

Bahrain Economic Quarterly

March 2016



SUMMARY

SIGNS OF SPRING

The very beginning of 2016 was characterized by exceptional stress for global financial markets. Since then the situation has stabilized somewhat, helped along by renewed moves toward looser monetary policy by the leading central banks. Also the Chinese authorities have reaffirmed their commitment to ambitious growth targets, thereby dispelling some of the uncertainty that weighed on investors earlier.

- ▶ **In spite of some loss of momentum in the second half of 2015, growth in Bahrain's non-oil economy has remained robust.** The non-oil sector of the economy expanded by a healthy 3.9% in 2015. Growth was particularly strong in construction, private education and health care, and the tourism sector
- ▶ **Headline growth was affected by a small drop in oil production.** The oil sector experienced a small 0.9% contraction in 2015 in spite of record output levels from the Bahrain field. This left the headline real GDP growth rate just short of 3% for the year as a whole
- ▶ **The GCC economies are re-engineering their fiscal models and encouraging greater participation by private capital in driving growth.** Efforts to curb government spending are coinciding with regulatory reforms and a greater willingness to embrace public-private partnership-type structures. Also, sales of government assets are under considerations in many countries
- ▶ **Oil prices seem to have found a tentative floor, although worries about excess supply still persist.** The near-term outlook is likely to be determined, to a large extent, by the ongoing efforts by leading OPEC and non-OPEC producers to establish a ceiling for production. While the US shale industry is undergoing financial pressure, new sources of supply are emerging above all from Iran

Bahrain economic outlook

	2014	2015	2016f	2017f
Real GDP growth, %	4.5%	2.9%	2.9%	2.7%
Non-hydrocarbons sector	4.9%	3.9%	3.5%	3.2%
Hydrocarbons sector	3.0%	-0.9%	0.5%	0.5%
Nominal GDP growth, %	2.9%	-4.8%	5.7%	9.6%
Inflation (CPI %)	2.8%	1.8%	4.8%	2.7%
Current account (% of GDP)	4.5%	-0.2%	-2.7%	1.2%
Fiscal balance (% of GDP)	-3.6%	-11.9%	-10.1%	-7.0%
Crude Oil Arabian Medium (USD)	96	50	45	60

Source: Bahrain Economic Development Board

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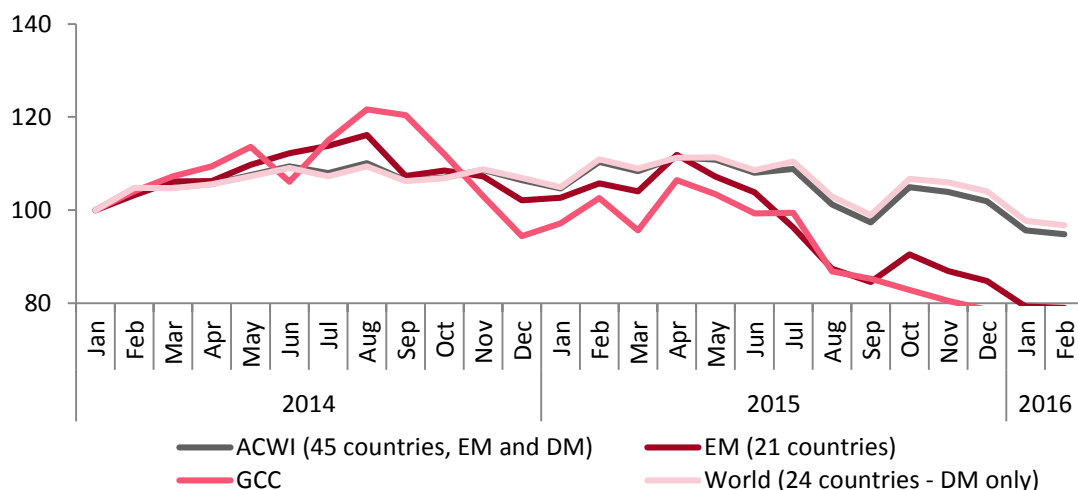
GLOBAL ECONOMY

HESITANT STABILIZATION

After a volatile last quarter of 2015, the opening weeks of 2016 were characterized by exceptional volatility for most asset and commodity markets. January represented the most challenging opening month of the year for global markets in more than two decades. The extraordinary turbulence stemmed from an unusual cluster of risks associated with prospects of US monetary tightening, worries about a Chinese slowdown, and commodity market deflation. Elements of political risk in different parts of the world further contributed to the mix.

Conditions began to improve toward the end of January with greater clarity about policy intentions in various key economies, typically involving an increased willingness to resort to stimulus measures. By and large, markets have recouped most of the losses they sustained at the beginning of the year, even if there has been little sign of a clear improvement in global growth prospects. The IMF in its January projections for global growth foresees only a very gradual pick-up in activity from an estimated 3.1% in 2015 to 3.4% in 2016 and 3.6% in 2017. Growth in the advanced economies is projected to increase slightly from 1.9% in 2015 to 2.1% this year and next. Emerging market growth is on track for a more consistent acceleration from 4% in 2015 to 4.3% this year and 4.7% next.

MSCI regional indices (Base Jan 2014=100)



Source: MSCI

Redefining the 'New Normal'

Just as market pressures at the beginning of 2016 were in large part connected with prospects of tighter US monetary conditions and slower Chinese growth, changing perceptions since then have paved the way for increased market stability. This seems to continue an established pattern of market performance driven more by central bank policy than economy fundamentals. In the absence of clear underlying trends, we are continuing to witness recurrent market volatility: bouts

of optimism interspersed with periodic disappointments, often ones associated with worries about removing some of the stimulus that has underpinned market confidence in recent years.

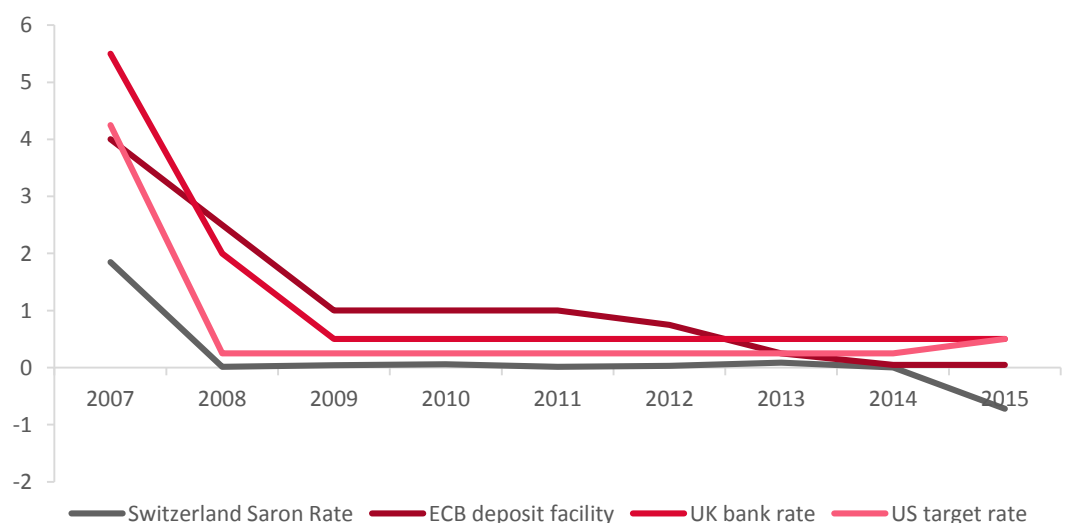
China has in recent weeks reinjected confidence in global markets by reiterating its commitment to strong expansion by announcing a real GDP growth target of 6.5-7% this year. This compares to last year's target of "around 7%" and actual growth of 6.9%. Reflecting their willing to resort to additional stimulus measures, the Chinese authorities have accepted a fiscal deficit projection of 3% of GDP, up from last year's target of 2.3%. Assuaging another major investor concern, Beijing has further committed to keeping the Renminbi "basically stable." There are some signs that the policy may be working. On the one hand, industrial production in China grew at an annual 5.4% in January-February, the slowest rate since early 2002. However, investment growth reached 10.2%, up from 8.9% in 4Q15. Similarly, policy interventions in the real estate sector seem to be stimulating increased activity.

A more permissive policy stance by China and leading central banks has helped dispel uncertainty and restore market confidence

At the same time, leading central banks around the world have underscored their willingness to continue with a very permissive policy stance:

- ▶ The European Central Bank (ECB) in March reduced all key interest rates (the main policy rate now stands at 0 and the deposit rate at -0.4%) while adding to its quantitative easing measures. The Bank increased its monthly asset purchases from EUR60bn to EUR80bn while including corporate bonds on the list of permitted assets. Similarly, a series of longer-term refinancing operations was launched
- ▶ The Bank of Japan, struggling to trigger inflation, in late January introduced a -0.1% rate for some reserves. Sweden's Riksbank has reduced rates to -0.5%, while the Swiss National Bank has lowered them to -0.75%. Also Denmark has negative rates, in all cases largely in response to the policy of the ECB

Key central bank rates around the world (%)



Source: Central banks

- ▶ The combination of market turbulence and loosening in other major economies has also limited the ability – or willingness – of the US Federal Reserve to pursue its expected normalization strategy. Following a more cautious stance adopted at the 16 March Federal Open Market Committee meeting, the consensus view of target policy rate at the end of 2016 was lowered from 1.375% to 0.875%. The need to “proceed cautiously” has been reaffirmed by Chair Janet Yellen even subsequently in spite of some signs of core inflation accelerating towards 2%. It now stands at 1.7%. Also unemployment is continuing to decline and is expected to fall to 4.7% this year. However, the extent of labor market slack is highlighted by a historically low participation rate of 62%, a level not seen since the 1970s

There is growing skepticism as to the ability of low interest rates to produce the desired economic outcomes and in some cases, they may be having adverse consequences for financial institutions

While these policy interventions have reduced market volatility, they also underscore the challenges associated with restoring economic conditions to the pre-crisis norm. Even though the US has made somewhat more headway than most of the rest of the world, attempts to normalize US rates risk tightening monetary conditions disproportionately by increasing rate divergence vis-à-vis other economies and boosting the Dollar. Similarly, attempts to retreat from the ultra-loose conditions have tended to trigger global market volatility which in turn has adverse effects also on the US. Under the circumstances, the Fed appears to have concluded that the risks of premature tightening outweigh the potential complications associated with waiting for too long.

But there are also questions as to the ability of continued monetary loosening to achieve the desired economic effects. For instance, the Bank for International Settlements has repeatedly warned that negative rates will create distortions:

- ▶ Some banks are affected by tighter margins while others are trying to offset negative rates through higher fees, which has in fact increased the cost of borrowing. In some cases, lenders have pushed up loan rates, thereby undermining the rationale of the policy rate cut
- ▶ Some households may be saving more because rock-bottom nominal interest rates make it harder to meet savings targets for pensions and so forth
- ▶ The availability of funding may not be the main challenge. Euro-zone non-financial corporate cash and deposits stand at some 23% of GDP, while the corresponding figure in Japan is close to 50%. This compares to less than 9% in the US. Companies have funds but are in many cases unwilling to invest
- ▶ There are doubts as to whether additional lending is appropriate in an environment where excessive leverage was widely viewed as one of the root causes of the crisis

More generally, loose monetary policy has encouraged, indeed necessitated, risk-taking by financial companies instead of necessarily stimulating additional investment in the real economy. By reducing returns from safe investments, low rates have forced financial institutions to take on more risk. Similarly, growing amounts of capital has flocked into high-growth but low-productivity sectors, such as real estate. This environment is underscoring the urgency of structural economic reform to stimulate growth. By making labor and product markets more flexible, countries can achieve more innovation and higher sustainable growth.

Oil: laying a floor?

Following a volatile year in 2015, oil prices came under renewed downward pressure at the beginning of this year. This was above all the result of continued perceptions of a sizeable glut in the market along with persistent worries about demand weakness, partly in connection with uncertainty about China. OPEC supply reportedly rose by 48,000 b/d to 33.113m b/d in January, the highest level in decades, albeit partly as a result of Indonesia's membership. Speculation about the impact of removing the Iranian sanctions further depressed sentiment by creating the prospect of further divergence between demand and supply.

By mid-January, prices had shed 70% of their pre-correction peak and stood at their lowest since 2004 at close to USD27 per barrel. A clear turnaround in market conditions became evident very soon thereafter, however, and prices have advanced by approximately 50% since their trough, even as bouts of volatility have characterized the incipient recovery.

Even as the outlook for oil prices remains far from clear, several factors now account for the change in sentiment:

- ▶ There seems to be a growing desire on the part of some of the world's leading producers to regain a measure of market stability. The Doha agreement negotiated between Saudi Arabia, Russia, Venezuela, and Qatar on 16 February involved an agreement to cap production at January levels, thereby at least reducing the prospect of potentially open-ended supply increases in what was seen as an oversupplied market. This in turn appears to have reduced incentives to short the oil price
- ▶ The Doha deal was described by its signatories and many analysts as the beginning of progress. Another round of talks among key producers is expected on the 17th of April. The initiative is reportedly supported by countries accounting for 73% of global production. Whatever the actual outcome of the agreement, the efforts seem to reflect a growing desire to re-stabilize the market at a time when doubts persist as to the extent of spare capacity in the market
- ▶ The commitment by the Chinese authorities to stimulate the economy while reiterating an ambitious growth target has alleviated concerns about demand erosion. In the meantime, demand growth in China as well as other leading emerging economies has remained robust. China's crude imports rose by an annual 20% to a record of 8 mbd in February. Local estimates suggest increases of 860,000 b/d this year. Indian oil demand rose by an annual 12% in February, having advanced by 300,000 b/d in 2015
- ▶ A number of extreme events have disrupted production in several key markets. OPEC output fell in February due to outages in Nigeria and Iraq which have affected some 800,000 b/d of supply
- ▶ Having rapidly increased from 5.5 to 10 mbd between 2010 and 2015, US production is once again declining and has contracted by more than 5% since last summer. The

Moves toward freezing oil production globally have led to some stabilization of oil prices even as worries about excess supply persist

US rig count has fallen to 372, the lowest level since November 2009. Non-OPEC production is expected by OPEC to fall by 700,000 b/d this year. The IEA estimate is a 750,000 drop, led by a 760,000 b/d decline in the US

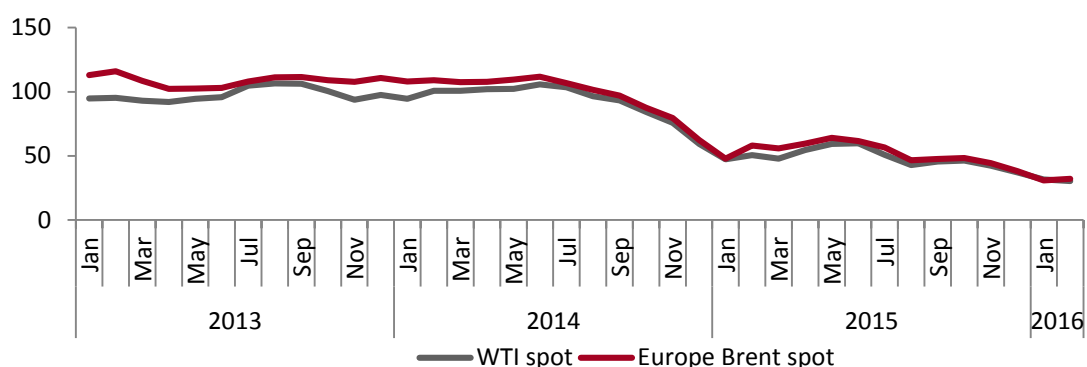
While it seems evident that a floor of sorts is emerging under the oil price, it is far from clear how continuous the market turnaround will be. The extent of oversupply has created a situation where short-term variations in inventories tend to influence prices. For instance, US crude supplies rose to their highest level in more than 80 years in late March, putting downward pressure on the WTI benchmark. The IEA now expects that global oil consumption will advance by 1.2 mbd this year, which will cut the surplus from an estimated 1.7 mbd in the first half of the year to 200,000 b/d in the second half. The market is expected to return to balance in 2017.

Three factors in particular are likely to be of critical importance in shaping the performance of the oil market in the near term:

- ▶ How effectively can the key producers enforce discipline about production limits? The past track record is mixed at best but prospects this time are potentially improved by doubts about the ability of many countries to increase production further
- ▶ How much new supply will come to the market? Iran reportedly increased its output by 187,800 b/d to 3.13 mbd in February, although questions about investment needs and sustainability abound. Also Brazil is expected to add some 100,000 b/d of supply this year. Any normalisation of the situation in Libya could add further barrels to the market
- ▶ How will the US shale sector evolve? With substantial efficiency gains and lower input costs, the North American shale oil industry has demonstrated considerable resilience. Break-even prices are estimated to have fallen by 40% between 2013 and 2015. Shale production has shown itself to be a highly flexible sector thanks to a multitude of small operators and the relative ease of increasing production. This has led many to view the US shale sector as the new swing producer in the global context. It is generally expected that an improving price environment will encourage additional production which, in turn, may cap price gains before long. Oil prices above USD50/barrel are expected to begin to exert a positive impact on US production. Nonetheless, many shale producers are under intense pressure, and a wave of consolidation in the sector is seen as highly likely. The rapid expansion of shale oil production was accompanied, indeed made possible, by a dramatic build-up in leverage, with estimates by the Bank for International Settlements suggesting that the aggregate debt of the global oil and gas industry rose from USD1.1trn to USD3trn between 2006 and 2014, led by North America. This underscores an unusually strong positive correlation between the credit cycle and the commodity cycle. With reserve values plummeting and liquidity conditions tightening, an estimated 52 US shale companies have entered bankruptcy since the start of last year

Whatever the near-term outlook for oil, concern is also mounting about the prospect of market conditions potentially tightening very quickly due to massive cutbacks in investment. Recent estimates by Morgan Stanley suggest that only nine landmark oil and gas projects are likely to be approved globally this year, compared to a total pipeline of more than 230. Overall, some USD400bn worth of projects have been suspended or cancelled.

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.

- ▶ A measured pace of policy tightening by the US Federal Reserve is likely to translate into at best modest increases to the cost of capital in Bahrain
- ▶ Stimulus measures by the Chinese authorities in particular should restore some confidence in the broader outlook for the global economy in the near term
- ▶ Both monetary easing and efforts to stabilize oil prices are likely to have some effect in terms of reversing the down-cycle for oil

THE GCC REGION

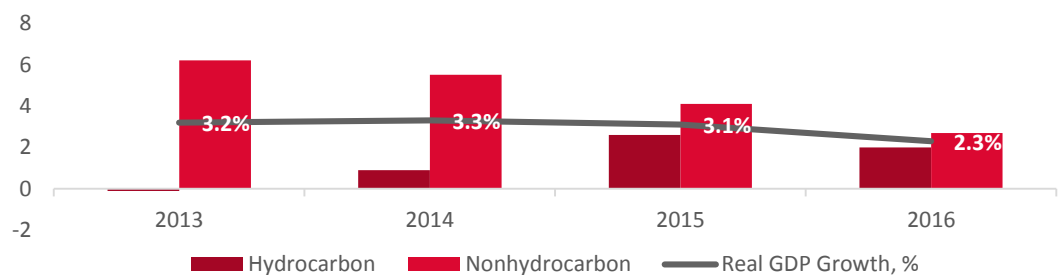
TURNING TO THE PRIVATE SECTOR

A longer-than-expected period of depressed oil prices is prompting new measures to diversify government revenues and rationalize expenditures

The lengthy period of oil price softness since 2014 has created challenges for a region where oil revenues and government spending have been instrumental in driving growth for decades. Lower-than-expected oil revenues have underscored the importance of the long-standing strategic commitment to economic diversification. In connection with this, new initiatives have been unveiled in terms of rationalising the operations of the public sector. Similarly, there is a renewed determination to encourage the participation of private capital in funding investments. All the regional sovereigns have tapped the debt capital markets in various ways but new options are also being explored in terms of privatisations and public-private partnerships (PPPs).

The economic growth momentum of the GCC economy has been clearly tempered by lower oil prices and bouts of global market nervousness. Nonetheless, the structural drivers appear quite robust and look likely to deliver, especially non-oil growth which will not fall far short of the trend rates established in recent years. Having exceeded 3% in 2015, regional headline real growth looks likely to fall somewhat short of that figure this year. The IMF in its latest forecast expects the GCC economy to expand by 2.8% this year. Growth is almost certain to be led by the non-oil economy which is projected to advance by 3.8% in real terms. Growth in the oil sector is expected to reach 1.4%. The IIF is somewhat more cautious with a headline growth projection of 2.3% broken down into 2.8% non-oil and 2% oil sector growth.

GCC real GDP growth, %



Source: Institute of International Finance

Non-oil dynamics characterized by continuity

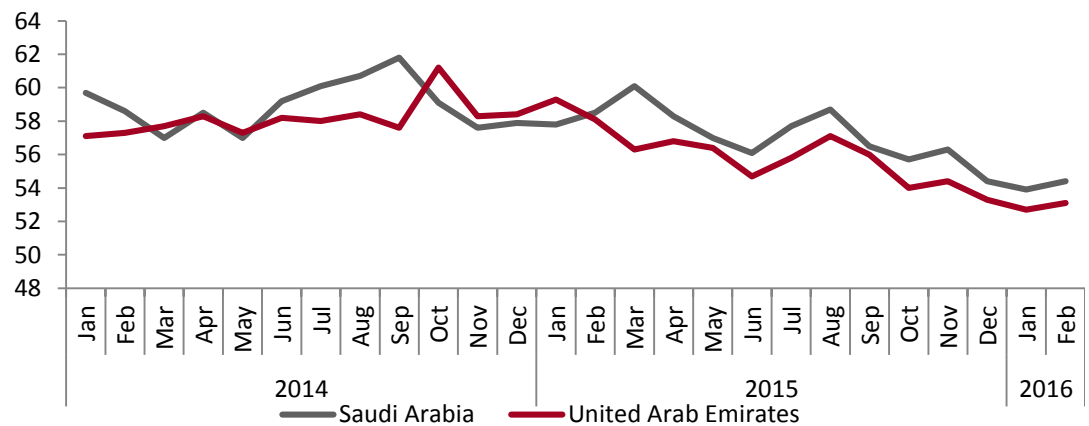
Despite the likelihood of moderation in the growth momentum of the GCC economies, the established pattern of resilience in the non-oil economy remains firmly in place. While this is reflective of structural growth drivers in the form of demographics, diversification, and global connectivity, it also reflects the sizeable pipeline of infrastructure investments across the region. In many cases, individual projects have been modified with respect to funding models as well as timelines, but most of the pipeline appears strategically anchored and underpinned by a strong political will. In economies such as Qatar and the UAE, commitments to landmark events offer

minimal opportunities for modifying the investment pipeline, and thereby serve as an important source of continuity and confidence.

Forward-looking indicators point to continued expansion in the regional non-oil economy

Forward-looking indicators of business confidence suggest that activity, while somewhat subdued, remains in a firmly expansionary mode, with readings exceeding 50. The Emirates NBD UAE Purchasing Managers' Index (PMI) in fact rose somewhat to 53.1 in February after a 52.7 reading in January. The slight improvement has been driven by expansions in output, new orders, and employment. Similarly, the Saudi PMI rebounded somewhat from 53.9 in January to 54.4 in February as purchasing activity and input stocks increased. The slight growth in the index shows that business conditions in both Saudi and the UAE are improving, even if at a slow pace, indicating the existence of investor confidence in those markets. By contrast, the Emirates NBD Dubai Economy Tracker for the first time posted a small decline in non-oil private sector activity in February. The headline index fell from 51.8 in January to 48, while new orders contracted from 51.7 to 49.0. Nonetheless, both employment and business optimism rose in February.

Emirates NBD Purchasing Managers' Index



Source: Emirates NBD, Markit

A range of new fiscal reform initiatives are being introduced across the GCC countries

While the national accounts data for the regional economies has been characterised by a high degree of continuity, the persistent oil market uncertainty has clearly exerted some downward pressure on performance and projections alike. For instance, the IMF recently revised down their forecasts for Saudi Arabia and the UAE. Following an estimated 3.4% expansion in 2015, the Fund expects Saudi growth to decelerate to 1.2% in 2016 before rebounding to 1.9% in 2017. Private sector projections in some cases put the expected growth closer to 2% in 2016 and 2017 alike. The IMF's 2016 projection for the UAE was modified from 3.1% to 2.6%. The IIF, similarly, expects growth of 2.5% in a deceleration from 3.3% in 2015. Kuwait is expected to see non-oil growth of approximately 3% in the near term, in large part thanks to Government-led infrastructure investment as the implementation of the USD130bn five-year development plan gathers momentum. Following an estimated 1% headline real growth in 2015, the economy is projected by the IIF to expand by 1.4% this year. The non-oil growth momentum in Qatar remains firm but some erosion is nonetheless expected from 7.5% in 2015 to 4% in 2016. By contrast, the oil sector looks likely to remain almost flat.

The slower growth is partly connected to ongoing fiscal consolidation across the region. For instance, the UAE is estimated to have seen a 7% decline in its consolidated public spending in 2015, which reversed the budget balance from a surplus of 5.2% of GDP in 2014 to a deficit of 4.1%. Similarly, Kuwait is expected to post a 7% of GDP deficit in FY2016/7. Qatar is projected to post a deficit of 3.4% of GDP in 2016 after a small 0.7% surplus in 2015.

Efforts to rebalance the budget involve a range of measures designed to curb the public sector wage bill and limit capital transfers to public sector entities. Beyond this, subsidy reforms are continuing and various governments are mulling plans for revenue diversification:

- ▶ Most of the GCC governments have removed subsidies on fuel products. The UAE removed subsidies starting from August 2015 and linked the price with the global market. Bahrain and Saudi Arabia have followed suit and increased domestic petrol prices by 60% and 40%, respectively. The Omani government introduced higher petrol and diesel prices for March, while the Kuwaiti government has announced its plan to cut subsidies on energy products gradually. According to Moody's, the GCC will save approximately 0.5% of GDP – around USD7bn – in 2016 from increased fuel prices
- ▶ Public sector efficiency is being boosted through restructuring. The UAE announced a new structure of the federal government early February which involved merging some ministries. The Saudi government has set up the National Project Management Agency which is designed to ensure close monitoring of government expenditure. Additionally, the government is improving budgetary policies and procedures as well as reviewing the existing government projects
- ▶ Across the GCC, efforts are underway to prepare for the introduction of a value added tax (VAT). The tax is expected to have a basic rate of 5% and, while the details of implementation are still pending, it is clear that sectors such as healthcare and education will be exempted from the tax. The UAE is expecting to raise some AED10-12bn in their first year of implementing the VAT. Across the region, the new tax is expected to boost fiscal balances by an estimated 2.5% of GDP
- ▶ The UAE is planning to introduce a 12% excise duty for automotive and Qatar is reportedly considering excise duties along with higher fees for public services
- ▶ Dubai has advanced plans to introduce an AED35 air traveler charge for each passenger taking a flight from one of its airports
- ▶ Kuwait is reportedly considering a business profit tax

Even as governments re-engineer their operations, non-oil growth continues to be underpinned by an ambitious infrastructure pipeline. The total value of projects planned or underway in the GCC reached USD2.65trn in mid-March, according to MEED estimates. This represented a small 2.3% drop over the total recorded a year earlier. The decline was mainly due to a 14.3% YoY contraction in the Saudi project pipeline, mainly caused by budget adjustments to the Kingdom's 500,000-unit housing megaproject and the suspension of a USD11bn Military Medical City project.

Elsewhere in the region, the pipeline has continued to grow somewhat, by 19.8% in Bahrain, 13.6% in Kuwait, 7.8% in the UAE, 5.1% in Oman, and 0.9% in Qatar.

Mobilising private capital for growth

The region-wide efforts to rationalise public spending come at a time when economic diversification is a central policy priority and the region is envisaging an unprecedented pipeline of infrastructure investments. Historically, lower oil prices have tended to translate into slower project implementation as well as suspensions. For instance, Standard & Poor has projected a gap of USD270bn until 2019 between spending on projects by the GCC governments and the project contracts awarded. In the infrastructure sector, a difference of USD50bn is expected for project contracts awarded. MEED Projects expected a 15% decline in awarded contracts in 2016.

While some project modifications are already taking place, it is also clear that the new environment is driving the GCC governments to identify alternative funding sources. In particular, there is a desire to involve private capital more effectively in meeting some of the financing requirements. After a relative pause of a couple of years, the new oil price environment has rekindled interest in Public-Private Partnerships (PPP) as a way of ensuring project continuity and restructuring public sector spending commitments. The opportunity for a paradigm shift is obvious. For instance, in Saudi Arabia, the government currently funds over 80% of the infrastructure projects in the Kingdom, and only 4% of total projects are PPPs.

Apart from the obvious short-term fiscal advantages, PPPs promise other benefits through more explicit risk sharing between the government and the private sector. Properly designed, they can increase the efficiency of procurement and project management. Including the private sector can also contribute further benefits by bringing new technology, expertise, and previous experiences to projects. Ultimately, this model can promote diversification and lessen the governments' dependence on oil revenues to fund projects that are aimed to drive economic growth. However, the regional experience highlights the need to clearly articulate government objectives and to properly identify the risks associated with projects that tend to have long life-spans and therefore entails long-term funding commitments.

While this concept is gaining popularity and interest across the region, the actual use of PPP structures has been relatively limited and uneven, to date largely confined to power projects:

- ▶ The first PPP project in the GCC was the Al Manah independent power project (IPP) in Oman in 1994. Since then, around 40 projects have been implemented across the region and others are in the pipeline. Most recently, Kuwait closed the first phase of Al Zour North independent water power plant in 2014. Bahrain, specifically, has seen independent power plants become the main modality of power generation
- ▶ In 2003, the UAE completed the Ajman Wastewater Project
- ▶ Saudi Arabia recently completely a pioneering PPP structure for the USD1.4bn Prince Mohammed bin Abdulaziz airport in Medinah. A similar model is now due to be applied to the Taif (Mecca) International Airport

New funding models are likely to become more important for ensuring the continuity of the infrastructure pipeline in the region

- ▶ The model is being considered for other types of transportation. However, past experience in this regard is limited. A key trial case for a road PPP in the GCC was the 350 km Mafraq-Ghuweifat Highway (between Abu Dhabi and the Saudi border) in the emirate of Abu Dhabi. An approximately USD3bn project, the Abu Dhabi Executive Council and Finance Department ultimately deemed the PPP bids (received in 2009) excessive and restructured the project as EPC in 2011
- ▶ Bahrain has been a regional pioneer of PPP structures for social housing

A number of factors have limited the use of PPPs but are receiving growing attention across the region. Relevant issues include the following:

- ▶ The complexity of PPPs has deterred governments. Most progress has tended to materialize in areas where there established models that can be easily and quickly replicated
- ▶ The institutional and regulatory framework for managing PPPs has in some cases been uneven or insufficient
- ▶ PPPs have in some cases been dismissed as overly expensive, although estimates of competing models have not always accounted for additional costs during the project lifetime, which tend to be incorporated in PPP calculations from the beginning

In response to these considerations, a number of regional government have been taking steps to enhance their regulatory framework for PPP. Having been the regional pioneer in introducing a PPP law, Kuwait adopted updated PPP legislation in 2014. The new law provides for the establishment of a Higher Committee for PPPs, which is mandated to approve projects using PPP model. The Kuwait Authority for Partnership Projects is planning to establish public joint stock companies to execute PPP projects.

In Dubai, a new PPP law was passed and came into force in November 2015. The new law, the first of its kind in the UAE, aims to regulate partnership between the private and public sectors, increase productivity, and improve the quality of public services. The Omani government has taken steps to develop a legal framework for PPPs in which a first draft is expected to be delivered in the first half of 2016. Qatar also aims to submit a new PPP law draft to cabinet by August in order to enact it by the end of 2016. The country has used this structure before between Qatar General Electricity and Water Corp and a Japanese-led consortium to develop a USD3bn water and power project.

Upcoming PPP projects in the GCC:

Project	Country	Value (\$bn)
National Railway	Oman	12-15
Duqm Refinery	Oman	6
Integrated Liwa Plastics	Oman	3
Al-Zour North 2 IWPP	Kuwait	2.7
Sohar 3/Ibri IPPs	Oman	2.6
Umm al-Hayman WWTP	Kuwait	1.6
Fadhili cogeneration IPP	Saudi Arabia	1.5
Taif International Airport	Saudi Arabia	1

Source: MEED Projects

Important institutional and regulatory initiatives are taking place across the region to facilitate the use of PPPs which in the past have been largely confined to the power sector

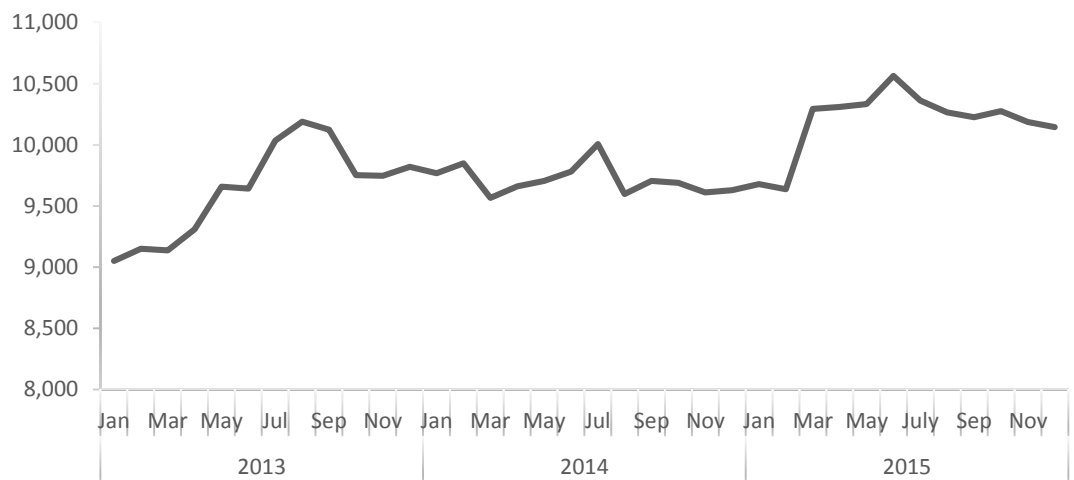
Oil production continues at high levels

Regional oil production has remained high and little change is expected this year

In line with the OPEC strategy of protecting market share, the GCC countries have continued to produce oil at high levels. By year end, Saudi Arabia held the highest share of OPEC oil production at around 30%. Saudi Arabia is currently the only major oil producer with spare capacity, and although it is producing at historically high levels, the Saudi oil minister recently confirmed that there are no plans for production cuts. The average Saudi oil production in 2015 stood at 10.2 mbd, a 5% increase from 2014. Kuwait and Saudi Arabia are reportedly planning to resume production for their share Khafji oil field.

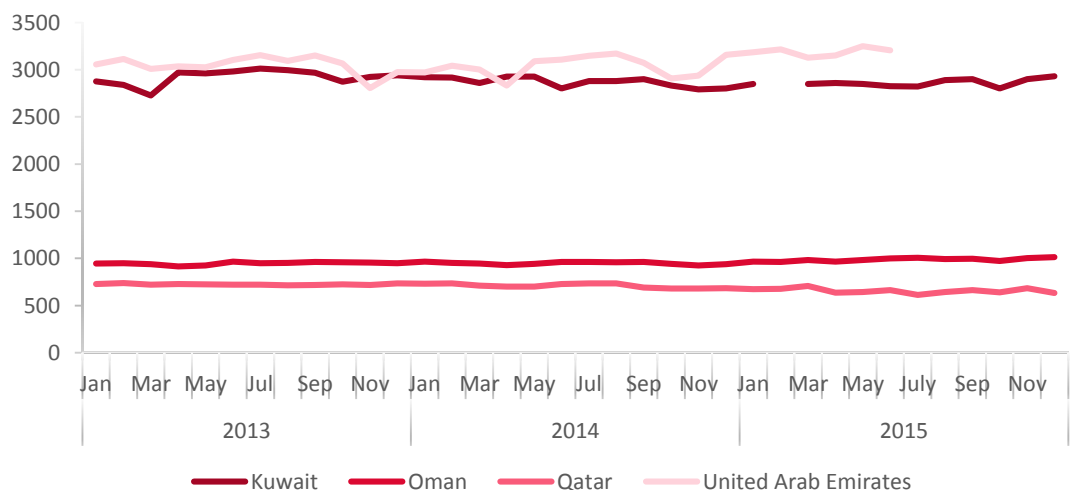
Overall Saudi oil products refinery output reached 2.77 mbd in December, an all-time high. Saudi oil demand grew by 5% in 2015 driven by the increasing demand in gasoline and diesel demand for transportation and residual oil use in additional refineries. Total consumption in the country stood at 2.29mbd in the last month of the year.

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



Source: Joint Organisations Data Initiative

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



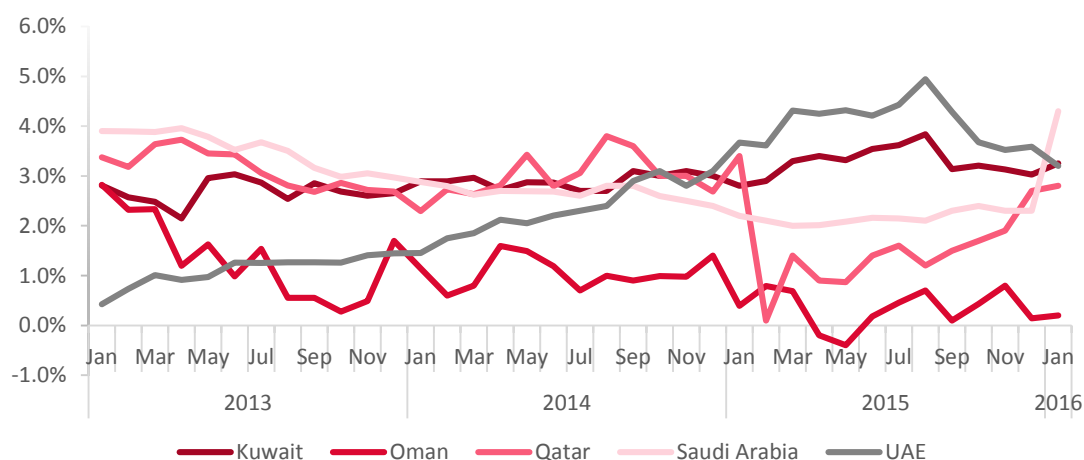
Source: Joint Organisations Data Initiative

Inflationary pressures diverging again

Following region-wide steps to modify subsidies, consumer price dynamics in the GCC have become increasingly volatile in recent months. Saudi Arabia was the only country in which consumer price inflation ranged between 2 – 2.4% throughout the year. Kuwait recorded a 2.8% inflation rate in January 2015 which continued to increase gradually to reach a year high at 3.8% in August. Inflation in Qatar was recorded at 3.4% in the beginning of 2015 but slowed down to 0.1% and continued to slowly increase to 2.7% in December. The UAE saw the highest inflation rates during the year with a summer peak of 4.9% in August and a yearly average of 4.1%. By contrast, Oman saw the lowest inflation rate in the region with an average of 0.3%, and consumer prices have actually declined by 0.2% and 0.4% in April and May.

The starting month of 2016 saw a general increase in consumer prices. Saudi Arabia's inflation rate was recorded at 4.3% YoY in January as compared to 2.3% in December. This jump was largely driven by the increase in transport prices by 12.6% as a result of higher energy prices. The prices of housing saw a significant increase by 8.3% in Saudi and 6% in Kuwait. In Qatar, consumer prices increased by 2.8% driven by increases of 18% in education prices and 6% in tobacco.

Consumer price inflation, %



Source: National statistical agencies

Credit growth tested by lower oil prices

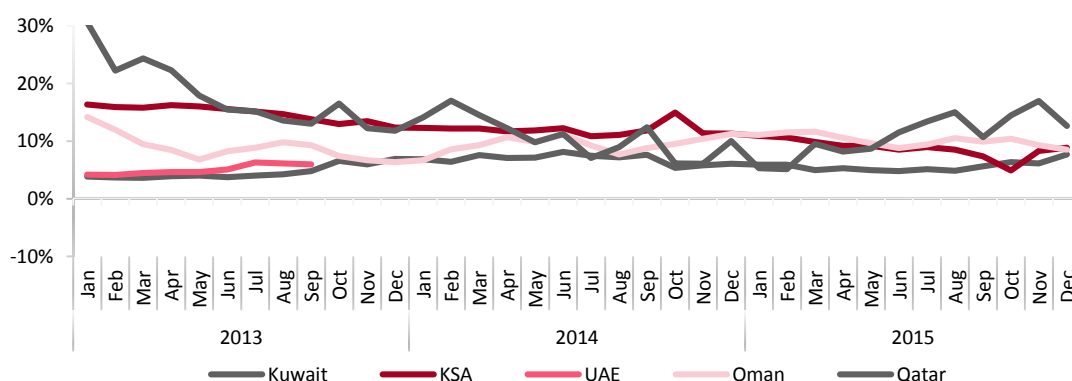
The lower oil prices have generally pushed GCC governments to increase their borrowing domestically which has brought about constraints on credit growth through some crowding out. Deposit growth in the region has declined from an average of around 10% in 2014 to 3% in 2015. The GCC as a whole saw somewhat tightening liquidity in 2015 and near-term changes in this regard are unlikely. Most regional economies have seen a decline in government deposits, which some banks have sought to compensate for by increasing their funding from foreign sources. Bank caution in some cases has been amplified by unfavourable real estate dynamics; in Dubai, prices have been declining for the past two years testing asset quality. However, capital adequacy ratios appear strong and banks have generally been well-provisioned for non-performing loans.

Credit growth has remained strong even with loan-to-deposit ratios edging up and funding structures changing

Liquidity conditions in the region's largest economy, Saudi Arabia, have tightened, although lending continues at a brisk pace. Annual money supply grew by 2.6% in 2015 as compared to 11.9% in 2014. In February 2016, the money supply growth actually turned negative for the first time in more than a decade with M3 falling by 0.9% MoM. Despite growing by 4.9% in October, the slowest growth during 2015, total credit picked up in the final months of the year to 8.3% and 8.9% in November and December, respectively. Credit to the private sector grew by around 9% YoY in 2015 and in fact reached 10% in February. The Saudi Arabian Monetary Agency has recently raised the banks' maximum allowable loan-to-deposit ratio to 90% from 85%. This will allow banks to continue expanding credit while limiting price competition for deposits.

Qatar saw the highest growth in credit in the GCC in Q4 with an average YoY expansion of 14.7%. This was driven by lending to the private sector which stood at 22.3% in Q4. There was a deceleration in private sector lending in December to 19.7%, the lowest since February, which could be expected to continue this year to ease the pressure on market liquidity. As of 30 November 2015, loan-to-deposit ratio rose to 116.8% from 103.4% a year earlier.

Bank credit growth, %



Source: GCC central banks

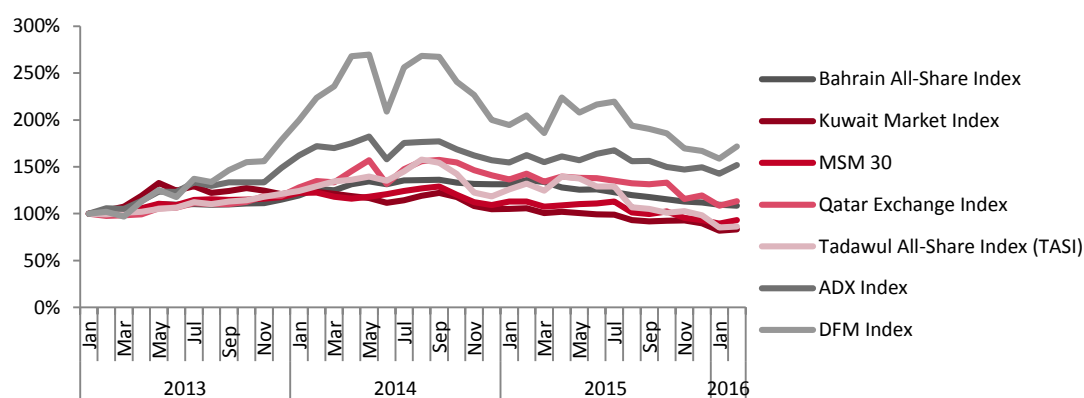
Source: Regional central banks

Stock markets remain under pressure

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

Reflecting global economic uncertainty and the oil price dynamics, stock markets across the GCC posted declines in 2015. Some of this negative dynamic was reversed since January, largely in connection with expectations of increased oil price stability. Nonetheless, volatility has persisted and some regional bourses closed the quarter with net losses. The best performer during Q1 was the Dubai market which increased by 6.5%. The Abu Dhabi market added 1.9% and Oman 1.1%. The other regional exchanges recorded losses, led by a 10.0% drop in Saudi Arabia. The Kuwait stock index shed 6.9% and Qatar closed almost flat with a 0.5% loss.

GCC equity market indices (January 2013 = 100)



Source: Regional stock exchanges

Reflecting the subdued market environment, only one IPO took place in the region during 1Q16. Saudi Arabia's Middle East Health Care Company (MEAHCO) went to market in March following delays to an original plan to IPO in January. The company is the operator of Saudi-German Hospitals in the Kingdom. MEAHCO floated a 30% stake which attracted SAR12bn worth of subscriptions. The individual investors oversubscribed 2.7 times while the same figure for institutions was 5.9 times as much.

However, there is growing interest across the region in reviving the primary market as governments seek to divest their holdings. In a landmark development, the Saudi national oil company, Saudi Aramco, is reportedly considering an IPO. Two options have been mooted as possible models: either a downstream portfolio of refining and chemical operations or a stake in the overall company.

More generally, Saudi Arabia is reviewing a number of options for privatization. Companies considered as likely candidates for IPOs include the Saudi Grain Organization, Saudi Arabian Airlines, and Saudi Railways Organisation. The Government is also considering plans to place public hospitals under the management of independent companies and restructure some of them as non-profit foundations. Additionally, Oman has announced plans to float three state-owned companies, and Qatar has begun to consider privatisation as an option. this year.

Sovereign issuance dominates the regional fixed income markets

New issuance activity in the regional fixed income markets has remained heavily skewed toward sovereign offerings. Conventional bond offerings during this quarter total 13 and raised USD15.36bn. The corresponding figures in 1Q15 were 17 and USD7.26bn.

Conventional issuance was dominated by the sovereigns. The Government of Saudi Arabia raised a total of USD10.7bn through two equal-sized offerings in January and March respectively. Qatar raised USD1.4bn through a seven-year offering in February. Kuwait raised just under USD500mn through three one-year offerings. Oman placed a USD260mn five-year development bond.

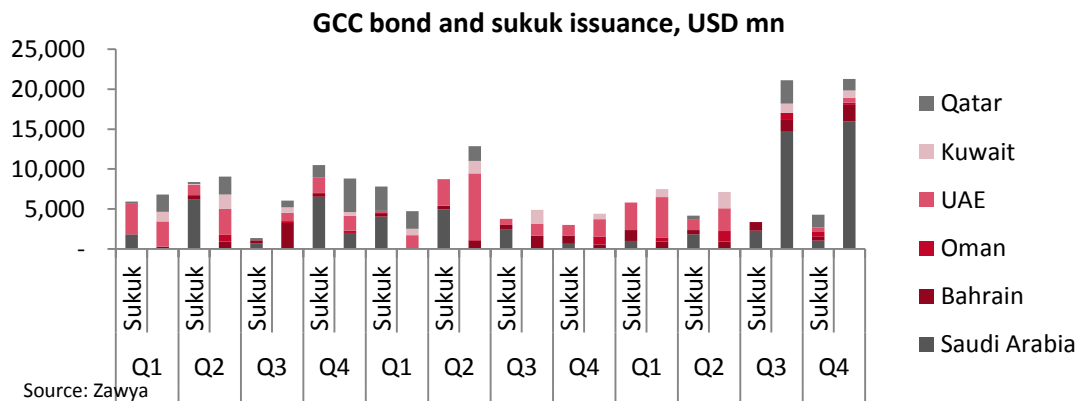
The largest commercial offering was a USD900mn five-year bond by the UAE's First Gulf Bank. In Kuwait, Kuwait Projects Company sold a seven-year USD500mn bond, while Burgan Bank placed two ten-year offerings worth some USD330mn. Qatar National Bank placed a USD300mn two-year bond.

In the Shariah-compliant space, there was a slight slow-down as compared to the opening months of 2015. A total of 11 primary sukuk offerings worth USD3.83bn took place in 1Q16. This compared to 13 offerings worth USD5.79bn a year earlier.

In the sovereign space, the Government of Sharjah in January raised USD500mn in a five-year offering.

Dubai Islamic Bank placed a USD500mn sukuk in March. Saudi Arabia's Rawabi Vallianz offshore services company in February raised some USD266.7mn for five years. The Islamic Development Bank placed two offerings worth USD1.83bn, a USD-dominated five-year sukuk and a seven-year issue in Euro. Gulf Investment Corporate of Kuwait in March raised just under USD110mn through a Malaysian Ringgit-denominated five-year sukuk.

GCC bond and sukuk issuance, USD mn



Source: Zawya

Implications for Bahrain

In spite of persistent oil price volatility, economic conditions in the region are characterized by continued resilience, especially in the non-oil economy:

- ▶ Regional disposable incomes are likely to grow slower than in recent years, which may reduce intra-regional travel and discretionary spending. Bahrain's offering is likely to benefit from cost competitiveness and a central location, however
- ▶ Liquidity conditions in the financial sectors are growing tighter, which may push up the cost of capital and increase reliance from funding sources from outside the region

BAHRAIN

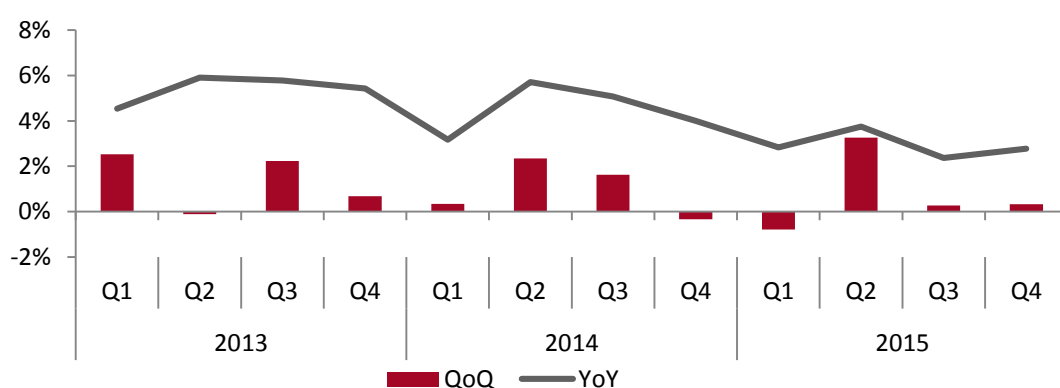
STRUCTURAL DRIVERS UNDERPIN NON-OIL GROWTH

Economic growth was dampened somewhat in the second half of 2015 but reached just under 3% during the year as a whole

While the Bahraini economy has continued to display considerable resilience throughout the period of depressed oil prices, the pace of growth was somewhat dampened in the second half of 2015. Non-oil growth in Q4 reached 3.1% YoY, comparable to the 3.3% rate seen in Q3 but short of the 4.7% expansion recorded in the first half of the year. During the year as a whole, however, non-oil growth reached 3.9%, a figure that reflects the resilience of structural growth drivers in the economy, specifically the continued positive momentum of diversification along with a sizeable infrastructure pipeline.

Due to a small 0.9% YoY contraction in the oil sector, the headline growth rate for 2015 came in at just short of 3%. The 2.9% figure compared to 4.5% growth in 2014. The annual pace of growth in Q4 was broadly in line with the average for the year at 2.8% in a clear pick-up from the 2.4% rate recorded in Q3. The oil sector expanded by 1.5% YoY in Q4 in a pronounced reversal of the 1.0% YoY contraction seen in Q3.

Real GDP growth



Source: Information & e-Government Authority

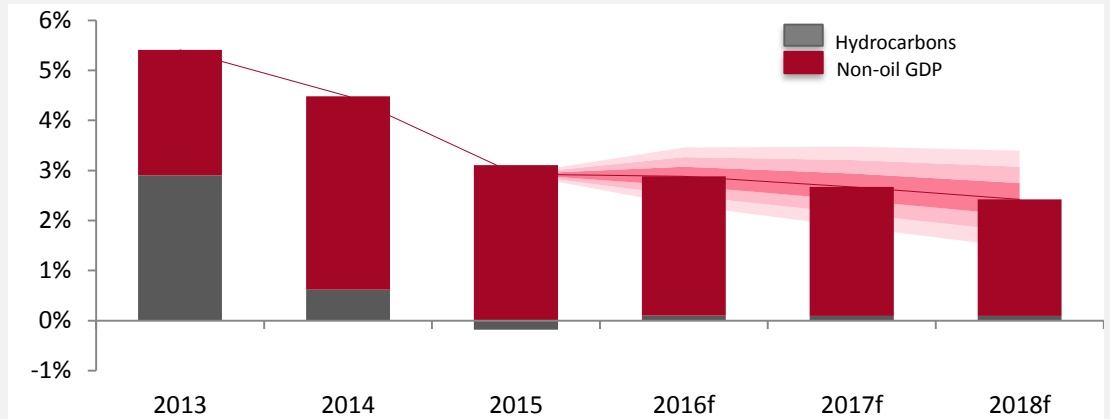
Forecasts: Strong structural drivers in the face of uncertainty

	2014	2015	2016f	2017f
Real GDP growth, %	4.5%	2.9%	2.9%	2.7%
Non-hydrocarbons sector	4.9%	3.9%	3.5%	3.2%
Hydrocarbons sector	3.0%	-0.9%	0.5%	0.5%
Nominal GDP growth, %	2.9%	-4.8%	5.7%	9.6%
Inflation (CPI %)	2.8%	1.8%	4.8%	2.7%
Current account (% of GDP)	4.5%	-0.2%	-2.7%	1.2%
Fiscal balance (% of GDP)	-3.6%	-11.9%	-10.1%	-7.0%
Crude Oil Arabian Medium (USD)	96	50	45	60

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

*Fiscal Balance for 2015 is forecasted

Projected real GDP growth contribution



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

In spite of important elements of continuity, the continued downward pressures on oil prices, along with steps toward fiscal re-engineering, is likely to curb growth somewhat in the near- to medium-term. This negative impact is likely to be countered to a significant extent by the large pipeline of infrastructure projects. We expect headline growth in 2016 to remain in line with 2015 level with the possibility of slight moderation in 2017.

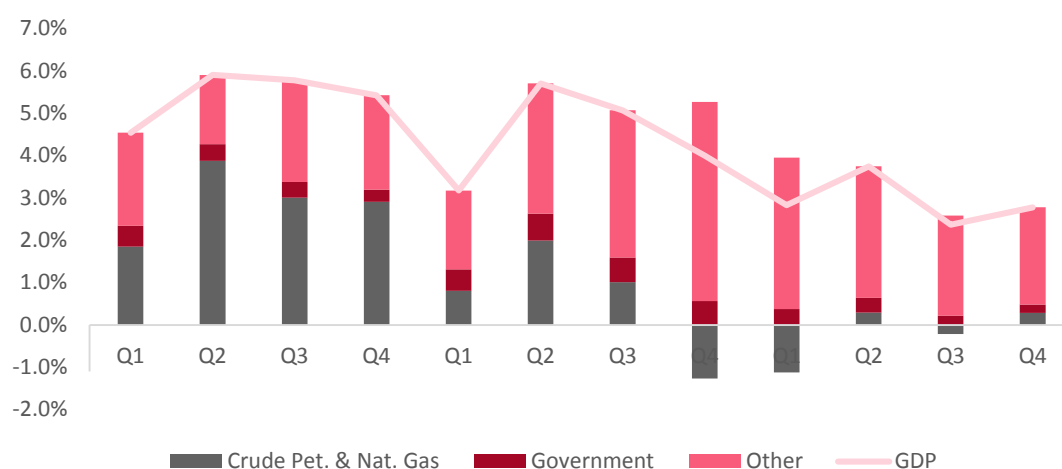
Non-oil growth marked by continuity

The non-oil private sector has continued to be characterised by remarkable continuity even in the face of unusual uncertainty for the regional economy. The performance of the non-oil sector is particularly encouraging in view of the ongoing efforts to rationalise government expenditure and retarget subsidies. In spite of a slight loss of momentum virtually across the spectrum, growth has remained positive in all sub-sectors.

While all main segments of the economy made positive contributions to headline growth in Q4, the role of the non-oil private sector remained dominant. It contributed 2.3 percentage points to the headline growth. The contributions of the Government services and oil sector were 0.2 and 0.3 percentage points, respectively. During the year as a whole, the growth contribution of the non-oil private sector was 2.8 percentage points. Government Services contributed 0.3 percentage points, whereas the contribution of the oil sector was -0.2 percentage points.

Growth in Bahrain is firmly led by the non-oil private sector, an important source of continuity in the current environment

Real GDP growth composition



Source: Information & e-Government Authority

Echoing the pattern established in recent years, growth in Q4 was led by the Social and Personal Services sector, which is dominated by private education and healthcare. YoY growth in the sector reached 7.3% in Q4 and 6.9% during the year as a whole. Construction was the second-fastest growing sector in Q4. The 6.8% YoY pace of growth in Q4 in fact marked a clear acceleration over 4.9% recorded in Q3. During 2015 as a whole, the construction sector expanded by 6.4%. The Hotels and Restaurants sector expanded by an annual 5.9% during Q4, marking its role as an increasingly important and consistent growth driver in the non-oil economy. Other strong performers during Q4 were Transportation and Communications, which posted a 4.3% YoY gain and Manufacturing, which grew by 3.4%. During the year as a whole, Transportation and Communications grew by 5.9% whereas Manufacturing expanded by 4.1%.

The fastest growing sectors of the non-oil economy continue to show remarkable resilience

YoY growth	2014					2015				
	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4
Crude Pet. & Nat. Gas	3.0%	4.1%	9.9%	4.7%	-5.9%	-0.9%	-5.6%	1.4%	-1.0%	1.5%
Manufacturing	3.8%	0.4%	3.8%	3.5%	7.4%	4.1%	5.9%	4.1%	3.3%	3.4%
Construction	7.1%	1.2%	3.4%	12.1%	12.3%	6.4%	7.7%	6.4%	4.9%	6.8%
Trade	4.0%	3.9%	3.1%	4.4%	4.4%	1.7%	2.7%	2.8%	0.2%	1.0%
Hotel & Rest.	4.1%	1.1%	5.5%	2.7%	7.1%	7.3%	9.4%	5.7%	8.4%	5.9%
Trans. & Comm.	6.5%	5.3%	6.9%	4.4%	9.7%	5.9%	6.9%	6.7%	5.8%	4.3%
Social & Pers. Serv.	7.7%	7.4%	8.2%	6.7%	8.7%	6.9%	7.6%	6.2%	6.3%	7.3%
Real Est. & Bus. Act.	4.0%	3.7%	3.8%	3.9%	4.6%	2.8%	3.8%	3.7%	1.7%	1.9%
Finance	3.6%	2.2%	4.1%	3.8%	4.3%	1.7%	1.6%	2.1%	2.1%	0.9%
Government	4.5%	3.9%	4.9%	4.6%	4.4%	2.2%	2.8%	2.8%	1.7%	1.5%

Other	7.6%	4.7%	4.8%	10.7%	10.2%	7.8%	11.6%	11.4%	4.3%	4.1%
GDP	4.5%	3.2%	5.7%	5.1%	4.0%	2.9%	2.8%	3.7%	2.4%	2.8%

Source: Information & e-Government Authority

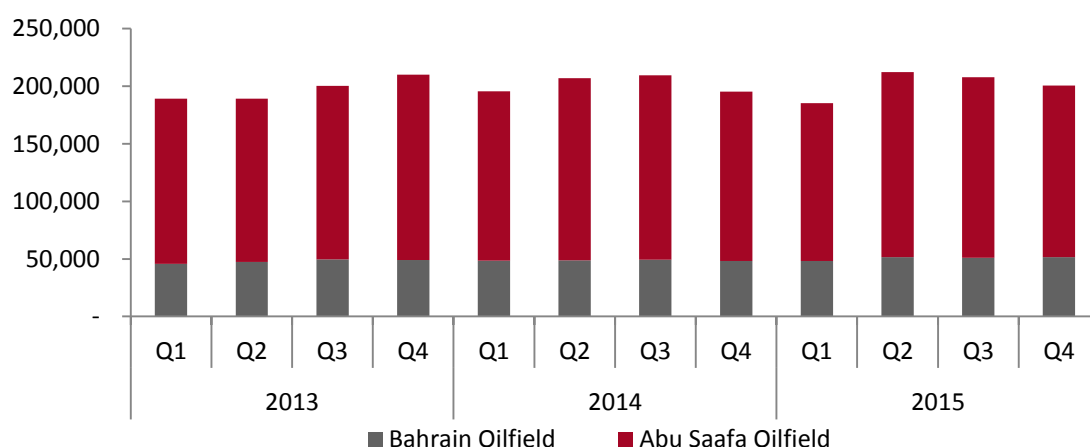
Oil production falls slightly short of last year's level

The total crude oil production in Bahrain posted a 3% YoY increase in the 4Q15, reaching a daily average of 200,659 barrels. However, the quarterly average has continued to post small declines since the 212,272 b/d peak posted in Q2. Overall, the oil sector output in 2015 fell marginally short of the output reached in 2014.

The daily average production from the onshore Bahrain field has reached an all-year high of 51,606 b/d in the last quarter. This represented a 7% increase compared to the same period in 2014 as well as 1% QoQ increase. 2015 saw the first increase in production above 50,000 b/d since the rehabilitation of the field began in 2009.

The average output of the offshore Abu Sa'afah field has been on a slight down trend since peaking at 160,840 b/d in Q2. The Bahraini share of Abu Sa'afah production reached a daily average of 149,053 barrels in Q4. This represented a 5% decline from Q3, much in line with last year's pattern when production similarly decreased in the last quarter of the year.

Crude oil production, b/d



Source: National Oil and Gas Authority

Economic diversification on track

The 2015 economic data highlights the continued momentum of economic diversification in Bahrain. In real terms, the oil and gas sector accounted for 19.7% of the Kingdom's GDP in 2015. In current prices, this proportion was 15.1%.

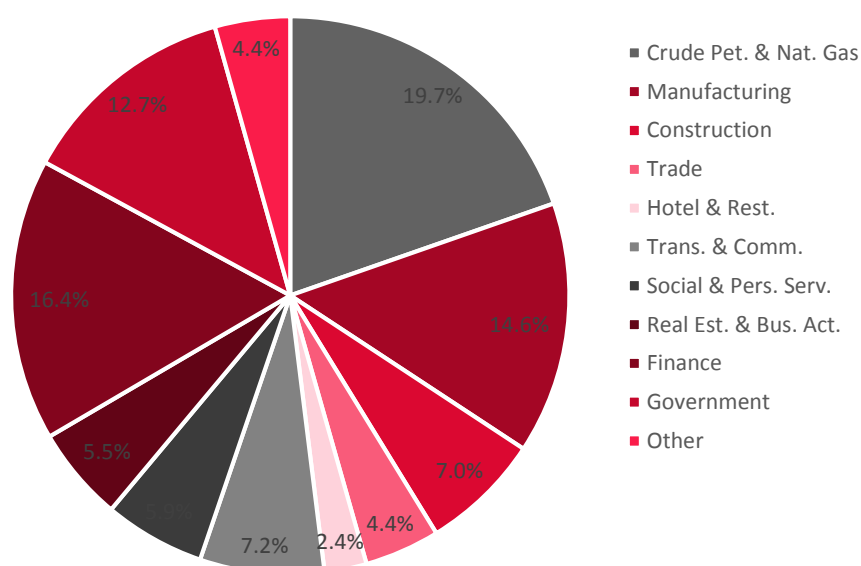
The non-oil economy continues to be dominated by three large sectors: Financial Services, Manufacturing, and Government Services. The Financial Services sector accounted for 16.4% of

80.3% of Bahrain's real GDP and 84.9% of its nominal GDP was generated by an increasingly diverse non-oil sector in 2015

Bahrain's real GDP in 2015, whereas its nominal GDP share was 16.7%. Manufacturing made up 14.6% of real GDP and 16.8% of nominal GDP. The corresponding figures for Government Services were 12.7% and 13.7%, respectively.

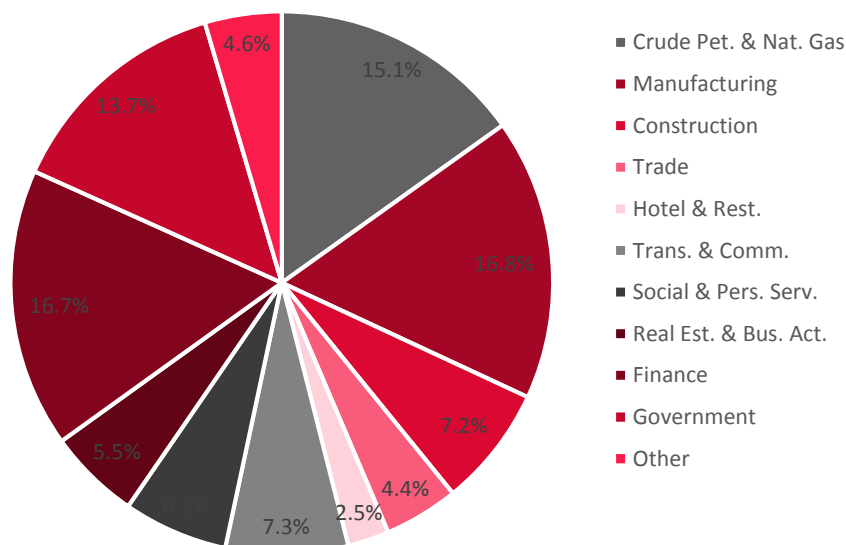
The robust growth dynamics of the next tier of sectors has left several clusters now accounting for 5-10% of the Kingdom's real GDP. The largest of these is Transportation and Communications which stood at 7.2% in 2015 (7.3% in nominal terms). Construction made up 7% (7.2%), while the share of Social and Personal Services was 5.9% (6.2%). Real Estate and Business Activities accounted for 5.5% of real and nominal GDP alike.

Real GDP composition, 2015



Source: Information & e-Government Authority

Nominal GDP composition, 2015



Source: Information & e-Government Authority

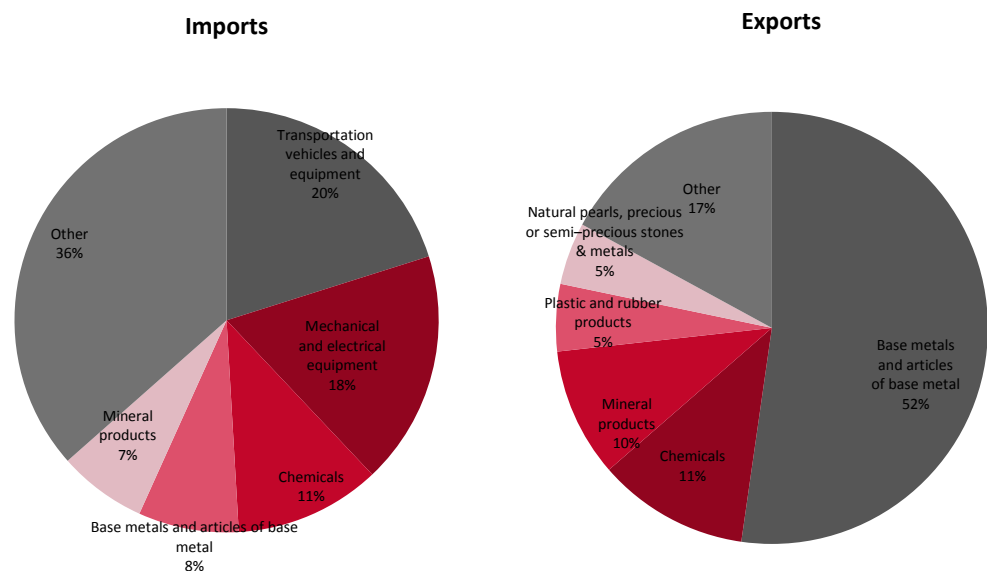
Export diversification gathers momentum

While economic diversification in Bahrain has manifested itself most clearly with respect to GDP composition, the export bundle, traditionally dominated by oil products, has also seen fairly consistent growth of services and non-oil merchandise exports. Following expansion in the manufacturing sector, the total value of non-oil goods traded has increased by around 19% since 2010. In 2015, the total value of non-oil merchandise trade with the rest of the world stood at approximately USD17.5bn.

The value of Bahrain's non-oil merchandise exports has increased by 12% since 2010. At the moment, the export bundle continues to be heavily dominated by base metals and articles of base metals, which account for more than half of total export value. Among the top five exported good categories in US Dollar value terms are chemicals, mineral products, and plastic and rubber products.

Bahrain's total non-oil merchandise imports reached USD12.4bn in 2015. The majority of imports were transportation vehicles (USD2.5bn) and mechanical and electrical equipment (USD2.2bn). The GCC region approximately accounted for 28% of Bahrain's total non-oil trade and 50% of the total value of non-oil exports.

Composition of Bahrain's non-oil merchandise trade, 2015



Source: Information & e-Government Authority

Infrastructure projects strengthen as a growth driver

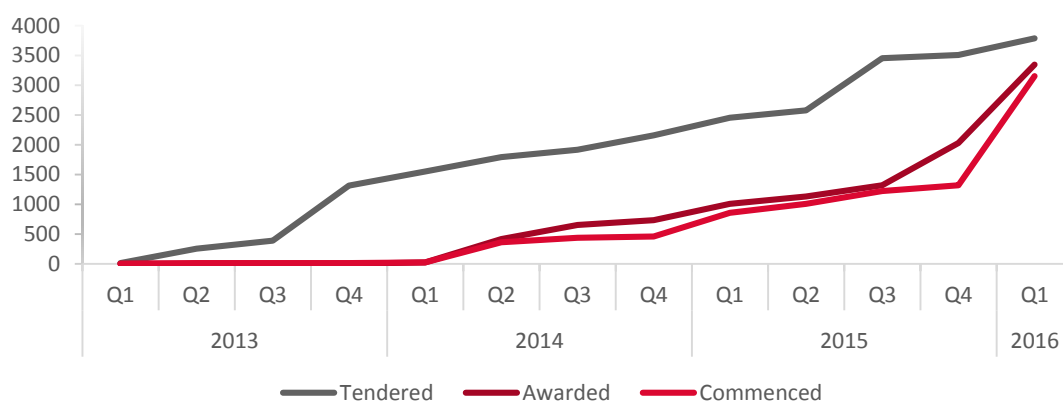
The large pipeline of infrastructure projects in Bahrain has proven resilient in the face of global and regional uncertainties. The pick-up in momentum has been particularly evident in recent months with respect to the GCC Development Fund. The total value of projects tendered rose from USD2.2bn in 4Q14 to USD3.6bn a year later. A further increase to USD3.8bn was observed by the

A rapid build-up of activity is underway in the GCC-funded infrastructure projects

beginning of March. The value of projects which have commenced rose from USD459mn in 4Q14 to USD1.3bn a year later. Following a remarkable USD1.3bn worth of project awards in January-February, this figure more than doubled to USD3.2bn as of 1 March. Just over USD6bn of the GCC Fund had been allocated to individual projects as 1 March.

The main funding priorities of the projects funded to date are housing (USD2.1bn), electricity and water (USD1.3bn), the airport (USD1bn), and roads (USD0.7bn). The airport project is designed to increase the capacity of the facility 4 times to 14mn passengers a year. The terminal project was awarded to a joint venture of the UAE-based Arabtec and Turkey's TAV in January and completion is expected in 2020. The GCC Fund is expected to cover some 70% of the overall project cost. The project partners in March announced plans to raise AED4bn (USD1.1bn) from regional financial institutions to fund the construction costs.

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



Source: Government sources

Also private sector projects are making good headway with important new developments:

- ▶ Diyar al Muharraq expects its USD3bn Marassi al Bahrain development to have its first residents within two years. The project is being developed by Eagle Hills Diyar, a joint venture between UAE-based Eagle Hills. The first phase of the project is projected to cost USD1.2bn and will include 480 seafront apartments, a shopping complex, and luxury hotels built by The Address Hotels and Resorts.
- ▶ Diyar al Muharraq also announced the launch of the second phase of its Al Bareh seafront development. Al Bareh is composed of three main product types: seafront residential plots dedicated for high-end villas, residential plots within walking distance to waterfront parks, and residential investment plots overlooking the main road designated for the construction of multi-storey buildings. Al Bareh plots are being offered for sale on a freehold basis to all nationalities
- ▶ Kuwait Finance House and Mabaneer Real Estate Company in February signed a memorandum of understanding which funds the USD94mn Avenues-Bahrain project over a one-year period. The new shopping complex, located in Bahrain Bay, is expected to open in the first quarter of 2017

A broad range of privately funded projects are making good progress with several key product launches in Q1

- ▶ Gulf Finance House has begun the site preparation work at the Harbour Row Development. The USD150mn mixed-use landmark project located within the Bahrain Financial Harbour area is expected to comprise of luxury residential units as well as commercial promenade
- ▶ Bin Faqeeh Real Estate Investment Company is starting work on its new Layan mixed-use project. Each residential villa is structured to have parking facilities for both cars and yachts
- ▶ Funded through a USD266mn grant from the late King Abdulla bin Abdulaziz Al Saud, the King Abdulla Medical City is expected to break ground by the end of 2016. Tendering for the project will begin after the completion of designs expected in June 2016. The project, located in the south of the island, is designed by SaudConsult and will be operated by the Arabian Gulf University. Phase 1 of the project will include a 300-bed hospital, staff housing, and mini shopping mall and is expected to begin in 2017. The hospital is expected to open by 2019

Fiscal reform makes headway

In line with efforts underway across the region to rationalise the fiscal system, the Government of Bahrain has continued with its three-pronged reform efforts. The approach is structured around the following main focus areas:

- ▶ Progressively eliminating fiscal deficits through broad-based initiatives to rationalise and better target government expenditure while diversifying revenues;
- ▶ Redirecting universal government subsidies on the basis of socio-economic criteria to better serve the needs of the citizens; and
- ▶ Fast-tracking regulatory reform and working to better mobilise capital for growth through focused investment promotion and targeted support for strategic infrastructure projects

A series of measures have been introduced and implemented following the adoption of a new natural gas pricing policy and the lifting of meat subsidies last year:

The government has modified subsidies for liquid fuels and utilities

- ▶ The Cabinet approved amended sales price of gasoline in January 2016. The price of 95-octane gasoline (*Mumtaz*) has been set at 160 fils per litre and the price of 91-octane fuel (*Jayyid*) at 125fils per litre. Apart from boosting government revenues, the new prices are expected to enhance the efficiency of energy use.
- ▶ New electricity and water tariffs have also been set starting March for the industrial and commercial sectors, as well as expatriate residents. The tariff reform constitutes a first step of a four-year program which will gradually increase the tariffs for different usage categories until it reaches 29 fils for power and 750 fils for water in 2019. While Bahraini citizens will continue to benefit from subsidized prices for their primarily resident, tariffs paid by nationals with more than one account will also increase for the secondary account.

- The Government has increased the excise duty on tobacco from 100% to 200%. The Ministry of Finance has previously reported that 100% tobacco duty has contributed BHD59.52mn to the government's revenues in 2013.

Subsidy reform reflected in the CPI

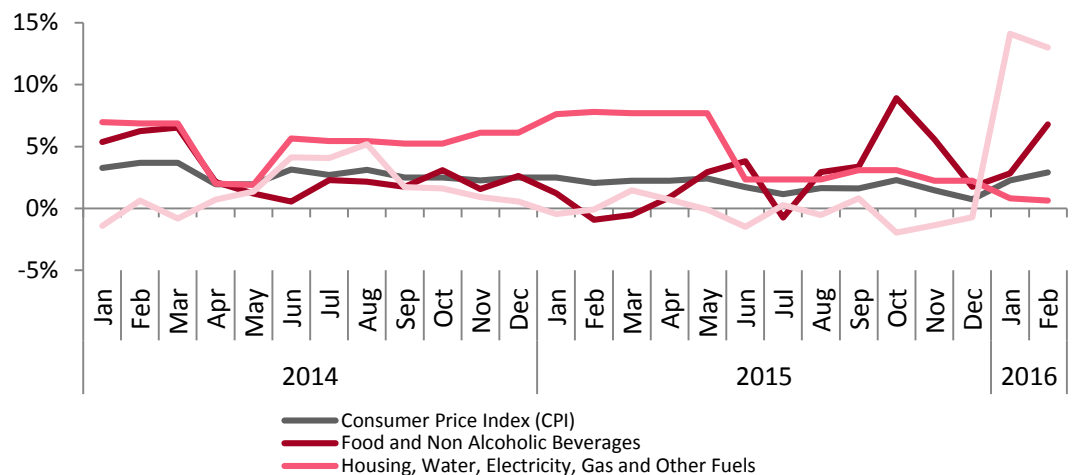
Consumer prices in Bahrain increased by a modest 1.9% in 2015 driven mainly by a 4.7% increase in housing, water, electricity, gas, and other fuels. Alcoholic beverages and tobacco increased by 3.5% followed by 3% in healthcare services prices.

Echoing region-wide trends, some acceleration in price pressures has become evident in recent months. The Consumer Price Index (CPI) increased by 2.9% YoY in February. Transportation prices increased by 13% YoY due to the increase in fuel prices domestically by 60% after the government removed fuel subsidies. Food prices have also increased by almost 7% during the second of the year. By contrast, Clothing and Footwear prices, it has been declining constantly since November and dropped by 4.5% in February.

In general, the inflationary impact of subsidy reforms in Bahrain – as well as the broader region – can be expected to be relatively measured and above all temporary. Most subsidy modifications are phased in gradually and affect relatively small segments of the CPI basket. The Dollar peg has historically been very effective in anchoring inflation expectations.

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

Consumer price inflation



Source: Information & e-Government Authority

Credit growth accelerates further

Domestic credit growth in Bahrain has continued at a brisk pace in spite of indicators of liquidity tightening in much of the GCC region. Total credit growth peaked in the final quarter of 2015 at a 10% annual pace.

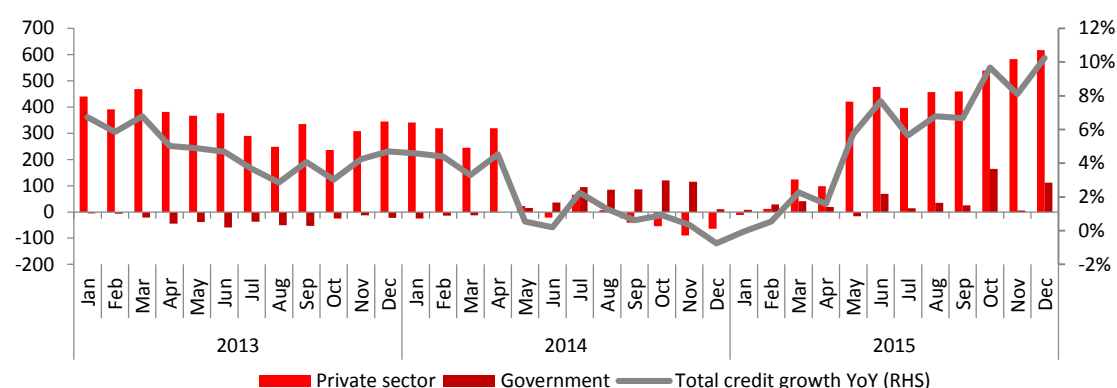
Credit growth was driven by the rise in Government borrowing in the last quarter even though government loans accounted for only 4% of total loans made in December. As compared to

Reflecting a benign liquidity situation and strong local banks, Bahrain has seen a clear acceleration in bank lending in recent months

December 2014, lending to the Government nonetheless increased by 61% to stand at around BHD300mn in December 2015. Government borrowing peaked in October at BHD473mn, the highest amount recorded in years.

Business loans, which account for the highest proportion of all bank loans borrowed in December at 53%, grew by 5% YoY. Most loans borrowed went to the construction and real estate and trade sectors, reflecting the strong momentum of the infrastructure pipeline. Personal loans, holding the second largest share of total loans at 43%, rose by 14% YoY in December.

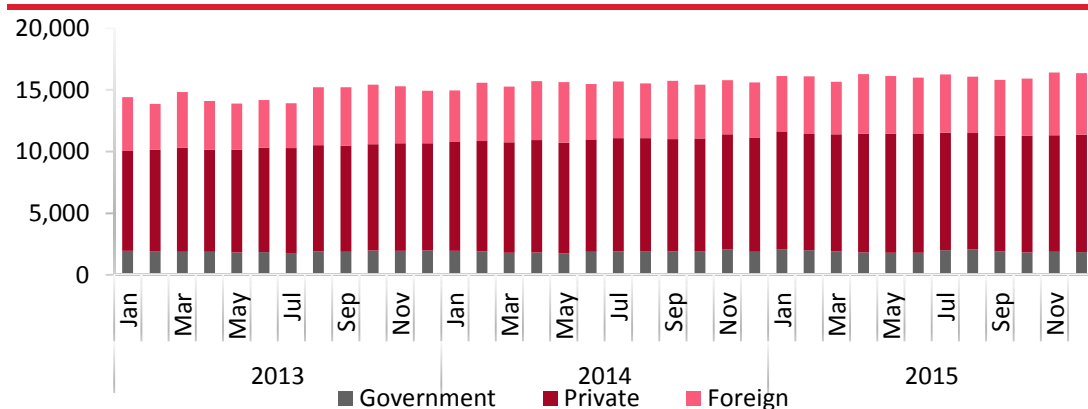
Year-on-year credit growth to the private sector and government (BHD mn)



Source: Central Bank of Bahrain

Bank deposits continued to grow in the last quarter of the year and recorded a year-high of BHD16.41bn in November. Total bank deposits stood at BHD16.35bn in December, which implied a 5% YoY growth. Private sector deposits, which represent a 58% share of total deposits, grew by 3% YoY as of the end of 2015. Foreign deposits saw the highest growth by year end at 12%. Government deposits, holding the smallest share of total deposits, saw 1% YoY decline in December but have remained relatively stable between BHD1.8bn and BHD1.9bn since September.

Deposit liabilities to non-banks (BHD mn)



Source: Central Bank of Bahrain

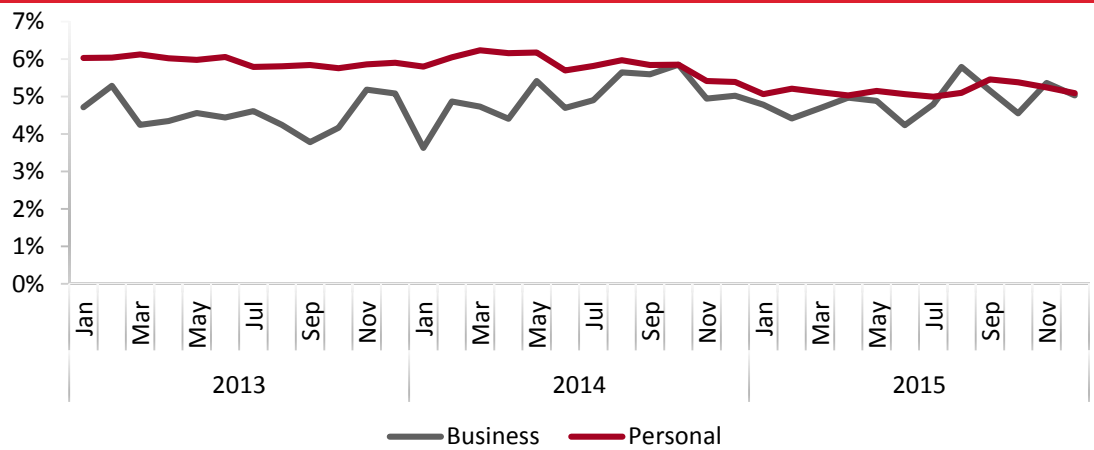
Bank deposits are continuing to grow and loan-to-deposit ratios remain historically low

Loan-to-deposit ratios in Bahrain declined slightly since Q3, from 49% to 48%, having peaked at 50% in October.

The cost of borrowing has remained more or less stable with convergence between business and personal loans. Interest rates on businesses declined to 4.6% in October but subsequently rebounded and closed at 5.0%. Interest rates on personal loans saw a gradual decrease since September from 5.5% to 5.1% in December.

The CBB has maintained the overnight deposit rate at 0.5 since it changed it from 0.25 in December, following the rate increase by the US Federal Reserve. The one-week deposit rate was also held at 0.75%.

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

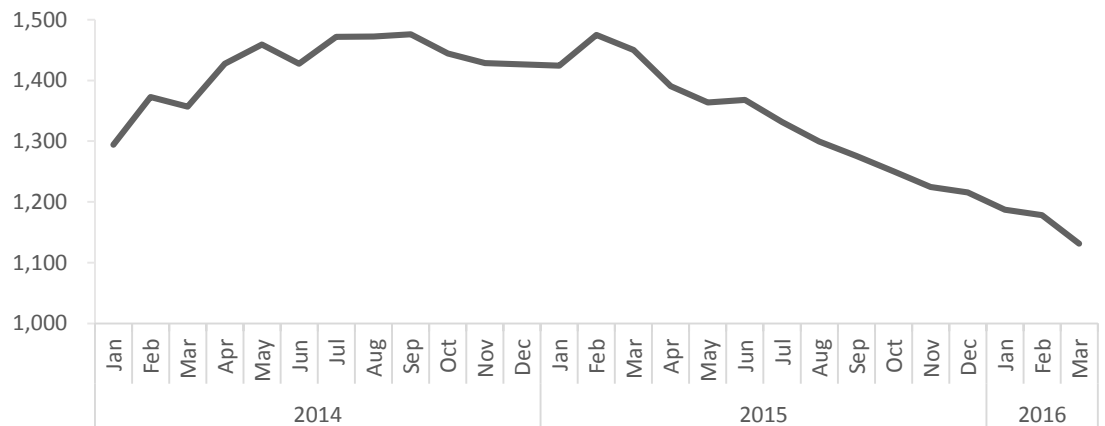


Source: Central Bank of Bahrain

Capital market innovation continues apace

Reflecting region-wide trends in a low oil price environment, Bahrain Bourse saw declines almost throughout 2015, a trend that continued in the beginning months of 2016. The Bahrain All Share Index dropped 47 points from February to stand at 1131.11 points in March. Market capitalization saw a slight decline from BHD6.98bn to BHD6.70bn during the same period. Nonetheless, the value of shares traded have seen a 5% improvement from BHD7.09mn to BHD7.43bn as the number of shares traded stood at 32.83mn in March. In line with the Bahrain All Share Index, the Bahrain Islamic Index marginally declined by 8% YTD.

Bahrain All-Share Index

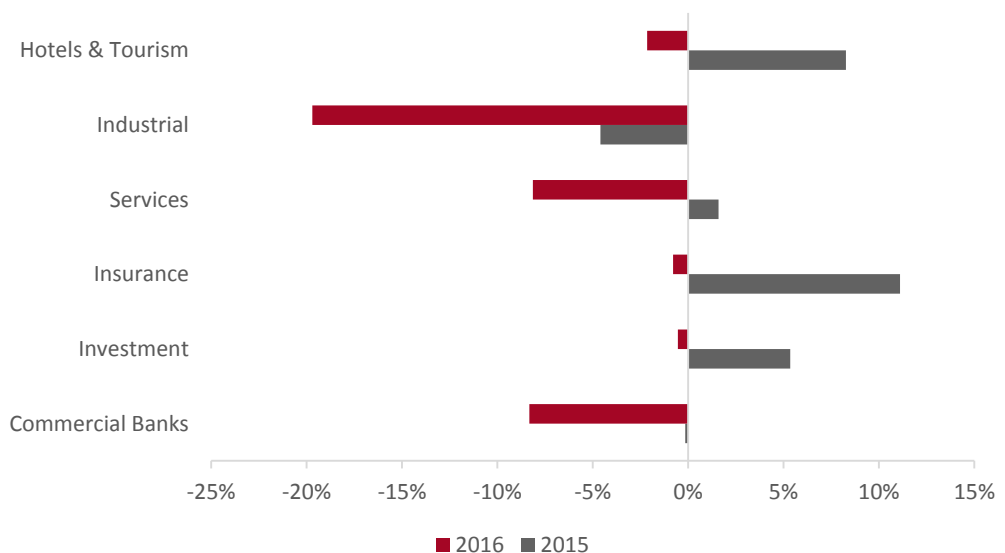


Source: Bahrain Bourse

In line with regional trends, stock markets have remained under some downward pressure in Q1

In line with the declining performance of the regional stock market, the Bahrain All Share Index dropped by 7% YTD in March. This is reflective of the decline in all of the sectoral indices during the same month. The Industrial sector's index saw the highest deterioration by 20%. The Commercial Banks and Services sectors declined by 8%. The Investment and Insurances sectors saw only a slight decline by less than 1%.

Sectoral stock market indices, 2015-2016 YTD March



Source: Bahrain Bourse

Continuing a track record of product and service innovation, Bahrain Bourse recently launched its Treasury Bills Market with the listing of eleven issues in the market by the Central Bank of Bahrain. The market further aims to enhance cash liquidity in local and foreign banks that deal in Bahraini treasury bills.

Issuance activity in the fixed income space has been dominated by Government offerings. Following the launch of a Euro-bond program with a USD1.5bn sale in November, the Government returned to the market with a USD600mn two-part bond sale in February. Pricing for a USD275mn, five-year tranche was set at a yield of 5.95%, while a USD325mn, 10-year tranche was priced at 7.65%. Total orders exceeded USD900mn. The offering took place less than a week after an earlier USD750mn issue was cancelled in connection with a sovereign downgrade.

The Central Bank continues to issue short-term bonds and sukuk on behalf of the Government of Bahrain. There have been 12 primary offerings of Treasury bills since the beginning of the year with an average interest of around 2%. In the Islamic sukuk market, the CBB arranged five issues of *Sukuk al ijara* and *Sukuk al salam*.

Issue Date	Issue	Value, BHD mn	Maturity, days	Average interest/ profit rate, %	Average price, %	Over- subscript ion, %
30 Mar 2016	Treasury bill No. 1592	70	91	2.12	99.466	123
23 Mar 2016	Sukuk Al-Salam No. 179	43	91	2.09		100
17 Mar 2016	Sukuk Al-Ijara No. 127	26	182	2.22		174
16 Mar 2016	Treasury bill No. 1591	70	91	2.09	99.473	127
9 Mar 2016	Treasury bill No. 1590	70	91	2.01	99.494	112
6 Mar 2016	Treasury bill No. 1589	35	182	2.22	98.889	114
3 Mar 2016	12-months Treasury bill No. 28	200	360	2.67	97.372	105
2 Mar 2016	Treasury bill No. 1588	70	91	2	99.496	100
22 Feb 2016	Sukuk Al Salam No. 178	43	91	1.98		100
17 Feb 2016	Treasury bill No. 1587	70	91	1.98	99.501	100
11 Feb 2016	Sukuk Al-Ijara No. 126	26	182	2.16		220
10 Feb 2016	Treasury bill No. 1586	70	91	1.95	99.510	140
7 Feb 2016	Treasury bill No. 1585	35	182	2.14	98.929	130
3 Feb 2016	Treasury bill No. 1584	70	91	1.96	99.507	100
27 Jan 2016	Treasury bill No. 1583	70	91	1.94	99.511	101
24 Jan 2016	Sukuk Al-Salam No. 178	43	91	1.98		100
14 Jan 2016	Sukuk Al-Ijara No. 125	26	182	2		185
13 Jan 2016	Treasury bill No. 1582	70	91	1.86	99.532	143
6 Jan 2016	Treasury bill No. 1581	70	91	1.86	99.531	136

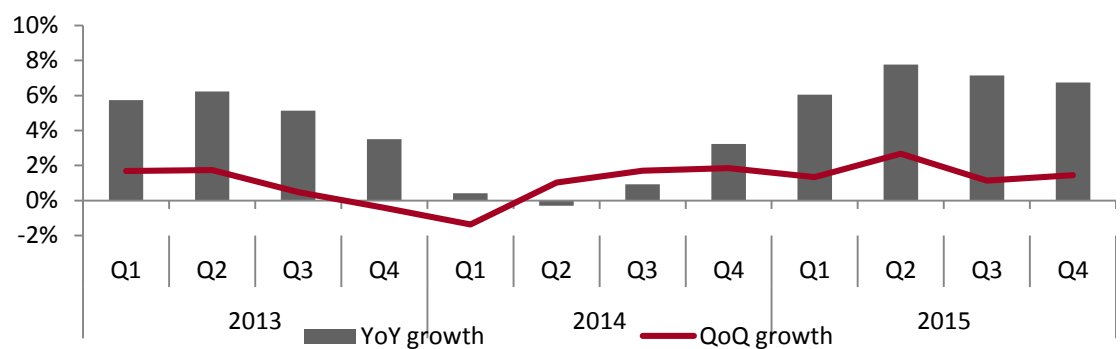
Source: Central Bank of Bahrain

In the corporate sector, the end of March saw the signing of a USD570mn *murabaha* facility by Nogaholding to finance elements of an investment program composed of the Bapco refinery modernization, an LNG import terminal, and a gas plant. The facility has a five-year tenor and is provided by a consortium of regional and international banks: Arab Banking Corp, Ahli United Bank, Arab Petroleum Investments Corp, Gulf International Bank, National Bank of Bahrain, Qatar Islamic Bank, Kuwait Finance House, Bank of Tokyo-Mitsubishi UFJ, BNP Paribas, and HSBC.

Labor market dynamics show resilience

Employment in Bahrain has continued to rise during 2015 to reach a total number of 725,113 by the end of the year. This represented a 5.5% increase as compared to the same period in 2014. Private sector employment, which accounts for 75% of total employment in the country, saw an almost 7% YoY increase and stood at 546,572 in Q4. Bahrainis currently represent 19% of total private sector employment.

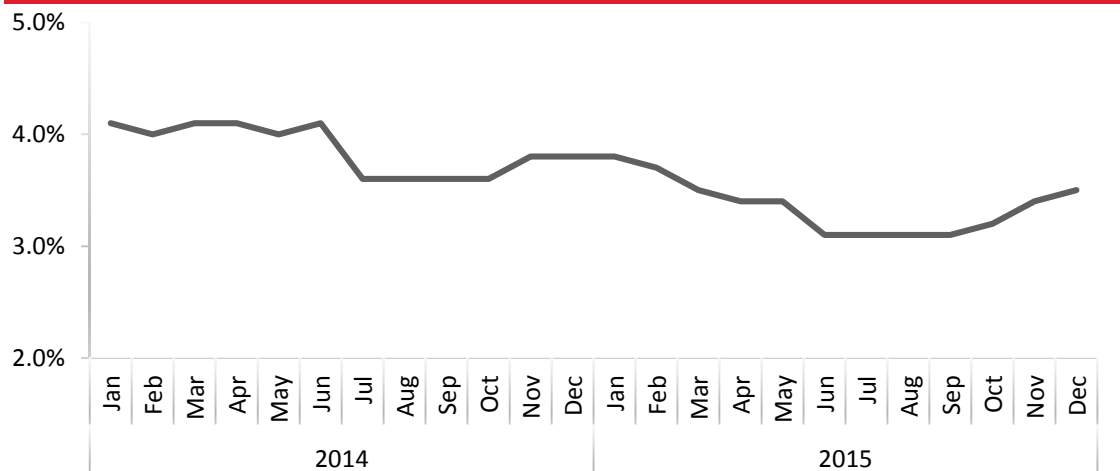
Private sector employment growth



Source: Labour Market Regulatory Authority

The official unemployment rate, which measures the number of people claiming the unemployment benefit, rebounded slightly over the last three months of the year to reach 3.4% in the last quarter. The majority of registered unemployed lie within the 25-29 age category, accounting for 36% of total claimants in December. In spite of the slight increase, unemployment remains low by historical standards.

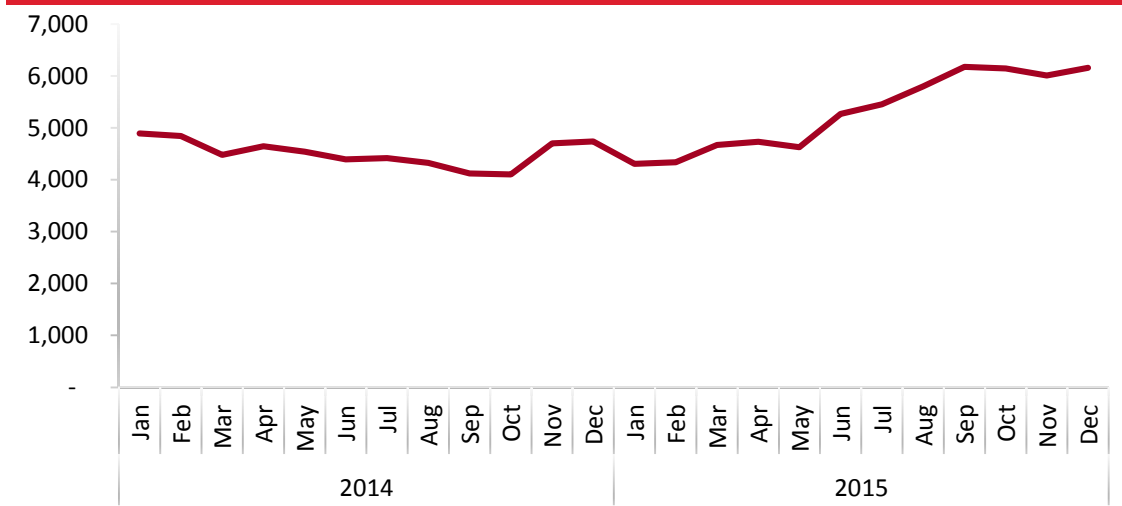
Unemployment rate (%)



Source: Ministry of Labour

The vacancy bank of the Ministry of Labour recorded 6,159 vacancies by the end of the year. The number of vacancies has increased by 30% YoY in December.

Number of vacancies reported by the Ministry of Labour



Source: Ministry of Labour

External assessments

Bahrain continues to hold the first position in the region in the 2016 Index of Economic Freedom published by the Heritage Foundation and the Wall Street Journal. The index assesses 178 economies based on multiple quantitative and qualitative factors in four categories: rule of law, limited government, regulatory efficiency, and open markets. Bahrain is ranked 18th globally but has been consistently recognized as the freest economy in the Middle East for the past several years. Bahrain's core strengths lie in its fiscal freedom, financial freedom, and trade freedom— all areas where the country scores 80 or above (out of 100).

The 2016 *Emerging Markets Logistics Index* published by Agility – a global logistics corporation- and Transport Intelligence – a logistics-focused research center – ranks countries based on size and attractiveness in terms of growth, as well as compatibility and connectedness. The report assessed 45 countries and ranked Bahrain the seventh most connected emerging market given its excellent domestic and international transport infrastructure. Bahrain further holds the 11th position in compatibility which is a composite index measuring market accessibility, business regulation, FDI, market risk, and the level of demand for logistics services.

Bahrain held the 42nd position globally in the *World Happiness Report* published by the UN Sustainable Development Solutions Network. In the Environmental Performance Index, Bahrain held the first position in the GCC and 86th globally among 180 countries assessed on environmental health and ecosystem vitality. Bahrain's performance is driven by the enhanced biodiversity and habitat, as well as improved waste water treatment and agriculture.

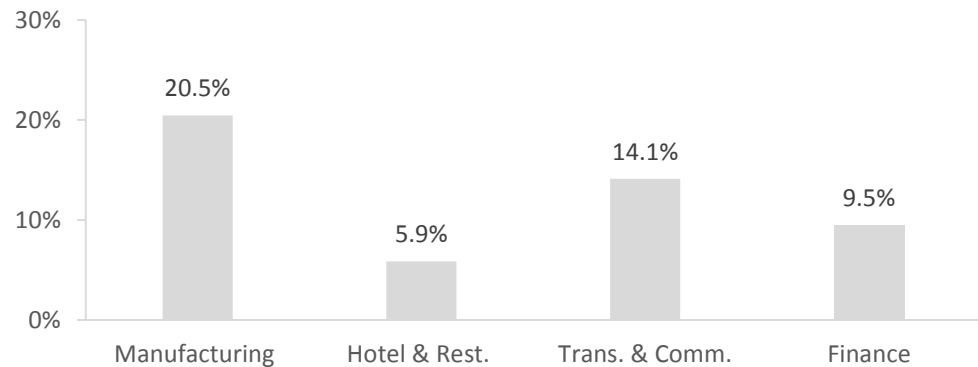
Following the recent downward pressures on oil prices, Moody's Investors Service downgraded Bahrain's long-term issuer rating from Baa3 to Ba1 with a negative outlook. Bahrain's foreign

currency bond ceiling was lowered to Baa2 from Baa1 and foreign currency deposit ceiling from Baa3 to Ba2. The local currency country risk ceilings were lowered from A3 to Baa1. Moody's stated that the main driver of the downgrade was the negative impact of the fall in oil prices on the government's finances, balances of payments, and overall economic performance. Standard & Poor's Ratings Services also lowered Bahrain's long and short term foreign and local currency sovereign credit ratings from BBB-/A-3 to BB/B. The outlook on Bahrain and the Central Bank is stable.

KEY SECTORS

NON-OIL DRIVERS STRENGTHEN

Contribution of priority sectors to GDP growth in 2015 (% of the GDP increment)



Source: Information & e-Government Authority

Employment growth in financial services

The financial services sector has continued to post strong growth in spite of the challenges created by oil price volatility. Employment in the sector increased by 2.8% during 2015. Growth was particularly rapid in the non-bank financial sector, highlighting Bahrain's strength in the middle office and ancillary services area. Employment by money changers rose by 10.8% whereas financial companies and microfinance institutions saw 8.3% growth. Banking sector employment expanded by 1.1%. The proportion of Bahraini women among the nationals employed in the sector rose to 38.2% from 37.4% last year. The Bahraini workforce employed by the financial services sector reached 9,040 in 2015, representing 70% of total workforce in the sector.

The new edition of KPMG's *Cost of Doing Business in Bahrain* report on the financial services sector was released at the end of 2015 and underscored a key competitive advantage of Bahrain's financial cluster in the area of operating costs. The report assesses the costs associated with operating a firm in the financial services sector in Bahrain, Dubai, and Qatar. It analyses the cost of licensing and registration, commercial rental rates, occupancy costs, manpower costs, communication and utility expenses, and corporate taxes. The findings indicate that the cost of doing financial services business in Qatar and Dubai is 46% and 37% higher, respectively, than in Bahrain (assessed on an office of 300 sq m with seven employees). Rental rates, manpower costs, and living expenses remain significantly lower in Bahrain than in the rest of the region.

New market entrants in the Bahraini financial sector included JS Bank, a Pakistan-based entity, which officially opened its first branch outside of Pakistan to target the GCC and the rest of the Middle East-North Africa region. JS Bank is the eighth Pakistani wholesale bank licensed in Bahrain. The bank has a network of 278 branches across 138 cities, and it is part of JS Group which is one of Pakistan's largest business entities.

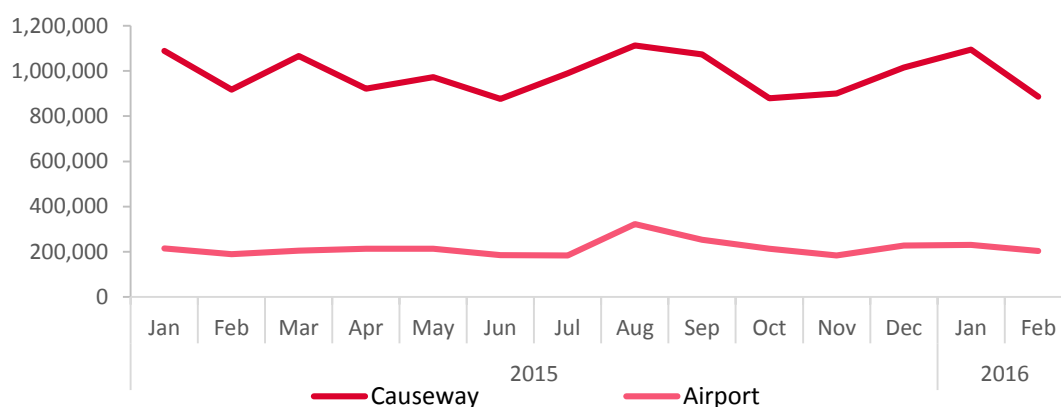
A number of key events with a financial services focus took place during Q1:

- ▶ The fifth annual *Euromoney GCC Financial Forum* in February brought together 700 financiers, investors, business leaders, and policy makers from the GCC and beyond. The conference included discussions on macroeconomic conditions, capital markets developments, wealth management, Islamic finance, technology and innovation over a two-day period
- ▶ The 12th annual *Middle East Insurance Forum* was held in February and attracted 400 delegates from across the region to discuss new strategies to assess the direction of the industry. The theme of the forum was “GCC: The New Insurance Landscape.” The Insurance industry in the region accounts for 0.5% of the world market and has considerable growth potential due to internationally low penetration rates. The forum saw the launch of the “Finance Forward Middle East Insurance Outlook Report 2016” which reviews the outlook for next year and discusses some of the key challenges facing the sector, including intense competition in the largest markets and regulatory fragmentation. The report further highlighted a significant divergence in the returns on assets that insurers in different markets generate
- ▶ The Bahrain Asset Managers Associations hosted a high-level panel discussion on “Special Purpose Vehicles (SPV) and Corporate Entities Component in Investment Banking and Asset Management” on the 29th of March. The discussion focused on the economic benefits and spill-overs of SPV related activities, the legal framework required for SPVs, and regional competition. The SPV business is seen to hold considerable potential for Bahrain to further position itself as a hub for asset managers

Tourism benefits from record visitor numbers

The total number of arrivals to Bahrain increased by 8% during with around 14.5mn visitors. In December, arrival numbers via the causeway increased by 7% and via the airport by 15%. The peak in Q1 was reached in January 2016 in connection with a busy calendar which included the Bahrain International Air Show as well as the Autumn Fair. Hotel occupancy rates reflected the increased number of arrivals in January at 55.8% which is higher than December’s 48%.

Visitor arrivals by port of entry



Source: Ministry of the Interior

Bahrain has been named the 'Capital of Gulf Tourism' by the GCC ministers of tourism in recognition of the strength of the tourism sector in the country. Under this initiative – a collaborative effort by Bahrain Tourism & Exhibitions Authority, Tamkeen, the Bahrain International Circuit, and the EDB – a range of initiatives aims to strengthen the development of a two-way tourism between Bahrain and other GCC countries and to familiarize the historic cities of the region.

The 30-day 'Shop Bahrain' festival, which concluded on 23 January, generated BHD11mn (USD28.9mn) of sales revenues, far in excess of expectations. The festival created more than 175 temporary job opportunities for Bahraini youth, and it involved 160 local businesses who got the opportunity to showcase their products to local and regional visitors. Over 60,000 visitors attended the various events held during the festival.

A number of other key events of the tourism calendar happened during Q1:

- ▶ The Bahrain Gaming Experience 2016 was inaugurated on 14 January at the Bahrain International Exhibition and Convention Centre. The three-day event, held in partnership with Sony, was the first of its kind in the region. During the event, Sony unveiled its virtual reality head-mounted display for the first time in the world
- ▶ The fourth edition of the Bahrain International Air Show took place between 21 and 23 January. Around 30,000 visitors turned out at both the public and trade days of the air show and more than 135 companies took part. The total value of orders

reached USD9bn, more than triple the 2014 figure

- ▶ The 27th Autumn Fair, largest consumer products exhibition in Bahrain, was held at the Bahrain International Exhibition and Convention Centre. The ten-day event showcased a wide range of merchandise from across the globe, including specialty foods, textiles, furnishings, electrical goods, and more. The exhibition attracted more than 144,000 visitors in the first week
- ▶ The annual Bahrain International Garden Show 2016 was opened on 24 February. The exhibition was organized by the National Initiative for the Development of the Agricultural Sector, in collaboration with Tamkeen and the United Nations Industrial Development Organization (UNIDO)
- ▶ On February 25, the Bahrain Food Festival was launched at Block 338 in Adliya. The ten-day event was organized by the Bahrain Tourism & Exhibitions Authority in celebration of 'Manama Gulf Capital of Tourism 2016'
- ▶ Bahrain hosted the 2016 Food and Travel GCC Tourism Awards Ceremony on 29 February. The event, organized by the *Food & Travel* magazine, was attended by regional as well as international guests working in the food and hospitality industry
- ▶ Produced by Feld Entertainment in partnership with the Bahrain Tourism and Exhibitions Authority, the Disney Live! Mickey's Music Festival debuted on 15 March at the Bahrain International Exhibition and Convention Centre and lasted until the 19 March
- ▶ The 17th Bahrain International Book Fair was inaugurated on the 24th of March and is expected to run until the 3rd of April. The exhibition, held at the Bahrain National Museum, was organized by the Bahrain Authority for Culture and Antiquities. The fair showcases more than 350 publishing houses and features a wide range of side events such as book signings and launches.

The 11th edition of the Spring of Culture was launched in February. The event is organized by the Bahrain Authority for Culture and Antiquities (BACA), the Economic Development Board, and the Shaikh Ebrahim Centre for Culture and Research, as well as several art galleries (Al Bareh Art Gallery, Al Riwaq Art Space and La Fontaine Centre of Contemporary Art).

The festival program features a range of events and activities, including thought seminars, music concerts, theatrical productions, and fine arts exhibitions. Some of the highlights in Q1 included a concert by Kadim al Sahir, Seal, and Halit Ergenç, as well as the famous Carcalla Dance Theatre.

Metals manufacturing gathers momentum

The manufacturing sector has seen a number of new developments over the first three months of the year, as well as progress with existing projects.

In January, Mumtalakat signed an agreement with Mueller Industries, a leading manufacturer of flow control and industrial products, and Cayan Ventures, a GCC-based industrial projects developer, to build a copper tube manufacturing mill. The USD40mn facility is expected to generate 200 employment opportunities. This will be the first copper tubing facility in the region and it will produce commercial copper tubes to serve air conditioning and refrigeration. The facility will be located at the Bahrain International Investment Park.

Additionally, Mumtalakat announced the acquisition of a minority equity stake in Gulf Cryo, a leading regional manufacturer, distributor, and service provider of industrial gases based in Kuwait. The company's capabilities include a considerable pipeline network, the largest merchant air separation production capacity in the region, as well as an extensive network of facilities manufacturing and distributing oxygen, nitrogen, acetylene, carbon dioxide, dry ice, hydrogen, nitrous oxide, food-grade, specialty and medical gases.

In the aluminium sector, Mumtalakat acquired 49% equity stake in Asturiana de Aleaciones S.A, a Spanish-based manufacturer of aluminium grain refiners and master alloys. This is part of a bigger plan to promote the downstream aluminium sector in Bahrain and to strengthen the synergies between local and international key players in manufacturing. Underscoring the growing momentum in the aluminium cluster, Alba recently announced that it has upgraded the technology for its Line 6 Expansion Project. The upgrade will boost Alba's production by another 26,000 metric tonnes per annum to reach 540,000 tn. This will bring Alba's total capacity to approximately 1,500,000 tn a year, making the company the largest single site smelter in the world. Alba's Line 6 Expansion Project timeline remains on track with the first hot metal scheduled for January 2019.

Electrosteel Castings, the world's third largest producer of ductile iron pipes and ancillary products, inaugurated their new USD6.6mn warehouse in Bahrain in February. The Bahrain facility will act as the regional hub for sales and distribution activities to other Middle Eastern markets and is designed as a one-stop solution for water projects in the region.

SMS Group, part of German SMS Holding GmbH, has announced plans to increase its presence in Bahrain. The company has moved its operations from Dubai to Bahrain and has upgraded its office (formerly known as SMS Meer, now known as SMS Technical Service Gulf SPC) to include technical service support. The company relocated 50 employees to Bahrain.

Al Futtaim Auto and Machinery Company, a leading supplier of commercial vehicles, construction, and industrial equipment in the region, is launching its operations in Bahrain. The company will distribute top brands such as Volvo Construction Equipment, SDLG construction equipment, Merlo telescopic handlers, Hartl crushers and screeners, Dexion industrial storage systems, Hart industrial doors, Steril warehouse docks, Nassau sectional doors and BP side loaders and forklifts.

Mondelez, which announced its opening in Bahrain, has launched the construction of its manufacturing plant in the Bahrain International Investment Park. The USD90mn factory will

produce Oreo, Ritz, belVita, Price, and TUC biscuits. It will create as many as 400 direct jobs and hundreds more of indirect jobs.

Many initiatives are underway to boost the potential of logistics sector. Three key logistics-related events took place in Bahrain during Q1:

- ▶ The annual *Gulf Industry Fair* showcased aluminum, energy, industrial services, logistics, and other companies over a three-day period. This year, the exhibition saw an increased participation of companies from the UAE and Saudi Arabia. The fair also included an Innovation Forum and Industry Careers Day
- ▶ The 12th Middle East Geosciences Conference and Exhibition (GEO16) hosted energy industry professional from more than 50 countries. The exhibition showcased oil and gas exploration technology, products, and services available in the region. The conference consisted of more than 200 technical presentations, around 120 poster presentations, and five panel sessions
- ▶ The first *GCC Logistics Conference* 'Costs and Challenges' took place on 30-31 March. The conference was jointly organized by a Germany-based leading logistics consultancy TransCare and the Economic Development Board. The event targeted top managers and shareholders who are planning to expand their transport and logistics business in the GCC

The first startup studio in the region

The ICT industry recently saw the establishment of Level Z, the first start-up studio in the MENA region, which was officially launched in August 2015. The facility is designed as an infrastructure for generating and developing multiples idea into successful business concepts in parallel through resource-sharing. The idea is developed into a product within Level Z, tested, launched, and ultimately rolled out into a company of its own. Level Z plays an active role in helping get investors to fund this new company. It continues to hold the major share in the early stages until the company fully stands on its own.

Level Z currently has five products in their pipeline. The first one to have been formally launched was *Skiplino*, a queue management system designed to reduce inefficiencies in queuing through better information management and dissemination. In guiding the process, the product takes into consideration factors such as distance from the service provider, the traffic to the service provider, and an indicator of the speed of the service. *Skiplino* is a free-of-charge app which allows the user to book his slot on the cloud. The product is available in both Arabic and English.

The second product of Level Z is *Verrt*, a platform that connects media providers and consumers globally. The idea is to provide all the necessary information without the involvements of intermediating agencies.

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