Foreign Direct Investment in Bahrain

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Boca Raton, Florida
USA • 2010

ISBN-10: 1-59942-321-9
ISBN-13: 978-1-59942-321-0

Acknowledgements

This thesis would not have been possible without the help, support and comments of a number of people. First and foremost, I would like to thanks Mr. H. K. Radice, Head of School of Politics and International Studies, University of Leeds, whose guidance throughout my PhD was invaluable. I am also grateful to Professor R. C. Bush of Leeds University for help during my research. Furthermore, I would like to thank the interviewees who all gave, generously their time. Finally a big thank you goes to my husband, Nawaf Al- Jalahma, who provided humour, inspiration and moral support throughout the writing of this thesis.

Abstract

A significant volume of literature has been developed that seeks to provide an explanation for the growth of FDI and its impact on less developed countries. The literature is characterized by diversity and controversy. Based on it, a range of reasons for encouraging investment have been proposed including its favorable effects on employment levels, the balance of payments and balance of trade of the host country and also the potential for acquisition of technology and skills (Cave: 1982 and Dunning: 1993). Equally, the potentially negative effects of growing levels of foreign investment on domestic market structures and national sovereignty have long been the focus of attention (Vernon: 1971 and Jenkins: 1987). More recent studies focused on the positive effect FDI can create through the integration of a host country into the global economy and the system of international division of labor based on fragmentation of production (Gereffi and Korzeniewicz: 1994, and Henderson, Decken, Hess, Coe and Yeung: 2002).

Little if any research has examined the impact of FDI on the oil monarchies. Conventional expectations persisted that once they enter the post-oil phase of their histories, it will be difficult for them to uphold their political legitimacy and survive intense domestic and international pressures upon their regimes (Taeker: 1998 and O'Reilly: 1999). It has been argued that oil income enable them to pacify opponents by providing their subjects with jobs that pay well and has had detrimental effect on both economic development and political liberalization. These expectations have tended to be contradicted by actual development. The private sector has become remarkably strong in the oil monarchies and their governments were not highly resistant to change as depicted by the rentier state paradigm (Mahdavy: 1970, and Beblawi: 1987). Taking Bahrain as a case study, this thesis argues that despite its limitations as a small nation and the paucity of its oil reserves, Bahrain punched well above its weight due to its open economy and foreign direct investment. Its domestic economy is well integrated into the global market. It was able to exploit some of the opportunities that were presented by economic globalization when niches were opened or vacated within the networks of global production. It has developed energy-intensive industries (aluminium and petrochemicals) and became the major financial centre of the Middle East. Yet in spite of the government incentives, it still faces some challenges in attracting FDI in downstream activities related to oil and aluminium, which suggests that additional reforms are needed.

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Abbreviations

AAOIFI	Auditing Organisation for Islamic Financial Institutions
ABC	Arab Banking Corporation
AGOIC	Arab Gulf Organization for Industrial Consultancy
ALBA	Aluminium Bahrain
ALCAN	Aluminium Limited of Canada
ALCOA	Aluminium Company of America
AMF	Arab Monetary Fund
ANZ	Australia and New Zealand Banking Group
ASEAN	Association of Southeast Asian Nations
ARAMCO	California Arabian Standard Oil Company
AZL	Arizona Land Income Corporation of the United States
AZI	Al Zayani Investments
AWAC	Alcoa World Alumina
BAC	British Aluminium Company
BANGAS	Bahrain National Gas
BAFCO	Bahrain Aviation Fuel Company
BAI	Bahrain Atomisers International
BALEXCO	Bahrain Aluminium Extrusion Company
BAMCO	Bahrain Alloy Manufacturing Company
BANOCO	Bahrain National Oil Company
BAPCO	Bahrain Petroleum Company
BATELCO	Bahrain Telecommunication Company
BDF	Bahrain Defence Force
BFH	Bahrain Financial Harbour
BIC	Bahrain Investor Center
BIS	Bank for International Settlements
BITs	Bilateral investment treaties
BTIBF	Bahrain Training Institute of Banking and Finance
BMA	Bahrain Monetary Agency
BMW	Bayerishe Motoren Werke (Bavarian Motor Woks; German auto manufacturer)
BP	British Petroleum
BTC	Bankers' Training Centre
CE	Central Europe
CIA	Central Intelligence agency (US government)
CSI	Closures System International
DIFC	Dubai International Financial Centre
DMI	Dar al-mal al-Islami (House of Islamic Finance)
DUBAL	Dubai Aluminium
E&P	exploration and production
EDB	Economic Development Board
EEC	European Economic Community
ECLA	Economic Commission for Latin America
ENI	Ente Nazionale Idrocarburi of Italy

EPZs	export processing zones
ERAP	Entreprise de Recherche et d'Activités Pétrolières
ESCAP	Economic and Social Commission for Asia and the Pacific
ESCWA	Economic and Social Commission for Western Asia
EU	European Union
FDI	foreign direct investment
FTAA	Free Trade Area of Americas
FTAs	Free trade agreements
GATT	General Agreement on Tarrifs and Trade
GATS	the service agreement
GCC	Gulf Cooperation Council
GCIBFI	the General Council for Islamic Banks and Financial Institutions
GDP	Gross domestic product
GIP	Gulf International Bank
GPIC	Gulf Petrochemical Industries Company
GPN	Global production network
GSP	Generalised system of preference
GARMCO	Gulf Aluminium Rolling Mill Company
HSBC	Hong Kong Shanghai Banking Corp
ICD	Islamic Corporation for the Development of the Private Sector
ICJ	International Court of Justice
ICSID	International Centre for the Settlement of Investment Disputes
IEDC	International Energy Development Corporation
IFC	International Finance Corporation
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
IIRA	International Islamic Rating Agency
ILO	International Labour Organization
IMF	International Monetary Fund
INOC	Iraq National Oil Company
ISI	Import substitution industrialization
ISO 9001	Quality Systems - Model for Quality Assurance In Design, Development, Production, Installation and Servicing
IT	information technology
JCC	Japan Capacitor Industrial. Co. LTD
KNPC	Kuwait National Petroleum Company
KPC	Kuwait Petroleum Cooperation
LDCs	less developed countries
LMC	Liquidity Management Centre
MFN	most favoured nation
MERCOSUR	Mercado Común Sudamericano (Southern Cone Common Market)
MIGA	Multilateral Investment Guarantee Agency
MNCs	Multinational corporations
NAFTA	North American Free Trade Area
NATO	North Atlantic Treaty Organisation
NICs	newly industrialized countries

NIOC	National Iranian Oil Company
OAPEC	Organization of Arab Petroleum Exporting Countries
OBN	own brand name
OBUs	offshore banking units
ODM	original design manufacturing
OECD	Organization for Economic Cooperation and Development
OEM	original equipment manufacturer
OIC	Organization of Islamic Conferences
OPEC	Organization of Petroleum Exporting Countries
R&D	research and development
SABIC	Saudi Basic Industries Corporation
SCVT	Special Council for Vocational Training
SMEs	small and medium-sized enterprises
TIFA	Trade and Investment Framework Agreement
TNC	transnational corporations
TRIPS	trade-related intellectual property rights
TRIMS	trade-related investment measures
UAE	United Arab Emirates
UEA	Unified Economic Agreement
UNCTC	United Nations Centre on Transnational Corporations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNFPA	United Nations Fund for Population Activities (now United Nations Population Fund)
UNIDO	United Nations Industrial Development Organization
UNESCO	United Nations Educational, Scientific and Cultural Organization
VW	Volkswagen
WHO	World Health Organization
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

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Chapter I

Introduction

1.1 Bahrain in the world economy

This thesis focuses on the role of FDI in Bahrain's economic development and government policies towards FDI. Attracting inward investment is a key component in its economic development initiatives, for the potential knowledge transfer and cross fertilization to domestic operators which it can provide (interview 6). Bahrain is one of the Arab Gulf states, the so-called oil monarchies that make up the Gulf Cooperation Council (GCC), Saudi Arabia, Kuwait, Qatar, Oman, Bahrain and the United Arab Emirates (UAE). The GCC economies share certain characteristics with developed economies. These include high levels of per-capita income, convertible national currencies, unrestricted flow of foreign exchange, a well-developed capital infrastructure, long life expectancies, high ratios of capital surplus, a sizeable foreign-aid programme and a high living standard. The GCC in fact surpasses some industrial nations in other aspects, particularly with regard to the expansive welfare system that has long prevailed in the area and the absence of any form of taxation on nationals. However, like most developing nations, they have a limited range of indigenous technological advances (Al-Fayez: 1993).

They have concerns which differ considerably from those of the bulk of emerging and developing nations. Inconsistent with the international model prevailing in the 1960s, they did not reject their traditional elites and capitalist legacies in favour of new political economies and did not embark upon policies of import substitution industrialization. The Gulf is also well-known for its extensive petroleum reserves, its political quarrels, and its proximity to the tides of instability that continuously sweep over the Middle East. Almost defenceless, the oil monarchies turned to the United States for protection and continued to spend extravagant sums on defence procurement and modernization projects. The financing was so easy from oil rents that accrue directly to the government.

Those monarchies, consequently, retain close business links with the US and Europe and have encouraged local private entrepreneurs to benefit from these connections. They have active private sectors, some of which have joint ventures and other constructive relationships with multinational corporations (MNCs), in petroleum-related industries for the most part. These states and their private sectors are, therefore, relatively well integrated into the global economy through these joint ventures and other forms of cooperation with MNCs as Henry and Springborg (2001) pointed out. Yet they are consequently exposed to potential populist backlashes against globalization, with the growth of Islamist oppositions in the region and public dissatisfaction with the US, spurred on by its support for Israel, the Iraq War and its aftermath. Nevertheless, they seem in a better position than the other republics in the region, which have rejected their traditional elites and capitalist legacies in favour of new political economies, to take advantage of the opportunities of the globalizing economies as this thesis argues because of FDI. This is despite the fact that those republics had the most promising prospects for balanced development in the 1950s and the 1960s. Iraq, for instance, was endowed with the world's second largest oil reserves, the most water of any country in the Arabic Gulf, some of the richest alluvial soils, a strong British educational system, and a relatively large, skilled workforce (Henry and Springborg: 2001).

Bahrain was chosen as a case study because it has been engaged in dramatically rapid change. This started with the discovery by the US' Standard Oil Company Chevron of commercial quantities of crude, which led to it becoming an oil exporting country with relatively high income per capita. The tribal structure and the economy of subsistence that was based on fishing, pearl trading and farming had been replaced by a modern state in most outward appearance: heavy automobile traffic, a well-known and busy international airport, a modern dry-dock and ship repair yard, an aluminium smelting plant, a major oil refinery, and a large number of offshore banking units including some of the biggest US and UK Banks. Multinational firms helped the development of these industries in Bahrain. Except for the Bahrain National Oil Company, which has recently been closed to foreign investors, major public enterprises have some degree of participation by foreign firms.

To sustain economic growth and to preserve control over its subjects, however, the state of Bahrain is more in need of new foreign direct and portfolio investment than the other Gulf States. These states have so far successfully pacified opponents by providing their subjects with jobs that pay well and with excellent social services. In twenty or so years, however, Bahrain is likely to enter the post-oil phase of its history. It has been the first producer of oil in the Arabian side of the Gulf and is likely to be the first country in it to confront the depletion of this basic economic resource due to the limited extent of its reserves. Unlike the Saudis and the Kuwaitis, it cannot rely on oil income to maintain its substantial expenditures and therefore, it must seek out economic alternatives to provide its growing and increasingly well-educated population with continued employment and extensive welfare services. Declining oil revenues discourage the government, the traditional source of employment in the Gulf, from more overstaffing. Instead, it requires the private sector to hire indigenous staff and limit the employment of expatriates. The private sector prefers, however, to limit local hires, viewed generally as less efficient and more expensive than expatriates from Asia, and fears facing reduced efficiency and possible declines in their modest manufacturing capabilities if they hire nationals.

Believing that foreign private direct investments in particular will contribute to the desired expansion of national output and employment, Bahrain has resorted to a variety of schemes to induce foreign firms to become more involved in the economy. It has undertaken extensive investment promotion programmes and concluded several agreements at the bilateral and multilateral levels that address investment issues, which complement its national and regional FDI policies (see chapter 3 section 3 and chapter 8). Developed countries and international institutions currently reinforce this trend by setting up a legal framework for minimizing policy intervention in FDI. Nevertheless, there is little if any research that has examined foreign direct investment in Bahrain and the significance of international investment agreement and recent policies changes on Bahrain's economy. The study of Bahrain will add to the vast literature of FDI in developing nations since most of the empirical work has been centered on Latin America and South East Asia, neglecting the Arab countries of the Middle East.

Furthermore, Bahrain is the first country in the Arabian Gulf to embark on major democratic changes, which have been recently praised by President George W. Bush, who described Bahrain as a pioneering country in reforms, democracy, freedom and development (Bahrain Tribune: Feb 14, 2005). While it is very unlikely that Iraq may become the model for the rest of the region, at least for quite a long time, the GCC states seem to be better positioned than the other countries in the region to take advantage of the new opportunities that will be created by the US new political agenda which has emerged after September 11 2001 to encourage or even force political and economic reform in the Middle East, leading to the establishment of democratic governments in all countries and their integration in the globalization process. The US also is pursuing schemes towards the establishment of free trade areas that will eventually liberalise trade and FDI within the region.

Most of what has been written recently on the countries of the GCC agree that they are in a much more favourable position than the other countries in the region to move towards economic reform as well as wider political participation because their economies are much more open, and their private sectors are strong and loyal to their countries (Henry and Springborg: 2001, and Luciani: 2005). The rentier state paradigm which emerged in the 1970s and 1980s, predicted however that those states are less likely to democratize and reform their economy because they are financially independent of society. This prediction has tended to be contradicted by actual developments, as several GCC states have engaged in the road towards wider political participation and economic reforms (Mahdavy: 1970, Beblawi: 1987, and Luciani: 1987).

Internationalization and democratization are widely regarded as pillars of globalization. Sakamoto (1994, p. 1), for instance wrote that ‘underlying the present global transformation, there seem to be forces that are generating fundamental changes on two dimensions-toward internationalization and democratization’. Similarly De Soysa (2003, p.3) argued that ‘the increasing liberalization of markets is happening apace with increasing levels of participation of people’. The rest of this introduction provides a brief description of FDI, which is as well as trade are the pillars of economic globalization, and chapters outlines.

1.2 Definition and development of FDI

Kiggundu (2002, p.152) defines FDI as ‘long-term capital investments made by the private sector across national borders’. According to the International Monetary Fund’s definition, FDI refers to an investment made to acquire lasting interest in corporations operating outside of the economy of the investor to gain an effective voice in the management of the corporation (IMF: 1993). Similarly, the OECD 1996 Benchmark definition of FDI defines a direct investment corporation in which a single foreign investor owns 10 per cent or more of either the ordinary shares or voting power of a corporation, unless it can be proven that the 10 per cent ownership does not allow the investor an effective voice in the management (OECD: 1996). Hence, ownership and influence, or control, are the most important characteristics of FDI, which determine the demarcation line of FDI and portfolio investment or between uninational or multinational firms.

Caves (1991) argues that firms must have some firm-specific ownership advantages, such as technical expertise, managerial skills or economies of scale in order to engage in foreign activities and that the potential gains from the ownership advantages of firms, must outweigh the disadvantages of establishing and operating a subsidiary in a foreign country, such as communication difficulties, customs and tastes. There are also different factors that stimulate firms to establish subsidiaries in a particular country or countries, such as transportation costs, import restrictions, availability of valuable minerals or raw materials and the ease with which the firm can operate in another country. These reasons are known as location-specific advantages (Dunning: 1992).

Nicholas and Maitland (2002) identify three possible hierarchical entry mode choices: full equity control through greenfield investment, which involves the establishment of a new production entity, or significantly modifying or expanding existing facilities; full equity control through acquisition/merger (when the foreign investor buys into an existing firm and takes over its operations and management); and joint ventures, either greenfield investment or acquisition. They explain that the nature of firm-specific advantages determines whether the firm chooses greenfield whollyowned operations, joint venture or acquisition. For example, when the ownership advantages are associated with tacit knowledge and embedded know-how, and all complementary local inputs can be relatively efficiently procured through local markets, the firm is likely to select the greenfield mode.

According to Vernon (1971), it is the 'product cycle' that determines why firms venture abroad to gather as much market share as possible because of temporary technological advantages. He explained that every technology or product goes through three phases, which are the introductory or innovative phase, the maturing or process development phase and the standardized or mature phase. When the manufacturing process becomes standardized, the comparative advantages of the firm change from those related to the uniqueness of the products that they produce to their ability to reduce their costs and this encourages firms to shift the location of production to developing countries, whose comparative advantage is their lower wage rate.

Hymer (1972) offered a slight variant of this theory. He argued that, while it is the product cycle that drives FDI, firms establish affiliates in foreign countries also to eliminate competition and to advance their monopoly power abroad. He also argued that it is cheaper to seek oligopolistic rents with an aging product elsewhere, such as in the developing areas, where this product would still be relatively competitive, rather than developing a new product in the existing market. According to Kindleberger (1975), it is the imperfections in markets that promote transfers of capital to areas that offer higher returns and FDI cannot exist in a world of perfect competition. To safeguard their profits in those areas, firms are forced to venture abroad.

Most of the recent writings on FDI agree with Kindleberger's arguments. For instance the internalization theory, which has become widely accepted by scholars, affirms that FDI exists because of market imperfections (Dunning: 1992). The arguments of this theory run as follows. Markets are imperfect because they are difficult to organize and involve considerable uncertainty. The imperfection of markets, particularly those of intangible assets such as technology or marketing skills, makes it difficult for sellers to obtain full benefit from these assets through external market transactions. This creates an incentive for firms to control subsidiaries in different countries and to internalize markets between them. Internalization also avoids problems such as the difficulties of fixing prices, the restrictions on capital movement, the differences in tax rates between countries and the existence of trade barriers.

Some of the explanations discussed above come together in the 'eclectic paradigm', which has become a dominant way of thinking about the spread of FDI and allows broad application of theoretical propositions to questions such as what types of firms go abroad, from what types of economies, and where they locate (Dunning: 2001). According to this view, firms have ownership-specific advantages they wish to exploit relative to their competitors by expanding abroad and the spread of FDI can be predicted by knowing these advantages and what it is the individual firm is trying to capitalize on vis-à-vis the competition. It distinguishes between different types of FDI such as market-seeking, or demand oriented FDI; resource-seeking, or FDI that goes after a resource, such as natural and human resources that are immobile; efficiency-seeking FDI, which tries to maximize an efficient division of labor by augmenting capabilities abroad; and strategic-asset-seeking FDI, which buys up assets that will complement its ownership-specific advantages and deny such assets to competitors.

Strategic linkage theory (Nohria and Garcia-Pont: 1991) and the network approach (Johanson and Mattsson: 1987) view FDI as an attempt to access external resources in order to offset the weaknesses of the investor. These resources may include market opportunities, natural resources, labor, capital, technology, and other strategic assets that are essential for the investor's long-term survival. In both approaches, linkages via FDI are considered to be a strategic choice that enhances, maintains, or restores the investor's competitiveness in a globalized market, rather than a profit-seeking motive aimed at extracting economic rent from a foreign market by exploiting its own strategic assets (Chen and Chen: 1998).

The bulk of the world's FDI as well as trade are carried out by multinational corporations, which move capital investments in accordance with their respective worldwide business strategies and in response to emerging opportunities anywhere in the world. Therefore, foreign direct investment has raised a number of policy issues at the national and international level. FDI as well as trade are at the heart of globalization. Globalization is often referred to as the most important economic, political, and cultural phenomenon of our time. It is a complex, worldwide, and multidimensional phenomenon that means different things to different people and is often associated with most of the world's significant challenges and opportunities. According to the UN report on globalization and governance, globalization is:

> 'a unique convergence of technological, economic and political forces of daunting power and influence, having a massive impact on all aspects of public and private life in economic, social, political and cultural affairs at global, national and local levels. As it influences states and their partner actors, it is also exploited and shaped both positively and negatively by those with the foresight and resources to appreciate its power Yet, so diverse and overwhelming is globalization's manifold influences that no one group or sector can control or stop it. As such, it has been responded to and manipulated by a range of actors in the public, private and civil society actors, is instigated in good and bad motives, and has benefited some social and economic groups, but has hurt others who have become more vulnerable and disempowered due to its influence' (United Nations: 2000, p.10).

The countries most active and benefiting most from globalization, now, are the same ones with the largest share of global trade and foreign investment. However, during the 1960s and 1970s foreign firms were generally treated with suspicion, as they were seen to use their economic strength to take advantage of developing countries, and the importance of trade to these countries has been associated with Robert Keohane and Joseph Nye's concepts of 'vulnerability' and 'economic interdependence' (Keohane and Nye: 1977). Foreign investment also has been for a long time connected to the antagonistic perspective of dependency theorists. Most of these theorists have stressed the unequal and distorted growth coupled with foreign investments, which tend in their view to create a branch economy of small inefficient firms incapable of boosting overall development (Frank: 1969 and Moran: 1978). They also have associated foreign direct investment with monopoly, imperialism, exploitative transfer pricing and technological dependence (Moran: 1978, and Lairson and Skidmore: 1979).

During the same period many developed countries enacted legislation to monitor and control the flow of foreign direct investment and the activities of foreign companies. Their concern was more in the context of economic sovereignty, since ownership and influence, or control, are the most important characteristics of FDI that determine the demarcation line of FDI and portfolio investment. However, there are severe problems in quantifying ownership and control since there is no international consensus on the minimum share-holdings necessary for a corporation to be able to exert significant control or influence. But then, if influence is considered as the sole criterion for delineating the boundaries between FDI and portfolio investment, this will lead to confusion. *De facto*, some multinational corporations have little influence over daily decision taking in their 100% owned plants. Others with only a minority equity stake have great influence (Dunning: 1992). Moreover, there is dissatisfaction concerning the limitation of the scope of FDI and the investment of multinational corporations to the ownership of foreign affiliates or assets. Many of these corporations also engage in various non-equity cooperative ventures such as licensing agreements and turn-key operations. These activities may give them some degree of control or influence over the foreign business associated with these agreements (Dunning: 1992).

However, by the closing years of the 1980s, there was a general warming of attitudes to FDI not just in the development literature but also on the part of the national governments traditionally strongly hostile to foreign companies. Lall (2002) put forwards several explanations for this change. First, the accelerating pace of technological change and the rising costs of innovation, as well as the growing reluctance of the technological leader companies to part with valuable technologies to unrelated firms, meant that countries had to invite those companies to obtain new technologies. The second reason was the emergence of integrated production networks under the aegis of leading companies in each economic sector, which meant that countries had to rely on FDI to participate in these large, technology-intensive networks. Third, the experience of developing countries, with some exceptionally successful countries drawing heavily on FDI and many regimes restrictive to multinational corporations doing poorly, led to serious rethinking of their role. Fourth, many host developing countries improved their capabilities to deal with these corporations, showing an ability to absorb leading-edge technologies transferred by them, and even to attract research and development facilities. Finally multinational companies themselves changed their patterns of behaviour, and many new sources of FDI emerged, reducing the threat of domination by a handful of giant enterprises. European, Japanese and other corporations of many nationalities grew, organized and behaved in ways different from the early multinationals.

Therefore, today the general policy position of most countries is to be receptive to FDI and as a result, national governments are actively seeking a better understanding of its determinants, impacts and implications. A solid understanding of the role of FDI in developing economies is vital for policymakers which are influencing the regulatory regime under which both FDI and local business partners operate. It is important to understand how foreign direct investment influences economic development and national welfare to formulate more efficient policies that will assist the development