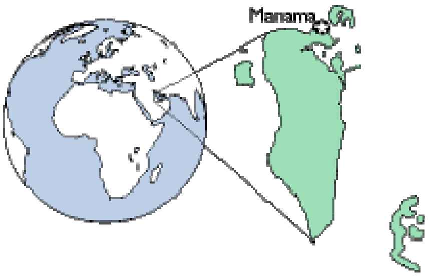
COUNTRY REVIEW

Bahrain



8 June 2010

ANALYST: Andrew Atkinson

EULER HERMES COUNTRY RISK GRADE: BB

Country Risk Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest risk.

Strengths

- Pro-business policy stance
- In addition to its oil sector, Bahrain has a vibrant manufacturing (aluminium- and petrochemicals-based) sector and is a regional and international financial hub
- Financial and other support provided by larger regional states
- Strong defence ties with the US and UK
- High incomes
- Supportive structural business environment that is highly rated by independent international assessments

Weaknesses

- History of tension between ruling Sunni elite and Shia majority, perhaps with Iranian involvement
- Mixed success of "democratic experiment"—the royal family retains firm control
- Regional volatility—neighbours include Iran and Iraq
- Potential terrorist target because of the close relationship with the US
- Despite diversification, there is a continued dependence on oil revenues, directly (own output) and indirectly (regional influence), and there is therefore an economic vulnerability to a sustained period of low oil prices
- Poor data transparency

Key Risks

- A large and sustained fall in oil prices, which would have negative implications for export earnings, other region-related financial inflows, economic growth prospects and health of the financial sector
- Regional conflagration resulting from military action involving Iran

Country Risk Assessment

Ratings	**Bahrain**		**Median**		**Peers**	
	Latest	**Previous**	**Grade BB**	**UAE**	**Israel**	**Malaysia**
Systemic Political Risk:	**P2-**	**P2-**	**P2+**	**P2+**	**P2-**	**P2+**
Systemic Economic Risk:	**E3**	**E3**	**E3**	**E3**	**E3**	**E2**
ME rating:	ME3	ME3	ME3	ME3	ME3	ME2
Structure	*5.0*	*5.7*	*3.8*	*5.7*	*1.6*	*2.3*
Policy	*5.2*	*3.8*	*4.3*	*3.9*	*3.8*	*4.3*
Solvency	*1.9*	*1.3*	*1.6*	*1.9*	*2.8*	*1.3*
External Liquidity	*2.8*	*2.3*	*3.3*	*3.3*	*4.3*	*2.8*
SBE rating:	SBE2	SBE2	SBE2	SBE3	SBE2	SBE2
COUNTRY GRADE:	**BB**	**BB**	**BB**	**BB**	**BB**	**A**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Manama
Population:	0.78 mn (2008)
GDP:	USD 21961 mn (2008)
Currency:	Dinar (BHD)
Form of state:	Constitutional monarchy
Head of government:	King Hamad bin Isa al-Khalifa
Next elections:	Parliamentary 2010

Major Industries (% of GDP at market prices, 2009e)	
Agriculture	0.5%
Industry	56.5%
Services	43.0%

Global Assumptions	2009	2010f
Real GDP grth (% yr/yr) *	-3.9	0.9
Inflation (%, av) *	-0.1	1.3
Dated brent (USD/b)	61.0	80.0

* Major economies

Main Exports (% of total, 2009e)	
Petroleum & products	79.0%
Aluminium & products	9.0%

Main Imports (% of total, 2009e)	
Crude oil	50.0%

Lead Export Markets (% of total exports, 2008e)	
Not specified	67.7%
India	4.0%
Saudi Arabia	3.0%
UAE	2.0%

Lead Import Markets (% of total imports, 2008e)	
Saudi Arabia	26.0%
Japan	9.0%
US	8.0%
China	6.0%

Basic indicators

Selected economic indicators	2006	2007	2008	2009	2010f
Nominal GDP (USD mn)	15,897	18,522	21,961	21,867	23,733
Population (mn)	0.74	0.76	0.78	0.80	0.82
GDP per capita (USD)	21,482	24,371	28,155	27,299	28,852
Real GDP growth (% yr/yr)	6.7	8.3	6.3	3.0	4.0
Inflation (%, average)	2.0	3.2	3.5	4.0	3.0
Fiscal balance (% of GDP)	4.3	3.1	7.5	0.2	2.1
Current account balance (% of GDP)	13.8	15.7	10.3	6.9	8.4
External debt/GDP (%)	49.1	45.9	46.9	49.4	51.8
External debt/Exports of goods & services (%)	33.5	30.7	36.4	47.3	45.6
Debt-service ratio (%)	3.7	3.6	3.9	5.3	4.8
Foreign exchange reserves (USD mn)	28,100	42,200	39,400	39,000	41,000
Import cover (months)	17	22	19	23	21
Exchange rate assumption, BHD:USD (av)	0.375	0.375	0.375	0.375	0.375
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Although significant changes were adopted **in 2002**, effective power has remained with the ruling al-Khalifa family. In that year, **Bahrain became a constitutional monarchy** when the ruler, Sheikh Hamad bin Isa al-Khalifa, appointed himself king as part of a series of constitutional reforms that also saw the creation of an elected lower chamber of the National Assembly and the release of political prisoners. The new legislative body (the Chamber of Deputies) is limited in authority and countered by an upper chamber (the Consultative Council) that is appointed entirely by the king every four years. Nonetheless, such democratic reforms, which include voting rights for women, are some of the most wide-ranging in the Gulf region. They have been championed personally by King Hamad who, since acceding to emir in 1999, has sought to address **social tensions between the country's small Sunni elite and the politically and economically marginalised Shia majority**. Such tensions contributed to communal violence in the 1980s and mid-1990s that was suppressed by the authorities.

Elections are scheduled for September/October this year but **the make-up of parliament is unlikely to be altered**. Polls in November 2006 were the first for the 40-member lower parliament that allowed women to vote and to stand as candidates. Although political parties are proscribed, after the election period deputies tend to group into political societies. In 2006, the Shia Al-Wefaq National Islamic Society was highly successful, becoming the largest single group in the reformed assembly, although not possessing a majority. Another Shia group, al-Haq, prefers to remain outside the parliamentary process and provides opposition through organised street protests. There **are periodic riots over unemployment, corruption and inadequate housing provision**. While the Shia majority is likely to use its parliamentary voice to press for an end to perceived discrimination in job and housing allocations, in the longer term, the intransigence of the ruling family in countering these demands is likely to lead to further violent clashes. There is also a regional dimension to this issue, with Shia-Sunni violence in Iraq and elsewhere in the region having the potential to spread.

It is unlikely that the ruling elite will have to counter significant challenges to its predominance in the short term. Policy continuity is therefore likely. Even if King Hamad is willing to make some further concessions to opposition forces, he is highly unlikely to meet their key demand that the elected chamber (Chamber of Deputies) is given a higher status in the legislative process than the non-elected Consultative Council. In the short term, domestic stability appears more at threat from international terrorism, rather than home-grown forces. Given the **presence in Bahrain of the US Fifth Fleet**, Manama is a potential target for some form of terrorist activity. However, this threat is likely to increase security rather than temper the political agenda.

Bahrain is a founder member of the Gulf Co-operation Council (GCC) and regional policy focuses on close ties with these states, particularly the major bilateral donors, Saudi Arabia, Kuwait and the UAE. Relations with Qatar have improved since the International Court of Justice ruled in Bahrain's favour on the sovereignty of the Hawar Islands. Indeed, relations have improved to the extent that plans for a causeway linking the countries are moving forward, albeit slowly. Wider foreign policy centres on **close military and trade links with the US and UK**, with a free trade arrangement with the US launched in August 2006. **Relations with Iran are strained**, partly because the Sunni regime in Manama regards Iranian influence on its Shia majority as a potential threat to domestic security. Additionally, Iran's dispute with the international community in relation to its nuclear programme poses a potential military threat to the whole region, with scope for related adverse human and economic costs. **There is no need for a borrowing programme with the IMF** and Bahrain would look first to regional allies for support in the event of a financial crisis.

Economic Stability

Bahrain is classified by the World Bank as "high income" and per capita GDP is currently around USD28,000. The economy is **relatively diversified** compared with fellow members of the GCC regional grouping. Although the **oil and gas sector** remains all-important—directly because of Bahraini involvement and, indirectly through regional transmission mechanisms—industry (principally **aluminium and petrochemicals**, with energy sourced through domestic gas supplies) and **financial (banking) sectors are well-developed**. The majority state-owned aluminium company (ALBA) is estimated to have the second-largest, modern aluminium smelter in the region, after Dubai.

Although Bahrain does not produce crude oil on the scale of its neighbours, it possesses **a significant refining capability and oil continues to account for almost 80% of export revenues**. In the period of high oil prices **2004-08, real GDP growth averaged over 7% annually** and some of the oil 'windfall' was channelled into public works programmes, in turn stimulating activity in construction, transport and other services. However, the global slowdown in 2009, associated lower oil prices and projected weak recovery in some key world economies in 2010-11 are forecast to restrict GDP growth, with official figures suggesting **3% growth in 2009 and our forecast of 4-5% in 2010 and 2011**.

As with most GCC states, **fiscal accounts and budgeting are opaque**. The limited projections that are provided are calculated by using highly conservative estimates for the price of oil. Large fiscal surpluses are traditionally registered, with the oil and gas sector generating an estimated 73% of total revenues. Of these oil revenues, approximately 78% is accounted for by income from the offshore Abu Saafa field, which is shared with, and managed by, Saudi Arabia. Bahrain's own onshore field (Awali) contributes a further 15% and gas accounts for the remaining 7%. **Transparency of public finances is poor and a low tax base contributes to over-reliance on revenues from hydrocarbons**. High oil prices in 2005-08 boosted the fiscal balance, with a surplus in 2008 that we estimate at around 7.5% of GDP, although this is likely to have been followed by near balance in 2009 when oil prices were lower. We forecast a **surplus of around 2% of GDP in 2010**. However, such data excludes “excess revenues” that are released into an oil stabilisation fund, so the fiscal picture is likely to be even better than the basic statistics indicate.

Within the GCC itself and wider economic community there has been considerable debate in relation to exchange rate policy, with strong convictions (but not necessarily upheld by the Bahrain Monetary Agency) that the GCC economies should delink their currencies from direct pegs to the USD. Monetary policy in Bahrain is geared to maintain the **exchange rate peg of the dinar to the dollar at USD1:BHD0.38.** We believe this long-standing fixed rate (established in 1981), is unlikely to alter within the ST. Indeed, the prospect of a common currency within a monetary union of GCC states now looks unlikely to be fully functioning for several years.

The external accounts are heavily influenced by trends in oil and gas markets. **Crude oil and related refined products account for approximately 79% of total exports**, with a further 9% of revenues coming from exports of aluminium and related products. Bahrain's own crude oil reserves are very limited and it regularly imports oil from Saudi Arabia (via a 33-mile underwater pipeline) to use at its refinery to produce added-value energy products for re-export. Oil exports include 30-40,000 barrels per day (b/d) from the aging Awali onshore fields, 200,000 b/d from Saudi Arabia for refining at Sitra and 150,000 b/d from the Abu Safa offshore field, which is shared with Saudi Arabia. The **current account registered annual surpluses equivalent to 10-17% of GDP in 2005-08 and we forecast diminished surpluses of 7% and 8% of GDP in 2009 and 2010, respectively.** Against this background, the country records financing surpluses and, in addition to boosting FX reserves, accumulated wealth is lodged in **an oil stabilisation fund for use in times of economic hardship**. External liquidity indicators are generally good, although there is some distortion because of the inclusion of liabilities of the offshore banking sector. The country does not release standard external debt information to the World Bank but our estimates indicate that total external debt is around 50% of GDP and 45% of export earnings, indicating little pressure in terms of servicing those obligations (the debt service ratio is around 5% of export earnings).

Structural Business Environment

The **structural business environment is sound** and generally above the average of the countries we assess. The Heritage Foundation’s 2010 Index of Economic Freedom, a broad measure of the openness of an economy, regards Bahrain as “mostly free”. It is ranked 13 out of 179 countries monitored—the highest in the Middle East/North Africa region—below Denmark, Chile and the UK but above Luxembourg, the Netherlands and Estonia. A restricted labour market (it is official policy for locals to be favoured in employment opportunities) is the only major weakness, while fiscal freedom and the banking and finance sector score particularly well. Lack of corporate taxes in all industries (other than oil) provides a competitive commercial advantage. Moreover, trade is liberalised and Bahrain reduced tariffs on GCC goods a year ahead of the deadline for compliance set by the organisation. In Transparency International’s 2009 Corruption Perceptions Index Bahrain ranks 46 out of 180 countries assessed, below Mauritius, Costa Rica and Malta but above Hungary, Poland and Czech Republic. According to the World Bank, Bahrain is ranked 20 out of 183 economies surveyed in terms of the ease of doing business, with registration of property, taxation and bankruptcy resolution as notable positive areas.

Bahrain acts as a **regional financial hub** and the banking sector, which receives plaudits from the IMF, has **transparent legal and regulatory systems** under the supervision of the Bahrain Monetary Agency (BMA) and 100% foreign ownership is permitted. **However, with bank assets equivalent to over 200% of GDP it is likely that the recent troubles in regional real estate markets will have negative consequences for some financial institutions**. Indeed, some debt restructurings took place in H1 2010, but it is likely that local authorities would prevent a major default and larger GCC members are also likely to provide financial assistance, in extreme need.

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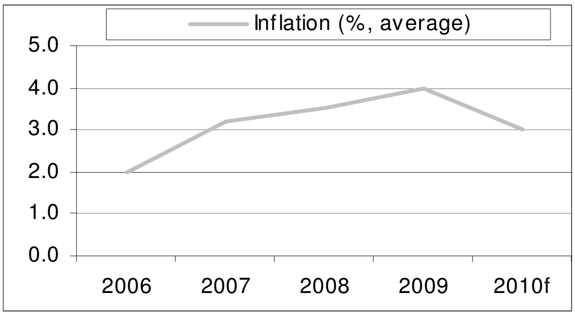
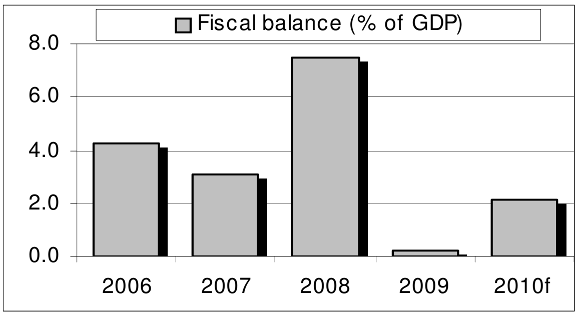
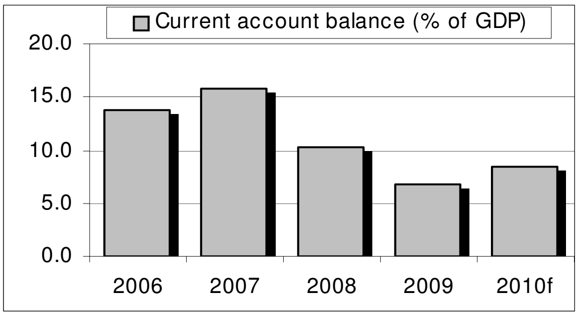
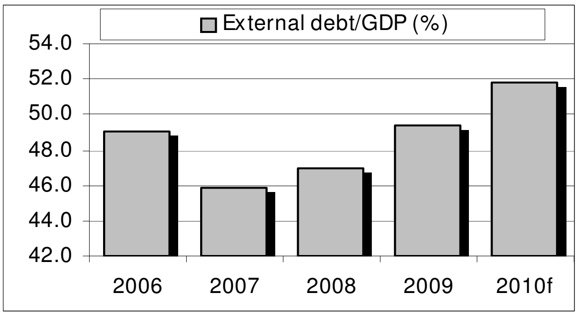
Charts


Real GDP grow th (% yr/yr)
10.0
8.0
6.0
4.0
2.0
0.0
2006
2007
2008
2009
2010f

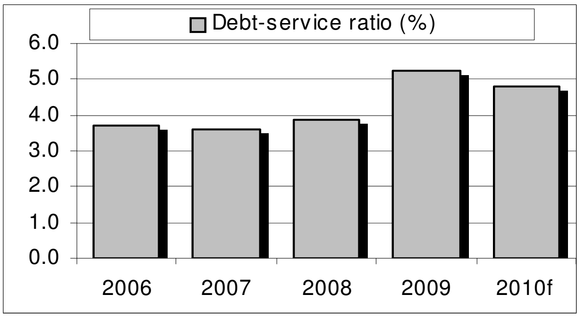

Inflation (%, average)
5.0
4.0
3.0
2.0
1.0
0.0
2006
2007
2008
2009
2010f

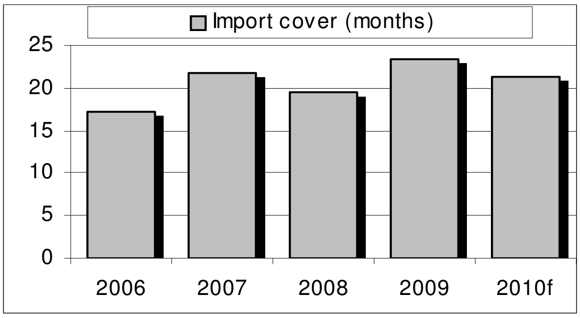

Fiscal balance (% of GDP)
8.0
6.0
4.0
2.0
0.0
2006
2007
2008
2009
2010f


Current account balance (% of GDP)
20.0
15.0
10.0
5.0
0.0
2006
2007
2008
2009
2010f


External debt/GDP (%)
54.0
52.0
50.0
48.0
46.0
44.0
42.0
2006
2007
2008
2009
2010f


External debt/Exports of goods & services (%)
50.0
40.0
30.0
20.0
10.0
0.0
2006
2007
2008
2009
2010f


Debt-service ratio (%)
6.0
5.0
4.0
3.0
2.0
1.0
0.0
2006
2007
2008
2009
2010f


Import cover (months)
25
20
15
10
5
0
2006
2007
2008
2009
2010f