Rabobank

Country Report

BAHRAIN

Summary

Bahrain is a rich, small, liberal and free-trade island economy, which houses an important regional financial center and some major oil and aluminum processing plants. This combined with its strategic position between Saudi Arabia's oil fields and nuclear Iran caused the US navy to select this kingdom as its most important base in the Persian Gulf. Recently, the Arab Spring also reached Bahrain, with the demands for a more accountable government. The protests were violently suppressed by 'invited' troops from Saudi Arabia and other Gulf states. Religious Shi'ite-Sunnite sectarian friction is present but plays only a secondary role in this relatively easy–going Arab enclave. Banking, business conferencing and tourism will suffer from the unrest, less so the oil processing industry.

Things to watch:

- Impact of unrest on status as financial hub
- Foreign exchange reserves
- Cost of external funding as reflected on income balance

Author: **Leendert Colijn**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-67063
L.Colijn@rn.rabobank.nl

Bahrain

National facts		
Type of government	constitutional monarchy	
Capital	Manama	
Surface area (sq km)	760	
Population (millions)	1.1	
Main languages	Arab (official)	
	English (widely spoken)	
Main religions	Shi'ites (56%)	
	Sunnites (25%)	
	Christian (9%)	
Head of State (king)	Hamad bin Isa Al-Khalifa	
Head of Government (PM)	Khalifa bin Salman Al-Khalifa	
Monetary unit	Bahraini dinar (BHD)	

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	21	0.03
Nominal GDP at PPP	30	0.04
Export value of goods and services	20	0.11
IMF quotum (in mln SDR)	135	0.06
Economic structure	*2010*	*5-year av.*
Real GDP growth	4.2	6.5
Agriculture (% of GDP)	1	0
Industry (% of GDP)	57	58
Services (% of GDP)	42	42
Standards of living	*USD*	*% world av.*
Nominal GDP per head	16843	171
Nominal GDP per head at PPP	23983	205
Real GDP per head	14383	180

Social and governance indicators	rank / total
Human Development Index (rank)	39 / 169
Ease of doing business (rank)	28 / 183
Economic freedom index (rank)	10 / 179
Corruption perceptions index (rank)	48 / 178
Press freedom index (rank)	144 / 178
Gini index (income distribution)	n.a.
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Saudi Arabia	3	Saudi Arabia	23
India	2	France	10
Japan	2	US	8
US	2	China	6

Main export products (%)	
Petroleum	74
Aluminium & aluminium products	8
Chemical products	5
Transport equipment	1
Main import products (%)	
Crude oil	43
Machinery and appliances	10
Transport equipment	9
Chemical products	9
Openness of the economy	
Export value of G&S (% of GDP)	95
Import value of G&S (% of GDP)	71
Inward FDI (% of GDP)	3.7

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

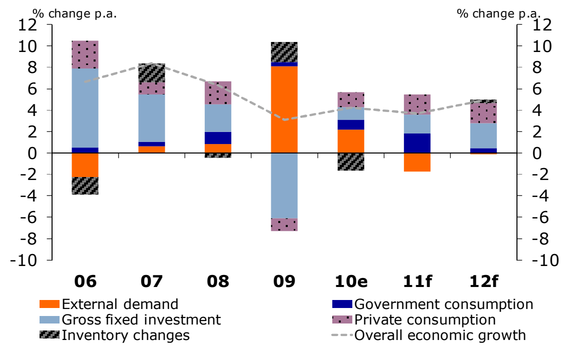
Economic structure and growth

Bahrain is the smallest country in the Persian Gulf with just over 1 million inhabitants of which half is expatriate. It is probably the most diversified economy in the Persian Gulf. The discovery of oil in 1932 brought rapid modernization to Bahrain. Also, it was the first Gulf state to take serious action in the late 1990’s to diversify its economy to prepare for the post-oil and post-gas period. By now and unlike its fellow Gulf Co-operation Council (GCC) states, Bahrain does not possess significant gas or oil reserves anymore, but continues to depend heavily on oil. Crude oil is imported from neighboring Saudi oil fields and processed on the island. Petroleum processing and refining account for over 70% of Bahrain's export receipts, over two-thirds of government revenues and 11% of GDP. Other major economic activities are the expanding and very energy-intensive production of aluminum and construction, which is based on imported natural gas.

Services are most visible through banking and finance. The latter represents some 25% of GDP, although also business conferencing and tourism contribute significantly to GDP. Tourism is to a large extent based on rich (male) Saudis taking weekends off, attracted by the nightlife in this in many respects liberal enclave.

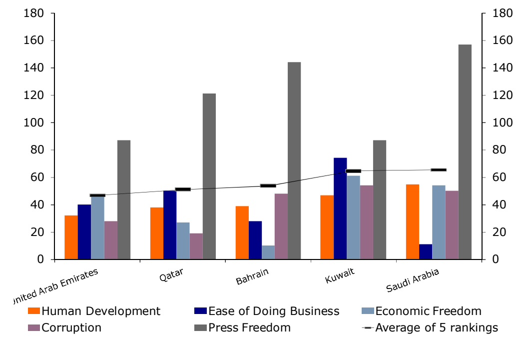
The financial sector started to grow already in the 1970's as Bahrain replaced civil war-plagued Beirut as the Middle East's financial hub. Currently, Kuwait, Dubai and Qatar are competing to become the leading financial center of the Gulf states. The present unrest on this island will do little good for Bahrain’s current leading position in this competition. But in the area of Islamic banking, attracted by the stringent banking regulation in place, Bahrain is only second to Malaysia. The highly developed banking, communication and transport facilities caused many numerous multinational firms and banks to choose Bahrain as its regional home. Helpful in its diversification plans was the implementation of a Free Trade Agreement (FTA) with the US in August 2006, which was the first of its kind with a Gulf state.

Chart 1: Growth drivers and performance



Source: EIU

Chart 2: Social and governance indicators



Source: EIU

Growth prospects remain positive as two effects of the unrest are estimated to balance out: oil processing volumes and manufacturing are likely to remain stable which helps to maintain or even increase income levels, but tourists may stay away, business conferences cancelled and banking could suffer as well. Real GDP growth is projected to average 4% over the next years. Although this estimate is subject to downward risk, even pessimists count on positive growth of 3%.

Political and social situation

Having been a British trading post and protectorate till 1971, the legal system is still based on English common law (and partly on Islamic law) and English is widely spoken. Also, the island is known for its indigenous middle class of largely Sunnite Muslim origin. In this trading-based society a political and social atmosphere developed, that is far more liberal and woman-friendly than found in politically rigid Sunnite Saudi Arabia and theocratic Shi'íte Iran. Non-religious and Christian minorities comprise almost 20% of the population of this small Gulf society, which is considered religiously and ethnically relatively tolerant. Political and economic power is effectively with the Sunnite minority, with the royal family having a dominant say. A constitutional reform in 2001 established a partly elected, albeit lame, parliament with loose 'societies' acting as proxy for political parties, which are not allowed. It was expected that these moderate concessions would make it immune to the wave of unrest, that hit the Arab world in 2011.

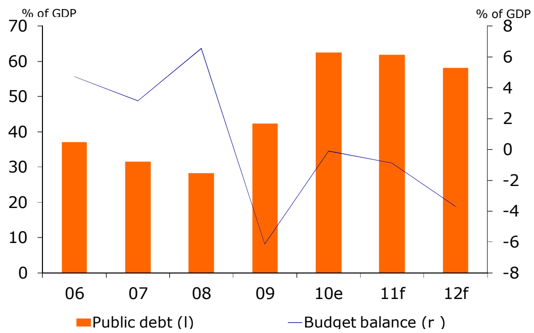
However, recently political unrest with several protesters killed erupted and this may very well continue openly or latently as demands for social change and more political liberties continue. There is wide-spread social discount about the lack of well-paid and intellectually stimulating employment perspectives for the often well-educated nationals, although unemployment of the nationals is fairly low (4%). Specialist jobs are often awarded to cheaper expatriates. Shortage of housing and low or lacking social benefits for the poor in this rich country add to the frustration. The political demands center on the lack of an accountable and elected government. The hard-line prime minister is a key target. He is member of the royal family, widely suspected of massive corruption during his 40 years of leading the government and now likely the richest person in the country. Initial empathy and understanding of the 'liberal' Crown Prince in the royal family for the demands and a one-off financial allowance for each family raised hopes for peaceful changes. By

mid-March 2011, however, the authorities are unwilling to give in and used violent means to clean the streets of the capital. They are backed by military forces from Saudi Arabia and the United Arab Emirates military. The king Hamad bin Isa al-Khalifa is generally expected to remain the ruler, but changes of ministerial faces in his government should come as no surprise.
The ruling elite has for long been Sunnite, while the Muslim population is largely Shi'ite. The protest, however, are broadly based and contrary to suggestions in the official communiqués, not sectarian (in a religious sense). Neither are there indications that Shi'ite dominated but non-Arab Iran is actively involved to stir unrest. The Bahraini Shi'ite majority is ethnically and culturally much closer to the Arab Shi'ites, who live in the oil rich regions of neighboring Saudi Arabia. Both groups face religious prejudice from their ruling Sunnite elites, political marginalization and socioeconomic disadvantages. The non-Bahraini third of the population (1.1 million) is not actively engaged in the political unrest, nor are there reports of strong anti-foreigner sentiments. However, the cheap non-Bahraini workers (no less than 75% of the labor force) are crowding out the employment perspectives of the often highly educated nationals. Unemployment, especially among the young and increasingly vocal women, has for long been a problem. In 2009, to help lower unemployment among Bahraini nationals, measures were taken by increasing the costs of employing foreign labor. In addition, unemployment benefits (first in the region in 2007) is available for nationals only.
Saudi Arabia's ruling elite has adopted a big brother approach to the rulers of this small neighbor by largely tolerating its liberalism, but remains very wary of both Shi'ite Iranian influence and modern tendencies to spill-over into their own country. As this recently threatened to happen, Bahrain was effectively invaded and treated as a province of Saudi-Arabia, the regional power. Also the Unites States naval forces have a major presence with the primary aim to defend the US's energy interests, located not in Bahrain, but in its immediate Saudi hinterland. Unrest could spread to Saudi's Eastern Province, by far the largest oil base of that country, which holds 10% of the world's oil reserves. The 2 million Shi'tes of this province form a regional majority, have expressed -albeit on a small scale- political grievances and even suggested secession from the Saudi Kingdom. Both Saudi Arabia and the US have thus likely to actively ensure their strategic interests in supporting the present rulers of this small state in the Gulf.

Economic policy
With its small economy and population, Bahrain is aware of the importance of free trade and inward investment for continued economic prosperity. It has developed a very liberal environment for domestic and foreign private investment, which are equally treated. Last year it was considered the freest economy in the Middle East and tenth freest overall in the world based on the 2011 Index of Economic Freedom (see chart 2). Stimulating the diversification away from oil and 'Bahrainisation' of the labor force are key elements of economic policy.
Macroeconomic policies are geared to maintain fiscal, monetary and exchange rate stability. Fiscally, oil related incomes dominated the revenues side, but this source is physically drying up. Revenues have structurally been decreasing as a share of GDP to around 29% in 2010, from 35% in 2000. In addition, oil prices increases did not compensate for lower volumes. Expenditures are fluctuating between 28% and 35% of GDP with subsidies a substantial part. Recently, a family allowance of USD 2,600 irrespective of financial need was granted, but proved unsuccessful in peacefully pre-empting protests. Large fiscal surpluses of up to 7% of GDP in the recent past are unlikely to be repeated in the years to come. The oil dependency is illustrated (see chart 3) by the huge change in the fiscal balance between 2008 (+7% of GDP) and 2009 (-6% of GDP) mostly as a result of lower oil prices. This also contributed to the sudden and very substantial increase in government debt in 2009. But in 2010, government debt increased further reflecting capital

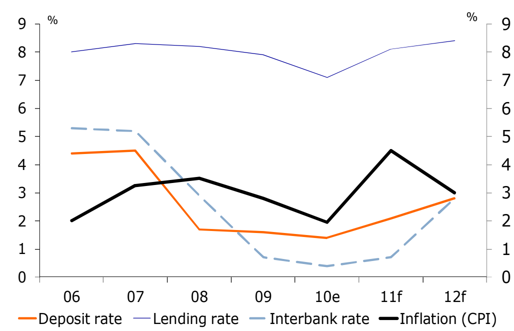
support for the financial sector to the amount of around 25% or more of GDP over 2009 and 2010. This capital support must have remained off-budget. This can be deducted from the steep rise of the debt-GDP ratio from 30% at the beginning of 2009 to a still acceptable level of 60% at the end of 2010 with published realized budgets over these years of only -6% and -0.1% of GDP respectively. Given the huge size of the banking sector (total assets close to 900% of GDP), if this sector is hit again, government support may potentially lead to unsustainable public debt levels. The authorities are aware that the low tax status of the island is nearing its end. Taxes are being prepared on personal incomes and wage earners must increasingly pay for social insurance contributions. Projections are moderate fiscal deficits of 2% to 4% of GDP and public debt/GDP ratios at a higher level of around 60% of GDP.

Chart 3: Public finances



Source: EIU

Chart 4: Interest rates and inflation



Source: EIU

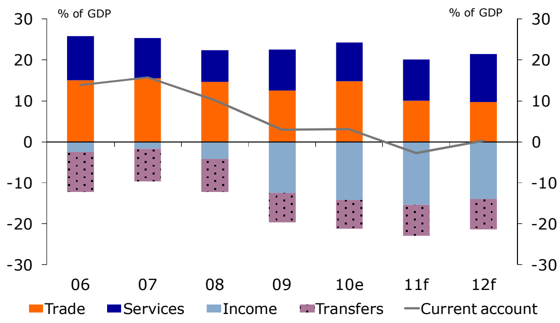
Monetary policy is primarily geared to maintain the fixed peg to the US dollar (unchanged for over two decades) without much direct intervention in the exchange markets. To help maintaining the peg, interest rates will continue to follow the US policy rates. Inflation are is thus largely imported through food and commodity prices, although market price pressures are partly mitigated by subsidies.
Bahrain's most important export products hydro-carbonic products and aluminium account for 27% and 10% of Bahrain's GDP respectively, both priced and paid for in US dollars. Moreover, oil revenues account for approximately 75% of Bahrain’s government income and the US dollar peg removes exchange rate risk for government income. A currency union with Kuwait, Qatar and Saudi Arabia is under preparation for many years already, but repeatedly postponed as consensus on the role of the union’s central bank and inflation convergence is still not attained.

Balance of Payments

As chart 5 shows, Bahrain's current account balance is structurally characterized by surpluses in merchandise trade (oil and aluminum driven) and international services (banking, business and tourism), totaling 20% of GDP or more. Large deficits occur in net transfers (5% of GDP), which is related to the country's large expatriate workforce (almost 50% of the population) sending home a portion of its earnings. The income balance shows persistent and growing deficits of up to 15% of GDP, reflecting the outflow of profits, dividends and interest payments, that substantially exceed the apparently low yields of Bahrain’s external assets. Bank’s funding costs are projected to remain high. As a result, the current account will show in 2011 a small deficit of 3% of GDP, compared to surpluses that reached 15% of GDP just four years ago.
Despite net outflows of portfolio and direct investments in 2010 and 2011 Bahrain's gross international reserves will slightly increase to just below USD 4.8n as some new debt is incurred

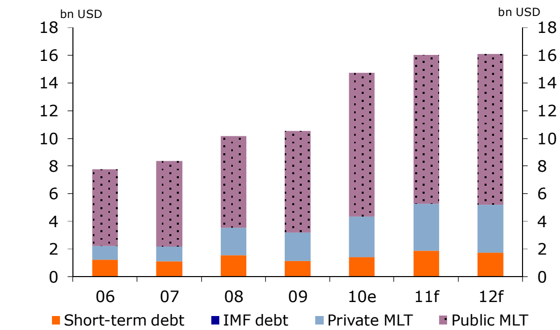
and informal balance of payment support is provided by the Saudi authorities to its 'province in need'.

Chart 5: Current account



Source: EIU

Chart 6: Foreign debt by creditor type

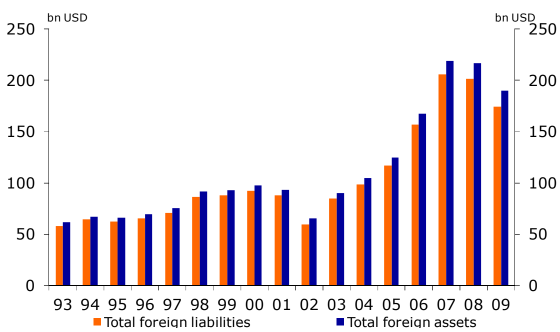


Source: EIU

External position

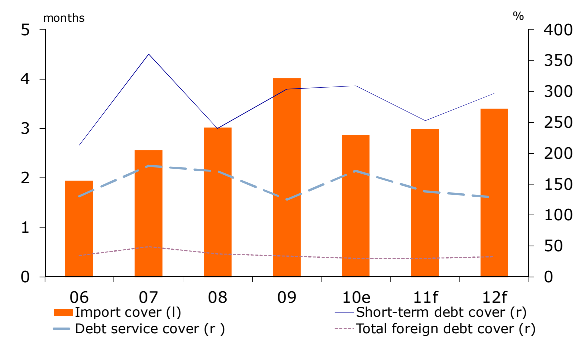
Total external debt is projected to double in nominal terms since 2006 from USD 8bn to USD 16bn by the end of 2011. Short-term debt is around 10% of total debt, which keeps refinancing needs at low levels. Annual repayments on medium and long term debt amount to only 8% of total outstanding, implying an average effective maturity of a comfortable 12 years, but at a price: the interest payments on this MLT debt was around 6% and is projected to increase. Most of the debt is guaranteed by the public sector, but owed to private sector creditors. There is no history of arrears.

Chart 7: Foreign assets and liabilities



Source: EIU

Chart 8:



Source: EIU

Data for the country's international investment position (chart 7) indicate a modest positive net creditor position of USD 16bn (75% of GDP) by the end of 2009, up from USD3bn in 1993. The increase is more or less in line with the accumulated current account surpluses of USD 10bn over the 16 year period. Value changes explain the remaining difference. The value of assets and liabilities (both substantial at around nine times GDP in 2009) strongly correlate, which reflects its status as a financial transit center.

In terms of liquidity, the country is in a moderately comfortable position. Annual debt service payments amount to a modest 15% of total current account revenues, where half of it is related to short term (presumably trade-related) obligations and 4% is needed for interest payments. Most other liquidity indicators (see chart 8) show a stable level, but the available foreign exchange reserves were and are projected to remain low at barely three months of import value.

Bahrain

Bahrain, Nominal GDP (US$), USD	15.9	18.5	22.2	19.3	20.8	21.7	24.2
Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	6.7	8.4	6.3	3.1	4.2	3.7	4.9
Consumer prices (average % change pa)	2.0	3.3	3.5	2.8	2.0	4.5	3.0
Current account balance (% of GDP)	13.8	15.7	10.2	2.9	3.0	-2.8	0.2
Total foreign exchange reserves (mln USD)	2688	4094	3797	3534	4481	4750	5230
Economic growth							
GDP (% real change pa)	6.7	8.4	6.3	3.1	4.2	3.7	4.9
Gross fixed investment (% real change pa)	31.1	15.2	8.2	-19.2	5.0	7.0	9.0
Private consumption (real % change pa)	5.7	2.5	5.1	-2.9	3.5	4.8	4.7
Government consumption (% real change pa)	2.8	2.5	6.8	2.2	5.6	10.5	3.0
Exports of G&S (% real change pa)	17.6	10.2	16.2	-17.8	7.6	6.3	6.5
Imports of G&S (% real change pa)	23.0	10.6	16.9	-27.2	6.4	10.0	8.0
Economic policy							
Budget balance (% of GDP)	4.7	3.1	6.6	-6.1	-0.1	-0.9	-3.7
Public debt (% of GDP)	37	32	28	42	63	62	58
Money market interest rate (%)	5.3	5.2	2.9	0.7	0.4	0.7	2.8
M2 growth (% change pa)	15	39	20	6	10	11	13
Consumer prices (average % change pa)	2.0	3.3	3.5	2.8	2.0	4.5	3.0
Exchange rate LCU to USD (average)	0.376	0.376	0.376	0.376	0.376	0.376	0.376
Recorded unemployment (%)	15%	n.a	n.a	n.a	n.a	n.a.	n.a.
Balance of payments (mln USD)							
Current account balance	2188	2907	2257	560	630	-610	60
Trade balance	2386	2865	3245	2439	3087	2170	2380
Export value of goods	12340	13790	17491	12052	15762	17720	16830
Import value of goods	9954	10925	14246	9613	12676	15550	14450
Services balance	1717	1823	1710	1912	1962	2200	2830
Income balance	-385	-299	-924	-2400	-2938	-3320	-3360
Transfer balance	-1531	-1483	-1774	-1391	-1482	-1650	-1800
Net direct investment flows	1935	87	174	2049	-78	-240	10
Net portfolio investment flows	-8831	-8560	9277	8276	-2680	-4620	-2700
Net debt flows	1274	589	1810	376	4225	750	110
Other capital flows (negative is flight)	4252	6384	-13815	-11523	-1149	4980	2990
Change in international reserves	817	1407	-298	-263	948	270	480
External position (mln USD)							
Total foreign debt	7772	8361	10171	10546	14772	16020	16130
Short-term debt	1262	1138	1583	1162	1451	1880	1760
Total debt service due, incl. short-term debt	2058	2276	2228	2818	2609	3420	4070
Total foreign exchange reserves	2688	4094	3797	3534	4481	4750	5230
International investment position	10195	13168	15455	15853	n.a	n.a.	n.a.
Total assets	167263	218713	217015	190239	n.a	n.a.	n.a.
Total liabilities	157068	205545	201560	174386	n.a	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	15.1	15.5	14.6	12.6	14.8	10.0	9.8
Current account balance (% of GDP)	13.8	15.7	10.2	2.9	3.0	-2.8	0.2
Inward FDI (% of GDP)	18.4	9.5	8.1	1.3	3.7	4.4	5.2
Foreign debt (% of GDP)	49	45	46	55	71	74	67
Foreign debt (% of XGSIT)	33	30	36	61	68	66	67
International investment position (% of GDP)	64.3	71.3	69.8	82.1	n.a	n.a.	n.a.
Debt service ratio (% of XGSIT)	9	8	8	16	12	14	17
Interest service ratio incl. arrears (% of XGSIT)	2	2	2	3	3	4	4
FX-reserves import cover (months)	1.9	2.6	3.0	4.0	2.9	3.0	3.4
FX-reserves debt service cover (%)	131	180	170	125	172	139	128
Liquidity ratio	131	146	217	288	244	218	233

Source: EIU