

ROLE OF THE FINANCIAL SECTOR IN BAHRAIN ECONOMIC DEVELOPMENT

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Abstract: *Since 1970s the financial sector of Bahrain has been showing significant growth and is rightly becoming a full-value sector of national economy. Around 400 financial institutions including international banks and different financial institutions represents it. Thanks to oil discovery and increased exports revenues Bahrain focused on becoming regional and international financial center. The development of the financial sector led to the diversification of the economy. Establishing of the world Islamic finance center was one of the key factors of increasing the role of the further economic diversification. The article analyzes main factors of the growth of the financial sector of Bahrain and estimates its role in the economic development of the country. Recent changes in oil prices in the world energy market and depletion of hydrocarbon reserves of Bahrain development of the non-oil industries is of great importance for the Kingdom. There are some other external factors such as competing with such GCC financial players as Dubai and Qatar financial centers, regional political crisis, etc., which influence Bahrain economic and financial development.*

Key words: *Bahrain, financial sector, Islamic financial center, and economic development*

JEL codes: *F30, O16, O53*

1. Introduction

The Kingdom of Bahrain has a developed financial sector that makes a significant contribution to its economic development. There are different international institutions represented in the kingdom today, they include Citybank, BNP Paribas, HSBC Bank Middle East Ltd, Standard Chartered Bank. Bahrain's special role is to create an Islamic financial industry that demonstrates sustainable development.

A variety of factors influence the gradual qualitative and quantitative growth. Due to the discovery of hydrocarbon reserves, the development of their processing and export revenue, the accumulated historical experience of international trade, the country has set the task of becoming an international financial center, which in its turn contributed to the diversification of the economy.

For almost half a century, Bahrain has been the financial capital of the Arab region. The emergence of the financial industry in Bahrain dates back to 1920, when the Eastern Bank (now the Standard Chartered Bank) began operating in the country, followed by the creation of the British Bank of the Middle East (now Hongkong and Shanghai Banking Corp (HSBC)) in 1944, then the first local bank - Bank of Bahrain (now National Bank of Bahrain) in 1957 and, finally, the Arab Bank (Arab Bank Limited) in 1960.

Launching offshore banking units accelerated the development of the banking sector mainly after the adoption of the relevant regulation in 1973. The oil boom and the subsequent rapid growth of business activity turned Bahrain (along with other Gulf countries) into a recipient of large financial resources. The civil war in Lebanon in 1975 led to the outflow of capital from Beirut, the financial center of the Middle East, to Bahrain.

Since 1978, the country began forming a world center of Islamic finances, when the Islamic Bank of Bahrain was established. Today, Bahrain is one of the global leaders in Islamic finances. The country is characterized by the highest concentration of Islamic financial institutions in the Middle East and North Africa. The leading positions belong to the kingdom in the field of Islamic securities (Srairi, 2019).

In 1984, the first Bahraini Investment Fund was established. In 2007, the Central Bank of Bahrain improved its regulatory framework by allowing hedge funds and other similar financial institutions to operate directly from Bahrain.

A key element of the financial system of Bahrain is the Bahrain Stock Exchange, which has been functioning since 1989.

The expansion of the role of Bahrain as a financial center continued until the competition for financial leadership in the region intensified: in 2004 financial centers were established in Dubai and in 2005 in Qatar.

The internal conflict in Bahrain in the spring of 2011 led to the outflow of capital to Dubai, where a number of financial institutions and businesses moved. Social and political tensions and the events of the Arab Spring in 2011 generally negatively affected Bahrain's position in regional finances (Tyrkba et al., 2017).

The decline in world energy prices since 2014 also had a negative impact on the growth rate of financial sector assets (Alsmadi & Oudat, 2019).

The breach of Bahrain's relations with Qatar also negatively affected the financial system of the kingdom. Qatar has a solid investment potential, Bahrain and its financial instruments provided an excellent opportunity for diversification to its private investors (Shkvarya et al., 2019).

Despite negative trends, a number of factors strengthen the financial position of the kingdom in the region. The development of the financial sector is based on the openness of the Bahrain economy, a stable macroeconomic and fiscal policy, a reliable regulatory framework, designed considering international standards, and highly qualified Bahraini specialists.

2. Methodology and Data

With the help of historical method, we have briefly shown the progress of the financial sector development. The factors of development have been detected due to the methods of induction and synergy. The author of the current paper also uses the method of observation and the results of meetings and conversations with some representatives of the financial sector of Bahrain, including the management of the Bank of Bahrain).

To conduct the research, different databases were used as a source of information, such as publications and reports of the Central Bank of the Kingdom of Bahrain, the Ministry of Finance of the Kingdom of Bahrain, the Bahrain Bourse, the Bahrain Economic Development Board, analytical articles from the financial and economic publications Financial Times and Forbse, as well as scientific works of Russian scholars specializing in Arab countries, in particular, orientalist V. Isaev and A. Filonik, economists L. Shkvarya (Isaev & Filonik, 2006, Shkvarya et al., 2019) and others.

3. Results and Discussion

Currently the share of the financial sector in Bahrain's GDP is 16.7%, 14,093 people are employed in finance, 66% of them are Bahrain citizens (www1). For an economy, that traditionally has been producing oil and relying on revenues from the energy sector, the share of the financial sector in GDP, which reaches almost a fifth of GDP, is quite sound. Although, at times of negative external factors, the share of finance in Bahrain's GDP structure has decreased, the contribution of the financial sector to the economy is significant. In addition, the financial system of Bahrain is diversified in terms of geography and activities of financial institutions. The financial system of Bahrain includes 385 financial institutions; their geography is very extensive. Banks and financial companies from the UAE, Jordan, India, Pakistan, the USA, Great Britain, France, Japan, Turkey, Kuwait, Iraq, Lebanon, Saudi Arabia, Palestine, Cayman Islands and others are operating in the country.

The banking system is the largest element of the financial sector; there are 98 banks in the country, including traditional and Islamic banks. They account for more than 85% of the country's total monetary assets, and banking sector assets (\$ 192.1 billion) exceed Bahrain's current GDP (\$ 35.4 billion) by 5.4 times (www1), which almost doubled from 106.4 billion dollars in 2000

It is worth mentioning that banks play a key role in reinvesting revenues from oil product exports, as well as financing other sectors. The stable annual growth of the banking system of Bahrain is largely ensured by the returns from the work of the energy sector, which is the main driver of bank liquidity and a source for reinvesting these returns in other sectors of the kingdom's economy.

Domestic assets of the banking system exceed Bahrain's GDP by 1.7 times and amount to \$ 59.8 billion (www4). Over the past ten years, foreign assets of the banking system of the kingdom more than doubled, amounting to \$ 131 billion in 2018. The highest value of foreign assets of banks in 2007 reached \$ 208.3 billion (www2).

One of the largest Islamic banks in the world is located in Bahrain, which strengthens the country's position as a global Islamic financial center. Al Baraka Banking Group has been incorporated in Bahrain since 2002 as an Islamic bank. Moreover, the first bank of Al Baraka Islamic Bank was opened in Bahrain back in 1984.

Today the group is widely represented, has subsidiary banks and representative offices in 17 countries (www4). Bank shares are listed on the stock exchanges of Bahrain and Nasdaq Dubai. The authorized capital is \$2.5 billion. Total assets in 2017 amounted to \$25.5 billion

(www4).

In 2017, Al Baraka Banking Group allocated \$ 930 thousand for social projects in Bahrain as part of a global program. 116 thousand dollars out of them were directed to educational, health, sports, cultural and social projects, interest-free loans worth \$814 thousand were issued to 23 individuals.

Al Baraka Islamic Bank spent \$382 thousand on social projects in Bahrain in 2017. Financing of economic opportunities and social investment programs amounted to 24.628 million dollars. Moreover, 68% was directed to local, micro, small and medium enterprises, 32% - on social projects (www4).

In general, Bahrain finances 8% of charity projects and 15% of interest-free loans issued by the Group in the world. Of course, such injections are substantial for Bahrain economy and help to some extent maintain social stability (Shkvarya & Frolova, 2017).

Particularly important factor for the development of the financial system of Bahrain and the integration processes in the GCC as a whole is the activity of Gulf International Bank (GIB), founded in the Kingdom of Bahrain in 1975 by 6 GCC countries. The main shareholder is the State Investment Fund of Saudi Arabia with a share of 97.23% (www3). The total assets of the universal bank are \$ 25.5 billion. Currently GIB Capital, a part of the GIB, is the leading regional bookrunner in sovereign and inter-Arab issues. For three issues, 4.25 billion dollars was attracted for Bahrain.

It is obvious that Bahrain is actively resorting to GIB services, using both accessibility and participation and reaping the benefits of the development of the financial center.

Bahrain is characterized by a diversified and dynamically developing insurance sector, represented by 144 insurance companies and organizations, including international companies.

Recently, there has been an increase in all indicators characterizing the development of the insurance business in the country; in particular, the number of the employed in the sector is increasing. The volume of paid insurance premiums has also increased significantly - from 90.1 million to 239 million Bahr. Dinars that is, more than 2.5 times. In 2015, the volume of insurance premiums reached \$ 723.649 billion (www1).

Institutional investment is a new, but dynamically expanding area of Bahraini finance. There are 2,288 funds in the kingdom with a net worth of \$ 6.84 billion. In general, investment funds are an effective mechanism for redistributing financial resources in the country.

The stock market currently trades shares of 44 Bahraini and foreign companies, 17 mutual investment funds and 15 issues of bonds and sukuk. Trades are held by 12 brokers (www5).

The capitalization of the exchange in January 2019 amounted to \$ 22.63 billion, more than 3 times higher than the 2000 indicator. Thus, it can be stated that the unfavorable price situation on the world oil market did not have a distinctive depressing effect on the work of the national exchange.

The main part of stock markets traditionally falls on securities of the banking sector or 52% of the value of all trading, followed by investment sector securities, insurance and other services (www5).

Local and foreign investors are almost equally active on the exchange with a slight excess in favor of the Bahraini - 55.2% and 44.8%, respectively.

Thus, Bahrain, despite such restrictive factors as territory, population, small economy, has a developed and diversified financial market with regional and global significance. The country's attractiveness and prospects for international financial business are based on a number of significant reasons.

4. Factors of financial sector development in Bahrain

A dynamic and high-quality growth of the financial sector contributed to the transformation of Bahrain and further maintaining the status of a regional and international financial center (Isaev & Filonik, 2006). Back in 2000, Bahrain refused to describe itself as an offshore financial center in favor of an international and regional financial center.

Strengthening the role of the financial sector in the country's economy reduces dependence on the energy sector and strengthens the country's competitive position in the global financial market.

One of the key factors for the successful development of the financial sector of Bahrain is the strategic location of the kingdom, which provides perfect access to other countries that are members of the GCC.

Bahrain is also characterized by a favorable liberal legislative environment. There are no restrictions on the export of capital, profits, dividends and currency conversion in the kingdom. Starting a business with 100% participation of foreign capital in many sectors of the economy is allowed.

Preferential taxation facilitates the entry of foreign financial institutions into the country. Now businesses are subject to a 5% value added tax. A single income tax at a rate of 46% is applicable to oil and gas companies (exploration, production and processing) operating in Bahrain. Municipal tax is paid for rental property. Social tax is paid by all employing companies

if the number of employees is more than 10. The only sales tax is the tax on the sale of gasoline at a rate of 12%.

Bahrain customs legislation aims to stimulate domestic production and export of goods. Means of production and goods intended for export are fully exempted from customs duties and taxes. Raw materials and semi-finished products imported for further processing, imported goods purchased for development projects are not subject to import duties. An important factor in the development of the financial system of Bahrain is the effective performance of the Central Bank of Bahrain.

A developed transport infrastructure, namely the presence of a world-class international airport and a regional hub for land and sea traffic, enhances Bahrain's attractiveness for conducting international business.

The presence of educated, bilingual (Arabic and English) labour force also stimulates the development of the country's financial system (Aydrus, Ryazantsev et al., 2019). In terms of developing the education system and creating the environment for improving the quality of human resources, Bahrain stands out from the other Arab countries (www8).

A stable macroeconomic situation helps strengthen the financial status of Bahrain in the region and the world. The national currency of Bahrain is fully convertible and sound. The exchange rate is very stable; it has practically not changed for 10 years. The country is actively involved in the life of the global business community. According to the Ministry of Finance, Bahrain and 44 foreign countries have concluded double taxation avoidance agreements, and almost all of them have already been ratified. 35 countries have signed investment promotion and protection agreements, 31 countries - agreements on economic, trade and technical cooperation and protocols of intent in this area, 38 agreements - on the exchange of information. A very important reason for the growth of the financial sector of Bahrain is the modern standard of living in a cosmopolitan, almost friendly atmosphere. In 2018, Bahrain was the 5th friendliest country in the world (www6). Two consecutive years in 2017 and 2018. Bahrain takes the 1st place in the Expat Insider ranking, evaluating the quality of living of expats in 72 cities of the world (www7).

5. Conclusions

The financial system of Bahrain has developed due to the openness of the economy, stable and consistent macroeconomic policies, especially fiscal policy, competent regulation, the

application of international standards and expertise, as well as the availability of highly qualified labour force.

Liberal legislation, a cosmopolitan lifestyle contributed to the transformation of Bahrain into an attractive climate for the financial business and specialists in this field. The development of the financial sector of Bahrain was accompanied by revenues from the energy sector, which is the main generator of bank liquidity and a source for reinvesting these revenues in other sectors of the kingdom's economy (Aidorus & Kokuytseva, 2012). The key link in the financial system of Bahrain, thus the most contributive to the economy, are banks. Bahrain is also a world leader in the development of Islamic financial institutions. Thus, despite the limited territorial, human and natural resources in Bahrain, favorable conditions were created for the activities of foreign and local financial institutions that help the country's economy diversify and strengthen its financial role in the region.

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