

# RAM

# COUNTRY ASSESSMENT REPORT

April 2011

## KINGDOM OF BAHRAIN

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# RAM

RATINGS



RATINGS

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## PUBLIC FINANCE RATINGS

APRIL 2011

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### Bahrain at a Glance<sup>1</sup>

#### Population:

1.1 million (2010e)  
Median age: 30.9 years

#### Nominal GDP:

BHD8.2 billion (2010e)  
USD21.7 billion (2010e)

#### Nominal GDP per capita:

USD20,475 (2010e)

#### Real GDP growth:

2004-2008 (average)	7.0%
2009	3.1%
2010e	4.1%

#### Unemployment rate:

N/A

#### Inflation rate:

2004-2008 (average)	2.7%
2009	2.8%
2010e	2.0%

#### General government debt (% of GDP):

2008:	14.6%
2009:	25.4%
2010e:	32.0%

## MIDDLE EAST

### – Kingdom of Bahrain

#### ■ Summary

The socio-political turmoil in Bahrain, which broke out in February 2011, obscures its economy's near- and medium-term prospects. Amid the unrest, economic activities will be predisposed to disruptions, if not already; perhaps more so following the declaration of martial law by the government in mid-March 2011. Meanwhile, the impact of the unrest on Bahrain's reputation as a stable and liberal financial centre could have adverse medium-term implications for its economy. Notably, the financial- and banking-services sector is the single largest economic sector in Bahrain, accounting for about a quarter of its gross domestic product ("GDP").

We believe that the Bahraini government's net-asset position could help shield its fiscal health from short-term economic shocks, even as it provides the government with the flexibility to extend fiscal support to the economy. We believe, however, that the positive implication of this cushion may also struggle to find a voice amid the uncertainties surrounding the social, political and economic landscapes in Bahrain.

<sup>1</sup> Sources for *Bahrain at a Glance*: International Monetary Fund ("IMF") World Economic Outlook ("WEO") database (April 2011), CIA World Fact Book, CEIC Data.

**System of government:**  
Constitutional monarchy

**Head of state:**  
King Hamad bin Isa Al  
Khalifa (since March 1999)

**Head of government:**  
Prime Minister Khalifa bin  
Salman Al Khalifa (since  
1971)

**Parliamentary elections:**  
Bahrain has a bicameral  
parliament. Both chambers  
have equal voting powers  
and number of members.

- (i) 40-member Consultative Council, appointed by the King.
- (ii) 40-member Chamber of Deputies, selected via elections. Elections were last held in October 2010; next expected by October 2014.

## ■ Economy

- Recent political upheaval casts cloud of uncertainty over prospects of Bahrain's small, external-sector-driven economy.
- Concern lies in the longer-term impact on Bahrain's reputation as a relatively stable financial centre in the region.

### ➤ Critical issues

The political turmoil and violent clashes in Bahrain have negative implications for its position as a regional financial hub, as well as for its economy in general. The financial- and banking-services sector is a major contributor to Bahrain's economy, accounting for about a quarter of its real GDP. Amid the tension, we believe that foreign and offshore banks operating there may consider relocating to an alternate base in the near to medium term, especially if the situation is prolonged. Economic uncertainties and the repatriation of foreign assets out of Bahrain could pose challenges on both the fiscal and monetary-policy fronts.

### ➤ Macroeconomic policy brief

Bahrain's monetary policy is overseen by the Central Bank of Bahrain. Its policy centres on maintaining a fixed exchange rate between the Bahraini dinar ("BHD") and the US dollar ("USD"). The peg (USD1.00 = BHD0.376) has been mostly unchanged since 1980. There is no restriction on capital movements. In this respect, the repatriation of assets out of Bahrain may complicate the defence of its exchange-rate regime and affect price stability<sup>2</sup>.

Meanwhile, the government's budget is prepared by the Ministry of Finance and Economy, in accordance with the "directives and aspirations of the political leadership". The budget must be tabled to the National Assembly for approval; if no agreement can be reached, the King may issue the bill as a decree that has the force of law. On this note, the Bahraini government has some savings and investments that it can draw on to provide fiscal support to the economy, although the effects may be muted amid the present turbulence<sup>3</sup>.

<sup>2</sup> Also refer to External Position, on page 7.

<sup>3</sup> Also refer to Government Finances, on page 4.

### ➤ Size, structure and stability

Bahrain's GDP per capita of USD20,475 places it in the "high-income nation" bracket. Unlike its peers in the Gulf Cooperation Council, Bahrain's supply-side GDP is the least dependent on hydrocarbons. This reflects both the country's inherently lower level of oil reserves and production, as well as its success in developing its financial-services sector. The latter makes up about a quarter of its real GDP and provides employment for about 14,000 people (or approximately 3% of the economy's total employment)<sup>4</sup>.

Although contributions from the oil sector do not dominate Bahrain's GDP, this segment remains an important feature of its economy. Oil-related income constitutes more than 70% of government revenues, making it a critical source of funds to finance public-sector consumption and investments, which account for about a quarter of its demand-side GDP. External demand is also crucial to Bahrain's economy given its smallish population of just slightly over 1 million people.

Bahrain's secondary and tertiary education enrolment levels are among the highest in the GCC region. Its education system is broadly perceived to be supportive of Bahrain's economic needs<sup>5</sup>. Meanwhile, unemployment statistics vary among different sources. Nonetheless, we understand that its unemployment rate stands at about 3%-4%<sup>6</sup> - a stark contrast to the mid-teens reported as recently as the mid-2000s<sup>7</sup>. This can be attributed to the success of Bahrain's unemployment insurance scheme, which was introduced in mid-2007. Under this scheme, which is funded by contributions from employers and employees (at 1% of their salaries), jobseekers are provided with training and assisted in finding a suitable position.

A rough gauge of the employment situation in Bahrain broadly suggests that there have been improvements between end-2005 and end-2009. We observe that the total number of people employed has risen, both in absolute terms (+11.3% average annual growth) and as a percentage of the population aged between 15 and 64 years<sup>8</sup> (48% vs 55%). The statistics indicate, however, that the majority of those employed in Bahrain are non-citizens, signalling room for improvement on this front.

<sup>4</sup> According to the Central Bank of Bahrain, the financial sector is the single largest employer in the country.

<sup>5</sup> Refer to the *Global Competitiveness Report* by the World Economic Forum.

<sup>6</sup> Refer to Bloomberg, *Bahrain unemployment rate stable at 3.6%*, *Albilad reports* (21 February 2011).

<sup>7</sup> CIA World Fact Book: 15% (2005).

<sup>8</sup> Usually regarded as the "employable" group within a country's population.

## ➤ Outlook

Amid the current socio-political turmoil, it will be challenging for Bahrain to achieve the 4%-5% expansion in real GDP that had been expected earlier<sup>9</sup>. Assuming only the financial-services sector stalls<sup>10</sup>, we estimate that GDP growth would already be set back by about 1 percentage point. Realistically, disruptions will likely be more widespread, even more so amid the emergency rule and reported intermittent labour strikes<sup>11</sup> that the country is experiencing as a result of the protests. Based on the IMF's recent half-yearly update of its global economic outlook, Bahrain is expected to chart a 3% GDP growth this year.

We believe that Bahrain's medium-term economic outlook depends on the length and manner of resolution of the anti-government stand-off. Our concern is that Bahrain's reputation as a safe, liberal and stable financial harbour has suffered permanent damage, and that foreign financial institutions will move out *en masse*. Its broader reputation as one of the more open economies in the GCC region is also at stake; the postponement of the high-profile 2011 Bahrain F1 Grand Prix<sup>12</sup> is one of the early signals of this. Under the positive-case scenario, the current uprising will be resolved through dialogue while further social and political reforms are rigorously pursued (similar to the events in the early 2000s; please refer to **Political Stability** for additional details). At this juncture, however, the final outcome remains unclear.

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<sup>9</sup> IMF World Economic Outlook, October 2010.

<sup>10</sup> On 17 March 2011, the central bank announced (via its website) that it was operating as usual, and would provide the necessary support to ensure the continued operations of banks in Bahrain.

<sup>11</sup> Refer to Zawya, *Bahrain moves to quash opposition* (17 March 2011), and Wall Street Journal online, *Bahrain security forces step up arrests of protestors* (20 March 2011).

<sup>12</sup> The 2011 race would have been the eighth edition of the Bahraini GP. Bahrain had been the first country in the Middle East to host a Formula One championship (2004), before Abu Dhabi joined its ranks in 2009.

## ■ Government Finances

- + Net-asset position to provide some cushion amid current uncertainties, but could be depleted in the medium term.
- Small earnings base (reliant on oil income).
- Current economic/political uncertainties may set back diversification efforts.

**Table 1: Selected fiscal indicators**

	2006	2007	2008	2009	2010e	2011b
<b>BHD billion</b>						
General govt ("GG") revenue	1.9	2.1	2.7	1.7	2.1	2.2
GG expenditure	1.7	2.0	2.3	2.2	2.7	2.6
GG balance	0.2	0.1	0.4	-0.5	-0.7	-0.4
GG gross debt	1.4	1.3	1.2	1.8	2.7	3.1 <sup>(3a)</sup>
GG net debt <sup>3c</sup> (estimate)	n/a	n/a	n/a	n/a	-1.3 to -2.3	-0.9 to -1.9
<b>% of GDP</b>						
GG revenue	30.9	29.3	32.4	23.8	24.3	25.9
GG expenditure	28.2	27.5	27.4	30.4	32.1	30.6
GG balance	2.7	1.9	4.9	-6.6	-7.8	-4.7
GG gross debt	23.6	19.2	14.6	25.4	32.0	36.5
GG debt (% of revenue)	76.6	65.5	45.0	106.7	131.9	140.9
GG net debt (estimate)	n/a	n/a	n/a	n/a	-15.9 to -28.0	-10.6 to -22.4
Nominal GDP (BHD billion)	6.0	6.9	8.3	7.3	8.5	8.5 <sup>(3b)</sup>
Nominal GDP (USD billion)	15.8	18.5	22.1	19.3	22.7	22.7 <sup>(3b)</sup>

Source: IMF WEO (April 2011), SWF Institute, Bahrain Ministry of Finance and Economy.

- (1) General government revenue, expenditure and balance for 2006-2010 are from the IMF WEO database. As per IMF WEO notes, general government includes the central government, state government, and monetary public corporations (including the central bank).
- (2) Revenue, expenditure and balance for 2011b are as per the government's budget, which we understand is for the central government only.
- (3) RAM Ratings' estimates/assumptions:
  - a) Budgeted deficit is assumed to be funded by debt.
  - b) Nominal GDP used for ratio calculations is assumed to remain unchanged from 2010.
  - c) Based on publicly available information from various sources and dates, we estimate that Bahrain has about BHD4 billion–BHD5 billion of government assets. These include the assets/investments of Mumtalakat Holdings (Bahrain's sovereign wealth fund), which are valued at about USD9 billion (or BHD3 billion; source: SWF Institute).

### ➤ Budgetary performance and debt load

We believe that the immediate impact of an economic slowdown (and any associated rise in fiscal expenditure) on the government's finances will be temporarily cushioned by its net-asset position. We estimate that these assets are sufficient to finance the country's deficits budgeted for this year and the next. Naturally, this cushion will recede if the deficits persist. At the same time, we understand that Bahrain's sovereign wealth fund (which we have considered as part of the government's assets in our net debt estimates) is primarily domestic-

based, i.e. its value is closely linked to the domestic economy's wellbeing. Amid the domestic turmoil, the buffer it provides could thus be less robust than our estimates suggest.

The government has again budgeted for a deficit in 2011 and 2012. We note that it is rather common for the Bahraini government to table a deficit budget, subsequently turning it into a surplus at the end of the period (e.g. 2003–2008). In the last 2 years, however, the government balance has dipped into negative territory on the back of lower oil prices (especially in 2009) and rising expenditure. We do not envisage this trend to reverse anytime soon. Although average oil prices are currently higher than those of 2009 and 2010, the prospects of hitting the revenue target of BHD2.2 billion could still be dampened by uncertainties on output and demand for this commodity. Over 70% of the government's revenue is oil-related income, hence inherently susceptible to the demand and price trends for the commodity. At the same time, we opine that the government is unlikely to cut back on spending as it seeks to bolster public goodwill and confidence amid the anxieties.

Over the longer term, the economic and political uncertainties could set back the government's effort to diversify its revenue base. The urgency to broaden the income base is already apparent, given that Bahrain's oil reserves are relatively small and could well be depleted over the next decade.

➤ **Contingent liabilities**

Bahrain has a sizeable banking sector, the assets of which (USD216.4 billion) were equivalent to about 11.2 times of its GDP as at end-September 2010 – suggesting a heavy contingent burden on the Bahraini government (as a lender of last resort). Nonetheless, several traits of the Bahraini banking sector may help mitigate this risk:

- About half of the banks operating in Bahrain are foreign-owned; these account for about 60% of its banking sector's assets. The Bahraini authorities had previously made clear that they would not bail out offshore banking institutions<sup>13</sup>, pointing out that this responsibility lies with the respective institutions' shareholders.

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<sup>13</sup> Refer to Reuters, *Bahrain not to bail out offshore banks*.

- The offshore banks' funding and assets largely stem from offshore clients. We understand that these banks are restricted from accepting domestic deposits and assets.

The preceding factors somewhat insulate the Bahraini economy against systemic shocks resulting from bank failures. In the absence of direct bailouts, the impact of a widespread disruption in the banking sector could still affect employment, private consumption and overall confidence in the economy, and pressure the government's fiscal plans from that respect. We had previously regarded this as a contained scenario – noting that the Bahraini financial sector had generally steered through the 2008/09 global downturn rather well and believing that the industry was unlikely to shed all its jobs at once. Given the current unrest in Bahrain, however, we believe that this risk has heightened from a year ago.

## ■ External Position

- Repatriation of foreign assets could disrupt Bahrain's fixed-exchange-rate regime and domestic price stability, although its position as a net external creditor should provide some cushion.

<i>USD billion (unless stated otherwise)</i>	2007	2008	2009	2010e
Current account balance	2.9	2.3	0.6	1.0
As a % of GDP	15.7	10.4	3.1	4.4
<b>International Investment Position (IIP)</b>				
Assets	218.7	217.0	190.2	n/a
Liabilities	205.5	201.6	174.4	n/a
<b>Net IIP</b>	<b>13.2</b>	<b>15.4</b>	<b>15.8</b>	n/a
As a % of GDP	71.4	69.7	81.9	n/a
As a % of current account receipts	47.7	54.4	90.8	n/a
<b>External debt</b>	25.8	33.6	32.5	n/a
As a % of GDP	139.5	152.0	168.4	n/a
As a % of current account receipts	93.1	118.7	186.8	n/a
Official reserves	4.2	3.9	3.8	n/a
<i>Mths of curr. acc. payment</i>	2.0	1.8	2.7	n/a
Nominal GDP (USD billion)	18.5	22.1	19.3	22.7

Source: IMF, CEIC Data. 2010e are IMF estimates (WEO, April 2011).

With over 70% of its export earnings related to oil, Bahrain's current-account balance naturally mirrors this commodity's price movements. Under normal circumstances, high oil prices would be a positive for its current account (the reverse would be true, if oil prices weaken). Amid the current domestic unrest and uncertainties (e.g. potential output disruptions, reduced exports), however, the positive price effect may not be realised. At the same time, the socio-political instability could also result in capital outflows, although we are unable to quantify this. On balance, however, Bahrain's position as a net external creditor broadly

indicates that the country has a foreign-asset buffer (USD190.2 billion as at end-2009) it can "bring home" to cushion the impact of capital outflows.

## ■ Political Stability

- Cloudy political climate, with the chance of a downpour.
- State of emergency declared in mid-March 2011, and is expected to be in force for 3 months.
- The King is understood to be still keen to push forward with reforms initiated in the early 2000s.

### ➤ Political stability

Reports on Bahrain are normally divided, with some exalting its virtues as a relatively liberal and progressive economy in the region while others criticise the government's biased treatment of civilians and political opponents.

The incumbent ruler, King Hamad bin Isa Al Khalifa, has been credited with political reforms following his ascension to the throne in 1999, which coincided with an easing in the domestic unrest that had beset Bahrain in the mid-1990s<sup>14</sup>. King Hamad had overseen the National Action Charter – a plan to turn Bahrain into a full constitutional monarchy – that was approved by the public via a national referendum in 2001. The following year, he pronounced Bahrain as a constitutional monarchy.

The international media has attempted to explain the cause of the recent protests in Bahrain from various angles, ranging from sect-driven resentment to general unhappiness over the pace and extent of social and political reforms. In any case, the authorities' forceful approach to dealing with the protests has mostly led to negative press, even though the government asserts that some of the protestors had turned violent – a claim the latter deny. We understand that the protestors have dispersed since the imposition of emergency rule in mid-March 2011, although underlying tensions may not dissipate as quickly. The reported aggression and violence by both sides, loss of lives and the presence of troops from neighbouring Gulf nations present a volatile mix that leaves the direction of Bahrain's political environment unclear at this juncture.

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<sup>14</sup> Refer to *BBC News - Timeline: Bahrain* and the US Department of State's background notes on Bahrain.

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➤ **External stability**

We believe that Bahrain's relationships in the context of the GCC and its cordial links with the US help cushion the risk of external threats and internal ones, to some extent. Amid the current protests, for example, Bahrain's Gulf neighbours – reportedly upon its invitation – have sent a complement of security forces to help maintain order in the island nation. Although there is a risk that such action could inflame the situation, it could also highlight the solidarity among the GCC leaders. Meanwhile, we understand that the GCC pact is also considering a USD20 billion fund to aid Oman and Bahrain in boosting their economies<sup>15</sup> over the medium term.

➤ **Institutional environment**

Prior to the recent unrest, Bahrain had generally held commendable positions in various global benchmarks on quality of governance, business environment and competitiveness. We believe this could well change in the upcoming updates on these indices. While underlying strengths such as Bahrain's financial-sector infrastructure and regulations will likely remain intact (it will not, however, guarantee that financial institutions will stay), we opine that these could be overshadowed by less favourable perceptions and appraisals of its economic, government and social stability.

As of end-March 2011, two of the 3 largest international rating agencies had downgraded Bahrain's sovereign ratings to just 2 notches above non-investment grade; the ratings remains on watch with the possibility of further downgrades in the near term. On this account, there is a chance that foreign companies with Bahraini exposure/operations may accelerate moves to reduce their exposures or even leave the country entirely, especially those that rely on the credit ratings as an investment rule. Investor sentiment on Bahrain will also likely be dampened.

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<sup>15</sup> Refer to Reuters, *Gulf States prepare aid fund for Oman and Bahrain* (10 March 2011).

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