Country report **BAHRAIN**

Summary

The largest country risks for Bahrain lie in the political and social spheres. We expect the social unrest originated in the Arab spring uprising last year to continue as the grievances of the Shi'a community are not likely to be met anytime soon by the ruling al Khalifa family. The fiscal position has been on a deteriorating trend since 2009 and is expected to post a 6% of GDP deficit in 2012. The current account balance is in moderate shape with small surpluses but too dependent on hydrocarbon exports. Most external liquidity indicators show stable levels, but an escalation of the social unrest is a large downside risk, as it is quick to affect investor sentiment and induce capital flight.

Things to watch:

- Continued social unrest as the government is reluctant to implement reforms
- Sentiment of foreign investors and businesses
- Global oil prices

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Bahrain

National facts		
Type of government	Constitutional Monarchy	
Capital	Manama	
Surface area (sq km)	760	
Population (millions)	1.2	
Main languages	Arab (official)	
	English (widely spoken)	
Main religions	Shi'ites (56%)	
	Sunnites (25%)	
	Christian (9%)	
	Other (10%)	
Head of State (king)	Hamad bin Isa Al-Khalifa	
Head of Government (prime-minister)	Khalifa bin Salman Al-Khalifa	
Monetary unit	Bahraini dinar (BHD)	
Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	20	0.03
Nominal GDP at PPP	31	0.04
Export value of goods and services	24	0.11
IMF quotum (in mln SDR)	135	0.06
Economic structure	*2011*	*5-year av.*
Real GDP growth	1.8	5.8
Agriculture (% of GDP)	0	0
Industry (% of GDP)	65	61
Services (% of GDP)	35	38
Standards of living	*USD*	*% world av.*
Nominal GDP per head	15600	144
Nominal GDP per head at PPP	24261	196
Real GDP per head	14231	175

Social and governance indicators	rank / total
Human Development Index (rank)	42 / 187
Ease of doing business (rank)	38 / 183
Economic freedom index (rank)	10 / 179
Corruption perceptions index (rank)	46 / 183
Press freedom index (rank)	144 / 178
Gini index (income distribution)	n.a.
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Saudi Arabia	3	Saudi Arabia	24
India	2	France	12
Japan	2	US	8
US	2	China	6
Main export products (%)			
Petroleum			71
Aluminium & aluminium products			9
Chemical products			5
Transport equipment			1
Main import products (%)			
Crude oil			48
Machinery and appliances			10
Transport equipment			9
Chemical products			9
Openness of the economy			*2011*
Export value of G&S (% of GDP)			120
Import value of G&S (% of GDP)			96
Inward FDI (% of GDP)			0.7

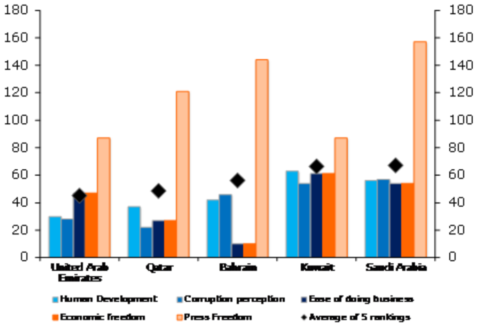
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Bahrain is the smallest country in the Persian Gulf with just over 1 million inhabitants of which half is expatriate. 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, and as such it is probably the most diversified economy in the region. 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. Bahrain jointly extracts oil with Saudi Arabia from the Saudi Arabian owned Abu Saafa oil fields, which is then imported and processed further in Bahrain. Production from these oil fields is expected to remain constant, but the government's efforts to increase the productivity of its Awali field should underpin economic activity. Thanks to ongoing investment into enhanced recovery methods, the Awali field could be producing over 100,000 barrels per day by 2016, compared with about 40,000 barrels per day in 2011. Petroleum processing and refining account for over 70% of Bahrain's export receipts, over two-thirds of government revenues and 11% of GDP.

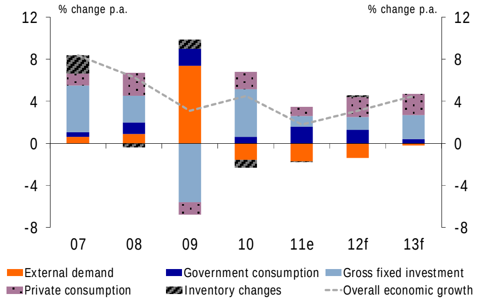
Services are most visible through banking and finance. The latter represents some 25% of GDP, although also business conferencing and tourism contribute significantly to GDP. Tourism is to a large extent based on rich (male) Saudis taking weekends off, attracted by the nightlife in this in many respects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

Figure 1: Social & Governance indicators



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

Figure 2: Growth performance



Source: EIU

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 the island will do little good for Bahrain's current leading position in this competition. Signs are increasingly emerging that foreign banks are downsizing their operations in Bahrain and moving their staff to Dubai and Abu Dhabi. The domestic retail banks are basically unaffected, but there was a significant, but short-lived, asset outflow from Bahrain's wholesale banking sector. While the outflow is sizeable compared to GDP with 17%, it looks much smaller compared to the size of liabilities in the banking system with 1.7%. Even so, since this sector has only limited links with Bahrain's real economy, the economic impact was negligible. Overall, the assets of the wholesale banks stabilized at a lower level. But in the area of Islamic banking, Bahrain is only second to Malaysia, due to the stringent banking regulation in place. The highly developed banking, communication and transport facilities caused many 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.

The impact of the Arab Spring protests (see also next section) to the overall economy was small. Except for a few days in March 2011, the unrest did not significantly affect business activity on the island, though it hampered private sector investment and hit the tourism sector, which has not yet fully recovered, but only accounts for a small 5% of GDP. The largest sectors by GDP contribution are financial services, oil production, government services, and manufacturing (mainly aluminum). The impact of the unrest was largely immaterial for the latter three sectors. Other sectors witnessed declines due to a lack of business confidence.

Going forward, the growth engines will be the hydrocarbon sector and public investment. The government will channel funds into the economy through higher wages, subsidies, and welfare grants, which will buffer consumption. Especially the USD 1bn GCC development package is of greater importance in the medium-term since it will flow directly into public investment projects. These projects include the areas of residential housing, transport, power generation and distribution, water treatment and sewerage, education, and industrial infrastructure. This is forecasted to boost economic growth to 3.1% in 2012, up from 1.8% in 2011.

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. 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 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.

This was not the case. By February 2011, a broad street movement emerged in Bahrain calling for faster political reform. While this movement initially encompassed both major Bahraini communities, it quickly split along sectarian lines after several fatalities and a failed negotiation process. Sectarian divisions increased after Shi'a opposition raised demands for radical political change and the government decided to use force against protesters. The government also asked Saudi Arabia for assistance; on 15 March 2011, Saudi Arabian forces entered Bahrain to help suppress protests and a state of emergency was imposed.

The Bahraini government has made some important strides since. It has lifted the state of emergency on 1 June 2011, attempting to signal a return to normalcy. It has also announced the withdrawal of Saudi troops and has set up an independent commission to investigate human rights abuses, held a national dialogue, moved trials to civilian courts and released several prisoners. The Shi'a opposition did significantly moderate its demands in response. In October 2011, the main opposition party al Wefaq and four other opposition groups listed their demands in the Manama paper. Demands included free elections to an elected government, separation of powers to ensure fair trials, but did no longer refer to previous demands such as establishing a constitutional monarchy. However, this only reflected the opposition's declining leverage in the face of the ruling al Khalifa regime's unconditional support from Saudi Arabia. But it did not reflect fewer grievances as the opposition managed to stage the largest protest rally on 9 March 2012 since the start of the uprising.

Any further progress in negotiations between the opposition and the ruling al Khalifa family is expected to be slow, since the internal divisions within the family are deep. Three camps can be distinguished. The first camp, that of the king, Sheikh Hamad bin Isa al Khalifa, is the most liberal one. The king maintains a relatively moderate position and is somewhat amenable to opposition demands, but his power is restricted by declining support of his family. His son, Crown Prince Salman bin Isa, tried to mend family ties but failed in his reconciliation initiatives. This has strengthened the two more hard-line camps in the family. The first hard-line camp is led by the Prime Minister Sheikh Khalifa bin Salman, the world's longest serving premier. He is significantly more conservative and rejects any deal that empowers the Shi'a opposition. Furthermore, he is very powerful, since he maintains strong relations with the Saudi regime, which has supported his policy in regards to the uprising and containing the Shi'a opposition. The third camp, also hard-line, led by the minister for the Royal Court Sheikh Khalid bin Ahmad, is also very uncompromising on the reforms issue.

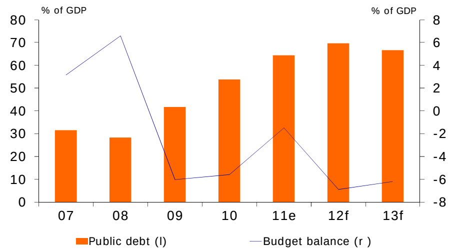
Going forward, we expect the unrest to continue as the grievances of the Shi'a community are not likely to be met anytime soon by the al Khalifa family, given the divisions within the family and the strong support of Saudi Arabia. The recent unrest in April 2012 during the Formula One Grand Prix weekend only highlights the incapability of the al Khalifa family to reach an agreement with the opposition. That weekend should have been used as an example to show the world Bahrain can contain the social unrest, but instead displayed heavy and violent clashes between security forces and protesters. Also, the fact that the Sunni community is becoming more organized and more vocal against changes in the political status quo increase the risk that the current polarization will become entrenched, limiting the likelihood of political reform. Overall, we believe that no resolution is in sight and social and political instability will persist in the medium term. Bahrain's international image is likely to suffer further.

Economic policy

The fiscal position has been deteriorating since 2009. In 2009, the first budget deficit was recorded since 2003, as revenues fell due to a large decline in oil prices. In 2010, the deficit increased due to a costly economic stimulus package. In 2011, the deficit is estimated to have moderated to 1.6% of GDP but expected to increase again in 2012 to over 6% of GDP.

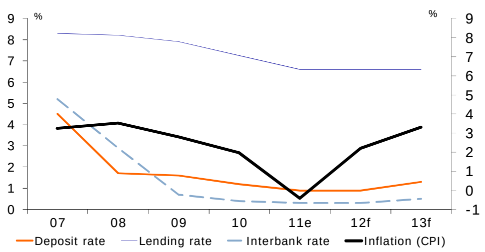
The reason we expect the deficit increase again this year is that government expenditures will increase in the form of a social spending package in an attempt to quell social unrest. This package entails an increase in public wages, food and energy subsidies, as well as one-off cash grants. While the latter may not be repeated, most of the wage increases are permanent. The base salary of public workers was lifted by 15%, in addition to employee allowances, effectively raising public wages by 20%. The deficit is expected despite high oil prices. Oil-related revenue now accounts for 88% of government revenues and highlights that public finances heavily depend on oil revenues,

Figure 3: Public finances



Source: EIU

Figure 4: Interest rates and inflation



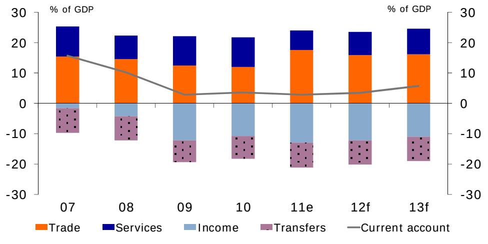
Source: EIU

despite the steady diversification of the economy. Revenue diversification is on the policy agenda, but has proceeded only at a slow pace and is not expected to generate major change in the near term. To structurally increase revenues, the government authorized a feasibility study on introducing value-added tax and corporate income tax, but these are longer-term prospects. A boon to government revenues is the faster than anticipated expansion of production capacity of the onshore Awali oilfield. Furthermore, Bahrain can profit from Gulf Cooperation Council (GCC) development funds after 2012, which will reduce the government spending burden. As such, we expect the budget deficit to shrink in 2013.

Even so, the large deficits in recent years have increased public debt substantially. It is forecasted at 70% of GDP at end-2012, up from 42% of GDP at end-2009. The government issued USD debt to fund its deficits; it 2010 it raised USD 1.25bn and USD 530m in 2011. No details of issuances are known for 2012.

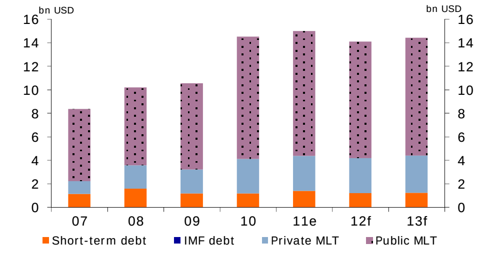
The structure of public debt is favorable as the maturity mostly is medium to long-term and interest payments are moderate at 3.2% of revenues. Furthermore, the government is a net creditor with liquid assets, particularly deposits with the central bank as well as commercial banks, liquid assets in the sovereign wealth fund named Mumtalakat and assets of the social insurance organization. The net asset position is estimated at 13.3% of GDP at end-2011.
The contingent liabilities appear reasonable despite the country's large banking sector, which is equivalent to around 900% of GDP. Particularly as several retail-licensed banks are owned by

Figure 5: Current account



Source: EIU

Figure 6: Decomposition of foreign debt



Source: EIU

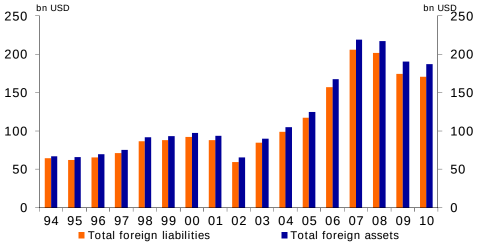
foreign sovereigns or banks in the GCC, which are expected to step in and extend financial support before the Bahraini authorities. Also, the government does not guarantee borrowing by nonfinancial public enterprises, as they tend to be self-sustaining.
Monetary policy is primarily geared to maintain the fixed peg to the US dollar, which has been unchanged for over two decades, without much direct intervention in the FX-markets. To help maintain the peg, interest rates will continue to follow the US policy rates. Inflation is thus largely imported through food and commodity prices, although market price pressures are partly mitigated by subsidies. Inflation is benign, forecasted to average only 2.2% in 2012.

Balance of Payments

Bahrain's current account balance is structurally characterized by surpluses in merchandise trade, largely oil and aluminium driven, and international services, mostly banking, business and tourism, totalling more than 20% of GDP. Large deficits occur in net transfers of 8% of GDP. This is related to the country's large expatriate workforce, which is almost 50% of the population, and sends home a portion of its earnings. The income balance shows persistent and growing deficits of up to 13% of GDP, which reflects the outflow of profits, dividends and interest payments. Overall, the current account will show a small surplus of 3% of GDP in 2012. Downside risks to this forecast are lower global oil prices which will rapidly decrease the surplus on the trade balance.

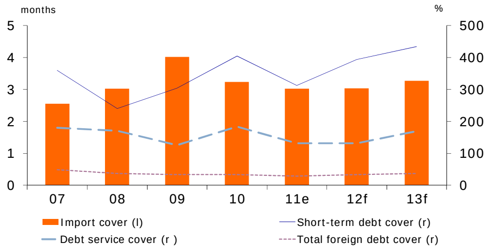
Bahrain's FX-reserves slightly decreased to USD 4.3bn in 2011, from USD 4.8bn in 2010. This was due to net outflows of portfolio and direct investments, despite a current account surplus. We forecast FX-reserves to increase to USD 4.7bn at end 2012, if oil prices remain elevated. However, a large downside risk to this forecast is the social unrest, which is expected to continue and affect foreign investor's sentiment.

Figure 7: International investment position



Source: EIU

Figure 8: External liquidity position



Source: EIU

External position

Total foreign debt is projected to almost double in nominal terms since 2007 from USD 8bn to USD 14bn by the end of 2012. Short-term debt is around 10% of total debt, which keeps refinancing needs at low levels. Most of the debt is guaranteed by the public sector, but owed to private sector creditors. There is no history of arrears.

Data for the country's international investment position indicate a modest positive net creditor position of USD 17bn, equivalent to 75% of GDP, by the end of 2010, up from USD3bn in 1993. No data for 2011 has been published. The increase is more or less in line with the accumulated current account surpluses of USD 10bn over the 17 year period. Value changes explain the remaining difference. The value of assets and liabilities, which are both substantial at around nine times GDP in 2010, strongly correlate, which reflects its status as a financial transit center.

The liquidity position of the country is moderate. 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 show a stable level, but the level of FX-reserves were and are projected to remain low at barely three months of imports.

Bahrain

Selection of economic indicators	2007	2008	2009	2010	2011e	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	8.4	6.3	3.1	4.5	1.8	3.1	4.5
Consumer prices (average % change pa)	3.3	3.5	2.8	2.0	-0.4	2.2	3.3
Current account balance (% of GDP)	15.7	10.2	2.9	3.5	2.9	3.4	5.7
Total foreign exchange reserves (mln USD)	4094	3797	3534	4782	4297	4730	5300
Economic growth							
GDP (% real change pa)	8.4	6.3	3.1	4.5	1.8	3.1	4.5
Gross fixed investment (% real change pa)	15.2	8.2	-17.7	17.9	3.4	4.1	8.0
Private consumption (real % change pa)	2.5	5.1	-2.9	4.2	2.2	4.8	5.0
Government consumption (% real change pa)	2.5	6.7	9.7	3.5	9.4	6.7	1.8
Exports of G&S (% real change pa)	10.2	16.2	-18.4	0.6	6.2	5.5	6.4
Imports of G&S (% real change pa)	10.6	16.9	-27.1	2.9	9.7	8.2	7.5
Economic policy							
Budget balance (% of GDP)	3.1	6.6	-6.0	-5.6	-1.5	-6.9	-6.2
Public debt (% of GDP)	32	28	42	54	65	70	67
Money market interest rate (%)	5.2	2.9	0.7	0.4	0.3	0.3	0.5
M2 growth (% change pa)	39	20	6	11	6	13	15
Consumer prices (average % change pa)	3.3	3.5	2.8	2.0	-0.4	2.2	3.3
Exchange rate LCU to USD (average)	0.039	0.039	0.039	0.039	0.039	0.040	0.040
Balance of payments (mln USD)							
Current account balance	2907	2257	560	770	577	740	1380
Trade balance	2865	3245	2439	2643	3498	3490	3900
Export value of goods	13790	17491	12052	13833	20519	18660	19470
Import value of goods	10925	14246	9613	11190	17021	15160	15570
Services balance	1823	1710	1912	2142	1275	1660	2050
Income balance	-299	-924	-2400	-2373	-2558	-2660	-2660
Transfer balance	-1483	-1775	-1391	-1642	-1637	-1760	-1910
Net direct investment flows	87	174	2049	-178	-1067	-1070	-980
Net portfolio investment flows	-8560	9277	8276	4756	-4918	-1800	-3010
Net debt flows	589	1460	-374	3956	463	-890	-70
Other capital flows (negative is flight)	6384	-13465	-10773	-8055	4460	3450	3250
Change in international reserves	1407	-298	-263	1249	-485	430	570
External position (mln USD)							
Total foreign debt	8361	10171	10546	14503	14965	14080	14410
Short-term debt	1138	1583	1162	1181	1378	1200	1220
Total debt service due, incl. short-term debt	2273	2226	2818	2605	3258	3600	3130
Total foreign exchange reserves	4094	3797	3534	4782	4297	4730	5300
International investment position	13168	15455	15853	16769	n.a	n.a.	n.a.
Total assets	218713	217015	190239	187046	n.a	n.a.	n.a.
Total liabilities	205545	201560	174386	170277	n.a	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	15.5	14.6	12.4	12.1	17.6	16.0	16.2
Current account balance (% of GDP)	15.7	10.2	2.9	3.5	2.9	3.4	5.7
Inward FDI (% of GDP)	9.5	8.1	1.3	0.7	0.7	0.8	0.7
Foreign debt (% of GDP)	45	46	54	66	75	64	60
Foreign debt (% of XGSIT)	30	36	61	75	59	59	57
International investment position (% of GDP)	71.3	69.8	80.8	76.5	n.a	n.a.	n.a.
Debt service ratio (% of XGSIT)	8	8	16	13	13	15	13
Interest service ratio incl. arrears (% of XGSIT)	2	2	3	3	4	4	4
FX-reserves import cover (months)	2.6	3.0	4.0	3.2	3.0	3.0	3.3
FX-reserves debt service cover (%)	180	171	125	184	132	131	169
Liquidity ratio	146	218	288	261	225	227	246

Source: EIU