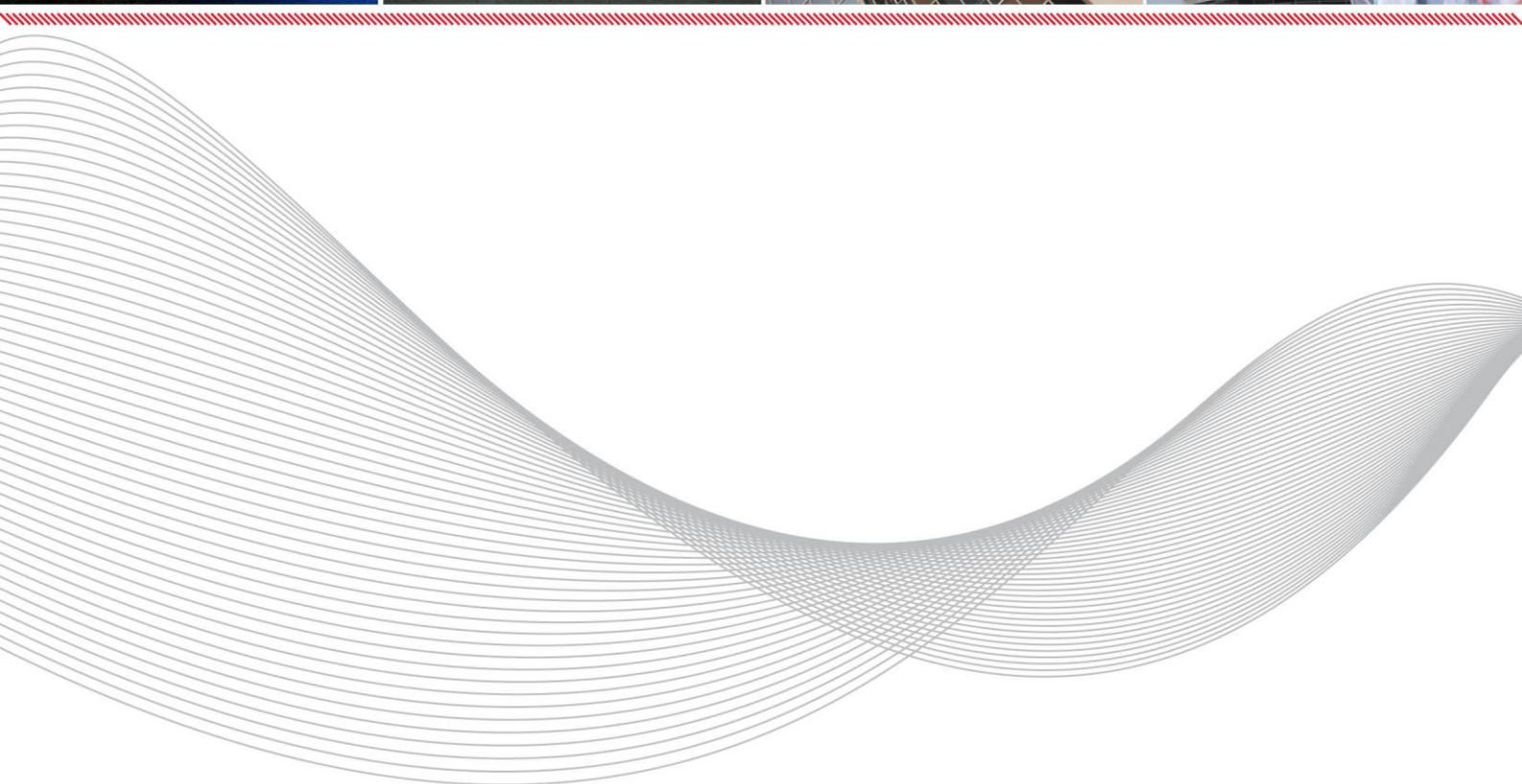
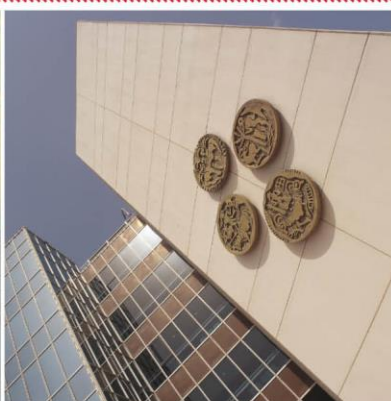


# Bahrain Economic Quarterly

December 2014



## SUMMARY

### RESILIENCE IN THE FACE OF UNCERTAINTY

In spite of increased volatility in the global oil markets, economic growth in Bahrain has remained robust with clear indications that infrastructure spending is significantly boosting the momentum of the non-oil sector. This serves as an important source of economic resilience at a time of renewed weakness in much of the global economy.

- ▶ **Q3 headline growth in Bahrain reached 5.1% YoY.** While somewhat below the 5.7% rate recorded in Q2, the latest GDP reading is indicative of a pronounced pick-up of economic activity in the Kingdom. This appears largely driven by the initiation of infrastructure projects, which boosted the annual rate of growth in the construction sector to 12.3% in Q3 as compared to 3.6% in Q2.
- ▶ **Bahrain's oil sector growth has remained positive.** Contrary to earlier expectations of more or less flat output levels this year, the hydrocarbons sector in Bahrain has continued to post positive growth throughout the year. Following 9.5% annual expansion in Q2, the sector recorded 4.7% growth in Q3.
- ▶ **Regional growth dynamics remain favorable in spite of some signs of cooling.** The strong performance of the GCC economies will be supportive of growth in Bahrain. GCC growth is above all due to robust non-oil growth drivers and a massive infrastructure pipeline which has cushioned the effects of lower oil prices.
- ▶ **Global uncertainty has depressed oil prices.** Continuing the pattern of recent years, global growth remains fragile and highly uneven. While the US economy has continued to strengthen, the Euro-zone is teetering on the edge of another recession and the outlook for emerging markets is mixed at best. This renewed weakness has triggered a sharp correction in oil prices at a time of continued output gains in North America.

#### Bahrain economic outlook

	2013	2014f	2015f	2016f
Real GDP growth, %	5.3%	4.2%	3.6%	3.3%
Non-hydrocarbons sector	3.0%	4.6%	4.5%	3.9%
Hydrocarbons sector	15.3%	2.9%	0.0%	0.5%
Nominal GDP growth, %	8.3%	3.1%	2.1%	5.8%
Inflation (CPI %)	3.3%	3.0%	3.0%	3.0%
Current account (% of GDP)	7.8%	5.7%	2.9%	2.0%
Fiscal balance (% of GDP)	-3.3%	-3.9%	-4.0%	-1.5%
Crude Oil Arabian Medium (USD)	106.4	96.0	80.0	80.0

Source: Bahrain Economic Development Board

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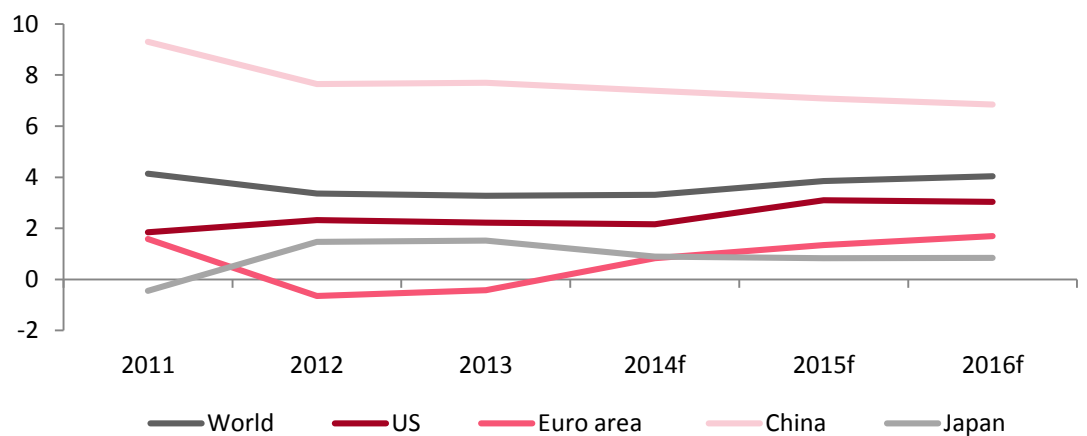
## GLOBAL ECONOMY

### THE RETURN OF VOLATILITY

*Renewed doubts about the strength and speed of the global recovery resurface*

Continuing a pattern of recurrent volatility established during the current crisis, recent months have been marked by renewed doubts about the strength and speed of the global recovery. This highlights the continued fragility of the global economy and its heavy dependence on aggressive, unconventional monetary policy. In a number of areas, new weaknesses and fault lines have emerged. Overall, the structural growth drivers have not yet recovered to the point of a strong, broad-based growth momentum. Apart from the risks overshadowing the recovery, the pattern of growth across countries remains highly uneven and, if anything, differentials are showing signs of widening. While the US economy is displaying increasingly consistent signs of strength, the Euro-zone is facing a real prospect of deflation and even a possible relapse to recession. Doubts are also multiplying about the prospects for Asia, while the performance of emerging markets has more generally been very uneven. All this increased anxiety has boosted financial markets' volatility and triggered a period of exceptional weakness in the commodity markets as with, for instance, the oil price declining by more than 40% from its early summer highs.

#### Real GDP growth, select countries (%)

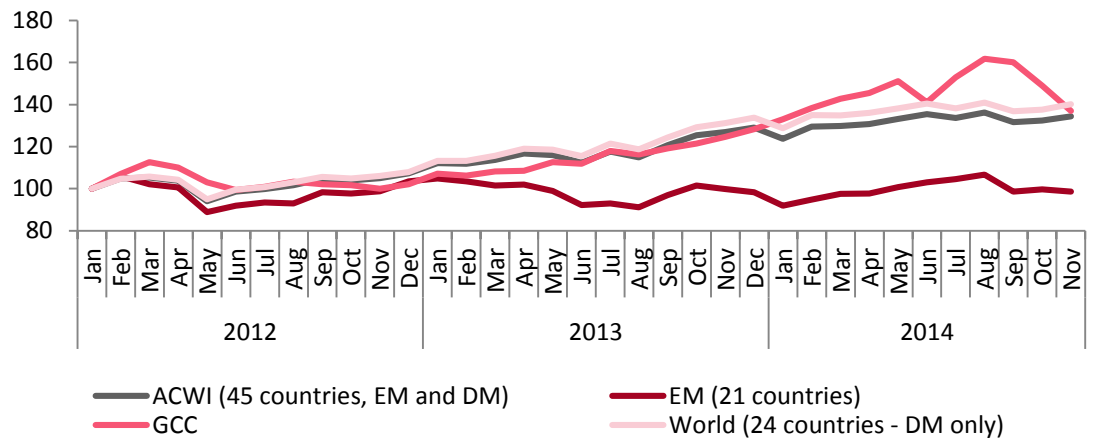


Source: International Monetary Fund, World Economic Outlook, October 2014 Update

*Equity markets have experienced renewed volatility in the face of new uncertainties*

Even as the continued loose monetary policy stance of most central banks has supported the performance of stock markets, anxiety about the global outlook and the impact of the oil price correction has triggered periodic corrections. In some countries, the weight of energy companies has negatively influenced market dynamics, while other markets have benefited from the likely stimulus effect of lower commodity prices. In a continuation of recent patterns, stock markets in the advanced economies have continued to outperform their emerging market peers. The link between unconventional monetary policy and stock market performance remains strong.

MSCI regional indices (Base Jan 2012=100)



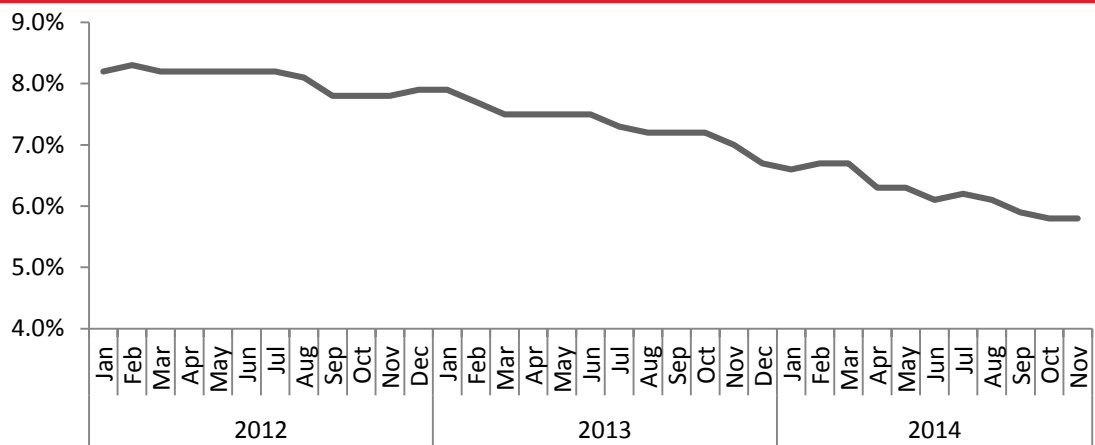
Source: MSCI

### The US now the bright spot of the global economy

*Stronger than expected economic growth and falling unemployment have put the US at the forefront of the global recovery*

While still saddled with a number of structural weaknesses, the US economy has clearly emerged as a leading driver of the global recovery. Economic growth has proven stronger than expected with 5.0% YoY expansion in Q3 in a slight increase from the Q2 growth rate of 4.6%. The labor market has continued to strengthen with the open unemployment rate falling to 5.8% in November as compared to 6.6% at the beginning of 2014. New job creation, as measured by the monthly increment in non-farm payrolls, has been robust with preliminary readings of 321,000 in November and 243,000 in October. The monthly totals have been consistently in excess of 200,000 since February. In spite of the positive momentum, unemployment remains above the Fed estimates of its long-term equilibrium rate of 5.3%, while employment rates are historically subdued.

US unemployment rate (seasonally adjusted)

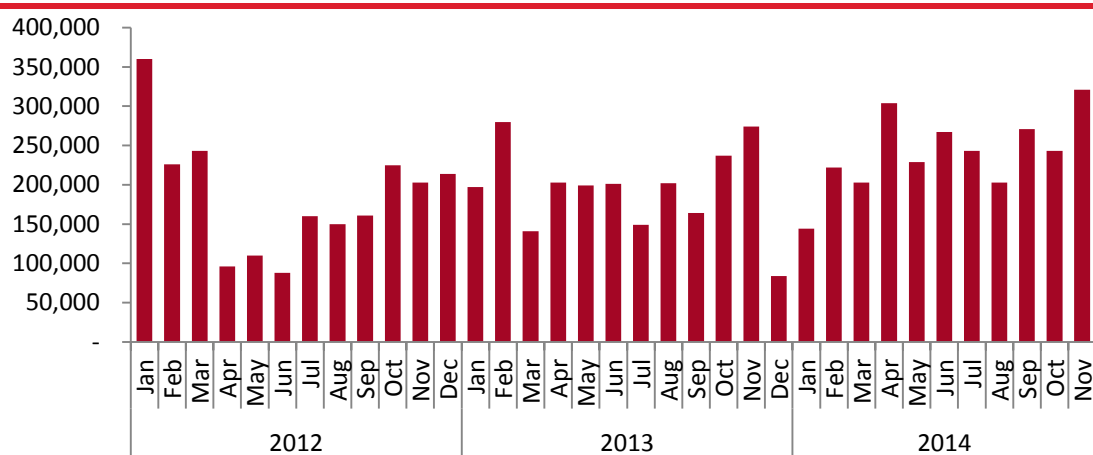


Source: Bureau of Labor Statistics

*Robust Dollar appreciation is creating new challenges for US policymakers*

US growth is likely to remain close to 3% in the coming quarters, even with significant uncertainties remaining in place. In spite of positive signs as of late, including a rebound in consumer sentiment to its highest level since early 2007, it is still unclear to what extent and how quickly the stronger labor markets will translate into increased purchasing power. Moreover, weaker demand growth in other parts of the world may depress US exports, a challenge potentially amplified by the strength of the US Dollar following sharp appreciation. On a trade weighted basis the Dollar has risen to its highest level since April 2006 and the monetary policy stance between the US and other advanced economies looks likely to diverge further over the coming year.

#### Monthly change in US non-farm employment ('000)



Source: Bureau of Labor Statistics

The recent growth dynamics are increasing pressure on the Fed to continue its move towards tighter policy. Having unwound quantitative easing, Fed officials have been signaling that interest rates could begin to rise toward the middle of 2015. Open Market Committee (OMC) members currently expect the funds rate to rise from the current near-zero level to 1.25% by the end of next year starting with a first increment in June. This stands in contrast to market expectations of much more moderate increases. The OMC in December abandoned its earlier commitment to keep rates at their current levels for a “considerable time” and instead indicated that it would be “patient” in making its decisions. The expected upward momentum of rates may come to be challenged by the absence of obvious inflationary pressures and the strength of the Dollar. In general, however, the Fed has tended to view lower oil prices as a growth stimulus.

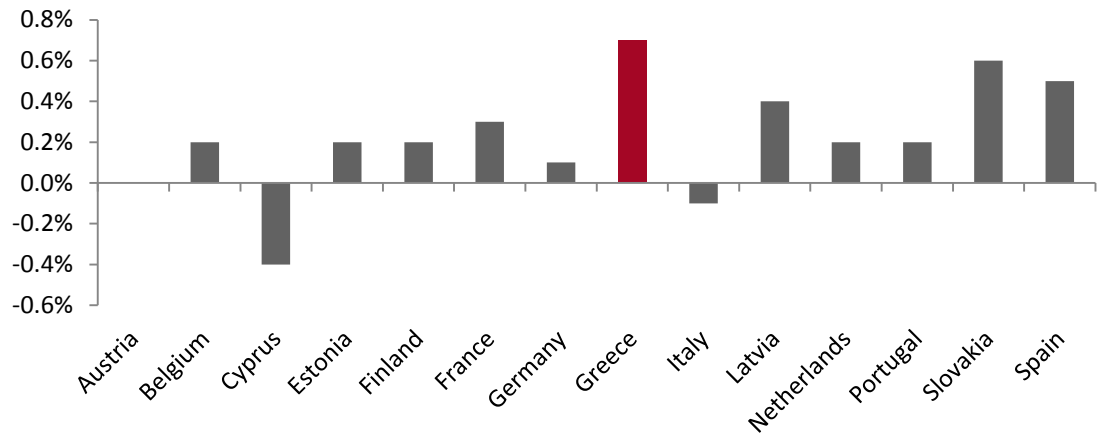
#### Hoping for policy innovation in Europe

In contrast to the positive momentum in the US, the Euro-zone economy continues to grapple with significant structural challenges and, in spite of new monetary policy initiatives, also some continued doubts about the effectiveness of the policy response to the downturn. Fueling concern of a relapse into recession, the Euro-zone as a whole experienced extremely sluggish growth during Q3 with a modest 0.2% QoQ increase. Among the largest economies, Germany and France barely posted positive growth while Italy saw a slight contraction. Consumer spending has been particularly weak across the Euro-zone core. The Bundesbank in December lowered its growth forecast for Germany to 1%. The stagnant conditions are underpinned by a number of structural

*Numerous structural problems in the Eurozone are fueling fears of a relapse into recession*

factors, including tight financing conditions, fears of deflation, and persistently high unemployment.

#### Eurozone Q3 GDP growth (% QoQ)

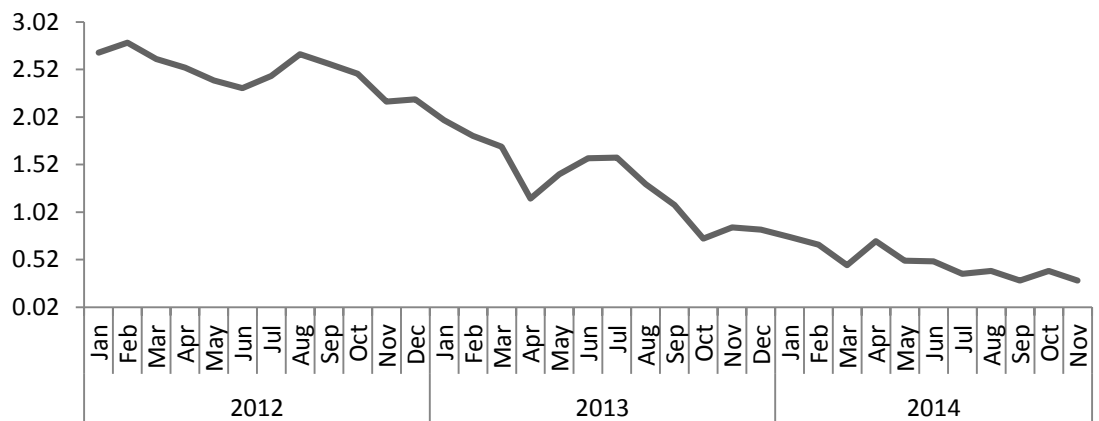


\* Data not yet available for Ireland, Luxembourg, Malta, and Slovenia

Source: Eurostat

The monetary policy situation in the Euro-zone is seen as a particular challenge as the European Central Bank (ECB) struggles to move closer to the target inflation rate of below but close to 2%. The November inflation reading of 0.3% marked a slight decrease on the 0.4% figure recorded in October. Moreover, core inflation, which excludes more volatile items such as food and energy, fell to 0.7% in November from 0.8% in September. The prospect of deflation, along with dovish comments by key policy markets, has fuelled expectations of more aggressive monetary easing by the ECB. However, progress to date has proven very gradual due to divisions on the Governing Council. While the Bank has been broadening the range of instruments it buys in its efforts to boost its balance sheet, it has stopped short of outright purchases of government bonds. This is widely viewed as unavoidable if President Mario Draghi's commitment to do "whatever it takes" to defend the Euro is to be truly honoured.

#### Eurozone inflation rate (% YoY)



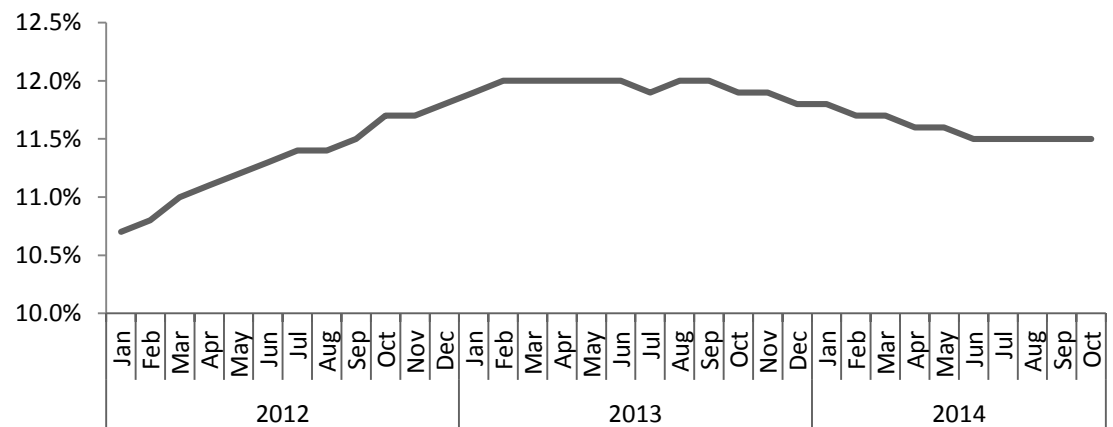
Source: Eurostat

The labor market dynamics in the Euro-zone remain challenging with persistent double-digit unemployment – 11.5% for the zone as a whole as of October. Member states such as Italy have

in fact seen increasing unemployment, from 12.3% in August to 12.6% in October. Efforts to tackle unemployment have been complicated by subdued business activity in the face of tight financing conditions, especially for smaller companies.

The general stagnation notwithstanding, the peripheral economies of the Euro-zone have seen some improvement this year. Ireland is likely to have posted approximately 5% growth this year. Even Greece, which has been a key focal point of the Euro-zone crisis, is finally emerging from the crisis and its exit from a tightly monitored IMF bailout program to a precautionary credit line has been boosting sentiment. While unemployment still stood at 25.9% in August, the Greek economy posted the fastest growth among Euro-zone economies in Q3 – 0.7%. The country's GDP is expected to expand by 2.5-2.9% in 2015. Among other things, Greece, whose tourism sector represents about 18% of GDP, has seen an increase in visitors and strong retail sales. The main challenges at the moment are linked to political risk with a substantial increase in the backing of non-mainstream parties. The failure by the Greek parliament to elect a president in December triggered early parliamentary elections in January. The possibility of a victory by the opposition Syriza has increased market anxiety as the party has suggested that it would write off debt or renegotiated the bail-out. This has pushed the government's short-term borrowing costs to 12% at a time when Greece's debt-to-GDP level is expected to peak at 174% this year. It has put upward pressure on yields in some other peripheral economies as well.

#### Eurozone unemployment rate (%)



Source: Eurostat

#### A loss of growth momentum in Asia tests global sentiment

*Investor worries persist about the sustainability of Chinese growth in spite of renewed stimulus measures*

The leading Asian economies seem to be at something of an inflection point with several signs of a loss of momentum in recent months. China's growth rate has continued to edge down toward the 7% mark. The 7.3% YoY rate of expansion in Q3 will likely make it difficult to meet the 2014 growth target of 7.7%. Other indicators support the impression of slower growth. Headline inflation has fallen sharply to a five-year low of 1.6%, down from 2.7% a year earlier. The December HSBC/Markit purchasing managers' index pointed to a contraction in manufacturing with a reading of 49.5 – the first decline in seven months. Fixed asset investment is growing at its slowest pace in more than a decade. The Chinese trade data in November was marked by the sharpest drop in the inflows of goods in eight months – a YoY decline of 6.7%, albeit partly reflective of lower

commodity prices. Also export growth decelerated to its slowest pace in half a year – 4.7%. As a result, China's trade surplus reached an all-time high of USD54.5bn.

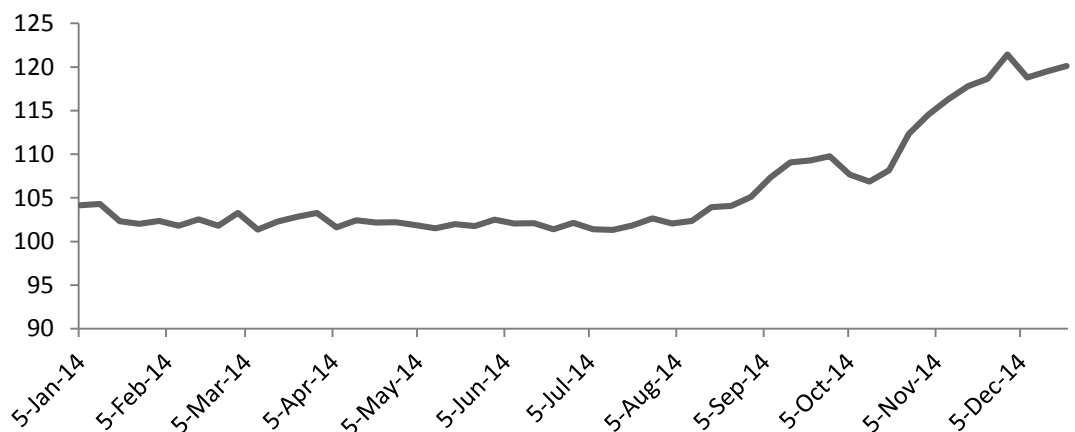
Anxiety about China's growth prospects has been fuelled by a build-up of leverage, concerns over the shadow banking sector, and an ongoing property market correction. The reversal in property prices is potentially significant as real estate activity accounted for approximately 16% of China's GDP in 2013 yet recent government estimates also put the total amount of wasteful investment in the country at USD6.8trn. Weak real estate prices are having a ripple effect on the rest of the economy. Heavy industrial production and manufacturing investments are both experiencing a slowdown due to the property slump.

Part of the challenge for the authorities comes from encouraging a structural shift in the economy away from investment to more sustainable consumption-led growth. Efforts to stimulate economic activity during the downturn have helped push up domestic bank loans to 139% of GDP as of August, while some estimates put total domestic loans at more than 200% of GDP. Under these circumstances, the People's Bank of China has embarked on renewed monetary easing with November seeing the first rate cut since 2012. The benchmark lending rate was cut by 0.4% and the deposit rate by 0.25%. The Chinese government has also approved new railway projects and loosened restrictions on mortgage lending. Following the establishment of a free trade zone in Shanghai a year ago, three more similar projects are underway in Tianjin as well as the provinces of Guangdong and Fujian. These stimulus measures, along with an exodus of cash from the real estate market, have pushed the Chinese stock markets to a four-year high as of December.

*The Japanese economy has relapsed into recession, although the re-election of the government may help restore confidence after earlier fiscal consolidation measures*

Japan's economic rebound, triggered by the launch of "Abenomics" in 2012 seems to have hit a bout of turbulence in recent months. The economy posted a 1.9% YoY contraction during 3Q14 in a major setback to the government's 2% growth target. This followed an even sharper 7.3% contraction in Q2 and marks a sharp departure from the annual growth rate of 1.5% seen during 2013. The relapse into recession highlights the challenges of fiscal consolidation in Japan where many analysts link the slowdown to an increase in the sales tax in April. This has both depressed consumer spending and coincided with a significant drop in companies' inventories. This may prompt the government to push back further tax increases to 2017.

#### Japanese Yen against US dollar (JPY per USD)



Source: Bloomberg

The re-election of Prime Minister Shinzo Abe's government following an early election in mid-December should add to the authorities' efforts to persist with their reform agenda against a backdrop of relative political stability. The economy should also begin to benefit from renewed aggressive monetary loosening measures announced by the Bank of Japan (BoJ) in October. The resumption of quantitative easing will boost Japan's monetary base by about JPY80tn a year, thanks mainly to increased purchases of longer-term government bonds. The decision has fuelled significant Yen depreciation even in the face of some asset inflows caused by its safe haven status. In trade-weighted terms, the Yen has fallen to its lowest level since the early 1970s. This is boosting the prospects of Japan's large export-oriented manufacturing sector as well as the performance of the stock market. While it also pushes up import costs, inflation seems a remote concern at a time when the most recent reading of core inflation stood at 0.9%. In spite of continuing challenges, the Japanese economy has made promising progress in certain areas. For instance, labour force participation has increased and unemployment has fallen to a 17-year low of 3.5%. The cumulative free cash flow of Japanese companies equals more than 60% of GDP, which creates a benign environment for renewed investment should confidence improve further.

### Emerging market concerns multiply

*Emerging markets face a number of cyclical and structural challenges which are underscoring the urgency of economic reform*

Having been at the forefront of global growth during the global downturn, emerging markets are showing increasing uneven and generally weaker performance. A number of factors account for this turnaround, chief among them the following:

- ▶ **Waning stimulus.** A number of emerging economies mobilized their often sizeable financial buffers to support growth during the global crisis. The effects of these stimulus measures are now typically waning, either because of the unwillingness or inability of governments to continue with them or their diminishing impact now that the easy wins have typically been accomplished. In many cases, for instance, infrastructure and real estate spending involves ventures of questionable economic value
- ▶ **Stronger Dollar.** The appreciation of the US Dollar has typically gone hand in hand with weaker emerging market currencies and thereby, at least for now, put an end to a long period of secular appreciation of many emerging market currencies. The JPMorgan Emerging Market Currency index has fallen to its lowest level since its inception in 2000. This is adding to inflationary pressures through higher import prices and limiting the ability of central banks to reduce rates.
- ▶ **Increased leverage.** A number of emerging market governments and corporations used the period of US Dollar weakness to raise substantial amounts of Dollar-denominated debt. The Bank of International Settlements estimates that emerging market names have issued USD2.6trn of international bonds – three-quarters of them in US Dollars. Emerging market lending by international banks totaled some USD3.1trn as of the middle of 2014. Lending to China reportedly doubled from the end of 2012 to USD1.1trn as of June 2014. The ability of some emerging market issuers to service their debts in the current situation is beginning to be questioned in many cases. The reduced ability of many issuers to return to the market will reduce the impact of leverage as a growth driver

- **Commodity prices.** The emerging markets were among the main beneficiaries of higher commodity prices during the period of strong Chinese growth and the heyday of US quantitative easing which, among other things, pushed significant amounts of capital into commodity investments. The reversal of these dynamics is now weakening the export receipts of many countries, in some cases contributing to increasing current account imbalances and generally weaker growth. While lower energy prices are a challenge to energy exporters and generally beneficial to importers, their positive impact is being dented by some of these broader concerns

Much like China, the other large emerging markets tend to be facing new challenges against the backdrop of generally softer growth. The waning impact of quick wins and easy liquidity is underscoring the importance of re-initiating structural reforms in many countries. For instance Brazil has seen a sustained slowdown with growth now expected to be less than 1% while inflation is near the top of the Central Bank's tolerance interval. The current account deficit as of October had widened to 3.7% YoY. Turkish economic growth decelerated to an annual 1.7% in Q3, well below its historic trend of 5% as well as the 2013 rate of 4.1%. Growth has been depressed by bad weather, tighter monetary conditions, and a weaker Lira.

Russia has been hit by a combination of low energy prices and the imposition of sanctions by the West in response to the events in Ukraine. The Russian Rouble has come under intense downward pressure in recent weeks and has by now shed more than 50% of its value vis-à-vis the Dollar since the beginning of the year. As a result, and partly due to restrictions on Western food imports, inflationary pressures have been rising with the headline rate trending toward 10%. Following more tentative initial steps, the Russian Central Bank sharply increased its policy rate by 6.5 percentage points to 17% in mid-December. The Central Bank further warned that the country could see a 4.5-4.7% drop in its GDP next year if oil prices stay in their current range. Oil and gas account for 70% of Russia's export revenues and about a half of the budget.

India's annual pace of growth in Q3 slowed to 5.3% from 5.7% in Q2, partly as a result of a poor monsoon season. The Indian Rupee sank to its lowest level in more than a year in mid-December, partly as a result of renewed deterioration in the trade balance. However, lower oil prices are reducing inflationary pressures with a CPI reading of 5.5% last month. They are also providing a chance to address some structural challenges in the economy. The price decreases have been translated into higher duties with the objective of reducing the budget deficit to 4.1% of GDP this year. India's oil exports in the year-to-July period reached some 6% of GDP.

### Volatility returns to the oil market

An exceptionally lengthy period of remarkable stability in crude oil prices came to an abrupt end in the autumn months. Having peaked at USD115.06 on 19 June, the Brent benchmark fell below USD60 per barrel for the first time in five and a half years on 16 December, followed by a period of considerable volatility. An unusual cluster of factors appears to account for this sharp turnaround:

- Anxiety about the global oil demand outlook has intensified as a result of weaker-than-expected data from China as well as the persistent weakness of the Euro-zone. The outlook

*Factors on both the demand and supply sides have triggered an abrupt and extended fall in oil prices*

for China is of particular importance when the country accounts for 22% of the global economy. Whereas global oil demand rose by 1 mbd in 2012 and 1.3 mbd in 2013, the increment is estimated to have fallen to 600,000 b/d in 2014. This pushed, for instance, the OECD commercial crude stocks to an unusual high of 59 days in Q4

- ▶ The supply of unconventional oil from North America has continued to increase at a brisk pace and upset many of the earlier projections of a more gradual rise, leading to perceptions of a global glut. US production rose to 9.12 mbd in early December, the highest level since records started in 1983. This compares to 5 mbd as recently as 2008
- ▶ Key producer nations appear to have accepted softer prices while seeking to defend their market share. OPEC collectively seem, at least for now, to have adopted a policy of not sacrificing output for higher prices. The most recent OPEC meeting in late November upheld the group's collective 30 mbd quota and recent statements by leading members have reiterated this position
- ▶ The US Dollar has remained strong, partly as the monetary policy stance in most other key countries has trended toward renewed loosening. A strong Dollar tends to coincide with commodity price weakness
- ▶ Worries about political risk-related supply disruptions have proven excessive, at least to date. Even as political risk globally has increased, oil production has to date been relatively unaffected. However, increased instability in Libya began to once again increase upward pressure on prices in late December
- ▶ Market dynamics have been in some cases amplified by financial investors

At the moment, the global oil markets find themselves at an inflection point where they continue to look for a new sense of direction. The perceived imbalance between demand and supply remains in place with continued output gains and at best mixed economic news from around the world. At the same time, leading producers have indicated that they are happy to wait for the market to correct itself without interventions. For instance, OPEC pumped, by various estimates, 30.01-30.56 mbd in November, which made it the sixth consecutive month of above-quota output. This contrasts with OPEC projections that the demand for its crude in 2015 is likely to be weakest in 12 years. The demand projection was recently lowered by some 300,000 b/d to 28.9 mbd. This is below the 29.93 mbd produced by OPEC more than a decade ago in 2003.

*OPEC has decided to defend its market share in the face of lower prices, which is putting pressure on higher-cost producers*

While the market is widely oversold, the key uncertainty at this point pertains to the speed of normalization. The current situation is expected to become an important test case for the North American shale oil boom which has pushed US crude production to its highest level in more than three decades. The sector is characterized by a dominance of relatively young and small operators typically with high levels of leverage following a rapid build-up of debt since 2010. Instead of trying to influence the price of oil, the American shale companies are price takers who seek to maximize their economic efficiency at any given price level. The responsiveness of the US to price volatility is potentially increased by the short life spans of shale wells which typically see sharp falls in their output within the first year. This reality has prompted many analysts to suggest that the US might become the new swing producer in oil.

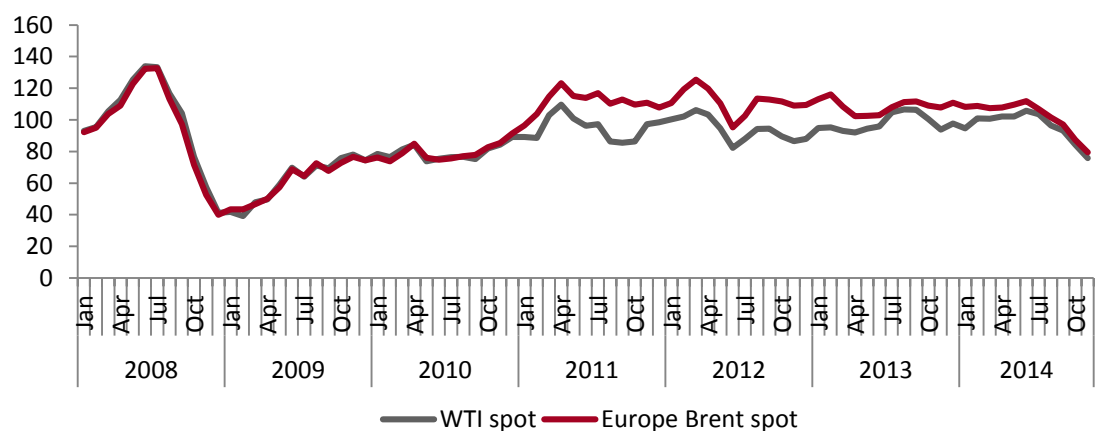
Providing extraction costs are covered, most North American shale companies with sunk investments are likely to continue operations for now. While some US fields, as well as Canada have relatively high break-even prices, other fields can continue to operate in the current environment. For instance, parts of the Permian shale formation in Texas and New Mexico reportedly has breakeven thresholds as low as USD40-50, which may allow the industry regroup away from costlier production areas. However, other estimates suggest that as much as a quarter of US shale could be uneconomical at current prices. Some US shale operators are benefiting from lower operating costs which allow them to adjust to the new market realities. Overall, many analysts still expect the US output to continue to increase in the near term to approximately 9.4 mbd next year.

But the price correction is already affecting the longer-term outlook for the market. The renewed price volatility is likely to curb investment, potentially quite significantly. This may compromise the ability of the oil sector globally to boost output in line with the projected demand growth. Some recent estimates suggest that USD1trn worth of oil projects could be jeopardized by the price correction. This would affect projects with a combined output capacity of 7.5 mbd. More than 10% of global oil production is deemed to be uneconomical at current prices. Capital expenditure by the oil industry is expected to fall by as much as 20% next year.

Going forward, global demand growth is expected to continue at a moderate pace. OPEC expects global demand to increase by 1.12 mbd to 92.26 mbd in 2015. The International Energy Agency expects the smallest demand increase in five years to 92.4 mbd this year. The agency has cut its 2015 demand forecast four times in five months. The IEA reduced its projected demand for OPEC crude by 300,000 b/d to 28.9 mbd.

While recent months have seen a relative reduction in operational and political risks in the oil market, the situation remains potentially volatile. For instance, Libya has seen sharp gyrations in its output in recent weeks due to the internal strife affecting key fields and export facilities.

#### Crude oil prices (USD/barrel)



Source: US Energy Information Administration

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

	IEA	OPEC	EIA
2013 Global oil demand (mbd)	91.8	90.2	90.5
Advanced economies	46.1	46.0	46.1
Emerging economies		29.0	
China	10.1	10.1	10.6
2014 Global oil demand (mbd)	92.4	91.1	91.4
Advanced economies	45.6	45.7	45.8
Emerging economies		29.8	
China	10.3	10.4	11.0
2015 Global oil demand (mbd)	93.3	92.3	92.3
Advanced economies	45.6	45.6	45.8
Emerging economies		30.6	
China	10.6	10.7	11.3
2013 Global oil supply (mbd)	91.4	90.2	90.2
OPEC	30.5	30.3	30.0
Non-OPEC	60.9	54.2	54.1
2014 Global oil supply (mbd)		91.1	92.0
OPEC	30.2	29.4	29.8
Non-OPEC		56.0	56.0
2015 Global oil supply (mbd)		92.3	92.8
OPEC		28.9	29.7
Non-OPEC		57.3	56.8

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

**Implications for Bahrain**

The global economic backdrop has become more challenging in recent months with mixed implications for Bahrain and the GCC region.

- ▶ The stronger US Dollar will likely further reduce import price inflation and contribute to the established track record of price stability.
- ▶ Moves toward economic tightening in the US are likely to translate into a gradual increase in the cost of capital, even though the benign liquidity situation in the region will cushion its impact.
- ▶ The situation in the oil markets looks likely to be characterized by volatility, at least in the near term. This underscores the importance of the ongoing efforts toward economic diversification.

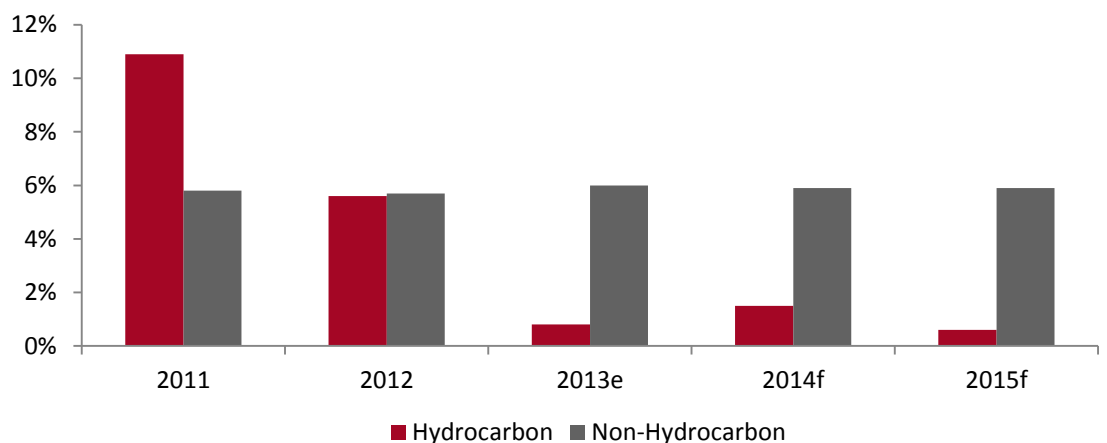
## THE GCC REGION

### NON-OIL GROWTH REMAINS ROBUST

*The non-hydrocarbon sector has established itself as the main driver of growth across the GCC*

Even as the GCC financial markets have felt the impact of increased oil price volatility in recent weeks, the dynamics of the non-oil sector across the region remain strong. The resilience of the non-oil economy is further supported by healthy financial sectors along with a firm commitment by GCC governments to support economic activity and priority projects. This underscores the steady momentum of economic diversification across the region. In the oil sector, the leading GCC producers have adopted a stance of continuity in terms of output levels, suggesting that the market is likely to normalize soon without interventions. This is likely to translate into a small positive contribution from the hydrocarbons sector to real GDP growth in the near term. Overall, the GCC region is expected to post growth in excess of 4% both in 2014 and in 2015.

**Composition GCC real growth (%)**

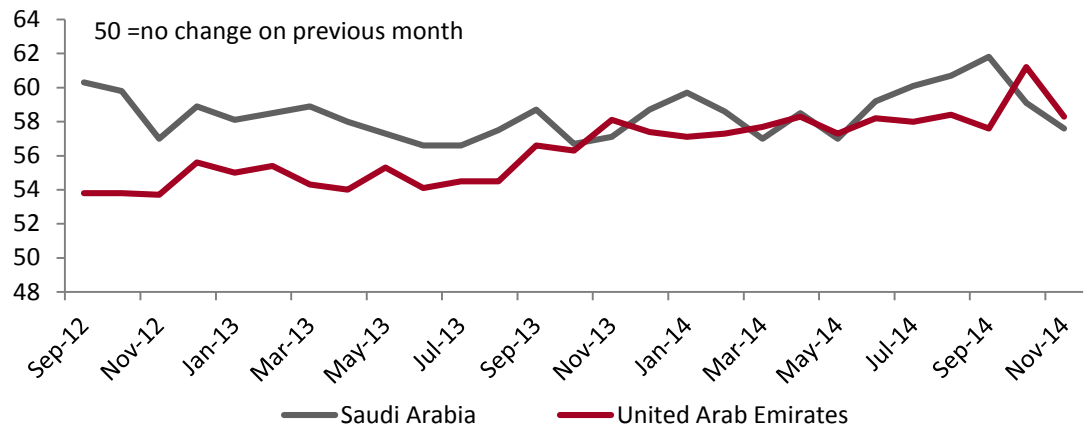


Source: International Institute of Finance, October 2014

### Regional growth continues given oil market dynamics

In general, growth dynamics across the GCC region continue to be characterized by a strong momentum in the non-oil economy alongside very modest growth in the oil economy. While the recent increase in global market volatility appears to have tested business sentiment, the growth momentum of the regional economies is increasingly linked to long-term structural growth drivers which are unlikely to be vulnerable to short-term market gyrations. The most recent readings of the HSBC/Markit Purchasing Manager's Index for Saudi Arabia and the UAE point to continued strong expansion, even though the figures have retreated somewhat from their recent peaks. The Saudi index in November stood at 57.6, down from 61.8 in September. The UAE reading was 58.3, which marked a drop from 61.2 in October.

## HSBC/Markit Purchasing Manager's Index



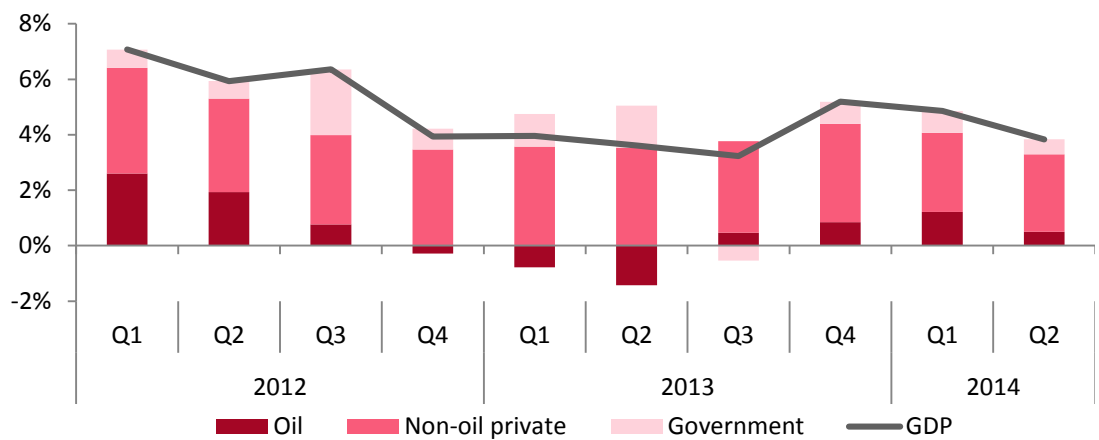
Source: HSBC, SABB

*Non-oil growth in Saudi Arabia is estimated to have exceeded 5% last year leaving the headline real growth rate at 3.6%*

The Saudi economy continues to be characterized by strong momentum in the non-oil sector. The 2015 budget documents estimated real GDP growth in 2014 at 3.6% in an acceleration from 2.7% in 2013 (recalculated due to change in the base year from 1999 to 2010). The loss of momentum was entirely due to the oil sector with robust non-oil dynamics continuing as before. Whereas the oil sector grew by 1.7%YoY, the non-oil economy as a whole expanded by 5.2% and the non-oil private sector by as much as 5.7%. The fastest growing sectors of the economy were construction with 6.7% YoY growth and non-oil manufacturing with 6.5%. Transport and communications expanded by 6.1% while wholesale and retail trade grew by 6.0%.

The Saudi government is continuing to unveil new initiatives to stimulate activity in priority sectors. Among other things, refining capacity in the Kingdom is expected to increase by 1.2 mbd by 2020 with the Yasref refinery currently beginning operations in the Yanbu Industrial City. Important infrastructure investments are supporting travel, tourism, and transportation flows. The new King Abdulaziz International Airport in Jeddah is close to completion and the General Authority of Civil Aviation is preparing a new strategy to improve air transportation across the country with a 2020 target of more than 100mn passengers. The Saudi Railways Organization is developing a 30-year vision for the sector which will, among other things, be linked to efforts to develop domestic tourism in conjunction with the Saudi Commission for Tourism and Antiquities (SCTA). The national railway network is expected to grow to approximately 10,000 km. The SCTA recently signed an agreement with Saudi Credit and Savings Bank to finance tourism and heritage sites across the Kingdom.

### Composition of quarterly Saudi real GDP growth



Source: Institute of International Finance, International Monetary Fund

*Robust non-oil dynamics are evident across the region with some recent overheating concerns abating*

The UAE economy has continued to post strong growth, even though a number of indicators point to a slight cooling down in certain areas. Real estate prices in November were flat, with a slight drop in Dubai villa prices. This is likely to reflect higher transaction costs and new limits of mortgage loans. The longer-term outlook for the sector remains positive with close to USD200bn of projects underway across the federation – almost two-thirds of all project spending. Passenger volumes are continuing to grow with Dubai seeing a 6.1% YoY gain in the first 10 months of the year and Abu Dhabi a 22.6% increase. Real growth in the UAE is expected to exceed 4% in 2014 and 2015 alike, more or less in line with broader regional trends.

Qatari growth has remained robust due to strong non-oil sector dynamics. Growth in 2014 is likely to exceed 6% with government estimates projecting a 7.7% expansion in 2015. This momentum is expected to enable the non-oil sector to overtake oil and gas as a percentage of GDP. At the same time, receding crude oil production and some major maintenance shutdowns in natural gas liquids (NGL) and liquefied natural gases (LNG) plants are expected to cause a decline in hydrocarbon production volumes. Reflecting the continued importance of infrastructure spending, growth in Qatar remains heavily investment-driven with fixed capital formation accounting for 29.1% of GDP in 1H14. The share of household consumption was broadly comparable to government expenditure at 14.1% and 13.9%, respectively.

### Fiscal continuity

The external and fiscal positions of the GCC governments remain generally very strong, although the current oil price correction has once again underscored the importance of boosting economic diversification and continued efforts to rationalize the fiscal systems. The sizeable reserves of most regional economies are likely to provide an important cushion and a source of continuity in the face of oil price volatility. However, the effective mobilization of these resources is also critical for ensuring the continued diversification of the regional economies. In view of these realities, recent reviews by international rating agencies have reaffirmed the ratings of the regional economies, although there were some revisions of the outlook to reflect the challenges thrown up by the oil price volatility.

*Saudi Arabia in December unveiled another expansionary budget with a heavy emphasis on social infrastructure spending*

Ensuring the continuity of economic activity and supporting priority investment projects are likely to be a central theme of the regional budgets for 2015. Several regional governments have signalled willingness to tap in to reserves to fund deficit budgets, if necessary. Saudi Arabia's 2015 budget approved by the Council of Ministers on 25 December made a firm commitment to the long-term economic development agenda and fiscal continuity. The budgeted expenditures were increased to the highest level ever – SAR860bn, which is expected to produce a deficit of SAR145bn. This follows a deficit of SAR54bn in 2014 after a 9% drop in revenues and a 12.7% increase in expenditure. The 2015 budget foresees a 16.4% fall in revenues and a 0.6% increase in expenditure, although budgets have historically been significantly overspent. Echoing the priorities of recent years, social infrastructure will be prioritized with education and health care accounting for 43.8% of total spending. After a significant build-up in recent years, investment spending is to be reduced by 35% to SAR185bn. Any actual deficit is expected to be financed from Saudi Arabian Monetary Agency's reserves which stood at USD736bn in November. Public debt has fallen to a low of 1.6% of GDP. Across the region, there has been more discussion about cutting waste and developing new government revenue sources in order to boost fiscal sustainability. For instance, the Omani government has revealed plans to reduce natural gas subsidies while increasing various levies.

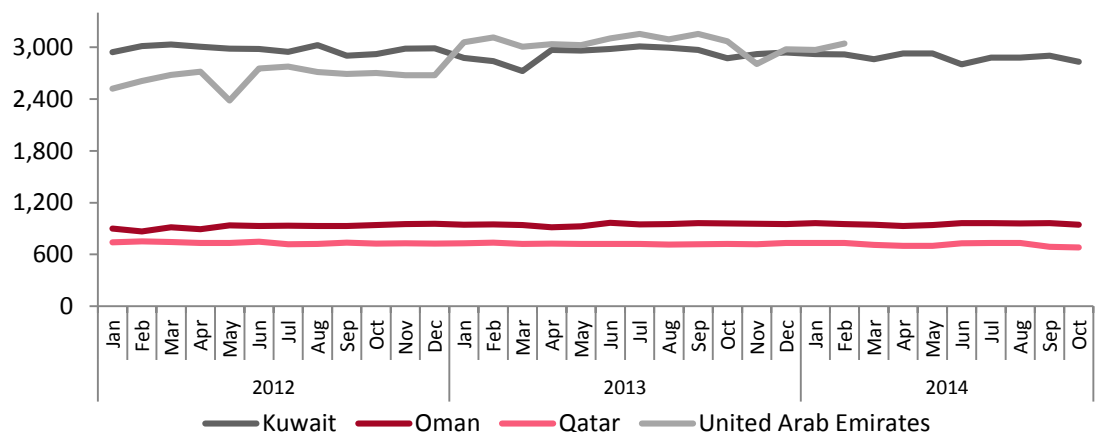
### Regional oil production remains flat

*Regional oil production has been characterized by continuity in reflection to OPEC's commitment to its production quotas*

Regional oil production has held relatively steady in the face of the recent price declines. Policy makers across the regions have repeatedly reiterated their commitment to ensuring continuity. Saudi production during the first ten months of this year averaged 9.73 mbd. The October reading was a comparable 9.69 mbd. UAE production has been in excess of 3 mbd with 3.17 mbd in August and 3.07 mbd in September. Kuwait's output has averaged 2.88 mbd during January-October with a total of 2.83 mbd in October.

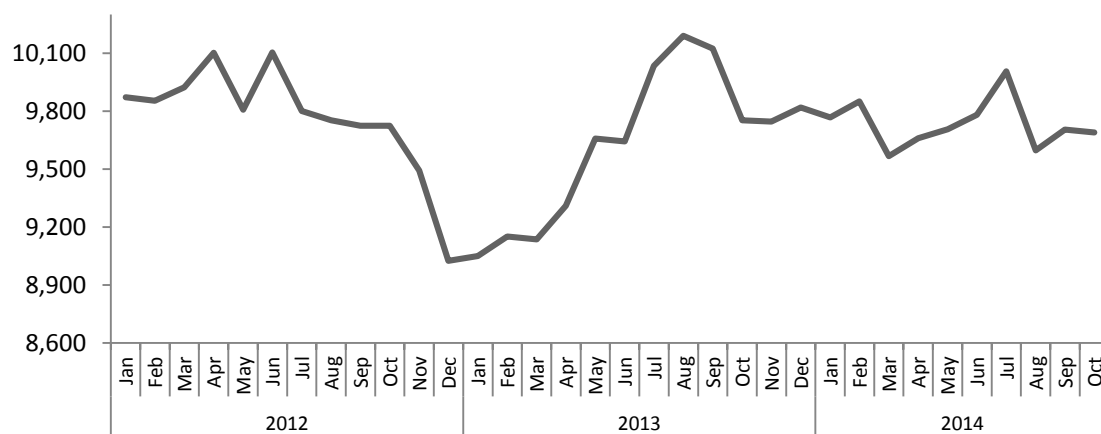
By contrast, regional export data has manifested more volatility in recent months. According to data compiled by the Joint Organisations Data Initiative, Saudi Arabia's oil exports in October were 6.9 mbd, which compared to 7.7 mbd a year earlier. This was the sixth consecutive month of exports of less than 7 mbd. However, other estimates suggest a smaller drop.

### Monthly oil production by some GCC producers ('000 b/d)



Source: Joint Organisations Data Initiative

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



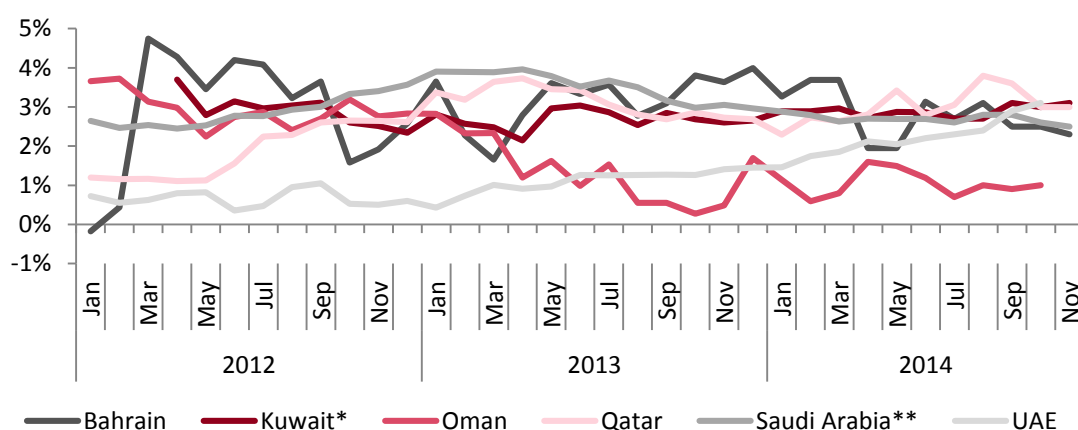
Source: Joint Organisations Data Initiative

### Regional price outlook showing signs of renewed divergence

*Easing food price pressures and a stronger US Dollar have kept consumer price inflation stable*

Consumer price inflation across the GCC region has been relatively stable in recent months in spite of the generally brisk non-oil activity. External price pressures have been fairly muted because of the strengthening of the US Dollar and easing food price pressures. The differentiator among country-specific inflation readings has tended to be domestic non-oil activity. In particular, Qatar has fairly and consistently recorded the fastest pace of price increases due to the ongoing infrastructure boom and the country's authorities have repeatedly highlighted inflation as a policy concern. Inflation in Qatar has tended to hover around 3% in recent months and reached a regional high of 3.8% in August. The UAE has seen the highest volatility in inflation rates in the region. The average for the first ten months of the year was 2.2%, albeit with a range of 1.5-3.1%. Oman has been at the other end of the spectrum with readings of less than 1%. The rest of the region has tended to post inflation rates in the neighborhood of 3%. In Saudi Arabia, inflation in November eased to an annual 2.5% from September's 2.8%.

### Consumer price inflation in GCC countries (% YoY)



\* Starting April 2013 Kuwaiti CPI rebased to 2007

\*\* Starting Sept 2012 Saudi CPI rebased to 2007

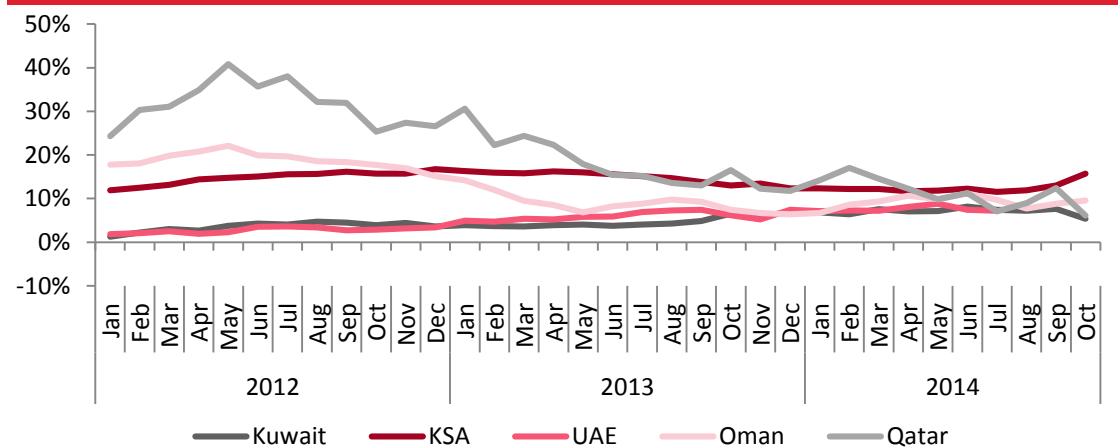
Source: National statistical offices

*Growth rates of bank lending seem to be converging across the region against the backdrop of a benign liquidity environment*

## Regional bank lending growth remains robust

In an encouraging sign of the strength of the regional non-oil growth drivers, the highly liquid banking sector has continued to inject capital into the real economy at a brisk pace, even if this year has seen some slowdown from the peaks seen in 2012-2013. Following a recent acceleration, Saudi Arabia is now the most dynamic regional market and saw 15% YoY growth in bank credit as of October. This marked a sharp increase from 11.9% in October. By contrast, Qatar, which has tended to see the fastest credit growth in recent years, witnessed a drop from 14.3% YoY growth in September to 9% in October. Also, Oman experienced an acceleration over the same period from 8.8% to 9.6% YoY growth. Credit growth in the UAE and Kuwait has continued to edge up gradually from its recent lows. UAE bank credit expanded at an annual pace of 7.8% in September. Kuwait experienced some renewed deceleration with a drop from 7.7% in September to 5.4% in October. The available data hence suggests some sensitivity to the oil price correction, although the pattern is far from uniform across the region and may reflect in part seasonal factors. Deposit growth has remained generally brisk with all the regional economies bar Kuwait and Bahrain recording double-digit YoY growth, typically in the range of 10-15%. Kuwait saw 3.0% YoY growth in October.

### YoY growth of domestic bank credit (%)



Source: National central banks

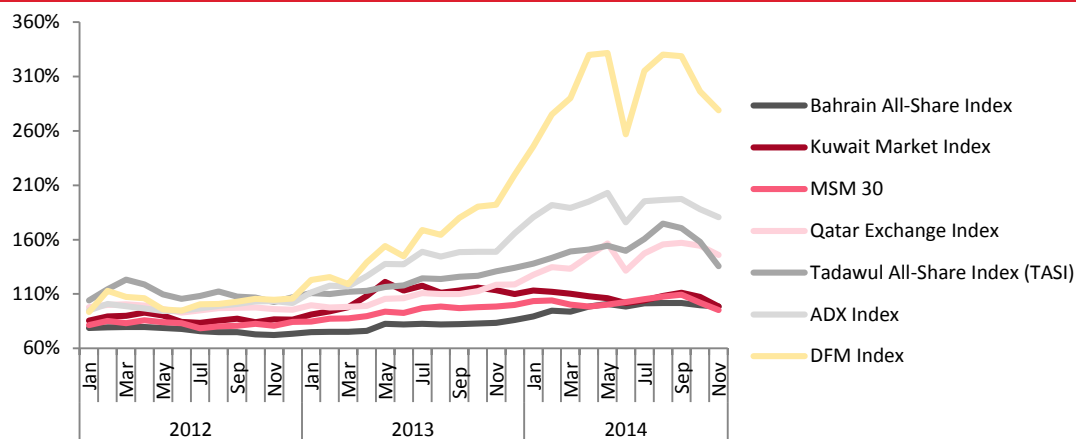
## Volatility returns to equity markets

*Investor sentiment generally positive albeit sharp corrections in some regional bourses*

The regional equity markets have typically reacted fairly strongly to the oil market volatility, which has raised some questions about a need to tighten regulation. Some of the regional bourses have corrected sharply even though the sentiment showed some signs of stabilizing around mid-December. The Dubai market corrected by more than a quarter during Q4 while Saudi Arabia's Tadawul contracted by an almost comparable amount (21.8% as of 30 December). Drops on the other regional exchanges typically varied between 10 and 20%. For the year as a whole, this left the Kuwait Stock Exchange down by 13.8% (30 December) and Muscat with a 9% drop. The gains of other regional exchanges were largely erased. Overall, Qatar Exchange was the best regional

performer with a 18.8% gain during the year. The Dubai market rose by 10.6% and Abu Dhabi by 3.6%. Tadawul was left with a small 0.6% drop for the year.

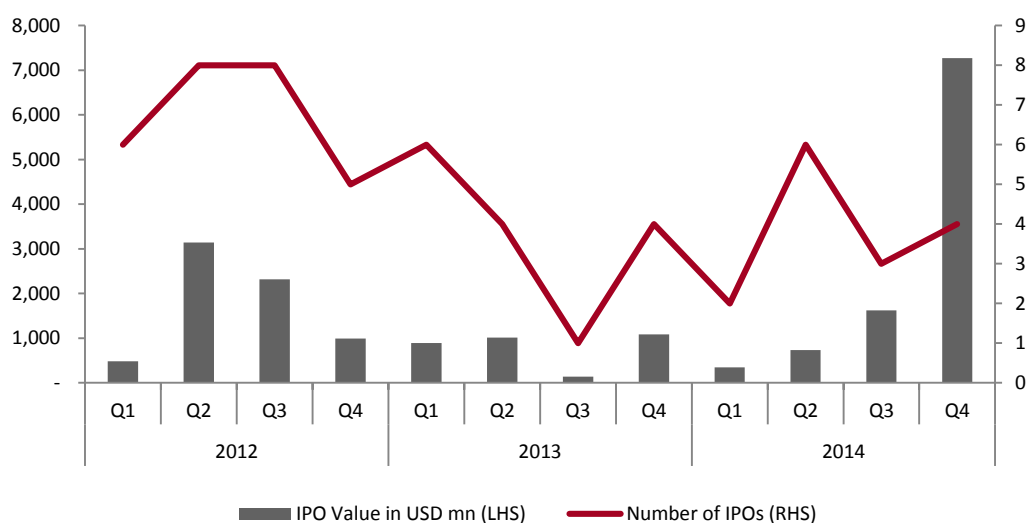
#### GCC equity market indices (Jan 2011=100)



Source: Bahrain Bourse, Kuwait Stock Exchange, Muscat Securities Market, Qatar Exchange, Tadawul, Abu Dhabi Securities Exchange, Dubai Financial Market

The challenging market conditions at the end of the year have not markedly dented IPO activity which, however, remains relatively subdued by historical standards. Q3 saw a fairly modest total of three regional IPOs, down on six in Q2. However, the average issuance size was much higher and pushed the total capital raised to USD1.6bn, up from USD0.7bn in Q2. Saudi Arabia's National Commercial Bank sold a 25% stake in a USD6bn landmark offering in October. The Emaar Malls Group floated 15.4% of its equity in a USD in a USD1.6bn offering in September. Dubai Parks and Resorts had a USD695.3mn IPO in November and the UAE-based Amanat Holdings floated a 55% majority stake for USD 381.8mn in October-November. Saudi Arabia's Electrical Industries Company floated a 30% stake for USD194.3mn in November. Oman's Al Maha Ceramics sold a 40% stake for USD20.6mn in September-October.

#### GCC IPO activity (regional exchanges)



Source: Zawya

*The regional IPO market closed the year on a strong note, although the number of issues remains modest*

Overall, IPO activity by Gulf names increased significantly from USD1.15bn in 2013 to USD9.97bn in 2014. The number of primary offerings rose from 10 to 15. With the exception of two offerings in 2013 and one this year, all activity took place on GCC exchanges. In 2014, Saudi Arabia accounted for 67.4% of all IPO activity in 2014, while the UAE made up 27.4%.

### The GCC fixed income markets lose some momentum

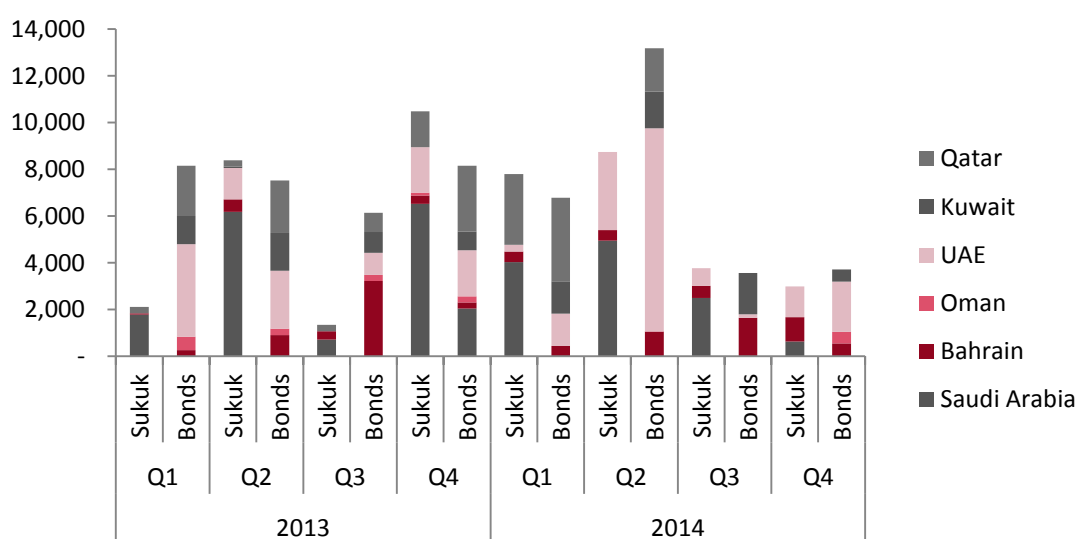
*Q4 was characterized by a clear slowdown in issuance activity in both conventional and Shariah-compliant fixed income*

The growth of the regional bond and sukuk markets has remained generally strong even if issuance volumes moderated clearly in the second half of the year. Overall, the region saw a slight increase in conventional bond issuance from 61 offerings worth USD25.4bn in 2013 to 83 issues with an aggregate value of USD28.6bn in 2014. In the Shariah-compliant space, there were a total of 23 sukuk issues in 2014 and they raised a total of USD23.3bn. This compared to 69 offerings worth USD26.4bn in 2013.

The level of issuance activity was clearly less in the second half of the year. UAE names continued to dominate in the conventional space with major deals including a USD500mn Mubadala GE Capital bond and a USD1bn Emirates NBD bond in November, both with five-year tenors. All Kuwaiti issuance was sovereign. The National Bank of Oman placed a USD500mn five-year bond in October. Overall, GCC bond issuance totaled USD3.6bn in Q3 and USD3.7bn in Q4.

In the sukuk space, the largest issues over the past quarter included a USD375.72mn four-year sukuk by the Islamic Development Bank, a USD500mn five-year Flydubai sukuk, and a USD700mn DIFC Investments sukuk with a 10-year tenor. Overall GCC sukuk issuance totaled USD3.8bn in Q3 and USD3bn in Q4.

### GCC bond and sukuk issuance (USD mn)



Source: Zawya

### **Implications for Bahrain**

The renewed volatility of oil prices notwithstanding, the dynamics of the regional economies are likely to remain robust with strong momentum persisting in the non-oil sector. This should continue to benefit the Bahraini economy.

- ▶ Investor and consumer sentiment should benefit from significant continuity in the non-oil sector, which should support regional tourism and investment flows.
- ▶ The regional governments are likely to redouble their efforts toward economic diversification which should continue to create new opportunities for Bahrain-based companies.

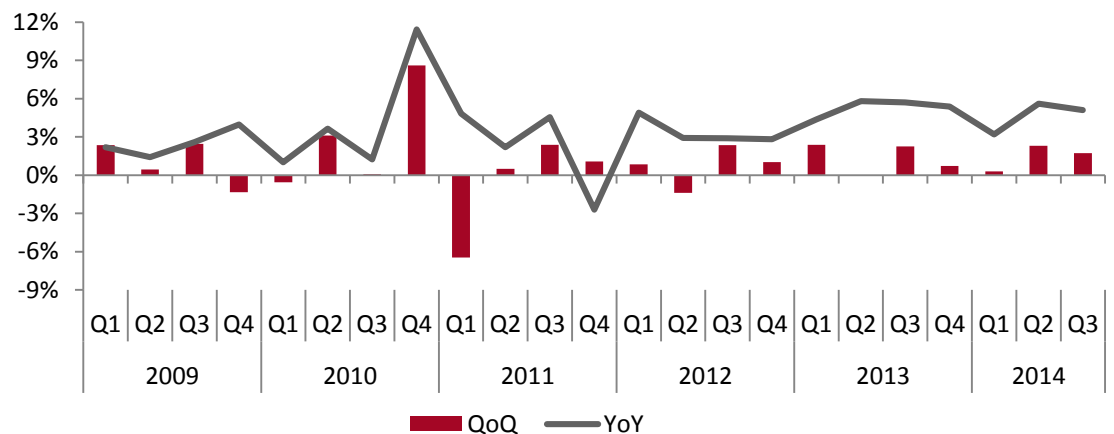
## BAHRAIN

## ECONOMIC GROWTH REMAINS STRONG

*Growth has significantly exceeded expectations in Q1-3, largely because of continued output gains in the oil sector*

While the initiation of numerous infrastructure projects was expected to boost growth this year, the pick-up in activity that has materialized in recent months has clearly exceeded expectations. The annual rate of real GDP growth in Q3 was 5.1%. While this marked a slight deceleration from the 5.7% pace recorded in Q2, it was a strong reading by recent standards. The QoQ rate of growth was 1.7%. The annual growth rates of the non-oil and oil sectors were 4.7% and 5.2%, respectively. The annual pace of headline growth for the first three quarters of the year taken together was 4.6%. While the momentum of the non-oil sector was in line with our previous projections of 4.3% during Q1-3, the oil and gas sector has surprised on the upside with continued output gains. In spite of the expected scenario of minimal growth, the sector has now expanded by 6.0% YoY during the first three quarters of the year.

## Real GDP quarterly growth



Source: Central Informatics Organisation

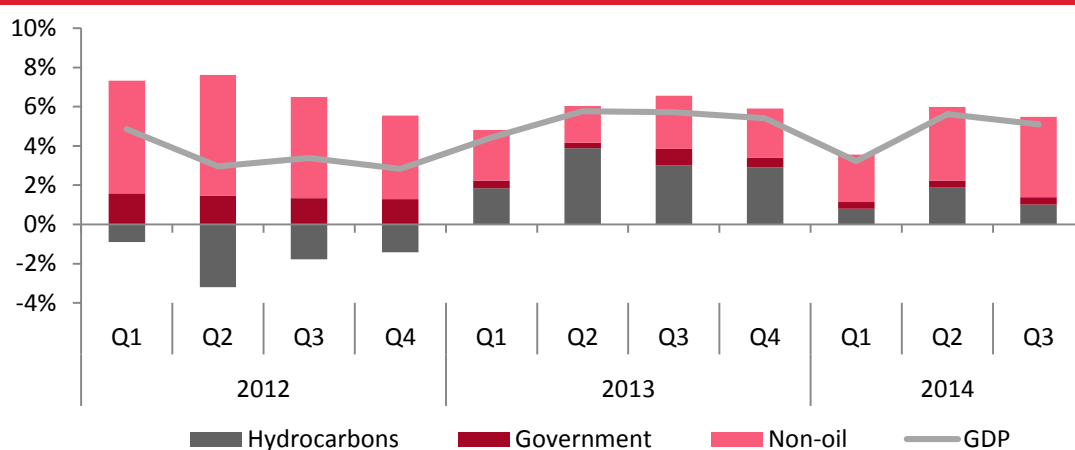
## Broad-based growth momentum

*The Construction sector saw a dramatic pick-up in growth in Q3 thanks to the initiation of several infrastructure projects*

The forward momentum of the Bahraini economy during 2014 has been broad-based. After a relatively slow start to the year, all sectors of the non-oil economy have seen a pronounced pick-up in growth. This has been particularly obvious in the case of the Construction sector, which experienced an acceleration from 3.6% annual pace of growth in Q2 to 12.3% in Q3, making it the fastest growing sector of the economy. This is largely reflective of the ongoing activation of the large infrastructure project pipeline worth more than USD22bn. The Hotels and Restaurants sector, which has consistently been the fastest-growing sector of the economy in recent quarters, saw a slight loss of momentum but nonetheless posted robust YoY growth of 7.4%. The only other sector to grow significantly faster than the non-oil economy taken as a whole in Q3 was Social and Personal Services, which is largely composed of private health care and education. This continues an established pattern, which has seen the sector emerge in recent years as one of the most dynamic in the country.

Several sectors advanced more or less in line with the average growth rate of the non-oil economy. These included Real Estate and Business Activities, which expanded by 4.6%, Retail trade (4.4%), and Manufacturing (4.1%). By contrast, the growth of the Government Services sector remained moderate in line with the pattern established in recent quarters as well as the strategic aspirations to put the private sector at the forefront of growth.

#### Breakdown of quarterly growth (in real terms, YoY)



Source: Central Informatics Organisation

#### YoY real growth of key sectors, 2012-2014

YoY growth	2012					2013					2014		
	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Crude pet. & Gas	-8.5%	-4.3%	-15.1%	-8.1%	-6.5%	15.3%	9.8%	22.2%	15.4%	14.6%	4.1%	9.3%	4.7%
Manufacturing	4.7%	8.7%	8.8%	2.4%	-1.1%	3.2%	2.0%	-1.9%	5.6%	7.4%	0.8%	4.4%	4.1%
Construction	4.1%	1.4%	5.8%	2.8%	6.6%	2.7%	2.9%	5.6%	0.7%	1.6%	1.4%	3.6%	12.3%
Retail	6.2%	5.8%	8.1%	7.9%	3.2%	2.0%	1.2%	1.4%	-0.1%	4.1%	3.9%	3.1%	4.4%
Hotel & rest.	11.2%	13.5%	20.7%	3.1%	9.0%	9.5%	9.4%	4.9%	12.1%	-3.0%	9.9%	10.3%	7.4%
Trans. & Comm.	4.5%	6.1%	3.2%	5.4%	3.2%	2.5%	5.4%	2.9%	2.6%	1.6%	4.9%	6.4%	4.0%
Social & pers. Serv.	12.7%	13.3%	12.3%	15.6%	10.0%	6.5%	6.5%	7.2%	7.9%	5.0%	6.6%	8.2%	6.6%
Real est. and Bus. Act.	3.6%	1.2%	3.4%	3.8%	6.2%	2.4%	1.7%	1.8%	3.0%	3.2%	4.4%	4.5%	4.6%
Finance	4.0%	4.3%	3.7%	4.2%	3.9%	2.3%	3.1%	2.8%	1.7%	1.5%	1.9%	3.9%	3.5%
Government	12.1%	13.5%	12.5%	11.5%	10.8%	2.1%	4.0%	3.0%	3.0%	2.3%	2.3%	3.3%	3.0%
Other	11.2%	10.0%	11.7%	7.5%	16.2%	2.8%	-1.5%	1.7%	2.6%	3.4%	5.9%	6.3%	12.2%
<b>GDP</b>	<b>3.4%</b>	<b>4.9%</b>	<b>2.9%</b>	<b>2.9%</b>	<b>2.8%</b>	<b>5.3%</b>	<b>4.4%</b>	<b>5.8%</b>	<b>5.7%</b>	<b>5.4%</b>	<b>3.1%</b>	<b>5.6%</b>	<b>5.1%</b>

Source: Central Informatics Organisation

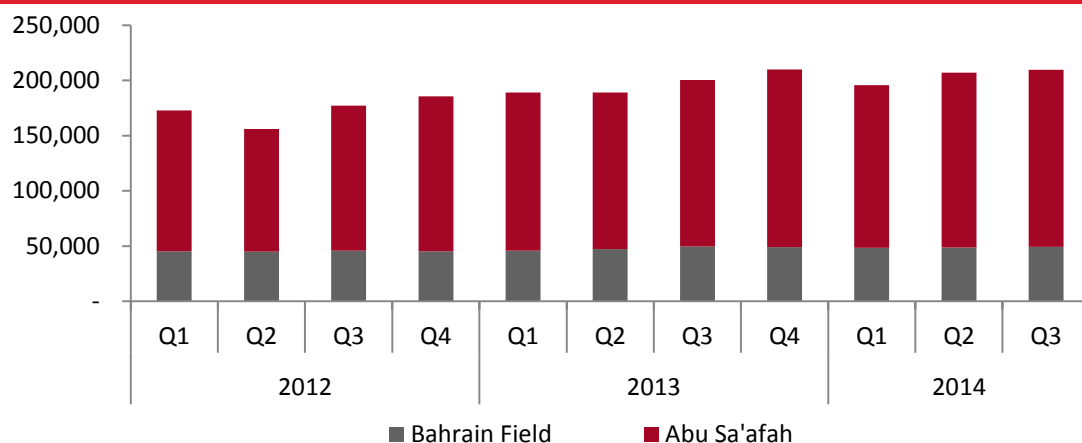
#### Stronger momentum in the oil sector

The hydrocarbons sector of the economy, having experienced an unusual cycle in 2012-2013 has continued to perform strongly this year. Both the onshore Bahrain (Awali) field and the offshore Abu Sa'afah have seen sustained output gains this year. Having peaked at 9.3% YoY growth in Q2, the oil and gas sector posted a 4.7% gain in Q3. Production from the Bahrain field rose from 48,758 b/d in Q2 to 49,187 b/d in Q3. Bahrain's share of Abu Sa'afah's output was 158,278 b/d in Q2 and

*The oil sector has defied expectations through a significant positive contribution to growth this year*

160,385 b/d in Q3. Both figures are clearly above the standard capacity production of 150,000. We currently expect Abu Sa'afah to revert to capacity in Q4 while output from the Bahrain field should be more or less constant. This would lead to some loss of momentum in the oil sector in Q4, although the year as a whole is still likely to be very strong in historical perspective.

#### Monthly oil output (barrels per day)



Source: National Oil and Gas Authority

#### A favorable near-term outlook

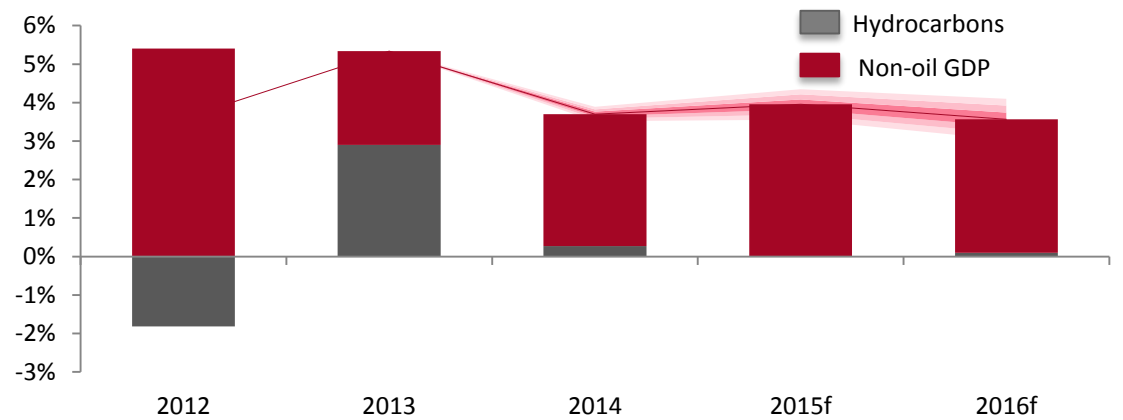
The performance of the Bahraini economy in the near term is likely to benefit from a number of positive drivers which should translate into robust growth figures over the coming three-year period. Above all, the build-up in infrastructure spending will continue. Spending from the USD10bn Gulf Development Fund will be the main driver in this regard, but initiatives are underway also to activate a number of significant priority projects that will draw on a range of funding sources, including private investment. The blueprint for the new government appointed in December includes a number of important initiatives ranging from the manufacturing sector to transportation and social infrastructure.

*Economic growth is likely to have clearly exceeded 4% in 2014 and should come close to this in 2015*

The current bout of oil price volatility, along with the expected tightening by the US Federal Reserve, pose some risks in terms of business confidence and cost of capital. However, the main near-term growth drivers are very resilient in our view, and the low loan-to-deposit ratios of retail banks suggest that the cost of capital is unlikely to be the main constraint on lending activity for now.

We expect GDP growth in 2014 to have exceeded 4% with our current estimate standing at 4.2%. We forecast 4.6% non-oil growth along with a 2.9% gain in the oil sector. Following region-wide trends, growth in 2015 is slightly to be somewhat lower at 3.6%, primarily due to what we expected to be flat oil production. By contrast, non-oil growth is likely to remain robust at 4.5%. 2016 growth is projected to be comparable with a headline rate of 3.3%. We project some deceleration in non-oil growth to 3.9% along with a small 0.5% gain in the hydrocarbons sector.

### Projected GDP growth



Source: Central Informatics Organisation, EDB estimates

### New initiatives to drive growth

*Bahrain continues to strengthen economic ties with key trade partners*

Bahrain continues to develop and strengthen its economic ties with growth markets globally, through international meetings and agreements to attract investments and projects to Bahrain. In an important recent initiative, a Bahraini business delegation attended the China Overseas Investment Fair in October. During the investment fair, the Chinese Overseas Development Association (CODA) signed a Memorandum of Understanding with the Bahrain Economic Development Board to promote investment projects across a number of sectors in both the Bahraini and Chinese markets. This agreement is also a result of the CODA's recent visit to Bahrain during which it studied the Kingdom's investment environment, business registration procedures, and industrial policies.

The MoU signed ranged a variety of different sectors in order to strengthen business ties between the two countries:

- ▶ Chinamex, the Chinese government agency behind the Dragon City Bahrain project, signed an MoU with the Bahrain EDB to establish a regional trading centre in Bahrain. This agreement also included provisions for the EDB to assist in the registration of the Chinese companies to be housed at Dragon City
- ▶ China National Building Material Company (CNBM) and Chinamex signed an MoU to offer trade financing services for the Chinese tenants at Dragon City Bahrain.
- ▶ The Bahrain Chamber of Commerce and Industry signed an MoU with the China Association of International Trading to establish ties and enhance economic relations between Bahrain and China.

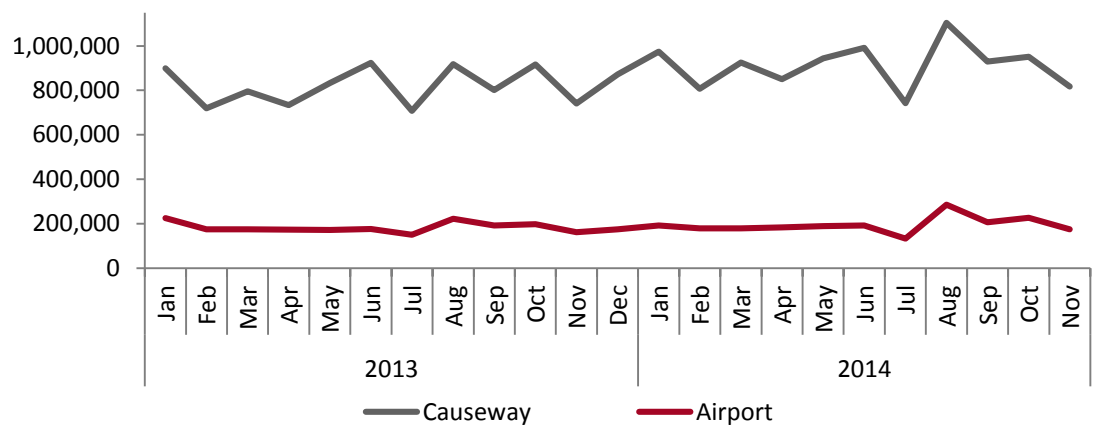
*Several upcoming projects in tourism expected to further strengthen the value added from this sector*

New initiatives are underway to develop Bahrain's tourism offerings further. Among other things, the availability of public beaches will improve through nine new developments along the west coast of Bahrain over the next five years. A USD50mn King Faisal Corniche project will revamp the northern Manama coastline, creating a multi-purpose modern beachfront development.

Efforts are underway to facilitate movement on the King Fahad Causeway that connects Bahrain to Saudi Arabia. The causeway authority recently announced plans to reduce time spent at customs by introducing a new entry-exit mechanism for GCC citizens which will require them to stop at only one set of customs. This new system is expected to be implemented during the first half of 2015 and will have a large positive impact on facilitating traffic flow.

The number of arrivals to Bahrain has remained on a fairly consistent upward trend, some seasonal volatility notwithstanding. The total number of arrivals to Bahrain through the King Fahad Causeway in November was 817,606, which represented a 10.3% YoY increase. The number of arrivals using the Bahrain International Airport experienced a rise by an annual 7.7% in November 2014 to reach 173,495. Sea port arrivals also increased to reach 5,538 in November 2014, an increase of 17.8% compared to the same month last year. Overall, the total number of visitors to the Kingdom was 997,089 in November this year, representing a YoY increase of 9.9%.

#### Monthly tourist arrivals in Bahrain by port of entry, 2013-2014



Source: Ministry of Interior

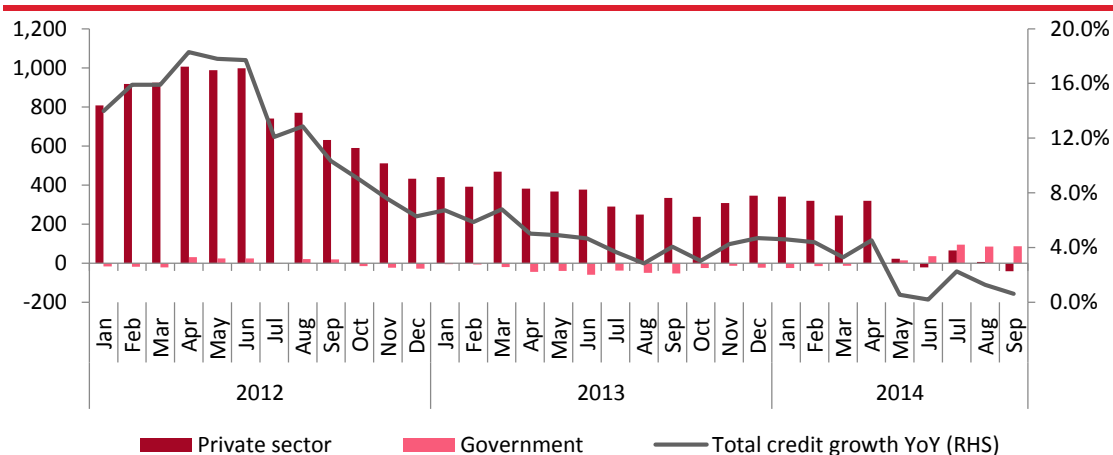
#### Credit growth holds steady

*Liquidity remains strong and credit growth fairly stable*

The recent data series on bank lending does not allow for YoY comparability because of the reclassification of some institutions from the retail to the wholesale category. However, data since the spring has been relatively flat, suggesting that credit growth has been comparable to the rates experienced during the past year and more. With loan-to-deposit ratios of less than 50%, the retail banking sector remains highly liquid and therefore in a position to accelerate lending further.

In terms of their financial results, Bahraini banks have continued to perform strongly. According to data compiled by the Bahrain Association of Bank, the combined assets of Bahrain-domiciled banks (34 institutions) rose from USD153.5bn at the end of 2013 to USD154bn by the end of the first half of 2014. The total assets of these institutions have grown by 22% since 2009. Combined net profits of the domestically incorporated banks rose from USD1.3bn in 2012 to USD1.8bn in 2013. Net profits totalled approximately USD953mn for the first half of 2014, suggesting that the banking sector is on target to exceed 2013's total.

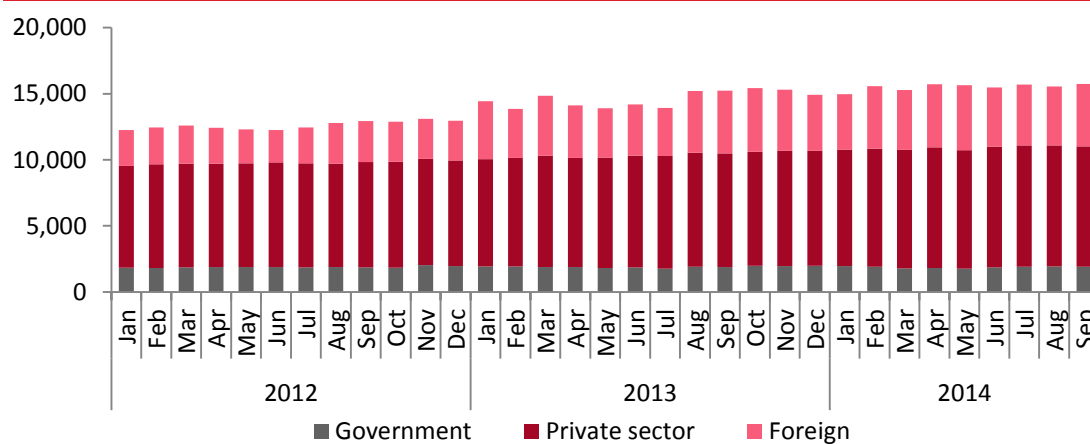
### Year-on-year credit growth to the private sector and government (BHD mn)



Source: Central Bank of Bahrain

Bank deposits continued the resilience that was evident in previous quarters. Total bank deposits in September 2014 grew by 3% when compared to the same month last year to reach a total of BHD15.7bn. The composition of deposits has remained fairly constant in recent years, with the most obvious increase in foreign deposits.

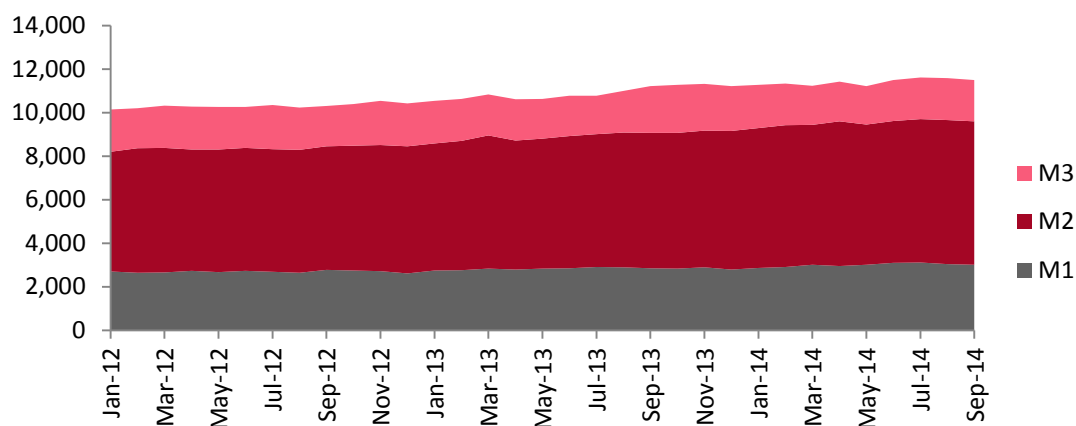
### Deposit liabilities to non-banks (BHD mn)



Source: Central Bank of Bahrain

Liquidity in Bahrain has continued its steady growth. M1, the narrowest measure of money which includes currency in circulation and demand deposit, grew by an annual rate of 5.9% in September 2014. M2, which includes time and saving deposits, grew by the same rate as M1. The broadest measure of money supply, M3, which includes general government and Social Insurance Organisation deposits, grew by 2.5% year-on-year.

### Money supply growth (BHD mn)

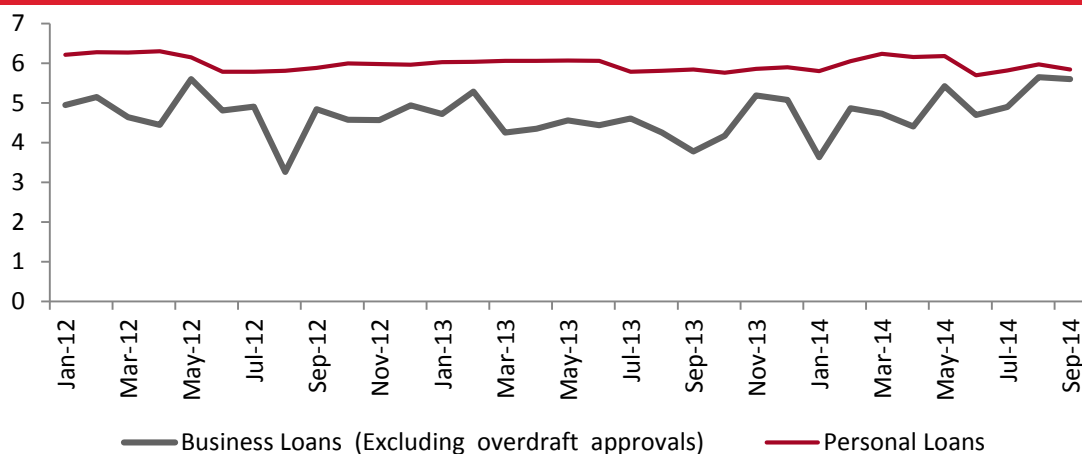


Source: Central Bank of Bahrain

*Interest rates for personal and business loans start to converge around 5.7%*

Interest rates for business and personal loans have converged markedly in recent months. In September, the average rate of interest for personal loans was 5.8% and for business 5.6%. Nonetheless, personal loan interest rates still remain slightly higher than business loan rates. Personal loan rates have remained virtually flat around 6% since early 2012 while the cost of business loans has fluctuated much more around 5%.

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



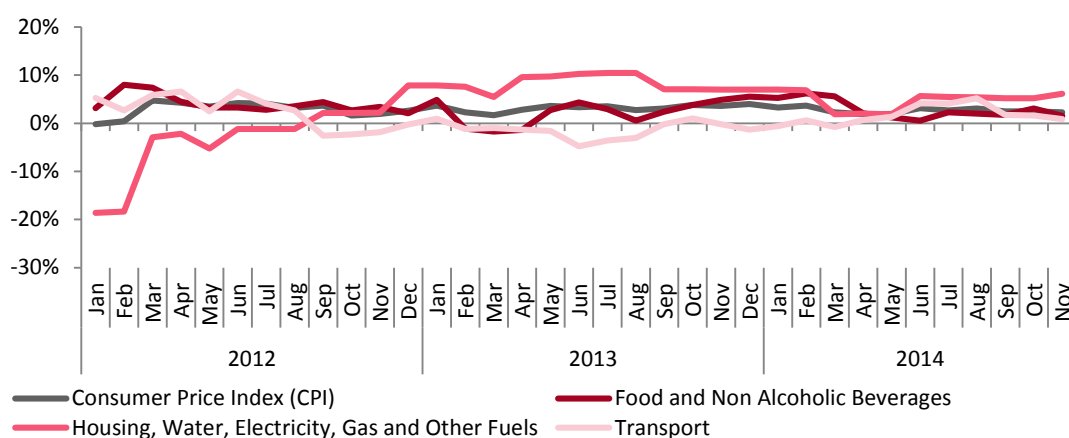
Source: Central Bank of Bahrain

### Steady consumer price growth

*Headline CPI figures suggest an absence of significant price pressures with an annual rate of 2.3% as of November*

Inflation dynamics in Bahrain have remained fairly constant and in line with broader regional trends in recent months. Headline consumer price inflation stood at 2.3% YoY in November 2014 having averaged 2.9% since the beginning of the year. Housing, water, electricity, gas and other fuels continued to be the sector experiencing the highest growth in prices at 6.1%. At the opposite end, transport was the sector with the smallest inflation increase, growing at an annual rate of 0.9%. In general, price increases across the different sub-indices have converged in recent months.

## Sector-specific consumer price inflation indicators (YoY, %)



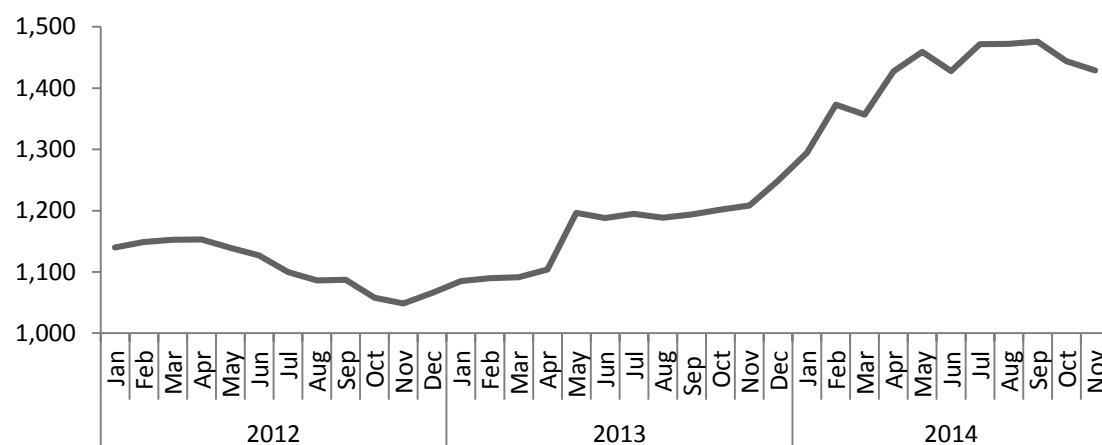
Source: Central Informatics Organisation

## Capital market resilience

*The Bahrain All-Share Index has continued its positive momentum with a year-to-date gain of some 14%*

At a time of considerable volatility in the regional capital markets, Bahrain Bourse has manifested considerable resilience. YTD, the Bahrain All-Share Index was up 13.4% as of 30 December, in spite of a 4.1% drop during Q4 – the smallest in the region. The initial public offering of Zain Bahrain this autumn brought the total number of companies on Bahrain Bourse to 48 companies, five of which are foreign.

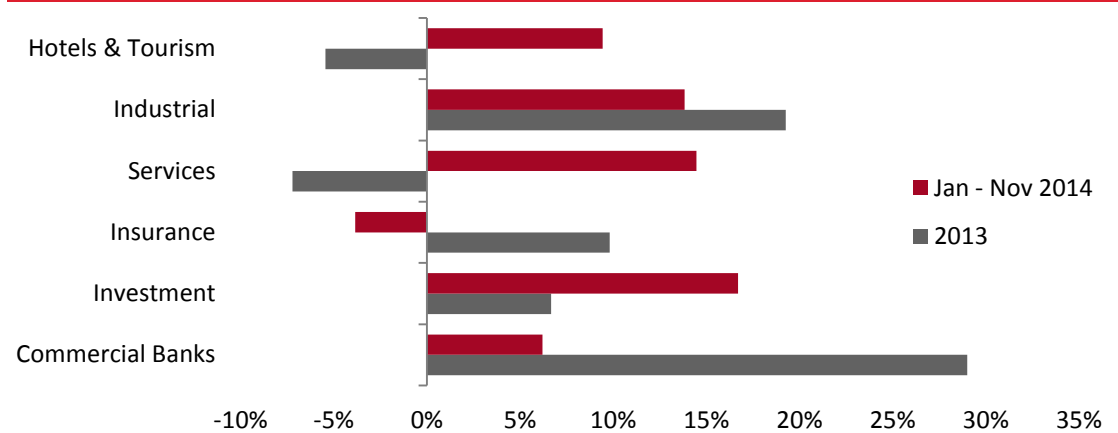
## Bahrain All-Share Index



Source: Bahrain Bourse

The performance of Bahrain's benchmark index has been favorable in the regional context with only Qatar and Dubai posting higher gains during the year. During the first 11 months of the year, a 10% gain in Bahrain compared to an average -2% drop for the GCC as a whole. This is partly reflective of the limited exposure of Bahrain Bourse to the oil markets. The momentum of the Bahraini market was led by the Investment sector which grew by 16%. Following that came the Services sector and Industrial sector, rising by 15% and 14% respectively.

## Sectoral stock market indices, 2013-2014



Source: Bahrain Bourse

As part of efforts to diversify its services, Bahrain Bourse plans to launch a range of Islamic investment products, including a novel equity-based murabaha financing tool and Islamic real estate investment trusts (REITs). In addition, the exchange also aims to host sukuk trading, which currently takes place over the counter. The bourse is also working on creating a Bahrain Islamic prices index, expected to be introduced next year. The Central Bank of Bahrain (CBB) is working on facilitating the introduction of new Shariah-compliant products through the creation of a Central Sharia Board to help oversee Islamic finance products in the Kingdom. This board will help further standardize the Islamic financial sector by replacing the current standard of self-regulation. This new measure will include new Sharia governance rules to expand the internal Sharia review and audit functions while making it mandatory for banks to have an independent external Sharia audit.

In an important stimulus to the Islamic fixed income market in Bahrain, Bahrain Mumtalakat Holding Company successfully priced a USD600mn seven-year sukuk with a 4% profit rate in November. This was Mumtalakat's first Dollar sukuk issue. The sukuk was a hybrid structure, comprising of a commodity *murabaha* and a *wakala* based on Mumtalakat's holding in its portfolio companies. This structure allowed the company to capitalize on the strong liquidity in Islamic financing. The issue was part of Mumtalakat's USD1bn Regulation S Multi-currency issuance program. The BBB- rated offering was 4.3 times oversubscribed. More than 81% of the offering was taken up by regional investors with some 19% sold to Europeans and Asians. Nearly all buyers were banks or fund managers. In the conventional space, Bahrain Commercial Facilities Company issued a USD50.05mn five-year bond in October. ICICI Bank's Bahrain branch issued a USD96.75mn three-year bond in November at 4%.

Beyond this, the Central Bank has continued with its regular T-bill and sukuk issuance.

*Bahrain Bourse has revised its rules through initiatives to boost access and liquidity*

## Bahrain sovereign short-term bond and sukuk issuance

Date	Issue	Value, BHD mn	Maturity, days	Average interest/ profit rate, %	Average price, %	Over-subscription, %
22 Dec 2014	Sukuk al salam No 164	36	91	0.72		190
15 Dec 2014	Sukuk al ijara No 112	20	182	0.82		385
15 Dec 2014	Treasury bill No 1526	45	91	0.70	99.823	107
8 Dec 2014	Treasury bill No 1525	45	91	0.70	99.824	140
3 Dec 2014	Treasury bill No 1524	30	182	0.79	99.604	275
2 Dec 2014	Treasury bill No 23	150	12 months	1.05	98.953	349
1 Dec 2014	Treasury bill No 1523	45	91	0.70	99.824	193
24 Nov 2014	Sukuk al salam No 163	36	91	0.72		302
17 Nov 2014	Treasury bill No 1522	45	91	0.70	99.824	189
12 Nov 2014	Treasury bill No 1521	30	182	0.80	99.597	184
11 Nov 2014	Sukuk al ijara No 111	20	182	0.82		365
10 Nov 2014	Treasury bill No 1520	45	91	0.70	99.824	216
2 Nov 2014	Treasury bill No 1519	45	91	0.69	99.823	175
27 Oct 2014	Treasury bill No 1518	45	91	0.70	99.824	213
20 Oct 2014	Suku al salam No 162	36	91	0.72		332
14 Oct 2014	Suku al ijara No 110	20	182	0.82		385
13 Oct 2014	Treasury bill No 1517	45	91	0.70	99.823	174
1 Oct 2014	Treasury bill No 1515	30	192	0.80	99.599	357

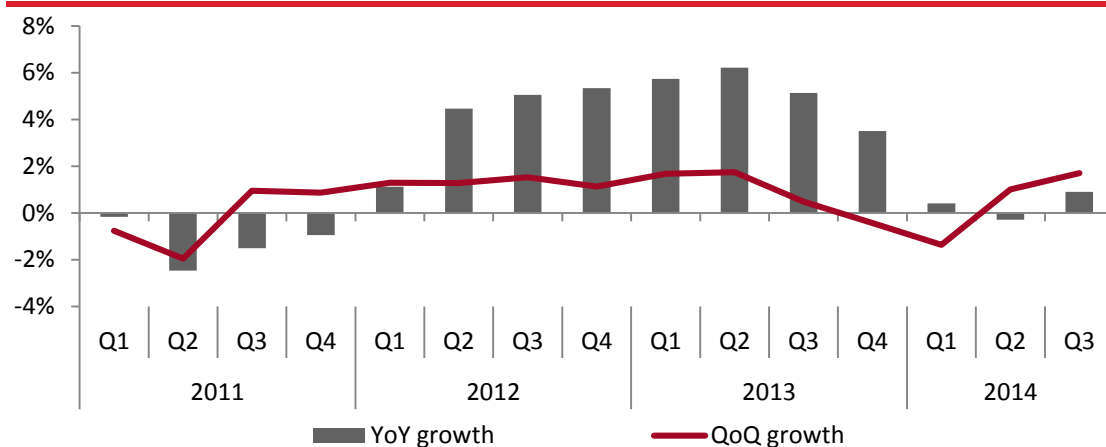
Source: Central Bank of Bahrain

## Labour market continuity

*Job creation for Bahrainis picked up in Q3 2014, in line with previous expectations*

According to the latest statistics by Ministry of Labour and the Labour Market Regulatory Authority, Bahrain's national workforce has continued its strong growth. In 3Q14, the number of Bahraini nationals employed grew by 2.2% compared to the same quarter last year. This significantly exceeded the 1.2% rate of growth in expatriate employment. In addition, the number of Bahrainis who entered the labour market grew by an annual rate of 8.4% during the same period.

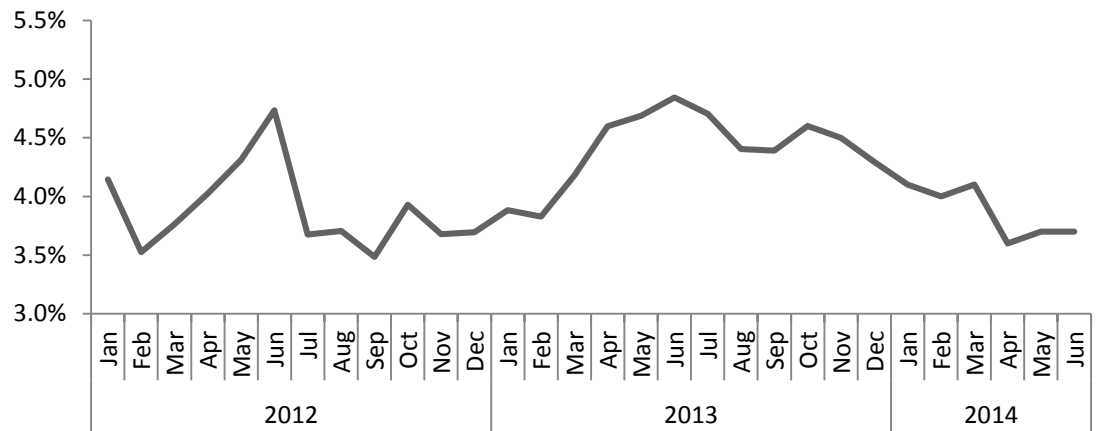
## Total private sector employment growth (excl. domestic workers)



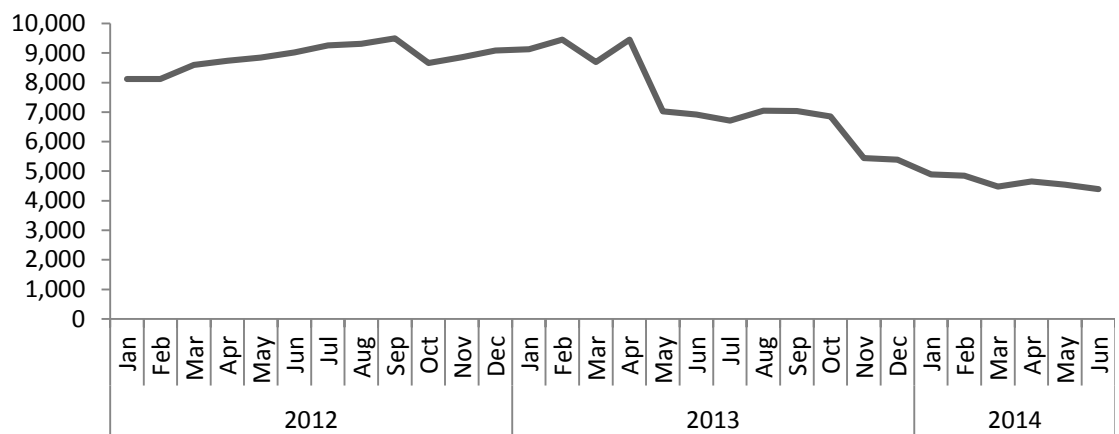
Source: Labour Market Regulatory Authority

*Open unemployment reflects obvious seasonality and has declined in recent months*

Private sector employment picked up significantly during 3Q14, growing by an annual rate of 0.9% and a QoQ rate of 1.7%. The number of employees in the private sector reached 502,821 in 3Q14. This reflects the significant pick-up in activity in the non-oil economy since the beginning of the year.

**Unemployment rate (%)**

Source: Ministry of Labour

**Number of vacancies reported by the Ministry of Labour**

Source: Ministry of Labour

**External assessments**

*Bahrain improves its ranking in the 2014 Corruption Perception Index*

The 2014 Corruption Perception Index (CPI), issued by Transparency International in December, ranked Bahrain third in the GCC and 55th among 175 countries globally. This represented an improvement by two places compared to last year. The CPI ranks countries based on perceptions of corruption in the public sector. Data is collected through expert and business surveys focusing on abuse of public power, asking questions around issues such as bribery of public officials, embezzlement of public funds and the effectiveness of anti-corruption efforts in the public sector. A country score indicates the perceived level of public sector corruption on a scale of 0-100, where 0 means that a country is perceived as highly corrupt and 100 means that a country is perceived as very clean.

*S&P revises its outlook on Bahrain while signaling optimism regarding the future*

A period of lower oil prices and their effect on Bahrain's public finances prompted Standard & Poor's Rating Services (S&P) to revise its outlook on the Kingdom of Bahrain to negative from stable. However, S&P cited favorable growth expectations for the Kingdom, linked to forthcoming

disbursements from the GCC Development Fund and Bahrain's diversified economic base as reasons for optimism regarding the future. S&P affirmed its 'BBB/A-2' long-and short-term counterparty credit ratings on the Central Bank of Bahrain and revised its outlook on the bank to negative from stable. Also, Fitch Ratings revised the outlook along similar lines.

### **Bahrain news**

- ▶ Following the signing of the World Trade Organization (WTO) agreement on trade facilitation in December 2013, Ministry of Industry and Commerce in co-operation with United Nations Development Program (UNDP) hosted a conference to assess the implementation of this agreement.
- ▶ Work began on the BD35mn King Faisal Corniche project which includes a 1.5km stretch of public coast, the Avenues Bahrain shopping center, with a public park covering 85% of the site's total area of 265,000 sq m. The project is expected to be completed early 2016.
- ▶ The Ministry of Works unveiled its 2021 strategic plan which includes planned changes to several roads as well as plans to connect all traffic lights in the Kingdom with fiber-optic cables to determine and adjust traffic flow accordingly.
- ▶ The Ministry of Transportation signed a concession agreement with a joint venture between National Express, a UK based bus operator, and Ahmed Mansour Al Aali. The joint venture will become the new public bus operator in Bahrain, operating around 140 buses using 26 different main routes covering all major areas in the Kingdom.
- ▶ Bapco announced it has selected Chevron Lummus Global (CLG) to provide process technology for two unites as part of its modernization program.
- ▶ Packaged food company Mondelez International, the maker of Oreo, Ritz, and Cadbury, announced plans to build a US90mn biscuit plant in Bahrain. Full production is expected to start early 2016 with an initial capacity of 90,000tn annually.
- ▶ Bahrain International Airport installed a new state-of-the-art passenger boarding bridge as part of its continuous efforts to improve the airport's infrastructure, increase its operating efficiency, and enhance passenger experience.
- ▶ Bahrain hosted the Bahrain International IT Exhibition (BITEX) 2014 in December. More than 70 specialized IT firms attended the exhibition, a 20% increase compared to last year.
- ▶ Best Western Hawar Resort Hotel opened for business in November, with a total of 44 rooms and suites.
- ▶ Bahrain introduced a cultural attaché to China to accommodate the needs of the roughly 500 Bahrainis studying in several Chinese universities as well as facilitating with delegations between the two countries.
- ▶ The Ministry of Municipalities Affairs and Urban Planning organized a first-of-its-kind

festival on fishing trade which featured new fishing technologies and methods

- ▶ The Global Entrepreneurship Week, which was held in Bahrain in November, included mentorship sessions for startups and small businesses.
- ▶ Alba hosted the 18<sup>th</sup> Arab International Aluminum Conference (Arabal 2014), which was attended by over 600 key decision-makers in the global aluminum industry. The conference included a workshop on hedging aluminum risk as well as a platform for participants to network.

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