

Bahrain Economic Quarterly

June 2016

SUMMARY

GRADUAL PROGRESS

With the notable exception of the “Brexit”-related jitters, the second quarter of the year has been characterised by a generally benign environment for global financial markets. This is underpinned by a growing conviction that loose monetary conditions in the leading economies are not about to be modified significantly in the near term. This appears to have somewhat eased concerns of dollar appreciation and supported the ongoing recovery in oil prices.

- ✦ **Economic growth in Bahrain rebounded in Q1.** Following a 0.9% QoQ pick-up from 4Q15, the headline YoY real growth rate reached 4.5%. The rebound was led by a 12.4% YoY increase in the oil sector. Non-oil growth at 2.7% YoY was comparable to the second half of last year.
- ✦ **Services and construction drove non-oil growth.** The fastest growing sectors of the non-oil economy were Social and Personal Services (mainly private education and health care), Construction, and Financial Services. These expanded by 8.4%, 5.4%, and 3.1% YoY, respectively.
- ✦ **The GCC governments are redoubling their efforts to support economic diversification.** A number of steps toward fiscal re-engineering are going hand in hand with an increasingly clear strategic commitment to reducing the oil dependency of the regional economies. Saudi Arabia’s Vision 2030 represents an important roadmap for the kind of paradigm shift pursued by all GCC governments.
- ✦ **Oil prices have experienced a pronounced rebound.** Erstwhile concerns about a supply glut have been eased by continued healthy demand growth as well as unprecedented supply disruptions. A key near-term uncertainty links to the conditions under which North American production would begin to rebound

Bahrain economic outlook

	2015	2016f	2017f	2018f
Real GDP growth, %	2.9%	2.9%	2.5%	2.2%
Non-hydrocarbons sector	3.9%	3.4%	3.0%	2.6%
Hydrocarbons sector	-0.9%	1.0%	0.5%	0.5%
Nominal GDP growth, %	-4.8%	4.8%	7.6%	5.6%
Inflation (CPI %)	1.8%	3.8%	2.0%	2.0%
Current account (% of GDP)	-0.2%	-2.7%	0.0%	1.2%
Fiscal balance (% of GDP)	-12.5%	-13.0%	-10.5%	-8.9%
Crude Oil Arabian Medium (USD)	50	45	55	60

Source: Bahrain Economic Development Board

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GLOBAL ECONOMY

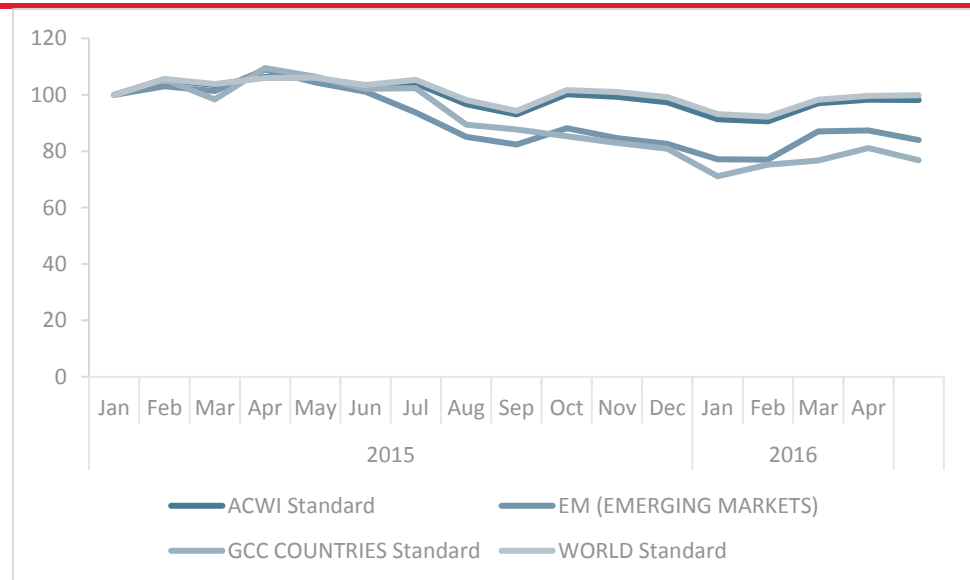
MODEST PROGRESS

Renewed stimulus measures in leading global economies have proven supportive of market sentiment even in the face of persistent, unusual risks

After a tumultuous beginning of 2016, renewed stimulus efforts by governments and central banks around world have proven generally effective in shoring up sentiment. Capital and commodity markets have tended to strengthen. More generally, however, the world economy is showing no sign of emerging from the malaise that has now plagued it for the better part of a decade. The International Monetary Fund (IMF) in its latest *World Economic Outlook* in April underscored the challenges of growth remaining sub-par for an extended period, while concern is also mounting about the persistent dependency on unconventional monetary policy.

Overall, the IMF expects global growth to reach a historically subdued 3.2% this year, in line with last year's performance. Some rebound – to 3.5% – is foreseen in 2017, primarily thanks to somewhat brighter growth prospects in emerging economies. Nonetheless, the Fund also underscored the unusual fragility of the global economy, which continues to necessitate proactive policy action to support growth and mitigate risks. The Institute of International Finance (IIF) projects somewhat more subdued global growth of 2.6% in 2016 followed by a slight acceleration to 2.9% in 2017.

MSCI regional indices (Base Jan 2015=100)



Source: MSCI

Cost of capital: lower for longer?

Recent weeks have seen a continued retreat from the earlier expectation of interest rate hikes by the US Federal Reserve. The non-farm payrolls report for May fundamentally challenged the perception of strengthening labour market dynamics, with only 38,000 new positions added during the month. This compared with expectations of 160,000 and led to a sharp reversal of rate expectations at a time when the argument for further gradual tightening had finally seemed to be

winning the day. In addition to the poor May data, revisions to past data reduced the three-month rolling average from 200,000 to 116,000. It is unclear to what extent a much stronger reading for June can be seen as a paradigm shift.

Renewed caution at the Fed led to 10-year bond yields falling to their lowest since August 2012. Investors now see minimal chance of rate rises this summer and the Fed has historically refrained from rate decisions ahead of a US presidential election. Echoing a growing conviction, Yellen recently suggested that the “neutral” rate required to keep the economy growing at its trend rate and near full employment could remain historically low for a long time.

Expectations of significant monetary tightening by the Fed have been scaled back with loose monetary conditions likely to prevail for now

The apparent policy reversal by the Fed will have potentially significant implications in the months ahead:

- ✦ It may reduce expectations of a rate gap between the US and other major economies, thereby reducing or reversing upward pressure on the US Dollar. This should be generally positive for capital flows into emerging markets
- ✦ The prospect of lower US rates is likely to be generally supportive of asset and commodity markets
- ✦ Lower rates should be supportive of global leverage which, in some ways, is emerging as an increasingly important impediment to future rate hikes

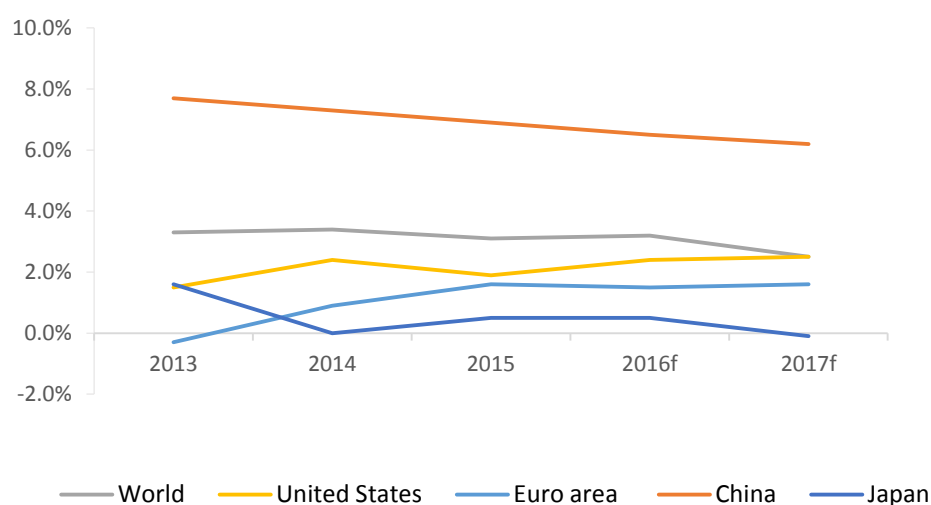
The Fed’s decision marks something of a reversal to the current global norm with most major economies pursuing extremely loose monetary policies. In the EU, low inflation, indeed the prospect of deflation, remains the main concern. Japan has struggled to achieve growth in the absence of ultra-loose monetary conditions and the latest IMF assessment advocates for renewed stimulus. The policy stance of the Chinese authorities is likely to remain highly permissive in the near term with the Ministry of Finance indicating that it would implement a proactive fiscal policy in the face of downward pressures on the economy. During the first five months of the year, expenditure was up by an annual 13.8%.

With the decision on 23 June by a majority of the UK electorate to withdraw from the European Union, the likelihood of monetary tightening has almost certainly diminished further. The outcome has ushered a period of market turmoil, wiping out some USD2trn of global equity value (nearly 3% of global GDP) in one day, and the prospect of protracted uncertainty as the UK renegotiates its relations with Europe. The near-term outlook for financial markets is therefore likely to be characterized by recurrent volatility.

The risk aversion triggered by the UK’s decision has brought the global total of government securities yielding less than zero to USD8.7bn, a USD380mn increase. Among other things, this is complicating the conduct of monetary policy by the ECB which is not allowed to buy bonds that yield less than its deposit rate – a criterion that now rules out half of German Bunds.

While there is an increasingly clear global consensus supporting ultra-loose monetary policy, along with relatively minimal concern about inflation, the ultimate impact of the ever more unconventional policy measures remains harder to determine. Among other things, the current state of affairs risks fuelling a bond bubble as well as contributing to an increasing abundance of liquidity. More than USD10trn worth of bonds globally now yield below zero, including the average yield of German government debt. This increases the sensitivity of markets to policy changes, with even minor modifications triggering asset price volatility.

Projected global growth, key economies (%)



Source: World Economic Outlook, International Monetary Fund

Oil: seeking a new range

Oil prices have begun to edge up quite consistently in spite of a failure to coordinate output levels by the key producer nations.

Oil prices have made a significant recovery from the lows recorded at the beginning of the year, roughly doubling since the January trough to hover around the USD50 per barrel mark until a slight correction in early July. This trend is generally expected to continue, even though the market remains subject to a number of uncertainties and can be expected to display recurrent volatility. For instance, OPEC now expects a continued rebalance of the market in the second half of the year thanks to demand growth and faltering non-OPEC production. Also, the International Energy Agency (IEA) has reduced its estimates of global excess supply this year to 710,000 b/d.

The immediate reasons for the rebound in prices are several-fold:

- ✚ The market has seen significant supply disruptions during the spring months. These have included wildfires in Canada, terrorism in Nigeria, and the ongoing civil war in Libya. Nigeria and Libya are of particular importance given their role as suppliers of light sweet crude. Globally, the effects of such outages averaged a record 3.7 mbd in May. In spite of output gains from Iran and Iraq, OPEC production in May reached 32.36 mbd, which is below the 32.6 mbd average expected to be needed to meet global demand in 2H16. Nigeria's output has fallen to its lowest level in more than

two decades

- ✦ US production, having been the key source of incremental output in recent years, is continuing to decline. Oil production was 8.75 mbd in May, down almost 1 mbd on the April 2015 peak. However, the non-gaseous liquids output has been more resilient, reaching an all-time high of 3.51 mbd in March before dipping to 3.46 mbd in May b/d YoY. The US Energy Information Administration (EIA) is forecasting 2016 crude output of 8.60 mbd, down from 2015's record 9.43 mbd. A further 400,000 b/d fall is forecast for 2017

In the meantime, global demand growth has remained resilient. Opec expects an increase of 1.2 mbd this year, down from 1.54 mbd in 2015. The most recent IEA projection is a demand increment of 1.3 mbd this and next year alike. India is due to become an ever more important demand driver, accounting for a projected 19% of the 2016 increment, up from 16% last year.

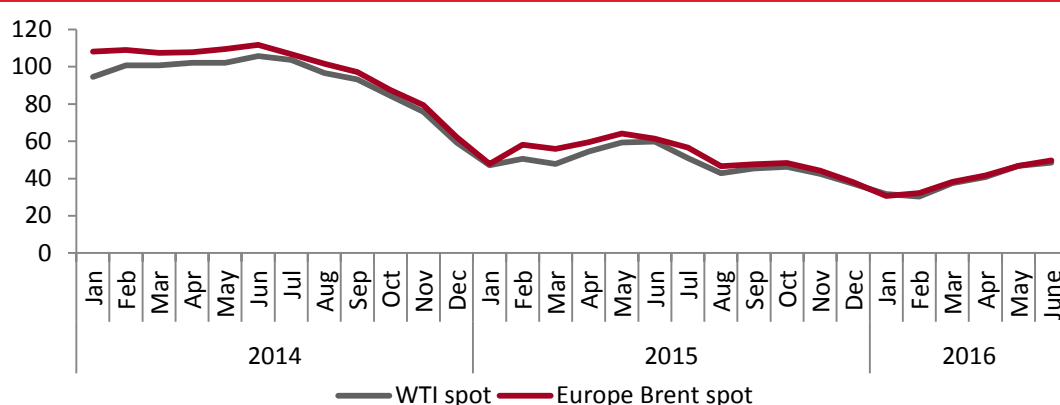
One of the key near-term uncertainties facing the market is linked to the ability of the US shale producers to ramp up output in a higher price environment. There are some signs of increased activity with the number of horizontal rigs edging up by 13 to 262 in late May-early June, according to Baker Hughes. This compared to a peak of 1,115 in November 2014. But the industry remains highly leveraged and several producers are facing financial difficulties.

Upward pressures on the oil price have been critically linked to production disruptions and lower-than-expected output gains in some key producer nations

Also Iran and Iraq have been of importance for market dynamics in recent months. Iranian production reached 3.38 mbd in April, up 460,000 b/d since the sanctions were lifted in January. A further increase to 3.42 mbd was observed in May, the highest figure since February 2012. The IEA expects Iranian production to reach 3.6 mbd this year, followed by 3.7 mbd in 2017. Following a roughly 40% output gain since mid-2014, Iraq is estimated to have produced 4.5 mbd in January and 4.39 mbd. Prospects of increasing this in the near term are deemed modest with a sharp reduction in upstream tenders. The rig count has fallen to its lowest since May 2012. Also storage and exports are reportedly complicated by capacity constraints.

Beyond the near-term trends, there is gradually mounting concern about the ability of the market to meet future demand growth due to massive cutbacks in investment. According to BP estimates, oil and gas investments globally contracted by USD160bn in 2016 and a further USD50bn drop is forecast this year. Overall exploration has nearly halved over 2013-2015 and global oil discoveries, estimated at 12.1bn barrels in 2015, were the lowest since 1952. Estimates by Goldman Sachs suggest that some USD550bn worth of oil and gas projects, ranging from Canadian oil sands to many deep sea projects, are unlikely to be commercially viable with prices of USD55. On the other hand, natural depletion and continued demand growth mean that the world will require some 3.4 mbd of new supplies by 2021.

Monthly crude oil prices (USD/barrel)



Source: US Energy Information Administration

Global oil demand and supply dynamics (mbd)

	IEA	OPEC	EIA
2015 Global oil demand (mbd)	93.3	93	93.7
Advanced economies	45.6	46.2	46.3
Developing economies	-	30.7	-
China	10.6	10.8	11.3
2016 Global oil demand (mbd)	94.5	94.2	94.9
Advanced economies	45.5	46.4	46.5
Developing economies	-	31.4	-
China	10.9	11.1	11.5
2015 Global oil supply (mbd)	-	95.1	95.7
OPEC	-	31.8	38.2
Non-OPEC	57.3	57.09	57.6
2016 Global oil supply (mbd)	-	-	96.4
OPEC	-	-	39.3
Non-OPEC	57.8	56.4	57.2

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

Implications for Bahrain

The near-term outlook for the global economy seems to be shaped to a large extent by moves toward more stimulus.

- ✦ The cost of borrowing is likely to remain historically low
- ✦ Lower US rates should contain the real exchange appreciation experience by dollar-pegged currencies, even if the market turmoil triggered by the Brexit vote may reinforce the safe haven status of the dollar in the short term
- ✦ While higher oil prices are positive for the fiscal position, the expected dynamics underscore the importance of continued fiscal reform

✚ Positive stimulus measures in key global economies should be supportive of trade dynamics

THE GCC REGION

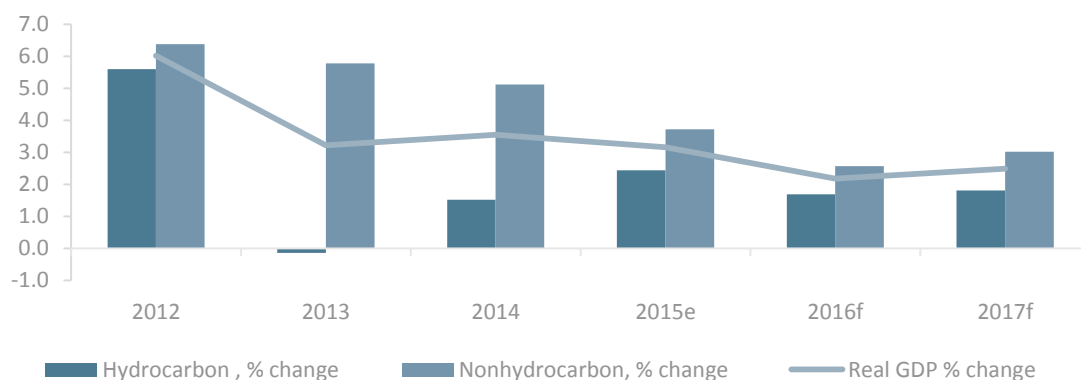
DETERMINED TO DIVERSIFY

Some slowdown in regional growth this year is expected to give way to a rebound next year

The political will behind a major economic paradigm shift in the GCC has become increasingly evident in recent months, as most palpably demonstrated by the Saudi Vision 2030 and the National Transformation Program that accompanied it. Countries across the region are continuing with their efforts to rationalize public finances. At the same time, they are devising new ways to drive economic diversification and enhance growth drivers that do not directly depend on the oil and public sectors. Among other things, the GCC has established a new Economic and Development Affairs Authority for the purpose of driving regional integration and policy coordination. Priorities include efforts to complete the regional customs union and the GCC common market.

While these efforts are improving the long-term growth prospects for the region, the near-term impact of continued oil price volatility and fiscal consolidation is having a dampening effect on growth. Following 3.3% real expansion across the region in 2015, the IMF expects headline real growth to slow down to 1.8% in 2016. But the resilience of the non-oil sector and a gradual normalisation in the oil sector should once again push growth up to 2.3% in 2017. The IFF is somewhat more upbeat with overall GDP growth forecasted at 2.2% in 2016 and 2.5% in 2017.

GCC real GDP growth, %



Source: Institute of International Finance

Non-oil confidence holding firm

The non-hydrocarbon sector (private and government) has been firmly at the forefront of economic growth in the region since 2012. Even in the face of the recent oil price gyrations, non-oil growth has remained generally robust with an aggregate, region-wide increase of around 3.7% in 2015. Nonetheless, it is clear that the negative confidence effects of oil price volatility, as well as the concomitant fiscal consolidation efforts, are tempering the positive progress somewhat.

The momentum of the non-oil economy is underpinned by strong drivers, including a massive infrastructure investment pipeline. This ambitious stream of project-related investments is likely to in relative importance in the years ahead. As of mid-June, MEED estimated the total value of projects in the region at USD2.67trn, down marginally from USD2.81trn a year earlier. Project cancellations over the past year have reduced the total by 16.1% in Saudi Arabia and by 8.5% in Qatar. By contrast, the other regional economies have posted YoY gains, with the fastest growth materialising in Oman (19.1%) and Kuwait (9.8%).

Generally speaking, a range of economic indicators across the region point to continued resilience in economic activity. Saudi growth is expected to slow down from 3.5% in 2015 to less than 2% this year before rebounding to around 2.5% in 2017. Growth in the non-oil private sector is likely to remain in the neighbourhood of 2.5% this year. Indeed, intermediate GDP data for 1Q16 suggests that confidence and activity in the non-oil economy have been hit by the headwinds of low oil prices and fiscal consolidation. Headline real GDP growth slowed to 1.5% during the quarter, as compared to 1.8% in 4Q15. Whereas the oil sector expanded by 5.1%, the non-oil economy actually experienced a small 0.7% contraction, partly due to the base effect of an unusually strong Q1 in 2015. The private sector grew by 0.2% in 1Q16 whereas the public sector contracted by 2.6%. While most indicators of activity have pointed to some softness in recent months, credit growth remains healthy and the National Transformation Program is expected to lend an important impetus to confidence and growth alike.

Following 4% growth in 2015, the UAE Central Bank projects 2.8% headline growth in 2016, followed by 3.0% in 2017. Non-oil growth is expected to reach 3.5% and 3.6%, respectively, much in line with the 3.7% figure recoded in 2015. The bank's Economic Composite indicator estimates overall growth of 3.0% and non-oil expansion of at 3.5% in 1Q16. After some volatility in recent months, the Emirates NBD Dubai Economy Tracker Index in May reached its highest reading since August (54.5). The improvement was above all attributable to strong local demand. Card spending in the UAE was reported to be up by an annual 6.8% in January-May, according to partial data compiled by Network International. The main area of weakness was tourism.

Qatar posted 3.6% headline growth in 2015 with non-oil expansion of 7.6%. The country's Ministry of Development Planning and Statistics has modified its growth forecast for the near term and now expects growth of 3.9% in 2016. Qatar also expects to run its first budget deficit in 15 years at 7.8% of nominal GDP in 2016, which compares to a 3.5% surplus in 2015. Growth in the country will benefit the 1.4bn cfd Barzan project which is due to begin in 2H16 and reach full capacity in 2017. This in turn will support manufacturing projects. Ongoing preparations for the 2022 FIFA World Cup will ensure that construction will continue to be a key growth driver.

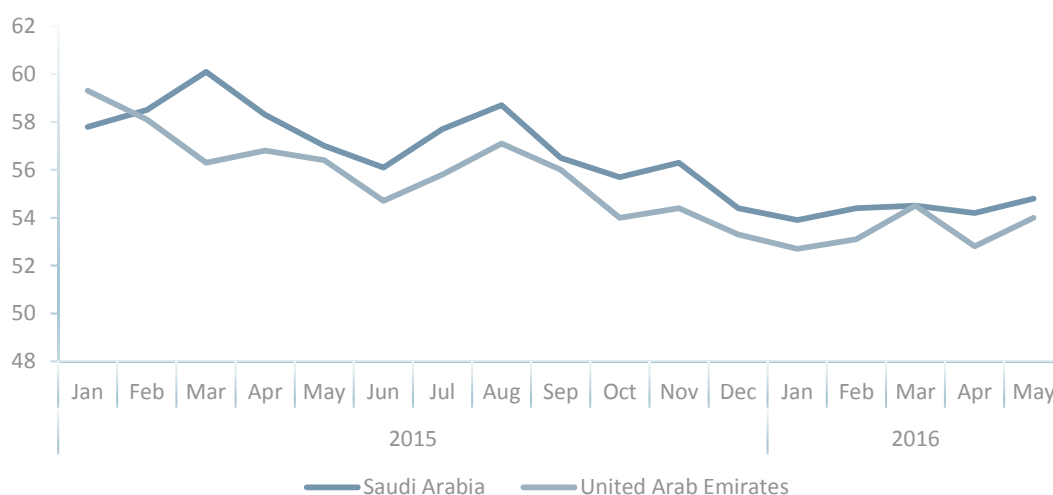
The World Bank in its latest (June) forecast for the GCC, on the basis of a 2016 oil price assumption of USD37 per barrel, has embraced a somewhat more cautionary outlook for the region. It expected growth to decelerate to 1.9% in Saudi Arabia, 2.0% in the UAE, 3.3% in Qatar, 1.3% in Kuwait, and 1.6% in Oman.

The Emirates NBD Purchasing Managers' Index, which is compiled for Saudi Arabia and the UAE, points to some strengthening of the economic conditions in the region's two largest economies. Saudi Arabia's PMI has edged up from 54.2 in April to 54.8 in May thanks to stronger order growth

Most indicators of real economic activity across the region point some slowdown in activity during the spring

and new project start-ups. In the UAE, the PMI increased from 52.8 in April to 54 in May as new orders increased at a fast rate and exports orders rebounded following two months of decline.

Emirates NBD Purchasing Managers' Index



Source: Emirates NBD, Markit

Envisioning the future

The development of the GCC region since the discovery of oil in the 1930s has been critically linked to this strategic resource. While transformative progress has been achieved, this oil-government services nexus has left economic growth in the region vulnerable to oil price fluctuations. In particular, lower oil prices have tended to curb the expansion of government expenditure, which in turn has held back other sectors of the economy.

This vulnerability has triggered efforts across the GCC to pursue economic diversification with a view to reducing sensitivity to oil price fluctuations. Bahrain launched a number of pioneering manufacturing and financial services projects starting in the late 1960s, while some regional economies have sought to anchor policy-making in medium-term plans. Saudi Arabia has been producing five-year economic plans since 1970s. The first Omani five-year plan was launched in 1976 and even included a 25-year development perspective.

Such efforts have become more established over the past decade or so. All the regional economies have drafted long-term visions and strategies designed to bring about the desired paradigm shift. Oman led the way by launching its Vision 2020 in response to low oil prices in 1995. Qatar and Bahrain followed suit with their Vision 2030 roadmaps in 2008. The UAE launched its Vision 2021 and Kuwait its State Vision Kuwait 2035 in early 2010. Saudi Arabia in 2004 published a Long-Term Strategy for the 2005-24 period before presenting a more comprehensive – and ambitious – Vision 2030 document on 25 April of this year.

In spite of considerable variation in scope, emphasis, and the level of detail, these documents are underpinned by an explicit recognition of the risks and limitations of the oil-based development model. In order to make headway, they typically propose a combination of measures, among which the following tend to figure prominently:

The strategic commitment to economic diversification in the GCC is of long standing

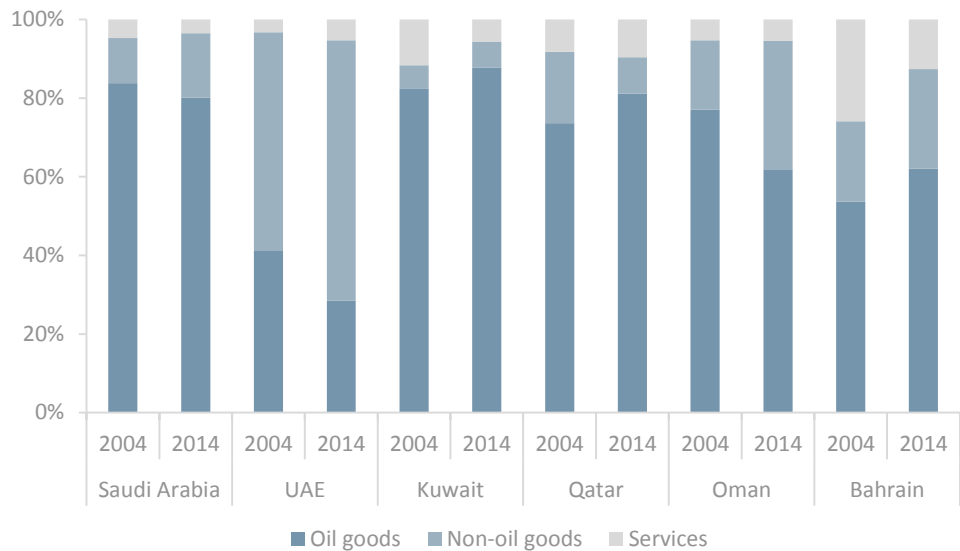
All GCC countries have unveiled vision documents which are designed to transform their economies away from a critical reliance on the oil-government nexus

- ✦ Vertical diversification represents attempts to capitalize on the local resource endowments (mainly hydrocarbons) through greater value chain capture, whether downstream hydrocarbons or energy-intensive manufacturing
- ✦ Cluster development involves attempts to encourage new economic activities around existing assets, whether ancillary services in finance or further processing of existing outputs
- ✦ Encourage the development of the private sector through regulatory reform and financial market development
- ✦ Capitalising on the unique geographic location of the GCC at the crossroads of three continents. This has involved heavy infrastructure investments in connective infrastructure and logistics-related activities, allowing the region to channel a growing proportion of global trade and travel
- ✦ Capturing the demographic dividend has grown in importance as the region nears its demographic peak and has involved activities ranging from social infrastructure (health care and education) to a variety of measures designed to increase economic participation

The practical progress of these diversification initiatives has tended to be most limited in the areas of government revenue and the composition of exports, both of which are attracting particular attention in the latest reform initiatives. Overall, the non-hydrocarbons exports of the GCC countries (non-oil merchandise and services) have grown by a robust 17% annually over a ten-year period from 2004 to 2014. Nonetheless, the share of these exports of total GCC exports have increased fairly marginally from around 26% to 34% over the same period.

The share of non-hydrocarbons goods of total exports has increased in almost all of the GCC countries with the exception of Qatar, which has dramatically ramped up its LNG exports during the past decades. Oman's non-oil goods exports have increased by an annual 22% since 2004 to reach a 33% share of total exports in 2014. All the other GCC countries have seen a double digit annual growth in the value of non-oil merchandise exports. Qatar and the UAE experienced the fastest increase in the value of service exports, by an annual 23% and 21%, respectively, over the past ten years. Qatar's service exports now make up 10% of total exports, the highest percentage in the GCC.

GCC export composition



Source: International Institute of Finance

The Saudi Vision 2030 represents the most recent roadmap produced by a GCC government for a less oil-reliant future. An ambitious document, it is of region-wide importance, given the size of the Saudi economy and the growing degree of economic integration with its regional neighbours. The document sets a number of important objectives:

- ✦ Increase non-oil revenues from SAR163bn to SAR1trn, which is expected to translate into increases of USD160bn by 2020, by which time the budget should balance, and a further 266bn by 2030. New non-oil revenue is expected to come from the introduction of a value-added tax, further excise duties on 'harmful' products such as sweet drinks and tobacco, as well as various fees imposed on the private sector. According to the government, there are no plans to introduce income tax for citizens
- ✦ Increase the private sector's contribution from 40% to 65% of GDP. Among other things, the public sector will be rationalised for increased efficiency as it contracts as a proportion of GDP. Moreover, public assets will be privatised. For instance, the Energy Ministry aims to transfer all its power generation to 'strategic partners' by 2020 and Saline Water Conversion Corporation is also slated for privatisation
- ✦ Increase non-oil exports from 16% to 50% of non-oil GDP by 2030
- ✦ Boost the output of SMEs from approximately 20% to 35% by 2030

More specific measures include efforts to develop local production in areas that historically have relied on imports. For example, the Kingdom will seek to localise half of the production (from 2% now) for its defence needs while also boosting the mining sector. Renewable energy will be another major focus area.

The vision was followed in June by a National Transformation Program, which includes 178 strategic objectives and will cost the government SAR268.4bn, in addition to a private sector

The Saudi vision represents an ambitious attempt to reposition the public sector

contribution of SAR179bn. The program seeks to create 491,000 new private sector jobs. Major initiatives in the program include a partial privatisation of Saudi Aramco, a 5% stake of which is to be IPOed. Based on an official valuation estimate of USD2-3trn, the listing could bring in USD100-150bn, which would make it the largest IPO in history. Scheduled for late 2017-early 2018, the IPO is expected to be a dual listing. The Public Investment Fund will become a sovereign wealth fund and its capital will be raised from SAR600bn (USD160bn) to SAR7trn (USD2trn). Its investments will be split evenly between domestic and foreign assets and will play a key role in diversifying the government's revenues. The program will be in part supported by an increase in government debt, which is projected to rise from 7% to 30% of GDP by 2020.

Oil production remains high

The failure to bring about a globally coordinated freeze in oil production during the spring months have been accompanied by historically high output levels by the GCC exporters. As of May, Saudi Arabia's output has been over 10 mbd for a record straight 15 months, exceeding 10.2 mbd throughout the year. A 250,000 b/d expansion of the Shaybah oil field in south eastern is imminent and will increase capacity to 1 mbd. The Khurais oil field expansion is due to be completed in 2018 and should boost capacity by 300,000 b/d to 1.3 mbd.

UAE oil production stood at 2.9 mbd in Q1, according to OPEC data. Even Oman has in recent months fairly consistently exceeded its 2016 liquids production target of 990,000 b/d with an average of 998,000 b/d during the first five months of the year. The main – temporary – exception to this picture was Kuwait which suffered a significant output fall in April due to a three day-strike that suspended some around 1.7 mbd of production capacity, which translated into a 140,000 b/d drop over the month as a whole.

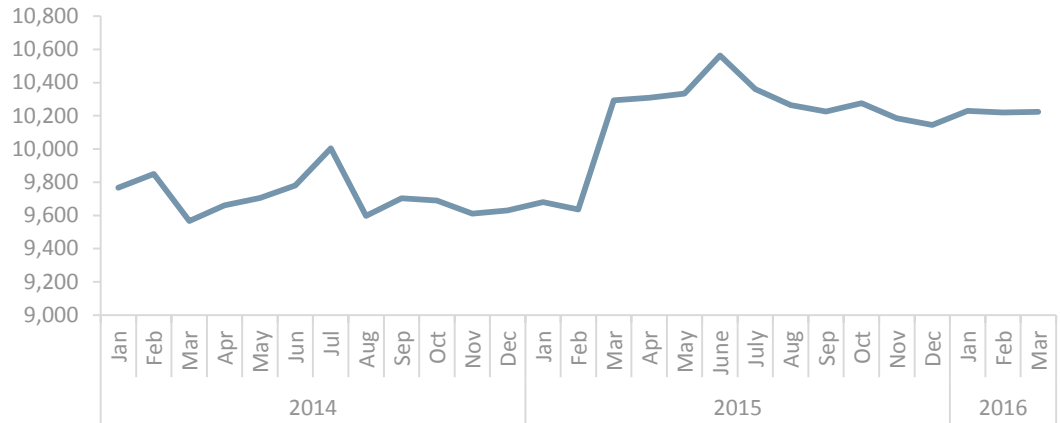
While the high production levels are linked to the OPEC strategy of defending market share, the current policy also reflects growing local demand and substantial efforts to develop the downstream industry. Overall domestic oil demand in Saudi Arabia stood at 2.2 mbd during Q1, a roughly 6% YoY increase, which is mirrored to varying degrees across the region. Crude throughputs at Saudi refineries reached a record 2.57 mbd in Q1. This marked the first time Saudi Arabia refined more than a quarter of its crude output domestically, which compares to 16% in 2013. Crude exports in Q1 nonetheless reached 7.64 mbd, up by 120,000 b/d on 4Q15.

Going forward, Saudi Aramco has also announced further plans to raise its total refining capacity from around 5.4 mbd recorded in 2015 (some of it outside of Saudi Arabia) to 8-10mbd. February saw record refinery throughput of 2.67 mbd. In recent months, Saudi Arabia has used a growing volume of oil to generate power. Direct crude burn reached 501,000 b/d in April, although the new 2.5bn cfd Wasit gas processing plant should help counter much of this.

Even more generally, Saudi Arabia is keen to develop local gas production further. Gas is seen as a strategic feedstock for industrial diversification. Saudi Arabia has increased its total gas processing from 11mn cfd in 2013, to 11.3mn cfd in 2014 and 11.6mn cfd last year. The authorities hope increase raw gas supply to 20bn cfd by 2020.

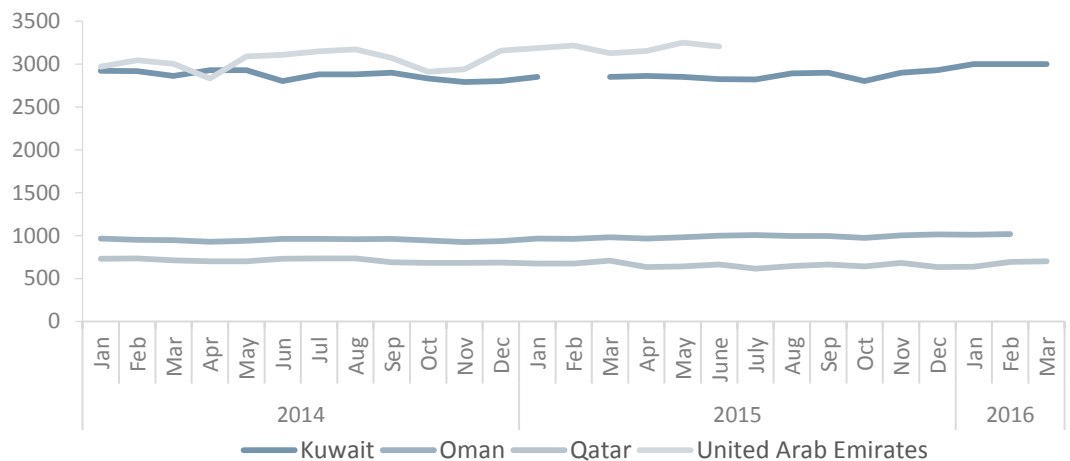
Regional oil production has remained at historically high levels throughout the spring months

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



Source: Joint Organisations Data Initiative

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



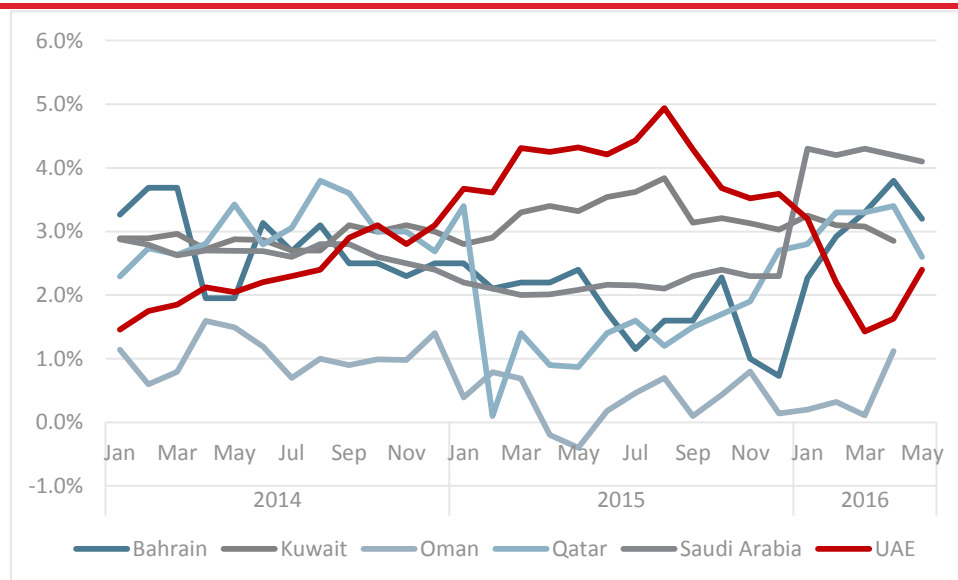
Source: Joint Organisations Data Initiative

Inflationary pressures generally contained

Inflation in the GCC has been characterised by relative stability in recent years, with the regional average ranging between 2.2% and 2.7% between 2009 and 2015. The ongoing steps to rationalise government subsidies are now putting some upward pressure on consumer prices with the region forecast to increase slightly to 3.2% in 2016. For instance, Saudi Arabia, following a review of energy subsidies, recorded 4.2% annual inflation in April. Transport is responsible for the bulk of this figure, increasing by 12.5%, while housing and utilities increased by 7.5%. Even Oman saw CPI inflation of 1.12%, which, though still a relatively low figure, is the highest reading since June 2014. Again, transportation costs led the way with a 4% increase linked to higher fuel prices. Qatari inflation reached 3.4%, the highest reading since September 2014, although it fell back to 2.6% in May.

Kuwait and the UAE have tended to go against the regional trend of late. Inflation in Kuwait stood at 2.85% YoY in April, the lowest reading since January 2015. UAE inflation has decelerated sharply from a peak of nearly 5% in 2015 to a trough of 1.4% in March before a renewed rebound to 2.4% in May. While this is indicative some cooling down in the housing market, it also reflects a base effect.

Consumer price inflation, %



Source: National statistical agencies

Credit growth tested by lower oil prices

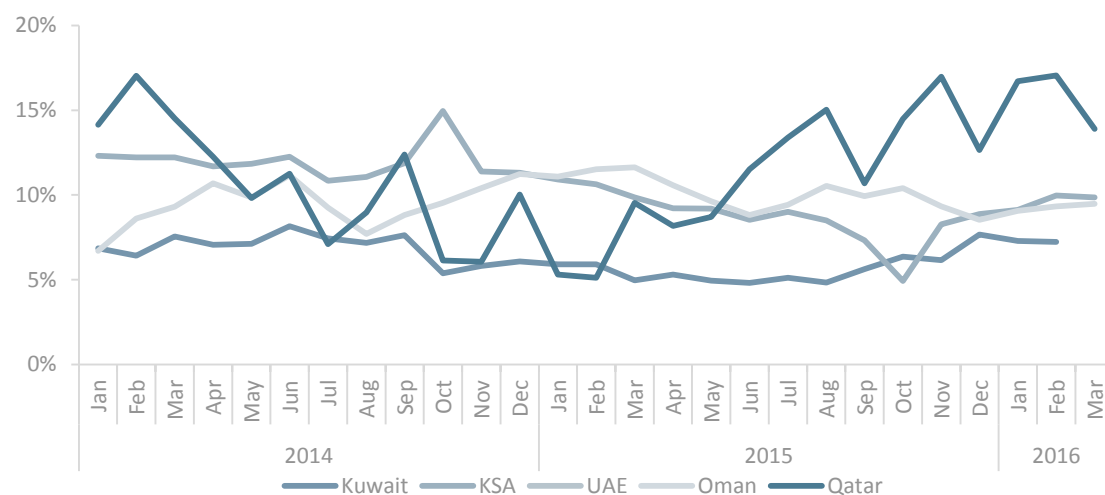
The GCC banking sector has generally continued to defy expectations of tighter credit conditions. Total YoY credit growth in recent months has ranged between 6% and 20% in the different regional economies. Overall bank credit growth averaged 10.2% in March. As usual, the fastest growth was observed in Qatar where the YoY pace of expansion reached 19.4% in April and credit has risen by 20.2% YTD. Saudi Arabia saw 10% YoY growth (12.4% YTD) and Oman 9.4% growth (14.0% YTD). The pace of expansion has been clearly slower in the UAE and Kuwait. UAE bank lending rose by 6.7% YoY in April (6.0% YTD) while Kuwait saw a pick-up to 8.4% growth in March (5.8% YTD).

While credit growth is hence holding up fairly well, deposit growth has decelerated across the region and has been clearly lagging behind the pace of lending. As of April, the fastest expansion of deposits was observed in Qatar at 8.3% YoY (9.6% YTD). The corresponding figure in the UAE was 4.0% (5.6% YTD) and in Oman 2.8% (6.8%). Saudi Arabia has seen small YoY drops in deposits – by 1.7% in April. Loan-to-deposit ratios remain highest in Qatar, Oman, and the UAE at 119%, 105% and 94%, respectively. These indicators have tended to increase across the region.

The tighter liquidity conditions have pushed up the cost of borrowing in much of the region. For instance, in Saudi Arabia, the three-month inter-bank SAIBOR rate has risen to its highest level since late 2008. In Qatar, similarly, the three-month interbank rate has risen to some 1.8% from 1.1% a year earlier.

In spite of the tighter liquidity conditions, the health of the regional banking sector remains generally robust after years of consolidation and tighter regulation. The financial results of the 56 leading regional listed banks increased by more than 6% for the 2015 calendar year. The improving profitability and rising assets were driven by growth in lending and related financing. Non-performing loans averaged 3.2%.

Bank credit growth, %



Source: Regional central banks

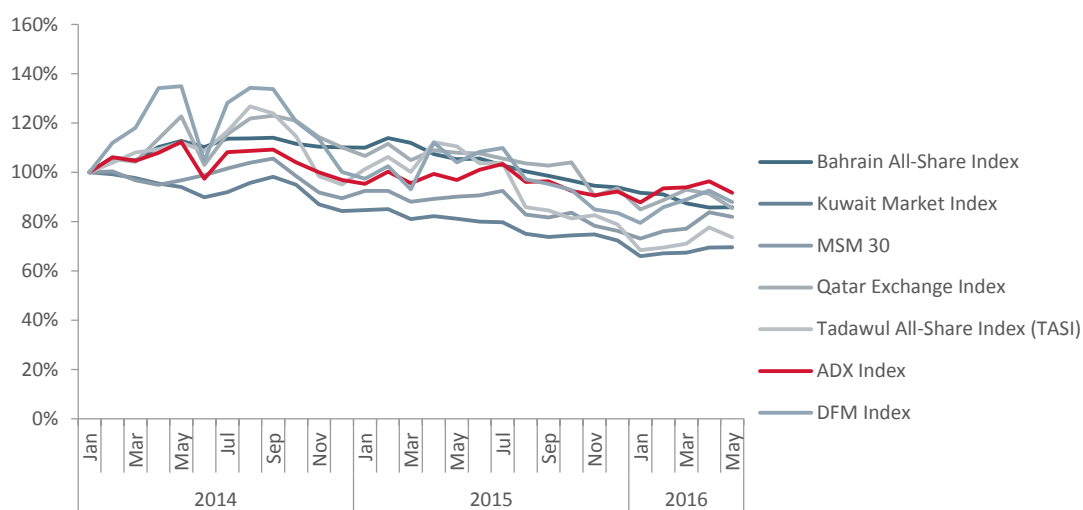
Stock market pressures ease somewhat

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

After a weak first quarter, the performance of the GCC stock markets improved somewhat in Q2, partly in response to strong oil prices. The only markets to post declines during the quarter were Dubai (-1.3%), Qatar (-4.7%), and Bahrain (-1.1%). Oman made the strongest gains, 5.7%, while Saudi Arabia advanced by 4.6%. Kuwait and Abu Dhabi recorded gains of 2.6% and 2.4%, respectively.

This left the regional equity markets with a mixed track record for the first half of the year taken as a whole. Three of the regional markets posted gains during 1H16 while four markets declined. Oman was the strongest performer with a 6.9% increase, followed by the UAE bourses: Dubai with a 5.1% gain and Abu Dhabi with a 4.4% advance. Saudi Arabia's Tadawul, even with the Q2 turnaround, shed a total of 5.8% during the first half of the year. The loss in Qatar was 5.2% and in Kuwait 4.5%.

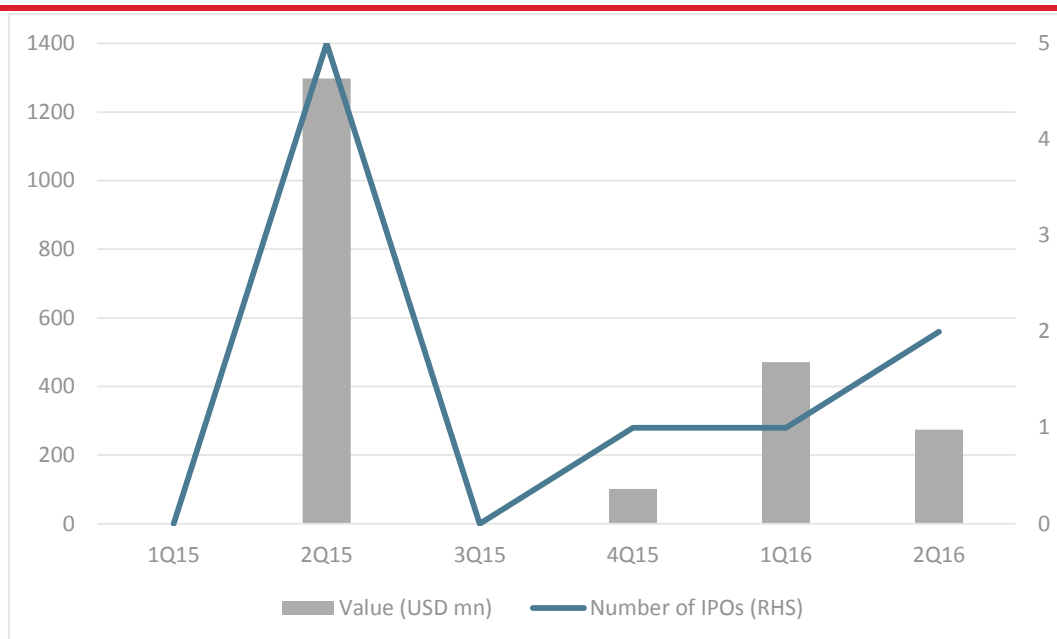
GCC equity market indices (January 2014 = 100)



Source: Regional stock exchanges

The regional IPO market revived somewhat in Q2, although all new issuance activity was once again limited to Saudi Arabia. While the number of offerings doubled, the value raised dropped by 41.9% from 4Q15, highlighting the challenging primary market environment against a volatile backdrop. Following its April IPO, Al Yamamah Steel Industries Co was listed in late May. The sale of a 30% stake raised SAR548.82mn in an offering which was 4.8 times oversubscribed.

L'azurde Company for Jewelry floated a 30% stake in a June IPO, a total of 12.9mn shares at SAR37each – SAR477.3mn. L'Azurde, part-owned by Bahrain-domiciled Investcorp, was the first majority private equity-owned company in Saudi Arabia to list. L'azurde is the largest manufacturer and wholesaler of gold jewellery in the Middle East and the fourth-largest gold jewellery manufacturer globally. It posted revenues of USD141.4mn in 2015.

GCC IPO activity (regional exchanges)

Source: Zawya, regional exchanges

Important reforms are underway at several regional stock markets. The Saudi Capital Market Authority in May announced three initiatives aimed at boosting foreign participation in the Saudi equity market. They consist of increasing foreign investment limits, moving from a T+0 to T+2 settlement cycle for securities and the introduction of securities lending and covered short selling regulations. Saudi Arabia is also planning to allow foreigners to buy exchange-listed debt instruments. The Abu Dhabi market is planning to bring back market making. The plan is for three institutions to offer 'bid' and 'ask' prices to increase trading volumes on the exchange.

Sovereign issuance reaches new records

The established pattern of increasing debt capital market issuance by GCC sovereigns has continued throughout the spring. This builds on a 37.2% YoY increase last year when aggregate issuance by GCC names (including corporates) reached USD118.7bn. But it also reflects a global trend as emerging market sovereign bond issuance in the first half of the year exceeded USD60bn in 50% rise over the corresponding period of 2015. By contrast, bond sales by emerging market companies were down by 15% to USD134bn, led mainly by Russia and Brazil.

Contrary to some expectations, the increased debt capital market activity does not appear to have benefited the regional sukuk market. GCC sukuk issuance during the first half of the year reached USD8.6bn, which was actually down on USD10.2bn a year earlier. This mirrors a broader global trend which saw a drop from USD38.4bn to USD33.5bn. By contrast, conventional debt issuance in the GCC rose from USD14.8bn to USD36.9bn over the same period.

Most GCC sovereigns turned to the market with substantial issues during Q2:

- ✦ Abu Dhabi led the way in April with a USD5bn international bond, the first since 2009, with equal tranches of five and ten years. The pricing was 2.218-3.154% and orders reportedly exceed USD17bn
- ✦ Qatar in May placed largest ever bond issue in the history of the Middle East. The USD9bn offering, which was nearly twice the USD5bn initially targeted, was composed of three tranches: two USD3.5bn tranches with tenors of five and ten years each as well as a USD2bn tranche with 30-year maturity. The pricing was 120-210 bps over US Treasuries
- ✦ Oman placed its first international bond in nearly two decades in June. The USD2.5bn offering was made up of two tranches with five and ten-year maturities with pricing of 3.625-4.75%. Oman privately placed a USD500mn six-year *ijarah* sukuk in June. The offering had a profit rate of 3.5%
- ✦ According to the Central Bank of Kuwait, the combined issuance of CBK bonds and Shariah-compliant *tawarruq* reached KWD4.47bn during the first half of the year. Issues with tenors of one year or more made up KWD1.55bn of this

Substantial sovereign issuance is also expected in the months ahead. Saudi Arabia, having recently raised a USD10bn bank loan, is planning an approximately USD15bn international bond placement. Also Kuwait is expected to fund much of its FY2016/17 deficit budget through debt. Under its public debt strategy, the Ministry of Finance plans to raise up to KWD2bn through domestic bonds and sukuk and an additional KWD3bn from the international markets. Kuwait posted a KWD55bn deficit in the 2015/16 fiscal year that ended on 31 March. This was the first shortfall in 16 years. The new budget foresees a KWD8.66bn deficit on revenues of KWD10.24bn.

Also corporate issuance has remained brisk, led by government-related entities and banks. Gulf International Bank in April placed SAR2bn worth of five-year notes. Saudi International Petrochemical Co (Sipchem) is going to the market with a SAR1.8bn sukuk.

In the UAE, the Abu Dhabi National Energy Company Taqa in June raised USD1bn through two equal tranches with maturities of five and ten years and coupon of 3.625-4.375%. Mubadala sold a USD500mn, seven-year bond in May. Etihad and its partners are raising USD500mn for capital expenditure. Abu Dhabi's Al Hilal bank raised USD225mn three-year sukuk through a private placement in June. Abu Dhabi National Insurance Company's (Adnic) placed an AED390mn convertible bond. Noor Bank placed a USD500mn Tier 1 capital issuance. DP World launched a seven-year USD1.2bn sukuk issue. Emirates Islamic issued USD750mn worth of five-year sukuk.

In Qatar, Ooredoo in June placed a USD500mn bond offering. The ten-year note will carry a coupon of 3.75%. Qatar National Bank raised QAR10bn in Additional Tier 1 Perpetual Capital Notes while Ahli Bank placed a USD500mn, five-year offering. Ezdan Holding launched an inaugural USD500mn five-year sukuk in May. Qatar International Islamic Bank has announced plans to raise up to QAR1bn. Commercial Bank of Qatar placed a five-year bond of USD750mn.

In Kuwait, Boubyan Bank placed a USD250mn perpetual sukuk in May, the first Kuwaiti sukuk since 2007. Gulf Bank issued KWD100mn worth of bonds.

Oman's Bank Muscat placed a USD500mn, five-year bond. Mohamed al Barwani Holding is placing a private placement sukuk of up to USD150mn US dollars following the issuance of new sukuk rules by the Capital Market Authority.

Implications for Bahrain

While the regional economic outlook is overshadowed by oil price volatility and fiscal consolidation, the strategic direction is becoming clearer.

- ✦ Sentiment in the regional economy has been fairly resilient and should benefit further from a clearer strategic direction
- ✦ While slower growth in some parts of the economy may entail some negative spill-overs, the regional financial markets are characterized by a high degree of continuity, which should benefit project activity

BAHRAIN

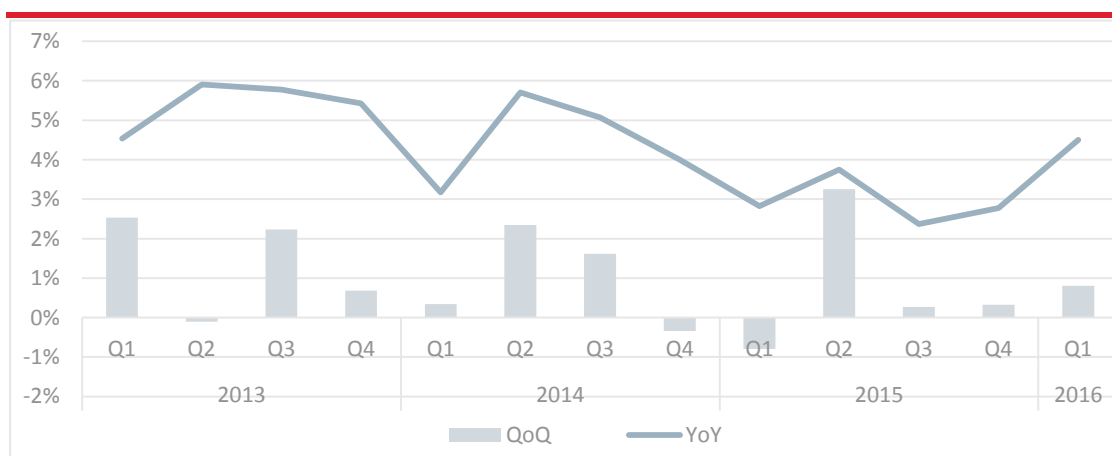
OIL REBOUND DRIVES A PICK-UP IN GROWTH

Stronger growth figures in 1Q16 were led by a rebound in the oil sector, which contributed roughly half of the GDP increment during the quarter

The first quarter of the year saw a pronounced acceleration in Bahrain's GDP growth following a slight slowdown in the second half of 2015. The QoQ expansion in real GDP was 0.8% whereas the annual pace of growth rebounded to 4.5%, a rate last seen in the second half of 2014. This compared to 2.8% growth in 4Q15 and to 2.9% during 2015 as a whole.

While the rebound is encouraging, it was to a large extent driven by a sharp, 12.4% increase in the oil sector. The non-oil sector was characterised by continuity, but the 2.7% pace of growth marked a slight deceleration from the 2.9% pace seen in 4Q15, let alone the 3.9% headline non-oil growth recorded during 2015 as a whole. While reflective of region-wide dynamics, the slight deceleration in non-oil growth underscores the growing importance of strategic infrastructure projects in underpinning the momentum of the economy.

Real GDP growth



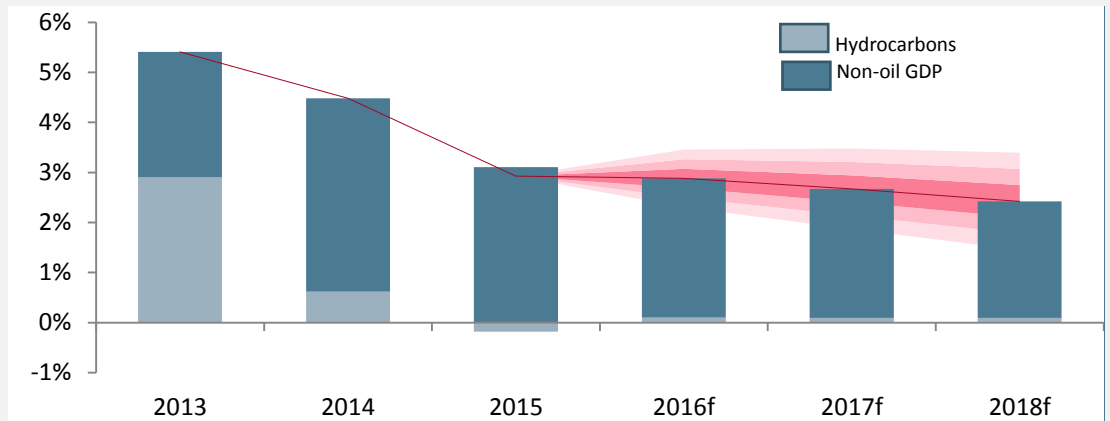
Source: Information & e-Government Authority

Forecasts: Non-oil resilience to underpin growth

	2015	2016f	2017f	2018f
Real GDP growth, %	2.9%	2.9%	2.5%	2.2%
Non-hydrocarbons sector	3.9%	3.4%	3.0%	2.6%
Hydrocarbons sector	-0.9%	1.0%	0.5%	0.5%
Nominal GDP growth, %	-4.8%	4.8%	7.6%	5.6%
Inflation (CPI %)	1.8%	3.8%	2.0%	2.0%
Current account (% of GDP)	-0.2%	-2.7%	0.0%	1.2%
Fiscal balance (% of GDP)	-12.5%	-13.0%	-10.5%	-8.9%
Crude Oil Arabian Medium (USD)	50	45	55	60

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

Projected real GDP growth contribution



Source: Information & e-Government Authority, Economic Development Board

Non-oil growth in the economy has remained under some downward pressure in recent months. Growth should benefit from the rapid build-up in especially GCC-funded projects, even if fiscal consolidation continues to temper sentiment in other sectors. The robust Q1 rebound in the oil sector heralds a potential slight improvement on last year.

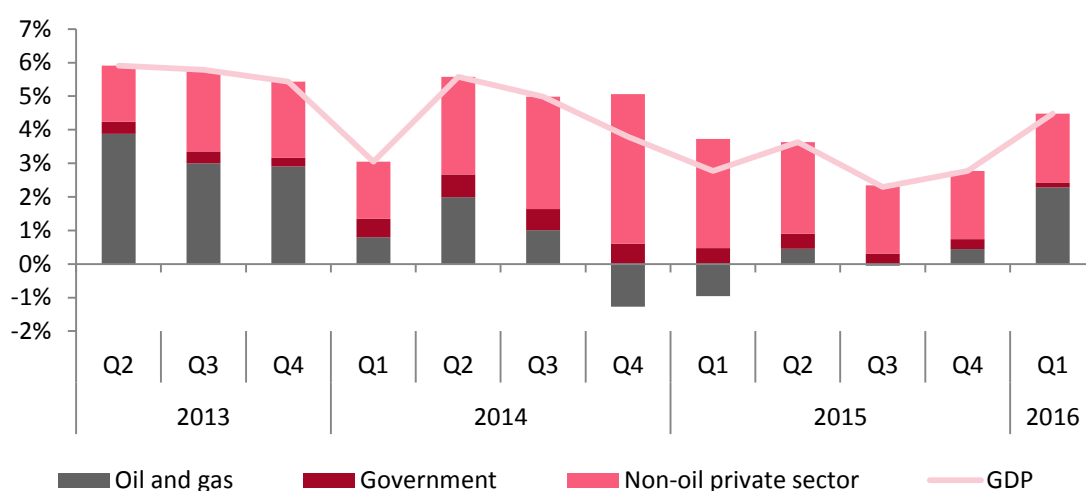
The composition of growth changes

Economic growth in Bahrain has been led by the non-oil economy ever since the second half of 2014. During this time, the contribution of the hydrocarbons sector has been either marginally positive or even negative, as happened in 2015. At the same time, the Government Services sector has contributed a small proportion of overall value creation, leaving the non-oil private sector at the forefront of economic growth in the Kingdom.

The composition of growth in 1Q16 stands in marked contrast to the dynamics seen over the past year and a half. A full 2.3 percentage points – more than half of the total real GDP increment – was contributed by the oil sector. This compared to only 0.4 percentage points in the last quarter of 2015. Government Services contributed 0.1 percentage points of growth in Q1, down from 0.3 points a quarter earlier. The growth contribution of the non-oil private sector was 2.1 percentage points, a figure that was more or less comparable to 2.0 percentage points in 4Q15.

In contrast to the pattern seen over the past year and a half, economic growth in Q1 was led by the oil sector

Real GDP growth composition



Source: Information & eGovernment Authority

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

The growth momentum of the non-oil economy was more uneven than has tended to be the case in recent quarters. The fastest-growing sector, as so many times before, was Social and Personal Services, a category dominated by private education and private health care. The sector expanded by an annual 8.4%, a brisk pace which was a marked acceleration over last year. The Construction sector continued to post strong numbers, as could be expected in view of the ongoing infrastructure build-up. The sector advanced by an annual 5.4% in a slight slowdown over last year's figure. The Financial Services sector expanded by 3.1% in a clear acceleration over the pace seen in 2015. The Transportation & Communications area saw 3% YoY growth.

The forward momentum was more subdued in sectors that are likely to involve discretionary spending, perhaps partly due to regional spill-overs. The Trade sector grew by 2.2%, a slight acceleration over the 2.1% pace recorded in 2015, whereas Hotels & Restaurants saw a deceleration to 1.5%. This may have been partly caused by a based effect as a result of an exceptionally strongly Q1 in 2015 when the sector expanded by 5.0%. Also Manufacturing, having been one of the main growth contributors in recent years, saw a deceleration to 1.2% YoY growth.

	2015					2016
YoY growth	Annual	Q1	Q2	Q3	Q4	Q1
Crude Pet. & Nat. Gas	-0.1%	-4.8%	2.2%	-0.3%	2.3%	12.4%
Manufacturing	3.2%	4.9%	3.2%	2.3%	2.4%	1.2%
Construction	5.9%	7.7%	5.4%	3.9%	6.8%	5.4%
Trade	2.1%	2.6%	2.8%	2.0%	1.0%	2.2%

Hotel & Rest.	3.0%	5.0%	1.4%	4.1%	1.7%	1.5%
Trans. & Comm.	6.8%	7.8%	7.7%	6.7%	5.2%	3.0%
Social & Pers. Serv.	3.5%	4.2%	2.8%	3.0%	4.1%	8.4%
Real Est. & Bus. Act.	1.7%	2.8%	2.6%	0.7%	0.9%	0.5%
Finance	2.3%	2.3%	2.7%	2.5%	1.8%	3.1%
Government	3.0%	3.6%	3.5%	2.5%	2.3%	1.1%
Other	7.9%	11.9%	11.7%	4.4%	4.2%	3.0%
GDP	2.9%	2.8%	3.6%	2.3%	2.8%	4.5%

Source: Information & e-Government Authority

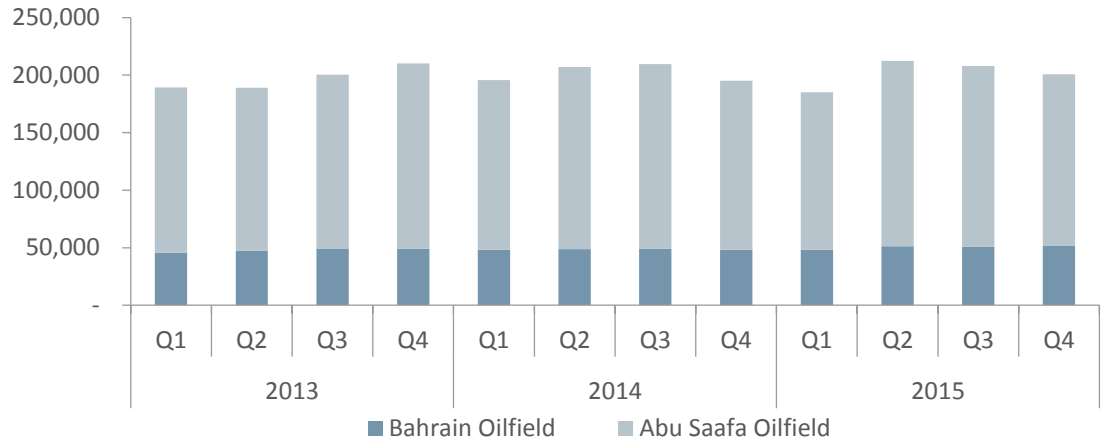
Oil production rebounds sharply in Q1

The oil sector, having experienced a small contraction during 2015 as a whole, returned to the forefront of growth in Q1. Production from the offshore Abu Sa'afah field reached a daily average of 160,910 barrels, some 7.3% ahead of the standard capacity of 150,000 b/d. This figure also exceeded the 149,053 b/d output seen in 4Q15 and 150,892 b/d during 2015 as a whole. The strength of the rebound was partly caused by an unusually weak average output level in 1Q15 when the daily average for Abu Sa'afah fell to 136,935 b/d.

Also output from the onshore Bahrain (Awali) field in the south of the island is continuing to edge up. In 1Q16, the average black oil production was 46,800 b/d while the total, including condensate, reached 50,400 b/d. This was broadly in line with the 2015 average of 46,200 b/d crude and a further 4,400 b/d of condensate.

A sharp rebound in the oil sector was led by above-capacity offshore production and accentuated by a relative weak Q1 in 2015

Crude oil production, b/d



Source: National Oil and Gas Authority

Infrastructure projects to strengthen as a growth driver

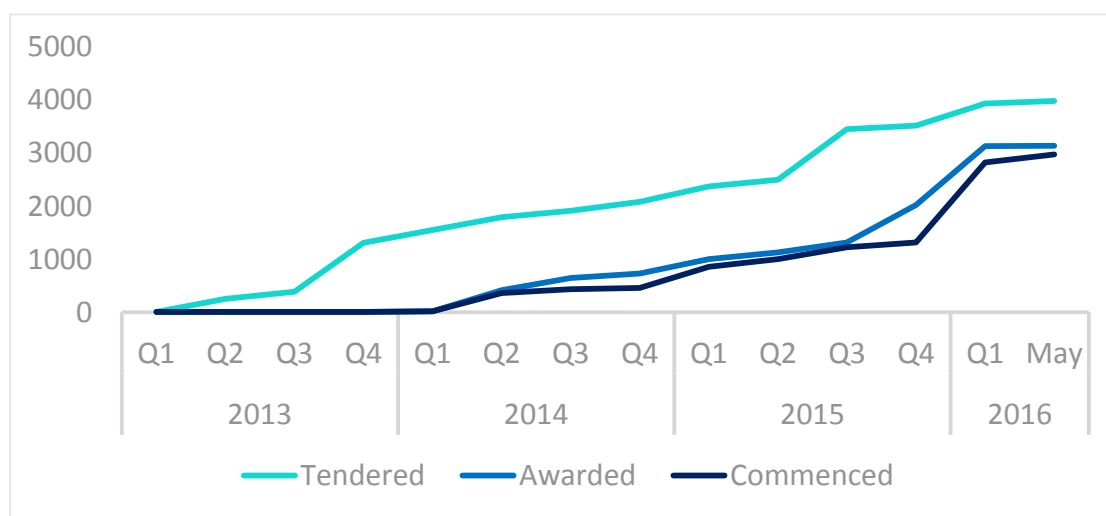
A large pipeline of infrastructure projects remains an important driver of non-oil growth in Bahrain as the region navigates through a period of oil price volatility and fiscal re-engineering. Bahrain is currently in the process of implementing over USD32bn worth of strategically significant priority projects, ventures with significant value or employment potential. MEED Projects in mid-June estimated the total project pipeline in the Kingdom at USD72.7bn, some 4.7% higher than a year earlier.

An important element of this project pipeline consists of investments financed by the GCC Development Fund. The value of such projects jumped sharply around the turn of the year and the aggregate value of projects that have started stood at just under USD3bn as of May. This compares to just over USD1bn in 2Q15.

One of the largest projects within this pipeline is the airport modernisation project. The main USD1.1bn expansion contract was awarded to a consortium of Arabtech Construction and TAV earlier in the year. Pending packages include maintenance, repair and operation hangar, ICT systems, and the air traffic control centre building. The first phase of the project is to be completed by mid-2019, at which point much of the current terminal building will be demolished to make way for the second phase which is due to be finished by the end of the 2020.

Following a pronounced pick-up in approvals, GCC Development Fund Projects are likely to constitute an important countercyclical driver this year and beyond

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



Source: Government sources

Also private sector projects are making good headway with several important new developments. In the manufacturing space, landmark projects are underway in downstream hydrocarbons and aluminium:

- ✦ The Bapco Modernisation program is gathering momentum following the appointment of a project management contractor in December. The refinery last year reached an above-capacity output level of 267,854 b/d and the modernisation program seeks to increase capacity from 267,000 to 360,000 b/d while modifying the output mix. Bapco has invited companies to submit bids for the engineering, procurement, and construction contract which is expected to have a total value of USD5bn. The project is expected to be fully complete by the end of 2020. Bapco in May also announced the creation of the Bahrain Gasoline Blending joint venture with UK-based Greenergy. The objective is to establish a regional gasoline blending hub
- ✦ The project finance package for the Bahrain LNG import terminal project is expected to be syndicated this summer in the form of a USD600mn 20-year loan. The majority is due to be financed by export credit agencies. The project will have a capacity of 800mn cu ft/d and an expected funding requirement of USD900mn. The project has a 20-year build-own-operate-transfer structure, which is a pioneering PPP model in the regional context
- ✦ Bahrain National Gas Company (Banagas) is planning to raise a loan of at least USD400mn to expand its gas processing facilities
- ✦ Aluminium Bahrain is currently syndicating a USD750mn seven-year commercial loan for its sixth pot line project. The overall project value is expected to be USD3bn, of which around 70% due to be financed through different debt structures. The main engineering, procurement, and construction management contract has been awarded and bidders shortlisted for the construction of a 1,300 MW captive power plant project. The project, once complete, will boost Alba's capacity by 540,000 tn/year to 1.5mn tn/year

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

Innovative models are being introduced to drive housing provision

Another major focus of activity is housing. The Government of Bahrain is pursuing an ambitious program of developing 40,000 housing units within a decade. Close to 15,000 units are currently under construction and a further 6,000 in the pipeline. The Ministry is seeking to develop new PPPs and has launched a Social Housing Financing Scheme support home purchases by nationals. The scheme is based on charging the beneficiary 25% of salary over 25-30 years, an approach that should increase receipts significantly over the loan period.

The state-owned Eskin Bank is looking to establish joint ventures with international developers for the purpose of developing 15,000-16,000 housing units. Potential partners have been approached in the GCC, Turkey, China, and South Korea. Under the planned joint ventures, the government would allocate land to build equity in the projects, while the developers along with financial service providers would fund the construction. The JVs are due to develop government land in Ramli and Al Madina al Shamaliya (Northern Town) as well as to redevelop more mature areas in Muharraq, Umm al Hassam, and Isa Town.

In the private sector, major new freehold projects have been launched this year in Diyar al Muharraq, Dilmunia, and Durrat al Bahrain. Among others, a 3,000-unit Deerat al Oyun project has commenced in Diyar al Muharraq. Construction work on the USD650mn Villamar project at the Bahrain Financial Harbour in central Manama is also resuming along with a USD150mn Harbour Row project.

Several important projects are moving forward in the transportation sector:

- ✦ The national carrier Gulf Air is planning to acquire 16 Boeing 787-9 Dreamliners and 29 Airbus A320/321neos in the coming years. The approximately USD7.6bn worth of orders will likely see the first deliveries by 2Q18. Reflecting the success of a restructuring program that was launched in 2012, Gulf Air reported losses of BHD24.1mn for 2015, down 62% from 2014
- ✦ A feasibility study has been announced for a planned national light rail scheme
- ✦ Engineering consultancy work is due to start on the Bahrain Northern Link Road (BNLR) which will be made up of series of roads and a causeway along the northern coast of the main island. The road will connect to the Saudi causeway. The main highway will be roughly 22.5 km long and should significantly ease congestion in central Manama

In the power sector, the Electricity and Water Authority (EWA) has received consultancy bids for the Al-Dur 2 independent water and power project which is expected to include a 1,500 W gas-fired power generation facility, and is scheduled to come online by 2019. Construction work is due to start in 2017. A BHD280mn power grid development project was launched in May is expected to be completed by the end of 2017. The scope of work includes the building and linking of three electricity transmission lines in Hidd, Um al Hassam, and Riffa.

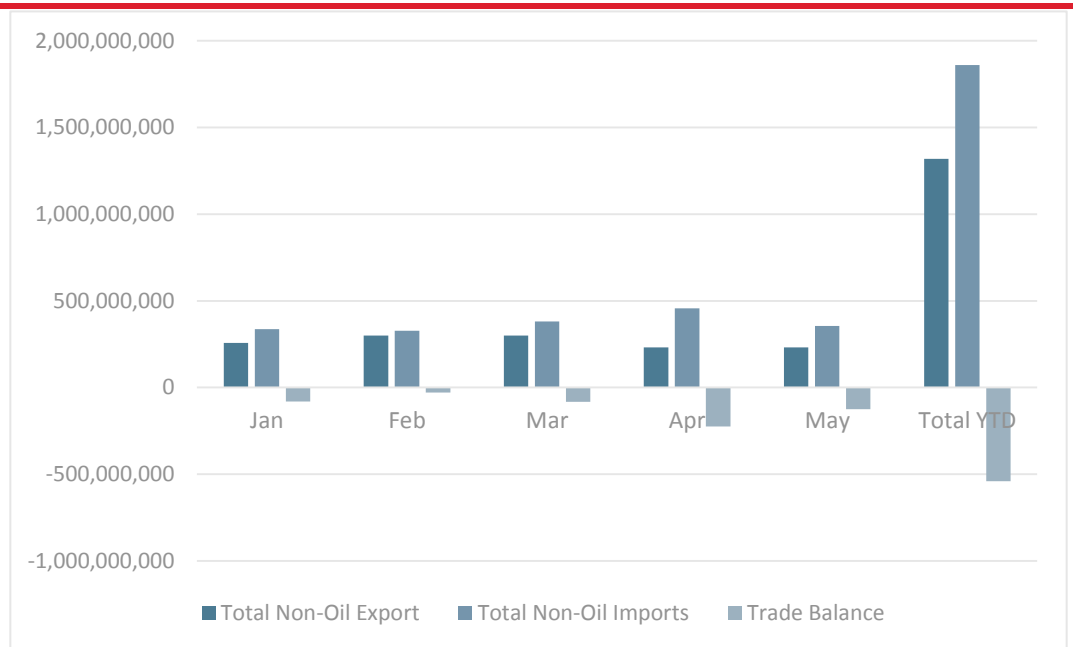
Trade balance improves

In spite of continued brisk expansion in the non-oil economy, Bahrain's trade balance has improved markedly in recent months. The trade deficit in Q1 dropped by an annual 37%. The trade deficit in non-oil merchandise was BHD125mn in May.

Two-thirds of the value of Bahrain's non-oil imports comes from the country's top ten trade partners led by China, the UAE, and the US. The most important categories of imports in May were motor vehicles and aluminium oxide.

The dominance of the top ten trade partners was even more pronounced in the case of non-oil merchandise exports where they accounted for 85% of the total. Saudi Arabia imported BHD507mn worth of goods from Bahrain during the first half of the year, followed by the US at BHD128mn, and Qatar. GCC countries in total accounted for 64.6% of Bahrain's non-oil merchandise exports. Metal products were dominant among the Kingdom's exports. Re-exports in May made up 16.9% of the total export bundle. 51.3% of re-exports were destined for Saudi Arabia.

Balance of non-oil trade, BHD mn



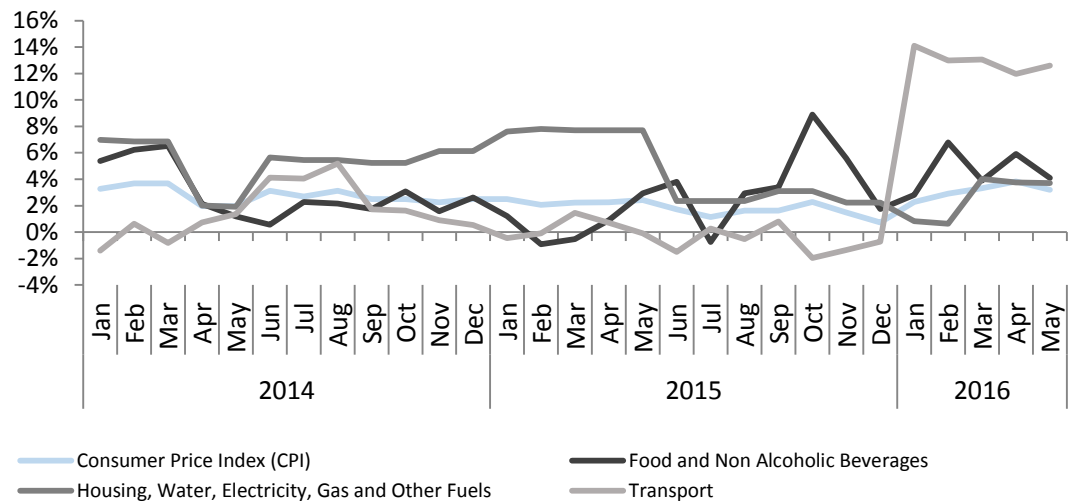
Source: Information & eGovernment Authority

Subsidy reform reflected in the CPI

The impact of subsidy reforms on inflation is likely to be temporary

Inflationary pressures in Bahrain have remained relatively stable in recent months. The Consumer Price Index rose by an annual 3.6% in May, slightly less than the 3.8% reading in April. The annual pace of inflation during the first five months of the year was 3.2%. Following the recent excise duty and subsidy modifications, the fastest pace of price increases was seen in alcoholic beverages and tobacco (20.9%) and transportation (12.6%). Food prices rose by an annual 4.1% in May whereas housing costs advanced by 3.7%. Clothing and footwear prices fell by an annual 3.9%, health care services by 0.3%, and restaurants by a modest 0.2%.

Consumer price inflation



Source: Information & e-Government Authority

Credit growth remains robust

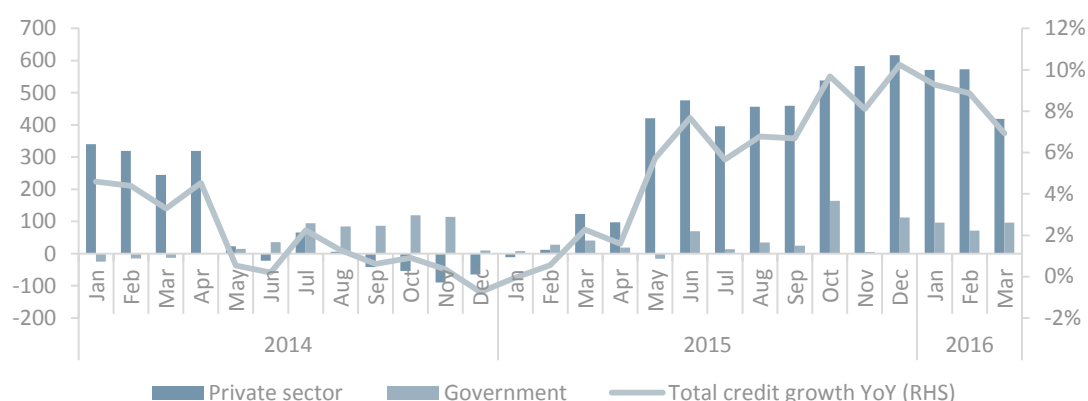
Bank lending has continued to increase at a brisk pace in spite of some moderation in the spring

Bahrain has seen strong positive momentum in bank credit over the spring months, even if the annual pace of increase has moderated somewhat, partly as a result of base effects. Overall bank credit rose by 7% in March 2016, down on the 9% pace seen in February but sharply up on 2% a year earlier. Lending to the private sector increased by BHD419.1mn whereas BHD96.1mn was added to Government loans.

Domestic credit growth has been partly linked to government loans which have tended to grow faster than in the past. By the end of Q1, government borrowing had increased by 45% YoY. Despite the rapid increase, government loans nonetheless constituted a small portion of total loans at 4%.

Private loans – personal and business loans – increased an annual 6% in March. Business loans, which constitute around 53% of total loans, rose by 2%. Growth was seen primarily in loans to hotels and restaurants (20%), Trade (10%), non-bank financial (9%), and manufacturing (15%). Personal loans saw a 10% increase in March.

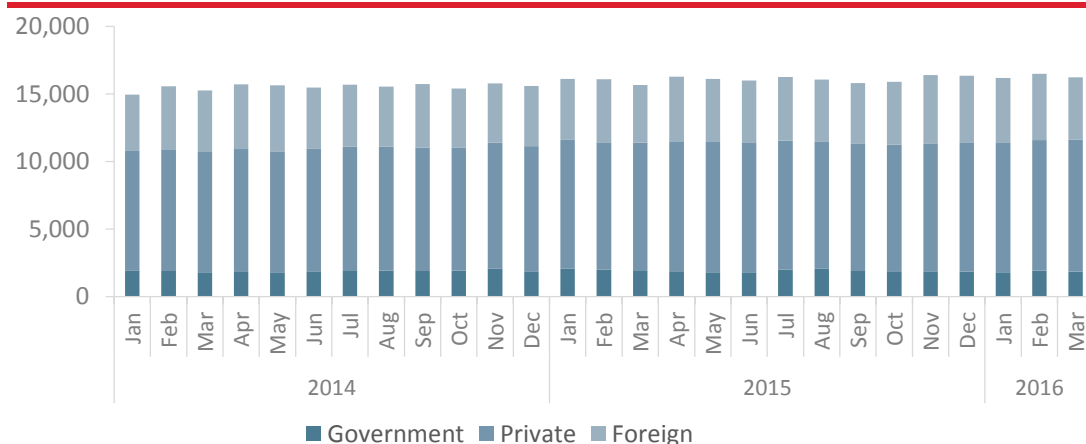
Year-on-year credit growth to the private sector and government (BHD mn)



Source: Central Bank of Bahrain

Echoing region-wide trends, the growth in bank deposits has been relatively subdued in recent months. The total bank deposits of domestic retail banks reached BHD16.2bn as of March and averaged BHD16.3bn during the first quarter. This compared to just under BHD15.7bn in the first quarter of 2015.

Deposit liabilities to non-banks (BHD mn)

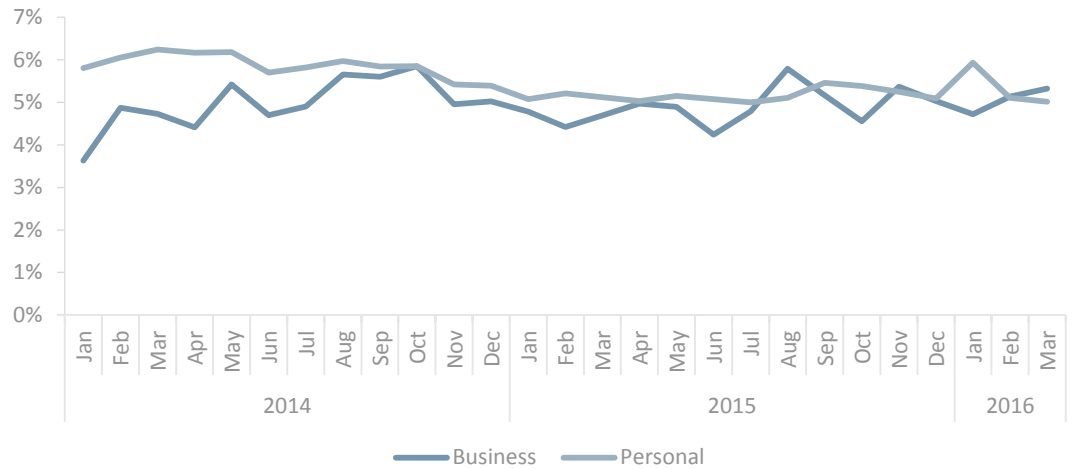


Source: Central Bank of Bahrain

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

In spite of region-wide concerns about the cost of credit, the interest rates charged by conventional retail banks on credit facilities have remained fairly stable. During Q1, the average cost of personal loans fell from a January high of 5.9% to 5%. By contrast, the interest rates on business loans (excluding overdrafts) edged up slightly from 4.7% in January to 5.3% in March.

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

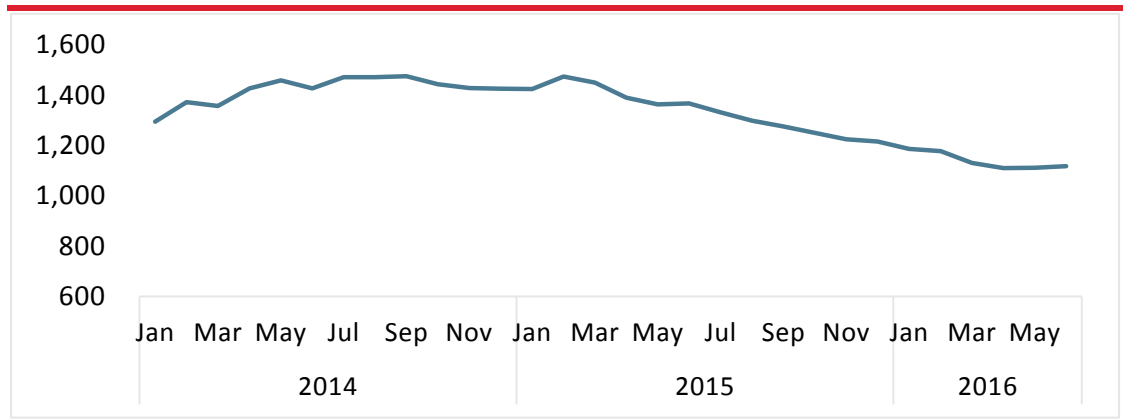


Source: Central Bank of Bahrain

Capital markets innovation continues apace

The performance of Bahrain's stock market during the spring reflected the mixed pattern observed across the region in response to volatile oil prices and fiscal pressures. During the first half of the year, the Bahrain index shed 8% of its value. This pace decelerated markedly in Q2, however, which saw a relatively modest 1.1% correction.

Bahrain All-Share Index

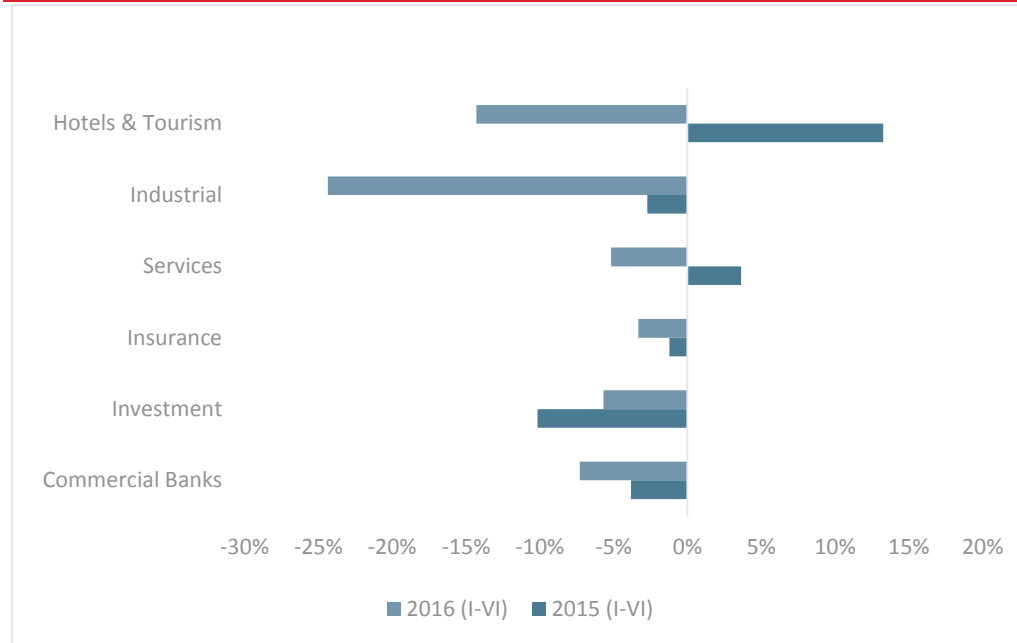


Source: Bahrain Bourse

In spite of some continued erosion, the market index has largely stabilized in Q2

The most resilient sector indices during the first half of the year were Insurance, Investment, Services, and Commercial Banks. The sharpest drop was seen in the industrial sector.

Sectoral stock market indices, 2015-2016 (first half)



Source: Bahrain Bourse

In spite of challenging market conditions, Bahrain Bourse has continued to innovate on a number of fronts:

- ✦ In April, the Bourse signed a cooperation agreement with Egypt to facilitate trading. Further cooperation agreements are being discussed with regional exchanges
- ✦ A new USD100mn Bahrain Liquidity Fund was launched in June to stimulate trading on the exchange. The fund will operate as a market maker and offer two-way quotes on most listed stocks
- ✦ Following the introduction of rules of real estate investment trusts, the first local REIT is expected to be listed in October
- ✦ Bahrain Bourse is planning to introduce the Bahrain Investment Market as of the beginning of 2017. This will target smaller gap growth companies and offer less burdensome listing rules than the main board

Bahrain Bourse is continuing to innovate through new products and structures

Issue date	Issue	Value, BHD mn	Maturity, days	Average interest/ profit rate, %	Average price, %	Over- subscript ion, %
3 Apr 2016	Treasury bill No. 1593	70	91	2.90	99.476	123
6 Apr 2016	Treasury bill No. 1594	70	91	2.07	99.481	128
13 Apr 2016	Treasury bill No. 1595	70	91	2.08	99.476	150
14 Apr 2016	Sukuk al ijarah No. 128	26	182	2.25		122
20 Apr 2016	Sukuk al salam No. 180	43	91	2.08		143
27 Apr 2016	Treasury bill No. 1596	70	91	2.03	99.49	185
4 May 2016	Treasury bill No. 1597	70	91	2.04	99.487	116
11 May 2016	Treasury bill No. 1598	70	91	2.06	99.482	113
12 May 2016	Sukuk al ijarah No. 129	26	182	2.25		100
15 May 2016	Treasury bill No. 1599	35	182	2.35	98.828	131
18 May 2016	Treasury bill No. 1600	70	91	2.03	99.488	111
25 May 2016	Sukuk al salam No. 181	43	91	2.08		100
1 Jun 2016	Treasury bill No. 1601	70	91	2.04	99.488	105
5 Jun 2016	Treasury bill No. 1602	35	182	2.34	98.382	159
6 Jun 2016	Treasury bill No. 1603	70	91	2.09	99.476	105
15 Jun 2016	Treasury bill No. 1604	70	91	2.09	99.475	154
16 Jun 2016	Sukuk al ijarah No. 130	34	182	2.3		131
22 Jun 2016	Sukuk al salam No. 182	44	91	2.05		102
29 Jun 2016	Treasury bill No. 1605	70	91	2.09	99.474	100

Source: Central Bank of Bahrain

Longer-term issuance included a Government Development Bond (No 11) on 5 May 2016 which raised BHD226mn and was 113% oversubscribed. The bond has a five-year tenor and coupon of 5.875%. On 1 June, the CBB issued its one-year Treasury Bill No 29 which raised BHD225mn. The offering had an interest rate of 2.86%, an average price of 97.187, and an oversubscription rate of 158%.

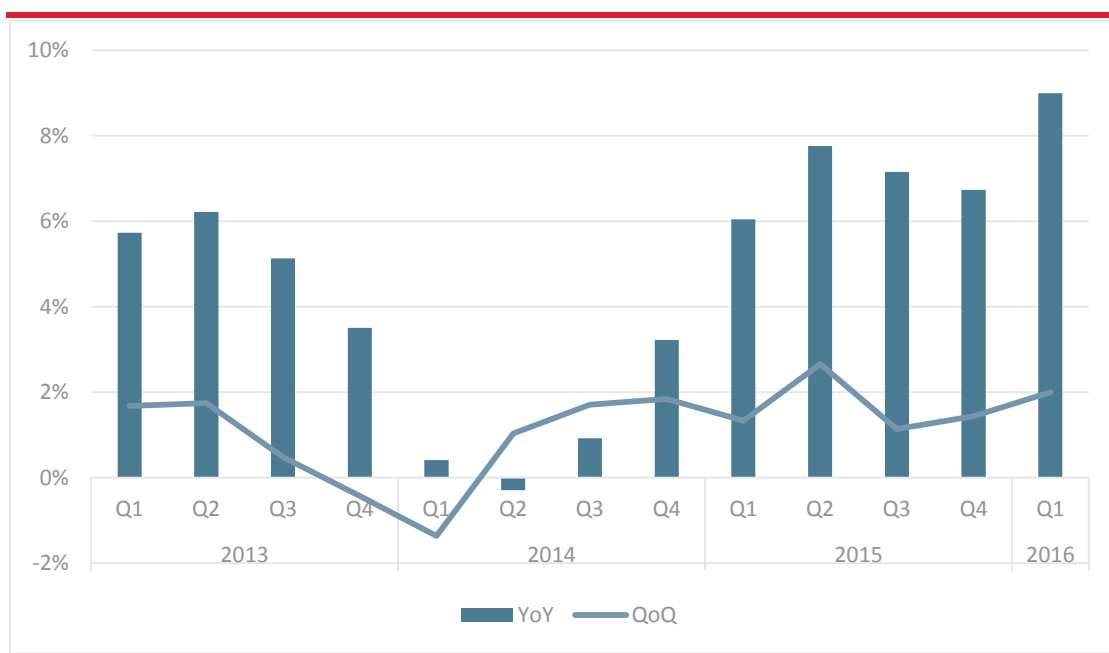
In the commercial space, BBK (Bank of Bahrain and Kuwait) placed an up to BHD100mn (USD265.3mn) perpetual tier-1 convertible capital securities offering in April. The subscribed notes totalled BHD86.1mn, well above the banks minimum threshold of BHD60mn. The notes were listed at Bahrain Bourse in May. Bahrain-based Islamic investment bank GFH Financial Group plans to issue a USD150mn sukuk.

Strong job creation has continued in reflection of the project market dynamics

Brisk employment growth in the private sector

The labor market has continued to reflect the resilience of the non-oil economy, in particular the strong momentum seen in construction. Overall employment saw an almost 7% YoY increase in Q1, with the private sector creating 46,669 jobs compared to 1Q15, a 9% YoY gain. According to Social Insurance Organization, Bahraini private sector employment stood at 92,567 in Q1 as compared to 91,233 in 2015.

Private sector employment growth



Source: Labour Market Regulatory Authority

External assessments

The 2016 Global Entrepreneurship Index published jointly by the Global Entrepreneurship Network (GEN) and the Global Entrepreneurship and Development Institute (GEDI), ranks Bahrain 29th globally out of 132 countries. The index measures a country's entrepreneurial ecosystem by combining individual datasets such as opportunity recognition, start-up skills, and risk acceptance, with institutional measures, including urbanization, education, and economic freedom. Bahrain jumped 14 places in 2016 compared to 2015. This performance was driven mainly by improvements in the quality of human capital, availability of risk finance and economic growth. Additionally, Bahrain tops the MENA region in the 'Networking' sub-indicator measured by entrepreneurs' personal knowledge coupled with their ability to use the Internet for business purposes.

The Human Capital report 2016 published by the World Economic Forum ranks countries based on their abilities to maximize their national human potential. The index contains two horizontal themes — learning and employment — running across five vertical age group pillars. Bahrain has an overall rank of 46 out of 130 countries, and score of 72.69. Bahrain is the top ranking country of the MENA region. The report also highlights Bahrain's education system quality, ranked 25th globally, as well as the wide availability of staff training ranked 22nd globally.

Fitch Ratings in June rated Bahrain's long-term foreign currency issuance at BB+ and its long-term local currency issuance at BB+, both with a stable outlook.

Bahrain Tops the MENA region the World Economic Forum's Human Capital Index

KEY SECTORS

INVESTMENT PIPELINE STRENGTHENS

A growing number of new projects and initiatives are driving the development of Bahrain's non-oil economy. In a further liberalising measure for investors, the Labour Market Regulatory Authority (LMRA) has made it possible for employers to avoid mandatory quotas on national employment in return to increased work permit fees for non-national employees. Under this option, a fee of BHD300 will be charged for any new or renewed work permit.

Investors and visitors can further benefit from revised visa rules. A new visa fee program was introduced in May and will offer three main options:

New visa rules are set to support tourism and business

- ✦ A new two-week single entry visa for a fee of BHD5
- ✦ A new one-year multiple entry visa for a fee of BHD85 with a duration of up to 90 days per stay
- ✦ A BHD25 multiple entry visa whose duration was extended from one week to two weeks

Metals manufacturing gathers momentum

In the oil and gas industry, Tatweer has broken ground on a new 500mn cu ft gas dehydration facility as part of its efforts to redevelop the Bahrain Field. The Bahrain (Awali) is the oldest active oil field in the GCC having begun production in the 1930s. New technology is being used to enhance recovery and boost production. The USD100mn deal was signed between Tatweer and UK-based Petrofac for the installation of the new facility which will cover five existing wells in addition to three new wells.

In another important milestone reflecting growing Indian interest in Bahrain's manufacturing sector, Ion Exchange announced the launch of a new chemical blending facility in the Kingdom in April. Ion Exchange is a leading Indian company and one of Asia's largest environmental solutions providers. The new facility will be based in the Bahrain Investment Wharf and will serve as a chemical export hub for the region where it hopes to capitalise on rapidly growing demand for water treatment technologies and services. Other Indian companies that have recently begun operations in Bahrain include Electrosteel, which opened a new USD6.6mn warehouse as a sales and distribution hub for the region. Synergies Castings Limited is establishing an aluminium casting and specialty alloy wheel manufacturing facility.

SSH, a specialist in master planning, infrastructure, building design, construction supervision and project management, announced plans to further invest in the development of its Bahrain office. A leading Middle East professional services company, SSH's expansion will increase staff numbers by 40.

Retail diversification and growth to support tourism

The retail sector has in recent years established itself as an increasingly important driver of tourism in Bahrain. Landmark shopping centres such as Seef Mall, the City Center, al Aali Complex, and Moda Mall have established themselves as key magnets for outside visitors.

Bahrain is currently witnessing renewed rapid growth in its offering of retail facilities. The emergence of neighbourhood shopping centres has emerged as an important trend with a focus on smaller properties offering cinemas, children's play areas, and food and beverage outlets.

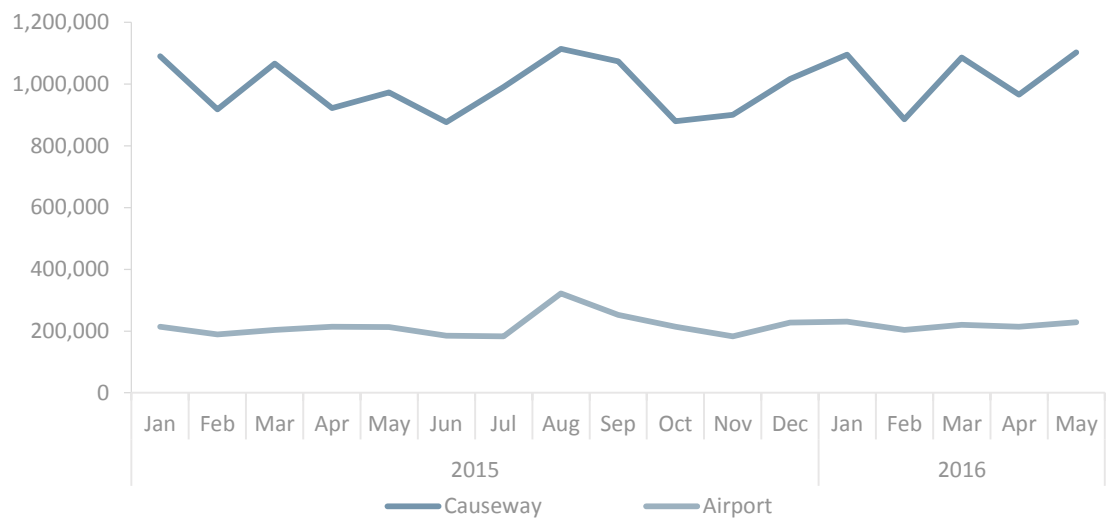
Important new development underway in the Kingdom include the following:

- ✦ The USD40mn Galleria, Bahrain's newest boutique mall by developed by the Dadabhai Group, was recently opened in Zinj. The mall has dedicated 30% of its floor space to food and beverage, 40% for retail units, and 30% for utility services. Its anchor clients include a 12,800 sq m Lulu Hypermarket
- ✦ Wadi Al Sail Mall in Riffa was officially opened in February 2016. The shopping complex encompasses 38,000 sq m of retail space, high-end leisure and entertainment facilities, and 46 shops. In April, Bahrain Cinema Company opened its new six screen cineplex at the mall. The new cineplex, which boasts of a 724-seat capacity, including 89 VIP seats, has been built at an investment of BHD2mn
- ✦ El Mercado, which focuses of food and beverage offerings in Janabiya, is expected to officially open in October 2016. The mall, 92% leased so far, is anchored by an Al Osra supermarket and is expected to have a 24-hour gym and three new American concept restaurants, amongst other attractions
- ✦ Expected to open in 2017, the Bahrain Avenues mall is currently being developed by the King Faisal Corniche Development Company on a 265,000 sq m area opposite Bahrain Bay in central Manama. The mall will have a children's arcade, cinemas, and restaurant and café offerings along with a spacious public park with access to the water view
- ✦ Another major mall development being planned is Marassi Galleria in the Diyar al Muharraq area in the north of the island. The 178,000 sq m facility will feature a high-end retail, indoor and outdoor entertainment, a multiplex cinema, themed courtyards, food and beverages outlets, and a family entertainment centre, as well as gardens and shaded walkways.

These new developments have contributed to a continued increase in the numbers of visitor arrivals to Bahrain. The total number of inbound arrivals to Bahrain increased by 12% YoY in May to stand at 1.3mn. This sharp increase was driven by the 13% increase in the number of arrivals via the King Fahad causeway. Arrivals through the Bahrain International Airport increased by 7%. The 2015 tourism survey has shown that hotel occupancy rate stood at 50% for the year as whole compared to a 45% recorded in 2014.

Important new retail sector developments will support the continued growth of tourism in Bahrain

Visitor arrivals by port of entry



Source: Ministry of the Interior

The future growth of the tourism sector will be underpinned by a number of new resort developments:

- ✦ Construction work is due to resume by September 2017 on the Salam Beach Resort & Spa development, which was initiated by Dubai investors before the 2008 global financial crisis. The scheme is now being developed by a project company in which Bahrain's Mumtalakat Holding Company has a two-thirds stake and Dubai Properties Group one-third. The project is expected to be completed by 2020
- ✦ Edamah, the real estate arm of Mumtalakat, has announced plans to develop the Hawar Island Project. Designed as an eco-friendly venture, the project is expected to cost USD928mn and to generate around 3,000 job opportunities. The first phase of the project is a 350-room, five-star hotel resort along with 150 apartments and villas. The hotel is due to open next year. The second phase, due to be completed by 2021, will include a 150-room hotel, a 200-room wellness resort and spa, 155 villas, a traditional market, and an ornithological research centre. Also, the old Hawar mosque will be restored as part of the project. The Hawar Islands are a group of 35 islands to the southeast of Bahrain's main island. Most of the archipelago is a wildlife preservation zone

Leveraging local talent to service ICT needs

BPO has emerged as an important growth area that capitalizes on Bahrain's human capital strength

The Business Process Outsourcing (BPO) industry has established itself as an increasingly important and dynamic subsector of the broader ICT sector in Bahrain. The BPO industry is expected to grow at an annual pace of 12.8% between 2013 and 2020. It offers exceptional opportunities for creating quality national employment and for capitalising on Bahrain's qualified labour force as a spring board for the broader region. Bahrainis currently constitute an estimated 47% of total employment in the ICT sector.

One of the most established players in the space is Bahrain-based Silah Gulf which recently received four awards at the 11th Annual Middle East Contact Center Awards in Dubai. Silah is a

customer experience solutions provider launched in 2009 as a joint venture between Bahrain's eGovernment Authority and UK-based Merchants. The company provides services across multiple sections including telecoms, financial services, tourism, retail, and government. Currently in its sixth year of operations, Silah employs around 800 people, roughly 70% of whom are Bahraini nationals. Through its regional expansion strategy, Silah aspires to offer some 5,500 job opportunities over the coming three years. The company operates a training centre and is strongly committed to create job opportunities for nationals.

Other major players in the Bahraini BPO industry include:

- ✦ Invita, a subsidiary of BBK (Bank of Bahrain and Kuwait), originally established as a unit within the bank which became an independent company in 2005. Invita offers a wide range of services besides BPO services, including IT and consulting services across banking and insurance, retail, telecom, utilities, and public sectors. 92% of the company's employees are Bahraini nationals. In 2010, it signed an MOU with the national labour fund Tamkeen to train Bahraini high-school as call-centre advisors
- ✦ Gulf Electronic Management Systems (GEMS), established in 2005, administers multiple medical insurance providers including Gulf Union Insurance Group and T'azur. GEMS offer multiple services including call centres, human resource management, and financial accounting in addition to medical insurance-related services
- ✦ Arion
- ✦ Grant Thornton

Focusing on payments

The payments sector has emerged as an increasingly important focus for financial service providers in Bahrain. On 22 May 2016, the Central Bank of Bahrain issued a directive requiring all banks to ensure that their ATM machines met the Payment Card Industry Data Security Standard (PCI-DSS) by the 30th of April 2017, in line with international best practices. The main objective of this issuance is to enhance customer security and provide additional means of protection in order to prevent any potential breaches of sensitive client data. The Central Bank has also directed retail banks to remove the 100 fils transaction fee imposed on non-customers in a bid to facilitate ATM use.

The EDB organized an Innovation in Payment roundtable with industry representatives on the 22nd of May. The sector is expected to achieve 6% annual growth globally in the coming years as non-cash transactions increase. The event discussed new options around covering unbanked segments of the population and adjustments to understanding customer requirements in order to match the needs and profiles of different market segments. Key local players in the sector include benefit, afs, Sadad, NEC Payments, and Payment International Enterprise.

The insurance sector in Bahrain can be expected to benefit from the introduction of National Social Health Insurance Program (Sehati). A law on the scheme is expected to be approved by the end of the year. The program will cover nationals free of charge and non-national through employer

Payments is an important area of potential for the development of ancillary financial services

levies. The scheme will allow beneficiaries to choose between private and public health care providers which will be given financial autonomy. The program will be covered by a new National Social Health Insurance Fund which will also be given the financial responsibility for the budget of the Ministry of Health.

In May, the Parliament approved a new law that will permit the introduction of private and collective investment undertakings as well as securitisation and captive insurance.

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