الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & FINANCIAL SECTOR OVERVIEW

Kingdom of Bahrain

August, 2021

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ECONOMIC OVERVIEW- Kingdom of Bahrain

Part of the six-member Gulf Cooperation Council ("GCC") states, The Kingdom of Bahrain has a nominal GDP of about US$35bn in 2020 (2019: US$39bn) and a population of around 1.5mn. A declining nominal GDP and an increased population, has reduced GDP per capita to US$22,878 during 2020 from US$23,504 during 2019, still classifying the Kingdom as 'high-income earning' as per the World Bank.

Table 1: Bahrain Economic Snapshot

Figures as stated	2016	2017	2018	2019	2020
Population ('000)	1,424	1,501	1,503	1,484	1,513
Nominal GDP (US$'bn)	32	35	38	39	35
GDP per capita (US$) #	22,619	23,709	23,991	23,504	22,878
Real GDP Growth (%)	3.2	3.8	1.8	1.8	-5.4%
Oil-GDP Growth (%)	-0.1	-0.7	-1.3	2.2	2.0%
Non-oil GDP Growth (%)	4.0	4.9	2.5	1.7	-7.1%
Average CPI (%)	2.7	1.4	2.1	1.0	0.0
Unemployment Rate (%)	3.7	3.6	3.9	4.0	4.9
Current Account Balance (% of GDP)	-4.6	-3.8	-5.9	-2.1	-8.0%
Fiscal Balance (% of GDP)	-13.6	-10	-6.3	-4.7	-13.0%
Overall Government Debt (% of GDP) @	81.3	88.1	95.0	103.4	128.3

(Source: Bahrain Government bond prospectus – Jan. 2021 & May 2020, EDB, CBB; negative current and fiscal balance indicates deficit; * including gold; @ gross, and inclusive of CBB's Government claims and retail banks' loans to Government; # World Bank)

Given a sizable share of hydrocarbons in the country's growth aggregate, external balance and public finances, Bahrain features a high degree of correlation to the hydrocarbon sector. Lower oil prices coupled with weak consumption and investment precipitated into a higher economic deceleration of 5.4% during 2020 (2019: growth 1.8%). While oil prices averaged at about US$42 per barrel in 2020 vis-à-vis US$64 per barrel in 2019, these have breached US$70 per barrel by May, 2021. Tracking a revived global growth outlook of 4.0% in 2021, along with gradual normalization of business sentiment, Bahrain may post moderate recovery in GDP growth, expected at 2.2% in the current year.

Deceleration in real economic growth is attributable to 7% decline in non-oil segment (2019: growth of 2%), with the oil based economy estimated to have posted 2.0% growth in 2020 due to relatively higher oil production vis-à-vis prior year. Non-oil based economy suffered in particular due to contraction in high contact and job-rich services sectors. Due to travel and logistics restrictions, hospitality, tourism and transportation sector were hit until H1'20. With partial normalization in the economy and widespread COVID-19 testing and tracing, hotels and restaurants grew 71.1% quarter-over-quarter ("QoQ") in Q3'20, followed by transportation and communications (up 22.4% QoQ) and manufacturing (up 4.2% QoQ). Financial corporations, representing highest share in the non-oil segment (17.1% of GDP in Q3'20), had registered 3% QoQ growth in Q3'20 following a 5.8% contraction during H1'20.

The onset of the pandemic resulted in lockdowns and slower demand, raising unemployment rate. About 3/4th of the population is represented by expatriate workers in the country (Q3'20). The number of employed Bahraini citizens was declining even prior to the pandemic, with unemployment rate having risen to 4.7% in 2019 from 4.1% in 2017. The government has taken a number of initiatives including providing social benefits to lower income families, providing salaries for Bahrain citizens and companies and supporting companies to avoid any further unemployment.

Bahrain has officially pegged Bahraini Dinar ("BHD") to the U.S. Dollar at US$/BHD @ 0.376. The currency peg has allowed the country to maintain price stability and growth, as an oil-centric small economy, albeit gradually diversifying. The pegged currency allows for limited monetary policy transmission, largely following the monetary policy of the United States Federal Reserve ("Fed rate") to preserve the peg. Mirroring the U.S. Fed rate, CBB reduced the benchmark one-week deposit facility rate twice with a cumulative 125bps decline to 1.0% during 2020, in addition to cuts in the overnight deposit and lending rates. The slowdown in demand led to a deflationary environment largely impacted by recreational activities,

[1] *Source: EIA, Brent crude spot prices*
[2] *Source: World Bank – Jan. 2021*

restaurants and hotel rent, with CPI during 11 months of 2020 averaging negative 3.6%. As demand picks pace globally, USD interest rates are expected to begin inching up, to be followed by local policy rates.

Persistent twin deficits, highly correlated to oil price movements, had responded to efforts at diversifying the economy over the past few years with significantly narrower deficits in 2019. The improving trend reversed in 2020 with both current and fiscal account posting the highest deficit in last four years. In response to the pandemic, the Bahrain government introduced a fiscal stimulus package of US$1.5bn in March 2020, with an additional drawdown of US$470mn from the General Account. The stimulus was invested in various measures to support the economy, businesses and households including (i) payment of salaries, (ii) payment of electricity and water bills for citizens[3], (iii) exemptions of some government fees, (iv) exemptions from rent to government, and (v) support to SMEs among others. The increase in expenditures and decline in revenues due to slower business led to a higher estimated fiscal deficit of 13.0% of GDP during 2020 (2019: deficit 4.7% of GDP).

With a 9.6% drop in global trade[4], Bahrain's exports and imports declined by 17.1%[5] and 10.6% respectively during 2020 from a year ago. As a result, the current account is estimated to have posted a deficit of 9.3% of GDP (2019: deficit 2.1%). Both direct and portfolio account posted strong inflows during the period to partially counter the effects on international reserves.

Debt position has remained significantly stressed. As the twin deficits further widened, gross government debt has increased substantially from 93.8% of GDP as at end-2019 to 118% of GDP at end-2020. Within this, Bahrain's external debt has also been consistently increasing and stood at US$25bn at end-2020 (2019: ~US$22bn), translating into slightly over 75% of GDP at 2020. For the outstanding external debt at end-2020, the repayments are clustered during the upcoming 10 years 2021-2032 with amortizations ranging between US$1.2bn - US$2.2bn each year. It may be notable that the country has been successfully accessing capital markets and recently issued US$2bn bonds in three tranches in January 2021 to finance the deficit. With fiscal break-even oil price for Bahrain hovering above US$100/bbl, the country may be expected to continue to tap the capital markets to fund its deficits. However, this may be unsustainable in the longer-term, calling for rapid investment in economic diversification.

Banking Sector Overview

Table 2: Key Financial Indicators - Banking Sector

Figures as stated	**Q4'19**	**Q4'20**	**Q4'19**	**Q4'20**	Q4'19	Q4'20	Q4'19	Q4'20	Q4'19	Q4'20
	Overall		CR		IR		CW		IW	
CAR (%)	19.2%	18.6%	21.1%	20.0%	18.3%	20.3%	18.6%	17.8%	17.4%	16.4%
Tier I CAR (%)	17.9%	17.3%	19.7%	17.5%	15.7%	17.9%	17.7%	16.9%	16.3%	14.9%
Gross Impairment (%)	4.8%	4.3%	4.9%	4.7%	10.4%	6.5%	4.5%	4.1%	1.1%	1.6%
Specific Provisions Coverage (%)	62%	68.2%	66.1%	70.3%	36.7%	42.9%	74.3%	74.3%	93.8%	87.7%
RoA (%)	1.1%	0.7%	1.8%	1.0%	0.4%	0.2%	0.9%	0.8%	0.7%	0.2%
RoE (%)	7.9%	2.6%	14.2%	9.7%	4.7%	2.1%	4.8%	-5.3%	6.3%	2.3%
Liquid Assets to Total Assets (%)	25.5%	24.5%	36.0%	34.4%	17.5%	17.8%	21.3%	21.5%	17.7%	14.6%
Financings to Deposits (%)	71.5%	71.0%	65.8%	66.3%	92.5%	79.7%	68.5%	71.3%	69.9%	63.2%

(Source: CBB; CR: Conventional Retail; IR: Islamic Retail; CW: Conventional Wholesale; IW: Islamic Wholesale)

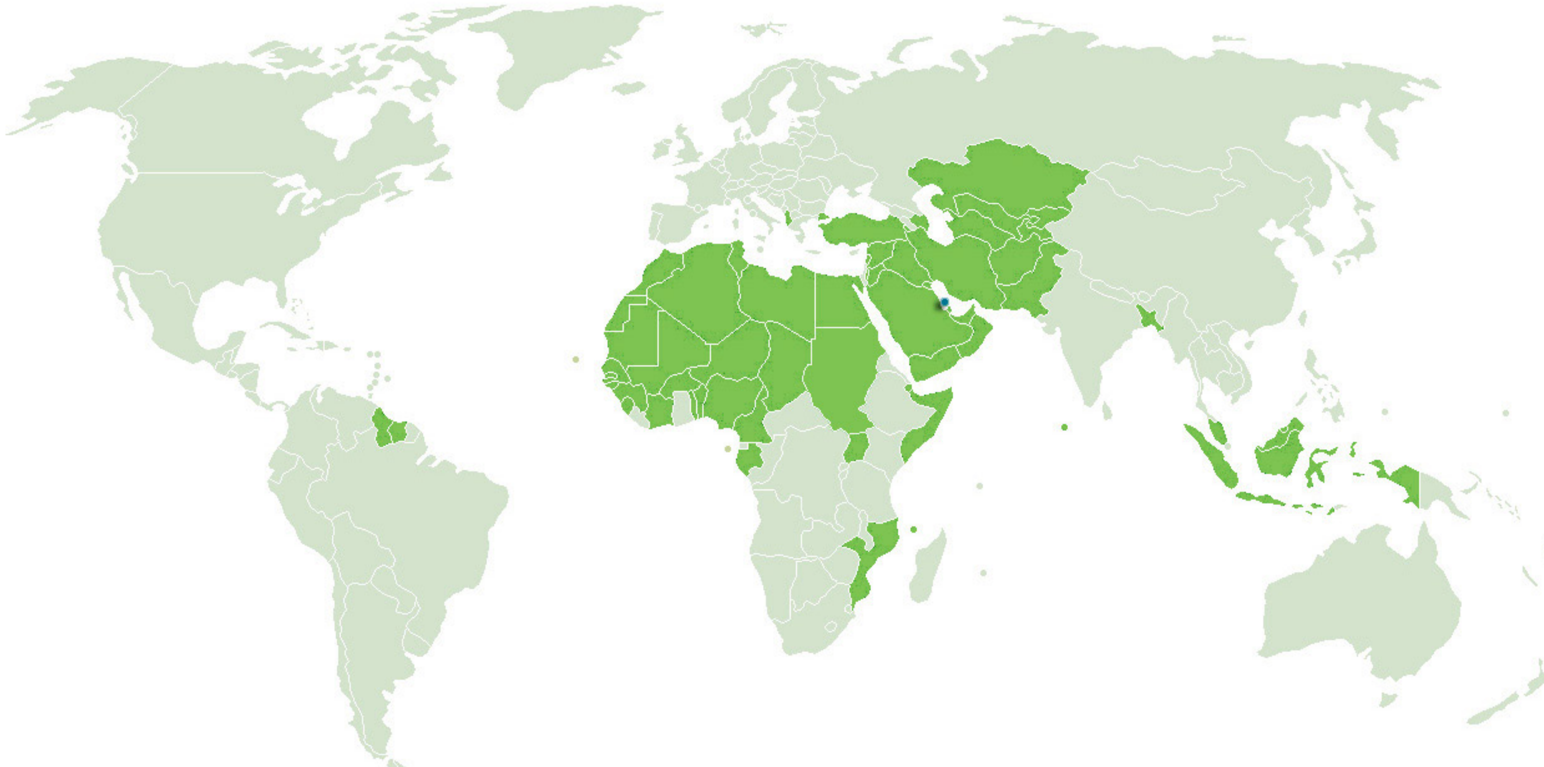
Financial sector in Bahrain has been strengthening over the years, becoming the largest contributor to the economy over the last few years. The Banking system has remained the leading strata of the financial sector, with 91 banks operating in

[3] Also for Bahraini companies for April-June 2020; For Bahraini citizens it covered primary residences until end-2020
[4] Source: IMF – January 2021 World Economic Outlook
[5] Including services credit

the Kingdom, distributed into 61 wholesale banks and 30 retail banks as at end-2020. Out of the 30 retail banks, 13 are locally incorporated, while 17 are branches of foreign banks. The sector employs more than 14,000 personnel, with around two third being Bahrainis and remaining being foreigners. CBB has been proactively managing the sector with a forward looking approach setting high standards of transparency, governance and competence for both conventional and Islamic banks in the country. CBB has taken a number of initiatives to strengthen the financial sector with a specific focus on stability, financial inclusion, Fintech and open banking.

The year 2020 posed challenges to the banking sector globally. The capital buffers of Bahrain banks showed some decline moving down to 18.6% during 2020 from 19.2% in 2019, with a similar fall in Tier 1 capital. As CBB took multiple measures to support businesses and households including interest rate cuts and loan moratorium, the sector's profitability measures took a hit, with RoA and RoE declining to 0.7% and 2.6% respectively vis-à-vis 1.1% and 7.9% respectively in 2019. Asset quality indicators are currently stressed, even as gross impairment ratio has declined to 4.3% by end 2020 (2019: 4.8%). Provisioning coverage depicted an increase to 68.2% during 2020 (2019: 62%). IIRA maintains a cautious outlook on the banking sector in Bahrain, as the Covid-19 concessionary measures are still in place and asset quality may be impacted due to weak macroeconomic conditions in the current year.

The country has the largest concentration of Islamic Financial Institutions, with 18 Islamic Banks, and an asset base of US$31.2bn as of end-2020. Islamic assets formed around 15.2% of the total banking system assets as of end-2020, and the segment is adequately capitalized. Though still high, gross impairment in the Islamic Retail Banks, has declined to 6.5% during 2020 from a high of 10.4% during 2019.



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