



# Bahrain Economic Quarterly

December 2016

## SUMMARY

### STRONG NON-OIL MOMENTUM IN Q3

The strong underpinnings provided by unprecedented infrastructure investment have continued to deliver healthy growth in Bahrain's non-oil economy. The regional economies are beginning to adapt to the new realities of fiscal reforms while benefiting from a rebound in oil prices. The global environment remains challenging but optimism regarding future growth is on the increase.

- ✦ **Bahraini growth accelerates in Q3.** Headline growth in Bahrain reached a healthy 3.9% in Q3 in a clear acceleration on the 2.7% pace posted in Q2. During the first three quarters of 2016, the Bahraini economy expanded by a real 3.6% YoY, which was in fact ahead of the 2.9% rate seen in 2015 as a whole
- ✦ **Non-oil momentum driven by infrastructure spending.** Non-oil growth in Bahrain reached a robust 4.7% during Q3, up from 3.6% in Q2. The YoY increase during the first three quarters taken together was 3.7%. Growth in Q3 was led by the Construction sector which expanded by an annual 7.2%. The forward momentum of the projects is beginning to push up growth in several other non-oil sectors as well
- ✦ **Regional economies adapt to new realities.** The pace of growth across the entire GCC region has moderated markedly as a result of government consolidation in a weaker oil price environment. While the prospect of cuts in oil production may delay a near-term pick-up, much of the regional non-oil economy is likely to see a clear acceleration in growth in 2017
- ✦ **Higher rates and higher oil.** The US presidential election in November was followed by a Fed rate increase and seems to have pushed up rate expectations more generally thanks to increased optimism about US growth prospects. At the same time, an agreement by OPEC and leading non-OPEC producers to cut output has triggered a rally in oil prices

#### Bahrain economic outlook

	2015	2016f	2017f	2018f
Real GDP growth, %	2.9%	3.4%	1.9%	1.9%
Non-hydrocarbons sector	3.6%	3.7%	2.8%	2.3%
Hydrocarbons sector	-0.1%	1.9%	-1.8%	0.0%
Nominal GDP growth, %	-6.8%	4.2%	6.2%	4.3%
Inflation (CPI %)	1.8%	2.9%	1.8%	1.8%
Current account (% of GDP)	-2.4%	-4.6%	-3.8%	-3.8%
Fiscal balance (% of GDP)	-13.0%	-12.6%	-8.9%	-7.4%
Crude Oil Arabian Medium (USD)	50	43	52	55

Source: Bahrain Economic Development Board

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## GLOBAL ECONOMY

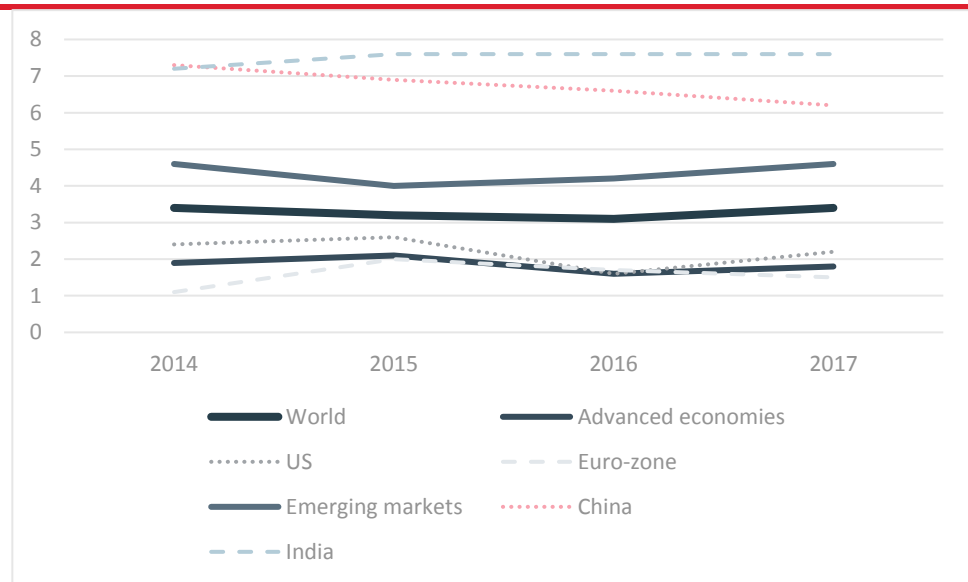
### WINDS OF CHANGE

*While political risk factors have become a growing influence on markets, economic growth is generally expected to accelerate in most major economies going into 2017*

Even though the prospects for the global economy generally point to a gradual improvement in the near- to medium-term, actual growth rates have persistently fallen short of expectations in recent years. While especially monetary policy remains supportive of growth in most major economies, political risk factors have repeatedly delivered unwelcome surprises. A wave of recent events, such as the Brexit vote in the UK or the Italian constitutional referendum, underscores the mounting political and social challenges following nearly a decade of below-trend growth globally. In many cases, the nature and impact of such events is difficult to predict, while especially their short-term market impact can be substantial.

Overall global growth in 2016 is estimated by the International Monetary Fund (IMF) to have reached 3.1%, which is the lowest point since the post-2009 recovery. Growth is expected to rebound somewhat to 3.4% in 2017. Continuing an established pattern, the momentum of the global economy is likely to be led by the emerging markets which are projected to expand by 4.2% in 2016 in a slight improvement on 4.0% in 2015. A further acceleration to 4.6% is projected in 2017. The advanced economies, similarly, are estimated to have reached the low point of the cycle with 1.6% real growth in 2016, down from 2.1% in 2015. Nonetheless, also their prospects are looking slightly brighter with a projected pick-up to 1.8% in 2017.

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



Source: International Monetary Fund, World Economic Outlook, October 2016

### Facing the prospect of higher rates

There is growing anticipation that the global economic narrative may have passed an inflection point with the generally unexpected presidential election victory of Donald Trump in the US. The cyclical recovery in the US has been showing signs of strengthening for some time. Moreover, the incoming administration has signaled clear ambitions to boost growth further through a more

active fiscal policy and a range of supply side reforms. For instance, the OECD expects the Trump administration's stimulus measures to add 0.4 percentage points to US growth, which would take the headline figure to 2.3% in 2017. The organization projects growth of 3% in 2018, a figure that is more in line with the 3-4% norm articulated by the administration-in-waiting.

Contrary to earlier fears, the election of Trump has triggered a broad-based rally in the financial markets. Especially stock markets have been fueled by expectations of tax cuts, pro-business regulatory reforms, and increased government spending. The US Dollar has appreciated sharply while bond yields have increased across the board.

With the market sentiment becoming more upbeat, the Federal Reserve on 14 December expectedly increased its federal funds rate by a quarter point to a range of 0.5-0.75%. This was the first rate increase in a year and only the second during the past decade. However, the decision was accompanied by indications that the pace of future rate increases could prove faster than previously projected. The median projection of Open Market Committee members is now for three quarter point increases in 2017 as compared to just two previously. The median interest rate forecast for 2017 now stands at 1.375%. The median forecast for 2018 is 2.125%, followed by 2.875% in 2019. The long-term rate expectation was increased to 3% which marks a clear reversal from the recent pattern of progressively more and more subdued rate expectations.

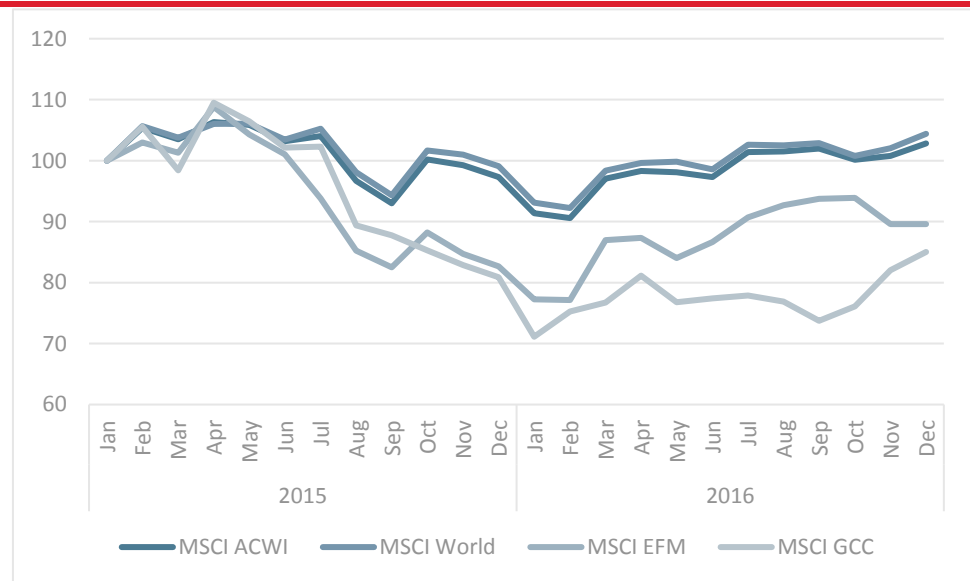
The rate increase opens up a number of important questions:

- ✦ The Fed's decision was consistent with steady progress toward its stated inflation and unemployment goals. The key inflation measure now stands at 1.7%, close to the 2% goal. The 4.6% unemployment rate in November was in fact below the Fed's 4.8% estimate of its long-run rate. A slight further decline is expected to 4.5% in 2017-2019. Nonetheless, the Fed's GDP growth projections remain relatively modest with 2.1% growth seen in 2018. This suggests that a meaningful push by the Trump administration to stimulate growth toward its target range could trigger more monetary tightening than currently foreseen
- ✦ There has been persistent concern over a possible correction in the fixed income markets. Recent weeks have seen increasing yields on US Treasuries. In response to the Fed rate increase, ten-year Treasuries rose above 2.5% and five-year paper crossed 2%
- ✦ The US is relatively unique among major economies in moving toward a tighter policy bias. Elsewhere, inflationary pressures remain minimal and political risk factors often overshadow a gradual recovery. This discrepancy has already pushed the DXY Dollar index to its highest level since 2003 and the US now faces record high spread differentials vis-à-vis other major economies. However, Trump has repeatedly spoken against a strong Dollar, which would, moreover, complicate his ambitions of boosting US manufacturing
- ✦ Tendencies toward Dollar appreciation have tended to be challenging for emerging markets which are nonetheless generally expected to serve as the main driver of global growth. The US election has triggered increased portfolio outflows from emerging markets. Estimated inflows in 2016 were the weakest since 2008. Emerging capital market performance has weakened markedly while emerging market currencies have shed 5% of their value vis-à-vis the US Dollar

*The outlook for US interest rates has become more bullish, although US tightening risks deepening global economic asymmetries*

Hence, any US policy tightening risks amplifying global growth asymmetries and may trigger volatility in the fixed income space and the broader emerging market universe. Along with the unusually numerous uncertainties associated with the global economic outlook, this may constrain the authorities' room for maneuver as it has done previously. For instance, a year ago, the Fed had projected four rate increases in 2016 but only one materialized. At the same time, there is growing concern about 'de-globalization.' One of the main uncertainties regarding the new administration links to its apparent skepticism toward trade liberalization. Among other things, Trump has indicated that he would abandon the Trans-Pacific Partnership initiative.

### Global equity market performance



Source: MSCI

### OPEC regroups

While there were growing expectations of a gradual oil market rebalancing over the past year, the process proved far from straightforward. Many countries continued to deliver historically high output levels, with for instance total OPEC production reaching an unprecedented 33.2 mbd in 2016, up from the previous record of 32.39 mbd in 2015. The combined OPEC output of 34.13 mbd in November was the highest ever recorded and even the slightly lower 33.97 mn in December still ranks as the second highest on record. Moreover, new supply is due to come online in at least three major producer states: Brazil, Kazakhstan, and Canada. Kazakh estimates suggest that the Kashagan field, which began commercial operations in late November, could ultimately reach output of 350,000 b/d. As a result, the International Energy Agency (IEA) expects total non-OPEC supply to rise by almost 500,000 b/d in 2017.

With the expected market rebalancing proving elusive, speculation about a possible output cut by the leading producers emerged as the main determinant of price dynamics toward the end of the year. Concerted supply cuts promised the prospect of a market rebalancing within a couple of quarters whereas continuation of the "free for all" risked translating into an indefinite glut in the market. Hence, any indications of an output deal had the potential to push up prices quite quickly as happened in early October when Brent prices reached a YTD peak of USD53.73. The subsequent



weeks witnessed renewed volatility as moments of optimism regarding output cuts alternated with record output data and signs of discord among key OPEC members. Pulled by these contradictory pressures, the Brent average of USD45.13 per barrel in 2016 ultimately came in 15.8% below the 2015 average of USD53.59.

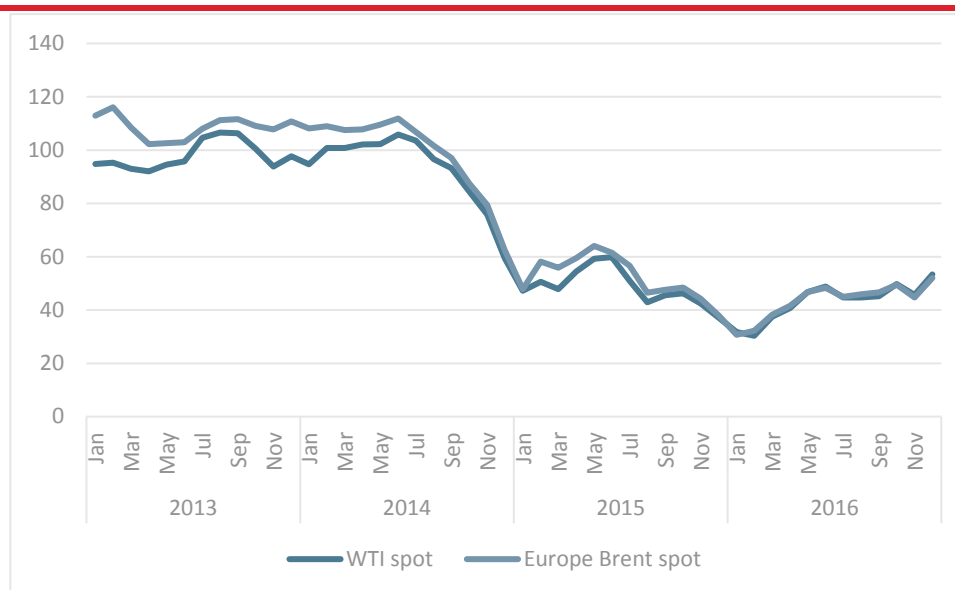
In the end, OPEC chose to act on its earlier plans and agreed on a formal output cut of some 1.2 mbd in its Algiers gathering at the end of November. The agreement is designed to bring OPEC's aggregate output to 32.5 mbd in early 2017, which would translate into a roughly 4.5% production cut. The largest cut would be made by Saudi Arabia (0.49 mbd), followed by Iraq (0.21 mbd), and the smaller GCC producers (a combined 0.3 mbd). Nigeria and Libya were exempted from the agreement because of significant production disruptions in recent years. The two countries are expected to add some 0.6 mbd to their combined output over the coming six months. Libya's output rose to 685,000 b/d in early January.

The OPEC deal was followed by a broader agreement with a dozen of the leading non-OPEC nations on 10 December. In the first deal between OPEC and other producers in 15 years, a group of countries, led by Russia, agreed to reduce their daily output by 558,000 barrels in the course of the first half of 2017. Russia's share of this will be 300,000 b/d. Saudi Arabia further fuelled market optimism by signalling that it could undertake larger cuts than originally indicated. If the proposed cuts do materialize as planned, oil markets could become significantly tighter with a projected deficit by 2H17.

The immediate impact of the Vienna agreement on oil prices was a nearly 10% rise. Brent breached the USD55 per barrel mark and rebounded to its highest levels since the summer of 2015. Gains in December alone were close to 20% and took the increase since the beginning of the year to some 50%. While questions still abound about implementation, compliance, and monitoring, the agreement does seem to be firming a floor for oil prices at close to USD50 per barrel.

Apart from compliance, a key determinant of future price dynamics will be the response of the US shale producers. A gradual recovery in US production is already underway from the September low of 8.58 mbd and the Department of Energy expects output in excess of 9 mbd by the end of 2017. The US rig count has risen from a May low of 404 to 597 in early December. The average output projected for 2017 is 8.78 mbd, 600,000 b/d higher than expected half a year ago, but much in line with the 8.77 mbd output attained in November. Especially in the Permian Basin, which stretches across Texas and New Mexico, there is potential for increased production even in the current price environment. Going forward, US production may receive further support from the planned policies of the Trump administration which has signalled a desire to de-regulate the sector.

### Monthly average crude oil prices (USD/barrel)



Source: US Energy Information Administration

### Global oil demand and supply dynamics (mbd)

	IEA	OPEC	EIA
2016 Global oil demand (mbd)	96.3	94.41	95.57
Advanced economies	46.6	46.70	46.71
Developing economies	49.7	31.12	48.86
China	11.9	11.23	11.65
2017 Global oil demand (mbd)	97.6	95.56	97.20
Advanced economies	46.6	46.85	47.10
Developing economies	51.0	31.77	50.10
China	12.2	11.50	11.98
2016 Global oil supply (mbd)	97.0	-	96.44
'Call on OPEC'	40.2	31.92	39.60
Non-OPEC	56.8	56.20	56.84
2017 Global oil supply (mbd)	-	-	97.53
'Call on OPEC'	-	32.63	40.27
Non-OPEC	57.0	56.50	57.26

Source: International Energy Agency, Organization of the Petroleum Exporting Countries, US Energy Information Administration

### Implications for Bahrain

The expected trends in the cost of capital and the price of oil are likely to have a divergent impact on the Bahraini economy.

- ✦ The cost of borrowing now appears to be trending up slightly faster than previously expected, even if there may be constraints on the US Federal Reserve's ability to tighten. Higher US rates will in turn test the relative attractiveness of other economies

- ✦ The prospect of a return to production quotas should be supportive of oil prices, even significant price gains are likely to be limited by a flexible supply response by the US shale producers. This should support the ongoing fiscal consolidation efforts underway in the GCC. Problems with enforcing the output cuts among key producers may result in renewed price volatility



## THE GCC REGION

### ADAPTING TO NEW CIRCUMSTANCES

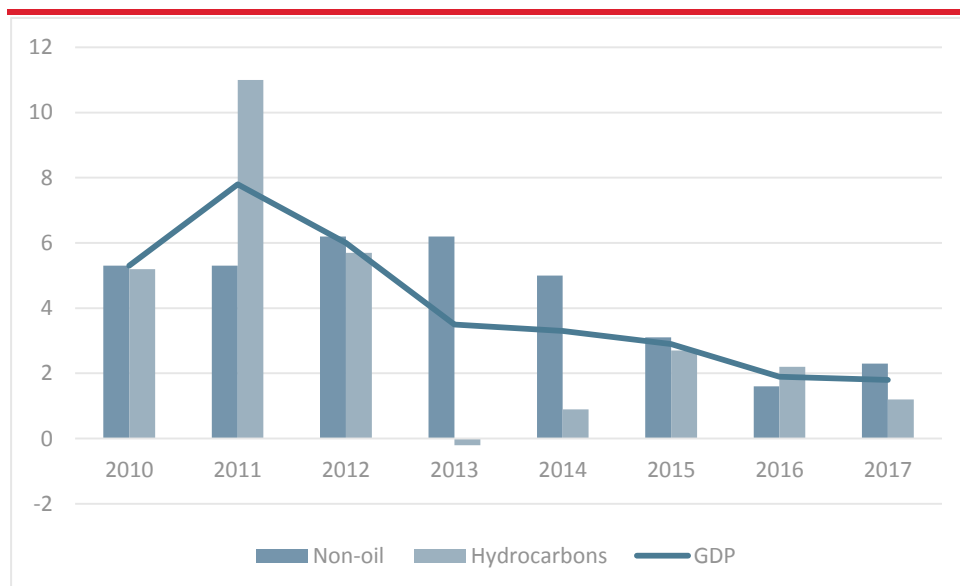
*Fiscal consolidation is likely to keep regional non-oil growth at a historically subdued level in 2017, although the possibility of higher oil prices should lend some support*

The past year has been characterized by an unusual cluster of challenges for the GCC economies. Sustained low oil prices have triggered significant fiscal consolidation efforts across the region, engendering a pronounced slow-down in economic activity. Similarly, reduced oil revenues have heralded tighter liquidity conditions in the financial markets, which has translated into slower credit growth and some upward pressure on the cost of capital. While committed to ambitious diversification targets, parts of the region have depended on record high oil output levels as a key source of growth as other sectors have adapted to the new economic realities.

In general, the current economic cycle is showing signs of bottoming out with oil prices generally expected to at least stabilize and quite possibly increase further. At the same time, while fiscal consolidation efforts will continue, they are likely to be less pronounced and disruptive in much of the region. In terms of economic policy, the way forward is better understood and both companies and consumers have begun to adapt to the changing circumstances. While the implementation of the OPEC oil quotas may reduce hydrocarbons extraction in much of the region, ambitious projects are underway further down the value chain.

Overall regional growth is estimated by the IMF to have reached 1.75% in 2016, a figure that is sharply down on 3.75% in 2015. The IIF estimates that GCC growth slowed from 2.9% in 2015 to 1.9% in 2016. The non-oil economy in the region is estimated to have grown by 1.6% while the oil sector expanded by 2.2%. Going forward, economic growth is likely to remain at close to current levels, albeit with a likely change in its composition in favour of the non-oil sector. The IIF expects non-oil growth to accelerate to 2.3% in 2017.

**GCC real GDP growth, %**



Source: Institute of International Finance

## Non-oil activity adapts to new conditions

While economic growth across the Gulf region remained clearly below its historical norm throughout 2016, the more diversified economies tended to display the greatest resilience. Overall, much of the region appears to have experienced something of a recovery from the oil price trough of Q1 and the improving oil price outlook towards the end of 2016 had a generally positive impact on forward-looking expectations. However, this was a fairly gradual rebound in the face of an unprecedented fiscal consolidation effort. The average fiscal deficit in the GCC is expected to have shrunk by some 20% of the region's aggregate non-oil GDP over the 2014-2016 period. Nonetheless, the regional fiscal shortfall in 2016 was still estimated by the IMF at USD200bn, much of it financed through debt. The fiscal shortfall is projected to fall to USD160bn in 2017, or some 12.8% of the regional GDP.

The fiscal correction has gone hand in hand with a reversal in the external position of the regional economies. With a USD435bn decline in oil-related export receipts from 2014 to 2016, the aggregate current account deficit for the region swung from a 8.25% (of GDP) surplus in 2014 to a projected 4.5% deficit in 2016. Thanks to fiscal rebalancing efforts and a recovery in oil prices, this gap is expected to shrink to 1.75% of GDP in 2017.

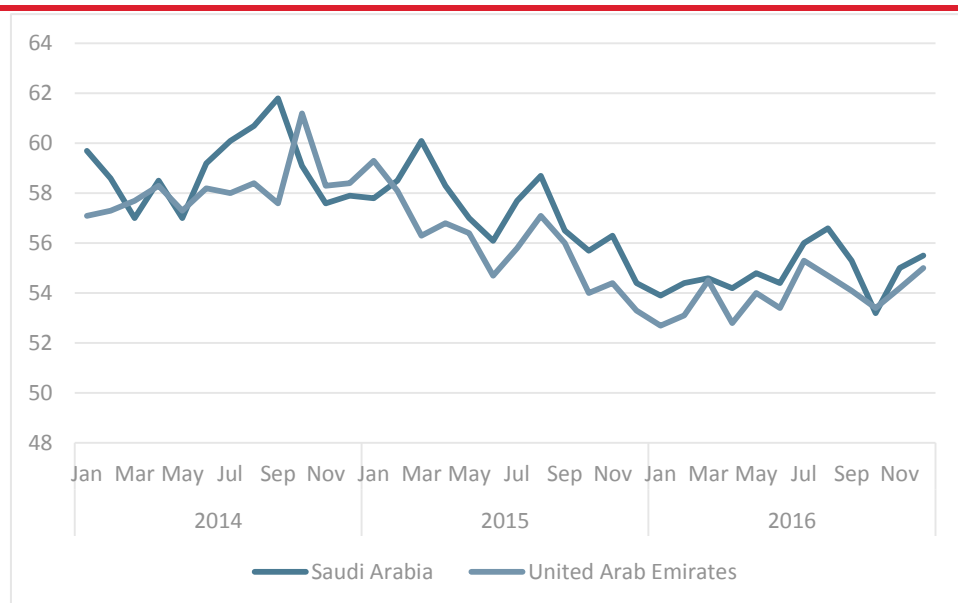
Growth in the region's largest economy, Saudi Arabia, has slowed down sharply from its historic trend levels. The preliminary 2016 economic data presented by the Government in connection with the 2017 budget puts the Kingdom's real growth at 1.4%, a figure that compares to 4.1% in 2015. The non-oil sector expanded by 0.2% with growth in the non-oil private sector slowing to just 0.1%. Overall, growth was led by the oil sector which, thanks to record output levels, expanded by 3.4%. The Saudi budget statement included a 2017 growth projection of 2%. Most private sector estimates remain significantly more cautious, foreseeing a real increment of less than 1%. The economy is likely to benefit from a slightly looser fiscal stance as well as new mechanisms for settling payment arrears with private contractors.

The UAE Central Bank projects growth of 2.2% in 2016 followed by a slight acceleration to 2.4% in 2017. Non-oil growth in 2016 is projected at 2.7%. Most indicators of economic activity in the country point to continued expansion. The Emirates NBD Dubai Economy Tracker posted a reading of 55.9 in December thanks to stronger momentum in tourism and retail trade. Expectations for 2017 are upbeat and inventories are continuing to build up. Marginal growth was seen in the construction sector and probably at least in part due to price cutting. Traffic flows through the UAE have remained strong with, for instance, passenger traffic at the Dubai International Airport rising by an annual 6.8% during the first ten months of 2016, although growth in tourist visitors has tended to be more subdued. This compared to a gain of 5.3% at Abu Dhabi.

The Emirates NBD Purchasing Managers' Index for Saudi Arabia and the UAE have been generally consistent with trends in the national accounts data. The momentum of the economy in both countries has been weaker than in 2015 but generally characterized by continuity. A clear improvement was observed at the close of year, probably in connection with increasing oil prices. The Saudi PMI attained a reading of 55.5 in December and nearly 30% of companies reported MoM increases in their output while new order growth remained strong. The UAE index reached a five-month high of 55.0 in December. Output increases were the fastest since August 2015.

*Growth projections for 2017 remain historically modest with the more diversified economies generally displaying the greatest reliance*

### Emirates NBD Purchasing Managers' Index



Source: Emirates NBD, Markit

The Qatar economy saw a pick-up in growth to an annual 2% in Q2, which translates to 1.7% for the first half of the year. Headline growth was held back by 2% YoY contraction in the hydrocarbons sector during 1H16 while non-oil growth was 5.8%. Overall growth in 2016 is projected by the IMF at 2.6%. Growth in 2017 is generally expected to trend toward 3.5-4%, supported by increased Government spending.

While the Kuwaiti economy has benefited from increased investment activity, indicators of consumer spending pointed to some weakening in Q3. Also consumer confidence has been subdued with the ARA index recording its lowest point of 83 in September. Earnings of listed corporates declined by 6% year-on-year (y/y) in Q1-3. Real estate sales during the first 10 months of the year were down by 26% YoY.

Also Oman is expected to see a deceleration in its non-oil growth rate in 2016 to the neighbourhood of 1%. While oil production has remained brisk, headline growth in 2016 is estimated at approximately 2% as compared to 3.7% in 2015. In its 2017 budget statement, the Government projected headline growth of 2% in 2017, led by a 4.7% expansion in the non-oil economy.

The regional project pipeline, a key pillar of economic continuity during the downturn, stood at USD2.78bn in mid-December, as measured by MEED. This marked a 5% YoY increase. Especially Saudi Arabia and Oman have seen renewed robust growth in YoY terms. After a year of consolidation, The Saudi figure was up 13.1% YoY at USD1.14trn. The Omani total rose 13% to USD194.02bn. The Kuwaiti total was up 1.1% at USD251.91bn. By contrast, both the UAE and Qatar experienced small YoY declines by 3.7% and 1.4%, respectively.

## Mapping the fiscal course for 2017

Several regional governments unveiled their 2017 budgets in December. Even if continued deficits remain the norm for now, these documents suggest that the rebalancing of the regional economies is making headway. All regional Governments project significant revenue growth, as a result of both higher oil prices and a variety of revenue diversification measures. At the same time, expenditures have been rationalized through subsidy reforms as well as critically important cuts in recurrent spending, including the Government wage bill. This is typically the most important category of spending and essential for achieving the medium-term fiscal targets in most countries.

The Saudi Cabinet approved the 2017 budget on 22 December. While it is a document characterized by continuity, it also suggests that the initial response to the new oil price environment is beginning to give way to gradual normalization.

- ✦ The fiscal stance of the Government is shifting toward cautious stimulus. After two years of consolidation, during which expenditure fell by 27% from a total of SAR1trn in 2014, the Government is planning to increase spending by 6% to SAR890bn
- ✦ Fiscal discipline has improved dramatically in spite of a 14.3% drop in revenues during 2016. Actual spending in 2016 was 1.8% below budget, as compared to overruns of more than 20% in recent years
- ✦ While deficit spending is set to continue for a third consecutive year, the fiscal imbalances are diminishing. The projected increase in Government expenditure will compare to an expected 34.7% rebound in revenues to SAR692bn. The deficit, while budgeted at SAR367bn, could fall below SAR200bn from an actual 2016 outcome of SAR297bn (before arrears), or 12.4% of GDP

Qatar released its 2017 budget on 15 December. It sees a 40% contraction in the budget deficit to QAR28.3bn. This follows an estimated QAR59.1bn shortfall this year as a result a 49% drop in revenues whereas expenditures were cut by 21%. The 2017 budget continues a cautious fiscal stance with a 5.4% cut in spending to QAR198.4bn while revenues are set to rebound by 14.5% to QAR170bn.

The UAE federal budget envisages expenditure of AED48.7bn and revenues of AED47.7bn. The 2017 budget is aligned with a AED248bn five-year budget approved in October. The UAE posted a 2.1% of GDP deficit in 2015, which was projected to rise to 3.9% in 2016 before closing to 1.9% in 2017, according to the IMF. Dubai in December approved an AED47.3bn budget for 2017, up 2.6% on 2016, led by a sharp rise in infrastructure construction. The budget projects an AED2.5bn deficit.

Oman's 2017 general budget projects revenues of OMR8.7bn, up on OMR7.36bn in 2016, and Government spending of OMR11.7bn, down 9% on the OMR12.65bn spending projected in 2016. This would produce a deficit of OMR3bn, or some 12% of GDP. This marks an improvement of a OMR5.3bn deficit in 2016, 60% higher than expected following a 30% drop in revenues. The budget continues to consolidate Government operations with an OMR100mn drop in expenditure by ministries. Overall Government expenditure is cut by 2%. The 2017 budget uses an oil price assumption of USD45 per barrel. The budget statement signaled minimal public sector

*Besides continued fiscal consolidation in 2017, Government revenues across the GCC are projected to increase and bring down budget deficits from their recent highs*

recruitment, a further review of subsidies, additional revenue diversification, asset divestments, and stricter prioritization among projects.

### Oil's record run drawing to a close

Up until the OPEC agreement in late November, the GCC countries generally continued to ramp up oil production to unprecedented levels. This made oil a key contributor to headline growth in much of the region during 2016. The three GCC OPEC producers produced 16.41 mbd in October, led by Saudi Arabia's 10.48 mbd and followed by the UAE's 3.05 mbd and Kuwait's 2.88 mbd. Saudi production was reported at 10.72 mbd in November, bringing the YTD 11-month average to 10.46 mbd, up 267,000 b/d YoY. Saudi Arabia has produced in excess of 10 mbd for 22 straight months. Oman's output has hovered around 1 mbd. At the same time, there has been a concerted effort to develop regional natural gas resources with for instance Oman's Khazzan field projected to raise domestic production by 40% by the end of 2017. The agreement by the leading global producers to restore a quota system is now likely to reverse the recent trend of increasing 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*

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



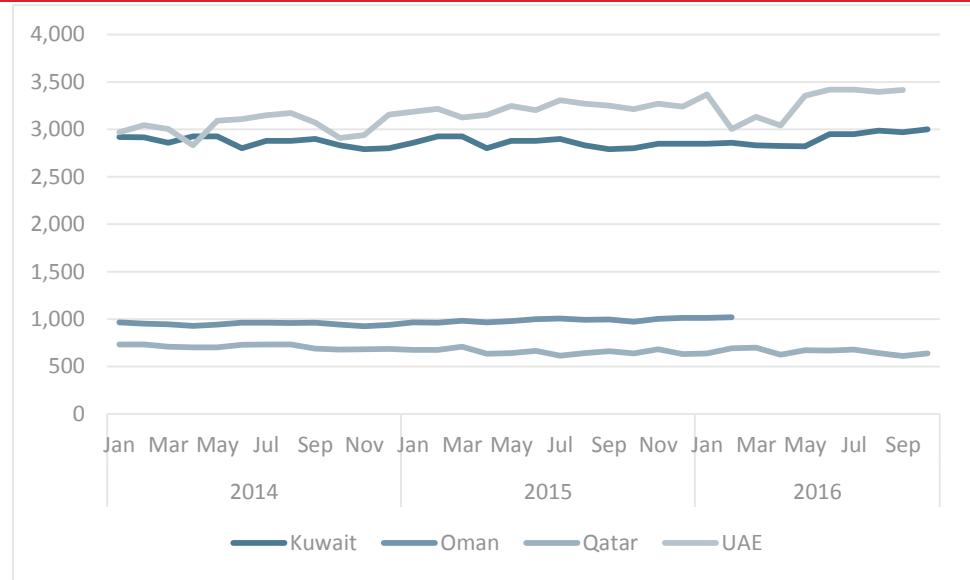
Source: Joint Organisations Data Initiative

Even if momentum in the upstream sector slows, ambitious new plans are being developed for additional downstream production. For instance, Saudi Arabia's refinery output of 2.8 mbd during the first 10 months of the year was up 396,000 b/d over January-October 2015. Saudi oil products exports averaged 1.41 mbd during Q1-3. This figure has more than doubled over the past three years thanks to significant new refining capacity. Saudi Aramco has announced plans to increase its global petrochemicals capacity from 12 to 34mn tn per year. The company's global refining capacity is to be doubled from its current level of 5.3 mbd to 10-12 mbd. Saudi Arabia's total crude and products exports in January-October averaged 8.96 mbd, up from 8.39 mbd a year earlier.

Increased downstream production is coinciding with slower domestic consumption growth. This is partly thanks to new gas development, but also a demand response to higher prices as a result of subsidy reform. Saudi Arabia last month announced plans to link all domestic energy prices to

market benchmarks. Energy subsidies are currently estimated to cost SAR200-300bn a year while domestic consumption is 4-5 times the global norm the size of the economy.

#### Crude oil production in other GCC countries, '000 b/d



Source: Joint Organisations Data Initiative

#### Fading price pressures

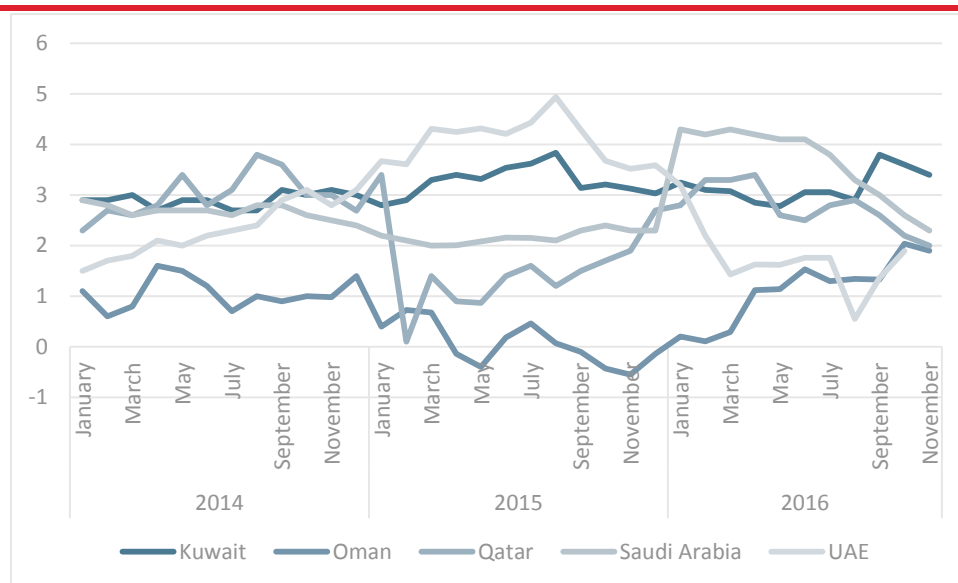
Most of the regional economies experienced upward pressure on consumer prices during the past year. This reflected the overhaul of universal subsidies as well as the introduction of various levies and charges. In general, however, the impact of such measures has turned out to be fairly ephemeral with most regional economies experiencing a renewed slow-down in consumer price inflation in recent months. This reflects the well anchored nature of inflation expectations, partly because of the US Dollar peg. The region has further benefited from minimal food inflation while the other major category of costs of living, namely housing, has tended to be contained because of relatively subdued real estate market dynamics. Most real estate market segments in the UAE are continuing to see price declines while the Qatar Central Bank Real Estate Price Index was down by an annual 10.9% in September. In Kuwait, residential real estate prices were down 12.5% YoY as of October. As a heavy import-dependent region, the GCC has further benefited from the strength of the US Dollar which has recently risen to a 14-year high in trade-weighted terms.

In general, inflationary trends across the region have tended to converge. The lowest inflation has been observed in the UAE and Oman, both of which have seen some pick-up recently with, for instance, the annual rise of consumer price increases in Oman accelerating fairly consistently from negative figures at the end of 2015 to 2% as of November. The fastest price increases in November were observed in Kuwait where the CPI rose by an annual 3.4%. By contrast, Saudi Arabia, which experienced inflation in excess of 4% at the beginning of the year, has seen the rate of price increases moderately steadily to an annual 2.3% in November.

*Inflationary pressures are generally diminishing with low import prices and subdued housing costs*



### Consumer price inflation, %



Source: National statistical agencies

### Bank lending moderates while sovereign issuance remains strong

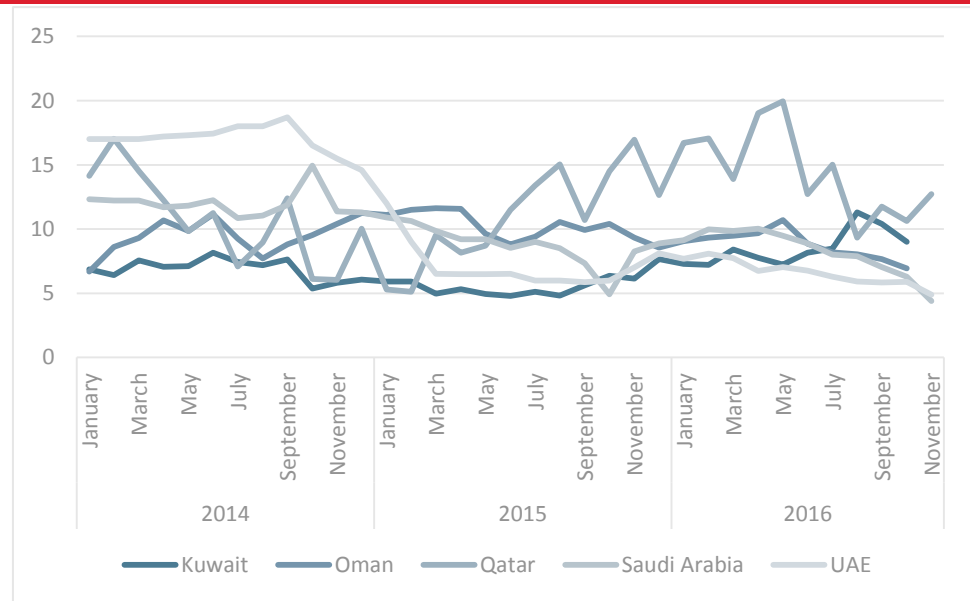
The liquidity conditions in the region have tended to become tighter in the face of a declining or stalling deposit base along with some increased pressure on the cost of capital. With US rates resuming their upward trajectory, Gulf central banks have typically responded in kind. For instance, SAMA increased its reverse repo policy rate by 25 bps to 0.75%, although it kept its repo rate unchanged at 2.0%. Similarly, sharply increased sovereign bond and sukuk issuance has drained liquidity.

*The liquidity situation in the region is showing signs of stabilizing thanks to higher oil prices and some regulatory interventions*

Policy makers have been able to mitigate these pressures through various interventions. SAMA has made time deposits at banks and introduced new report facilities of up to 28 days while reducing its weekly SAMA bill issuance from SAR9bn to SAR3 billion. The Central Bank of Oman has relaxed reserve requirements from 5% to 3% with the differential invested in Government bonds. Banks have been authorized to hold more Government paper. By contrast in Qatar, lending growth has been affected by new regulations mandating deleveraging and a reduction in loan-to-deposit ratios to 100%.

In general, the liquidity situation is showing some signs of stabilizing with for instance most Saudi monetary indicators rebounding in October after a gradual slowdown during much of the preceding year. This appears to be directly linked to a successful international bond issue as well as the resumption of Government payments to contractors. Moreover, the regional banking sector continues to benefit from robust health with capital adequacy in excess of 15% across the Gulf. Provisions for non-performing loans, similarly, are high.

While the annual rate of loan growth has generally trended down, this has been a very gradual process and is not uniform across the region. For instance Qatar has seen some recent increases. Also in Kuwait, credit growth has tended to exceed last year's rates of increase. Most of the region is still seeing YoY new loan growth of 5% or more.

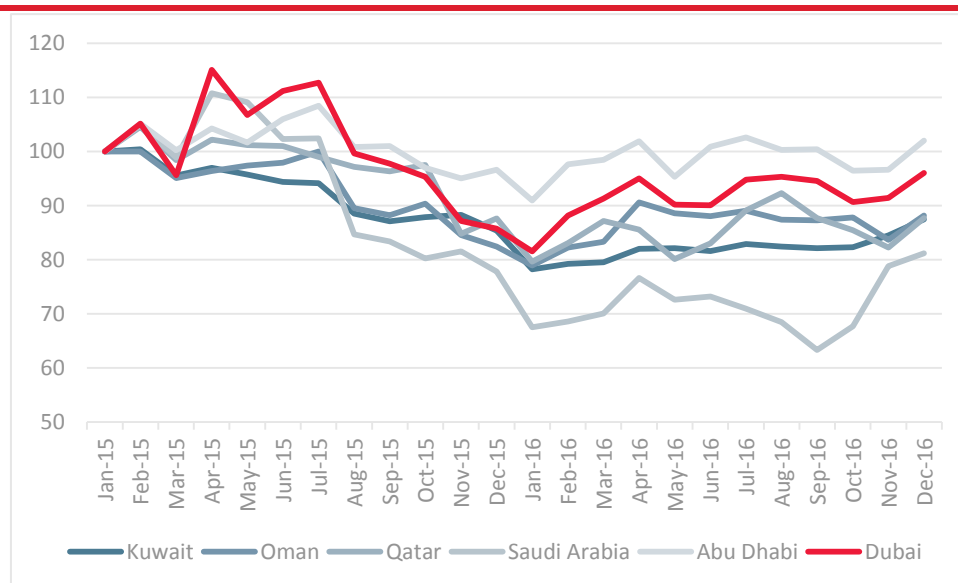
**Bank credit growth, %**

Source: Regional central banks

Equity markets across the region posted substantial gains in the closing weeks of 2016. This mirrored the positive momentum of stock markets globally but also reflects the prospect of higher oil prices, as well as increased optimism regarding the economic policy environment. All the regional exchanges achieved positive net gains during the year as a whole. Market gains were led by Dubai which advanced by 12.1%. Oman posted a 7% gain, Abu Dhabi 5.6%, Saudi Arabia 4.3%, and Kuwait 2.4%. The Qatar index narrowly made it into the positive territory with a 0.1% gain. The sharpest positive turnaround at the end of the year was seen in Saudi Arabia with the Tadawul All Share Index advancing by a remarkable 29.1% during Q4. The second best performer during the quarter was Kuwait which rose by 6.4%. By contrast, primary market activity has been subdued. The second half of the year saw no IPOs across the region. However, the Riyadh Real Estate Investment Traded Fund, with a paid-up capital of SAR500mn, was listed on Tadawul in November.

*Regional stock markets have rebounded somewhat from the depressed levels seen around the turn of the year*

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



Source: Regional stock exchanges

2016 proved a landmark year for fixed income issuance in the GCC. Total conventional bond issue by GCC names rose to an all-time high of USD60.8bn, up more than three-fold on USD17.9bn in 2015. Sukuk volumes remained relatively stagnant with USD5.7bn worth of primary issues, down on USD7.9bn in 2015.

In line with recent trends, GCC fixed income activity has continued to be decisively dominated by large-scale sovereign issuance. In general, external borrowing has risen in relative importance as a way of meeting the funding needs of the Gulf governments. For instance in Saudi Arabia, the public debt is estimated to have risen from SAR142bn in 2015 to SAR317bn – approximately 13.2% of GDP – in 2016. Just under a third of the total is now foreign debt.

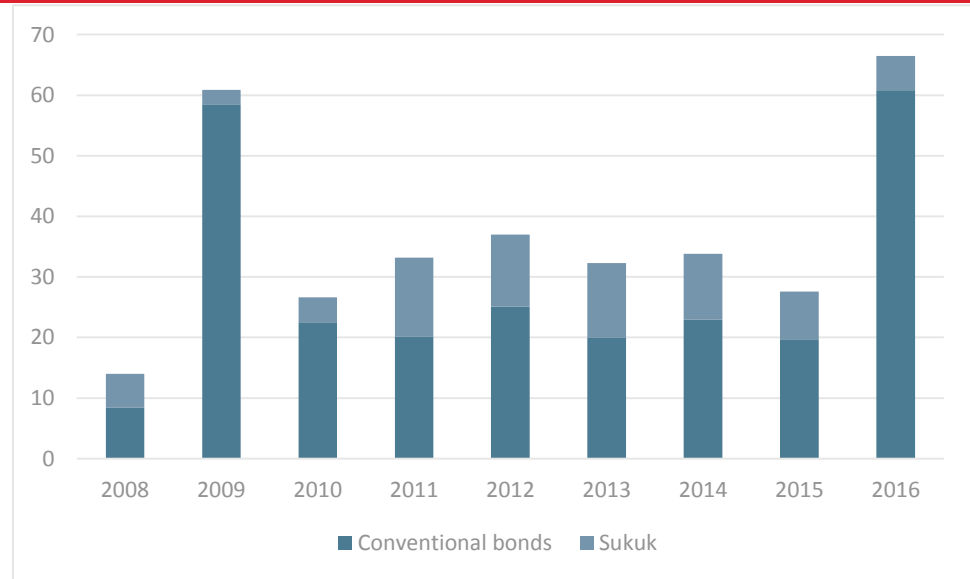
The landmark event for the markets in Q4 was the USD17.5bn Saudi international bond, the largest ever issue from an emerging market. Qatar Central Bank offered QAR1.5bn of bonds in November with tenors of three, five, seven, and ten years.

With all the regional budgets foreseeing deficits in 2017 and an aggregate funding gap of some USD170bn, sovereigns look set to dominate capital market activity also in 2017. The Saudi budget statement for 2017 included plans to issue SAR120bn worth of bonds. Also the State of Kuwait is understood to be readying for an international bond offering, probably in 2017. Kuwait had earlier suggested that it would issue up to USD10bn during the current financial year which will end in March. Oman expects to fund its projected 2017 budget deficit, among other things, through OMR2.1bn of international borrowing and OMR400mn of domestic borrowing.

The capital raising needs of the regional sovereigns are serving as an important driver of capital market development. For instance, the Saudi Ministry of Finance has announced plans for local and international sukuk issuance in a bid to diversify its funding options. It is further working to develop the secondary fixed income markets by listing its issues on Tadawul.

Beyond the regional Governments fixed income issuance has involved mainly regional financial institutions. Meeting the capital requirements of Basel III has been an important driver for banks. The Islamic Development Bank issued a USD1.25bn five-year sukuk as part of its USD25bn program in October. The Arab Petroleum Investment Corporation (Apicorp) issued a Formosa bond in October. The USD300mn deal was oversubscribed.

#### GCC fixed income issuance, USD bn



Source: Thomson Reuters

#### Implications for Bahrain

With the regional outlook becoming stable or even somewhat positive, Bahrain is likely to experience some positive spill-overs:

- ✚ Bahrain is likely to continue to benefit from significant inflows by regional tourists, helped along further by an improved product offering and competitive costs
- ✚ Regional investment flows are likely to prove resilient or even increase. Bahrain is a major beneficiary of intra-GCC investment

## BAHRAIN

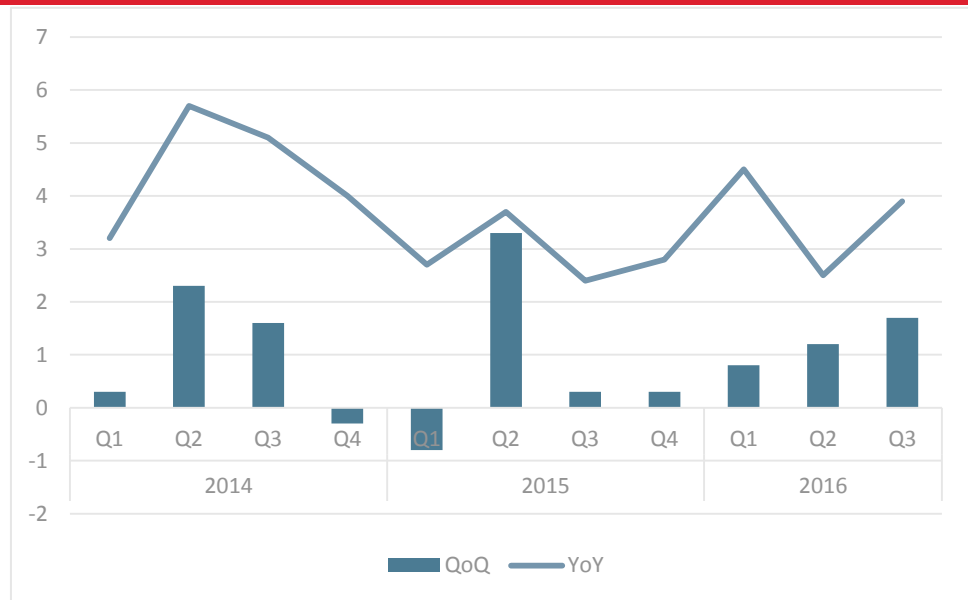
## ROBUST NON-OIL MOMENTUM

*Q3 saw a clear acceleration in the growth momentum of the economy. The non-oil sector posted its best performance during the year to date at 4.7% while the headline rate came in at 3.9%*

The third quarter of 2016 was characterized by a high degree of continuity in terms of the rate and composition of economic growth in Bahrain. The headline year-on-year growth of the economy reached 3.9%, which marked a clear improvement on the 2.5% seen in Q2 while nonetheless falling short of the 4.5% growth recorded in Q1. Much of the variation in these figures during this past year was attributable to the hydrocarbons sector which posted a small 1.7% contraction in Q2 but expanded by 0.8% YoY in Q3. The non-oil economy expanded by a remarkable 4.7% in Q3. This marked a clear further acceleration on the 3.6% pace posted in Q2 and was sharply ahead of the rather subdued 2.7% pace seen in Q1. This suggests that the Q1 figure was something of an anomaly and non-oil dynamics now appear to be strongly anchored in firm structural drivers. 3Q16 was the fourth straight quarter of accelerating quarter-on-quarter growth. The Bahraini economy was in real terms 1.7% larger in Q3 than in Q2.

During the first three quarters of the year taken together, the national economy expanded by 3.6% in real terms over the corresponding period of 2015. The rate of expansion in the hydrocarbons sector was 3.4%. The non-oil economy was 3.7% larger than a year earlier. This outcome was very much in line with the 3.9% rate recorded in 2015 taken as a whole.

## Real GDP growth

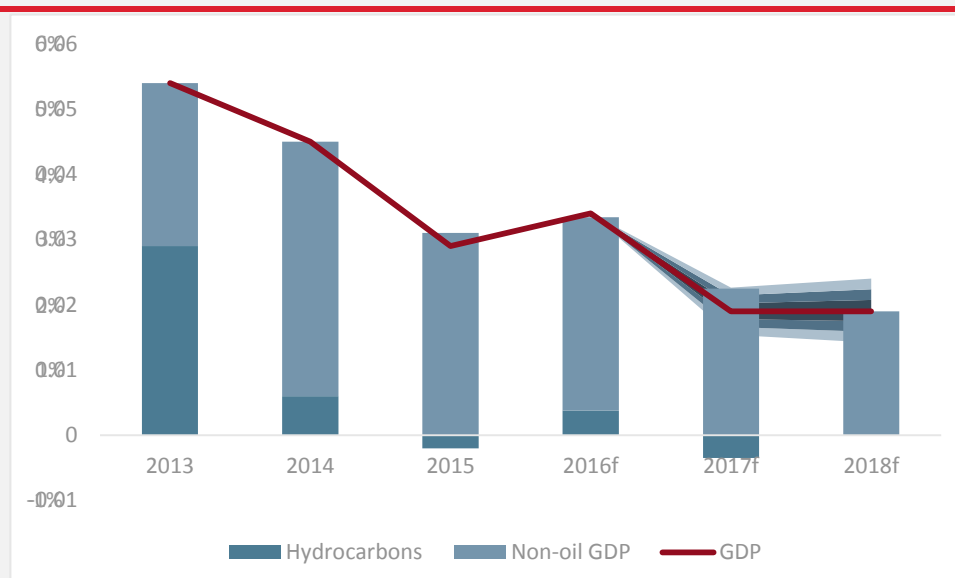


Source: Information & e-Government Authority

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

	2015	2016f	2017f	2018f
Real GDP growth, %	2.9%	3.4%	1.9%	1.9%
Non-hydrocarbons sector	3.6%	3.7%	2.8%	2.3%
Hydrocarbons sector	-0.1%	1.9%	-1.8%	0.0%
Nominal GDP growth, %	-6.8%	4.2%	6.2%	4.3%
Inflation (CPI %)	1.8%	2.9%	1.8%	1.8%
Current account (% of GDP)	-2.4%	-4.6%	-3.8%	-3.8%
Fiscal balance (% of GDP)	-13.0%	-12.6%	-8.9%	-7.4%
Crude Oil Arabian Medium (USD)	50	43	52	55

Source: Central Bank of Bahrain, Ministry of Finance, Information & e-Government Authority, Economic Development Board forecasts

**Projected real GDP growth contribution**

The strong Q3 national accounts data makes it highly likely that 2016 as a whole will match 2015 in terms of economic growth. In fact, both the non-oil economy and especially the oil sector now look likely to expand slightly faster than in 2015. Hence, even as the economy has been affected by a range of fiscal consolidation measures, a rapid build-up in infrastructure investment has proven to be a potent countervailing force.

Going forward, the economy is likely to benefit from some additional tailwinds from higher oil prices even if further fiscal consolidation is expected in line with the Government's plan to reach a budget balance by 2022. The rapid build-up in project spending is likely to continue during much of 2017 thanks to a number of new manufacturing and real estate investments. Nonetheless, base effects and subdued Government expenditure are likely to bring headline growth rates to approximately 2%. The oil sector may post a small net decline in 2017 having exceeded expectations in 2016.

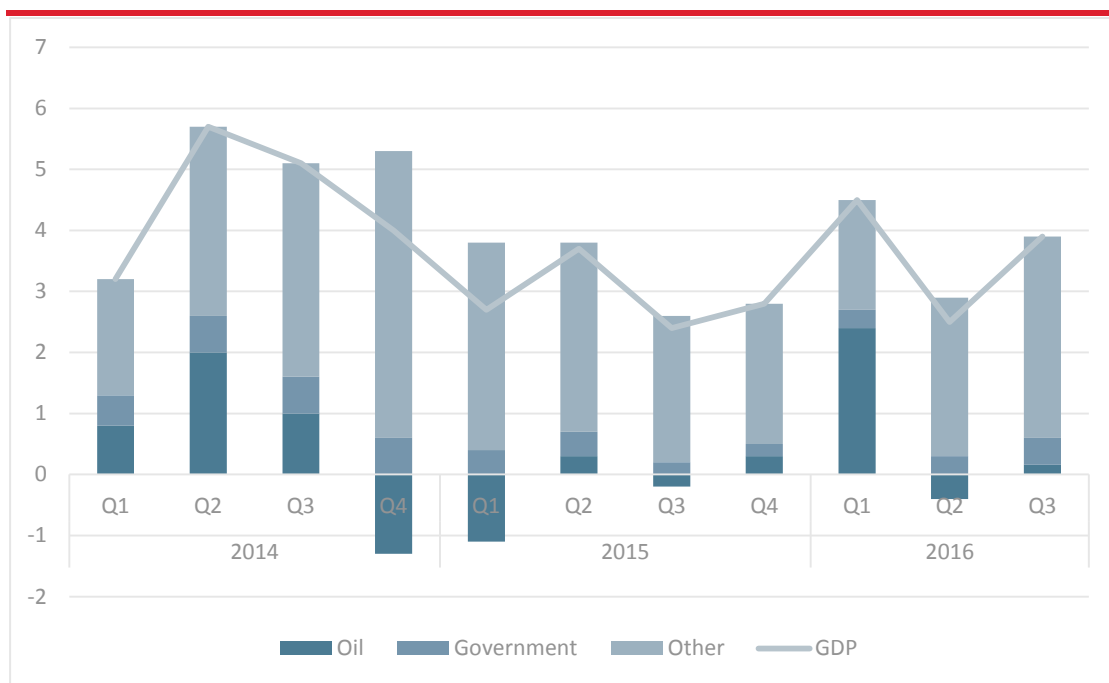


## The growth drivers accelerate

*The growth contribution of the non-oil economy made up nearly three-quarters of the total GDP increment*

Economic growth drivers in Bahrain strengthened appreciably during Q3 as compared to the first half of the year. All in all, the dynamics of growth in the Kingdom were broadly comparable to the pattern observed in 2015. All sectors of the economy posted positive progress in YoY terms. Much in line with an established track record, the non-oil private sector delivered the vast majority of the GDP increment, accounting for 3.3 percentage points of the headline growth figure. The contribution of the Government Services sector increased somewhat but remained fairly modest at 0.4 percentage points. The hydrocarbons sector delivered the remaining just under 0.2 percentage points of the real GDP increment.

### Real GDP growth composition



Source: Information & eGovernment Authority

As compared to the first half of the year, the pattern of growth became significantly more broad-based. Furthermore, most sectors saw an acceleration in their momentum. The fastest growing single sector, as so often before, was Social & Personal Services, an area dominated by private education and health care provision. It was the only sector to achieve double-digit YoY growth at 10.5%. This marked a further improvement on an already strong Q2 figure of 9.9%. The second fastest growing sector was Financial Services, which expanded by a brisk 7.4% in a sharp pick-up from the 4% rate posted in Q2.

At the heart of the strong momentum of the non-oil economy was the Construction sector which has been propelled forward by an unprecedented pipeline of infrastructure projects. The Construction sector expanded by an annual 7.7% in a clear further improvement on the 5.9% figure posted in Q2. Construction is historically a sector with strong forward and backward linkages in the economy and its increased strength likely accounts for some of the marked acceleration seen in the growth rates of several other sectors.

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

The Transportation & Communications sector expanded by an annual 4.6% and there were some clear improvements in areas such as Trade and Hotels & Restaurants that generally tend to be more sensitive to changes in discretionary income. By contrast, the Manufacturing sector, traditionally one of the stronger growth drivers, saw its rate of expansion decelerate to just 0.8%, likely due to seasonal factors.

	2015					2016		
YoY growth	Annual	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Crude Pet. & Nat. Gas	-0.9%	-5.6%	1.4%	-1.0%	1.5%	12.1%	-1.7%	0.8%
Manufacturing	4.1%	5.9%	4.1%	3.3%	3.4%	1.2%	3.3%	0.8%
Construction	6.4%	7.7%	6.4%	4.9%	6.8%	5.4%	5.9%	7.2%
Trade	1.7%	2.7%	2.8%	0.2%	1.0%	2.2%	2.3%	3.1%
Hotels & Restaurants	3%	5%	1.4%	4.1%	1.7%	1.5%	1.1%	2.2%
Transp. & Comm's	5.9%	6.9%	6.7%	5.8%	4.3%	3%	2.4%	4.6%
Social & Pers. Serv.	6.9%	7.6%	6.2%	6.3%	7.3%	8.4%	9.9%	10.5%
Real Est. & Bus. Act.	2.8%	3.8%	3.7%	1.7%	1.9%	0.5%	1.8%	4.7%
Finance	1.7%	1.6%	2.1%	2.1%	0.9%	3.1%	4%	7.4%
Government	2.2%	2.8%	2.8%	1.7%	1.5%	1.1%	2.3%	3.5%
Other	7.7%	11.6%	11.4%	4.3%	4.1%	5.5%	2.1%	2.7%
GDP	2.9%	2.8%	3.7%	2.4%	2.8%	4.5%	2.5%	3.9%

Source: Information & e-Government Authority

### Oil output exceeds projections

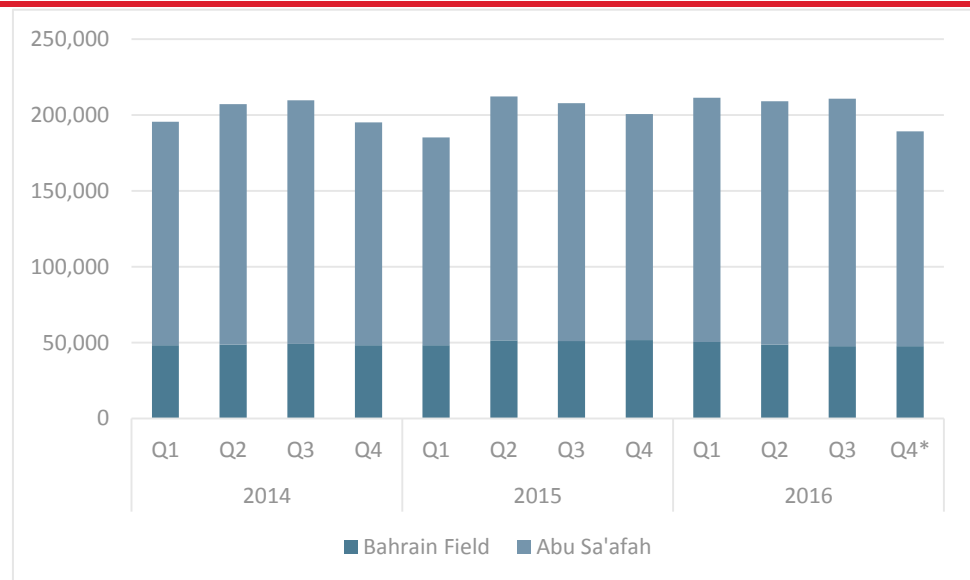
*Oil production remained at a historically high level through most of 2016*

Overall oil production in Bahrain continued at a historically high level in Q3, although seasonal maintenance brought down the total in Q4. The offshore Abu Sa'afah field continued to produce above its historical capacity in Q3, with an average daily output of 162,934 barrels in Q3. The onshore Bahrain field, by contrast, saw a slight drop in its production to 47,685 b/d. The preliminary estimate for Abu Sa'afah production in Q4 was a significantly lower 141,483 b/d due to scheduled maintenance toward the end of the year. Production from the Bahrain field remained more or less flat with a preliminary estimate of 47,738 b/d in Q4.

During the year 2016 as a whole, oil production in Bahrain exceeded 200,000 b/d with a total of 205,677 b/d. Abu Sa'afah produced slightly in excess of its standard capacity with an estimated annual average of 156,925 while production from the Bahrain field reached 48,753 b/d. Bahrain's total oil output in 2016 was 2.1% higher than in 2015. Offshore production from Abu Sa'afah increased by 4% whereas the Bahrain field witnessed a 3.6% YoY drop.

Bapco in November concluded an agreement with Eni of Italy and the local Tatweer Petroleum on the future development of national production assets. The partners are planning to evaluate exploration and productive resources in the Kingdom. Bapco recently completed a geological and geophysical survey of its offshore blocks and deep gas reserves. It is inviting international oil companies to develop these assets with a bidding round expected in 2018. Bahrain launched deep drilling in the Khuff reservoir in 2014. The drilling was at the depth of 8,000-10,000 meters and production began in 2015.

#### Crude oil production, b/d



\* The December figure is an estimate.

Source: National Oil and Gas Authority

#### Infrastructure accounts for continuity

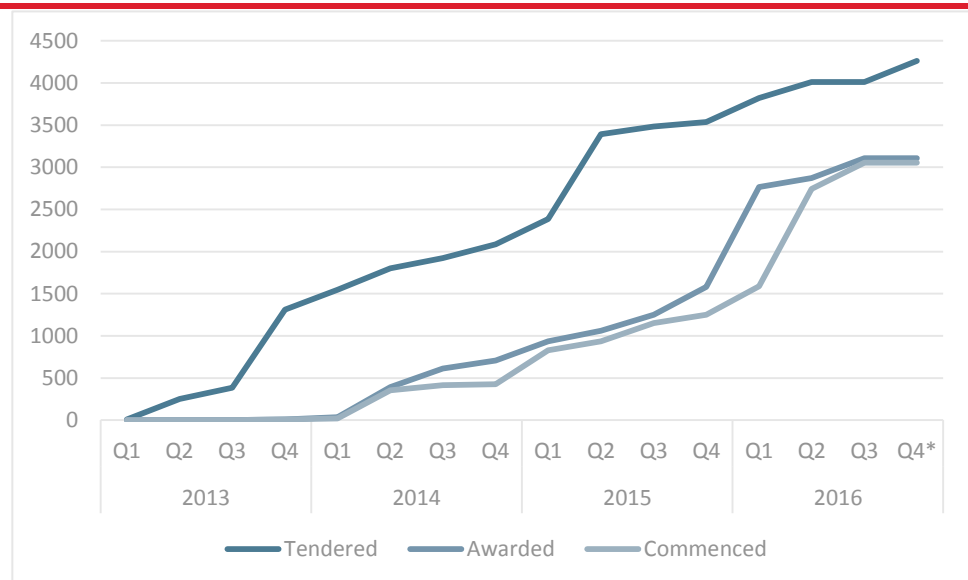
The sharp increase in the growth rate of the Construction sectors attests to the critical role of infrastructure investments as a major countercyclical growth driver in Bahrain. The overall pipeline

*The aggregate value of GCC-funded projects that have broken ground more than doubled in the course of 2016*

of projects stand at USD69.7bn as of early December, according to MEED. While the total was marginally down (-3.7%) in YoY terms, it is equivalent to nearly twice the Kingdom's GDP.

The GCC Development Fund constitutes an important element of this project pipeline and has seen a major acceleration in implementation during the past year. The total value of projects that have actually broken ground more than doubled from a total of USD1,251mn in 4Q15 to USD3,056mn as of December 2016. During the same period, the value of projects that had gone to tender rose by 20.5% to USD4,262mn. Consequently, the aggregate value of active projects should continue to expand significantly further in the course of 2017 as work on these ventures begins. More than a third of the GCC project pipeline is allocated to housing developments, while 21% is accounted for by electricity and water projects, and 16% by the airport redevelopment.

**GCC Development Fund project pipeline, USD mn (cumulative totals)**



Source: Government sources

Apart from landmark manufacturing investments (see below), several other projects are making headway:

- ✦ Tendering is underway for the EPC contract for the Tubli sewage plant expansion. The project is set to double the capacity of the plans from 200,000 to 400,000 cu m a day
- ✦ A financial consultant has been appointed for the Al Dur 2 independent power and water project for a 1,500 MW gas-fired power station
- ✦ Development work is due to start shortly on a light rail network

Much of the project pipeline is focused on the real estate sector which has shown considerable resilience in the face of challenging market conditions across the region. While rentals in the office and retail markets have been generally stagnant, they have generally exceeded expectations in the residential segment.

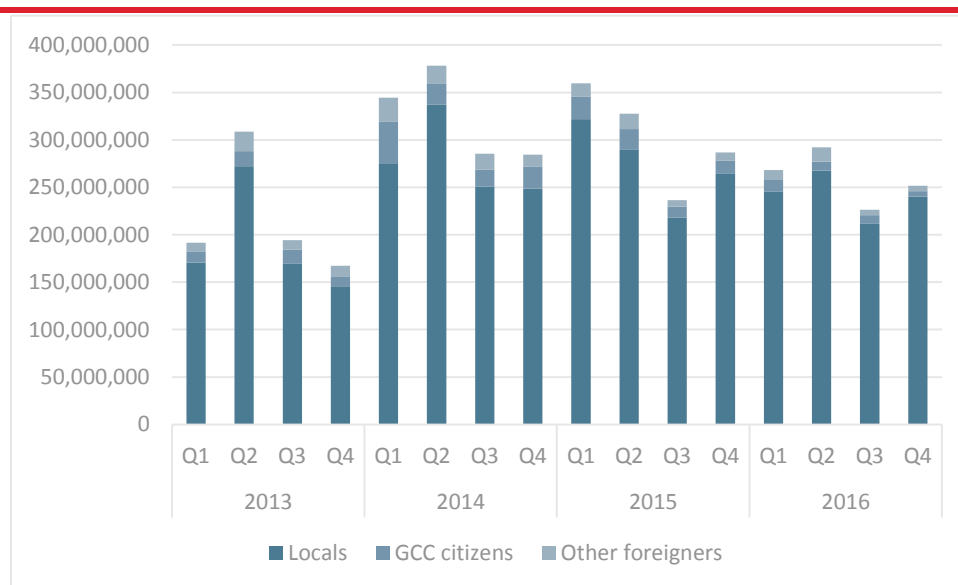
The recorded value of new contracts awards in Bahrain reached an estimated USD357mn in 4Q16. Major new awards in October included the relocation of cable networks and the construction of

new substations in connection with major highway developments. Japan's JGC won a USD98.7mn contract to build a pipeline system and storage facilities in the second phase of a project designed to recover high-value products from gas. Upon completion, the combined gas processing capacity of BNGEC (Bahrain National Gas Expansion Company) and Banagas will reach 653mn cu ft a day. A USD55mn project for the Waterfront Villas on Dilmunia Health Island was, similarly, awarded in October.

The most important project award in November were the USD150mn Harbour Row residential project, a USD53mn award for the construction of the Marassi Residences at the Marassi al Bahrain residential project, and Marina Development at Bahrain Marina. Harbour Row, located next to the Bahrain Financial Harbour, will have 450 residential units as well as retail and restaurant offerings. Work is expected to be completed in late 2018. The Marassi Residences is a 875,000 sq m development with 281 units and part of the Marassi al Bahrain project undertaken jointly by Eagle Hills and Diyar al Muharraq. Completion is projected in late 2018.

According to the Survey and Land Registration Bureau, the aggregate real estate trading volume during 2016 reached BHD1.21bn, which was some 14.2% below the 2015 total of BHD1.04bn. The slowest quarter during the year was July-September, when transactions totalled BHD226.36mn. In Q4, they rebounded to BHD251.77mn, which was 12% down YoY.

#### Aggregate value of real estate transactions, BHD



Source: Survey and Land Registration Bureau

#### Trade volumes rebound in H2

The autumn saw some renewed growth in trade volumes after a quiet summer. Imports reached a total of USD10.6bn during the first eleven months of 2016, down 7.1% YoY. Non-oil exports of national origin totalled USD4.4bn, which was 8.2% below the total attained in January-November 2015. Re-exports amounted to an aggregate of USD1.8bn during the first 11 months of 2016, which represented a near-halving from 2015 levels – a drop of 45.2%. This has been linked to significantly

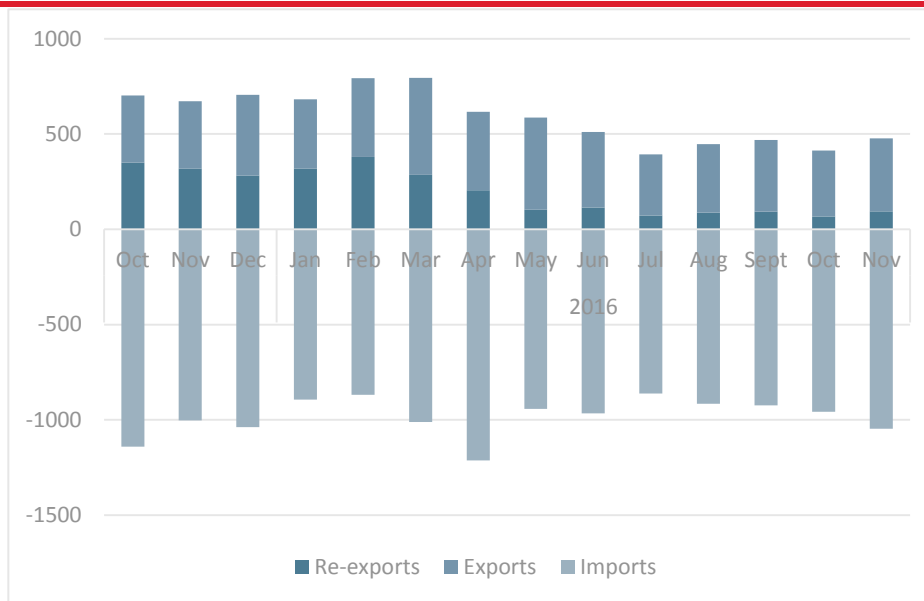
Major real estate projects were awarded towards the end of 2016

Trade volumes showed renewed growth in the autumn

lower import volumes in other parts of the region, most notably Bahrain's main re-export market, Saudi Arabia.

In general, the total value of Saudi imports has since March been consistently below the monthly figures recorded in 2012-2015. However, the numbers rebounded sharply in October. Saudi import volumes, as opposed to values, have, in fact, continued to grow. Import values have been affected by the strength of the US Dollar along with a period of weaker commodity prices.

#### Non-oil trade, USD mn



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

#### Inflationary pressures diminish further

*Consumer price inflation slowed down sharply in 2H16 with food price inflation in fact turning negative*

Bahrain experienced a clear pick-up in price pressures during the first half of the year as a result of a range of subsidy modifications. Since then, however, the Consumer Price Index readings have been on a remarkably consistent downtrend. Indeed, the annual rate of consumer price increases slowed down to just 1.5% in October and 1.9% in November. Overall, consumer prices during the first 11 months of the year were 3.2% higher than during the corresponding period of 2015.

Trends within the Consumer Price basket have become increasingly divergent, however. A sharp deflation has been observed in food prices, which declined by an annual 7.1% in October and by 5.1% in November. To an extent this is reflective of an absence of major upward pressures in the global agricultural commodities markets as well as the strength of the US Dollar. Bahrain, like the rest of the Gulf, imports most of its food. Moreover, the sharp reversal in prices also reflects a base effect from the upward jump that materialized a year earlier as a range of subsidy reforms were implemented.

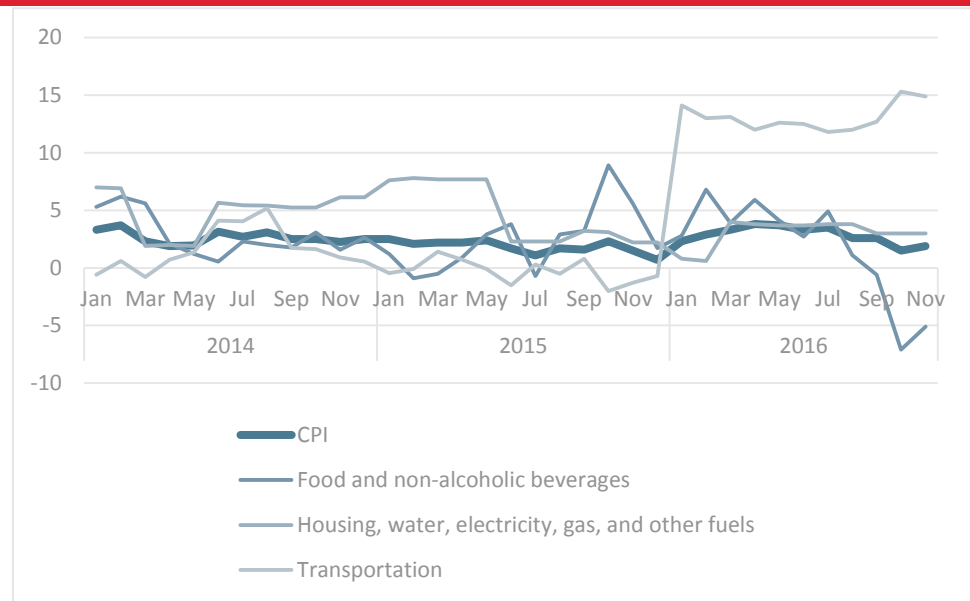
Housing costs have been on a very gradual downtrend and rose by an annual 3% during the September-November period. This suggests that the effects of earlier subsidy reforms have proven fairly short-lived. It also reflects the general stability of the real estate market at a time when new



supply is coming to the market and demand growth has been curbed by lower growth across the region.

A strikingly different picture can be observed in the transportation costs which have been rising at double-digit rates throughout the year and increased by an annual 15.3% in November.

### Consumer price inflation



Source: Information & e-Government Authority

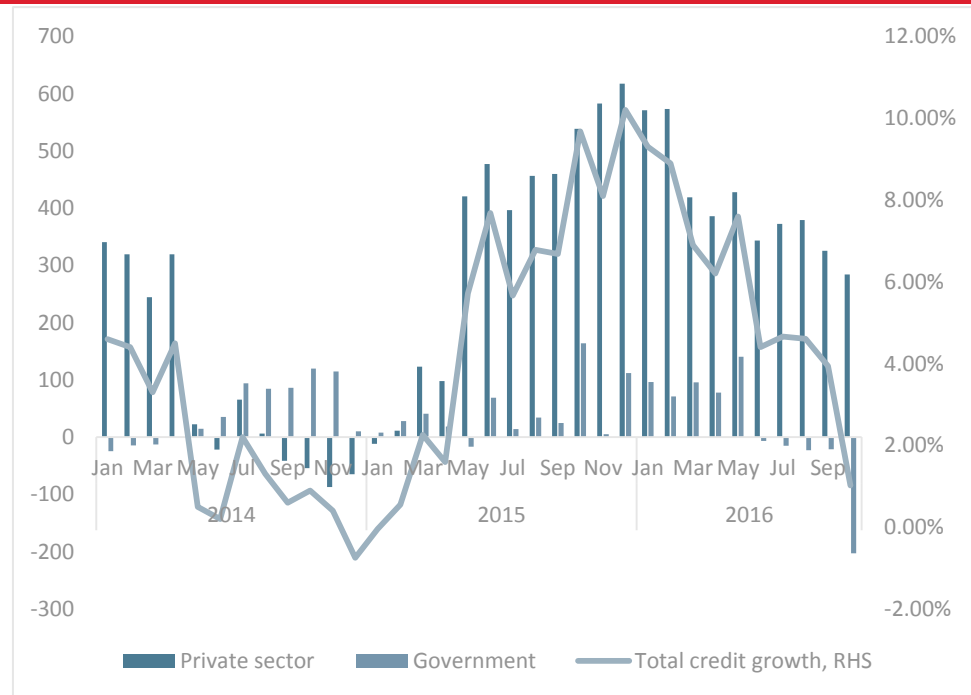
### New loan growth decelerates

*New credit growth decelerated somewhat in Q3 mainly in connection with slower growth of Government loans*

Credit growth in Bahrain has experienced some renewed slowdown from the peaks recorded around the beginning of 2016. The YoY increase in new retail bank loans was just over 1% in October. However, during the preceding quarter, the annual rate averaged 4.4%. The sharply lower rate in October was most immediately attributable to a sharp decline in lending to the Government, which contracted by BHD202.5mn YoY – or some 42.8%. However, little change in the aggregate volume of lending to the Government was observed as compared to the preceding quarter.

The composition of the outstanding loans portfolio has remained fairly static in recent months. Business loans accounted for 52.1% of the total, led by Construction and Real Estate (16.7% of the total portfolio), Trade (14%), and Manufacturing (6.9%). The share of personal loans in the total retail bank portfolio was 44.5%. Loans secured by a property mortgage made up 18.7% of the total, more than any other category. 3.4% of all retail bank lending went to the Government as of October.

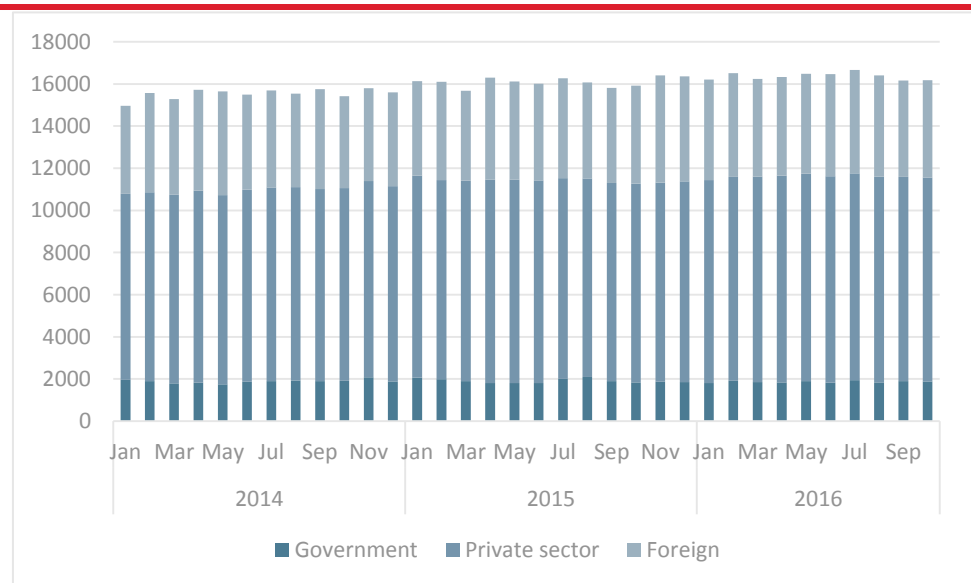
### Year-on-year credit growth to the private sector and government (BHD mn)



Source: Central Bank of Bahrain

Deposit growth has remained subdued during the year and in fact the overall deposit base declined slightly between July and October. In YoY terms, deposits declined by just under 1.8% to stand at BHD16,174.6mn as of October. Nonetheless, bank liquidity is relatively ample by regional standards. The loan to deposit (Dinar-denominated) ratio of Bahraini retail banks was 88.4% in Q3, up somewhat on 84% a year earlier.

### Deposit liabilities to non-banks (BHD mn)



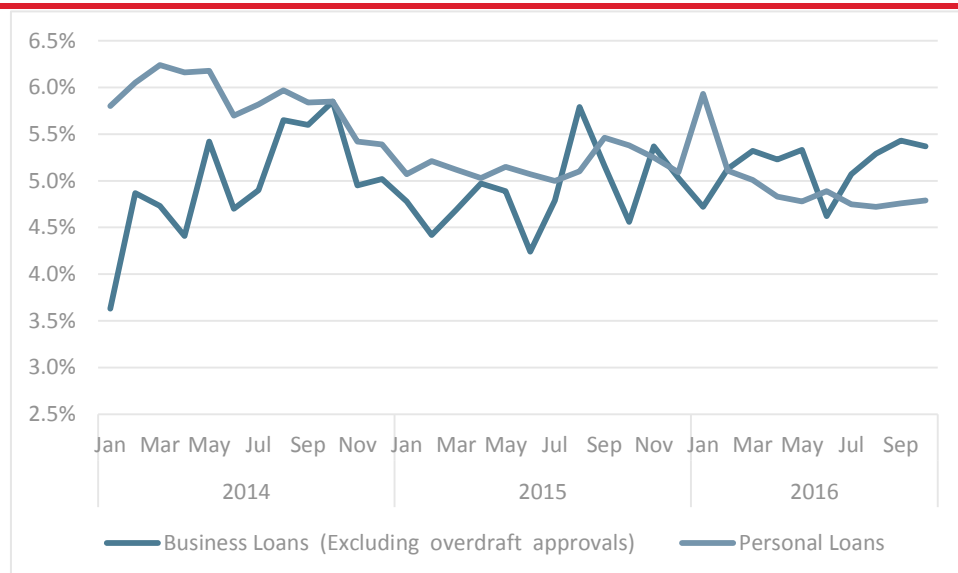
Source: Central Bank of Bahrain

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

The cost of credit has remained broadly stable in recent months. Some divergence has become apparent between different types of loans. Whereas the cost of personal loans has generally remained stable or even declined somewhat, the cost of business loans has been under some upward pressure. The cost of personal loans stood at 4.8% in October and averaged 5.2% during the first ten months of 2016. By contrast, the average rate levied on business loans on October was 5.4%, which compared to just under 5% during the first ten months of the year.

The Central Bank of Bahrain mirrored the recent Fed rate increase when it decided on 14 December to raise its key policy rate on the one-week deposit facility from 0.75% to 1.00%. The overnight deposit rate rose from 0.50% to 0.75%, the one-month deposit rate from 1.25% to 1.50%, and the lending rate from 2.50% to 2.75%.

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



Source: Central Bank of Bahrain

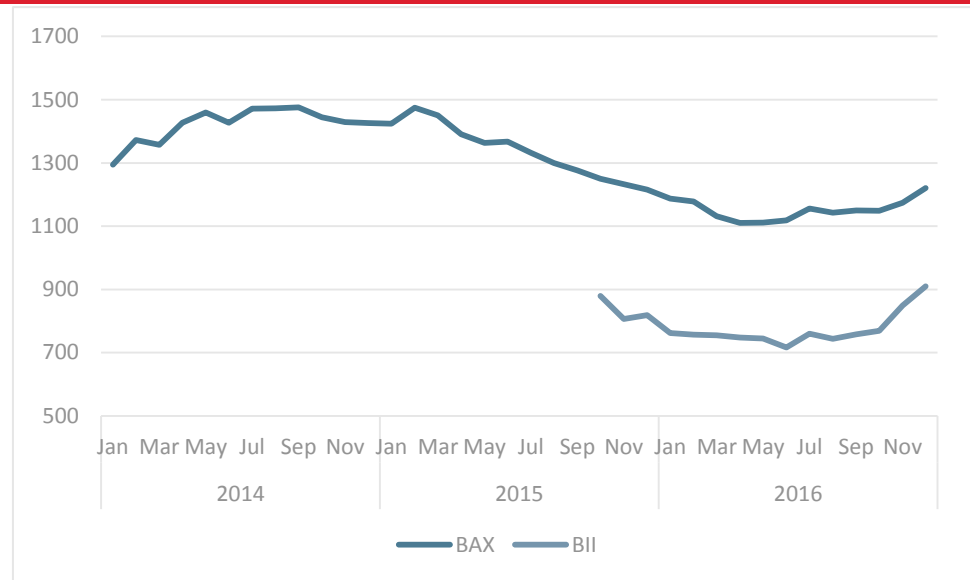
#### Bourse recoups losses in Q4

*Bahrain Bourse narrowly rebounded to positive territory for the year as a whole*

Echoing region-wide trends, Bahrain Bourse closed 2016 on a positive note. A year-end rally took the Bahrain All Share Index narrowly into positive territory for the year as a whole. BAX posted a 0.38% advance during the year and rose by 3.95% in December alone. This compared to a 14.77% decline in 2015. The Bahrain Islamic Index advanced by 11.18% during 2016 and saw a 7.95% increase in December.

The market capitalization of Bahrain Bourse rose by 5.97% in December 2016 to reach BHD7.25bn. Reflecting positive momentum, the value of shares traded increased by 201.89% in December to a total of BHD29mn.

### Bahrain All Share Index and Bahrain Islamic Index

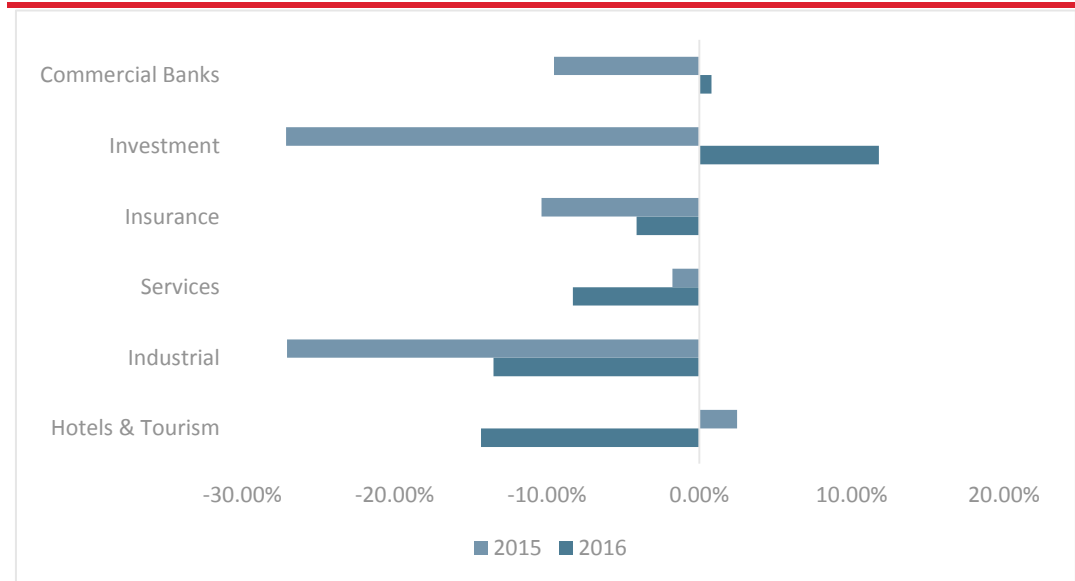


Source: Bahrain Bourse

The performance of the individual sector indices has remained variable. In general, the financial sector companies proved the strongest performers during the year. The Investment sector led the way with an 11.8% increase during the year. This represented a sharp reversal from a 27.1% loss in 2015. The Commercial Banks index posted a 0.8% gain on top of a 2.5% decrease in 2015. The Insurance index declined by 4.1% in an improvement on a 10.4% decline in 2015.

Most sectors posted net losses for the year as a whole, led by the Hotels & Tourism sector index which recorded a 14.3% drop after a 2.5% increase in 2015. The Industrial sector declined by 13.5% in an improvement on a 27.1% loss in 2015. The services sector shed 8.3% following a smaller 1.8% decline in 2015.

### Sectoral stock market indices, 2015-2016



Source: Bahrain Bourse

Stock market gains were led by financial sector companies

In a new listing for Bahrain Bourse, the Eskin Bank Realty Income Trust began trading on 2 January 2017. The trust has a total of 198mn units are listed with a nominal value of 100 fils each. The IPO consisted of 144,394,499 units with an aggregate value of BHD14.4mn. The trust is targeting 6.5% in net distributable income which will be payable semi-annually. The assets of the trust consist of Segaya Plaza, a mixed retail and residential property on Manama, and the commercial components of Danaat al Madina, a mixed-use development in Isa Town. The Eskin trust is the first Shariah-compliant real estate trust in Bahrain. Trading is open to GCC investors.

In the fixed income space, the last quarter of 2016 opened with a USD2bn two-tranche international sovereign offering in October. The issue was composed of a USD1bn Shariah-compliant tranche with a seven-year tenor and a USD1bn 12-year conventional bond. The sukuk was priced at 5.625% and the bond at 7%. The 144A/Reg S offering was met with strong investor interest and the order book exceeded USD7bn.

In early November, the Central Bank placed issue No 13 of Government Development Bonds. The BHD285mn offering has a tenor of 7.5 years and pays a coupon of 5.875%.

Otherwise, fixed income activity has been dominated by short-term sovereign issuance. The total outstanding value of Treasury bills at the end of the year stood at BHD1.785bn.

Issue date	Issue	Value, BHD mn	Maturity, days	Average interest/ profit rate, %	Average price, %	Over- subscript ion, %
2 Oct 2016	Treasury bill No. 1619	35	182	2.21	98.893	123
5 Oct 2016	Treasury bill No. 1620	70	91	2.03	99.489	100
12 Oct 2016	Treasury bill No. 1621	70	91	2.02	99.491	123
13 Oct 2016	Sukuk al ijarah No. 134	26	182	2.20		114
19 Oct 2016	Sukuk al salam No. 186	43	91	2.02		100
26 Oct 2016	Treasury bill No. 1622	70	91	2.00	99.496	129
2 Nov 2016	Treasury bill No. 1623	70	91	2.01	99.493	114
9 Nov 2016	Treasury bill No. 1624	70	91	2.03	99.490	100
10 Nov 2016	Sukuk al ijarah No. 135	26	182	2.20	99.483	258
13 Nov 2016	Treasury bill No. 1625	35	182	2.25	98.874	100
16 Nov 2016	Treasury bill No. 1626	70	91	2.05	99.485	100
23 Nov 2016	Sukuk al salam No. 187	43	91	2.05		128
30 Nov 2016	Treasury bill No. 1627	70	91	2.05	99.484	100
1 Dec 2016	12-month Treasury bill No. 31	225	365	3.02	97.038	120
4 Dec 2016	Treasury bill No. 1628	35	182	2.27	98.866	100
7 Dec 2016	Treasury bill No. 1629	70	91	2.06	99.482	114
14 Dec 2016	Treasury bill No. 1630	70	91	2.09	99.475	100
15 Dec 2016	Sukuk al ijarah No. 136	26	182	2.25		100
21 Dec 2016	Sukuk al salam No. 188	43	91	2.05		100
28 Dec 2016	Treasury bill No. 1631	70	91	2.18	99.452	127
1 Jan 2017	Treasury bill No. 1632	35	182	2.32	98.842	117

Source: Central Bank of Bahrain

*A two-tranche USD2bn international offering in October met with strong investor interest*

In the corporate space, Gulf Holding Company has signed a sukuk agreement with Al Rajhi Bank of Saudi Arabia and GFH Financial Group. The issue will be used to finance the USD700mn Vilamar Project located next to the Bahrain Financial Harbour.

### Continuity in the insurance sector

Bahrain's insurance sector experienced continued expansion against the backdrop of a challenging regional market environment in 2015. Total gross premiums written in the country attained BHD272.1mn in line with the 2014 total. The strongest growth was observed in the Shariah-compliant and medical market segments:

*Growth in the insurance sector is led by Shariah-compliant and medical insurance*

- ✦ Insurance penetration in Bahrain rose from 2.32%, from 2.15% in 2014
- ✦ Bahrain is currently home to 25 locally incorporated insurers and 11 branches of foreign companies. Their total assets rose by some 7% to reach BHD1.8bn in 2015
- ✦ The gross contributions of Takaful companies rose by 3% to a total of BHD63.2mn. The now account for close to a quarter (23%) of the market
- ✦ Medical insurance gross premiums rose by 11% to BHD53.6mn and now represent roughly a fifth of the total premiums written in the Kingdom
- ✦ Long-term insurance (life and savings products) now account for a fifth of the total premiums at BHD55mn
- ✦ Motor insurance premiums rose by some 4% to BHD75.8mn, making it the largest single category of insurance with a 28% share of all premiums written in 2015

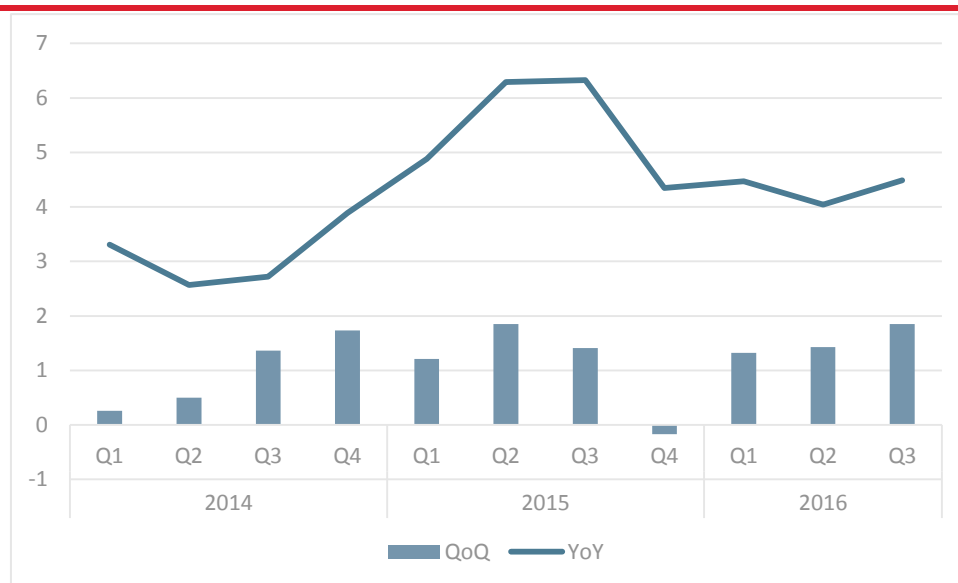
### Job growth remains historically high

Job creation in Bahrain has continued as a brisk pace is line with the healthy momentum of the non-oil economy. The total number of contributors to the Social Insurance Organisation rose by an annual 4.5% in Q3, to a total of 646,840. The annual growth rate of contributors has been in excess of 4% since 4Q14.

*Private sector job creation remained strong with SIO contributors increasing by an annual 4.5% in Q3*



### Change in the number of contributors to the Social Insurance Organisation, %



Source: Social Insurance Organisation

### External assessments

Index/report	Description	Global rank	MENA rank	Key strengths highlighted
<b>ICT Development Index</b> by United Nations International Telecommunication Union	A composite measure that ranks countries according to their level of ICT readiness (Access), ICT intensity (Use), and ICT capability (Skills)	29 (out of 175)	1	High ICT use 185.25 mobile-cellular telephone subscriptions per 100 inhabitants 94.8% of households have a personal computer 93.48% of individuals use the internet
<b>Globalization Hotspots</b> by DHL	Globalization hotspots are defined as cities with the most intense international flow of trade, capital, people, and information as compared to their internal, domestic activity	2 (out of 113)	1	Manama City classified as a Globalization Hotspot
<b>Islamic Finance Development Index</b> by Thomson Reuters	Designed to represent the overall health and development of the Islamic finance industry. Composed of five key pillars: quantitative development, knowledge, governance, corporate social responsibility, and awareness	2 (out of 124)	1	Global leader in Islamic financial regulations Global leader in Shariah governance

*Bahrain has performed well in recent international rankings focusing on areas such as human capital, connectivity, and entrepreneurship*

<b>Human Capital Report</b> by the World Economic Forum	Evaluates how effectively the human capital potential of a nation has been realized. Evaluates Learning and Employment as two general themes across different age categories	46 (out of 130)	1	Increased rates of educational attainment High education quality High staff training Availability of skills within the labour force
<b>Youth Development Index</b> by the (British) Commonwealth	Assesses the environment for young people (aged 15-29). Composed of five areas: education, health & wellbeing, employment & opportunity, civic participation, political participation	41 (out of 123)	1	Bahrain classified in the 'Very High Youth Development' category High civic participation with youth volunteering time Existence of a youth policy, voter education, and ability to address views to politicians
<b>Human Capital Report</b> by the World Economic Forum	Evaluates how effectively the human capital potential of a nation has been realized. Evaluates Learning and Employment as two general themes across different age categories	46 (out of 130)	1	Increased rates of educational attainment High education quality High staff training Availability of skills within the labour force
<b>Global Entrepreneurship Index</b> by the Global Entrepreneurship and Development Institute (GEDi)	Evaluates a country's entrepreneurial ecosystem by combining 'Individual' measures such as opportunity recognition, start-up skills, and risk acceptance with 'Institutional' indicators such as urbanization, education, and economic freedom	34 (out of 137)	1	

Key aspects of Bahrain’s competitiveness

Ranked **1<sup>st</sup> in MENA** across all indices, while globally:



## KEY SECTORS

### PUSHING FOR INNOVATION

At a time of fiscal consolidation across the GCC region, the traditional model of economic growth through factor accumulation is being increasingly tested. With projected slower growth in inputs, productivity has assumed an ever more critical role as a driver and enabler of economic progress. This is forcing established companies to revisit and refine their business models in pursuit of greater efficiency. In Bahrain, a number of sectors are seeing important investments into new technologies and scaling up, typically concomitantly with significant efficiency gains. On a macro-level, economies are having to think more creatively about ways of encouraging innovation and risk taking. Bahrain has seen important new regulatory initiatives along with structured efforts to encourage innovative start-up activity and technological development.

#### Regulatory reform makes headway

The past couple of months have seen several important regulatory initiatives designed to enhance Bahrain's unique value proposition as a liberal but well regulated platform for business in the GCC. These include the following:

- ✦ Implementing regulation for the Commercial Register Law (Ministry of Industry, Commerce, and Tourism Resolution No. 126 of 2016). This modernizes the modalities of corporate registration and mandates an electronic process through a designated website
- ✦ Amendment to the Implementing regulation of the Commercial Companies Law (Ministry of Industry, Commerce, and Tourism Resolution No. 127 of 2016). This provides for shelf companies and set out the annual reporting requirements for WLL companies. Partners are authorized to acquire stakes in competing companies unless forbidden by articles of association
- ✦ Cabinet Resolutions No. 49 and No. 50 of 2016 further liberalized foreign ownership regulations through new criteria for 94 activities that allow for 100% foreign ownership as well as 12 others where foreign participation is capped at 49%. The fully liberalized sectors include various kinds of ICT activities, metals casting, oil and gas services, and air freight
- ✦ Law No. 18 of 2016 on Investment Limited Partnerships provides the legal framework for the creation of partnerships for Private Investment Undertakings, Collective Investment Undertakings, securitization, and captive insurers. The law is intended to make it easier for companies to raise capital by allowing them to establish financial investment funds
- ✦ Legislative Decree No. 22 of 2016 on Protected Cell Companies Law introduces new corporate structures that can carry out Private Investment Undertakings, Collective Investment Undertakings, securitization, and captive insurance. The law allows for existing companies to be converted into cell companies with the consent of the Central Bank. The cell structure can reduce the costs of set-up and management of companies

*Important efforts are critically needed and underway to encourage a transition to a more productivity-driven growth model in the GCC*

- ✦ Legislative Decree No. 23 of 2016 on Trusts Law covers all types of trust structures (not just financial as the old law). It is designed to facilitate estate planning, charitable activities, and financial activities, such as securitization
- ✦ Supreme Council of Health Resolution No. 26 of 2016 on the Assessment and Accreditation of Private Hospitals
- ✦ Double taxation treaties were ratified with Cyprus and Portugal

### Introducing Islamic FinTech

The 23<sup>rd</sup> World Islamic Banking Conference was held in Bahrain on 5-7 December. A pre-conference day highlighted the growing importance of the rapidly evolving field of FinTech for the future of Islamic finance. Globally, FinTech has established itself as a major industry with an estimated 1,000 active companies boasting USD105bn in funding and USD870bn in market capitalization. The main focus of these ventures is the personal/SME segment, where technological innovation is seen as having particular potential for improving access and efficiency. Estimates from other sectors suggest that digital disruptions can reduce the market share of incumbents firms by up to 50% over a 5-10-year period.

The Central Bank of Bahrain is working toward creating a regulatory sandbox for FinTech companies. Key priorities for supporting the growth of the sector are likely to involve regulations on crowdfunding, easier processes for setting up businesses, and appropriate, efficient, non-punitive bankruptcy regulations. Access to venture capital is likely to be critical and is an area where Governments can play a critical supporting role.

Bahrain is particularly well positioned to service the needs of the Islamic financial industry given its exceptional cluster of Islamic financial institutions and standard-setting bodies. The ICD-Thomson Reuters Islamic Finance Development Report 2016 launched at the WIBC named Bahrain the regional leader (and second globally) in the development of Islamic finance for the fourth consecutive year. Bahrain stands out particularly due to its regulatory environment and governance mechanisms. Among other things, Bahrain gained a top ranking in the Shari'ah Governance sub-indicator.

At the same time, Islamic finance is seen as highly conducive to technological innovation that can achieve greater inclusion. Moreover, the central principle of risk sharing in Islamic finance is very much aligned with the nature of venture capital investment. In both cases, there is an emphasis on equity investments with the expectation of profit sharing and the recognition that the capital of the investors is potentially at risk.

The Bahrain Institute of Banking and Finance (BIBF) is preparing a FinTech workshop in February jointly with UPaid Payment Solutions and MasterCard. The event will target financial services professionals and consultants. It will review opportunities and solutions in the space and discuss the potential of FinTech for Islamic finance. BIBF is further introducing an Islamic Finance e-Platform which will use digital learning tools to allow for international access to the Islamic finance courses offered by the institute. Specifically, BIBF's Advanced Diploma in Islamic Finance as well as the standards produced by the Accounting and Auditing Organization for Islamic Financial

*Bahrain, building on its established strengths, is positioning itself as a pioneer in the area of Islamic FinTech*

Institutions (AAOIFI) will be converted to an e-platform along with assessments and case studies. The platform is sponsored by several local Islamic banks along with the Central Bank and is due to formally launch by February. BIBF has also launched a new “Convergence of halal market economy and Islamic capital” course. The program is offered jointly with DinarStandard, a New York-based advisory firm. The halal food and Muslim lifestyles sector was estimated to be worth USD2trn globally in 2013. It is projected to grow to USD3.74trn by 2019.

In the area of new market entrants, the Central Bank of Bahrain in late October licensed T.C. Ziraat Bankası A.S. to open a branch in Bahrain. Ziraat will be operating as a conventional wholesale bank in the Kingdom making it the ninth Turkish bank to hold such a licence in Bahrain. Ziraat is a fully state-owned commercial and retail bank which was originally established in 1863. In terms of assets, it is the second largest bank in Turkey. Its primary focus historically is on the agricultural sector. It currently has operations in 18 countries globally.

### ICT entrepreneurship ecosystem takes shape

Creating a conducive environment for the development of technology start-ups is one the key economic priorities of Bahrain. Bahrain’s established technology start-ups include the payment firm PayTabs and CTM360, a cyber security firm. In addition, several foreign technology companies are using Bahrain as a regional base. Examples include Huawei, Tech Mahindra, and Sage Software.

Several important developments happened in this space during the closing months of 2016:

- ✦ One of the key focus areas for Bahrain in developing its ICT sector has been closer collaboration with China. A high-level visit to the China High Tech Fair in Shenzhen in November resulted in new collaboration agreements with Invest Shenzhen, Shenzhen Capital Group (a local venture capital group), and BYD Auto Industry Company
- ✦ The fifth MENA Angel Investors Summit was hosted by Tenmou in November. Tenmou is Bahrain’s first business angels organization. The summit has emerged as a key event for the region’s growing start-up community. The event featured pitches by some 30 start-ups from 15 different countries. Since the start of the event in 2010, the MENA Angel Investors Summit has connected an estimated 1,000 investors with 150 entrepreneurs
- ✦ Amazon Web Services decided to open an office in Bahrain in January 2017. It will support users transitioning to make use of the AWS Cloud. The office is further planning to expand AWS Cloud Training and Global Certification Programs. AWS technology is also the backbone of the new Cloud 10 Scalerator set up in Bahrain by the technology investment firm C5

*Important steps were taken in Q4 toward creating a conducive start-up ecosystem in Bahrain*

### Manufacturing projects make headway

Bahrain’s manufacturing sector is amidst transformative change with several major expansion projects which, apart from increasing capacity, will embody more efficient technology:

- ✦ ALBA Line 6 project is progressing following the close of a USD1.5bn worth of commercial loan financing at the end of Q3. This is expected to be followed by a USD1bn package from export credit agencies by the end of 1Q17. The total project budget stands at USD3bn. At the same

time, the company is pursuing a cost-reduction strategy which was originally launched in 2014. The current stage is designed to reduce cash costs by USD100 a tonne by the end of 2017. The first phase of the project achieved savings of USD148 per tonne

- ✦ Bapco is looking to award the key EPC contract for its modernization project in the first half of 2017 having received bids from four consortia led by Fluor, Technip, JGC, and CB&I, respectively. The crude distillation capacity of the refinery is set to increase from 267,000 to 360,000 b/d. The project is expected to be completed in 2020
- ✦ Following their October 2016 agreement, Kuwait's Petrochemical Industries Company and the National Oil and Gas Authority of Bahrain are due to select an EPC contractor for their joint aromatics chemicals complex by June. Bapco was appointed in September 2014 as the feed contractor for the project. The plant will have a total capacity of 1.44mn tonnes a year. Bapco will deliver the naphtha feedstock for the facility. The total project budget is estimated at USD1.5bn
- ✦ Nogaholding, the national holding company for hydrocarbons assets, in December finalized the arrangements for a USD741mn, 20-year loan to finance an LNG import terminal which is being built as a joint venture by nogaholding, Teekay, Samsung, and Gulf Investment Corporation. GS Engineering & Construction of Korea last year won the USD655mn EPC contract for the terminal. The new facility will have a capacity of 800mn cfd. The financing package involved nine international and regional banks
- ✦ Apicorp (Arab Petroleum Investments Corporation) in December acquired a 30% stake in Falcon Cement Company, the largest cement producer in the Kingdom. The company is planning to increase its capacity from 1,000 tn to 2,400 tn per day

In terms of new market entrants, Armacell in October announced plans to build a new manufacturing facility in the Kingdom. Armacell is a global leader in flexible foam for the equipment insulation market. The factory will be based in the Bahrain International Investment Park and will produce elastomeric rubber insulation for the heating, ventilation, air conditioning market in the GCC and Africa.

Kuwait-based Agility, which is one of the regional leaders in the area of logistics, announced plans to invest USD10mn to expand its regional logistics hub in Bahrain. The facility will cover an area of 28,000 sq m. Agility first set up operations in Bahrain in 2003.

### Travel technology expanding Bahrain's tourism sector

Disruptive technology is quickly emerging as a major driver of change within the travel industry. Markets globally, the Gulf region included, are having to adjust to a new business environment where consumers can research, book, enjoy, and review their travel experiences much more directly and instantaneously than before. The improved availability of information and a growing range of products is allowing travellers to seek unique, memorable travel experiences, often including destinations that are seen to be offering something different. Such travel experiences are frequently associated with not only distinctive activities but also individualistic choices of accommodation and other travel-related services. Travel technology has both answered the call

*Important new investment have been announced in food manufacturing, trailer production, and logistics*

*Technological change is emerging as a major disruptive force to improve consumer choice in the tourism sector*

of consumer demand, and at the same time fuelled an expanded appetite for more convenience and engagement. At the initial stages of this paradigm shift, technology was harnessed primarily to activities such as pricing and booking airfares, accommodation and car hire. Companies such as Sabre, which has its regional headquarters in Bahrain, led the way in developing programs that allowed travel agents to book basic travel requirements easily. Technology has now rapidly expanded to include consumer options for all aspects of tourism including tours, guides, restaurant reservations, business events, activities, and more.

The rapid pace of technological change within the travel sector is reshaping the development of the tourism sector in the GCC, including Bahrain. For example, technology companies that specialize in private accommodation such as Airbnb and Flipkey now offer units available for rent in Bahrain. Last year, Dubai Tourism announced a partnership with Airbnb where the Emirati authority licenced over 4,000 units for short-term rental. Ride-sharing services have, similarly, emerged as a prominent disruptor to traditional travel behaviour. UAE-based Careem continues to show strong growth and has emerged as one of the region's start-up 'unicorns.' The company recently attracted a USD100mn investment by Saudi Telecom in exchange for a 10% stake. Careem is working with the Economic Development Board and the Ministry of Transportation and Telecommunications to build its presence in Bahrain as well. The company aims to work with Bahrain taxi companies to offer services in the Kingdom.

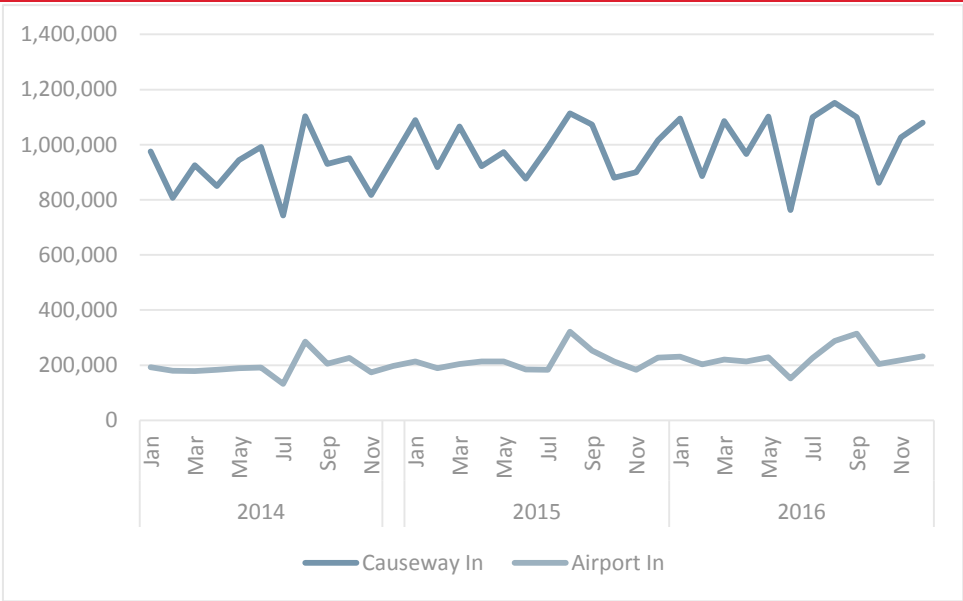
Visitor activity technology is also affecting how Bahrain's visitors experience the destination. Apps such as Eat and the newly launched, Bahrain-based Tamarran allow visitors to manage their experience in a convenient and bespoke way. Unique tour offerings have reached the GCC by way of services such as ToursByLocals and Vayable.

Bahrain continued to see healthy growth in its inbound visitor numbers during 2016. According to the Nationality, Passports, and Residence Affairs Directorate of the Ministry of Interior, the total number of visitors arriving through the King Fahad Causeway and the Bahrain International Airport rose by 3.67% during the year to reach just under 15mn (14,948,267).

Inbound visits across the King Fahad Causeway increase by 3.36% during the year to attain a total of 12.2mn. Arrivals through the airport reached a figure of 2.7mn, which marked a 5.1% YoY gain.



Visitor arrivals by port of entry



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

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