Czech University of Life Sciences Prague

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Bachelor Thesis

Investment Climate and its Perspectives in Bahrain

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Thesis title

Investment Climate and its Perspectives in Bahrain

Objectives of thesis

Studying the theoretical aspects of attracting investments and their role in the global economy. Identifying the distinctive feature of the Bahraini economy, its main peculiarities of the Islamic finance system and its role in the economy. Analysing the investment climate and main dynamics of FDI in Bahrain.

Methodology

The methodology used in this thesis includes the time series analysis, graphical descriptive statistics method, a historical method, as well as the study of scientific and journal articles, regulatory documents and a wide range of primary and secondary data provided by international organisations and the Bahraini national authorities.

The proposed extent of the thesis
30 – 40 pages

Keywords
investment climate, direct investment structure, economic situation, changes, economic development

Recommended information sources:
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Khuseinova D., Khusainov M. (2012), Theoretical Foundations of Islamic Banking. Business in law
Protsenko A. (2003). Vertical and Horizontal Foreign Direct Investments in Transition Countries.
Tkachenko I. (2009) Investments: A Study Guide for University Students – M.: Publishing Centre "Academy"
Wasseem M. (2006). The location determinants of FDI in the GCC countries. Journal of Multinational Financial Management

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Declaration

I declare that I have worked on my bachelor thesis titled "Investment Climate and its Perspectives in Bahrain" by myself and I have used only the sources mentioned at the end of the thesis. As the author of the bachelor thesis, I declare that the thesis does not break any copyrights.

In Prague on March 2023 ___________________________

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Investment Climate and its Perspectives in Bahrain

Abstract

The thesis concentrates on the analysis of the actions taken by the government of Bahrain, that are aimed at improving the economic situation of the country by attracting foreign investments, diversifying and rebuilding the economy. The methodology that was used in this work is based on the historical method, the analysis of a big amount of statistical information, the source of which is a number of authorised organisations, such as the Gulf Cooperation Council, government agencies of the country, the World Bank, Organisation for Economic Co-operation and Development, etc. A all-round review conducted in this work makes it possible to identify the main points in attracting investments and their role in the state's economy, and also gives an idea of the role of the country in the region and the world as a global centre of Islamic banking.

Keywords: investment climate, direct investments, investment structure, economic situation, economic development.

Abstrakt

Bakalářská práce se zaměřuje na analýzu opatření přijatých vládou Bahrajnu, které jsou zaměřeny na zlepšení ekomonické situace země přilákáním zahraničních investic, diverzifikací a obnovou ekonomiky. Metodika, která byla v této práci použita, je založena na historické metodě, která analyzuje velké množství statistických informací, jejichž zdrojem je řada oprávněných organizací, jako je Rada pro spolupráci arabských států v Zálivu, vládní agentury země, Světová banka, Organizace pro hospodářskou spolupráci a rozvoj atd. Celkový přehled provedený v této práci umožňuje identifikovat hlavní body při získávání investic a jejich roli v ekonomice státu a také dává představu o roli země v regionu a ve světě jako globální centrum islámského bankovnictví.

Klíčová slova: investiční klima, přímé investice, investiční struktura, ekonomická situace, ekonomický vývoj.

Table of content

List of Figures

List of Tables

1 Introduction

The Kingdom of Bahrain has achieved tremendous results since its inception as a sovereign state in 1971 when the Trucial Oman (also referred to as the Trucial Coast or the Pirate Coast) stopped its existence and Bahrain, the United Arab Emirates and Qatar declared their independence from the Great Britain's protectorate. Nowadays Bahrain is ranked as the 35th most developed country (the Human Development Index of 0.875) whose economy can be characterised as a growing high-income economy.

Located in the very heart of the Persian Gulf and surrounded by major "oil" states, the small-sized (with the total area of 780 sq km) archipelago takes advantage of its strategic location between such huge geopolitical rivals as Iran and Saudi Arabia. National oil reserves and production had been declining steadily since 1970 and prompted Bahrain to follow the path towards economic diversification and focus on developing the non-oil sectors, such as retail, hospitality and banking. In this light, intensification of the cross-border capital flows is seen as one of the most promising ways to promote a sustainable economic development. This directly leads to the need to undertake several steps, on the governmental level, towards optimisation of the legal and regulatory environment and, therefore, ensure favourable conditions for foreign investors.

Taking a set of the efficient measures aimed to diversify the national economy and promote its international competitive ability, the kingdom is keen to strengthen its economic and political positions within the Gulf Cooperation Council, as well as on the global arena. Several studies written was devoted to the processes of economic and social development within the kingdom. Also, various aspects of growth and modernisation within the GCC, including Bahrain, were studied. However, there have been no studies to date on the overall assessment of Bahrain's investment climate and what role foreign investments play in the Bahraini economy on the modern stage. Thus, the experience of the Kingdom of Bahrain in terms of attracting foreign direct investments (FDI) appear to be an interesting case on the agenda of the world economy research. Hence, the economy of the Kingdom of Bahrain is the object of this research while the subject is the role of foreign direct investments in the process of economic development of Bahrain.

2 Objectives and Methodology

The main goal of my thesis is to evaluate the FDI's contribution to the diversification of the Bahraini economy. And in order to achieve this purpose, there have been set the following objectives:

- **a.** to study the theoretical aspects of attracting FDI and their role in the global economy.
- **b.** to identify the distinctive features of the Bahraini economy and the key aspects of the kingdom's interaction with the GCC Member States.
- **c.** to identify the main peculiarities of the Islamic finance system and its role in the economy of Bahrain.
- **d.** to analyse the investment climate and main dynamics of FDI in Bahrain, as well as to consider the prospects of the trade and investment policy which is being implemented by the Bahraini government.

Thus, the main hypothesis can be formulated as following:

Foreign investments contribute to the structural transformation of the Bahraini economy and are the key determinant of its successful development and diversification.

The methodology applied in this paper includes the time series analysis, graphical descriptive statistics method, a historical method, as well as the study of scientific and journal articles, regulatory documents and a range of primary and secondary data provided by international organisations and the Bahraini national authorities.

The time framework of this research covers the period from 1971 which refers to the moment of the inception of the Kingdom of Bahrain as a sovereign state to 2020-2022 as there is no available data provided by the Bahraini authorities regarding 2023. And a greater emphasis is placed on the statistical data referred to the modern stage of economic development of the country under consideration.

A study conducted by a British economist John Dunning in the sphere of the cross-border capital flows and the activities of multinational enterprises made up the theoretical basis for this paper.

3 Foreign direct investments (FDI) in the system of the international economic relations

3.1 Definition of FDI and their role in the global economy

International capital flows have recently become an integral part of the modern globalized economy. A wise investment policy appears to be beneficial for both developed countries with an excess of financial capital and developing ones which may get an opportunity to move to a brand-new stage of economic development by means of attracting FDI.

Generally, investments are carried out in order to allocate financial capital and raise it subsequently. On a macroeconomic level, investments make up the basis for scientific and technical progress, balanced development of all sectors of an economy and ensuring its international competitive ability. And on a microeconomic level, investments are important for business units of different kind in terms of ensuring their financial sustainability and market competitive ability of their goods and services provided.[1]

Basically, it is widely agreed to distinguish **a.** direct investments; **b.** portfolio investments; **c.** other investments (*Figure 1*). Portfolio investments are usually made on a short-term basis in order to obtain a speculative profit by means of various financial instruments and derivatives as a result of changes in exchange quotations. Unlike the portfolio ones, direct investments lead to a lasting presence of an investor in an investment object.[2] Hence, foreign direct investments are a form of investing foreign capital in investment projects implemented within a country-recipient which assumes an active participation of an investor from a country-donor.

According to the definition provided by the Organisation for Economic Co-operation and Development (OECD), FDI "reflects the objective of obtaining a lasting interest by a resident entity in one economy ("direct investor") in an entity resident in an economy other than that of the investor ("direct investment enterprise")".[3] A foreign investor, which may be an individual or a government, as well as an enterprise (private or public, incorporated or unincorporated) or a group of them, generally supposed to own at least 10 per cent of ordinary shares or voting power, although the percentage may vary in different countries. This provides a long-term relationship between the direct investor and his/her direct investment enterprise (a branch, subsidiary or associate) and empowers the direct investor to participate in the decision-making process. Initial

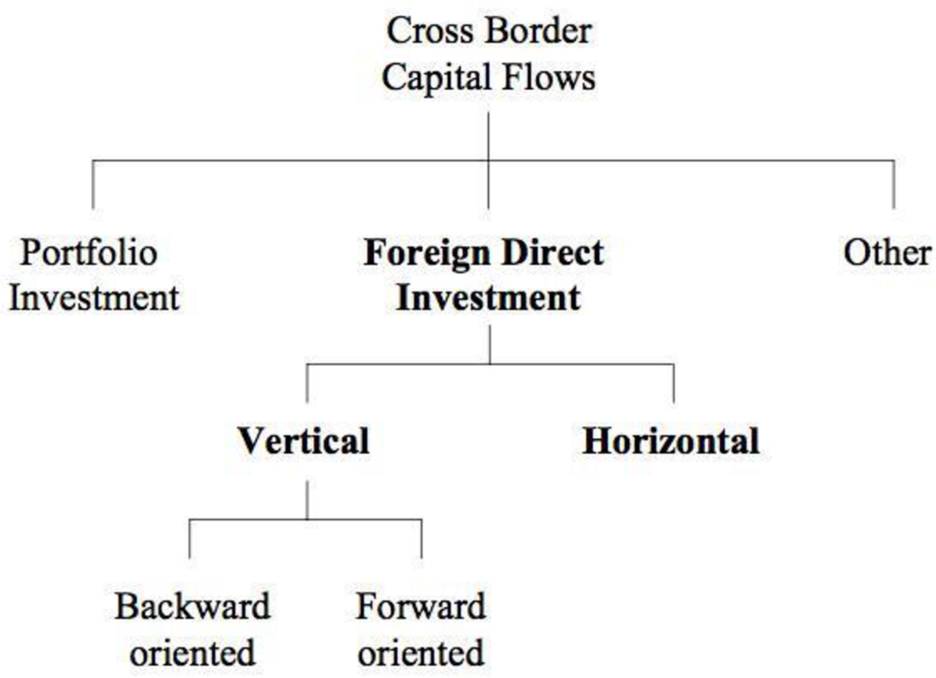
[1] Tkachenko I. Investments: A Study Guide for University Students – M.: Publishing Centre «Academy», 2009

[2] Ibid. – p. 6

[3] OECD Benchmark Definition of Foreign Direct Investment. Third Edition. OECD, Paris, 1996. – p. 7

acquisition of foreign equity, as well as further deals which the investor's capital is involved in are also referred to FDI.

Figure 1 **Structure of International Capital Flows**



Source: Protsenko A. (2003). Vertical and Horizontal Foreign Direct Investments in Transition Countries. – p. 4

There are two main types of FDI – **a.** horizontal and **b.** vertical – which are distinguished according to the goals and objectives set by the investor (market seeking or reducing costs). Horizontal FDI take place when an investor is planning to conduct the same business activities within a host country and, thus, provide the same goods and services as those being provided in its domestic market. By means of making horizontal FDI an investor has an opportunity to reduce costs of transportation and trade barriers while serving foreign markets. Horizontal FDI are also vital in case the only way to serve a foreign market is to do it locally.[4] The main goal of a direct investor making horizontal FDI is expanding to new markets.

[4] Protsenko A. (2003). Vertical and Horizontal Foreign Direct Investments in Transition Countries. – p. 16

As for vertical FDI, they take place when a producer goes international and outsources some stages of production abroad, so the overall production process becomes geographically fragmented. This makes it possible for the producer to reduce production costs on different stages of the manufacturing process since the prices for factors involved in production may be lower in the host country than those in the home country.[5] Unlike the horizontal ones, vertical foreign affiliates of a parent company are cross-border interdependent in terms of labour demand. Hence, the main goal of a direct investor making vertical FDI is minimization of initial costs.

Furthermore, we distinguish two main types of vertical FDI with accordance to the place of a foreign affiliate in the production chain. Thus, backward vertical FDI take place when a foreign affiliate is built up to supply input goods to its parent company. In case of forward FDI, a foreign affiliate uses input goods delivered by a parent company for its own production.[6]

There are several ways a direct investor can establish a formal presence within a host country, that is by means of establishing an **a.** associate; **b.** branch; **c.** subsidiary. When an associate is being established the direct investor possesses only a minority of stake in the equity of the direct investment enterprise. A branch appears to be the most straightforward way for a company to go multinational and expand to a foreign market when a foreign affiliate is wholly owned by the parent company.

And a subsidiary is being formed when a local company is acquired by a foreign investor who owns the majority (up to 100 per cent) of the company's equity.

[5] Ibid. – p. 14

[6] Ibid. – p. 5

Multinational enterprises (MNEs) have a significant external impact over host economies. They are of a key importance for emerging economies since they lead to more efficient utilization of national resources and, consequently, contribute to the overall economic growth in the host country. When a foreign MNE entries a national market inefficient local companies get displaced and local resources are redistributed among profitable businesses. This also results in an increase in the average labour productivity as MNEs invest more capital per unit of labour. Moreover, MNEs, as a rule, are larger than local companies and higher levels of labour productivity are ensured due to so-called "effect of scale". What is more, the presence of a MNE's foreign affiliates in the host market encourages local businesses to perform more effectively as they are bound to maintain their market competitive ability. This is possible for local businesses due to the transfer of advanced technological and managerial know-how provided by MNEs through vertically integrated links of so-called "demonstration effect".

Hence, FDI are mutually beneficial for both local and foreign companies. The latter provide national firms with their extensive procurement and marketing channels. In return, local business collaborate with MNEs so it is easier for them to adapt to local business practices and market characteristics.

3.2 Key aspects of attracting FDI

Foreign investments appear to be one of the ways to raise global competitive ability of a national economy and integrate it into the system of the international economic relations.

Businesses are motivated to make FDI by different concerns. According to John H. Dunnings, a British economist, the primary goals of a company going multinational are acquisition of natural resources and gaining access to new markets.[7]

[7] Dunning J.H., & Lundan S.M. (2008). *Multinational Enterprises and the Global Economy, Second Edition.* Great Britain: MPG Books Ltd. – p. 68

"Resource seekers" gain competitive advantage of increased utilization of specific high-quality resources which are available at lower prices compared to those in the home country of a parent company. And "market seekers" establish foreign affiliates in order to adapt their goods and services to local consumer preferences and gain greater customer satisfaction. Moreover, they are keen to maintain their presence within local markets which are also being served by their competitors.

As for mature MNEs, "efficiency seekers" and "strategic asset seekers", they restructure their production processes and allocate their resource- and information-intensive business activities in developing and developed economies, respectively, to advance their global competitiveness.[8]

There is a variety of ways FDI of different kind may influence the economic development process within a host economy:

- **a.** in case national capital is not being superseded due to a fierce market competition, FDI increase the volume of aggregate capital and, therefore, boost economic growth.
- **b.** in case FDI are more profitable compared to national investments, they make up the basis for economic development of a host economy.
- **c.** in case FDI and the level of qualification of labour resources are highly correlated, they raise labour productivity and, as a result, ensure economic growth.[9]

The reason of close interdependence between FDI and the level of qualification of labour resources lies in the fact that successful transfer of technological know-how, provided along with the foreign capital, takes place only provided that local employees have obtained the required knowledge and are able to apply it in production process. This, in turn, determines the influence FDI have over the level of employment, average wages and employees' qualification.

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[8] Dunning J.H., & Lundan S.M. (2008). *Multinational Enterprises and the Global Economy, Second Edition.* Great Britain: MPG Books Ltd. – p. 72-74

[9] International Practice of Foreign Investment Regulation: A Study Guide / G. Kostyunina, N. Liventsev: MGIMO University. – M.: Ankil, 2001. – p. 8

However, there is a need to consider negative effects which potentially may influence the economic environment of a host country. That is, firstly, superseding of national capital and businesses caused by so-called "crowding out effect" and, secondly, transfer pricing which leads to the capital outflow from the national economy.[10] Due to these reasons, a well-designed and balanced governmental policy regarding foreign investments is crucial for a sustainable economic growth.

Countries-recipients of FDI conduct comprehensive analysis of potential investment projects in terms of volume of foreign capital and local labour involved to ensure that the activities of foreign MNEs bring tangible benefits to national economies. A national investment strategy basically corresponds to a particular set of goals and objectives outlined by a government. If a government considers the policy of import substitution as a priority, high customs barriers are applied and FDI inflows are restricted. A host economy determines the percentage of foreign stock in the equity of a joint venture, as well as the number of local components in finished products supplied by a direct investment enterprise. In case a government attaches more importance to export promotion, FDI are considered as a tool of promoting export-oriented producers which involves local labour and resource factors. Such a policy is typical of economies with an abundance of labour resources and the majority of FDI is made in labour-intensive projects. A government can provide export-oriented foreign affiliates with a wide range of tax incentives, such as tax "holidays", subsidized rates of rent for land and non-residential (industrial) premises and duty-free import of raw materials and equipment needed.

Favourable tax environment plays an important role in terms of attracting FDI since tax burden is one of the primary aspects considered by MNEs before making capital investments in a foreign economy. The OECD estimates that a 1% increase in the tax rate on FDI is followed by a 3.7% cutback of average FDI inflow.[11] Nevertheless, a local taxation system is not the one and only aspect which determines the image of a foreign economy in terms of its attractiveness to invest in. A low tax burden does not make up the lack of access to a qualified labour force, immature infrastructure or an undeveloped private sector and is unlikely to promote a high level of MNEs' in the region by itself. Hence, it is a must for countries-recipients of FDI to consider various peculiarities of their national economies in order to design and undertake reasonable measures towards promoting an attractive investment climate.

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[10] Ibid. – p. 9

[11] OECD (February 2008). *Tax Effects on Foreign Direct Investment.* Policy Brief. Retrieved from https://www.oecd.org/investment/investment-policy/40152903.pdf

3.3 Global and regional investment trends

The COVID-19 pandemic had already caused significant impact on the global investment climate, and the conflict in Ukraine has further compounded this. The conflict in causing a cost-of-living crisis that is affecting billions of people worldwide, resulting in higher prices for energy and food that are reducing real incomes and increasing debt stress. The current state of uncertainty and risk aversion could further lower global FDI. The long-term impact of the war on investment flows to countries is uncertain. The effects on these countries will depend on their exposure to the food, fuel, and finance crisis, as well as their economic and political stability, which are critical factors that affect international private investment.[12]

As for the MENA (the Middle East and North Africa) major economies, they are likely to maintain the highest investment momentum into 2023.[13] At the same time a study conducted by Wasseem Mina (the UAE University) and based on the panel data for the period 1980-2002, shows that oil potential and oil utilization negatively influence FDI flows. On the contrary, FDI inflows are positively influenced by the relative degree of oil utilization, that is oil production relative to oil reserves.[14]

As new investments are vital for generating new job opportunities and, thus, promoting economic development, the MENA states are keen to facilitate trade and investment within the region as well as on the international arena. They are facing the need to improve regional coordination and create a transparent environment for foreign investors. In addition, one of the key objectives is a harmonization of the policy implemented by the regional leaders which would promote the process of integration of the MENA economies into OECD.

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[12] UNCTAD (2022). World Investment Report 2022. – Retrieved from https://unctad.org/system/files/official-document/wir2022_en.pdf

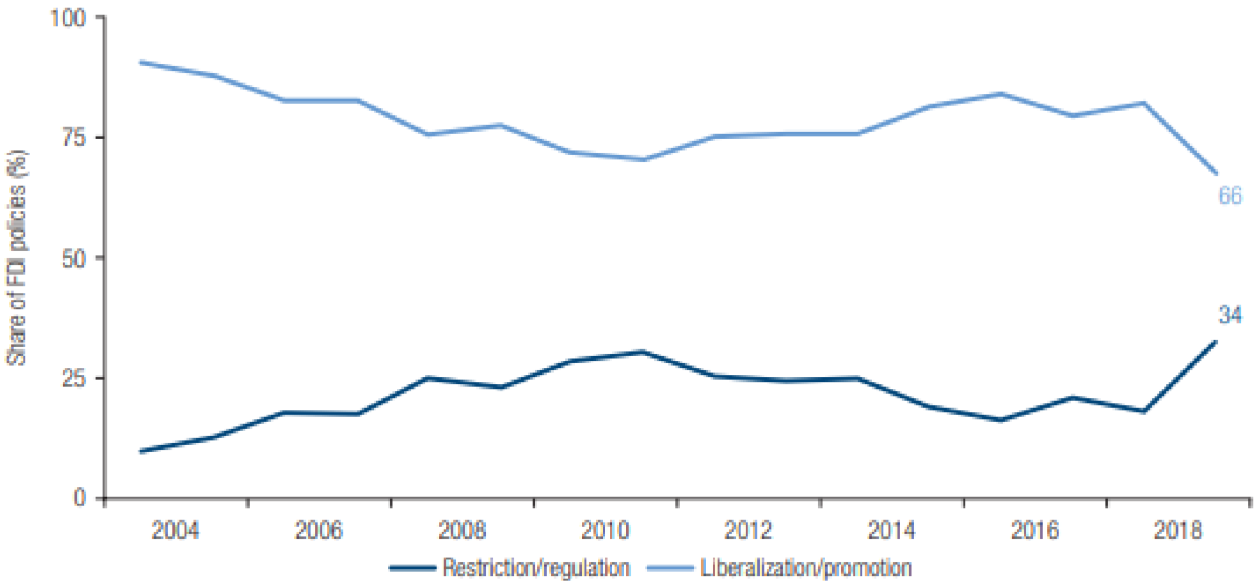
[13] *fDi Intelligence* (2022). MENA countries to carry the strongest investment momentum into the new year. – Retrieved from https://www.fdiintelligence.com/content/data-trends/mena-countries-to-carry-the-strongest-investment-momentum-into-the-new-year-81805

[14] Wasseem M. (2006). The location determinants of FDI in the GCC countries. *Journal of Multinational Financial Management*, 17(4), 336-348

Some countries that have received FDI have experienced greater benefits compared to others, and certain portions of the population within those countries have been left behind. FDI has the potential to create many employment opportunities and improve overall living standards by providing higher wages. However, it can also exacerbate income inequalities, which may disproportionately affect individuals with lower levels of skills. In Southeast Asia and MENA foreign companies have helped to reduce gender employment gaps, unlike in other regions, though they do not always offer improved career advancement prospects for women. [15]

A broader debate on the role and place of cross-border capital flows that have recently shown a considerable increase is being on the agenda of the global society, as the impact of the overall globalisation. The activities of multinational corporations facilitating the FDI flows worldwide remain one of the major concerns among both scientists and "on-the-street" people.

Figure 2 Number of investment policies globally



Source: UNCTAD 2019.

As Figure 2 shows over 33% of investment policies globally led to tightened restrictions or regulations on FDI, while measures that aimed to promote and liberalize FDI decreased to less than 66%.

[15] *fDi Intelligence* (2022). The fDi Report 2022. – Retrieved from https://www.fdiinsights.com/fdi/report22?login=true

4 The features of the economy of the Kingdom of Bahrain

4.1 The place of the Kingdom of Bahrain in the Gulf Cooperation Council

The Cooperation Council for the Arab States of the Gulf (widely referred to as the Gulf Cooperation Council or the GCC) was established as a result of the meeting which took place in Abu Dhabi, capital city of the United Arab Emirates (UAE), on 25th May 1981 (21st Rajab 1410 AH) when the leaders of the UAE, Kingdom of Bahrain, Kingdom of Saudi Arabia, State of Kuwait, State of Qatar and Sultanate of Oman expressed their will to establish a framework to boost "coordination, integration and inter-connection among the Member States".[16] The Gulf states share common history and cultural heritage and their economies are homogeneous to an extent, which makes the basis for a comprehensive integration. Under the GCC Charter, the Council is aimed to contribute to further deepening and strengthening of interaction among the Members, which ensures prosperity and well-being of their nations.[17] Although, after the Iran-Iraq War of 1980-1988, the political reasons and security concerns took place, the GCC appears to be the most efficient tool in economic sphere particularly.

The integration of the GCC economies was implemented gradually. The first step on the way of activation of foreign trade and further cooperation was the establishment of the Free Trade Area which took place in 1983. This resulted in a 10-fold growth in the intra-regional trade turnover (*Figure 3, Figure 5*). The GCC Customs Union was established in 2012, although its project was approved by the Supreme Council, the highest authority of the organisation, in 2003. The Customs Union began to function fully in 2015 when a harmonized system of customs procedures was designed. Also, the GCC Common Market was declared in 2015.[18] The GCC leaders continuously work in a strong partnership with the World Bank in order to facilitate the integration processes within the region and adopt all the necessary criteria (inflation rates, interest rates, annual deficit ratios, etc.) of economic performance, which promote the convergence of the national economies.

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[16] Secretariat General of the Gulf Cooperation Council. *About the GCC*. Retrieved from http://www.gcc-sg.org/en-us/AboutGCC/Pages/StartingPointsAndGoals.aspx

[17] Secretariat General of the Gulf Cooperation Council. *The Charter.* Retrieved from http://www.gcc-sg.org/en-us/AboutGCC/Pages/Primarylaw.aspx

[18] Secretariat General of the Gulf Cooperation Council. *Financial and Economic Cooperation: The integration of financial markets in the GCC States.* Retrieved from http://www.gcc-sg.org/en-us/CooperationAndAchievements/Achievements/EconomicCooperation/FinancialandEconomicCooperation/Pages /Fifththeintegrationoffinancial.aspx

Figure 3 GCC Intra-Trade: Exports

(Million Dollar) (مليون دولار)

COUNTRY	2011	2010	2009	2008	الدولة
U.A.E	9,626	8,812	9,069	8,731	الامارات
BAHRAIN	3,918	2,559	1,958	2,341	البحرين
K.S.A	24,676	20,521	19,078	22,065	السعودية
OMAN	4,987	5,200	4,405	5,009	عمان
QATAR	7,448	6,910	3,704	1,173	قطر
KUWAIT	(1) 1,410	1,410	1,383	1,552	الكويت
TOTAL	52,066	45,411	39,597	40,870	المجموع

Source: Statistics provided by the Secretariat General of the GCC

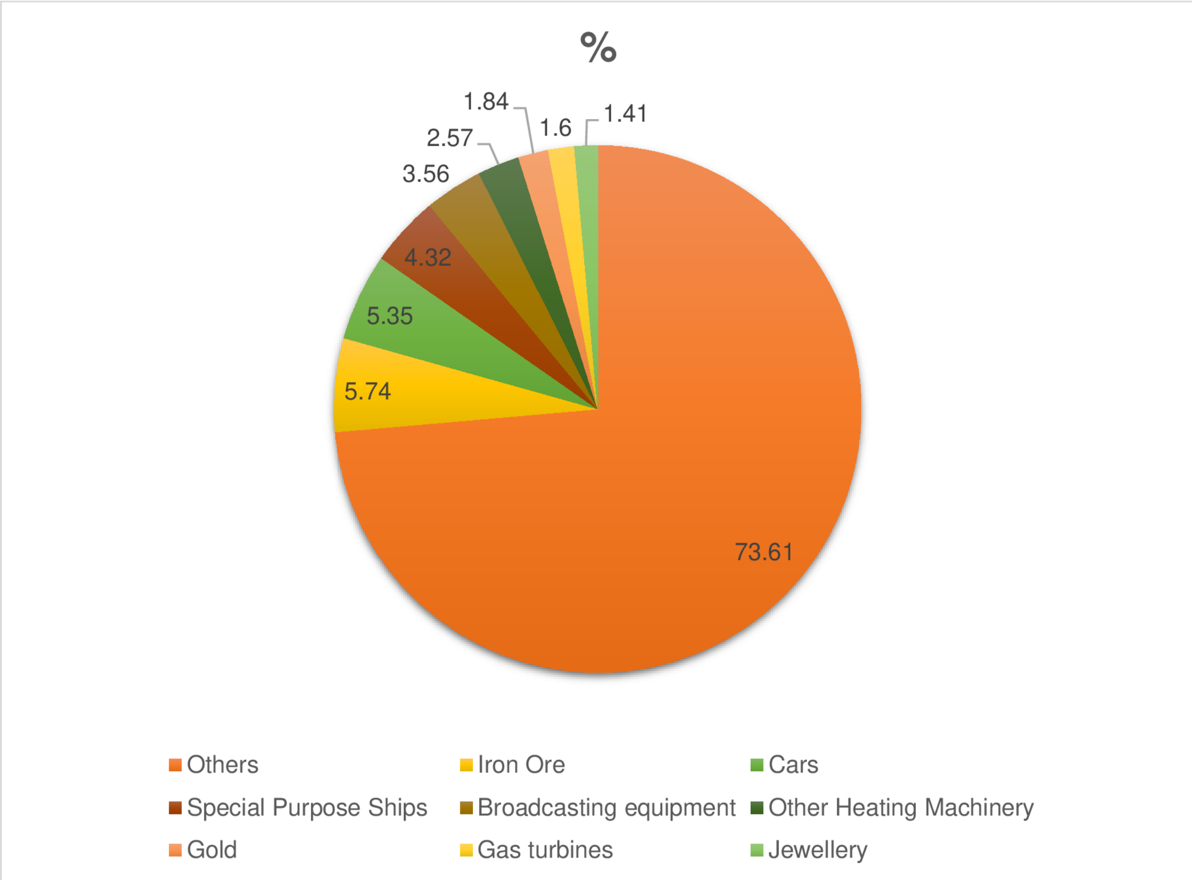
The GCC states are mostly energy-based economies. Energy resources prevail in the structure of the GCC exports and are supplied mainly to Asia. Export of petroleum products accounts for 50 per cent of the region's GDP and 80 per cent of total export earnings.[19] The GCC states import a wide range of goods, including iron ore, 5.74 per cent; cars, 5.35 per cent of the total Bahrain's imports (*Figure 4*), and specialized equipment, from Asia, Europe and North America.

Bahrain was ranked as the 88th largest exporter globally in 2020, with a total export value of 10.1 billion USD. Over the past five years, Bahrain's exports have decreased by 7.29 billion USD, from 17.4 billion USD in 2015 to 10.1 billion USD in 2020.

Bahrain was ranked as the 88th largest trade destination in the world in 2020, with imports totaling 11.9 billion USD. Over the past five years, Bahrain's imports have decreased by 4.29 billion USD, from 16.2 billion USD in 2015 to 11.9 billion USD in 2020.

[19] Kostyunina G., Lomakin N. (2014). *Evolution of economic integration within the Cooperation Council for the Arab States of the Gulf. Russian Foreign Economic Journal*, 6-2014. – p. 87

Figure 4 Bahrain Imports in 2020



Source: Compiled by the author according to the Observatory of Economic Complexity (OEC) data
[Bahrain (BHR) Exports, Imports, and Trade Partners | OEC - The Observatory of Economic Complexity]

The beginning of extensive exploration and oil extraction on the Arabian Peninsula predetermined the modern image of the GCC states considerably. And this is the case in the Kingdom of Bahrain. In 1929 the Standard Oil Company of California, an American petroleum corporation (now broken into several "baby Standards" such as well-known ExxonMobil and Chevron), established its affiliate in Bahrain which was incorporated as the Bahrain National Oil Company (BANOCO) in 1976. The fist oil was discovered in 1932 and exported in 1934.[20]

[20] BAPCO. *Historical Milestones.* Retrieved from http://www.bapco.net/en-us/about-bapco/our-history

Since then, the kingdom's hydrocarbon industry has been developing progressively. Gas (discovered in 1948) and aluminium production followed the oil industry and made up the basis for the petrochemical sector.

And regional integration appeared to be of a key importance for the industrialization of Bahrain's economy. The kingdom takes advantage of its strategic trade and investment cooperation with the GCC states. The Bouyan Petrochemical Company of Kuwait owns about 12 per cent of the joint equity of Bahrain's BANAGAS. Besides, in 1979 the Gulf Petrochemical Industries Company (GPIC) was incorporated in Sitra as a joint equally owned (33,3%) venture between Saudi Basic Industries Corporation (SABIC), Kingdom of Saudi Arabia, Petrochemical Industries Co. (PIC), State of Kuwait, and National Oil and Gas Authority (NOGA), Kingdom of Bahrain. Moreover, SABIC Investment Company, KSA, is one of the main shareholders on the ALBA aluminium refinery and owns up to 20 per cent of the equity.[21]

Figure 5 GCC Intra-Trade: Imports

(Million Dollar) (مليون دولار)

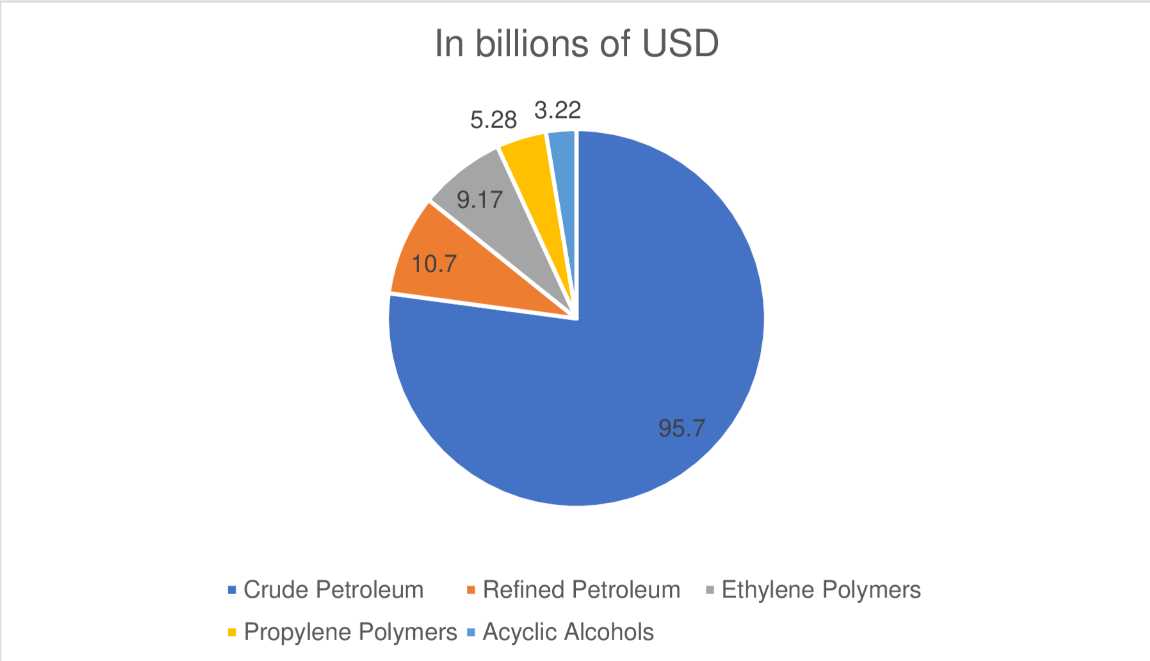
COUNTRY	2011	2010	2009	2008	الدولة
U.A.E	7,576	6,081	5,864	6,996	الامارات
BAHRAIN	1,414	1,041	1,326	1,607	البحرين
K.S.A	8,569	5,956	4,679	4,974	السعودية
OMAN	8,580	6,797	5,339	7,175	عمان
QATAR	4,354	4,273	4,446	3,996	قطر
KUWAIT	(1) 2,526	2,526	2,281	2,667	الكويت
TOTAL	33,019	26,675	23,934	27,415	المجموع

Source: Statistics provided by the Secretariat General of the GCC

[21] Aidrous I.A. Bahrain: Competitiveness the world economy. *Bulletin of Peoples' Friendship University of Russia. Series: Economics*, 2016, № 4, 61-74. – p.67

As for bilateral mutual trade relations, the main strategic partner of Bahrain within the region is Saudi Arabia, the largest economy in the Gulf (*Figure 6*). Only one sixth of the total volume of crude oil involved in the Bahraini production of refined petroleum comes from the Bahrain field while most of the crude oil is being pumped from Saudi Arabia through an A-B pipeline laid between the countries in 1945, the longest commercial submarine pipeline in the world.

Figure 6 Saudi Arabia Exports in 2020



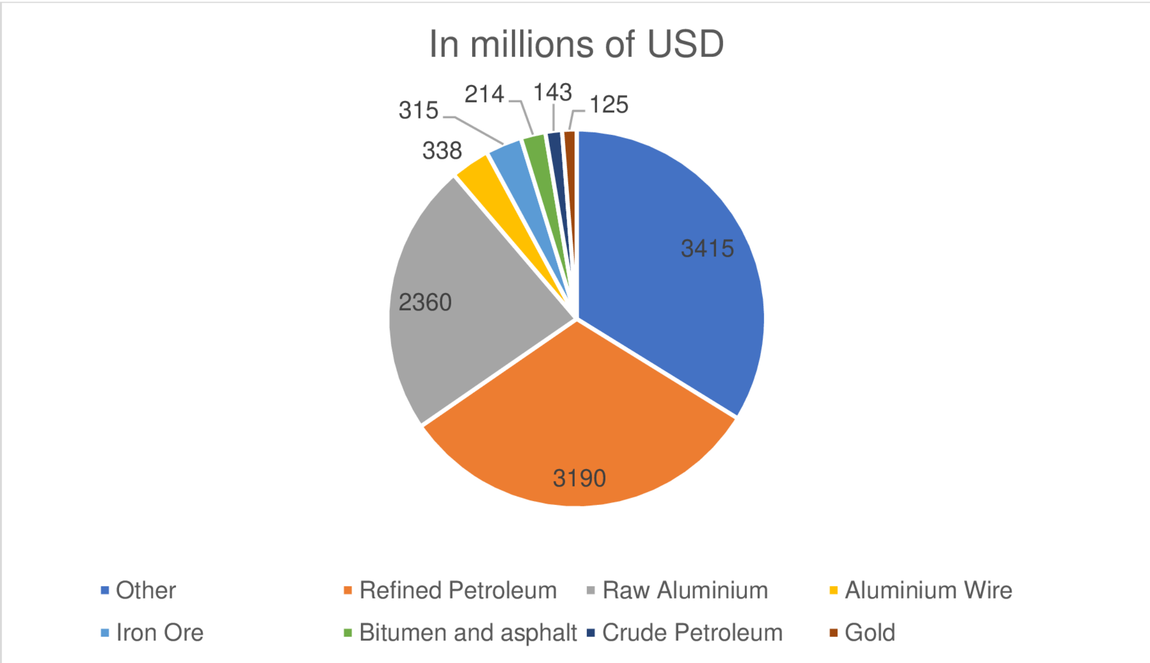
Source: Compiled by the author according to the Observatory of Economic Complexity (OEC) data
[Saudi Arabia (SAU) Exports, Imports, and Trade Partners | OEC - The Observatory of Economic Complexity]

Interaction with KSA is vital for a successful development of non-oil sectors of the Bahraini economy as well. Saudi Arabia provided the initial finding for the construction of the 25-km-long King Fahd Causeway which turned Bahrain into the main regional destination for tourism and leisure activities for KSA and Kuwait's nationals. This physical connection with KSA makes Bahrain an attracting destination for the global investment and banking markets. Official estimates show that about 27,000 vehicles cross the causeway every day and more than 10 million – every year.[22]

[22] Plans unveiled for Bahrain-Saudi Causeway. (2016, February 11). Retrieved from http://www.arabianbusiness.com/plans-unveiled-for-bahrain-saudi-causeway-expansion-621408.html

Refined petroleum products lead the most recent exports of the country (31.7 per cent of the total exports: 3.19 out of 10.1 billion US dollars of the Bahraini government's export revenues come from refined petroleum)[23] along with raw aluminium, aluminium wire, iron ore and bitumen and asphalt (*Figure 7*).

Figure 6 Bahrain Exports in 2020



Source: Compiled by the author according to the Observatory of Economic Complexity (OEC) data
Bahrain (BHR) Exports, Imports, and Trade Partners | OEC - The Observatory of Economic Complexity

As the overall macroeconomic situation within the region is highly correlated with trends in global prices on energy resources, the leaders of the Member States pursue the policy of economic diversification in order to reduce market volatility, create new employment opportunities in the private sector and drive their national economies away from excessive reliance on energy sector.

[23] Bahrain Export. OEC. Retrieved from https://oec.world/en/profile/country/bhr

4.2 Bahrain as a global centre of Islamic banking

Basically, the Islamic financial system can be described as a financial system that introduces a profit-sharing principle instead the interest-based one. The functioning of the Islamic banking is based on the Shari'a – a set of rules and laws related to the management of the economic, social, political and cultural aspects of Islamic society.

According to the formal norms of Islamic ethics, wealth is recognized only in case it is earned by honest work, as well as in the form of inheritance or a gift. The key distinctive feature of Islamic banks from traditional ones is the receipt of income without any interest rate charged. Therefore, in order to gain profitability, Islamic banks frequently get involved into various investment projects and simultaneously share both profits and risks of the co-investors. Making investments into a project or an enterprise, Islamic banks require the maximum transparency of all the financial transactions and equal distribution of all the risks and benefits. Thus, the Shari'a equalizes the role and opportunities of business owners and investors. This ensures the implementation of the "Al-Ghurm bil Ghum" principle according to which the party is entitled to gain profit only provided that this party also carries the responsibility for potential losses.

Nevertheless, there is several special sources of income which are typical of Islamic banks' business activities. Hence, the main financial operations carried out by Islamic banks are "Musharakah", "Mudarabah", "Murabaha" and "Qard ul Hasan".

Musharakah is a partnership in the sphere of Islamic finance when the two parties join their financial capitals to provide the initial funding for a project and distribute the prospective profits and losses in advance with accordance to mutually agreed percentage. As a way of a cooperation, Musharakah is typical of the short-term financial investment deals.

Mudarabah (or Qirad) represents an agreement between the two parties, according to which one of the parties provides all the required initial funding to finance a future project while the main contribution of the other (mudarib) is its entrepreneurial abilities, managerial skills and business expertise. In case the enterprise goes bankrupt, the investor carries all the financial losses while the manager becomes unemployed. On the contrary, if the venture is profitable the revenue is distributed between the parties as it had been agreed at the moment of the deal.

Murabaha is a purchase-and-sale contract according to which the payment is done only when goods and services already supplied. Such a kind of contracting makes up the basis of the modern Islamic banking activities as the amount of money charged as a deferred payment is usually greater than it is at the moment of the deal.

Qard ul Hasan (literally means "a good loan") is a "charitable credit" or an interest-free loan which is granted as a material assistance to the individuals in need, various organisations or regions, as well as a short-term subsidy for a specific economic activity which is to be conducted by an enterprise, often a partner of the bank.

Since Islamic banks are the financial institutions which are more like investment companies than to banks as such, there is a considerable difference between their products and those provided by traditional banks. The main products and services offered by Islamic banks are the following:

a. Bai Bithaman Ajil – a contract or a trade deal with a deferment of payment.

b. Bai al-Salam – a commercial deal when the payment is done in advance.

c. Bai al-Ina – a purchase-and-sale contract with the consent to payment in instalments or a leasing deal with the right of future redemption.

d. Ijarah – a leasing deal.

e. Aqd-al-Wadiah – a service provided by Islamic banks, and which corresponds to safekeeping, custody, deposit and trust, when the bank charges its client a free for the safe custody of the depositor's funds;[24]

f. Takaful (and re-Takaful) – Shari'a compliance insurance products.

On the one hand, being part of the national credit systems, Islamic banks are subjected to the governmental regulation which is carried by the Central Banks. On the other hand, Islamic banks' activities are carried out with accordance to the principles of Islam and, thus, a special role is assigned to the Religious Committee which maintains continuous control over the process to ensure that all credit operations are conducted on an interest-free basis.

Nowadays Islamic banking represents the most dynamic segment of the global finance market. Many experts note that the world's financial crisis has not had any detrimental impact over the global positions of the Islamic banks which experienced a 15 per cent annual growth during the crisis years.[25]

The dynamic development of the financial industry in the Kingdom of Bahrain can be referred to the 1970s when the "oil boom" of 1973 and the rapid activation of local businesses made it possible for the Bahraini government to undertake the first steps towards developing the non-oil sectors of the national economy. The formation of the global centre of Islamic finance was started in 1978 when the Islamic Bank of Bahrain was established. It was followed by the establishment of another four banks of that kind in 1980s.[26] Nowadays the bank is widely listed among the top Islamic banks worldwide.

Bahrain can be considered as an "intellectual haven of Islamic finance".[27] A unique and legally exhaustive system which fulfils all the specific aspects of Islamic banking was introduced by the Central Bank of Bahrain.

[24] Widiah. (n.d.). Retrieved from https://www.islamicbanker.com/education/wadiah

[25] Khuseinova D., Khusainov M., *Theoretical Foundations of Islamic Banking. Business in law*; 3'2012 – p. 268

[26] Aidrous I.A. Bahrain: Competitiveness the world economy. *Bulletin of Peoples' Friendship University of Russia. Series: Economics*, 2016, № 4, 61-74. – p. 63

[27] Aidrous I.A. Islamic finance development: A role of the Kingdom of Bahrain. *International Finance*, 47(623)-2014, 39-47. – p. 42

The developed set of rules covers the areas of licensing requirements for capital adequacy, risk management, business practices, financial crimes and regulatory reporting.[28] In 2006 the Central Bank of Bahrain also established the Waqf Fund which makes up a platform for cooperation among all the interested representatives of the industry.[29] Besides the constructive activities of the Central Bank of Bahrain, various international organisations such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), aimed to design fundamental standards in the field of accounting and auditing, reporting, management and ethics for Islamic banks; the

Council for Islamic Banks and Financial Institutions (CIBAFI), an international Islamic financial infrastructural non-profit institution; Liquidity Management House, a joint-stock company aimed to promote short- and mid-term investment activities conducted with accordance to the Sharia principles.; etc.

The CIBAFI's activities appear to be of key role in the sphere of Islamic finance, as the council promotes the interests of Islamic financial institutions and provides such services as collection, analysis and subsequent publication of the data on Islamic banks on the global arena. The organisation also provides consulting on the issue of creating new Islamic financial structures, as well as training for personnel engaged in Islamic finance. Since 2013 the CIBAFI began operating on an international level pursuing the goal to design the normative base and practice of Islamic financial activities outside the Arab world.[30]

Although the number of conventional banks prevail in the system of various financial institutions within the country, the role of the kingdom in the global system of Islamic finance can hardly be overestimated. Here there is a need to stress that a greater focus of the Bahraini government of the involvement into the system of Islamic banking instead of a conventional one is a reasonable step since Islamic banking is proved to be less risky for all the parties involved in transactions. Seref Turen, an assistant professor at the Department of Business and Management in the University of Bahrain, conducted a study, based on the risk-return characteristics of the Bahrain Islamic Bank (BIB) and the Bahraini economy in general, which reveals that the "existence of the BIB's stock in the stock market" may "generate a stabilization effect to general movements of stock prices".[31]

[28] Ibid.

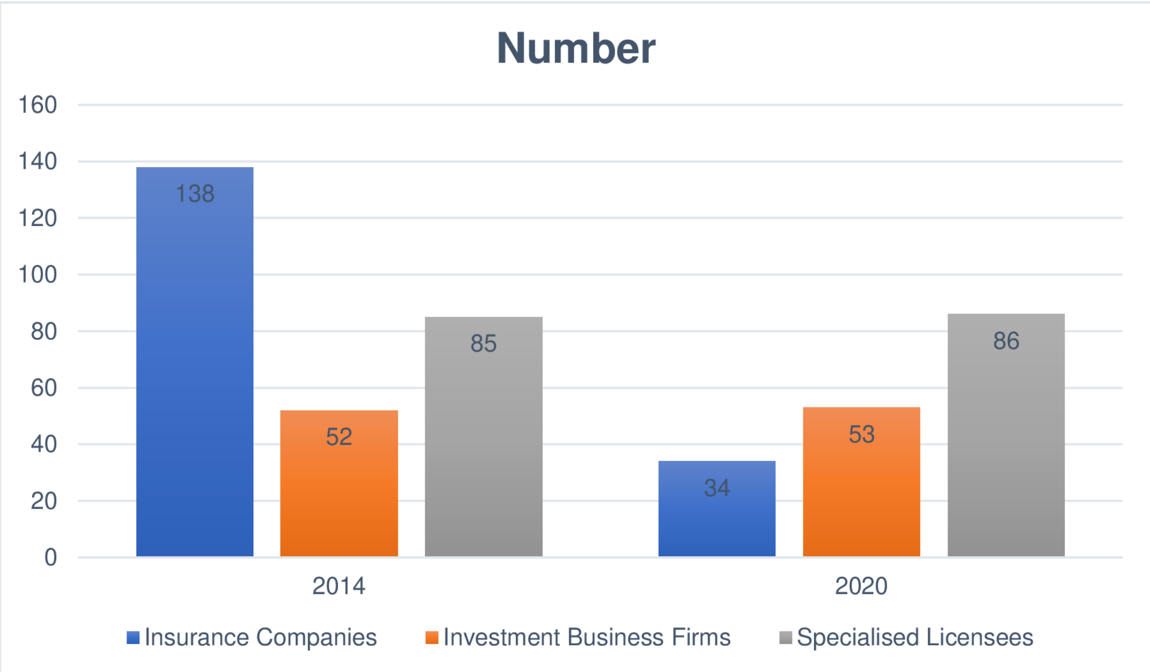
[29] Ibid. – p. 44

[30] Ibid. – p. 43

[31] Seref T. (1996). Performance and Risk Analysis of the Islamic Banks: The Case of Bahrain Islamic Bank. J.*KAU: Islamic Econ.*, Vol. 8, pp. 3-14. – p. 12

Hence, a great variety of initiatives has been undertaken by the Bahraini government in the sphere of Islamic banking in the last three decades. An active involvement of the kingdom in the process of creation of a global infrastructure for Islamic financial institutions is of a key importance to diversify the national economy and excel in the non-oil industry and, therefore, promote the economic and political positions of the country on both the regional and international levels, which is a conscious goal of such an Arab state.

Table 1 Financial Institution Operating in Bahrain



Sources:
Compiled by the author based on the data from Information and eGovernment Authority. Bahrain Open Data Portal. *Finance and Insurance*. Retrieved from https://www.data.gov.bh/en/Dashboards
Central Bank of Bahrain. Banking.
Retrieved from https://www.cbb.gov.bh/banking/

5. The role of FDI in the economic development of the Kingdom of Bahrain

5.1 Investment climate in Bahrain and the role of special economic zones (SEZs) as a channel for attracting FDI.

Nowadays the offshore industry covers about one third of the world trade and one half of all financial transactions carried out and represents innovative global business.[32] The practice of establishing special economic zones (SEZs) affects interactions within and beyond boundaries and strengthens economic, social and political interdependencies significantly.

For immature economies development of SEZs is economically and politically reasonable step which makes it possible for them to boost economic diversification and promote cooperation on a regional level, as well as internationally.

In the GCC states the process of establishing SEZs, as an instrument of consolidation and liberalization, was uneven. The first special economic zone (Jebel Ali Free Zone) was established in Dubai, UAE, in 1985. While a large-scale projection of free economic zones (FEZs) in such GCC members as Qatar, Oman or Saudi Arabia started only in 2009. For instance, the creation of a multifunctional SEZ – King Abdullah Economic City – have been planned by Saudi Arabia by 2020. The prospective SEZ is to provide a seaport, industrial and educational zones, recreational and residence areas and a business district. This aims to promote a better economic environment and generate about 1.3 million new jobs for both local population and expats.[33]

Furthermore, the principle of public-private partnership (PPP) is applied in the process of creating and financing FEZs within the GCC states. Thus, the Kuwait Free Trade Zone, located in the port of Shuwaikh, was established by the National Real Estate Agency which is privately owned.[34]

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[32] Sinskaya, O. (2008). *Special economic zones and offshore territories*. Rostov-on-Don. – p. 2

[33] Ivanova, E. (2016). *Special Economic Zones as a Tool of Economic Diversification of the United Arab Emirates*. Course Paper. –p. 10

[34] Ibid. – p. 12

In Bahrain, Kuwait and UAE, multinationals are provided with such a regulatory incentive as exemption from restrictions on foreign ownership. In Kuwait this is also followed by a simplified regulation of the labour market, namely by a facilitated access to hiring foreigners; in Emirates – by the absence of a minimum volume of exports required.[35]

In case with the Kingdom of Bahrain, SEZs of different kind are one of the strategic directions of economic development. They represent a sustainable channel for attracting FDI to the national economy and "the gateway to the trillion-dollar Gulf market".[36] According to a report by FDI Magazine, the Bahrain Logistics Zone (BLZ), Bahrain International Airport and Bahrain International Investment Park were ranked 9th, 13th and 24th, respectively, among the world's top 25 "Free Zones of the Future".

As the national economy is being industrialized, Bahrain attaches more importance to the development of "special" or "specialized" zones over the conventional free ones, which is typical for the MENA countries in general. These multifunctional zones provide the platform for continuous improvement of production capacities, favourable employment conditions for, accelerated economic diversification and improved image for attracting FDI.

Thus, the Bahrain International Investment Park (BIIP) covers manufacturing and international services industries and provides foreign investors with a duty-free access to the regional markets, turning the country into a "gravity point" for large volumes of FDI. The BIIP is not treated as a free zone as such, but it provides foreign investors with a wide spectrum of incentives and benefits, such as 100% foreign ownership and repatriation of capital (no minimum is required), free-trade access to the USA markets, no recruitment restrictions or corporate tax guaranteed for first 5 and 10 years, respectively.

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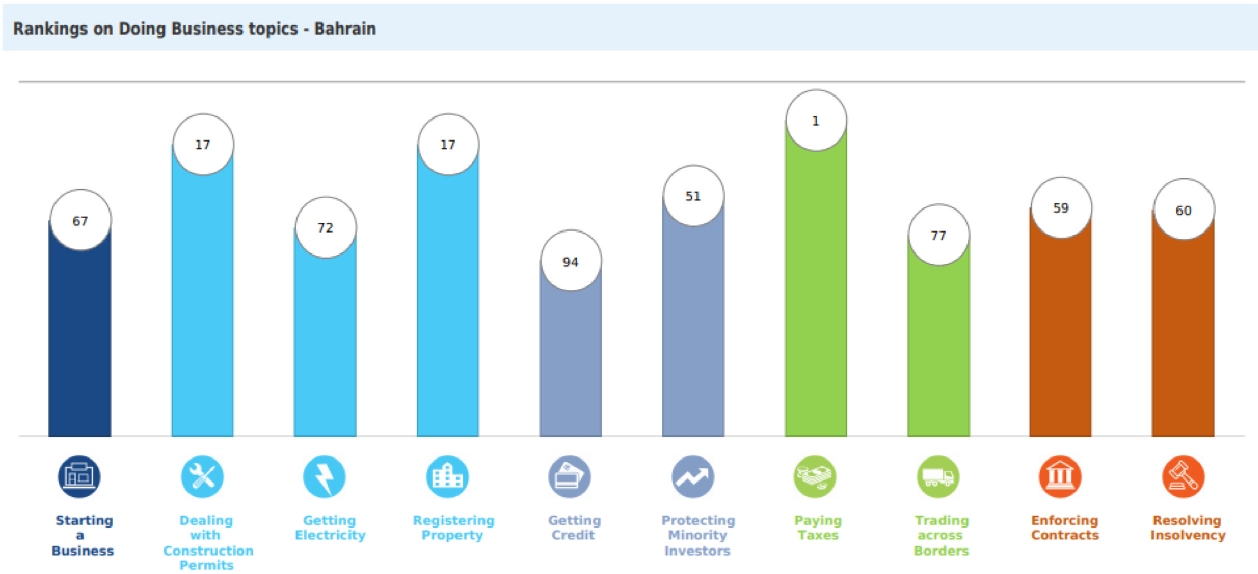
[35] MENA-OECD Investment Programme (2009, 23 November). *Towards Best Practice Guidelines for the Development of Economic Zone*. – Marrakech. – p. 6-8

[36] Neeraj G. (2010, 26 June). Bahrain's free zones among world's best. *ArabianBusiness.com* Retrieved from http://www.arabianbusiness.com/bahrain-free-zones-among-world-s-best-293049.html

What is vital for "market seekers" especially, they have an opportunity to avoid the 5 % import tax since no tax is levied on the goods which are to be sold to the very heart of the GCC markets, including Bahrain, while no import duties are charged on both raw materials and equipment needed to sustain a manufacturing process within the BIIP. The investment climate within Bahrain is, thus, can be described as attractive, which finds its reflection in the international rankings of the country (*Figure 8*).

Figure 8 Doing Business in Bahrain



Source: The World Bank. Doing Business in Bahrain. Retrieved from https://archive.doingbusiness.org/content/dam/doingBusiness/country/b/bahrain/BHR.pdf

Multinationals looking to locate their operations in the Middle East are to go through a three-step application process. To start with, a project is considered for an approval by the Ministry of Industry, Commerce and Tourism and then a company is being informed of the decision. In case the decision is positive, the company gets the necessary assistance and guidance provided by the BIIP One-Stop Shop to reach a lease agreement. And, finally, the company is granted with a final industrial license once all the legal requirements are fulfilled.[37]

[37] BIIP. *Application process*. Retrieved from http://www.biip.com.bh/default.asp?action=category&id=4

In addition to the BIIP, the Bahrain International Airport (governed by the Bahraini Mumtalakat) and the Bahrain Logistics Zone established in 2006 and 2008, respectively, also have contributed to the economic diversification of the island nation of Bahrain, making it the world's 12th most-free economy.[38] These SEZs provide customs-free areas, cover various export and re-export storage and distribution, bonded cargo facilities and third-party logistics, which facilitate all the activities implemented and reduces an average processing time up to 32 minutes.[39]

All things considered, the variety of projects that have been implemented within the local SEZs shows that the Bahraini government provide foreign direct investors with great opportunities for carrying out various types of business activities in the Middle East, possessing the modern high-quality equipment and special customs services along with an appropriate legal and regulatory framework.

The functional diversity of the SEZs existing on the territory of the kingdom makes it possible to attract foreign investors of various specialisation, which, according to available statistical data, is reflected in the structure of re-export and exports in general, and also has a certain impact on the social sphere in terms of forming a competitive national labour force, as well as favourable employment conditions for the population.

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[38] MEED Middle East Business Intelligence (August 22, 2013). *Bahrain economic zones.* Retrieved from https://www.meed.com/sectors/government/bahrain-economic-zones/3183300.article

[39] Ibid.

5.2 The role of FDI in the economy of Bahrain

Table 2 FDI in Bahraini Economy

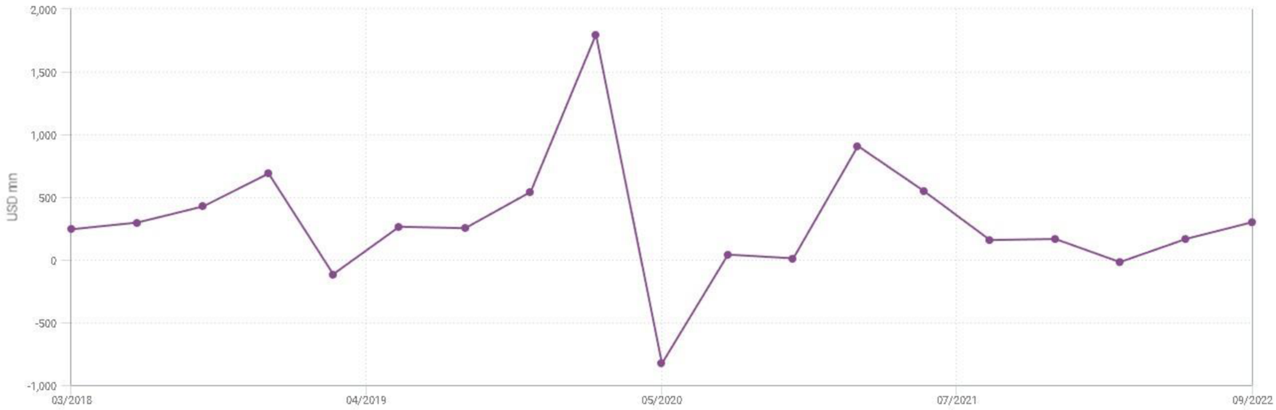
Foreign Direct Investment	2017	2018	2019	2020	2021
FDI Inward Flow (million USD)	1426	1654	942	1021	1766
FDI Stock (million USD)	27481	29136	30077	31705	33471
Number of Greenfield Investments	42	27	29	24	30
Value of Greenfield Investments (million USD)	1266	1424	1051	1090	1061

Source: UNCTAD via Santander Trade Portal. Bahrain: Foreign Investment.: Foreign investment in Bahrain-Santandertrade.com

Bahrain has one of the highest ratios of FDI stock to GDP in the region and has a friendly environment for foreign investment. However, the Covid-19 pandemic caused FDI to contract by one-third to USD 1 billion in 2020, while FDI stocks reached USD 31.7 billion. To attract foreign investment, the government of Bahrain is implementing comprehensive reforms that align with national development and economic diversification plans. In 2020, foreign investment mainly targeted Bahrain's manufacturing, education, healthcare, and information technology industries. The major investor countries include Saudi Arabia, Kuwait, India, and the United Arab Emirates.[40]

[40] Santander Trade Portal. Bahrain: Foreign Investment. Retrieved from Inversión extranjera en Bahréin - Santandertrade.com

Figure 7 FDI quarterly



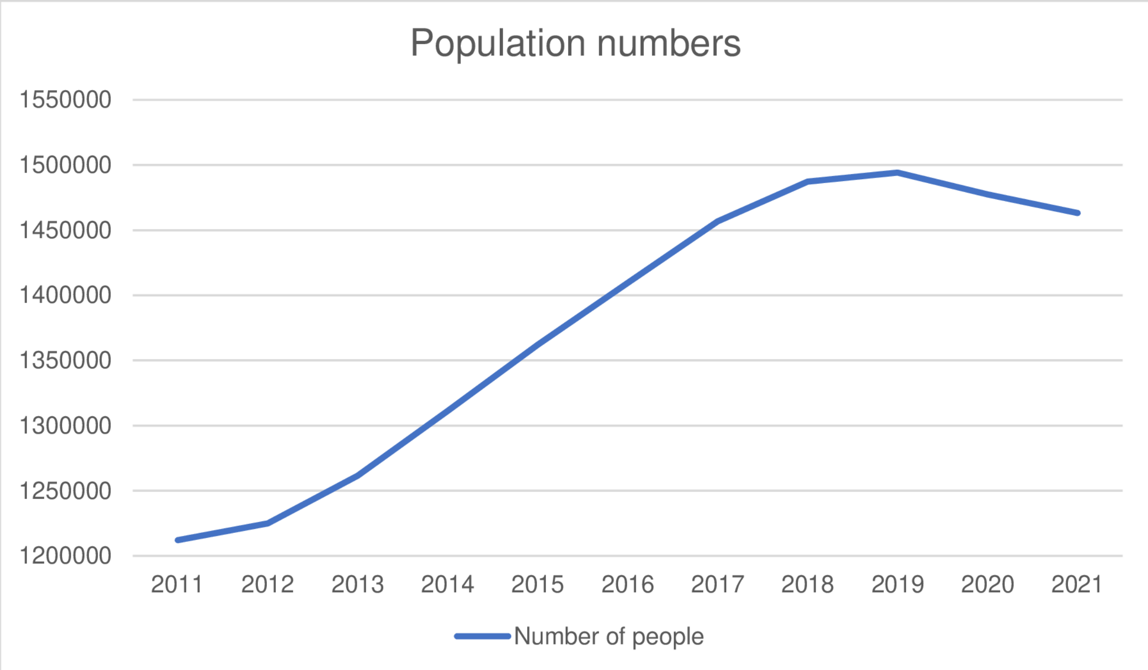
Source: Compiled by the author based on the data provided by CEIC.

The sharp decline in 2020 in Figure 7 is directly related to the pandemic.

According to the "Economic Vision 2030" issued by the Bahrain Economic Development Board, the Bahraini government is pursuing the goal to turn the national economy driven by oil wealth into a productive and globally competitive one. This requires a comprehensive set of measures to be undertaken. The primary issue comes along with a constantly growing national labour market (*Figure 10*). About 4.000 educated Bahrainis join the local labour force every year.[41] But the private sector can employ about 1.000 employees annually. It had been possible for the government to address the issue of unemployment by offering its citizens the jobs in the public sector, which led to the imbalance between over-sized public sector and squeezed private sector.

[41] Bahrain Economic Development Board. (2013, November 25). The Bahrain Economic Vision 2030: From Regional
Pioneer to Global Contender. Retrieved from https://issuu.com/economicdevelopmentboard/docs/bahrain_vision_2030

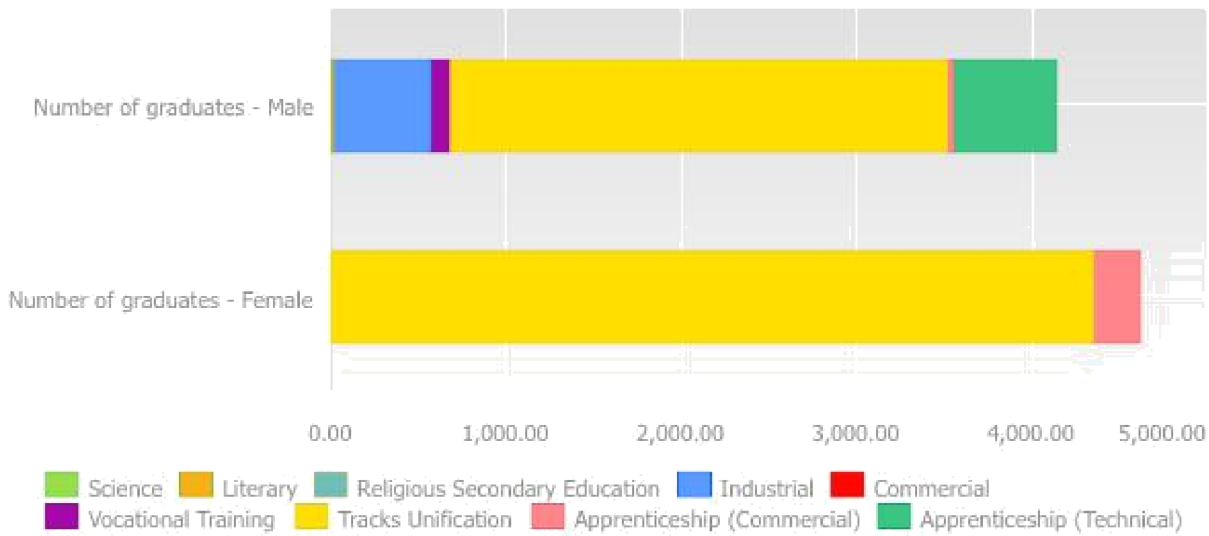
Figure 8 Bahrain Population Number



Source: Compiled by the author based on the data from The World Bank. Retrieved from: [Population, total - Bahrain | Data (worldbank.org)]

Thus, to remedy such a situation the government aims to promote a thriving private sector and raise the level of employment within the country. For this reason, a favorable investment environment appears to be the main determinant of the higher level of the advanced enterprises' presence in the national market and, consequently, the key determinant of the success. The growing number of the Greenfield investments, which take place when a new production unit is established from the scratch (and, as a rule, within a SEZ), are of a particular importance for further industrialization of the national economy. The promotion of various high-value-added activities in different sectors of the economy would create a considerable number of employment opportunities for the skilled Bahrainis (*Figure 10*).

Figure 9 Bahraini Graduates of Government Secondary Education by Specialisation



Source: Information and eGovernment Authority. Bahrain Open Data Portal. *Education*. Retrieved from http://www.data.gov.bh/en/Dashboards

Another urgent issue is the need to improve productivity and innovation of the local businesses. This could also be addressed be means of attracting FDI which come along with the transfer of the technological and managerial know-how. Mature multinationals looking to enter the GCC rapidly expanding markets with a growing demand are a sustainable source of advanced technologies which are to be shared with the local producers be means of the "demonstration effect".

And, finally, the overall goal of the government, that is ensuring a sustainable economic growth, is unlikely to be reachable without the integration of the country into the global trade and information infrastructure. This requires a strong cooperation between the public and private sector. The greater involvement of the latter in the provision of financial capital allocated to the development of the system of the infrastructure services may possibly be ensured by the consolidation of the regional and international investors willing to create globally spread distribution channels.

Undoubtedly, a continuous and stable influx of foreign direct investment strengthened the position of Bahrain in the past, as well as other GCC Member States, in terms of improved production capacity, technologies available and a potential for further cooperation. As long as the country-recipient of FDI excels in maintaining the right balance in export promotion and import substitution, unique business expertise brought about along with a substantial volume of foreign capital facilitates the positive structural shifts in the Bahraini economy and lays the basis for further development of the national industry and mutually beneficial trade cooperation with the partners within the GCC and other foreign investors.

5.3 Prospects of the trade and investment cooperation

Although the GCC states are mostly seen as the recipients of foreign direct investment, they represent one of the world's financial hubs. This is particularly true for Bahrain as the country position itself as a global center of Islamic banking. Thus, the GCC states are possessed of substantial financial funds which have been accumulated since the "oil boom" in 1970s. Another origin of financial capital is the intensified production of refined petroleum and revenues from its export as well as the thriving spheres of hospitality and tourism. The sovereign wealth funds of the GCC states account for at least 40 per cent of the assets of all the existing funds of that kind.[42] The majority of the GCC members consider foreign direct investments as the most preferable instrument for making any capital investments.

As the Gulf countries strive to develop and diversify their economic relations in the framework of the Gulf Cooperation Council, as well as internationally, they are interested in establishing steady mutual investment links with such rapidly growing economies as China, India, etc.

[42] Rusakovich V.I. (2009). Opportunities and directions of Persian Gulf's countries in the global processes of capital migration. *Bulletin of Peoples' Friendship University of Russia. Series: Economics*, 2009, № 3, 27-35. – p. 33

6 Conclusion

The following objectives have been achieved, as a result of the research conducted:

a. there have been identified the key determinants of foreign direct investments inflows.

b. as well as there have been considered various reasons and consequences of the policy implemented by the Bahraini government regarding foreign investment regulation.

c. moreover, there have been studied the governmental measures aimed to promote a favorable investment climate and boost the influx of FDI to the national economy.

The study shows that the Kingdom of Bahrain is an important actor of the economic relations both in the framework of the Gulf Cooperation Council and on an international level. What is more, the multifunctional special economic zones established within the country appear to be the most efficient tool in terms of providing favourable conditions for foreign investors of different industrial specialisation, which contributes to the sectoral restructuring and, thus, diversification of the national economy. Despite the success in increasing the rate of attracting investment and, as a result, improving the investment climate in general in 2015-2018, Bahrain currently faces a difficult task to overcome the crisis in the energy sector. After experiencing a slowdown due to the COVID-19 pandemic, Bahrain's economy made a significant rebound in 2021, thanks in part to the increase in global oil prices. Furthermore, the extension of crucial measures of the financial support plan implemented in 2020 to assist individuals and companies also contributed to boosting Bahrain's revenue and economic expansion.

Foreign direct investment inflows appear to be of a particular importance for the economy of Bahrain in terms of moving away from an overdependence on the energy sector and on the refined petroleum export revenues. The governmental policy regarding FDI is implemented with accordance to the “Bahrain Vision 2030”, a strategy designed by the Bahrain Economic Development Board and aimed to promote the political and economic interests of the country on the international arena.

Bahrain offers a favourable and stable investment environment, characterised by a pro-business mindset and a welcoming approach to foreign investment and enterprise. Despite being largely dominated by state-owned enterprises, Bahrain seeks to enhance the private sector's participation to stimulate economic expansion.

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