% YoY increase:
- Just over USD1bn worth of Bahraini projects were awarded in July, according to MEED. This consisted of the main EPC contract for the fifth captive power plan at ALBA
USD979mn worth of new projects were awarded in August. New announcement included a USD53bn construction award for the Ikea store by Ghassan Ahmed al Sulaiman Development Co., the USD584mn Deerat al Oyoun project by Diyar al Muharraq, the Utilization of Hidd water tanks by the Ministry of Electricity and Water (USD20mn), the ALBA power distribution package (USD100mn), a 507-villa East Hidd housing project by the Ministry of Housing (USD54mn), and East Hidd infrastructure works (USD161mn).

The total value of projects awarded in September was USD482mn, according to MEED. This figure was accounted for by the Muqaba sewerage network project of Ministry of Works and Urban Planning. In addition, Amlak Real Estate awarded the Souq al Buhair renovation project.

Trade dynamics reflect lower commodity prices

Foreign trade volumes have shown some softening in the summer months, which is likely partially attributable to seasonal factors, such as reduced hours in the construction sector. Also low commodity prices globally have had an impact.

The most important sources of imports in August 2016 were China (USD130mn), the UAE (USD84mn), the US (USD77.9mn), Japan (USD77.6mn), and Saudi Arabia (USD65.5mn). The most important types of imported goods were motor vehicles, followed by aluminium oxide, and mobile phones.

The main exports were iron, aluminium, and petrochemical products. The main markets for products manufactured in Bahrain were Saudi Arabia (USD79mn), the US (USD67.2mn), and Qatar (USD42.8mn). The main important destinations for re-exports were regional: Saudi Arabia (USD48.2mn), the UAE (USD13.8mn), and Kuwait (USD4.8mn).

Non-oil trade, USD mn

![Non-oil trade chart]

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

Price pressures moderate
The Consumer Price Index is Bahrain has mirrored regional dynamics and remained under general upward pressure over the past year in connection with subsidy reforms in various areas. However, price pressures have typically abated somewhat during the summer months, which suggests that the policy changes are not having much of an enduring impact on price dynamics. Consumer prices in the Kingdom increased by 3.2% during the first eight months of the year, which is broadly in line with historical trends. The YoY headline rate of inflation reached its highest point during this year in April when it stood at 3.8%. Since then, headline inflation has gradually moderated to 2.6% as of August.

Among the main components of the CPI basket, price pressures have been mainly associated with Transportation costs in connection with the normalization of fuel prices. Transportation inflation reached a high of 14.1% YoY in January. Since then, it has shown a gradual deceleration to 12% as of August.

Housing cost inflation accelerated in the spring to a YTD high of 4%, a figure that subsequently declined to 3.8% as of August. Food prices have shown greater volatility around a general downtrend during the year. They reached a high of 6.8% YoY in February but fell to a low of 1.1% in August.

### Consumer price inflation

![Graph showing Consumer price inflation](image)

Source: Information & e-Government Authority

### Credit growth moderates somewhat

In spite of region-wide concerns about liquidity, bank lending in Bahrain has remained healthy, expanding by an annual 4.4% as of the end of June. The pronounced deceleration from 7.6% YoY rate seen in May was due to a drop in new lending to the Government. The average annual rate of credit growth during the first half of the year was 7.2%.

Credit growth has tended to be led by private sector loans, although January-May saw also historically high increments in lending to the public sector. As of June, loans to the general
government sector accounted for 3.4% of total outstanding bank credit. At BHD274.5mn, they were 2.4% lower than a year earlier.

54.2% of total bank credit was made up of business loans in June, a 0.8% increase on a year earlier. The construction and real estate sector accounted for 16.7% of all outstanding loans, followed by trade at 14.5%, and 7.3% by manufacturing. Personal loans made by 44.3% of all outstanding bank credit and, at BHD3.54bn, were up 9.7% in YoY terms. Reflecting the ongoing infrastructure activity, there has been a marked increase in mortgages. The volume of loans secured by a property mortgage rose from BHD1.03bn in June 2015 to BHD1.47bn a year later. Their share of total outstanding loans rose from 13.4% to 18.3%.

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

Echoing region-wide trends, deposit growth has been fairly subdued in recent months. The total deposits of Bahraini retail banks stood at BHD16.46bn in June. This marked a 2.9% increase in YoY terms.

The overall liquidity situation remains favourable with the ratio of retail bank loans to non-banks standing at 48.6% of their deposits. This figure compared to 47.9% a year earlier.

Deposit liabilities to non-banks (BHD mn)
The cost of borrowing remained generally stable, in fact even declined somewhat during the first of the year. The Central Bank of Bahrain in late September decided to keep its key policy rate, the one-week deposit facility, at 0.75%. The overnight rate remained at 0.5%, whereas the one-month rate was increased from 1% to 1.25% and the repo lending rate from 2.25% to 2.5%.

Average rate of interest on credit facilities (conventional retail banks)

The cost of credit has remained more or less flat in recent months.

Bourne rebounds in Q3

Bahrain Bourse posted a 2.8% gain in Q3, putting it around the regional average for the quarter. However, the all-share index was still down by 5.4% for the first three quarters of the year taken together. This was broadly reflective of region wide trends in the capital markets.
a 0.7% gain in September, market capitalization reached BHD6.84bn. The Bahrain Islamic Index shed 7.4% during the first three quarters of the year.

**Bahrain All-Share Index**

![Index Chart]

*Source: Bahrain Bourse*

The overall performance of the sector indices has mirrored the All-Share Index. The only sector to have posted a net gain during the first three quarters of the year is Investment, which rose by 0.4% in a marked turnaround from a 19.9% drop recorded during the same period in 2015. Both Investment and Services gained significantly during September, by 4.4% and 1.9%, respectively.

**Sectoral stock market indices, 2015-2016 (year-to-date change for Q1-3)**

*Source: Bahrain Bourse*

In the fixed income space, activity has been dominated by short-term issuance. Interest in the offerings was typically strong and the terms in line with those seen in the first half of the year. The
total outstanding value of Government Treasury bills stood at BHD1.76bn as of the end of September.

In July, The CBB issued the 12\textsuperscript{th} offering of three-year Government Development Bonds. The BHD300mn issue received subscriptions worth BHD379mn. The expected interest rate was 4.45%.

A USD2bn international offering was launched in early October. It is composed of a USD1bn seven-year sukuk and USD1bn conventional bond with a 12-year tenor. The sukuk was priced at 5.625% and the bond at 7%. The order book for the 144A/Reg S transaction exceeded USD7bn.

<table>
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<th>Issue date</th>
<th>Issue</th>
<th>Value, BHD mn</th>
<th>Maturity, days</th>
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<th>Average price, %</th>
<th>Over-subscription, %</th>
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<td>123</td>
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</table>

Source: Central Bank of Bahrain

Brisk employment growth in the private sector

Employment trends in Bahrain continue to reflect the positive momentum in the non-oil economy. Total private sector employment rose by an annual 6.3% in Q2 to a total of 754,863. The rate of increase was slightly down on 7% in Q1, probably in reflection of seasonal factors ahead of the summer months.

Bahraini private sector employment in Q2 rose to 159,711, a YoY increase of 0.8%. Non-Bahraini employment advanced by 7.8% to 595,151. The median Bahrain salary in the public sector was BHD686 a month as compared to BHD393 in the private sector. Both rose by an annual 2.1%.

The pace of job creation mirrored the numbers of new corporate registrations (CRs). The four-month moving average of new CRs rose by 47% in Q2.
Private sector employment growth

Source: Labour Market Regulatory Authority

External Assessments

Bahrain has continued to perform strongly in a number of key international indices and rankings:

- The World Economic Forum’s (WEF) Human Capital Index 2016 ranked Bahrain first in the Middle East and 46th worldwide with an overall score of 73%. The quality of Bahrain’s education system was ranked 25th worldwide while the level of staff training was ranked 22nd. The Kingdom attained the 38th position for the ease of finding skilled employees. The index ranks a total of 130 economies.

- The Global Innovation Index ranked Bahrain 57th in the world with a score of 35.5. Bahrain’s areas of particular strength were ICT, online Government services, e-participation, cost of redundancy dismissal, and tertiary inbound mobility. Bahrain has moved up 10 slots in the ranking since 2013. The index is compiled by Insead, Cornell University, the World Intellectual Property Organisation.

- The WEF Global Competitiveness Report 2016-2017 classified Bahrain as an innovation-driven economy. It attained the 48th position of 130 countries globally. It was ranked fifth in the MENA region.

- Bahrain has continued to perform well in expatriate surveys. The Expat Insider ranked the Kingdom 19th globally and first in the MENA region. The HSBC Expat Explorer ranked Bahrain 9th globally and, similarly, first in the region.
KEY SECTORS

WORKING TOWARD A PARADIGM SHIFT

The ongoing fiscal consolidation in the GCC region will over time serve as an important driver of productivity. Instead of being able to capture profits made possible by subsidized input prices, companies will increasingly have to invest in productivity through more effective management, better organization, and innovation. Ultimately, this will help the economy transition to a more dynamic, productivity-led growth model which will enhance resilience, growth and living standards.

One of Bahrain’s main advantages in the face of this paradigm shift is a substantial pipeline of new investments across the sector spectrum. This will allow companies to adopt new technologies and business models faster than might otherwise be the case. At the same, new infrastructure and housing will be more efficient and less likely to waste resources.

Another important initiative to support greater efficiency and sustainability in the economy is the creation of the Bahrain Unit for Sustainable Energy which is responsible for developing strategies, policies, and regulation for greater energy efficiency. The unit will support investment projects in renewables and energy conservation.

Manufacturing fueled by large projects

Near-term prospects for Bahrain’s manufacturing sector are likely to be critically linked to major new investments. Key developments in this regard include the following:

- ALBA’s sixth pot line will make the company the largest single-site smelter, dramatically improve efficiency through new technology adaption, and support the growth of the aluminium downstream sector
- Bapco’s modernization project will deliver higher efficiency through scaling, the adoption of modern technology, and a modification to the output mix.
- A new USD90mn biscuit factory being built by food and beverage giant Mondelez at the Bahrain International Investment Park is on track for completion by the first quarter of next year. This will mark a major expansion of the company’s regional base in Bahrain. The factory will have an annual capacity of 90,000 tn and will create some 400 direct jobs
- CIMC Vehicle Group, part of China International Marine Containers Group Ltd. (CIMC), has announced plans to launch its first manufacturing operation in Bahrain. The new facility will serve as a major reefer trailer manufacturing and export hub in the Middle East. Reefer trailers are vehicles which are used in the transportation industry to transport temperature sensitive goods. CIMC is a nearly USD8bn group with 300 companies and 60,000 staff

In an important development for the logistics sector, Bahrain opened its first free-hold trade zone, Phase I of the Investment Gateway Project in late September. The project is located on a 600,000 sq m reclaimed island in in Hidd and will offers 300 plot for warehousing, light industry,
showrooms, and retail outlets. The facility is located between the International Airport and King Salman Port. It is expected to generate USD312mn of investment and create 7,000 jobs. 95% of the project led by Manara Development has been sold. A 2mn sq m second phase is expected to be completed in 2018 and attract investments of some USD1bn and create 20,000 jobs.

**Strong visitor numbers drive tourism**

Bahrain’s tourism and hospitality industry has been experiencing strong, sustained growth in recent years, according to the latest GCC Hospitality Industry Report published by Alpen Capital. Going forward, the sector is expected to grow at an annual 7.3%. The Government is hoping to increase overseas visitor numbers from 11.6mn last year to 18mn in 2018.

A key driver behind the projected growth of the tourism sector is a large pipeline of as much as BHD2bn worth of related investment projects. One of the latest additions to the pipeline is a BHD45mn project called Sa’ada, which will link Muharraq’s historic souq with the waterfront. It will provide recreational, tourism, and commercial facilities.

Overall, the numbers of inbound visitors compiled by the Nationality, Passports, and Residence Affairs Directorate of the Ministry of Interior point to continued healthy growth. The total number of visitor arrivals during the first three quarters of the year was 11.38mn, which compared to 11.05mn during the corresponding period in 2015, a 3% YoY increase. The number of incoming visitors through the airport rose by 5.1% to 2.08mn. Arrivals through the Causeway increased by 2.5% to 9.25mn. Overall, 23mn people travelled through the King Fahad Causeway in 2015, compared to 12.7mn in 2005.

**Visitor arrivals by port of entry**

![Visitor numbers rose by an annual 3% during Q1-3](image)

*Source: Ministry of the Interior*
Shaping a payments center

Bahrain offers a unique value proposition in the area of ancillary financial services. As the most established financial hub in the Gulf region, it has developed a large and diverse national skills base and a strong infrastructure for financial services. Ancillary service provision can further benefit from the most competitive operating costs in the region.

In reflections of these fundamentals, Bahrain is continuing to make headway as a centre for payments. Roundtables between industry representatives, the Central Bank of Bahrain, and the Economic Development Board were held in May and September. The objective of these forums has been to enhance collaboration among relevant stakeholders to improve payments infrastructure and boost innovation. The payments sector in Bahrain can benefit from strong regulatory fundamentals thanks to the Ancillary Services module of the CBB Rule Book.

The payments industry can in turn deliver broader economic benefits. Among other things, the efforts in this area are designed to support and encourage start-up activity in the payments space, most notably for apps, an opportunity supported by Bahrain’s 185% mobile penetration rate. Innovation in this area can also help to better serve the needs of a large underbanked community of expatriate manual workers, estimated to number some 200-300,000. This has tended to lead to high cash circulation with little visibility on how it is spent.

Following the recent launch of the Electronic Fund Transfer System (ETFS), the cheque clearing process has been reduced to less than a day and initiatives are under consideration to eliminate paper cheques altogether. New initiatives are also under consideration in terms of establishing a tiered, risk-based know-your-customer model, which would open up outsourcing possibility. Also existing identity documents can be better incorporated and leveraged in the process. Know-your-customer procedures can also potentially be centralized and aligned across several different types of companies and sectors.

ICT entrepreneurship ecosystem takes shape

One of Bahrain’s most attractive value propositions in the ICT sector is access to qualified, bilingual talent. While this has spawned the growth of business process outsourcing and comparable activities, it can also contribute to the growth of indigenous entrepreneurship. The need to expand the start-up ecosystem is receiving increasingly focused attention with the arrival of several incubators and accelerators. A strong ICT ecosystem will in turn encourage technology-focused entrepreneurship, drive innovation, and attract investment. As an example of the positive momentum, 500 Startups, a leading global VC seed fund and accelerator based in Silicon Valley, in December announced in Bahrain the launch of a USD30mn 500 Falcons funds for MENA companies.

The focus on ICT entrepreneurship is reflective of the broader sector dynamics across the region. Technology has emerged as an increasingly important driver of economic development in the GCC where it is projected to post 10% annual growth over the coming five years. Overall spending in the Middle East was expected to reach nearly USD200bn in 2015.
One of recent entrants in the emerging Bahraini ICT ecosystem is C5 Accelerate Ltd. C5 is a specialist technology investment company with a focus on cybersecurity, big data analytics, and cloud computing. It has offices in London, Luxembourg, Johannesburg, and Manama. The Bahrain facility, launched at the end of last year, is the first cloud accelerator in the Middle East and Africa. The proposed business model is designed to accelerate company growth through the adoption of cloud technology which offers scalable infrastructure for SME to expand their operations in a cost-effective manner. The program will focus on companies operating in line with the economic development priorities of the GCC region.

Cloud computing across EMEA is worth USD40bn annually and adoption is accelerating with projected revenue growth of more than 14% a year in by the end of the decade.

The program was launched with ten qualifying businesses which are undertaking a four-month curriculum in Bahrain. C5 will initially accept two such batches a year. Program participants will, among other things benefit from training in strategy and business principles and have the ability to interact with the C5-linked network of global business leaders as well as their fellow program participants. Companies will also have access to the USD100mn Gulf Technology Corporation venture capital fund which is managed by C5. The program operates in partnership with Amazon Web Services which will support participants through advice as well as AWS Grants.

Technology collaboration is strengthening also between Bahrain and China thanks to agreements signed in September at the Shenzhen-Bahrain Business Forum. A memorandum of understanding with the Galaxy Institute for Innovation and Entrepreneurship seeks to explore opportunities for setting up incubators in Bahrain, along with joint business forums and promotional activities. It will also include establishing a Galaxy Institute in partnership with Bahraini companies to support investments and entrepreneurship in Bahrain and China. Under the MoU, the EDB and the institute will exchange ideas on innovation, as well as planning around entrepreneurship-related laws and regulations.

An MoU was also signed with the Chinese technology company Huawei to expand the ICT sector in Bahrain. Key initiatives include the Safe Cities project designed to improve security through virtual solutions as well as improvements to ways in which security services interact. Huawei will also work to develop the Internet of Things in Bahrain. Huawei has had its regional headquarters in Bahrain since 2009.
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