

Bahrain's Economic Triad: Liberalization, Growth and Stability

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The Kingdom of Bahrain is unique. A tiny archipelago only 250 square miles in area, Bahrain has slightly over one million residents, almost half of whom are foreigners. Located along historical trade routes moving goods from east to west, Bahrain has been inhabited by traders for thousands of years. This has resulted in one of the most open societies in the region—both culturally and economically. Openness is not only a hallmark of Bahrain's past, but is the key to the country's strategic plans for the future as well.

Economically, Bahrain stands in stark contrast to its oil-exporting neighbors in the Arabian Gulf. Although it sits only 20 miles off the east coast of Saudi Arabia and the world's largest oil reserve, Bahrain's only oil field produces less than 35,000 barrels of oil per day. Located west of the world's largest natural gas field, which Qatar and Iran share, Bahrain also has relatively little natural gas.

As a result of its small size and meager natural resources, one would expect that Bahrain would not be a major contender in the world economy. However, this is not the case. For many years the Bahraini leadership has made a concerted effort to modernize, liberalize, and diversify its economy, while simultaneously investing in its most important resource—its people. As a result of these efforts, Bahrain has not only created a modern, service-based economy and established itself as the financial capital of the region, but positioned itself well to weather the economic storm that is buffeting the world.

Economic Liberalization Leads to Investment

The Government of Bahrain has substantially liberalized Bahrain's economy over the past decade, passing laws allowing foreign property ownership, establishment of foreign companies without a local partner, reducing or eliminating taxes and tariffs, and divesting government ownership and control in key industries. The government has also tightened its anti-money laundering laws and enhanced the Central Bank's oversight and regulation of financial institutions. Following the creation of a Supreme Privatization Council in the spring of 2001, King Hamad bin Isa Al-Khalifa also issued a decree in October 2002 that outlined a strategy for privatizing numerous sectors including tourism, telecommunications, transportation, electricity and water, ports and airport services, oil and gas, and postal services.

Consider telecommunications, which was the first key sector to be liberalized. The Telecommunications Regulatory Authority (TRA), established in 2002, awarded the first independent mobile telecommunications services license to MTC-Vodafone, thus ending the monopoly of Bahrain's telecom service provider, Batelco. Additional licenses and concessions followed and full liberalization of the telecommunications sector was completed on July 1, 2004.

This was only the first step. The Government, under the privatization law, made a commitment to gradually dispose of its interests in key companies and industries. The government established a quasi-independent holding company, Bahrain Mumtalakat Holding Company, to manage its investments. Mumtalakat has actively moved to diversify its investment portfolio and is currently in the process of divesting its remaining 36.6 percent share of Batelco.

As a result of these and other market liberalization policies, Bahrain is arguably the most business-friendly location in the Middle East. The Heritage Foundation has named Bahrain the most economically free country in the Middle East, and the 16th most free country in the world in their annual Index of Economic Freedom. Bahrain has no income tax, no value-added tax, no withholding tax, no capital gains tax, no wealth tax, no inheritance tax, and has largely eliminated corporate taxes. One of the few business expenses levied, as part of a major labor reform policy, charges companies a fee of BD 10 per month/per employee (approximately US\$ 26.50) to the cost of employing foreign labor. Eighty percent of the monies collected from the labor fund are re-invested in the education and training of the Bahraini work force.

Bahrain welcomes foreign investment and allows for 100 percent foreign ownership of companies, as well as the establishment of foreign companies without a local partner or sponsor. This move by the Bahraini government has been highly successful in attracting Foreign Direct Investment (FDI). FDI in 2006 and 2007 were among the highest levels ever recorded for Bahrain. According to the 2008 World Investment Report, Bahrain ranked #1 in the Gulf Cooperation Council (GCC) and #12 in the world for inward FDI.

Andrew Trevis, Plant Director for Kraft Foods, has said, “Setting up a business in Bahrain was easier, quicker and more straightforward for us than in any other country in the region. The ability for Kraft Foods to own 100 percent of the company here was highly attractive. This was not the case in any of the other GCC nations we were considering. We have also found Bahrain’s ministries to be both transparent and consistent; two qualities that are critical to the successful establishment of a business.” Kraft is not alone in that assessment. In March 2009, Ernst & Young announced that it would be moving its world energy headquarters from Houston to Bahrain, noting the Kingdom’s central location in the Gulf and easy access to Saudi Arabia. Occidental Petroleum also announced that it would create a joint-venture company in Bahrain, investing more than \$1.5 billion in local operations.

Diversification and Creation of a World-Class Financial Sector

A common saying in economic analysis is to “follow the money.” In other words, an unencumbered market will invest money where it should be allocated to produce the greatest gains. If one examines the growth of the financial services sector in the Middle East, the money often leads to Bahrain. Widely regarded as the best-regulated financial center in the Middle East, Bahrain has been the region’s undisputed financial capital for more than 40 years. Though much of this achievement can be attributed to the aforementioned liberalization policies, Bahrain’s regulatory environment has also played a

significant and positive role in the success of the financial sector. The Central Bank of Bahrain is generally recognized as the most successful monetary authority in the Arab world in terms of regulation, innovation, non-discriminatory treatment, license management and operational efficiency.

Financial services currently make up 27.6 percent of Bahrain's GDP, and there are over 400 licensed financial institutions. This has created a large pool of local talent; of almost 10,000 people employed in the industry, 72 percent are Bahraini. And this sector has continued to experience strong growth. Banking assets rose by 33.5 percent in 2006, and by more than 18 percent in the first half of 2007. Despite the global economic downturn, opportunities for growth can be found in fund administration, project finance, private banking and asset management.

Bahrain has also been an innovator in Islamic finance and has the largest concentration of Islamic financial institutions in the Middle East, including commercial, investment and leasing banks, insurance companies and mutual funds. Bahrain hosts a number of organizations central to the development of Islamic finance, including the Accounting and Auditing Organisation for Islamic Financial Institutions, the General Council for Islamic Banks and Financial Institutions, the International Islamic Financial Market and the International Islamic Rating Agency.

An Open Economy Leads to Stability

Historically, the United States and Bahrain have shared a solid and growing trade relationship. This relationship was strengthened dramatically in August 2006 when the US-Bahrain Free Trade Agreement (FTA) entered in to force. In the years following the signing of the FTA, both countries have benefited economically. Total bilateral trade between the United States and Bahrain grew from \$782 million in 2005 to more than \$1.3 billion in 2008. While some of that growth comes directly from the FTA, it can also be attributed to progressive fiscal and economic policies that have transformed Bahrain into a leader in the region, capable of taking advantage of other economic opportunities in other markets. The free-trade agreement between the United States and Bahrain was not the beginning of a trade relationship, it was a natural outcome—an affirmation of the open market policies, transparency and liberalization that Bahrain has pursued for years.

Bahrain, whether through choice or through necessity, has made difficult choices over a sustained period to liberalize its economy and create a market/regulatory environment that is among the most open in the world. As the world navigates the economic turmoil associated with the recent financial market collapse, Bahrain finds itself uniquely positioned in the region to survive largely unchanged. No doubt the economic downturn will be felt, as it has already begun, but Bahrain's economic liberalization policies have left it with an advantage over its neighbors. Just as there is a "flight to safety" when markets are unstable, there will be a "flight to freedom" as investment dollars become more limited. Investment will follow the path of least resistance and flow to where there is the greatest opportunity to succeed. Situated at the heart of the Gulf, and just 20 miles from Saudi Arabia's Eastern Province, which accounts for 50 percent of Saudi Arabia's GDP, Bahrain

offers an open market at the gateway to a quickly developing region with a combined GDP approaching a trillion dollars—a market that will likely continue to grow despite the global economic downturn.

Bahrain demonstrates the benefits of economic liberalization and openness—international trade and investment flourish. Although Bahrain’s GDP may be relatively small at just over \$20 billion/year, it has grown consistently at about five percent annually for more than a decade, and is expected to continue to grow for the foreseeable future. Through Bahrain’s market reforms, it has charted a course leading to economic growth and stability.