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### *The prospect of economic development in Bahrain through the services sector*

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**THE PROSPECT OF  
ECONOMIC DEVELOPMENT  
IN BAHRAIN THROUGH  
THE SERVICES SECTOR**

THE PROSPECT OF  
ECONOMIC DEVELOPMENT  
IN BAHRAIN THROUGH  
THE SERVICES SECTOR

Submitted by  
ZAKARIA AHMED HEJRES

To the University of Durham as  
a thesis for the degree of Ph.D. in  
the Department of Sociology

September 1998

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I certify that all material in this thesis which is not my own work has been identified and that some material in chapters two and three on Economic Integration has been submitted previously by me for the degree of MSc in the University of Strathclyde in 1985.



13 JAN 1999

## ABSTRACT

This study investigates the problems associated with the future economic and social development of a small economy - Bahrain. Bahrain has adopted an industrialisation strategy to diversify the economy since the sixties. The outcomes of that strategy were encouraging at first, but were not sustainable in the long-run. Since the early eighties, changes in the external and internal situations have triggered a debate, which called for a review of the strategy.

This study has two-fold objectives. The first is to contribute to the early conclusion of the debate on the to be taken for the future economic development of Bahrain. The second is to discuss the possibilities of adopting a services sector led strategy for the economic development of the country.

The study emphasises two important factors which debate on the strategy has not given special attention to. The first is that Bahrain has unique features because of its' smallness. The second is the important of utilising and analysing the sectoral and subsectoral data to become to a more objective conclusion about the role of industrial or/and services sector.

The study capitalised on the small economy concept. The small island economies have especial natural and characteristics as compared to large economies. The small island economies differ in terms of population size, land, natural and financial resources, small domestic market and etc. This has made these countries to be more depended on the regional and international market for both exports and imports. These have profound implications to the countries in pursuing their economic and social development objectives. Politicians as well as economists in formulating policies for future economic development have overlooked this uniqueness.

Notions of unbalanced growth and the theory of the leading sector are relevant to the development of a small island economy. But concepts such as self-reliance and the theory of dependency are not. Economic integration among countries, especially among developing countries has accelerated economic development. For a small economy, economic integration is imperative, whatever form it may take.

This theoretical framework has been adopted to discuss and analyse the history of economic development in Bahrain for the period 1975-1991. The analysis carried out at a macro level, as well as sectoral subsectoral level, and activity level based on the data available. The study also adopted certain criteria to measure and compare the performance of the main economic sectors. These criteria's include value added, value of input and value of output, and creation of job opportunities, operating surpluses and revenues generation.

The analysis shows that the diversification strategy based on industrial led sector introduced structural changes in the economy, which benefited the industrial and services sectors since the sixties. But by the mid eighties, the services sector showed more potential for economic growth as compared with industrial sector.

The ability of the services sector to contribute to accelerated growth is evaluated using Singapore as a case study, identifying institutions and policies. The comparison between Bahrain and Singapore, which shared a large number of common features, shows that Bahrain can draw from the development experiences of Singapore, especially in the development of the services sector.

The study concludes that it important for Bahrain to mobilise all resources to conclude the debate on the path of future economic development, and adopt a comprehensive economic strategy. It is suggested that this strategy should be based on the development of the services sector.

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# INTRODUCTION

# INTRODUCTION

0.1 : Introduction .

0.2 : Objectives .

0.3 : Scope .

0.4 : Methodology .

0.5 : Significance .

0.6 : Limitations .

0.7 : Organisation .

## 0.1 : Introduction :

Historically, Bahrain's economy was based on small farming and fishery especially pearl diving, as well as on trading activities related to the trans-shipment and re-export of goods within the Gulf area and the rest of the world. Bahrain has been the focal point of the area because of its strategic geographical location within the Gulf and its unique position between the West and the East. This will be discussed at greater length in Chapter Three. Oil was first discovered in Bahrain in 1932 and exported in 1934. Later it was discovered in Kuwait in 1939, Saudi Arabia in 1945, Qatar in 1949, the United Arab Emirates in 1960 and Oman in 1967. The early discovery of oil in Bahrain, compared with the rest of the Gulf Cupertino Council (GCC) countries, had an impact on transforming its society into a modern economy. It also led to a movement of labour from traditional jobs, such as those in the agriculture and fisheries sectors, into modern industries such as oil production and oil refining.

This had a profound economic, social and political impact on Bahrain. On the economic side, the economy grew faster and per capita income increased rapidly. On the social side the standard of living reached a high level and the society became more open to the rest of the world. Politically, governmental organisations came into existence and political interest groups formed.

After thirty years of oil production and exports, and enjoying a high level of revenue inflow from international oil sales, Bahrain embarked on the first diversification programme in 1967. His Excellency, Sheikh Khalifa Bin Sulman Al-Khalifa (1), Head of the Finance Department of the Bahrain government, initiated the programme in 1966. His Excellency held discussions with senior executives and with the assistance of the Bahrain

Petroleum Company Limited (BAPCO) (2) and the California Texas Oil Corporation (CALTEX) (3) (Bahrain Economic Development Study, 1967), prepared the economic development study of the government of Bahrain. The main emphasis of economic development was on manufacturing industries, namely petroleum and aluminium activities, as well as on agriculture and service activities. The main focus of the development study therefore may be stated as that of an industrialisation strategy. This will be discussed in more detail in Chapter Four.

Before embarking on a diversification strategy, Bahrain had to face the question of choosing the appropriate economic path. At that time, the choice of the strategy was influenced by two main factors. First was the dwindling oil production and revenue and second, the internal situation which needed urgent action, especially in regard to the growing number of Bahrain's entering the labour market with little prospect of getting jobs. Second were the internal and external political pressures from Nasserism (4), the emergent national movement, which clamoured for industrialisation as a means of achieving political independence and fostering economic and social development. This was further influenced by the general trend in less developed countries, who also emphasised industrialisation as a strategy to achieve economic and political independence.

Regarding the first factor, Mr. Sayed Mahmood (5), Director of Finance, highlighted the Bahrain government's concern about the immediate and future problems facing the country: the rapid growth in population, a significant number of young men completing their schooling and entering the labour market each year with few prospects for employment, the declining refinery throughput and the levelling off of oil revenues at a point in time when the government's need for funds was increasing, especially on the welfare

programme (Bahrain Economic Development Study, 1967). As regards the second factor, the spread of the Nasserism movement throughout Arab countries also affected Bahrain. This led to the creation of a national movement to challenge the authority of the British administration in Bahrain. The national movement at that time was inspired by the aspiration of less developed countries for political independence and the fostering of economic development by adopting industrial development strategies.

These circumstances led Bahrain to adopt a diversification programme based mainly on an industrial development strategy. This enabled Bahrain to be in a unique position, as compared not only with other GCC countries but also with many other Arab states, with exception of a few such as Egypt, Lebanon, Iraq and Tunisia. Bahrain has been ranked as a highly industrialised country in the Arab world between 1975 - 1985 ( Ateaba & Besadh, p 69, 1986 ).

By the end of the sixties and the beginning of the seventies, Bahrain had embarked on an important development programme with the setting-up of the manufacturing industries (this will be discussed at greater length in Chapter Four). The outcome of the industrial strategy, which was based on the availability of cheap energy sources and a low cost foreign labour force, was encouraging as explained in chapter four .

The government invested heavily in providing the required infrastructure such as industrial areas utilities, natural gas, electricity and other infrastructure for the development and expansion of the manufacturing sector. The government also increased its involvement in the economy by taking a direct role and investing in setting-up and expanding the manufacturing industries. In addition, the government also provided incentives and subsidies and

established governmental organisations to facilitate the development of the manufacturing sector.

In 1983, however, the situation changed, and government revenue fell significantly due to decline in international oil and aluminium prices. Oil revenue fell from B.D 339.6 million in 1982 to B.D 375.0 million in 1988 and further to B.D 285.1 in 1994. This led to an increase in the state budget deficit from a surplus of B.D 159.2 million in 1981 to deficit of B.D 130.2 million in 1993. This in turn limited the government's ability to finance not only the new industrial projects and other related expansion but also the infrastructure necessary for the industrial strategy. At the same time, competition among the GCC countries also increased on two levels. First, competition in providing subsidies and incentives to the existing manufacturing industries began to be felt. Secondly, competition to attract new local and foreign investment into manufacturing industries increased. Dubai built a large industrial area (Jabel Ali) at a cost of U.S \$ 2.3 billion in 1984 to cater for foreign investment.

Bahrain's oil reserves in the meantime are also being exhausted. It is estimated that oil reserves will be depleted shortly. The annual oil production has already declined from 22,309 million barrels in 1975 to 15,123 million barrels 1993.

The decline in the international oil price since 1983 has had a further adverse effect on the state budget. Since then, the state budget has shown increasing budget deficits. This has raised the issue of whether Bahrain can afford to continue to take the same path and develop manufacturing industries. The situation has been aggravated by the stiff competition that has come from the heavily subsidised manufacturing industries of the GCC countries.

As we will see in Chapter Four, the government has adopted a number of policies to reduce the financial deficit in the state budget, which has sought to rationalise government expenditure and increase revenue. However, there are two fundamental issues that have limited the success of the rationalisation strategy. The first is the role the government has played in providing public services such as health, education and other types of social services. The second is the role of the government in providing the infrastructure and incentives to facilitate the development of manufacturing industries. The second issue is the central theme of this research. How should the future economic and social development of Bahrain take place? Is it financially and economically viable for Bahrain to look at the industrial sector as the leading sector in the future? Or should it search for another economic sector as the basis for future economic development?

These questions have triggered a serious debate in Bahrain among government officials, businessmen, academic scholars and other special interest groups. They all however agree that the primary sector, i.e. agriculture and oil production, is not a suitable candidate to play a crucial role in future economic development.

This debate has taken place through various forms of communication such as interviews, seminars, media communiques, and open debates in newspapers.

As regards the role of the industrial or services sectors, the degree of emphasis has varied among different governmental organisations. On the one hand, some strongly emphasise industrial sector development as the best strategic choice for Bahrain's economy. They argue that with more government subsidies and protection from unfair imported competition, as

well as the creation of a climate conducive to investment, the industrial sector will play the leading role. Given that there exists a highly developed infrastructure and relatively well trained cheap local and foreign labour, manufacturing industries can be the growth engine of the Bahrain economy.

The emphasis of the industrial development strategy was on developing down-stream small and medium scale manufacturing, based on hydrocarbon and aluminium. In opening a seminar on financing industrial development in the GCC countries, His Excellency, Sheikh Salman Bin Hamad Al-Khalifa (6) said that the general trend in Bahrain and in the Gulf countries is to enhance the future role of the industrial sector (Al-Ayam, 1993). Industrial development can be achieved through the adoption of a marketing strategy to promote the comparative advantages of Bahrain, especially its geographic location close to the high per capita income area of the GCC countries. His Excellency, Yousuf Al-Shirawi (7), ex-Minister of Development and Industry, was of the view that the West was leaving manufacturing in certain sectors for others as its own industry had become increasingly sophisticated. By promoting Bahrain internationally as a convenient place for high-quality cheap industrial production, Manama hoped to expand existing industries and develop subsidiary, downstream businesses for them (MEED, 1992).

This concept was also emphasised by His Excellency, Sheikh Mohamed Bin Mubark Al-Khalifa (8), Minister of Foreign Affairs, in his speech at the joint ministerial council between the GCC and the European Community (EC). He said that the unified industrialisation development strategy confirmed that industrialisation was invulnerable and was a feasible economic choice for the GCC countries not only to diversify their economy but also to create an industrial society capable of absorbing new technical skills and the adoption of modern technology. He further stated that it would help to maintain a high

growth rate in the economy and increase the standard of living in GCC countries. Industrialisation was the only option available to the GCC countries, given the natural resources, oil and natural gas (Gulf Cooperation, 1991).

However, industrial development required continued subsidies and incentives to compete with the rest of the Gulf countries. Mr. Saker Shaheen (9), Director of Industrial Development in the Ministry of Development and Industry, stated that in order to attract foreign investment in industries, the Industrial Development Centre was providing a ready-built factory for foreign investors, easy industrial licensing procedures and conducting pre-feasibility studies on some industrial projects. He also said that the new industrial strategy would concentrate on the down-stream small and medium scale industries in aluminium and petrochemicals (Al-Ayam, 1991).

Nevertheless, even with such subsidies and incentives, Bahrain was not in a position to compete with the other GCC countries on large scale industrial projects because of lack of economy of scale. His Excellency, Yousuf Al-Shirawi, commenting on the reason for shelving the U.S \$365 million methyl plant project, said that "we cannot compete with the big plants in the region. Only small units will be built for specified use. An Indian subsidiary of the UB group is looking at the possibility of building one to supply its butyl rubber plant in India, UB Elastomers" (MEED, 1992).

These arguments put forward the case for an industrial development strategy that would contribute substantially to higher economic growth, creating new jobs and increasing state budget revenues. They stated it was a more appropriate strategy for Bahrain's future economic development without oil.

On the other hand, other government officials argued that given the constraints in natural resources, especially oil and gas, and on generating new sources of revenue, Bahrain could not afford to continue maintaining the same pattern of public expenditure, especially that related to the industrial sector because of limitations on the availability of funds. In an interview announcing the new state budget, His Excellency Ibrahim Abdul Karim (10), the Minister of Finance and National Economy, said that the coming economic policy would concentrate on the industrial development as a first priority and then on services development, namely banking, finance and tourism as a second priority (Gulf News, 1989).

Mr. Isa Al-Borshaid (11), Ex-Under Secretary of the Ministry of Finance and National Economy, in giving reasons for the establishment of the Development Bank, said that the idea of establishing the Bank was to provide financial facilities to all economic sectors. The aim was to bridge the gap between short and long term financing facilities and hence encourage investment in the industrial and services activities, especially in small and medium scale projects in Bahrain (Gulf News, 1991).

His Excellency, Ibrahim Abdul Al-Karim also said that "instead of having to apply doses of morphine, the cabinet can now really begin to develop a strategy for the future (Financial Time, 1992). Some elements of that strategy are in place. Bahrain allows 100 per cent foreign ownership of companies, permits overseas consultants, engineers and other professionals to establish themselves without local sponsorships, has launched an industrial development bank, and as a reaction to the number of offshore banking units leaving the island, has set up a promotional unit designed to stem its decline and preserve Bahrain's position as a financial centre. There is also a Board of

Trade that will promote the country's private sector and a cautious programme of privatisation.

In addition, Mr. Isa Al-Borshaid said that future strategy should concentrate on attracting small and medium scale industries, especially those related to modern technology, information systems, banking services, high tech transportation and telecommunication services, as well as providing various services related to production, promotion, marketing, consultation, technical and technological services, with special emphasis on high value added manufacturing and services activities (Gulf News, 1991).

Other government officials argued that if some other sector or economic activity had been given the same privileges and incentives as well as infrastructure, as that given to the industrial sector, it would have contributed much more to economic growth and job creation than the industrial sector. The Ministry of Information is a strong advocator of the development of the tourism sector. Based on a one-year general survey, the Ministry of Information, in coordination with Bahrain Research Centre, prepared a five-year plan to develop the tourism sector. The plan projected that the tourism sector would generate about 5,000-7000 new jobs, raise tourism revenue around B.D 279.5 million in 1996 and contribute positively to the balance of payment (The Tourism Development Plan, 1992).

Dr. Khadem Rajab (12), after analysing the tourism sector in terms of its contribution to value added, foreign exchange earning and job creation, concluded that the tourism sector was a feasible future sector in Bahrain's economic development and required government attention as well as that of the private sector and other economic sectors in the country (Gulf News, 1992).

His Excellency, Tariq Al-Moayed (13), ex-Minister of Information, said that the policy of abandoning the previous requirement that any venture on the island should be 51 per cent Bahraini, was intended to attract new technologies and new industries in new fields. Ministries would be free to allow foreign owned companies to be set up if the projects were deemed to be useful for the economy and create employment for Bahrainis (Financial Times, 1991).

Therefore the main argument of these government officials centre around the fact that the country cannot maintain industrial development from a natural resource and financial return point of view. Hence a wider strategic stand is important to complement and not to replace the industrial strategy. They laid emphasis on the type of manufacturing industries that are less dependent on scarce and depletable oil and gas resources. Besides, they should not be a burden on government financial resources and should not require government intervention in terms of subsidies and protection. Therefore they advocate the adoption of services activities, mainly banking, finance and tourism, in addition to small and medium scale manufacturing industries with high technology producing high value added.

The same debate is taking place in the business community but with different emphasis. The business community argues in general that the non-existence of a clear future economic strategy has hindered private sector investment. The private sector requires a published long-term vision of the Bahrain economy. Mr. Jassim Murad (14) said that "it seems that Bahrain does not know exactly what type of projects it should concentrate upon. Do we want Bahrain to become an industrial country? Or a tourism country? Or a financial services country? Or a commercial services country? Everybody

agreed on the importance of diversification of the Bahrain economy, but the question is which economic path we should take". He continued saying that "industrial development might be a feasible choice but I should take into account Bahrain's economic and social circumstances, especially the shortage of labour in general". Industrial development and dependence on an imported foreign labour force will benefit the foreign labour force and will not contribute positively to job creation for Bahrainis (Al- Ayam, 1990).

On the other hand, Mr. Abdul-Nabi Al-Shoala (15) argued that industrialisation is an inevitable choice for Bahrain regardless of all the challenges surrounding that choice. Bahrain should embark on industrial projects to increase the technical capacity of the economy, provide the professional and highly skilled labour force required and above all create the industrial atmosphere for the future economic development, if we want to meet the requirements of the modern society (Al-Ayam, 1990).

Dr. Hassan Fakhroo (16) said that its central geographical location and well developed infrastructure qualified Bahrain to play the leading role in servicing the area, to become the focal centre in the area or a commercial mediator in the area (Al-Ayam, 1990). He argued that tourism sector development does not require financial subsidies but requires governmental attention (Al-Ayam, 1990).

Mr. Mohamed Al-Zamel (17), one of the most distinguished industrialists and businessmen, said that although the establishment of the group (Al-Zamel) dated back to the early eighties, the industrial emphasis was there right from the early seventies, viz 1972, with the setting up of the aluminium fabrication factory in the industrial area of Mina Sulman (Al-Ayam, 1993).

We see from the above that the private sector was also entering the same debate about future economic development. Different key figures of the private sector different views about future strategy. Such differences on the strategy to be followed have hindered private sector investment, especially in those types of investment that require large funding and long-term commitment.

The MEED said that industrialisation was the government's main means of diversifying the economy away from oil, and private sector funds would help finance infrastructural development (MEED, 1993 ).

To summarise the above debate, the advocator of industrial strategy argues that this strategy will increase independence, increase local participation in terms of ownership and will be less fragile in the general political atmosphere. While the services sector strategy is very sensitive to the political atmosphere, it requires a political will, increased dependency on the rest of the world and will destroy national pride and ownership. Furthermore, it is very vulnerable to changes in international economic and political relationships.

On the other hand, the advocators of services sector strategy argue that recent economic development shows that the industrial sector has failed to sustain the Bahrain economy. With huge government investment, the industrial sector has not lived up to the expectation of creating jobs, general value added and increased government revenue.

In one of the recent studies by Demetriades, Al-Jebory and Kamperis on the economic development of the small economy of Cyprus, the manufacturing sector showed a discouraging result. A dynamic econometric model of the

Cyprus economy has been used to capture the effects of the manufacturing sector. The main finding of this study was that "manufacturing exports seem to provide a very small impetus to economic growth and have only a marginal beneficial influence on the current account balance. Both results can, in fact, be ascribed to the narrow resources base of the small island economy. This is reflected in the high import content of manufactured products since raw materials and machinery required for the production of these goods are usually imported. As a result the strategy of diversification through the support of the manufacturing industry seems to be one with doubtful economic benefit" (Demetriades, Al-Jebory and Kamperis, 1993).

The Bahrain debate misses two fundamental issues related to the economy. The first is that Bahrain is a small scale economy and therefore it has limitations on economic choices, unlike large economies. The second is the absence of detailed sectoral and subsectoral data required to research the appropriate economic choice.

Therefore, this research will draw heavily on the character and uniqueness of the small economy as well as the importance of examining detailed data on sectoral and subsectoral levels to reach any firm conclusion. This research will highlight the importance of the above and will attempt to concentrate, analyse and conclude the above debate which would help the future economic and social development in Bahrain.

Bahrain is a small island, and by nature is less gifted in terms of natural resources and heavily dependent on the rest of the world for its imports and exports and even labour force. Unlike larger economies, the small economy gives less priority to nationalism and ownership of the means of production. Type of ownership alone will not guarantee a higher economic growth rate

and create more jobs. For example in the UK and the USA, banks and industries make labour forces redundant when profits fall, and what guarantees jobs and profit margin is the efficiency of the industries and keeping on top of business development. Privatisation may be another form of transferring ownership from an inefficient public sector to the private sector, either local and/or foreign.

The detailed sectoral and subsectoral data are used to examine the contribution of the services sector and then to compare the development of the industrial and services sectors.

The location of Bahrain in the larger context in the Middle-East and in the specific context of the GCC countries provides Bahrain with a unique role to play. Bahrain, for instance, has an open cultural and social society with a comparatively large share of women in the labour force. The availability of a highly advanced infrastructure in communication, transportation and other services is comparable with developed countries. In addition, Bahrain has a well established modern soft infrastructure consisting of regulations, laws and procedures, and is also an international arbitration centre. Being small, there is an advantage to the Bahrain economy in that it can mobilise internal resources and hence adjust more quickly and easily to external shocks than a larger economy can. Historically, Bahrain, with an advantageous geographical location, played the role of servicing the Gulf area. In this respect, the private sector has played a major role in economic development. These are the comparative advantages of Bahrain over the rest of the countries of the region. These advantages will provide the right recipe for the development of the services sector in the future.

As we will see in later chapters, historical development shows that the services sector was the major source of job creation and value added in Bahrain. Demetriades, Al-Jebory and Kamperis argue that "the main reason behind the success of small island economies, which seems to have been overlooked by the early literature, was their comparative advantage on the provision of services of which tourism seems to be the most important one" (Demetriades, Al-Jebory and Kamperis, 1993).

It is therefore worth while investigating in more detail the future potential of basing economic and social development on the services sector strategy. The requirement of development of the services sector is much more affordable to Bahrain because it does not depend on much financial and natural resources. It requires a political will and further development of the soft infrastructure as well as more investment in human resources such as education and training. The adoption of the services sector led strategy may also provide the government with a golden opportunity for a gradual withdrawal from the economy. Hence, emphasising the role of the private sector in future strategy is the cornerstone of this strategy. This way the government could afford to allocate more financial resources to the social services sector, especially to education and training. Such strategy should therefore be policy oriented to encourage the private sector and to attract local and foreign investment.

Bahrain can capitalised on three main advantages for future development especially for the services sector development. The first is the existence of educated and motivated local labour force, oriented toward the services sector type of skills and jobs. The second is existence of well established legal and institutional systems as well as a conducive investment environment to foreign investment . Bahrain has been ranked as the third internationally in the index of economic freedom by the Heritage Foundation

in 1995. The third is Bahrain's membership in regional economic integration of the GCC. This has an impact of widening the market and fostering economic development .

After the peace treaty with Israel and peace in Lebanon, and with more globalisation of the factors of production, possible sources of competition in the services sector in the Middle East are Dubai, Tunisia, Lebanon, Israel and Cyprus.

It is a matter of utmost urgency that a conclusion is reached to the above debate and agreement made on what is the appropriate strategy for Bahrain's future economic and social development. Otherwise, business opportunities will be lost and Bahrain will not be able to capitalise on the competitive edge it has in some sectors such as financial and banking, manufacturing industries, telecommunication and personal services.

## 0.2 : Objective :

The main objective of this research is to contribute positively to the early conclusion of the above debate on the future strategy of Bahrain. It will also investigate the prospects for the services sectors in Bahrain's future economic and social development in order to formulate an overall strategy and to highlight a specific policy recommendation as Bahrain enters the post-oil economy era.

To that end the study will :

- 1) Establish a theoretical framework of the economic development of the small economy in the context of regional integration and the leading

sector concept as well as the role of the services sector, and examine the relevance of such to the Bahrain economy.

- 2) Highlight the recent economic development, strategies and policies in the Arab countries and the GCC countries.
- 3) Trace the recent economic development in Bahrain resulting from oil production.
- 4) Identify the future role of the government in the economy and examine its consequences for long term development.
- 5) Evaluate the overall performance of the primary, industrial and services sectors in the recent development of Bahrain.
- 6) Examine the overall performance of the economy, particularly in terms of value added, employment, production, exports and economic diversification.
- 7) Examine the prospect of the future economic development of Bahrain through the services sector with especial reference to financial and banking sector.

### 0.3 : Scope :

The study will start by highlighting the special nature of the small economy and its relevance to the Bahrain economy. Then it will develop a theoretical framework related to the small economy. The framework encompasses the leading sector concept of stage growth theory, economic integration,

dependency and services sectors. There will be a brief discussion on the policies and economic structure of the Arab countries and the GCC countries. Then an overall analysis of Bahrain's economic development, with special reference to industrial and services sectors will be provided. The services sectors will be broken down into subsectors and analysed in detail, then compared in general with the services sector in Singapore. Based on the outcome of the above, a strategic option will be selected to determine future economic and social development in Bahrain.

#### 0.4 : Methodology :

The general approach adopted in this research consists of :

- (a) consolidating the various theoretical contributions toward the small economy, economic integration, stage growth theory and services sectors.
- (b) the examination of the case of Bahrain within the established theoretical framework.
- (c) comparing the services sectors in Bahrain with those in Singapore.

The research relies heavily on analysing time series data to explain, support and draw conclusions regarding the various phenomena encountered.

#### 0.5 : Significance :

- 1) The study will contribute positively to the early conclusion of the debate on the future economic development in Bahrain.

- 2) The study has the courage to attempt to adopt stage growth theory, which is based on analysing industrial development mainly in developed countries, to analyse and construct the future economic development in Bahrain based on the development of the services sectors.
- 3) The study has addressed the uniqueness of Bahrain as a small economy with limited prospect for economic development individually.
- 4) This study is believed to represent the first attempt to analyse in detail the functioning of the Bahrain economy within the framework of a services sector economy.
- 5) This study is considered a serious attempt to reinitialise future economic development in Bahrain through the services sectors.
- 6) The study will provide detailed information by sector and subsector especially on the services sectors.
- 7) The various policies recommended may contribute to the formulation of future government policies.
- 8) The study identifies a number of areas in which future research appears to be desirable.

#### 0.6 : Limitations :

The study was restricted by the following limitations :

- 1) The lack of certain microeconomics data restricted the analysis and examination of real potential for development, especially in the private sector.
- 2) The lack of key data such as invisible imports and exports restricted the analysis of the role of services sectors.
- 3) The lack of data on national accounts for the period before 1974 and the use of a comprehensive approach to analyse and reduce the effects brought about by rapidly rising oil prices since 1973.

#### 0.7 : Organisation :

The study is organised as follows :

- Introduction summarising the main argument of the study.
- Chapter One : on the small economy as a base to show the uniqueness of the Bahrain economy as a small economy.
- Chapter Two : theoretical background covering the concepts of stage growth theory with emphasis on Rostows' stages growth and leading sector concept and economic integration.
- Chapter Three : shows Bahrain's position in the context of the Arab countries and the GCC countries.
- Chapter Four : describes and analyse Bahrain's historical and recent economic development.

- Chapter Five : sets up a comparison among the three sectors of the economy with emphasis on the services sector.
- Chapter Six: is the conclusion.

### Notes on the Introduction:

- 1- His Excellency, Sheikh Khalifa Bin Sulman Al-Khalifa is the Prime Minister of state of Bahrain. His Excellency was Head of the Finance Department in 1966 when Bahrain launched the first diversification programme.
- 2- BAPCO is Bahrain Petroleum Company owned by the Government of Bahrain (60%), and Callex (40%) refines crude oil in Bahrain for export. The Government bought the Callex share in 1997.
- 3- CALTEX is a multinational oil company.
- 4- Nasserism is related to Colonel Jamal Abdul Nasser, the President of Egypt from 1953 to 1970. The main objectives of Nasserism can be summarised as follows: freedom, democracy and unity. Industrialisation strategy is the means to achieve economic and social development and hence the cornerstone in realising the above objectives.
- 5- Mr. Sayed Mahmood was the Director of Finance in the 1960s, Minister of Finance in the 1970s and died in 1994.
- 6- His Excellency, Sheikh Sulman Bin Hamad Al-Khalifa is a leading thinker, a distinguished intellectual figure and chairman of Bahrain Research and Studies Centre and under-secretary for Ministry of Defence.
- 7- His Excellency, Yousuf Al-Shirawi was the Minister of Development and Industry from 1975 to 1994.

- 8- His Excellency, Sheikh Mohamed Bin Mubark Al-Khalifa is the Minister of Foreign Affairs.
- 9- Mr. Sager Shaheen was the Director of the Industrial Directorate at the Ministry of Development and Industry, which currently named Ministry of Industry.
- 10- His Excellency, Ibrahim Abdul Karim is the Minister of Finance and National Economy.
- 11- Mr. Isa Al-Borshaid was Under-secretary of the Ministry of Finance and National Economy until 1993 and then Under-secretary of the Ministry of Health until 1995.
- 12- Dr. Khadem Rajab was a director of the Tourism Directorate at the Ministry of Information and currently is Assistant Under-Secretary for Tourism.
- 13- His Excellency, Tariq Al-Moayed is ex- Minister of Information.
- 14- Mr. Jassim Murad is a well-known businessman and member of the Bahrain Chamber of Commerce and Industry.
- 15- His Excellency Abdul-Nabi Al-Shoala was member and Vice-Chairman of the Consultative Council and a leading businessman as well as Vice-Chairman of the Bahrain Chamber of Commerce and Industry. His Excellency became Minister of Labour and Social Affairs in 1995.

16- Dr. Hussan Fakhroo is a leading intellectual thinker in economic and social development in Bahrain, a member of the Board of Trustees in the Bahrain Centre for Studies & Research and an active participant in a number of public and private societies.

17- Mr. Mohamed Al-Zamil is a leading industrialist and a well-known businessman.

## CHAPTER ONE

### THE SMALL ECONOMY

## Chapter One

The Small Economy :

1.1 : Definition .

1.2 : Characteristics .

1.3 : Disadvantages .

1.4 : Advantages .

1.5 : Implications Of Small Economy .

1.6 : Implications For Bahrain .

1.7 : Conclusion .

## The Small Economy

" Small is Beautiful "

Schomeaker, 1979.

### 1.1 - Definition :

The definition of the small economy is of course a subjective matter. Therefore, it varies from one researcher to another, reflecting the extent to which the small economy concept can be a relative term. However it is generally agreed that the use of a single variable for the purpose of defining the small economy is too narrow a concept. The common factor used by most of the studies which have analysed the concept of the small economy is the size of the population. Hein has defined the microstate or the small economy as the countries in the upper cut off point of around one million population ( Hein, 1985, p 16 ).

Streeten argued that " the dividing line between small and large countries changes through history, as populations grow on the one hand, and the number of countries on the other hand". He suggested that what is meant today by a small country is one with less than ten million inhabitants, and by a very small country one with less than five million inhabitants. He further argued that " in economic modelling, the difference is often defined according to whether a country can affect its terms of trade. Hong Kong for instance exports more manufactured goods than India, and has even had a large enough impact on clothing markets in advanced countries to be subjected to import controls. Hong Kong would therefore have to be considered as large, India as small".

There are however other factors used to define the small economy, mainly land area, size of gross national products ( GNP ), energy consumption and etc.

Based on the above definition of the small economy, Bahrain can be concluded to be a small economy, as Bahrain's total population has just exceeded 500,000 inhabitants, according to the 1991 population census, with a total area of 660 square kilometres. Besides, Bahrain is totally dependent on the single depletable natural product of oil and the Gross Domestic Product (GDP) of Bahrain was B.D 1.7 million in 1993.

## 1.2 : Characteristics :

In many respects, small countries are not different from their larger counterparts. They tend to have a colonial past, struggle with weak economies, contain very limited human resources and aspire toward improved social goals. Often, they have to rely on the technical know how, the finance and sometimes the culture of rich developed countries (Farrugia, 1993 ). The characteristic that distinguishes small countries as a category on their own is precisely the scale factor. In general, the economic structure of the small country will be less diversified than that of a large country at the same level of development. Obviously, there are exceptions with regard to some countries such as Singapore, Hong Kong and Taiwan. However the major characteristics of small countries are as follows :

1. They have a small area.
2. They have a small domestic market.

3. They have a small population.
4. They are less gifted with factor endowments, having one or two natural resources.
5. They are highly dependent on the exports of one or two primary products and the imports of all other necessities.
6. They have a less diversified economic base.
7. Government revenues are the main source of foreign exchange and government expenditure is the growth engine of the economy.
8. They are more integrated with international systems in terms of politics and economy.

Naturally, such characteristics impose certain political, economic and social behaviour on small countries. At the same time we can derive certain disadvantages and advantages. As Tisdell argued "small island nations have limited control over their economic destiny. They have, however some control" (Tisdell, 1993, p 5).

### 1.3 : Disadvantages :

Since small countries have also a small area they are therefore less diversified in terms of natural resources and raw materials. Streeten argued that "whatever mineral resources a small country has will tend to be in excess of domestic demand. As a result, primary products account for 75% of the

exports of small countries as a group, but only 15% for the 15 largest countries " ( Streeten, 1993, p 43 ). Besides, the smallness of the country imposed further limitations on the size of the domestic market and to large extent on the per capita income of the population, with the exception of Singapore, Hong Kong and the oil producing countries.

This also imposed another serious limitation, i.e. inability to exploit economies of scale due to a limited domestic market and little scope for specialisation in production. Briguglio said that " in return this ( limited ability to exploit economies of scale ) gives rise to high per capita unit costs of production, high costs of infrastructural development per capita, high per unit costs of training specialised manpower and a high degree of dependence on imported technologies " ( Briguglio, 1993, p 12 ). Another disadvantage for small countries is the concentration on the production of products which they feel to be a comparative advantage. For example, Fiji produces sugar, the Caribbean islands produce bananas and deal with tourism, Bahrain, Qatar and the United Arab Emirates produce oil. Furthermore, small countries tend to be heavily dependent on international trade for exports and imports. The European Community ( EC ) has a trade ratio of exports and imports to Gross Domestic Products ( GDP ) of 30%, while each member country has a ratio of 40-100% ( Streeten ). Bahrain's exports and imports ratio to GDP was 125% in 1992. This has also cable with limited access to external foreign capital markets.

Small economies also have a limited manpower resource base. This limit the scope for drawing on an experienced and efficient labour force and leads to an increase in the unit costs of wages and salaries and unit costs of training in general. A more severe constraint on small countries is their inability to peruse independent macroeconomics policies. They are always at the mercy

of the international world, especially the bigger neighbouring countries. National security policies and defence are a large burden on the domestic resources. Khatkhat and Short argue that " the degree of openness of mini economies is so great that it has an adverse impact on the ability of policy makers to conduct macroeconomics stabilisation policies" ( Khatkhate and Short, 1980 ).

Furthermore, since governments in small countries dominate the foreign exchange earnings and allocation of resources to expand the size of the public sector, this has the implication of increasing the role and the influence of the government on the economy as well as restructuring the progress of the private sector. Mckee and Tisdell indicate that the smaller the economy the greater is government expenditure as a percentage of GDP. For example the ratio in Fiji was 29.4 %, Kiribati 86.5 %, Papua New Guinea 30.9 %, the Solomon Islands 47.2 %, Tonga 45.0 %, Vanuatu 56.9 % and Western Samoa 50.0 % in 1987 ( Mckee and Tisdell, 1990 ).

The private sector in these countries is characterised as a dependent sector on the government expenditures and has a neglective role to play in the economic development. Small countries tend to rely more in relative sense on the government employment than the larger countries. In Bahrain for example, total employees in the government sector consist about 38 % of the total employees in the whole economy in 1992 ( Bahrain Economic Indicators, 1993 ). Besides, The government of the small economy tend to have undiversified revenue based. The government revenue consist mainly from the exporting one or two primary products and taxes. However the former is subject to the fluctuation in the international prices and the latter has a very narrow base. Oil revenue in Bahraains' state budget contributes 75 % of the total revenue, while the rest is attributed to local taxes and overseas grants

which contributes 25 % of the total non-oil revenues in 1993. ( Bahrain State Budget, 1993 ).

The narrow tax base imposed a severe one on the ability of the small country to increase revenues and conduct meaningful fiscal policies. Besides, the small economies have no influence on the international prices either of their exports of the main commodity and/or imports of their major commodity. Briguglio argued that " small size renders the economy as a price-taker of a very high order, since in a small economy importers and exporters are unable to influence international prices " ( Briguglio, 1993, p 26 ).

It is also clear that the small size of the economy tends to limit the competition in the domestic market due to the fact that the economy does not support a large number of companies producing a same product. This might create a tendency in the government entities to limit the issue of licensing and hence generating a monopolistic and an oligopolistic production and service organisations.

Above of all these disadvantages is the small economies are becoming increasingly marginalised from the world economy due to their inability to form part of the global strategies of transnational companies. This tendency toward marginalisation could become more pronounced by the progression towards economic integration of the developed world, particularly within the European Community and NAFTA ( Briguglio, 1993, p 27 ).

Moreover, Parry said that " the global basis of decision making which results in the tendency inherent in direct investment from abroad to shift decision-making power in parts of the private sector outside the country " ( Parry, 1973, p 65 ). Besides, Barry argued that " nowadays, a foreign firm

probably would not consider a location that did not offer unrestricted remission of profits, tax holidays of ten years or more, duty free imports of machinery and raw material, and training programmes for its workers " ( Barry, 1984 ). If that the case, then marginalisation of the small in the global economy will increase as well.

#### 1.4 : Advantages :

Having examined the characteristics and the disadvantages of the small countries, there are also more advantages to compensate the above drawbacks. The small countries have greater flexibility to adjust to the changes in the international trade, which carries with it greater uncertainties and external shocks. The small economy is severely affected by the external shock, but it also has the ability to adjust quickly. This due to the fact that, in a small economy the decision maker has the room to quickly and effectively mobilise the domestic resources to observe the external shock. The economic management of the domestic and foreign resources is much easier than in the larger country, provided that there are a strong and firm leadership.

Furthermore, small countries enjoy the benefit of having smaller public administration and therefore greater flexibility in supervision and administration control, and hence smaller bureaucratic organisation. Streeten, argued that larger organisations are not only more cumbersome than small ones, but there is a greater risk that information gets lost or distorted as it is passed up and down the chain of command ( Streeten, 1993 ). Beside small countries gain from the labour migration to developed countries and oil exporting countries, financially, through workers remittances and human capital, by gaining more experience and the knowhow.

Workers remittances to Jordan in the seventies and early eighties have an overall positive impact on the balance of payments and have provided the funds for further investment. However this is not the case for other small countries such as Singapore and oil exporting countries. In Bahrain, for example, where there is a need for foreign labour forces, workers remittances are considered to be a drain on the domestic resources. However, Bahrain has benefited from the foreign labour forces by bridging the gap in the human resources and hence accelerating its economic and social development ( Bahrain Strategic Committee, 1986 ).

Small countries tend to receive more foreign aid and grants from donor countries and technical assistance from the international organisations such, World Bank and International Monetary Fund ( IMF ). Isenmans' analysis of aid allocations, argued that the small countries received more foreign aid per head than the larger countries ( Isenman, 1976 ). Bahrain for example, has received U.S.\$ 37.0 million as a grant from Saudi Arabia and Kuwait in the 1992 ( Bahrain State Budget, 1992 ). Moreover, the small countries tend also to receive more private capital from abroad as a ratio of the total capital formation. Economic development experiences of Singapore, North Korea and Taiwan have shown that the private capital has played a major role in the capital formation of these countries and hence achieving higher economic growth.

#### 1.5 : Implications of small economy :

Therefore policy implications for the small countries can be summarised as follows :

- 1- There is a greater need for a firm and strong political leadership to implement a decisive economic management of the country's' resources.
- 2- Planning mechanism should be in place and long-term oriented to visionluse the future economy and more flexible on the short and medium-term to make use of unexpected favourable changes and to adjust speedily to unfavourable ones.
- 3- Self-reliance as a first principle with utilisation of international relationships to meet the final end of the country's' benefits.
- 4- Diversification in all aspects of the economy, industry, services, imports, exports, energy and etc.
- 5- Developing an export-oriented infrastructure with an advance related services facilities.
- 6- Maintaining ample foreign exchange reserves to up-set any disruptions in international trade. This should be done even on the expense of sacrificing the yield from alternative useses of the funds as such as financing budget deficit.
- 7- Contiuously improving the countrys' international credit rating. That an out-standing credit rating will allow the country access to international capital markets to overcome shortage in funds. Beside it will attract foreign investment and hence bridge the gap between domestic saving and investment.

- 8- There is a need to maintain higher ratio than the larger countries in terms of goods inventories, especially non-perishable ones and industrial capacity.
- 9- 9-Large scale industrial production should be avoided unless an adequate and stable export market is granted.
- 10- Priorities in research and development ( R & ) should be given to the methods of adoption new technology.
- 11- Integrate with a larger countries in the region to reap the benefits of the economic integration.

#### 1.6 : Implication For Bahrain :

The above analysis concentrates on the advantages and the disadvantages related to the economic development of the small countries. The analysis deliberately has ignored other factors which have indirect influences on the economic development of the small countries such as political, social, cultural and etc. Based on the above analysis the economic development in the small country can be determined to a great extent by international economy and international trade.

Therefore policy implications for the small countries can be summarised as follow : The emphasis will be on the limited natural resources and the smallness of the domestic market in terms of demand and supply. Such factors work to have the limited scope of the small economies for agriculture and/or industrial economic development. Besides it have imposed a great deal of external dependence on the regional and international markets in terms of

imports and exports. However, the small economy has a distinct advantage that work for its favour, is its ability to mobilise the internal resources and restructure the economy easily.

The inherited problem of the smallness has an economic and political implications on the country. It increased the country's dependence on the outside market and established close linkages with the international power and with countries it trades most. The dependence may take various forms. The direct form is the foreign ownership and control over the key sectors in the economy. The indirect form is the dependence on trade flows, finance and monetary, technical and educational dependence.

One more serious form is the dependence on the importation of labour force, the skilled and the unskilled. Such forms of dependence imposed on the country to become increasingly open to the international market and hence more integrated within international division of labour. Therefore the country's agricultural or industrial economic development will be based on the importation of the country inputs and exportation of the outputs. The economic dependence of the small country has an impact on cultural and socio-political systems. The cultural impacts can be seen in the changes of the consumption habits and behaviour shifting from locally produced goods and services to foreign imported ones. This will lead to changes in the demand structure which has implications on the economic development and increased dependence on imports. Moreover, other social values and way of standard of living are introduced which have an impact on the political system of the country.

Therefore the question of self-sufficiency and self-reliance for the small economy ignored the actual realities mentioned above and hence cannot stand

on a solid ground to form a base for future economic development in the small country. This is due to the fact that the country by definition is dependent one and so the only alternative economic development path to pursue is to concentrate on maximising its benefits of being small and utilise strong economic and political linkage with larger economies either on regionally or internationally.

In the concluding remarks Coles' argued that the poor performance of the islands ( South Pacific ) have suggested a wide range of constraints such as small size, but one of the causes of slow growth has been the adoption by island governments of import substituting and domestic self- sufficient policies. Instead of an outward looking private sector which had to fight and be efficient in the international marketplace, governments encouraged production for local needs behind tariff walls, and licensing frameworks which supported inefficiency and a lack of entrepreneurial spirit " ( Cole, 1993 ). Therefore, the role of economic planning within this context is to visualise the role that the country can play to utilise domestic resources most efficiently and to maximise return from its position as well as its economic and political linkages with the larger economies.

#### 1.7: Conclusion :

Based on the above analysis, we conclude that the small-scale economy has very special and unique position in the context of economic and social development literature. The implication of the concept of the small economy will developed furthermore in the coming chapters.

## Chapter 2

### The Theoretical Framework

## Chapter 2

### The Theoretical Framework

2.1: Introduction

2.2: Economic Development

2.3: Economic Theories of Development

2.4: Stage Growth Development

2.5: Dependency

2.6: Economic Integration

2.7: Services Sectors

2.8: Implications for Bahrain

2.9: Conclusion

## 2.1: Introduction:

The purpose of the present chapter is to set a theoretical framework for economic development in the small economy, and its reference in economic development theories. The chapter reviews the theories and the experience of developed and developing countries in economic planning and economic development. Then it highlights major issues in this respect with special reference to stages of growth, development and dependency. Economic integration will also be examined as a means to accelerate economic development in a larger context. Special consideration is given to the services sectors as leading sector in the economic development of the small- scale economy. The implications of the above framework will be applied in the case of small economies in general and in Bahrain in particular.

## 2.2: Economic Development:

Generally speaking, there is a common mistake in using economic growth and economic development terms as if they are interchangeable. There is a fundamental distinction between them. Economic growth refers to a rise in national or per capita income and product, while economic development implies much more. However, there can be no economic development without economic growth. Economic growth is a necessary but not sufficient condition for improving and maintaining the living standard of a large number of people in countries with a low and static level of GNP per capita.

The main factor in economic development is that the people of the country should participate in the production of the economic benefits and not only enjoy them. Edgar Owens argued that:

Development has been treated by economists as if it were nothing more than an exercise in applied economics, unrelated to political ideas, forms of government, and the role of the people in society. It is high time we combine political and economic theory to consider not just ways in which societies can become more productive but the quality of the societies which are supposed to become more productive - the development of people rather than the development of things (Owens, 1987, p. xv).

Furthermore, the World Bank and International Monetary Fund (IMF) have also taken a wider perspective of economic development. The World Bank's World Development report asserted that:

The challenge of development ... is to improve the quality of life. Especially in the world's poor countries, a better quality of life generally calls for higher income - but it involves much more. It encompasses as ends in themselves better education, higher standards of health and nutrition, less poverty, a cleaner environment, more equality of opportunity, greater individual freedom, and a richer cultural life (World Development Report, 1991. P 4).

The IMF also has introduced what the so called social safety-net approach in its packages of economic reforms and restructuring programmes. That

is to reduce undesirable impacts on employment, social services, food subsidies etc.

In defining the meaning of economic development, Todaro has set up three equally important aspects. Firstly, raising people's living level, in terms of their incomes and consumption levels of food, medical services, education etc, through relevant economic growth. Secondly, creating conditions conducive to the growth of people's self-esteem through the establishment of social, political and economic systems and institutions which promote human dignity and respect. Thirdly, increasing people's freedom to choose by enlarging the range of their choice of variables such as increasing varieties of consumer goods and services (Todarao, 1997, p. 18).

The differences in approaching economic development reflect the fact that modern economic growth did not start everywhere in the world at the same time. It was rather started in Europe and North America and spread slowly to Japan and elsewhere.

Gills, Perkins, Roemer and Snodgrass argued that an economy was seen as a pie of fixed size. One could cut oneself a bigger piece of the pie, but only by taking away a portion that originally belonged to someone else. Few saw the possibility of increasing the size of the pie so that all could have larger slices (Gills, Perkins, Roemer and Snodgrass, p 18, 1996). Therefore, the era of modern economic growth make the essence of economic development that, on average, the per capita income of all people in a country rises, not just the income of a select few.

Development is not purely an economic aspect; it encompasses more than the material and financial side of society. It is involved beyond improving income and output to an improvement in institutions, social and administrative structures. In addition it encompasses a change in the people's attitude towards changes in values, customs and beliefs, as well as recognition of the effect of the country's development in an international context.

### 2.3: Economic Theories of Development:

As maintained earlier, from a historical viewpoint a continued growth in per capita output over a long time is a relatively recent phenomenon. Throughout the history, economic growth and population tended to grow at almost the same rate. At that time the purpose of economic production system was to produce various means of survival. But with the introduction of the industrial revolution the purpose of the economic production system has changed to production for making higher profits. Technological progress has facilitated the achievement of such an objective by increasing the efficiency of available resources to maximise output and hence profits.

However the post-World War two literature on economic theories of development has also shown a new generation of thinking. Currently, there are five lines of economic thought that dominate economic development literature. Todaro classified the current economic theories of development into the following: firstly, the linear-stages-of-growth model, secondly, theories and patterns of structural change, thirdly, the international

dependence revolution, fourthly, the neo-classical, free-market counterrevolution, fifthly, the new or endogenous theory of economic growth (Todaro, p70, 1996).

The linear-stages theories of the fifties and sixties approach the process of economic development as a series of successive stages of economic growth through which all countries must pass. Economic development is viewed as compensation for the right quantity and mixture of saving, investment and foreign aid for developing countries to proceed along the path that developed countries pass through. The linear-stage growth theory will be examined in more detail in the coming sections.

However, this approach was challenged by two competing economic schools of thought. The first used modern economic theory statistical analysis in an attempt to portray the internal process of structural change if developing countries were to succeed in generating and sustaining a process of rapid economic growth. The second viewed underdevelopment in terms of international and domestic power relationships and the resulting proliferation of dual economies and dual societies both within and among the nations of the world. It emphasised the need for major new policies to eradicate poverty, to provide diversified employment opportunities and to reduce income inequalities. The dependency theory will be examined in more detail in coming section.

In the eighties, the fourth approach to economic development prevailed, emphasising the beneficial role of a free market, open economies, and privatisation of inefficient and wasteful public enterprises. According to this theory, failure to develop is not a result of external and internal

expensive relationships, but rather too much government intervention and regulation of the economy. The fifth approach came in the nineties as a modification and extension of traditional growth theory in a way that helps explain why some countries develop rapidly while others stagnate and why, even in a neoclassical world of private markets, governments may still have an important role to play in the development process.

Adam Smith, the founding father of the classical school provided the earliest understanding of the operation of the capitalist market system, when he used the term invisible hand. The invisible hand is simply what he referred to as the forces of supply and demand at work in a perfectly or nearly competitive economy. He argued that:

As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value: every individual necessarily labours to render the annual revenue of society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it.... He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention (Smith, 1973, 423).

Adam Smith's analysis of the market system is important to economic progress and development where capitalism is a productive system has the potential to increase human well being. He emphasised the importance of the division of labour and the law of accumulation as an element

contributing to economic progress. The division of labour or specialisation began to evolve rapidly with the spread of the industrial factory system.

The expansion of domestic and foreign markets provide opportunities for and increase in the division of labour which raises productivity due to specialisation in the production process. While market expansion provides the opportunity and inducement for growth in output and productivity, productivity will only occur if firms respond to new opportunities by committing more resources to production. The introduction of the newest technology in the production system tends to increase efficiency and hence profit, which leads to more physical capital accumulation. Such investment requires an increasing in saving by those groups in society such as manufacturers and landlords who have sufficient income.

It is capital accumulation, technological progress and specialisation of labour that are the sources of expanding economic growth.

Young, in 1911, emphasised the important of expanding the markets for economic growth. He argued that the market does not just expand through an increase in area or population but also per capita income grows. The increase in per capita income is the outcome of the increasing division of labour.

Malthus, another classical economist, has shown interest in what might happen over time to mass welfare in an economy through economic growth. Hunt summarised Malthus argument as follows.

Economic growth generates increased demand for labour and hence rising wages. Rising wages led in turn to an increase in population and hence labour supply: with an increase in living standards parents choose to have more children and, in addition, a higher proportion of children survives infancy. She added that any rise in mass living standard could be only be temporary because the increase in population would rapidly outstrip the capacity of the agriculture sector meet the growing demand for food, for additional land brought into cultivation is generally less fertile than that already cultivated (Hunt, 1989, p14).

Furthermore, Ricardo begins on the same lines as Malthus but introduces the consequences of rising food demand. He introduces technical innovation in agriculture and the use of international trade to obtain lower cost food in exchange for manufactures. With the introduction of even one these factors growth may continue while real wages remain buoyant as a result of the rising demand for labour. Therefore, in Ricardo's mind economic growth should be financed out the profits accruing from productive activity.

Unlike Smith, Malthus and Ricardo, Karl Marx believed capitalism is one stage in society's historical development that began with primitive communism, slavery, feudalism and capitalism, where imperialism is the highest stage. This will create the socialist system than moves to communism as the last stage. Marx believed that the creation of wealth that is enjoyed by the capitalist system was really the result of surplus value created by the workers or what he called the proletariat.

Another early theory about economic growth and development is the work of Rosenstein-Rodan. After analysing the economic structures of a number of poor countries, he emphasised what he called the hidden potential. The analysis centred on taking advantages of the increasing returns that could be realised from large-scale planned industrialisation projects that encompassed several major sectors of the economy simultaneously. A big push of industrial investments could launch a chain reaction of various circled and complementary investments that would then ripple in many directions through the economic system.

Rosentein-Rodan has stated that:

The market mechanism alone will not lead to the creation of social overhead capital, which normally accounts for 30 to 35 percent of total investment. That must be sponsored, planned, or programmed (usually by public investment). To take advantage of external economies (due to indivisibilities) requires an ' optimum size ' of enterprise to be brought about by a simultaneous planning of several complementary industries (Rosenstein-Rodan, 1984, 209).

Ragnar Nurkse also saw the solution for less developed countries by a large-scale increase in investment in a form of balanced growth. This is the so-called balanced growth theory. He emphasised that by attempting to solve the problem of underdevelopment via an expansion on the supply side alone, that is, through the expansion of production capacity, one ran

the risk that the lack of demand for new output would short-circuit the attempt to move the economy forward ( Cypher and Dietz, 1997, p 142).

Furthermore, Albert O. Hirschman was also advocating the big push approach, in that he supported an industrialisation first strategy and he firmly believed that the key to rapid industrialisation was to be found in large-scale capital formation in several industries and sectors. But Hirschman advocated a big push for only a limited range of industries, with the idea that by inducing development in key sectors first, overcapacity would be created in these sectors, with supply bottlenecks which would simultaneously increase production difficulties elsewhere in the economic structure. These bottlenecks would create pressures for new investments to solve the supply inadequacies.

Therefore, he deliberately advocated unbalanced economy to mobilise scarce resources, create profitable investment opportunities and establish backward and forward linkages among the existing industries. He stated that, once the indirect employment effects (via backward and forward linkages) are taken into account, investment in large-scale (capital-intensive) industry turns out to be just as employment-creating as investment in small-scale (labour intensive) industry for the industrially advanced countries of Latin America. (Hirschman, 1984, 97).

Having discussed the principal economic theories of development, the coming sections (4 and 5) will concentrate on schools of thought on economic development which has been briefly discussed at the beginning the of current section.

## 2.4: Stage Growth Development:

The analysis of economic development literature reveals that there are two distinct approaches. These approaches are the stages of economic growth theory and the structuralism theory. The successful implementation of the Marshall investment plan provides a historical experience of developed countries in their transformation stage and has provided a base for the growth of the stages of economic growth theories. The simplest stage theory is that of Fisher and Clark who employ the distinction between primary, secondary and tertiary production as a basis of a theory of development (Fisher and Clark, 19).

The stages approach however is associated more with W.W. Rostow, who argued that the transition from underdevelopment to development can be described in terms of a series of steps or stages through which all countries must proceed, (Rostow, 1960). In the opening chapter of his book Rostow stated that:

This book presents an economic historian's way of generalising the sweep of modern history ... It is possible to identify all societies, in their economic dimension, as lying within one of five categories: the traditional society, the pre- condition for take-off into self-sustaining growth, the drive to maturity, and the age of high mass consumption. These stages are not merely descriptive. They are not merely a way of generalizing certain factual observations about the sequence of development of modern societies. They have an inner logic and continuity ... they constitute, in the end both a theory about economic

growth and a more general if still highly partial theory about modern history as a whole (Rostow, 1963).

According to Rostow all societies have to go through five stages of growth traditional, transitional, take off, maturity and high mass consumption. The most important stage of these is the take - off stage when growth becomes self-sustaining and investment rises to a level such as to increase national income and hence increase per-capita income generating sufficient levels of saving and investment to guarantee future growth.

He also stated that:

As a matter of historical fact a reactive nationalism - reacting against intrusion from more advanced nations - has been a most important and powerful motive force in the transition from traditional to modern societies, at least as important as the profit motive. Men holding effective authority or influence have been willing to uproot traditional societies not, primarily, to make more money but because the traditional societies failed - or threatened to fail to protect them from humiliation by foreigners.... Without the affront to human and national dignity caused by the intrusion of more advanced powers, the rate of modernisation of traditional societies over the past century-and a half would have been much slower than, in fact, it has been. Out of mixed interest and motives, coalitions were formed in these traditional or early transitional societies which aimed to make a strong modern national government and which were prepared to deal with the enemies of their objective, that is, they were prepared to struggle against the political and social groups rooted in regionally based agriculture, joined

in some cases by the colonial or quasi-colonial powers. (Rostow, 1984, 233).

One of the most important features of this stage is the establishment of the leading growth sector. The leading sector which can be one or a group of industries is the central part of this theory, where its development generates demand and encourages the setting up of new industries to take over its role in the future. Rostow set up the conditions for the take-off stage in the following:

- (1) A rise in the rate of productive investment from, say 5 percent or less to over 10 percent of national income;
  - (2) the development of one or more substantial manufacturing sectors with a high rate of growth; (and)
  - (3) the existence or quick emergence of a political, social and institutional framework which exploits the impulses to expansion.
- (Rostow, 1960, 39).

Rostow has set up conditions to be met by any industry to be able to play the role of leading sector. These conditions are, the market for its product should be expanding fast to provide a firm basis for the growth of output. It should generate secondary expansion. The industry has an adequate and continual supply of capital for ploughed - back profit. Finally, the new product's function can be continually introduced in the industry meaning scope for increased productivity. However there is no specific single pattern of growth or sequence for the take - off. It may take a form of a technological innovation or a political revolution or a sudden discovery of very important exported raw materials. In any way the leading sector or industry should meet the above pre-conditions otherwise the take-off will be abortive.

The stage of take-off and the leading sector imply that successful industrialisation is imbalanced, in the sense that a single or limited industry is the source from which an initial acceleration ramifies through the economy. The leading sector influences the other sectors or industries through the forward, lateral and backward linkages. The concept of take-off can be explained on two levels. The sectoral, non-linear nation, when the leading sector is the realm with its forward, backward and spreading effects. The other level is highly aggregative, in which the rate of growth of income is the product of an average propensity to save and the inverse of a reasonably stable capital - output ratio. (Fishlow - 1965).

Fishlow argued that Rostow fails to elaborate the conditions under which one rather than the other yields a more cogent explanation of how growth took root or how the two are related. And by not introducing recency constraints and a more adequate discussion of technological diffusion into his sectoral theory he deprives it of clarity and consistency that the aggregate approach does enjoy.

Frank argued that Rostow's stages don't correspond to the past and present reality of underdeveloping countries, because the tractional stage is the only stage to start undevelopment. Therefore, it denies the history of the undeveloped countries. Beside the theory doesn't say anything about how to get from one stage to another. Even the take-off stage which depends on the rate of investment and growth doesn't affect the real structure of underdeveloped countries. Moreover, the development of developed

countries is not wholly based on mobilizing the domestic resources especially financial. Marx on India and others of Latin America have argued that the undeveloped countries here played a crucial role in financing the capitalisation of the developed countries.

## 2.5: Dependency:

Theorists from third world countries have attempted to explain underdevelopment as an external consequence of western capitalism through the formation of a world market and various form of imperialism and colonialism. The cornerstone in the analysis of dependency is that underdevelopment is not a condition that all countries experience or a stage that all countries pass through before development. It is rather regarded that development and underdevelopment are opposite sides of the same coin (Frank ,1967, p . 9).

In other words, it means that the development of some countries will inevitably lead to the underdevelopment of other countries in the world economic system. The development gap between developed and less developed countries will continue widening as a result of colonialism and the trade interrelationships in the world economy. Hence the analysis of the dependency in the present less developed countries should start with the analysis of colonialism in these countries.

The underdevelopment of the less developed countries is attributed to the existence and maintenance of the historical evolution of a highly unequal international capitalist system of rich country- poor country relationships.

The co-existence of rich and poor nations in an international system dominated by such unequal power relationships between the center and the periphery renders attempts by poor societies (the periphery) to be self-reliant and independent in their development efforts difficult and sometimes even impossible (Todaro , 1979 , p 90-91).

T. D. Santos, who was an advocator of the international dependency school of thought, argued that:

Dependence is a conditioning situation in which the economies of one group of countries are conditioned by the development and expansion of others. A relationship of interdependence between two or more economies or between such economies and the world trading system becomes a dependent relationship when some countries can expand through self-impulsion while others being in a dependent position, can only expand as a reflection of the expansion of the dominant countries, which may have positive or negative effects on their immediate development. In either case, the basic situation of dependence causes these countries to be both backward and exploited (Santos , 1969).

Such a framework of analysis has become known as dependency theory. The insight of the dependency theory was that it was of limited value to study the development of the societies of the third world in isolation from the development of advanced societies. Therefore we should deal with the world as one system and analyse the development of underdeveloped countries. This will reveal the difference in the historical development between underdeveloped and developed countries.

A well known theorist of the dependency was Frank. Frank's basic theoretical concept centered on underdevelopment which is a condition characterised by the less developed countries of today. He distinguished between development and undevelopment and hence asserted that:

"The now developed countries were never underdeveloped, though they may have been undeveloped. "

He describes the relationship between developed and underdeveloped countries as a series of metropolis and satellite links, whereby the surplus generated at the satellites through a high rate of investment has been transferred to the metropolis in terms of profits and dividends. This has the effect of hindering the capital formation in the satellite which leads to underdevelopment, therefore the relationships between these two are of the nature of an extraction and transmission of surplus. As a result, for developing countries to develop, they should reduce such linkages to a minimum and start their own internal development base on collective corporation among those which are relatively at the same level of development (Frank, 1969).

Simon and Ruccio argued that Frank has employed three different forms of explanation at different points in his theory. Those forms of explanations are structural, functional and international explanations (Simon and Ruccio, 1986). They argued that the mode of explanation is structural in that the theoretical model exhibits what are posited as being the underlying structure (processes and relation) that causally produce the condition to be explained, underdevelopment. The explanatory emphasis is on the causal

mechanisms or structures, not as in monothetic explanation, on empirical generalisation or laws. Rather the explanatory brunt is borne by establishing that there were mechanisms operating in those particular circumstances sufficient to cause the underdevelopment.

The functional explanation emphasised that the existence of underdevelopment is to be understood in light of the function it plays in the accumulation process, while the international explanation involves making sense of an action by showing that it was an attempt to achieve a particular goal on the part of the agent, a goal that can be understood in terms of the desires of the agent and the beliefs he or she has concerning how best to satisfy those desires. The dependency theory, especially the work of Frank, has attracted a lot of criticisms.

## 2.6: Economic Integration:

One of the major aspects of international trading relationships during the post-war period had been the development of regional trade groupings. The idea has gained growing importance in the realm of regional economic integration. Harberler (1964) characterized the period as "the age of integration". Apart from political considerations, such a tendency has originated from the expected and potential economic gains thought to be made possible by enlargement of the market, and by more effective use of scarce resources.

Simultaneously, developing countries have increasingly sought to strengthen economic cooperation among themselves as an important way of accelerating their economic and social progress. Indeed these countries

are actively involved in the establishment of a large number of institutions and arrangements designed especially to foster economic cooperation at the regional or sub regional level. Although the past experience of economic integration among developing countries has not reached a satisfactory level, there is considerable potential for economic integration to accelerate and reduce the cost of economic development. Therefore such economic integration is usually conceived as a strategy for economic development, rather than a tariff issue which is basically how it has been viewed in the context of developed countries.

In the eighties, economic integration rose as a form in which all blocks of countries around the world look at as a way to foster economic growth. It has become the characteristic of this area and most likely will be in the next millennium. It is becoming apparent that the nation states are coming under a serious threat nowadays. Kenichi Ohmae, in his book "The End of the Nation State" has agreed that traditional nation states have become unnatural, even impossible business units in a global economy (Ohmae, 1996, p. 5).

There are a number of factors that have contributed to the decline of the nation state and the rise of the economic integration. One factor is the foreign direct and indirect investment which now has geographical constraints. Investment by individuals and transnational corporations go anywhere for business opportunities and money becomes stateless.

Another factor is that industrial production is becoming more globally oriented than local market oriented. The transnational corporations are changing their strategy from serving a specific market and/or state to any

attractive markets and wherever they exit. Peter Dicken argued that the transnational corporation not only directly controls and coordinates its own complex internal networks on an international or global scale but also indirectly controls many of the externalised networks in which it is embedded (Dicken, 1992, p. 226). It is becoming increasingly difficult to use the nationalism slogan of “ Made In X Country “ as the contents of the finished product is made-up of various companies in various countries. In such global context, it is impossible to draw a line between what is belonging to the nation state and the global.

Ohame stated that:

In the earlier age, to be sure, national interest meant something different. It used to provide a clear and unmistakable dividing line between what was ours and what was someone else's. This plot of land is ours, not theirs, this factory is ours, not theirs, this company is ours, not theirs. But how does this kind of logic apply today to a Honda plant in Ohio or a Nissan plant in Tennessee or an IBM plant in Japan or a Motorola plant in Malaysia? Whose “ interest “ does each of these serve? The answer is far from clear (Ohame, 1996, p 68)

The other factor is advance in the information technology. The revolution in information technology has wiped out the boundaries among the state nations. The movement of information from one country to another does not require a passport. Internet and other forms of technology have made the whole world a small village, and made people aware of others' living conditions and standards of living in general.

The factor that gives rise to economic integration is individual awareness especially in terms of consumption. The above factors have opened a wide range of choices to the individual, so that he has become more global in taste than local. O'Hare stated that, for more than a decade, some of us have been talking about the progressive globalisation of markets for consumer goods like Levi's jeans, Nike athletic shoes, and Hermes' scarves - a process, driven by global exposure to the same information, the same cultural icons, and the same advertisements, that I have elsewhere referred to as the "Californisation" of taste (O'Hare, 1996, p.15).

#### 2.6.1: Concepts and Forms:

Economic integration involves the process of gradual removal of discriminatory barriers among regional national economies with the objective of optimizing the economic performance of the group. Myrdal (1956) argued that 'the economy is not integrated unless all avenues are open to everybody and the remuneration paid for productive services is equal'. On the other hand some theorists go further and argue that it is not enough to remove discriminatory barriers: policies of coordination and harmonization should be introduced. These enable the group to achieve optimal functioning and development of the economy as a whole. Tinbergen (1965) has defined economic integration as the creation of the most desirable structure of international economy removing artificial obstacles to optimal operation and purposely introducing all the desirable elements of coordination or unification.

In general we may distinguish between two types of economic integration (Tinbergen 1956): negative integration and positive integration. The former refers to the removal of barriers of trade and any restrictions on the process of trade liberation among the participating countries. The latter refers to the modification of existing instruments and institutions, and the creation of new ones (a) to enable the market of the integrated area to function properly and effectively and (b) to promote other broader policy aims of the union.

From the literature it appears that the general approach to economic integration has been closely linked to the establishment of Customs Unions. It has mainly given rise to the analysis of the welfare of implication of economic integration. It emphasized integration through market forces of the participating countries as a means of economic fulfillment. Optimum re-allocation of resources in the integrated region within the context of such an approach may distinguish several forms of economic integration.

The simplest form is the Free Trade Area. It involves the removal of tariffs, and other quantitative restrictions among member countries and allows them to set their own tariff rates on imports from the rest of the world. The second form is Customs Unions which involve, apart from the elimination of tariffs among member countries, the pursuit of a joint tariff policy against the rest of the world. The third form is a Common Market. Besides the requirements to establish the Customs Unions, it involves the removal of restrictions on the movement of factors of production (especially labour and capital). The fourth form is the Economic Union. It

requires the economic and social policies to be harmonized to some extent. In Balassa's (1962) classification he called the highest form of economic integration supranational union. Here the governments of the participating countries have to relinquish their sovereignty over economic and social policies to a supranational decision-making body.

However, most of the economic integration schemes which have taken place in reality have been associated with the first two forms; indeed most developing countries tend to be sensitive to factor mobility, but they may allow, under certain circumstances, free mobility of goods. Since economic integration need not embrace all sectors of the economics concerned, partial integration limited to one sector or even one industry has proved to be a more promising form of integration, especially to developing countries. Mennes (1973) has considered two schemes which are particularly relevant to developing countries. One aims to increase exports of manufactured and semi-manufactured products to the world market by preferential trade schemes, either among developing countries or between developed and developing countries. The second is aimed at the joint undertaking of specific projects, or project cooperation.

Regardless of the form that economic integration may take, very much depends on the aim and the degree of integration desired by the participating countries. The basic objectives of the various forms are to facilitate trade exchange and specialization in production in an enlarged market region. Besides, they discriminate against the rest of the world in one way or other.

### 2.6.2: Customs Unions:

As noted earlier the theory of Customs Unions seems to dominate the thinking of economic integration. The essential elements of integration theory were delineated by the works of Viner (1950). He emphasised the relative efficiency in the allocation of resources and gains from trade. He did this through a static comparative advantage analysis of trade creation versus trade diversion. Trade creation refers to a situation when external barriers and internal free trade lead to a shift in production and consumption from high to lower cost member states. Trade diversion, however, refers to the erection of external tariff barriers causing production and consumption of one or more member states to shift from lower cost non-member sources of supply to higher cost member producers. Lipsey (1960) defined customs unions as the branch of tariff theory which deals with the effects of geographically discriminatory changes in trade barriers. Hence establishing them will generally alter the relative prices of goods in the domestic market of the members with repercussions on trade flows, production, and consumption.

Customs Unions are based on the assumption of constant terms of trade, constant production costs, and zero demand elasticities for products (Robson 1972). The development of the theory has included the relaxation of constant costs assumption, and the incorporation of substitution among commodities leading trade expansion and consumption to offset trade diversion. Moreover, it has incorporated the terms of trade and the analysis of trade deflation on free trade area.

One of the major limitations of Customs Union theory is that it fails to explain that countries could reap the benefits of Customs Unions through trade creation and expansion without incurring offsetting losses through trade diversions. This can be achieved by forming free trade areas or choosing an appropriate policy of non preferential tariff reduction. Furthermore it does not tackle the major interest on economic development, such as the dynamic changes of production structure and technology, the processes of substitution, the processes of diversification, and so forth.

Although several writers have acknowledged these limitations and expressed the irrelevance of the orthodox integration theory of developing countries, it does not mean that the results of economic analysis are entirely irrelevant. Mikessel (1963) argued that the theoretical analysis of Customs Unions or of regional preference arrangements should generally be directed more towards the problems of their impact on the directions of investment in the developing countries for future output, rather than limited to an analysis of the welfare implications of shifting existing trade patterns. Furthermore Cooper and Massel (1956) have approached customs Unions in terms of the advantages that may be afforded by swapping markets for the products of each participants' high cost industries. In many developing countries that has been valued so much that they are willing to give up a certain amount of achievable national income to this end.

Robson (1980) argued that, in evaluating the merits of integration among developing countries, what is relevant is not so much its impact on the existing patterns of production and trade as its impact on those which are likely to emerge in the absence of the formation of regional groupings :

enlargement of the market, mobilisation of unemployed resources; increase in opportunities for profitable domestic and foreign investment. Thus the argument for regional integration among developing countries is largely based on the prospective gains from rationalizing the emergent structure of production.

### 2.6.3: Integration among Developing Countries:

The case for regional economic grouping among developing countries lies in (a) the expected and potential gains arising from a pooling of resources particularly of small countries, (b) the enlargement of regional markets and (c) the exploitation of economies of scale.

Since the majority of developing countries are characterised by the smallness of their economies as reflected in low per capital income and population, such factors work against the achievement of rapid growth (Scitovsky 1963, Finance and Development, June 1974).

Since these countries considered industrialisation as a necessary strategy for achieving economic development the consequences of their smallness have adversely affected such strategy (Chenery, 1980). Thus the first best policy option within the national framework has been reconsidered in favour of pursuing regional policy as a second best option.

With the objective of industrial development in mind, regional integration offers several advantages. Firstly, elimination of trade barriers among the participating countries will have an important impact on intra-regional trade, especially on manufactured and semi-manufactured goods. This is

due to the fact that developing countries are facing discriminatory tariffs in trading with developed countries. Moreover the integration scheme will facilitate exchange of information on prices and costs, and hence lead to reduced risk and uncertainty facing the investors in particular. Also the creation of a regional market enables the industries to reap the benefits of economies of scale and thereby increase opportunities for profitable investment, efficient utilisation of the existing capacity, and employment of idle resources.

Another advantage of economic integration among developing countries may be found in the protection that is given to infant industries in the partner countries.

Since integration involves the enlargement of the market which in turn has a favourable impact upon productivity, growth rates and so forth, the costs of protecting the infant industry may be reduced. This will enable more resources to be freed for investment, hence increasing output and economic growth. There are also economic advantages namely: increase of the group's bargaining power in its external relationships, and improvement of the political relations among the participating countries. Both of these have a very important role to play in the enhancement of economic gains. Penaherrevá (1980) argued that these (political) motives are extremely important in the genesis of integration efforts. The absence of both or of one of them, in particular the latter, is a crucial factor in stagnation or breakdown of such efforts.

In general regional integration among developing countries very much depends on the empirical significance of various factors (Robson 1980).

The most important of these is the weight attached to industrialisation in economic development. For example, the enlargement of the market and the removal of trade barriers provide substantial scope for the industries to reap the benefits of economies of scale and hence reduce the overall costs of production. Furthermore, this may increase the opportunities for the country to export its manufacturing products to world markets, rather than to protected regional markets. Besides, both the magnitude of scale economies in prospective regional industries and the differences in the costs of producing industrial products in the different member countries may provide opportunities for comparative advantages with the resultant benefits of specialisation. Finally, the allocation of the market and the costs of transporting both raw materials and finished products within the region may offer scope for improvement in communication, infrastructure etc.

#### 2.6.4: Approaches to Economic Integration:

Theoretically there are three principal approaches to achieve economic integration within a regional framework. They are not mutually exclusive and sometimes have been implemented in combination. The first is the classical approach, which involves across the board trade liberalisation for all or most products with the formation of Customs Unions or free trade area, has been used as a basis for most economic integration attempts among developing countries in various regions of Africa, Central America and the Caribbean. It can be said that this approach (integration by market mechanism) has proven to be the most frequently pursued by developing countries and the one which has least contributed to their development

problems. Vaitsos (1978) argued that it has contributed not inconsiderably to present disillusionment with economic integration.

The second approach is the complementary one, which involves trade liberalisation for certain existing industries or product groups on the basis of rationalising production. The objective is to promote specialisation among a limited number of existing plants in order to both reap the benefits of economies of scale and utilise excess capacities. This approach represents a narrower form of regional integration and has been used in Latin American Free Trade Association. It is (a) too demanding, in terms of administrative operation, and (b) too time consuming, in that it involves a long process of negotiation, to set selective mechanism.

The third, the joint project approach, takes the form of intercountry agreements for the encouragement of existing industries or the establishment of new industries on a regional basis. This involves measures to both promote and regulate investment in industries that enjoy economies of scale in order to meet more economically the combined demands of member countries and, hopefully, exports to world market.

The last two approaches pursue common policies on economic development based on planning to achieve specific objectives. They regard market forces as inadequate to meet these objectives and hence various forms of intervention in the market system, directly or indirectly, are required.

In general these approaches emphasise the importance of regional integration to bring about profitable specialisation, but each has its own

means of achieving that. The first approach attains its objective through the operation of market forces by negotiating a suitable tariff structure which is expected to work in the desired direction, The latter two, however emphasise the appropriate scope for specialisation in existing or new industries, based on detailed feasibility and cost benefit studies and then utilising various policies of tariff, fiscal, monetary and so forth to achieve the desired changes in the pattern and production.

#### 2.6.5: Problems of Economic Integration:

It has been generally argued that regional economic integration among developing countries is a useful means of accelerating their economic growth rates. This is due to the following factors: (a) the size of their economies which are considered to be small and (b) the existence of barriers on trade and factors mobility which are currently a feature of international economies. A country would participate in an integration scheme if there were prospects for economic gain (of course there may be political gain); moreover, it would only retain its participation as long as it considered itself, at least in the long run, better off in the scheme than outside it. On the other hand, an economic integration scheme would not last unless a reasonably equitable distribution of benefits and costs were maintained among the participating countries. Of course such schemes do not benefit the participants equally, and indeed some of them may even be harmed. Hence problems arise. These problems may be classified into two categories: (a) the short term problems which are connected mainly with terms of trade, balance of payments and changes in revenue, and (b) the long term problems which are related to the transfer of production factors from one country to another and to increases in productive capacity.

On the lower level, problems may arise from increasing the scope for profitable specialisation. This may be attributed to the fact that in most developing countries, money costs do not reflect the true social costs because of the existence of various market distortions. For example, a large scale investment characterised by economies of scale may raise a doubt about the reliability of the price system to provide profitable specialisation in such distorted conditions. Thus any hopes of bringing about a suitable framework for trade liberalisation merely by the adoption of a proper common external tariff may often be very small. Another problem may arise from the strengthening of appropriate production structure. It is well known that transport facilities in most developing countries are relatively poor and that they are usually geared to the need of overseas rather than intraregional trade. Such inadequacy of infrastructure (largely physical) prevents the utilisation of free trade in the region.

Another problem is concerned with the distribution of the benefits arising from the integration scheme. It has been argued that infant industry normally requires a substantial period of protection to become commercially viable even when access to the whole regional market is assured. On the other hand the existence of market distortions will prevent the true opportunity cost of such protection being made clear and hence an excess of nominal costs over import prices may not reflect true trade diversion. Thus, conflicts of interest are bound to arise especially when protected industry does not distribute its benefits over the whole market area in such a way that each participant attracts its equitable share. Moreover, since these countries have differences in development level, factor endowment etc, polarisation is bound to occur. It favours those

participating countries which enjoy relatively higher per capita income and larger factor endowments.

Although many integration schemes have adopted corrective fiscal measures and mechanisms to offset the problems associated with integration, interest has shifted to the development of a more practical and coordinated approach. Such an approach will be conducive to more equity and economic efficiency.

## 2.7: Services Sectors:

Based on historical view and the classical economic theory standpoint, the service sector has always been considered to include activities which are unproductive. Adam Smith has distinguished productive activities by relating them to goods production, ie, manufacturing sector, and unproductive activities by relating them to service production, ie, service sector (Adam Smith, 1937, p.314-315). Malthus also shared the view with Adam that wealth creation is confined to production of tangible goods. According to Elfring, such a doctrine of production, wealth and services was adopted by David Ricardo (1772-1823), John Stuart Mill (1806-1873) and Thomas Robert Malthus in England and by important French and German economists (Elfring, 1988, p. 12). Only in the nineteenth century, economists came to recognise that service is a productive activity. Say argued that " labour producing immaterial products should be considered productive, essentially because these immaterial products are useful (Say, 1803, chapter 13). Since then the concept of the service sector has gained more acceptance that it is productive and contributes to national income, with exceptions among the orthodox Marxists.

The above point of view influenced the methods of analysis of production as well as statistical research, so that very few researchers were interested in the activities of services as a source of value, and the data available on these activities remained scant and fragmentary. This also has an implication on fundamental issues related to the service sector, which we will analyse below, such as its definition and classification.

During the period following World War II this country (United States Of America) became the worlds' first " service economy ", that is, the first nation in which more than half of the employed population is not involved in the production of food, clothing, houses, automobiles, or other tangible goods (Fuchs, 1968, p. 1). There is no doubt that the service sectors have gained a substantial recognition in the economic development research in developed countries after World War II.

According to a recent World Bank Book, the service sector's contribution to gross domestic product in OEDC was 2.5 %, 1.1 % and 1.9 % in 1971, 1981 and 1987 respectively. The industrial sector contributed 0.8 %, 0.3 % and 1.3 % receptively for the same period (World Tables, 1993). While the service sector contribution to the gross domestic product in the U.S.A has been 2.6 % in 1971 and 1.9 % in 1987, it was 2.5 % and 1.9 % respectively in the OECD. At the same time, the service sectors contributions were 2.2 % in 1971 and 1.9 % in 1987 (World Tables, 1993). In fewer developing countries the importance of the service sectors in the economic development has not been emphasised. This was due to the fact that the strategic economic planning in those countries has been dominated by the notion that it is industrial development that creates

output and jobs without giving much emphasis on the comparative advantages of these countries, regardless of whether this is in the industrial development such as the services sector.

After four decades of unsuccessful attempts to accelerate and sustain their economic development, the less developing countries have to a large extent recognized the role of service sectors in the economic development, especially in less fortunate small island countries. In Singapore, for example the contribution of the service sector to Gross Domestic Product has increased from 64.5 % in 1980 to 68.5 % in 1990 (Bahrain Research Center, 1993). However, before we pursue the role of the service sector in economic development in less developing countries, it is worthwhile defining the service sector itself.

#### 2.7.1: Definition:

There is no universal agreement on the definition of Services. The economic literature on defining the service sector has a wide range of definition. This is due to the fact that service activities range from labour intensive activities such as domestic work or capital intensive activities such as international finance and communication, perishable activities such as cleaning or durable such as health and education, simultaneous activities such as live concerts or decoupled such as computer-aided instruction.

The classical definition of services was put forward by the Committee on Definition of the American Marketing Association which defined services as “ activities, benefits, and satisfactions which are offered for sale or are

provided in connection with the sale of goods" (The Committee On The Definition Of The American Marketing Association, 1960, p. 21). Regan defined services as " represent either intangibles yielding satisfactions directly (insurance), tangibles yielding satisfactions directly (transportation, housing), or intangible yielding satisfaction jointly when purchased either with commodities or other services (credit, delivery), (Regan, 1964, p. 57).

Hill defined services as " a change in the condition of a person, or of goods belonging to some economic unit, which is brought about as the result of the activity of some other economic unit, with the prior agreement of the former person or economic unit (Hill, 1977, p. 318). Bannock, Baxter and Rees, defined services as " consumer or producer goods which are mainly intangible and often consumed at the same time as they are produced ... service industries are usually labour-intensive " (Bannock, Baxter and Rees, 1983, p. 406). Greenwald referred to service as " the component of the gross national product that measures the output of intangible items " (Greenwald, 1973, p. 533), While Pearce referred to services as " intangible goods; one of their characteristics being that in general they are consumed at the point of production " (Pearce, 1981, p. 390).

Ammer and Ammer defined service industry as " an industry that produces services rather than goods. The chief service industries are transportation; retail trade; insurance; " (Ammer and Ammer, 1984, p. 421). These definition look at the service sectors from various angles, ranging from the uniqueness of the service output to tangibility and intangibility of the services to the perishability of the services. This has created confusion

among researchers on the role of the services sector in the economic development.

Riddle argued that " Various recent studies on the service sector reach different conclusions, in large part because of differing definitions of services " (Riddle, 1986, p. 8). She identified the problems and cleared the misunderstanding encountered in defining services such the ones mentioned above. She defined services as the following:

Services are economic activities that provide time, place, and form utility while bringing about a change in or for the recipient of the services. Services are produced by (1) the producer acting for the recipient; (2) the recipient providing part of the labour; and / or (3) the recipient and the producer creating the service in interaction (Riddle, 1986, p. 12).

Nevertheless, it is accepted that there is no completely satisfactory definition for the service sector. However, for the purpose of this research the above definition will be adopted, because it meets the objectives of this study and emphasize the tangibility of the service sectors, and hence its measurability in economic development.

### 2.7.2: Classifying Service Sectors:

There are a numerous classification systems proposed for the service sectors. Each of this system focuses on different dimensions and aspects of the service sectors. According to Riddle, these systems have been classified into three main categories (Riddle, 1986, p. 13-17). Firstly, production-based classification, which generally classifies the economic activities into three sectors, taking services as residual activities. Fisher and Clark (-1935 - 1940), Sabolo (1975) and Fuchs (1968) have used such classification. Secondly, Consumption-based classification classified services focusing on type of consumption rather on method of production. Singer has used such classification in studying the Brazilian economy in 1971. Thirdly, function-based classification, which classified services on their societal function. A wide range of researchers, such as Foote and Hatt (1953), Katouzaian (1970), Browning and Singelmann (1975) and U. S Census Bureau (U. S. Dept has used this classification. Of Commerce, 1984).

Organisation For Economic Cooperation And Development (OECD), report on the measurement of value added at constant prices in service activities, has classified the services as all activities that fall in major divisions 6 through 9 of the International Standard Industrial Classification (ISIC), (OECD, 1986, p. 6).

In this research, the classification of the service sector is based on the function of the industry, which goes in line with the classification adopted in International Standard Industrial Classification (ISIC) of the United Nations. On a broad category base the System of National Accounts (SNA) the service sectors are including the following subsectors:

- 1- Transport and communication
- 2- Finance and real estate services
- 3- Trade, hotels and restaurants
- 4- social and personal services
- 5- Public administration

### 2.7.3: Role of Service Sectors:

Decision-makers, generally, are accustomed to associate the role of service the sector in economic development with the developed countries. This is rooted in the thinking that services are luxuries, rather than necessities, in the process of economic development. It also stems from the argument that the service sector will grow automatically without policy planning, primarily due to increases in per capita income (UNCTAD, 1984). Riddle, has examined the traditional factors determining economic development and the factors determining the economic activities by country groups and concluded " economic development strategies need to be rethought to place more emphasis on service sector development.

Recent efforts to direct more resources into the extractive sector appear ill considered unless attention is also given concurrently to service sector infrastructure.... Resource allocation to manufacturing sector is premature unless physical infrastructure, financial, social, and political services are already well-developed (Riddle, 1986, p. 66). Hartwell, also emphasized the important of the service sector and stated that "... prerequisites of the industrial revolution include ... not only an agricultural revolution, but a number of service revolutions a commercial revolution, a financial

revolution, a transport revolution, and, finally, a revolution in government (Hartwell, 1973, p.363).

The leading role of the manufacturing sector in economic development was underlined with the commencement of the industrial revolution. There is no similar revolution that has been made in respect of "service revolution", yet activities in the services sector such as finance, banking, transportation, communication, and etc, have been experiencing various forms of revolutions. Advance technological development, scientific progress, globalisation of knowledge and the internationalisation of production factors has enabled the service sector to overcome some inherited deficiencies, such as intangibility, low productivity, etc. Such developments have prepared the stage for even a more important role those services sector has to play in the future.

However, due to heterogeneity and the special nature of services, the sector has various forms of integration and interrelations with the rest of the economy. Riddle summarised the role of service sector in economic development:

Service industries facilitate every aspect of social, political, and economic life. Without transportation, communication, utilities, or construction services, little economic activity is possible. An efficient government, a healthy and literate work force, and stable financial markets are as much a prerequisite for economic growth as is the availability of raw material (Riddle, 1987, p. 83).

Therefore we may argue that no economy can survive or sustain economic growth without a developed service sector. There are two approaches in considering the role of the service sector in economic development. One approach regards services as complementary to the production of goods, either as independent activities or as activities integrated into the process of production of goods, whose output is directly incorporated in the value of the goods. The second approach emphasise the dependency of service as autonomous activity undertaken in response to a specific demand, which may or may not be complementary to the demand for goods.

Besides, there are three different methodologies adopted to examine the role of the service sector in economic development. Firstly, a cross-section time-series study of developed and developing countries. This methodology represent the works of Fuchs' (1968) on a sample of 20 OECD countries' data in 1960, Chenery and Taylor (1968) on a sample of 45 countries over the period 1950 - 1963 and Gemmell (1983) on a sample of 30 countries, divided equally between developed and developing countries for the period 1969 - 1970. Secondly, a comparison of sector shares in contemporary less developing countries with the earlier economic history on the current developed countries. This methodology represents the work of Turham (1971) on employment creation in less developing countries and Berry (1978) on urban services expansion in Latin America with data evidences on Columbia. Thirdly, a country case studies, representing the work of Bhalla (1970) on a comparison of modern and traditional services in the Philippines and Taiwan, Seow (1979) on an evaluation of service sector growth in Singapore and by Ofer (1967) on the general service development in Israel.

This research will concentrate on the second approach in quantifying the role of the service sector in economic development. The main indicators used here are based on the contribution of the service sector to gross domestic product, creation of employment, improving balance of trade and growth in sectoral productivity. The methodology adopted is mainly based on a country case study of Bahrain with some reference to the other methodologies where applicable.

According to a cross-section study conducted by Gemmell on developed countries, the analysis provides some interesting general observations on the role of the service sector. Firstly, the service sector begins to expand at the expense of the industrial sector share in the economy. Secondly, the de-industrialisation phase is not a temporary phase, as is sometimes claimed, arising from slower growth or recession affecting the industrial sector disproportionately, hence reducing its share (Gemmell, 1982). The general conclusion of Gemmell's analysis is that empirical evidence supports the existence of clear patterns of structural change across developed and developing countries.

The role of the service sector in less developing countries is more important than has been really understood. Bhagwati has studied the advantages and disadvantages based on the comparative advantage of less developing countries in producing certain type of services and therefore urged them to join the developed countries in service negotiation under the General Agreement On Trade And Tariff- GATT- (Bhagwati, 1987). A study by OECD countries of 56 less developed countries revealed that some 28 % of their labour force was employed in the service sector

Furthermore, 19 of the countries studied, close to one third of the sample, services were producing more than one-half the gross domestic product (OECD, 1974). Besides, in a study of the invisible transaction of 18 less developing countries from all regions covering the period 1967-1973, although trade in goods was found to be more significant, in a few of the countries service exports grew dramatically faster than goods exports (Shelp, 1981).

There is no need for developed countries and less developed countries to wait longer to reach the current USA level of per-capita income to develop service industries. As the studies showed, less developed countries have a competitive advantage in producing a large range of services, which can be profitably traded internationally. Economic development planners in less developed countries should recognise the fact that the implications of modern management techniques and technological advance have internationalised the means of production and led the world economy to a stage of servicisation. Riddle stated that:

" It makes little sense to continue defining economic growth in terms of " industrialisation " - i.e. manufacturing sector growth - when the manufacturing sector plays only a support role (in the sense of providing equipment and supplies for other economic activities). Focusing instead on " servicisation " would acknowledge the service sector appropriately as the crucial vehicle for economic growth (Riddle, 1987, p. 101) "

#### 2.7.4: Criticism to service sectors:

One of the major criticisms in regard to the service sector is that the development of the service sector does not require an economic strategy or policy planning. It emerges as a by-product of increase in per-capita income. More profound critics label the service sector as a low productivity sector. Inman, in his introduction and review of the essays commissioned for the inaugural conference of the Fishman- Davidson Center for the study of the service sector, has summarized Fuchs and Baumol's propositions (Inman, 1988, p. 4).

Fuchs has examined three hypotheses related to the growing importance of the service sector in the U.S.A economy. The first is that, services have an income elasticity of demand greater than 1 so that as real income per capita increases, real services per capita grow more than the proportional growth in income. The second is that as economic specialisation and automation increase with economic growth, it becomes efficient for services once provided within the firm or household to be contracted out to experts outside the organisation. The third explains the growing relative importance of services in national employment by the slower relative growth of labour productivity in services than in agriculture or in industry. Fuchs, has concluded that, although each hypothesis is valid and explains a portion of the growth of the service sector, the major explanation for the relative importance of services in U.S. employment is the third hypothesis of lagging productivity growth (Fuchs, 1968).

Baumol in his simple two-sector growth model of an economy with differential productivity growth, concluded that the growing importance of service employment in the U.S economy over the period from 1929 to

1965 is due in large measure to the lagging performance of labour productivity in the service sector (Baumol, 1966). Others argued the importance of reemphasising the role of the manufacturing sector in economic development, because of its high productivity which led to higher real wage income and a stronger balance of payment position. Moreover, national defense requires a strong manufacturing sector that can be mobilized quickly in time of war; a service economy cannot be transformed easily into a military economy (Inman, 1988, p. 8).

## 2.8: Implications for Bahrain:

The purpose of this part is to put together a theoretical framework based on the above discussion and to bring the discussion of the Chapter One on the small economy. This will serve to highlight the impact of the smallness of a country and hence the economy on the choices that the country can make to pursue its future economic development. The emphasis will be on the limited natural resources and the smallness of the domestic market in terms of demand and supply. Such factors tend to the limited scope of the small economies for agriculture and/or industrial economic development in the long-term. Besides it imposes a great deal of external dependence on the regional and international markets in terms of imports and exports as well as investment.

However, the small economy has a distinct advantage that works in its favour, which is its ability to mobilise the internal resources and restructure the economy in a shorter time than the larger one. The inherent problem of the smallness has an economic and political implication on the country. It increases the country's dependence on the external market and

establishes close linkages with the international power and with countries it trades with most.

Dependence may take various forms. The direct form is the foreign ownership and control over the key sectors in the economy. The indirect form is the dependence on trade flows, finance and monetary, technical and educational dependence.

One more serious form is the dependence on the importation of a labour force, both skilled and unskilled. Such forms of dependence impose on the country a need to become increasingly open to the international market and hence more integrated within international division of labour. Therefore the country's agricultural or industrial economic development will be based on the importation of the country inputs and exportation of the outputs. The economic dependence of the small country has an impact on cultural and socio-political systems. The cultural impacts can be seen in the changes of the consumption habits and behaviour shifting from locally produced goods and services to foreign imported ones. This will lead to changes in the demand structure, which has implications on the economic development and increased dependence on imports. Moreover, other social values and standard of living are introduced which have an impact on the political system of the country.

Therefore the question of self-sufficiency and self-reliance for the small economy ignores the actual realities mentioned above and hence cannot stand on a solid ground to form a base for future economic development in the small economy. This is due to the fact that the small economy by definition is dependent. Hence, the only alternative economic development

path to pursue is to concentrate on maximising its benefits of being small and utilize strong economic and political relationships with larger economies either regionally or internationally. Therefore, the role of economic planning within this context is to visualise the role that the country can play to utilise domestic resources most efficiently and to maximise return from its position as well as its economic and political linkages with the larger economies.

The strategic approach to economic development in small economies should be based on the notion of un-balanced growth. Thus the most applicable approach is the theory of growth stages developed by Rostow. The theory conceptualise the economic growth in the role of the leading sector where it takes stage by stage to pull the whole economy sustained growth.

The leading sector concept might be more appropriate for small open economies when the domestic resources and efforts have been concentrated towards the development of a particular sector. Such an approach may maximise efficiently the scarce resources of the small economy. At the same time it provides the country with more powerful means to play a definite role in the region.

Having said that it will be more appropriate for the small economy to widen the scope for economic development on a regional base, as economic development literature reveals that regional economic integration has been considered as a means to foster and achieve economic development. The regional economic integration has to be seen as a complement and not as a replacement of the free market. It should be

adopted in such a way as to take care of the comparative advantages of the country's members and their ability to specialise in producing and providing certain goods and services.

As in the case of Bahrain, the size of the country has imposed a number of constraints on economic development. Smallness has left Bahrain with virtually no natural resources other than oil and natural gas. Although these resources are playing an important part in the international economic development, they have a limited role to play in the future economic development of Bahrain. This is due to the fact that they are non-renewable depleting resources with a short life. Oil and natural gas are expected to last for 10 and 30 years respectively. The past oil based economic development was not sufficient in terms of establishing forward and backward linkages with the other sectors. Therefore, it would be inappropriate from a long-term economic development planning view to base the future economic growth of the Bahrain economy on the oil and natural gas utilisation only.

The smallness of the Bahrain economy has also imposed certain limitations of the size of the domestic market and hence the domestic demands for goods and services. This has the implication of limiting the scope to utilise the benefits of the economies of scales, especially in the recent economic development. The diversification policy that was adopted by Bahrain during the late 1960s has shown little promise. The industrial approach to diversify the economy away from oil and natural gas failed to get the expected out-comes. This is mainly due to limitations of domestic demand, a high unit cost of production and in some case competition coming from the regional countries.

Historically, Bahrain was the focal point for cultural exchanges and trade movements in the region. The central strategic geographical location had enabled Bahrain to play the role of a gate way to the region. Through history and until the present time, Bahrain has had international exposure. The influences come from the surrounding countries in the region and from the international powers. This fact has the implication of increasing Bahrain's dependence on the outside world. The direct dependence has taken the form of foreign ownership and control over some sectors especially the oil and gas sector as well as importation of foreign labour, the skilled and the unskilled and the indirect dependence in the form of trade linkages, financial and monetary, technological and educational dependence.

The external economic and political dependence has affected the cultural and socio-political systems. This has led to changes in the consumption behaviour, shifting the demand structure towards luxury-imported goods and services and hence aggravating the balance of payments position. Moreover, there are a number of changes that have taken place in the values and social behaviour of the people towards a liberal and open society.

Another factor that relates to the smallness of the Bahrain economy is the role of one sector in the economy. The past economic growth has shown a pattern where one sector has played the leading role in stimulating the growth. Earlier the trade sector and then the natural pearl diving industry have been the leading sectors in the economy. However, after the discovery of oil and gas it has come to play the role of the leading sector in

the recent economic development. The oil and gas sector has provided Bahrain with ample opportunities to develop the infrastructure needed for economic development. Revenues from this sector enabled the government to concentrate on the development of economic and social infrastructures as well as developing the industrial sector, mainly by establishing and participating in major industrial projects. However, although the oil and gas sector has provided the means by which Bahrain can develop it falls short in laying the foundation for other sectors or industries to take over. This is due to non-existence of direct forward and backward linkages with other sectors and industries in the economy. In the past decade Bahrain's economy has been subjected to fluctuations in the international oil prices and the government budget has run into deficit in order to continue providing the same level of services and play at the same time the role of encouraging economic growth.

Having said that Bahrain has also recognised the fact that regional economic integration may facilitate the achievement of economic development. It participated actively in the formation of the Gulf Co-operation Council (GCC) in 1981 with Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates (UAE). Despite the over-riding importance of political and security motives in setting-up the GCC, economic co-operation has an important role to play in this organisation. The GCC countries have adopted a number of agreements highlighting the long-term co-operation especially in unifying the economic agreement. The agreement's objectives are to eliminate customs duties among the members, establish a common external tariff against the rest of the world and hence establish a free trade area, with the hope of developing a common market for complete movement of goods and services.

Besides these ties with the GCC, Bahrain has also strong political and economic relationships with USA, U.K., Japan and EC countries in general. These relationships have influenced Bahrain's role in the region.

Having examined Bahrain's economy in terms of a small economy, external dependence, the leading sector and regional economic integration, it is noted that Bahrain's long-term planning depends very much on mobilising these features most efficiently to achieve economic development. It requires a clear vision of Bahrain's future role in utilising its membership in the GCC, the Arab countries and the strong relationships with the international powers to achieve a long-term self-sustained economic growth. The question of self-sufficiency and self-reliance does not apply in the context of Bahrain. The policy that is adopted in many developing countries to escape from dependence through delinking and self-reliance is self-defeating. This is because such a policy required certain economic and political pre-positions that Bahrain should fulfill initially. As Szentes argued " However its (delinking) actual feasibility depends on a range of factors; the scale and intensity of economic, and other linkages with the outside world and also on how cohesive are the social forces inside the country and the capability of the economy to sustain itself. Any negligence or miscalculation of such conditions may easily make the concept of self-reliance or delinking mere wishful thinking (Szentes, 1988).

In place of adopting policies towards self-reliance, Bahrain may search for a role within the framework illustrated above. One possible role is to become a service center for the whole region, especially for the GCC

countries. This is based on a number of observations, which can be summarised as follows:

- a. Bahrain has comparative advantages in terms of highly developed infrastructure and well-regulated investment environment.
- b. Bahrain enjoys a more sociable open society that makes the working environment more conducive.
- c. Bahrain has a skilled and a trained labour force with an open mind and a high share of women's participation.

In addition, Bahrain can utilize its relationship with some countries, which have an influence on the region, such as USA, U.K., and Japan. Bahrain has already got development schemes for certain services and gained the international business community's recognition as an attractive place for investment, especially in banking and finance services as well as in the provision of professional specialised services.

## 2.9: Conclusion:

The survey of the main theoretical discussion basis for development of small economy and its implication sets the framework of the small scale economy in the context of stage growth theory, economic integration and the development of the services sector. It is evaluated in the context of Bahrain. In general, we may conclude that it is more appropriate for Bahrain to consider selecting the services sector as providing the most for

its long-term scope economic development. Implications of this will be tested in the following chapters.

## CHAPTER THREE

# THE ARAB COUNTRIES & THE ARAB GULF COUNTRIES

## CHAPTER THREE

10

### The Arab Countries & The Arab Gulf Countries

#### The Arab Countries :

3.1 : Definition.

3.2 : Classification.

3.3 : Historical Development.

3.4 : Recent Economic Development.

3.5 : Industrialisation In The Arab Countries:

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#### The Arab Gulf Countries :

3.7 : Introduction

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3.9 : Economic Structures

3.10 : The Need for Development

3.11 : Problems of Industrialisation

3.12 : Regional Integration

3.13 : Conclusion .

□

### 3.1 : Definition :

The Arab countries consist of 19 countries, occupying about 10.2 % of the world with a total area of 1320 million hectares. The total population was estimated to be around 234 million in 1992, with growth rate of 2.3 % per annum.

Assuming that the current population growth rate of 3 % will continue, the forecasted population will be 287 million in the year 2000. The population concentrated in the age group 14 years and below represents 43 % of the total which would characterise Arab countries as young nations, where the economically active population is small.

Table ( 3.1 ) shows basic indicators for the Arab countries for 1992. The total labour force was estimated to be 66 million in 1992 which represents 29 % of the total population. It is expected that about 15 million more will join the labour market by the end of this century, raising the total labour force to 81 million by the year 2000. This is principally due to the increased rate of growth of population and a higher participation rate for women in the labour market which accounted for 13 % in 1991 ( Unified Arabean Report, 1992 ). The total population of the Arab countries represents about 10 % of the world population while the labour force represents only 5% of the world labour force.

This indicates a high dependency rate among the population, which is double the world-wide standard. The higher population growth rate which led to a larger number of people seeking employment opportunities has put more pressure on the Arab Countries to provide them with jobs. This situation might be aggravated when we take into consideration that employment

opportunities in OECD and oil producing countries are less now than in the past.

Arab countries share a lot of common features such as religion, social habits, language and history. Their geographical location is considered strategic, due to the fact that they are located between the West and the East. Such a position has allowed Arab countries through history to play an important role in the international economy. Arab countries also enjoy a vast range of natural resources, making them one of the most highly interdependent countries and independent economic groups in the world. Natural resources range from huge fertile land and water resources as in Egypt, Sudan and Iraq, to ample oil and natural gas reserves in Saudi Arabia, Qatar and Algeria. It also has various raw materials in almost every country. Moreover, the Arab countries have a large domestic market with a total population of 234 million and a per capita income of US 1996 dollars in 1992 ( Table 1.3 ).

### 3.2 : Classification :

There are a number of classifications of the Arab countries based on different criteria. Arab countries can be classified in three groups based on size, population and natural resources. The first group might include countries with a large size and population as well as abundant resources, such as Egypt. The second group are countries with a small population and relatively poor natural resources, such as Jordan and Tunisia. The third group includes countries dependent on oil production such as Saudi Arabia and Kuwait.

Because of the vast area and difference in the geographical location between two continents, there are differences among these countries, especially in terms of factor endowments. The Arab Fund For Economic And Social

Development ( AFESD ), the Arab Monetary Fund ( AMF ) and The Arab Oil Exporting Countries ( AOEC ), have classified the Arab countries based on oil production and exports. For the purpose of the analysis of this research, Arab countries will be divided into two groups on the basis of natural resources, oil production and exports. The Arab oil producing countries include Algeria, Bahrain, Kuwait, Iraq, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE). The second group is the Arab non-oil producing countries including Egypt, Djibouti, Jordan, Lebanon, Morocco, Mauritania, Sudan, Syria, Tunisia and Yemen.

### 3.3 : Recent Historical Development :

Through history Arab countries passed through various stages of economic, social and cultural development prospects. There was a time when they roamed the known world and established a great empire. Disregarding the religious factors, such development has been triggered by the trading activities with the rest of the world. Although there were agricultural and craft activities, they were not on such a large scale as to create economic surpluses to enable the Arab countries to finance a large empire. In fact their geographical location between Europe, Africa and the East enabled the Arab countries to establish trading blocks within these areas. They have benefited from their knowledge of the trade routes and their travelling and moving goods and commodities in and out of the trading blocks. This enabled the Arab countries to accumulate funds to finance the trading centres, trading cities and developing empires. Ameen argued that when the Arab countries created prosperous cities and empires they depended on their role as a middle nation between developing Europe, black Africa and prosperous Asia ( Ameen , 1988, p 30 ).

Generally speaking, in the sixth century the Arab countries lost much of their power and influence, especially on the international trade to Europe. Worse they have been colonised and cut off from the cultural and industrial development in the West. However, towards the end of the eighteenth century an Arab revival movement started, aimed at getting political independence and modernising the economy. This era ended by the middle of this century but left its mark on their economic development in recent years. The political struggle for independence strongly influenced the economic stand of the Arab countries. During the first half of the century they were under colonial rule. This had the effect of directing their economies to meet the demand of the colonial countries. Egypt and Algeria, for example, produced agricultural products such as cotton and fruit needed for manufacturing industries in England and France, while Saudi Arabia and Bahrain were producing oil to meet international demand. Such an era has shaped the Arab economies as producing countries for an external demand. It was an era of increasing political and economic division.

In the 1950s and 1960s, Arab countries witnessed the emergence of a national movement against colonial rule, especially in Egypt, Iraq and Algeria. Having achieved political independence, nationalism under the leadership of Nasserism sought economic independence on the ideology of self-reliance. As a result, industrialisation has become the strategy and central planning by the government was the means to achieve economic development. As a result, structural changes have been introduced to the Arab economies which have shifted the emphasis from privately owned and export oriented production to nationalised and inward oriented production. Besides, there was an attempt to establish economic corporation among them under the Arab league.



However a number of studies have indicated that the outcome of the industrialisation strategy in Arab countries was disappointing in terms of meeting the economic and social objectives of these countries. Moreover, the oil producing countries during these two decades had a marginal role to play and introduced no structural changes in their economics.

In the 1970s there were two events which made a significant impact on the Arab countries until the nineties. They were the October war and the oil price boom in 1973. The effect was a sudden huge capital inflow into the country from the sales of oil to the oil producing countries which in turn led to higher workers' remittances to the non-oil producing countries through emigrant workers. It provided an effective means to conduct their economic and social policies. As a result, a number of structural changes have taken place. In the non-oil producing countries, the strategy of industrialisation based on inward oriented methods has been changed to outward oriented ones. In the oil producing countries, an outward looking industrialisation strategy was adopted based on more government involvement in the economy.

Directly and indirectly, oil revenues have been used to finance large industrial projects and to build up the infrastructure required for industrial development. Governments have become more involved in the economic process which has led them to establish some sort of central planning to deal with the growing public sector. Non-oil producing countries also benefited from the increased oil prices in terms of grants, aids, workers remittances and etc. Such capital inflow to these countries has been directed toward consumption and quick high return investment in services.

As can be seen there was a shift of emphasis on industrialisation strategy from non-oil producing countries to oil producing countries. The experience

of the former with industrialisation however was not encouraging, in spite of these countries having a better potential for industrial development due to the existence of a large market, cheap labour, and raw materials. The oil production only had cheap capital, but imported the rest of the production factors. The development of a central planning mechanism by the public sector within an open market economy has reduced the role of the private sector in the economy. In addition to this, the 1970s also witnessed more divisions among the Arab countries, especially after the visit of Mr Anwar Sadaat of Egypt to Israel.

#### 3.4 : Recent Economic Development :

The recent economic development of the Arab countries, starting from the seventies, can be classified into four stages. The first stage was characterised by high economic growth resulting from a boom in oil prices in 1973. The second stage started after a decline in oil prices in 1982, leading to a six years of long economic depression. The third stage started just when the economic reforms and rationalisation of government expenditures policies came into effect, leading to a higher economic growth rate between 1988 - 1989. The fourth stage began with the invasion of Kuwait by Iraq in 1990, leading to the financial and economic desolation of the Arab countries. Table ( 3.2 ) shows the growth rate of gross domestic product of the Arab countries for the period 1973 - 1992.

The Arab countries' gross domestic product ( GDP ) grew by 6.0 % in 1992. It increased from U.S.\$ 440.8 billion in 1991 to U.S.\$ 467.2 billion in 1992. Such growth comes mainly from Group 2, the non-oil producing countries, where their gross domestic product increased from U.S.\$ 117.2 billion in 1991 to U.S.\$ 128.4 billion in 1992, representing a growth rate of 9.5 %. On

the other hand, the oil producing countries' gross domestic product increased from U.S.\$ 323.5 billion in 1991 to U.S.\$ 338.8 billion in 1992, representing a lower growth rate of 4.7 %.

Table ( 3.3 ) shows the gross domestic product of the Arab countries by major sectors for the period 1991 - 1992. As can be seen from the table, the main source of growth comes from the industrial sector which grew by 55 % in 1992. The value added of the sector increased from U.S.\$ 150.5 billion in 1991 to U.S.\$ 161.5 billion in 1992, at the same time its contribution to the gross domestic product increased from 18 % to 26 % for the same period. The primary sector has also increased by 7 %, while the service sector has grown by only 2 % in 1992. Although the lowest growth rate has been achieved by the service sector, its contribution to the gross domestic product remained the highest, despite the fact that it has declined from 49 % in 1991 to 47 % in 1992. The deterioration in the growth rate and contribution of the service sector came mainly from the non-oil producing countries.

On a subsectoral basis, Table ( 3.4 ) shows the gross domestic product of the Arab countries by subsectors for the period 1991 - 1992. The mining sector is the major contributor to gross domestic product in the Arab countries, representing 22% in 1992. Its value added increased from U.S.\$ 93.1 billion in 1991 to U.S.\$ 101.9 billion in 1992 with a growth rate of 9.4 %. This indicates the heavy reliance of these countries on the production of non-renewable commodities, mainly oil and gas.

The second contributor is the government sector with a share of 17 % of the gross domestic product in 1992 and a growth rate of 5.8 % compared with 1991. This reflects the high involvement of governments in the economic life of the Arab countries.

The third contributor is the agriculture and trade and hotels sectors with 13 % and 12 % of the gross domestic product respectively in 1992. The Manufacturing sector contributes only 10 %.

Classifying the Arab countries into two groups, the picture changes significantly for producing countries ( Group 1 ). The mining sector which is mainly oil is the major contributor to the gross domestic product with 28 % in 1992, while for non-oil producing countries ( Group 2 ), trade and hotels and agriculture sectors contributed 19 % and 18 % of the gross domestic product respectively. The government sector is the second largest contributor to the gross domestic product in the oil producing countries with 19 % in 1992 compared to 11 % in the non-oil producing countries. It is an interesting phenomena that the oil producing countries favour a free market strategy compared to non-oil producing countries, yet governments are heavily involved in the economic life in Group one countries. In contrast, manufacturing is the second contributor to the gross domestic product in the non-oil producing countries, with 16 % in 1992.

Government involvement in the economy can also be measured in terms of government expenditure to the gross domestic product. Government expenditure in the gross domestic product in the oil producing countries is 7 %, compared with 5 % for non-oil producing countries in 1992. Table ( 3.5 ) shows revenues and expenditures of the Arab countries for 1986 - 1992. As can be seen, revenues and expenditures represent 29 % and 35 % of the gross domestic product respectively, which results in a budget deficit of 6 % to the gross domestic product in 1992.

The most marked feature of the Arab economy over the past two decades is the rise in the role of oil. The oil sector has been the most influential sector over all the economy. Its relative share of economic output has fluctuated in accordance with its own price and production as well as in relation to individual economies' capacity to absorb extra revenues coming from this sector. Therefore oil revenues have been the tool to finance most of the governments' programs and developmental plans. It has led to increased government expenditure mainly in financing infrastructural projects and large industrial projects. The former has led to a construction boom fuelled by both public and private spending. The latter has set up the base to the establishment either for large scale industries or small scale industries. As in the activities in other sectors, most notably manufacturing and construction, the relative share of the oil sector has tended to fall, although the sector continues to play its dominant role by influencing the other sector activities through income inflow.

Another feature is the role in the economy of the public sector, which has declined as dominant sector as compared to the fifties and the sixties in the non-oil producing countries, although it has increased its role in the oil producing countries. In both groups however, the role of the public sector continues to be the growth engine of the economy.

Table ( 3.6 ) shows government revenue and expenditure as a percentage of GDP in the Arab countries. The government expenditure to GDP, as providing an indicator of the government involvement in economy has declined from 47.0 % in 1986 to 39.7 % in 1992. On the other hand, the government revenues to GDP have increased to 32.8 % in 1992, compared with 30.1 % in 1986. This indicates to a large extent the adjustment policies that were carried out by the Arab countries during the late eighties.

The manufacturing sector has undoubtedly benefited from the overall increase in consumption and capital formation in the Arab countries in recent years. Substantial demand for consumer and intermediate goods products has been met by local industries, especially in the area of food and beverages, processing and building materials. The capital goods industries, particularly engineering industries such as textiles has been affected by access to export markets, while much of the investment in new chemical, petrochemical and basic metal industries has only recently come to fruition.

The development of these industries has had the function of distributing wealth rather than of creating it, although the investment has been justified on the grounds that these industries will in time generate income and employment independent of the oil sector.

The effect of oil revenues has also spread to the social sectors such as education, health and housing. It has contributed largely to raise the living standard of the population.

### 3.5 : Industrialisation In The Arab Countries :

After the Second World War most of the Arab countries started industrialisation by either government or private sector efforts. Egypt started industrialisation much earlier, in the 1920s, by adapting the import substitution approach which has been an example for the Arab countries. The import substitution policy in the Arab countries has led to the development of manufacturing industries, mostly in small light industries. Most of these small industries were concentrated on food processing, textiles and clothes, as well

as the establishment of assembling industries of consumer durable goods. Later on, Arab countries witnessed the development of some large industries in the 1960s and some high technology industries in the 1970s and 1980s.

The industrialisation process among Arab countries varies in structure and type which reflects the differences among them in terms of economic, social and political parameters. Accordingly, a number of studies have categorised Arab countries into three groups :

1. Countries that have made progress in industrialisation such as Iraq, Egypt, Algeria, Syria, Morocco, Lebanon, Tunisia and Bahrain to some extent. Although there are a common characteristics shared by these countries, industrial progress varies among them.
2. Countries that started industrialisation after the increase in oil prices in the 1970s such as Jordan, UAE, Kuwait, Saudi Arabia, Qatar, Oman and Libya. The industrialisation process in these countries has to a large extent been linked to the availability of high oil revenue.
3. Countries that have achieved limited progress on industrialisation such as Yemen, Sudan and Somalia.

Table ( 3.7 ) shows value added created by the manufacturing sector in Arab countries at current prices. The value added of the manufacturing sector has increased from U.S.\$ 42.7 billion in 1987 to U.S.\$ 45.1 billion in 1992, reaching its highest level of U.S.\$ 47.4 in 1990. The main contribution in the manufacturing sector came from oil producing countries ( first group ) which has contributed about 57 % of the total value added of the Arab countries in 1992. However, in terms of value added as a proportion of the Gross

Domestic Product, non-oil producing countries have the highest share, representing about 16 % compared with oil producing countries of 8 % in 1992.

This indicates that some progress has been made in establishing non-oil related manufacturing industries. In general, the growth of the manufacturing sector and its contribution to GDP was not encouraging.

The average growth rate for the sector was 3.4 % during the period 1984 - 1992 and its contribution to GDP has improved slightly, increasing from 8.9 % in 1984 to 10.0 % in 1990.

### 3.6 : Industrialisation Policy :

The structure of the industrial sector in Arab countries is still in the primary stages and most of the manufacturing industries are geared to the consumer, i.e. final consumption. The sector lacks the type of manufacturing industries that have forward and backward linkages. This indicates the problems of the industrialisation of Arab countries which adopted an import substitution policy. Arab countries fail to produce commodities that have substance in the international market, as have been the case with oil, cotton and citrus fruits.

Therefore, industrialisation was not able to introduce structural changes in the foreign trade of the country by increasing exports and reducing the heavy dependence on agricultural and mining commodities. The industrial commodities contributed about 2% of the total exports of the Arab countries for the period of 1975 - 1980. [UNCTAD, Handbook Of International Trade & Development statistic 1985, N.Y. U.N, 1986].

The trade balance of industrial goods has always been in favour of imports in non-oil Arab countries especially for countries that have a long experience in industrial development such as Egypt, Morocco and Lebanon. (UNCTAD, 1986).

With an increase in the imports of even final consumer goods, there is a large portion of un-utilised manufacturing capacity namely in food processing industries. There are also un-utilised capacities in industries related to engineering, electronic, chemical and petrochemicals.

Therefore the problems of industrialisation in the Arab countries, which hinge on the policy of import substitution, have concentrated on substituting the final consumer commodities without providing the ground for the development of intermediate and machinery goods. This may be due to the fact that as in most of the developing countries, the Arab countries have adopted the strategy of industrialisation by stages. The stages approach starts by replacing the imports of final consumption goods because it is normally easier and does not require large capital investment. Then it is supposed to move into replacing the intermediate goods after accumulating the know how to plan the final stage of machinery production.

The experience of the developing countries has shown that such a stage approach has never succeeded. This is due to the fact that the import substitution approach failed to earn foreign exchange, increase productivity and efficiency and establish linkages among industries.

Saad Al-Deen and A. Fatheal, argued that import substitution in the Arab countries had two major impacts (Arab Development - 1986). It led to the creation of consumer goods that did not have a significant impact on imports

and provided comparative advantages such as cars, T.Vs etc. This has led to structural change in the final demand toward higher consumption at the expense of higher saving. The other impact was on balance of payments. The increasing demand for capital goods and machinery as well as the raw materials needed to set up and operate the manufacturing industries has led to aggravate the balance of payments. The higher imports were not accompanied by higher exports because the output of these industries was geared to meet the domestic demand for consumption.

During the 1970s the industrial policy in Arab countries has changed from import substitution to export promotion, as a result of two main factors, one economic and the other political. The economic one was the increase in oil prices which provided the oil exporting countries with huge revenues to finance their industrial build-up. The political one was the change in the political stand of a number of Arab countries to more outward looking policies. This included countries such as Egypt, Algeria and Iraq.

## THE ARAB GULF COUNTRIES:

### 3.7 : Introduction :

The use of the term Arab Gulf Countries is always surrounded with ambiguity and hence it is very important from the beginning to state its definition clearly. It is obvious that this terminology would not include Iran as it is not an Arab country. But it could include Iraq as an Arab country sharing location with the Gulf Co-operation Council (GCC) countries.

The Arab Gulf Countries included in this study comprise Bahrain, Kuwait, Oman, Saudi Arabia, Qatar and the United Arab Emirates (UAE).

The Arab Gulf Countries may have a vested interest in regional economic integration, given their present stage of economic development and the regional availability of capital. The large increase in oil revenue since 1973 initially created favourable conditions for rapid economic development which could be enhanced substantially through regional co-operation among these countries. Nevertheless the decline in oil revenues since 1982 also strengthened the case for regional co-operation in general, and industrial co-operation in particular, as a way of rationalising the use of the available resources.

These countries share a wide range of similarities. They share the same religion, language and cultural traditions and, apart from Saudi Arabia, have a similar geographical area and population. There has been a similarity in economic activities and occupations before and after the oil era, as well as in the implementation of social and economic policy. There are also similarities in the scarcity of natural resources, with the exception of oil and natural gas. The common characteristics of these countries have provided the common ground for economic co-operation among them. Consequently several attempts to provide co-ordinated policies were undertaken in the seventies.

These attempts can be categorised into three main groups (Beseisn, 1983).

First, there was bilateral co-ordination, which established a number of joint committees on an ad hoc basis such as Kuwait- Bahrain co-operation arrangements on economic, cultural and information matters, the Oman-UAE Committee, the Saudi Arabia- Qatar transit arrangements and so forth.

Secondly, there was multilateral co-operation which was started by the establishment of a joint economic committee consisting initially of Bahrain, Oman, Qatar and the UAE and then expanded to include Kuwait and Saudi Arabia. The GCC countries, except for Oman, are also members of the Organisation of Arab Petroleum Exporting countries (OAPEC) which has set up several major projects in the region, such as the Arab Shipbuilding and Repair Yard company (ASRY) in Bahrain and the Arab Petroleum Investment Co-operation (Apicorp), an energy investment bank based in Saudi Arabia. In addition, the GCC countries, with the inclusion of Iraq have established the Gulf Organisation for Industrial Consulting (GOIC), which is more oriented towards the need for industrial co-operation in the region. The GOIC encouraged the setting-up of the Gulf Aluminium Rolling Mill Company and carried out a large number of feasibility studies on the production of petroleum, coke, tyres, glass and silicon.

Thirdly, there was sub-regional co-operation which took place on a sectoral and institutional basis such as industry, trade, agriculture and fisheries, finance and development planning.

A more ambitious attempt at regional co-operation among these countries was the establishment of the Gulf Co-operation Council (GCC) in 1981. Despite the over-riding importance of political and security motives in setting up the GCC (which is beyond the scope of this work), economic co-operation has an important role to play in this organisation.

The main features of the agreement are :

- a. The elimination of customs duties between the GCC countries provided that goods satisfy a minimum local value added content criterion (MEED, 1983)
- b. The establishment of a common minimum external tariff against the rest of the world, set at a minimum of 4 per cent and a maximum of 20 per cent.
- c. Co-ordination of import and export policies in terms of specification and standardisation, thus strengthening the GCC's position in dealing with the rest of the world and reducing the costs of import and export substantially.
- d. Co-ordination of industrial activities and standardisation of industrial inputs and outputs with emphasis on the allocation of these industries to member states according to relative advantages of natural and human resources.
- e. Co-operation in technological choice of industries, training and labour policies to facilitate both the movement of technological aspects and labour force.
- f. Establishment of unified investment strategies, internally to facilitate their economic development and externally to achieve long-term profitable scope.
- g. Co-ordination in financial, monetary and banking policies with consideration of the possibility of introducing a common GCC currency.

The framework of co-operation is a dynamic one. The emphasis on the co-ordination of investments, of development effort and complementary activities takes its context from a desire to foster growth and development by reaping the benefits of rationalisation of production and intra-regional specialisation.

As the Secretary General stated " There is a wide range of possible instruments or patterns for economic co-operation among countries, extending all the way from customs unions to full integration. The GCC's economic agreement seems to have spanned much of this range. Another distinctive feature is the adoption of the principle of gradualism, so that co-operation is expected to proceed pragmatically and cumulatively, rather than abruptly. Furthermore, and perhaps uniquely, the economic agreement stipulates an important role for the private sector in the implementation and maintenance of economic inter-relationships " ( Secretariat General, 1985 ).

### 3.8 : Factor Endowment :

The GCC countries occupy approximately 2.6 million sq km with a total population of 1209 million in 1981. The World Bank Development Report for 1983 projected that total population of these countries in the year 2000 will reach 24.5 million. Table ( 3.8 ) shows the same basic indicators for the GCC countries.

As the table shows, the GCC is relatively small. On the other hand, GNP per capita is one of the highest in the world. The smallness of population has a serious effect in terms of the size of the domestic market and the quantity and quality of the labour force. To deal with the latter point, the GCC countries have adopted a policy of foreign labour force importation as Table ( 3.9 ) shows. This is due to the fact that these countries have committed

themselves to develop the economy quickly, utilising the mounting oil revenues before the time when they would run out of such advantage. However, such policy has led to a large dependence on an imported labour force which has increased from 53% of total labour force in the GCC in 1975 to 57% in 1980. The tendency of dependency varies considerably within the GCC, where in Oman the lowest was 37% in 1980, while in UAE the highest was 91% in 1980.

The reliance on imported labour to accelerate economic growth has created social and economic problems. This is due to the adoption of highly ambitious economic policies which do not take into consideration the labour market supply. The development of the educational system towards higher education and specialisation added further constraints on the expansion of the labour market because of the longer years spent by the adult population in the educational process. However, although higher education in these countries may indeed ease some of these constraints in the long-run, it has undoubtedly been more a constraint in the short-term.

In terms of natural resources the most important resources are oil and natural gas. The GCC countries produced a large proportion of the world crude oil production, accounting for 23.2% and 14.1% in 1979 and 1983 respectively.

Table ( 3.10 ) shows the oil production of the GCC countries. The GCC countries export most of their oil production as crude oil, ( about 90%) with the exception of Bahrain which exports only refined oil. They also have substantial proven oil reserves which in 1979 and 1983 accounted for 42.4% and 39.6% respectively of the world's proven oil reserves. Table ( 3.10 ) also shows the oil reserves. Regardless of the quantitative indicators of oil

production and reserves of oil for the GCC countries, the important question is whether the price of oil can be maintained at a high level or whether it will deteriorate in the future. The decline in oil prices can be attributed to relatively weak economic growth in most developed countries and to energy conservation policies adopted by these countries in the face of high oil prices adopted by these countries; the oil price increases of 1973 and 1979-80.

The accelerating pace of availability of oil substitutes, primarily coal and nuclear power, have put downwards pressure on demand for oil. This may be aggravated by the US Monetary policy of high interest rates and high exchange rates, since all oil transaction deals are done in dollars. On the supply side the emergence of non-OPEC oil supply countries, mainly the U.K. and Mexico have put more pressure on the GCC members in OPEC.

The outlook for oil prices is uncertain and hinges on many things, such as: the rate and magnitude of the economic recovery in industrialised and newly industrialised countries; the rate of acceleration of substitution for oil; the oil price and production policies of Saudi Arabia and non-OPEC oil supply countries and so forth.

There is also the production of natural gas which is mainly associated with the production of crude oil. It plays an essential role in reducing production costs by providing cheap fuel for electrification, water distillation and the refining industry. Table ( 3.11 ) shows the volume of natural gas production in the GCC countries. It shows the average utilisation of the natural gas was only 64% of the total production during 1978-1982. The low level of natural gas utilisation or the flaring of gas, can be attributed mainly to the fact that the gas produced is associated gas and hence there is no control over its production. Other contributory factors are insufficient domestic needs and

difficulties in economically transporting the natural gas to industrialised countries. The latter is because it is costly to establish and operate gas liquefaction process plants; International prices for liquefied gas are low and the technology required is very highly advanced. The GCC countries have a significant share of the world natural gas reserves. Table ( 3.11 ) shows the proven natural gas reserves.

### 3.9 : Economic Structure :

The major feature of the GCC countries' past economic growth is the rapid increase in the GDP. The compound growth rate of GDP during the period of 1970-1982 was 31% and in actual terms the GDP increased from US dollars 8,485 million in 1970 to US dollars 21,706 million in 1982. Table ( 3.12 ) shows the aggregate growth of GDP by major economic sectors for a selective year.

The enormous increase of GDP in 1974 and the subsequent decrease in 1982 can be attributed mainly to the increase in oil prices in 1973 and the decrease in oil prices in 1981 respectively. The high growth rates thus do not reflect the actual performance of the productive capacities in their economies. It is primarily related to the development of the extractive industries. The mid-eighties witnessed the GCC countries facing lower GDP growth and massive budget deficits. The GCC countries then adopted adjustment policies, which led to better economic performances in the second half of the eighties.

Table ( 3.12 ) shows a breakdown of the GCC countries GDP by major economic sectors for the period 1985 - 1990. It is clear from Tables ( 7 & 8 ), that the structure of their economy has undergone some changes during this

period. In particular, the high contribution of the mining and agriculture sector to total output has been declining and that of manufacturing, construction, trade and finance sectors have increased.

The share of the mining and agriculture sector in the total output of the GCC countries in economy has declined substantially from 79.5 % to 43.8 % and the share of manufacturing has increased from 7.4 % to 23.3 % for the years 1974 and 1990 respectively. On the other hand, the service sector has grown from U.S.\$ 7,040 million in 1974 to U.S.\$ 60,802 million in 1990, hence increasing its share of the GDP from 13.1 % to 39.4 % respectively.

The production and exportation of crude oil has provided these countries with the main source of foreign exchange. Indeed it has provided them directly or indirectly with employment, activated the domestic markets and, most importantly, provided the public sector with almost all of its total revenue. Table ( 3.13 ) shows the GCC governments' main source of revenues and the type of expenditure. The figures show clearly the high dependence on oil as a main source of revenue. The total revenue has increased from U.S.\$ 61,052 million in 1985 to U.S.\$ 61,340 million in 1990, and oil revenue represents about 69 % and 75 % respectively of the total revenue. This indicates to a large extent the low level of taxation and tariff in these countries which is unlike the other developed and developing countries where tax revenue is considered to be the main source of government revenue. On the expenditure side, the total expenditure increased from U.S.\$ 80,563 million in 1985 to U.S.\$ 79,883 million in 1990.

The trade patterns of the GCC countries reveal a high degree of openness to the outside world. In terms of exports, Table ( 3.14 ) shows that the total exports have increased from U.S.\$ 63,807 million in 1985 to U.S.\$ 82,023

million in 1991, which accounted for a 123.3 % increase in exports. The average annual growth rate of exports was 20.5 % for the same period. The table also shows that the value of imports have increased substantially from U.S.\$ 7,568 million in 1985 to U.S.\$ 11,577million in 1991. The value of exports also increased significantly leading to huge trade surpluses. This was mainly due to an increase in oil exports and the increase in international oil prices. The surpluses in the trade balance increased considerably from U.S.\$ 56,239 million in 1985 to U.S.\$ 68,103 million in 1991.

### 3.10 : The Need For Development :

Past economic growth has not been translated much into economic development in a way that diversified the GCC countries' productive base. Their economic activities are still heavily influenced by exogenous factors and the manufacturing sector has not played an instrumental role in promoting growth; neither has the services sector. It is very important to notice here that the economic growth of the GCC economies has been tied up to depletable non-renewable resources. The scale of depleting oil is not a really productive way of generating one form of wealth into another. The transformation of tangible assets into financial assets beyond their immediate capital needs runs the risk of increasing liquidity above the capacity to absorb, and hence raise inflation. Moreover they are at risk of being depreciated by inflation or devaluation of international currencies, as well as being subjected to various forms of commercial and non-commercial uncertainties.

On the other hand, the tangible underground asset, stored at zero cost is more likely to appreciate in value over time, unless the real interest rate on investment is high enough to offset the above argument.

However, this is not to say that the oil production of the oil producing countries should be determined by their absorptive capacity: there are other factors which have influenced oil production decisions, such as the availability of energy, world demand for energy, and the discount rate on oil production. This is not to mention the political factors. It seems that oil production will be on a scale exceeding domestic absorption and hence creating considerable revenues. Therefore these countries are faced with a crucial decision to rationalise the use of oil revenues by transforming them into more long-lasting productive assets and generating incomes for the interest of future generations.

The GCC countries recognise this fact and have adopted an industrialisation strategy as a way of achieving their economic development. They are all aware that their economies are unilaterally dependent on one resource and work to diversify their industries, utilising fully the natural resources and introducing industries that would substitute the need for imported goods. The policy of industrialisation has been reflected in their development plans and programs. In Saudi Arabia, the industrial development plan (1975-1980) has provided for establishment of industries which are primarily dependent on hydrocarbon materials and those which could meet national requirements for social prosperity ( Arab Economist, 1981 ). It involves new oil refineries, gas complexes, petrochemical and fertiliser schemes, iron and steel, aluminium smelter and agricultural projects. Kuwait's development plan (1976-81) was aimed at comprehensive industrial development to diversify the sources of the gross national income.

Bahrain's development program ( 1982-87 ) aims to diversify the economy with emphasis on industries that employ locally produced aluminium and effective use of natural gas. Oman's development plan includes the

establishment of an industrial sector; an oil refinery, copper ore mining, iron and steel industries, and gas liquefaction factories. Qatar's industrial development strategy aims at utilising oil revenues to broaden production bases and realise a gradual shift from reliance on a unilateral source of income to a balanced economy. Finally, UAE development policies seek to achieve a balance in favour of a developed standard in both economic and social fields for the whole state. They provide for diversified production and a qualified national work force by establishing industries that depend on raw materials such as oil ( Arab Economist 1981 ).

It is obvious that industrial development is at the core of the GCC countries economic development strategies as an effective means of utilising productively a larger part of oil revenues.

### 3.11 : Problems Of Industrialisation :

The achievement of the fundamental development objectives of the GCC Countries hinges to a large extent on their ability and desire to surmount the problems and constraints which prevent such development. These problems are common to many of the developing countries along with others which are related particularly to their specific nature and environment.

The industrial sectors in these countries are faced with almost the same difficulties and drawbacks, with variations in degree and extent. Almost all industries have been developed on the basis of the availability of cheap energy and government subsidies, directly or indirectly. Therefore, the growth patterns of the industrial sector are similar in each country, hence this may both increase regional competition and duplication and reduce their international competitiveness.

Another problem is the severe shortage of labour in these countries. Labour shortages are revealed at all levels of labour, skilled, semi-skilled and non-skilled labour. The reliance on the policy of labour importation to accelerate industrial development has reached an alarming stage threatening to disturb the economic and social balances. The costs of such a policy have been reflected in the general rise in wage rates and most importantly the high costs of providing social services such as food subsidies and housing by the government. The GCC countries are allocating a sizeable proportion of their public expenditure to education and vocational training ( UAE about 20% in 1976 and Bahrain about 11% in 1980 ). However this is not likely to ease the problem in the short or medium term since they are adopting ambitious development plans.

More fundamental is the problem of the smallness of the GCC countries' domestic markets which are considered to be too small to sustain a large scale industrial production. Demas (1965) has argued that the size of a country imposes certain constraints on the pattern of growth and, subsequently, on the nature and degree to which such growth can be self-sustaining.

Chenery ( 1960 ) in his empirical study of 51 countries, using populations and per capita income as independent variables, found out that in intermediate industries in general ( and some branches of other industries such as petrochemical and metal ) the volume of the domestic market played a crucial role in their development due to the existence of internal economies. Therefore the smallness of the domestic market tends to affect industrial investments adversely, leading to misallocation of resources and under-utilisation. This is due to the choice of technology, which in these

industries of petrochemicals, iron and steel are prone to technological rigidity, and economies of minimum efficient scale of production.

### 3.12 : Regional Integration :

Given the limitations and constraints for industrial development in the GCC countries, regional integration may offer many advantages to overcome that. Despite the fact that their oil industry is highly integrated with the international economy and similarity in industrial growth, regional integration would facilitate economic development. Through regional co-operation these countries would be in a position to achieve developmental objectives which either cannot be attained individually or can be attained but at a very high cost. By pooling resources and markets they might be able to optimise their investment decisions regionally and internationally, as well as broaden the potential for more sustainable growth.

However, as has been argued earlier, economic integration may take two broad dimensions. It might be approached as a trade liberalisation among the participating countries in the scheme of forms of customs unions and free trade area. On the other hand, it might be approached partially by joint-projects and co-operation in selective industries and commodities. With the GCC countries in mind, a trade liberalisation approach may not be considered to be the most appropriate now, since these countries have not yet developed a substantial commodities basis, which limits the scope of regional trade. For example, during the period of March 1983 to September 1984, Bahrain exported about 60 million US dollars to the other GCC countries representing 1.3% of total exports in 1982. But it imported about 53 million US dollars from the other GCC countries representing 1.2% of total imports in 1982 ( Memo 1984 ).

Therefore industrial integration ( package deal ) may be considered to be more appropriate now since these countries' priorities are to diversify their economies and increase production. Indeed it would play an important role in the development and diversification of their industrial production structure and rationality in allocating financial resources. Industrial integration would eliminate duplication in many industrial projects and hence encourage concentration of efforts and specialisation in production. Moreover, it would enlarge the internal market and hence provide the basis for the realisation of internal and external economies of scale for many industries. Finally, industrial integration would enhance their bargaining power internationally, as well as heralding the way for more co-operation in various issues such as finance, banking, technology, labour and so forth.

In this respect industrial integration should not be seen as a substitute for national development plans but rather as a supplement for the selection of industries that have potential on a regional basis.

### 3.12 : Conclusion :

As we have seen the Arab countries and the Arab Gulf countries strategy have been based on the development of the industrial sector . It means that the development of services sector is left to be a by- product of the industrial sector development . We known from chapter two that such development will take a long-time . Therefore, these countries will continued to be dependence on the exports of services facilities specially the highly professionals ones from the developed countries . This open a an a venues for countries that have a comparative advantages in the area . Bahrain one of the countries who already have a well advanced services sector and have a good economic and

political relationships with those countries . Such an advantages can be capitalised upon by Bahrain to develop the services sector for the future economic and social development .

Table (3.1) : BASIC INDICATORS FOR ARAB COUNTRIES, 1992

Area	1.4	Million hectares
Population Growth	234	Million
Population	2.3	Per-cent
Labour force	66	Million
Women participation	13.3	Per-cent
GDP	467.2	Billion dollar
Per capital income	1996.4	dollar
Oil reserves of the world	61.8	per-cent
Gas reserve, of the world	20.8	per-cent

Source : UNIFIED ARABIAN ECONOMIC REPORT, 1993

Table (3.2) : GDP BY MAJOR GROUP AT CURRENT PRICES

(1980 - 1992)

( Billion, US\$ )

Item	1980	1985	1986	1987	1988	1989	1990	1991	1992
Group ( 1 )	353.8	288.2	256.8	281.1	285.1	301.2	343.8	323.5	338.8
Group ( 2 )	85.7	85.6	93.5	102.0	97.9	101.1	115.1	117.2	128.4
<u>Total</u>	439.5	373.8	350.3	383.1	383.0	402.3	458.9	440.8	467.2

Source : UNIFIED ARABIAN ECONOMIC REPORT, 1993

Table (3.3) ARAB COUNTRIES BY MAJOR SECTORS  
AT CURRENT PRICES

( Billion US\$ )

Sector	1992			1991		
	Group 1	Group 2	Total	Group 1	Group 2	Total
- Primary	131.3	30.2	161.5	122.1	28.7	150.8
- Industries	60.1	29.7	119.7	50.3	27.0	77.4
- Services	155.4	61.6	217.1	156.2	57.3	213.5
- GDP at production cost	347.0	121.8	468.8	328.7	113.1	441.8
- Indirect Taxes	(8.2)	6.6	(1.6)	(5.2)	4.1	(1.0)
- GDP	338.8	128.4	467.2	323.5	117.2	440.8

Source : UNIFIED ARABIAN ECONOMIC REPORT, 1993

Table (3.4) : GDP BY SECTOR AT CURRENT PRICES

(Billion US\$)

Sector	1992			1991		
	Group 1	2	Total	1	Group 2	Total
- Agriculture	35.8	23.8	59.6	34.6	23.1	57.8
- Mining	95.5	6.4	101.9	87.5	5.6	93.1
- Constriction	30.8	6.2	37.0	25.5	5.7	31.2
- Manufacturing	26.9	20.0	47.0	22.6	18.2	40.9
- Electricity & water	2.4	3.5	6.0	2.2	3.1	5.3
- Transport & Communi	18.2	11.5	29.7	21.4	10.5	31.9
- Hotels & Trade	29.6	24.5	54.2	31.7	22.4	54.1
- Finance & Real Estate	18.9	1.4	20.3	19.9	1.3	21.2
- Housing	6.6	2.1	8.7	6.9	2.0	8.9
- Government	64.0	13.8	77.8	60.0	13.5	73.5
- Other Services	18.1	8.3	26.4	16.3	7.6	23.9
- GDP at Production cost	347.0	121.8	468.8	328.7	113.1	441.8
- Indirect Tax	(8.2)	6.6	(1.6)	(5.2)	4.1	(1.0)
- GDP	338.8	128.4	467.2	323.5	117.2	440.8

Source : UNIFIED ARABIAN ECONOMIC REPORT, 1993

Table (3.5) : REVENUES & EXPENDITURES OF THE ARAB COUNTRIES, 1986 - 1992

( Billion US\$)

Items	1986	1987	1988	1989	1990	1991	1992
<u>Group 1 :-</u>							
- Revenue	65.2	78.1	67.2	78.8	101.0	86.6	96.8
- Expenditures	103.6	111.4	98.9	96.3	113.4	142.0	119.2
Deficit	(38.4)	(33.3)	(31.7)	(17.5)	(12.4)	(55.4)	(22.4)
<u>Group 2 :-</u>							
- Revenues	26.2	26.6	25.2	25.7	28.0	30.3	38.7
- Expenditures	38.8	36.7	35.9	34.4	35.0	36.4	45.0
Deficit	(12.6)	(10.1)	(10.7)	(8.7)	(7.0)	(6.1)	(6.3)
<u>Total</u>							
- Revenues	91.3	14.8	(11.8)	13	23.4	(9.4)	15.9
- Expenditures	142.4	4.0	(8.8)	(3)	13.4	20	(7.8)
Deficit	(51.1)	(43.3)	(42.6)	(26.3)	(19.4)	(61.3)	(28.7)

Source : UNIFIED ARABIAN ECONOMIC REPORT, 1990 - 1993

Table (3.6) : REVENUES & EXPENDITURES AS PERCENTAGE OF GDP

( Billion us\$ )

Item	1986	1987	1988	1989	1990	1991	1992
<u>Group 1 :</u>							
- Revenue	31.1	35.2	31.2	34.8	38.6	34.2	34.2
- Expenditure	49.4	50.2	46.0	42.5	43.4	55.9	42.0
<u>Group 2 :</u>							
- Revenue	28.1	26.2	25.8	25.7	24.4	26.0	29.9
- Expenditure	41.6	36.1	36.8	34.4	30.4	31.2	34.7
<u>Total</u>							
- Revenue	30.1	32.4	29.5	32.0	34.3	31.6	32.8
- Expenditure	47.0	45.8	43.2	40.0	39.4	48.1	39.7

Source : UNIFIED ARABIAN ECONOMIC REPORT, 1990 - 1993

Table (3.7) : VALUE ADDED OF THE MANUFACTURING SECTOR

( Billion US\$)

Item	1987	1988	1989	1990	1991	1992
<u>Group 1 :</u>						
- V.A	26.7	31.1	29.5	30.2	23.0	25.9
- V.A (%)	10.1	10.8	9.9	8.8	7.4	7.6
<u>Group 2 :</u>						
- V.A	16.0	13.3	13.9	17.2	17.2	19.2
- V.A GDP	14.4	14.8	15.4	16.4	15.8	16.2
<u>Total</u>						
- V.A	42.7	44.4	43.5	47.4	40.2	45.1
- V.A Growth (%)	11.2	11.9	11.3	10.7	9.7	10.0

Source : UNIFIED ARABIAN ECONOMIC REPORT, 1990 - 1993

**Table (3.8) :**

***Basic Indicators for the GCC Countries***

<i>Area</i>	2,392	<i>Thousands KM.</i>
<i>Population (1991)</i>	20.7	<i>Million</i>
<i>Population growth (1990)</i>	4.1	<i>Per-Cent</i>
<i>Labour Forces (1990)</i>	34.7	<i>Per-Cent</i>
<i>Women's Participation (1990)</i>	7.6	<i>Per-Cent</i>
<i>GDP (1991)</i>	11,997	<i>US Dollar</i>
<i>Per Capita income (US\$ - 1991)</i>	11,997	<i>US Dollar</i>
<i>Oil reserves of the world (1991)</i>	45.5	<i>Per-Cent</i>
<i>Gas reserves of the world (1991)</i>	12.6	<i>Per-Cent</i>

***Sources :***

- 1- *Unified Arabian Economic Reports, 1992 & 1993*
- 2- *UN Population Statistics, 1993.*
- 3- *Human Resources Development, UN, 1994.*

**Table (3.9) : LABOUR FORCE IN THE GCC COUNTRIES**

<b>COUNTRY</b>	<b>LABOUR FORCE</b>	<b>%</b>
<i>Bahrain</i> (1991)	226,448	100
- Bahraini	90,662	40
- Non Bahraini	135,786	60
<i>Kuwait</i> (1985)	670,385	100
- Kuwaiti	126,410	19
- Non Kuwaiti	543,975	81
<i>Oman</i> (1992)	632,000	100
- Omani	211,000	33
- Non Omani	421,000	67
<i>Qatar</i> (1993)	110,000	100
- Qatari	20,900	19
- Non Qatari	89,100	81
<i>Saudi Arabia</i> (1990)	4,446,000	100
- Saudi	1,786,000	40
- Non Saudi	1,660,000	60
<i>UAE</i>	N.A	

**SOURCES :**

- 1 - THE ECONOMIST INTELLIGENT UNIT, COUNTRY PROFILE, 1994  
1995
- 2 - BAHRAIN ABSTRATIC, 1992

**Table (3.10) :**

***Oil Production & Oil Reserves for the GCC Countries***

<b>Years</b>	<b>Oil Production</b> <i>(Million Barrels)</i>	<b>Per Day Prod.</b> <i>(Thousand Barrels)</i>	<b>% of World Total</b>	<b>Oil Reserves</b> <i>(Million Barrels)</i>	<b>% of World Total</b>
1976	4,968	13,611	23.7	262,260	41.2
1977	5,113	14,009	23.4	281,005	43.5
1978	4,796	13,139	21.8	275,416	42.9
1979	5,371	14,714	23.4	273,291	42.6
1980	5,146	14,098	23.6	271,925	40.9
1981	4,834	13,243	23.6	270,929	40.1
1982	3,382	9,266	17.3	274,180	39.0
1983	2,716	7,440	14.1	274,872	38.9
1984	2,590	7,096	13.3	302,385	40.8
1985	2,235	6,124	11.5	303,334	40.1
1986	3,010	8,247	14.7	367,151	43.2
1987	2,648	7,255	13.4	370,957	41.7
1988	3,277	8,978	15.7	456,330	46.0
1989	3,442	9,429	16.5	464,180	46.5
1990	3,935	10,779	17.9	461,527	45.7
1991	4,324	11,884	19.8	461,870	45.5

**Source :** *GCC Main Economic Indicators, 1982-1993, 1990 - 1991.*

**Table (3.11) :**

***Natural Gas Production & Reserves for the GCC Countries***

<b>Years</b>	<b>Oil Production</b> <i>(Million Barrels)</i>	<b>Per Day Prod.</b> <i>(Thousand Barrels)</i>	<b>% of World Total</b>	<b>Oil Reserves</b> <i>Million Barrels</i>	<b>% of World Total</b>
1976	83,207	228	6.3	4,442	7.2
1977	87,196	239	6.7	5,341	7.9
1978	81,402	223	6.0	5,686	8.3
1979	94,183	258	6.6	6,251	8.4
1980	90,057	247	6.3	6,721	8.1
1981	88,742	244	5.7	7,003	8.0
1982	66,925	184	4.3	7,262	7.9
1983	61,523	169	3.9	7,235	7.7
1984	65,000	178	3.8	10,218	10.4
1985	71,251	196	4.1	10,074	9.9
1986	86,434	237	4.8	15,450	14.1
1987	59,188	245	4.9	16,061	14.3
1988	97,532	268	5.1	17,179	14.8
1989	104,520	278	5.2	17,300	13.4
1990	108,765	298	5.2	17,317	13.0
1991	135,766	372	6.4	17,888	12.6

**Source :** *GCC Main Economic Indicators, 1982-1993, 1990 - 1991.*

*Table : (3.12) GDP OF THE GCC BY MAJOR ECONOMIC ACTIVITY  
AT COST PRICES*

*( U.S. \$ MILLION )*

<i>ITEM</i>	<i>MINING &amp; AGRICULTURE</i>	<i>INDUSTRIAL</i>	<i>SERVICES</i>	<i>GDP</i>
<u><i>UAE</i></u>				
<i>1985</i>	<i>12,654</i>	<i>5,525</i>	<i>9,594</i>	<i>27,773</i>
<i>1987</i>	<i>9,264</i>	<i>4,889</i>	<i>9,996</i>	<i>24,148</i>
<i>1990</i>	<i>16,303</i>	<i>5,292</i>	<i>12,070</i>	<i>33,665</i>
<i>1991</i>	<i>15,502</i>	<i>6,186</i>	<i>28,149</i>	<i>12,647</i>
<u><i>BAHRAIN</i></u>				
<i>1985</i>	<i>660</i>	<i>770</i>	<i>1,757</i>	<i>3,704</i>
<i>1987</i>	<i>641</i>	<i>797</i>	<i>1,732</i>	<i>3,170</i>
<i>1990</i>	<i>899</i>	<i>998</i>	<i>2,006</i>	<i>3,903</i>
<i>1991</i>	<i>827</i>	<i>1,011</i>	<i>2,412</i>	<i>4,250</i>
<u><i>SAUDI ARABIA</i></u>				
<i>1985</i>	<i>28,682</i>	<i>17,544</i>	<i>39,371</i>	<i>85,597</i>
<i>1987</i>	<i>22,277</i>	<i>15,430</i>	<i>34,923</i>	<i>72,630</i>
<i>1990</i>	<i>42,124</i>	<i>17,275</i>	<i>39,343</i>	<i>98,742</i>
<i>1991</i>	<i>47,558</i>	<i>17,892</i>	<i>44,810</i>	<i>110,260</i>
<u><i>OMAN</i></u>				
<i>1985</i>	<i>5,072</i>	<i>1,134</i>	<i>3,692</i>	<i>9,898</i>
<i>1987</i>	<i>3,949</i>	<i>759</i>	<i>3,031</i>	<i>7,739</i>
<i>1990</i>	<i>5,708</i>	<i>850</i>	<i>3,978</i>	<i>10,536</i>
<i>1991</i>	<i>4,715</i>	<i>1,028</i>	<i>4,390</i>	<i>10,133</i>
<u><i>QATAR</i></u>				
<i>1985</i>	<i>2,695</i>	<i>899</i>	<i>2,559</i>	<i>6,153</i>
<i>1987</i>	<i>1,677</i>	<i>949</i>	<i>2,820</i>	<i>5,446</i>
<i>1990</i>	<i>2,540</i>	<i>1,435</i>	<i>3,405</i>	<i>7,380</i>
<i>1991</i>	<i>2,326</i>	<i>1,232</i>	<i>3,074</i>	<i>6,632</i>
<u><i>KUWAIT</i></u>				
<i>1985</i>	<i>10,407</i>	<i>1,688</i>	<i>7,973</i>	<i>20,068</i>
<i>1987</i>	<i>8,183</i>	<i>3,300</i>	<i>9,516</i>	<i>20,999</i>
<i>1990</i>	<i>6,905</i>	<i>2,189</i>	<i>9,078</i>	<i>18,172</i>
<i>1991</i>	<i>1,577</i>	<i>1,126</i>	<i>8,586</i>	<i>11,289</i>

CONTINUED

*Table : (3.12) GDP OF THE GCC BY MAJOR ECONOMIC ACTIVITY  
AT COST PRICES*

*( U.S. \$ MILLION )*

<i>GCC</i>	<i>MINING &amp; AGRICULTURE</i>	<i>INDUSTRIAL</i>	<i>SERVICES</i>	<i>GDP</i>
<i>1985</i>	<i>67,075</i>	<i>29,749</i>	<i>74,024</i>	<i>170,848</i>
<i>1987</i>	<i>45,991</i>	<i>26,124</i>	<i>620,18</i>	<i>134,132</i>
<i>1990</i>	<i>67,574</i>	<i>25,850</i>	<i>60,802</i>	<i>154,226</i>
<i>1991</i>	<i>72,505</i>	<i>28,475</i>	<i>91,421</i>	<i>192,401</i>

*SOURCE : THE ECONOMIC BULLETING GCC, 1986 - 1993*

**Table (3.13) :**

**Government Revenues Expenditures for the GCC Countries**

*(Million US\$)*

<i>Years</i>	<i>Revenues</i>	<i>Expenditures</i>	<i>Balance</i>
1976	52,811	44,360	8,451
1977	59,394	55,408	3,986
1978	66,686	63,547	3,139
1979	103,022	76,838	26,184
1980	151,407	98,907	52,500
1981	147,940	116,073	31,867
1982	101,167	103,752	(2,585)
1983	88,510	96,857	(8,347)
1984	70,665	86,485	(15,820)
1985	58,471	75,427	(16,956)
1986	39,328	65,563	(26,235)
1987	49,127	74,341	(25,214)
1988	44,393	65,420	(21,027)
1989	58,703	70,741	(12,038)
1990	74,633	89,826	(15,193)
1991	63,646	120,421	(56,775)

**Source :** *GCC Main Economic Indicators, 1982-1993, 1990 - 1991.*

*Table : (3.14) : Gcc Trade Balance*

*(Million US\$)*

<i>Years</i>	<i>Exports</i>	<i>Imports</i>	<i>Total Balance</i>
<i>1985</i>	<i>63,807</i>	<i>7,568</i>	<i>56,239</i>
<i>1986</i>	<i>44,337</i>	<i>6,687</i>	<i>37,650</i>
<i>1987</i>	<i>52,465</i>	<i>6,687</i>	<i>45,778</i>
<i>1988</i>	<i>52,465</i>	<i>7,226</i>	<i>45,239</i>
<i>1989</i>	<i>65,819</i>	<i>10,133</i>	<i>55,686</i>
<i>1990</i>	<i>85,845</i>	<i>11,577</i>	<i>74,268</i>
<i>1991</i>	<i>82,023</i>	<i>13,920</i>	<i>68,103</i>

*Source : GCC Main Economic Indicators Handbook, 1994*

## CHAPTER 4

### BAHRAIN ECONOMY

## CHAPTER FOUR

### BAHRAIN ECONOMY

4.1 : Introduction.

4.2 : Economic Development.

4.3 : Public Finance.

4.4 : Impact Of Oil Revenues On Government Policies.

4.5 : Government Role In The Economy.

4.6 : Diversification Strategies.

4.7 : Conclusion.

□

#### 4.1 : Introduction:

The State of Bahrain consists of 38 islands, occupying an area of approximately 674 sq.km. Five thousand years ago, this group of islands was known first as Dilmun, then Taylos , Awal and finally Bahrain. Bahrain is located in the heart of the Arabian Gulf, some 15 miles from the Saudi Arabian coast and slightly more distant from Qatar.

Throughout history, the strategically central location has enabled Bahrain to play a major role in the economic and social development of the countries in the region. Niedercorn, in his intensive research into Bahrain's history has concluded that " It ( Bahrain ) functioned as a major advance base for settlement of the Near East by migrants from Southeast Asia and as entrepot for trade between Southeast Asia, India, Mesopotamia and Africa. Without doubt Bahrain was once known as Dilmun. For millennia this island appears to have played the role of religious, political and commercial headquarters, as well as the sacred ancestral homeland of the Asumerian nation ( Niedercorn, 1985, p. 23 ). In terms of trade, Bahrain was the stop-over point for trade between Europe and Indian sub-continental countries during the fifteenth to seventeenth centuries. In the eighteenth and nineteenth centuries, Bahrain's role in inter-regional trade increased substantially. This was due to the increasing importance of natural pearls in international trade.

Bahrain was the place where pearls were bought and sold as well as exchanged for other goods and commodities. It has acted as a gate to international trade on one hand and as a regional distribution centre on the other hand. Such a role was enhanced further by the discovery of oil in the thirties of this century.

The historical event that forced Bahrain into the international arena was the invasion by the Portuguese in 1507. Khuri argued that 'the coming of the Portuguese in 1507 marked the beginning of a new era that saw the rise of oceanic trade and correspondingly the involvement of the Gulf in world affairs ( Khuri, 1975, p 10 ).

The constant contact with the rest of the world had the impact of creating economic, social as well as political structures much earlier than the other countries in the region. The structure of the economy characterised a service oriented economy, then it developed more towards producing agricultural products and natural pearls, then oil. In both types of economy Bahrain maintained a close link with the international market. The social structure that emerged created a new class of merchants and later small business contractors. The political system developed towards the establishment of a state administration and a bureaucratic system.

The major development in Bahrain's history was the discovery of oil in 1932. The oil production in 1934 and export in 1936 introduced enormous structural changes in the economic, social and political life of the island.

#### 4.2 : Economic Development :

In the early years prior to the discovery of oil in 1932 the main source of livelihood was pearl fishing, agriculture and trade. Manufacturing industries were limited to copper work, pottery, boat building and weaving, which catered to local demand. Bahrain had a strong tradition of ship building and fishing in the early years, which faded when oil began to attract people into new activities. Fishing is a traditional activity which has survived, but is in decline, as limited stocks have prevented expansion.

The pearling industry was the oldest and the most famous of the traditional activities of Bahrain. The pearl fisheries provided the major source of both income and employment for Bahrainis. Just before the First World War, about twenty thousand adult men, a little less than half of the male population, were employed in pearl production ( Khuri, 1980, p 58 ). The government revenue was through import duties on imports financed through export of pearls. The primary importance of pearling was further underscored by the fact that several other important activities such as trading and shipbuilding were quite closely related to, and indeed rather dependent on, pearling. Clarke states that " pearl diving is the oldest industry in Bahrain and has been the reason why an otherwise small and comparatively unresourceful group of islands has been scene of so many bitter wars and invading armies' ( Clarke, 1981, p 44 )

Pearling and its related industries remained the most important one on the island until the 1930s when oil discovery took place. Thereafter the industry was affected by four important factors. Firstly, competition in the product market from both cultured and artificial pearls developed in Japan had the effect of lowering the price of natural pearls to a fraction ( some 10 % or less ) of what they were earlier. Secondly, competition in the labour market from petroleum, which grew rapidly and offered a stable and higher income attracted those in pearling. Thirdly, a series of reforms or controls on the industry and its institutions were introduced in the 1920s by the British government as part of its role as the island's protector. Fourthly, the international depression of the 1930s depressed the demand for luxury goods such as pearls. Datta and Nugent have argued that the most damaging factors were the competition coming from cultured and artificial pearls and the

competition with the oil industry in attracting a suitable labour force, which led to a rapid decline of the pearling industry ( Datta and Nuget, 1985 ).

The dramatic story of the pearling industry has highlighted a number of lessons to be learned for further economic development in Bahrain. The primary activities unrelated to pearling were agriculture and fishing, both subsistence activities which unlike pearls provided rather steady employment. Agriculture was the second most important source of income. The main crops were dates, alfalfa and vegetables. Dates constituted the main staple diet, and the palm provided material for housing. Artesian wells were the most significant source of water for agriculture. The fishing industry also provided steady employment and income for a large proportion of the Bahraini population.

Foreign trade was the other main activity. Because of its location Bahrain was the distribution centre. The foreign trade encouraged the merchant sector, as well as providing the government with revenue. Customs duty in 1930 accounted for 97% of government revenue.

Post second World War development consequent to the post war recovery led the government to promote trade to satisfy the demand for goods induced by the oil wealth. This was assisted by investment in the seaport and the airport. Oil thus mitigated the effects of the decline in the pearling industry.

The discovery of oil and the subsequent establishment of the oil refinery marks the entry of Bahrain into the modern era of economic development. The exceptional increase in the price of oil which was a characteristic of the seventies brought in the financial resources necessary for the spurt in

economic and social development which commenced in the latter half of the seventies.

Bahrain's economy heavily depends on oil. The fluctuations in its output and prices have significantly affected the economic growth of the modern period. While this was so, historically Bahrain has been the hub of the Gulf. Air and sea ports have helped Bahrain to become the centre of Gulf trade for many years until other Gulf states improved their infrastructures. In recent times, Bahrain has developed banking services to become one of the international centres for such services. In addition, its drive to move away from depending on rapidly declining gas oil and gas resources has encouraged the setting up of industrial projects notably in Aluminium and petrochemicals. Economic development from 1975 onwards reveals the dependence of Bahrain on oil and the efforts of the government to diversify the economy away from oil and towards a service economy.

Bahrain entered into a period of rapid growth in the 1970's following the increase in the price of oil. Thus Gross Domestic Product (GDP) increased from BD 48.5 m. in 1969 to BD 1.157.1 m. in 1980, an increase of approximately 23 times over the decade. Per Capita income increased from BD 237.6 in 1969 to BD 3492 in 1980 ( Ministry Of Finance And National Economy, 1991 ).

The rapid growth in the economy was also accompanied by structural changes in the economy, particularly in the industrial and service sectors, the industrial sector benefiting from the government's drive to diversify the economy away from dependence on oil, and the service sectors which fulfilled the needs of an economy rapidly transforming itself into a modern

economy. Service sector improvements were significant in Banking, Telecommunications and personnel services.

Just as the rapid growth of the economy was the result of the increasing price of oil, its decline was also the cause of the rapid decline in the price of oil. Oil prices commenced their period of decline from 1982 when the price peaked at US 41 per barrel. The growth of the economy between 1976 - 1991 is shown in Table ( 4.1 ).

As the table shows, growth rate in current terms fell after 1983, and has not been able to reach the earlier rates since. Oil GDP in current terms reveals the instability of oil prices since 1982, when negative growths were recorded. In constant terms the growth has been relatively modest since 1977.

The economic development of Bahrain thus reached its watershed in the early 1980s. Henceforth the economy was in relative decline pulled down by the declining price of oil on the one hand and the declining production of oil in the other. The growth of the economy was dependent on the increase in non-oil output.

Three distinct stages of growth between 1976 and 1990 can be distinguished. The period 1976 to 1980 was the period of rapid growth with the average growth in the economy reaching 25.6 % per annum in current terms. This was followed by a period of 1981-1985 which was considered a period of relative decline, average annual growth falling to 3.8% per annum for 1986-1991. The period that followed was one of further decline, growth averaging 2.1 % per annum. Per Capita income, which had reached BD 3,492 in 1980, declined to BD 3,280 in 1985 and further to BD 3,014 in 1991.

In real terms too the three periods were distinguishable. Between 1976 and 1980 the economy increased by an average of 12.6% per annum, while during 1981 and 1986 the average growth was 0.6% per annum . During 1986 and 1990 the economy in real terms performed better, achieving an average growth rate of 4.2% per annum in contrast to 1.86% per annum in current terms.

The annual average population growth was lower than the average annual growth in GDP during the years 1976 to 1980, but was in excess of GDP growth since 1980. Thus per capita income which averaged BD 2,658 during, and increased to an average of BD 3,414 during 1981 to 1985, declined to BD 2,660 during 1986 - 1991.

The different sectoral growth, benefiting from the government's drive to improve infrastructure and develop industries and banking, has introduced significant structural changes in the economy. The annual average sectoral growth during the three periods 1976 - 80; 1981 - 1985 and 1986 - 1991 is given in Table ( 4.2 ). The table clearly shows the different periods of growth. The period 1976-1980 was a period of high growth in virtually all sectors when Bahrain invested the increasing availability of finance from the higher oil prices in infrastructure development. Rapid improvements were made in the seaport, airport, roads, land reclamation schemes etc.

The period 1981 - 1985 was a period of relatively lower growth. The oil price started its decline and with it the decline in the rest of the economy was evident. However, strong growth continued in banking, communication, port development, and in Gulf Air. Construction kept pace with the rest of the development.

The period 1986 - 1991 was the period when the real effect of the decline in oil prices was felt. The decline during the period also extended to Banking and construction. The banking decline was a reflection of the lower savings in the region consequent to the decline in oil prices, while lower government spending, particularly on capital expenditure had its effect on construction. The growth in Manufacturing was due to the increasing price of aluminium, particularly during the latter half of the period.

This sectoral growth had a significant effect on the structure of the economy. The sectoral contribution during the different periods shows the changing pattern of the economy.

Table ( 4.3 ) shows the changes very clearly. The oil sector (mining) was the leading sector during 1976-80, when output as well as prices of oil was high. The decline set in after 1986 which reduced the contribution of the sector to 18% during 1986-1990. The trend is revealed both in current and real terms.

Oil prices declined after 1983 when crude oil prices reached their peak of US 41 per barrel. Since then the trend of prices has been falling. Real output also fell due to the declining productivity of the Bahrain field, which is in the phase leading to its complete abandonment.

The other significant change in the structure is the rise of Banking which in 1976 - 1980 was contributing 13.2%, increasing its share to 25% during 1981 - 1985 before falling to 20.9% in 1986 - 1990. This increase in the sector's contribution was due to the establishment of off-shore banking units (OBUs), as well as increasing financing by the banking system of the growing domestic economy.

Manufacturing was the other beneficiary of the changing structure of the economy. In real terms, manufacturing increased from 13.5% during 1976-80 to 17.7% during 1986 - 90. The reason for this was the establishment of joint venture manufacturing units. The Petrochemical production, ship repair facility and Aluminium downstream facilities benefitted from the joint ventures of the regional countries, locating their manufacturing facilities in Bahrain. In addition the increasing production capacity of primary aluminium production and the operation of the refinery in excess of its capacity lead to the increasing contribution of the manufacturing sector to the economy.

In addition, Trade, Transport, and Hotels increased their contribution as infrastructure was added to cater to the developing needs of the economy.

These developments lead to a change in the relative position of the sectors in the economy. If the sectoral contribution in current terms is taken, during the first period the leading sector was Mining contributing 29% to the GDP, followed by Manufacturing, Trade & Hotels, Finance & Real Estate, Public Administration and Transport. By the period 1980-88 the structure of the economy changed. Mining was still the dominant sector, but the development of Banking had overtaken the others to become the second largest followed by Public Administration, Manufacturing, Transport (including communication), Trade & Hotels. Further changes in the structure were revealed during the period 1986 - 1990. Falling prices and the increasing importance of the Government had made Public Administration the largest contributor to the economy. This was followed by the Finance & Real Estate sector. By this period the mining sector had become the third largest contributor to the economy.

The economy was clearly moving away from dependence on oil. The non-oil economy was taking the direction of becoming a service economy.

Limited water and land resources have effectively limited the growth of agriculture, though the aquifer which extends from Saudi Arabia has provided large quantities of fresh water to develop date growing, vegetable and forage crops. Growth has however been limited since the availability of water is insufficient to support the increasing demand for drinking water requirements as well as for the development of agriculture. Thus the contribution of agriculture remains about 0.7% of the GDP. Fisheries similarly is restricted by the availability of stock and the requirement to share stock with the rest of the Gulf countries. The contribution of Fisheries has been 3% to the GDP.

Mining is one of the leading sectors of the economy. In 1976 its contribution was 37.8% of the GDP and ranked as the highest contributor to the GDP. This sector, including the off-shore field, Abu Saafa, provides the crude oil both for export and further refining in the refinery located in Bahrain. Falling production in the Bahrain field from around 61,000 barrels per day in 1975 to about 43,000 barrels per day in 1990 has reduced the importance of the sector, which now contributes only 16% of the GDP.

The Manufacturing sector contributes to the economy significantly. This sector comprises the export based large industries such as the 250,000 barrels per day Refinery, the Aluminium smelter, which has expanded to 460,000 tons p.a of primary aluminium, the ship repairing yard catering for Large tanker repairs, as well as gas based industries, which dominate the output of the sector. There is a significant number of small industries employing about 60% of the workforce of the sector. Manufacturing sector growth in real terms was averaging 10.4% during 1976-1980 when the large joint ventures

were being established. But growth since then has been moderate, averaging only 3.35% during 1981-85 and 4% during 1986- 1990.

Fluctuating prices have affected the sector since refined products and gas based products have followed the trend in oil prices. Aluminium prices have also similarly fluctuated as this is also an energy based product, apart from facing the effects of the trade cycle in industrial countries. These influences have made the output growth in current prices fluctuate widely.

Transport and communication contributed about 6.5% of the GDP in 1976 but increased its contribution to 10.4% by 1990, due to the improvement in the Port and Airport as well as in communication facilities. A significant contributor in the sector is communication, which services the Banking and other service sectors. Its contribution within the sector amounts to approximately 27%. The major development within the sector is the growth of Gulf Air which uses Bahrain as a hub for its activities.

Trade and commerce is one of the traditional activities in which Bahrain has excelled. It was originally the centre of Gulf trade. The sector, which includes hotels and other leisure activities, contributed 10% to the economy in real terms. It developed moderately until 1983 when its contribution peaked at 14.7% of the GDP. Developments in the other Gulf states have largely led to the erosion of the influence of Bahrain in Trade within the region.

The finance and real estate sector was one of the fastest growing sectors. In 1976 it contributed only 6.5% of the GDP. From 1977 onwards there was a rapid increase in its contribution when offshore Banking units were being set up. Its contribution peaked in 1985 when it accounted for 29.7% of the output in real terms. By 1990 its contribution had declined to 21.4% of the GDP.

Public administration is a large sector, as government is the prime mover of the economy. The total government budget is approximately 33% of the GDP and therefore very much influences economic activity. Public administration has increased from contributing 15% of the GDP in 1976 to 22% in 1990.

The Gross Domestic expenditure pattern also reveals the changing character of the economy. Fixed investment as a proportion of GDP increased during the early seventies when higher oil revenues brought about increasing surplus in the economy. Thus in 1976 Fixed investment jumped to 46.8% of the GDP in current terms from 24.6% the previous year. It further increased to 53% in 1977. The growth slowed down; between 1978 and 1982 the proportion declined to between 30 and 35%. It once again increased in 1983 and 1984 due to higher oil prices to 41% and 43% respectively. Since then the decline in investment set in when oil prices fell into the declining trend. By 1990 fixed investment had fallen to 28% of the GDP.

Consumption also increased, particularly government consumption which increased by over 20% per annum up to 1982. Private consumption increased by a lower rate amount during the early seventies, but the steady increase has led to consumption outpacing Fixed investment. Total Consumption which was 54% in 1975 thus increased to 62% in 1990.

The declining investment has implications for growth since the incremental capital output ratio is very high. Unless productivity in the economy increases substantially, it may be difficult to sustain the pace of development, given the increasing consumption expenditure.

### 4.3 : Public Finance :

Public finance is the heart of the economic and financial policy. Revenue and expenditure policies are the mechanism and the means by which scarce resources are allocated and distributed, and the economy stabilised to achieve economic and social development. Revenue policies determine the magnitude of the resources available to support government programmes and finance economic development. Expenditure policies determine the allocation of available financial resources to the various components of government, reflecting national economic and social objectives and priorities. Taken together, revenue and expenditure policies thus constitute the core of government efforts to direct the development of the country so as to achieve national goals.

Bahrain's experience in public finance is crucial to understand the past and future economic and social development. Trends of government revenues and expenditures, both recurrent and non-recurrent, can be seen from the analysis of the pattern of public finance in Bahrain. Table ( 4.4 ) shows average revenue and expenditure by decades since the 1930s. In general, total revenue increased from B.D 205.2 thousand in the 1930s to B.D 474,556.5 thousand in the 1980s. The contribution of oil revenue to the total revenue has been fluctuating. Its contribution increased from 55 % in 1930s to 66 % in the 1980s with a peak of 72 % and 73 % in the 1950s and the 1980s respectively. On the other hand, total expenditure has increased from B.D 160.7 thousand in the 1930s to B.D 459,556.8 thousand in the 1980s. The purpose of Recurrent expenditure in the total expenditure declined with the exception of the 1960s, when it increased to 82 %. The share thus decreased from 90 % in the 1930s to 61 % in the 1980s.

The pattern of government expenditure by sectors during the past five decades reveals certain policy implications. In the 1930s and the 1940s, public finance expenditure policy concentrated on transfers and other payments to municipality and other semi-governmental organisations, representing 56 % and 37 % of the total expenditure respectively. There was also emphasis on infrastructure building, where expenditure on the sector represented 16 % and 23 % of the total expenditure respectively. In the 1950s and 1960s, public finance expenditure policy accommodated the development of the services sectors, i.e. education and health. Expenditure on the service sector represented 31 % and 47 % respectively. At the same time, infrastructure building continued, with expenditure contribution of 21 % and 28 % of the total expenditure respectively. In the 1970s there was a total shift in the public finance expenditure policy towards the development of a modern infrastructure of roads, port, airport, electricity and etc. The expenditure on the infrastructure sector almost doubled, from 28 % in the 1960s to 47 % in the 1970s. Emphasis on service sector development continued with expenditure on the sector representing 21 % of the total. In the 1980s, there was a complete change in the public finance expenditure policy which shifted the focus to the public administration sector with special emphasis on defence and public security. The expenditure on the public administration sector represents 46 % of the total expenditure.

At the same time, the infrastructure and service sectors have a share of 38 % and 24 % of the total expenditure respectively. The above analysis of expenditure reveals the following: Firstly, government involvement in the economy started in the 1950s. Secondly, the policy of the 1950s and 1960s emphasised the development of the service sector, reflecting the government strategy of redistributing wealth by the provision of services to increase the standard of living as well as building up the human resources infrastructure.

Thirdly, the policy on infrastructure building, especially in the 1960s and 1970s reflected the governments' strategy to enhance the economic base and diversify the economy away from oil production. Fourthly, the policy of the 1980s emphasising the development of the public administration reflects government concern about defence and security due to the Iraq - Iran war and later the Gulf war.

#### 4.4 : Impact Of Oil Revenue On The Government :

Bahrain was the first country to discover oil in the Arabian Gulf in 1932. It has benefited very much from oil production. As Table ( 4.5 ) shows, oil production increased from US Barrels 31,000 in 1933 to US Barrels 10,014,905 in 1948. The largest increase in oil production was in 1968 when production reached a ceiling of US Barrels 27,597,728, which then continued until recent years. The sale of oil had a very favourable impact on government revenue. The largest increase in oil revenue came with the first oil shock when oil prices increased from US dollar 3-5 in 1973 to US dollar 8-10 in 1974. This had the impact of increasing government revenues as table ( 4.4 ) also shows the contribution of oil revenue to total government revenues, which increased from 55 % in 1935 to 75 % in 1991. This indicates a structural change in the government revenue toward more dependence on oil production sales. Table ( 4.6 ) shows the growth of the total government revenue for the period 1930-1994.

The rapid increase in oil revenue had two major impacts on government policies. Firstly, it limited government efforts to expand non-oil revenues both in terms of direct and indirect taxes. This had a long term negative impact on government revenue as it prevented the development of a tax base. Secondly, it provided the government with a cheap source of funds. The huge

growth of government revenues allowed the government to increase its expenditures on various services and facilities. The oil revenue financed government expenditure on social services, investment in physical infrastructure and large industrial projects. As a result, the private sector also expanded its investment and activities to meet the demand created by government expenditures.

On expenditure side, table ( 4.7 ) shows government expenditure for the period 1930 - 1994 . The expenditure has increased substantially at the beginning of the seventies, as a result of an increase in the government revenues . In 1974 only, it has increased from B.D 32.8 million to B.D 77.9 million in 1974, representing an increase of 137 % .

#### 4.5 : Government Role In The Economy :

The government has played an important role in the recent development of Bahrain's economy. The huge oil revenue enabled the government to allocate a large amount of resources to accelerate the economic and social development of Bahrain. The government's role in the economy varied from time to time, depending on political, economical and social conditions dominant at a certain time. For the sake of simplifying the analysis, we may distinguish four stages where overall government policies changed, reflecting changes in the government role in the economy. These stages were not exclusive features; they are interrelated, but one factor had distinct characteristics at a certain time.

During the first stage, the government played the role of the initiator in the economy from 1960 to 1970. The government role at this stage was to initiate growth by providing infrastructure and investment opportunities.

The private sector also played a major role in responding to these investment opportunities. As will be explained in section 4.6 ( Diversification Policies ), the government participated only in the Aluminium smelter project where large investment was required. The other manufacturing and services projects were initiated by the private sector alone or jointly with the foreign private sector. During this stage the government was ready to invest in a project only when the private sector was reluctant to do so.

During the Second, stage the government played the role of provider in the economy from 1970 to 1985. The change in the government role was helped by the availability of huge revenue. The increase in international oil prices provided the government with a continued inflow of financial resources. This provided the government with the means to get more involved in the economic life of the country. The government provided a modern and well developed infrastructure as well as an advanced social services system, covering education, health, housing and other social services. The government also invested in manufacturing projects such as Aluminium downstream projects and petrochemicals projects. It also invested in the services sector such as in banking establishments, public transportation, car maintenance and telecommunications. Further it invested in agricultural projects such as dairy production, agricultural production and fishing projects.

At this stage the role of the government was that of a leader in all aspects of the economy and the private sector played a supplementary role. The role of the foreign private sector was not encouraged because there were more than enough financial resources to meet the new investment opportunities.

During the third stage (1983-1992) the government played the role of provider and facilitator at the same time. The government recognised the fact that oil and oil revenues would not stay high forever and the government could not go on spending at the same levels as before. The decline in oil revenue as expected started to affect the state budget, and the state budget recorded a budget deficit.

As a result, the government took several measures to rationalise and reduce public spending. Actions were taken to limit the growth in recurrent expenditure, especially on manpower and consumable goods. Further, the government took measures to reduce capital expenditure in the economic and social development programme in 1984 and introduced a ceiling of B.D 150 million on capital expenditures. For the first time the government also introduced the concept of privatisation and/or contracting-out of some government activities.

During the fourth stage from 1993 onwards the government played the role of facilitator. This stage is considered to be the turning point in government policies toward a new area of softer government approach in dealing with the economy. The new policies were reflected in the state budget of 1993-1994 where manpower expenditure was frozen at the level of 1992 capital expenditure as well as other recurrent expenditures reduced (Ministry Of Finance And National Economy, 1992 ). The government also set about implementing a privatisation programme, aimed at reducing public spending as well as financing the state budget deficit. During this period the government also took a number of measures to enhance the link between economic and fiscal policies and maintain economic growth.

The 1995 - 1996 budget more clearly emphasised the government's lead in its role as a facilitator in the economy ( Ministry Of Finance And National Economy, 1994 ). Government policies of high economic growth, creation of jobs and diversification were emphasised but this time under the leadership of the private sector. Further, government recurrent expenditure was reduced by 10 %, in addition to a number of measures aimed at decreasing the size of the government administration through such policies as contracting out some activities and the introduction of early retirement schemes.

#### 4.6 : Diversification Strategies :

Diversification is the magic word that has continued to have a substantial impact on the history and future of Bahrain. Diversification in the economy is a conscious and continuous process, but in a small economy like Bahrain it is more than that. It is also a dynamic process in a rapidly changing world. Through history, Bahrain has been battling with the diversification question. The recent structural diversification was in the 1930s, when Bahrain's pearling industry collapsed due to reasons explained earlier in this chapter. Although the structural diversification was painful and had a damaging effect on a large number of business activities, the discovery and development of the oil industry made up the difference and facilitated the transition period. However, the most challenging structural diversification that Bahrain has been forced to adopt is in the replacement of the oil industry.

The government of Bahrain was quite aware of this challenge. In respect of the recent modern economy of Bahrain, we may classify the evaluation of the diversification policies into four distinguished periods. Firstly, in the early

sixties, the Finance Department of the Bahrain government was responsible for economic diversification as well as financial and fiscal responsibilities. In 1966 the department, which was headed by His Excellency, Shaikh Khalifah Bin Sulman Al Khalifa, launched the most critical study on the future growth of Bahrain's economy. The study was conducted in co-operation with the Bahrain Petroleum Company Limited ( BAPCO ) and the California Texas Oil Corporation ( CALTEX ). The aim of the study was to find solutions for the immediate and future problems facing Bahrain. Such problems, as expressed by the Bahraini officials, were the rapid growth in population with little prospects for employment, the trend toward reduction in refinery throughput, and the levelling off of oil revenues ( Bahrain : Economic Development Study, 1967 ).

Following this, the Finance Department took important steps in making official the central role of diversification in Bahrain's government functions. The first official attempt was the establishment of a Development Bureau in May, 1967, as an office attached to the finance department. The objective of the bureau was to encourage economic development with special emphasis on industrial development and hence diversify the economic base of the country. Its primary function was to create employment opportunities by encouraging investment to help in stimulating the economy. Its first activities were concerned with the production of a booklet outlining the advantages of Bahrain to foreign investors and with reviewing both natural resources and manpower availability ( The Bahrain Government Annual Reports, 1967 ).

The second step was the establishment of the Bahrain Statistical Bureau in October, 1967. The Bureau was made responsible for the collection, collation and publication of statistical data required to provide, inter alia, the necessary factual basis for sound planning and decision-making ( The Bahrain

Government Annual Reports, 1967 ). The setting-up of the Physical planning Unit in August, 1968 was a similar concrete step in the diversification of direct economic development. The unit responsible for the preparation of overall planning schemes, both town and rural, for the whole country and for the detailed planning of specific areas ( The Bahrain Government Reports, 1968 ).

The establishment of the Development Bureau and the Statistical Bureau can be considered to be the early realisation of the importance of diversification policies for the Bahrain economy. The Development Bureau played a critical role in initiating important manufacturing and services projects to diversify and expand the economic base. In the industrial sector, the Bureau contributed closely in the establishment of the Aluminium Smelting Company, Aluminium Bahrain ( ALBA ), which was inaugurated in 1968. The planned production of the smelter was raised from 55 thousand tons a year to 90 thousand tons a year through the addition of a third pot line. Capitalisation in consequence was been increased from B.D 32 million to about B.D 42 million. Several projects were also examined for the introduction of subsidiary industries around the aluminium smelter ( The Bahrain Government Reports, 1969 ). The smelter was to provide important opportunities for employment as well as an important source of foreign exchange. In the services sector, the Development Bureau facilitated the establishment of the Earth Station, working through an Instelsat 111 Satellite, which enabled communication with all other earth stations in the satellite's line of flight. The Earth Station provided all types of telecommunication services including telephony, telegraphy, telex, data transmission and, if required, television ( The Bahrain Government Reports, 1968 ). Since then, diversification policies have gathered momentum and the Bahrain economy has witnessed a huge inflow of new manufacturing and services projects, for

example the establishment of Bahrain Flour Milling Company, Bahrain Insurance Company, Arab Ship Repairing Company and etc.

The financial sector also made substantial progress where there were eight banks of varied nationality. In 1965 the total assets of the banks were B.D 33 million and by 1969 they had increased to B.D 50 million. In the same period deposits rose from B.D 26 million to B.D 40 million ( The Bahrain Government Reports, 1969 ). The private sector took up the new investment opportunities, utilising government incentives to invest in manufacturing and services sectors. The Commercial Registry Office issued 337 permits, of which 304 new permits were in 1970 compared with 264 new permits in 1969 ( The Bahrain Government Reports, 1970 ). The major investments of the private sector went into service sector activities, such as hotels and restaurants, transport and a wide range of personal services, while in the manufacturing sector, private investment went into small and medium industries, such as paints manufacturing, food and food related processing industries.

In the seventies, after independence in 1971, Bahrain reorganised the whole public sector management administration. In January, 1970 the Amiri decree No 1 ordered that a State Council be established and replaced the Administration Council which had been in office since 1956. The new council became the Cabinet for the new State of Bahrain after independence in August, 1971. The Finance Department was renamed Finance and National Economy Department with more responsibilities to include, besides financial affairs, housing, customs, port and post office ( Bahrain Government Reports, 1970 ). Then the department was subsequently renamed Ministry of Finance and National Economy in 1973 with more specific responsibilities including government budgeting and economic planning. With the increase in

international oil prices in 1973, the Bahrain Government requested the Ford Foundation to provide advisory services to the Government. The services were to assist the government of Bahrain in projecting revenue and expenditure and to suggest appropriate policies and programmes to meet the fiscal requirement of national economic development ( Ford foundation, 1975 ).

Another important step to facilitate the diversification of the Bahrain economy was taken by the Ministry of Finance and National Economy to convert the state budget base from annual to biannual in 1978 ( GCC, 1992 ).

Thirdly, in the eighties, Bahrain witnessed three important events related to the diversification policies. The first was the establishment of the long-term programming in 1980, when the Cabinet approved a proposal put forward by the Ministry of Finance and National Economy to prepare an economic and social development programme for the period 1982-1985 ( Ministry Of Finance And National Economy, 1980 ). The main objectives of the programme were to expand and diversify the economic base, improve the quality of the social services such as health, education and housing, reduce dependence on imports, and rationalise consumption by encouraging saving and investment. The Ministry took the lead in preparing the development programme by establishing a technical directorate named Planning and Economic Affairs ( PEA ). Planning and Economic Affairs directorate conducted intensive research and identified the economic and financial requirements after classifying the government Ministries into four economic sectors. These sectors were the Infrastructure, Economic, Social and Administration sectors.

The Planning and Economic Affairs directorate divided the work among various sections such as planning and evaluation and established a joint committee with the other ministries. The programme concentrated only on capital government expenditures, i.e. investment projects. The total costs for the four-year economic and social development programme was B.D 1.2 million for the period 1982-1985 ( Economic And Social Development Programme, 1982 ). The development programme had however a short term life. Just one year into its operation, the government revised the programme and expanded it to cover six years, up to 1987. This was due to the decline in government revenue as a result of the decline in international oil prices in 1983.

A further reorganisation of the Ministry of Finance and National Economy established a major second division named Economic Affairs in 1983. This step was taken to give more emphasis to the role of the Ministry in the economy. The Economic Affairs division consisted of three directorates, Evaluation and Economic Research, Economic Relations and Investment (Amiri Decree, 1983 ). The third one was the establishment of indicative planning 1985, by the setting up of the Strategic Choices Committee ( Ministry Of Finance And National Economy, 1985). The committee was chaired by the Ministry of Finance and National Economy ( The Under Secretary ) and representatives from key ministries, such as the Ministry of Development and Industry, the Ministry of Commerce and Agriculture, the Ministry of Education, the Ministry of Labour and Social Affairs and Bahrain Monetary Funds. The directorate of Evaluation and Economic Research was given the responsibility as a technical body for the committee. The objective of the committee was to study the economic alternatives facing the Bahrain economy and to form a long-term strategy up to the year 2010.

The Strategic Choices Committee ( SCC ) worked on the technical and analytical studies by establishing specialised subcommittees jointly with top government and private sector experts. The subcommittees were Population and Labour Force, Industry and Trade, Public Finance and Infrastructure, and Financial Services and Services committee. The SCC produced its final report in April, 1986, highlighting the advantages and disadvantages within the Bahrain economy, setting up objectives for each sector and the action plans to achieve these objectives by public and private sectors ( Ministry Of Finance And National Economy, 1986 ). The work of the SCC was pioneering not only in Bahrain but also in the Gulf area. The major shortcoming however was the failure to recognise the importance of establishing follow-up mechanisms. In the nineties, SCC was revived under a new name, the Development Strategy Committee( DSC ), after the end of the Gulf War in 1991 ( Ministry Of Finance And National Economy, 1991 ).

The objectives of the DSC were the same as the SCC. The work of the DSC relied mainly on the technical staffs of the Ministries, especially from the Ministry of Finance and National Economy and a specialised consultant firm to study specific sectors. The committee conducted a large number of studies covering the economic sectors and other related issues, such as labour law, commercial law, competitiveness, and the promotion of Bahrain. The committee also set up informal mechanisms to follow up the recommendations of its report ( Ministry Of Finance And National Economy, 1993).

#### 4.7 : Conclusion :

As has been argued, historically, Bahrain has been the focal location for trade and services in the Gulf region . The early discovery of and hence an

increased in the government revenues enabled Bahrain to develop a well established infrastructure ( physical, human and soft ) . However, the decline in the oil prices has introduced structural changes in the economy . Manufacturing sector and services sector have increased their contribution on the expense of the mining sector . Beside, the role of the government in the economy has been changing over the time, from provider to facilitator .

The government has increased its' effort to diversify the economy away from oil based since 1967 . The successful industrial strategy of the sixties was very expansive . The decline of the revenues in eighties has raised the debate highlighted in the introduction . As step forward to early conclusion of that debate, chapter five will set a comparison between industrial sector and services sector development .

**Table (4.1) : Economic Growth 1976-90**

(Per Cent)

Years	Current			Constant		
	Non-Oil	Oil	Total	Non-oil	Oil	Total
1976	51.2	28.5	43.9	38.3	37.8	38.1
1977	28.4	19.4	25.9	10.5	14.4	11.9
1978	13.3	7.9	11.8	7.3	2.0	5.3
1979	18.1	15.6	17.5	9.6	(4.8)	4.2
1980	13.3	71.9	28.4	4.5	2.0	3.6
1981	14.9	6.8	12.1	(1.4)	(13.5)	(5.4)
1982	10.8	(6.9)	5.0	12.7	(37.3)	(2.6)
1983	12.1	(13.2)	4.8	12.5	2.4	10.5
1984	4.4	1.6	3.7	1.3	12.0	3.2
1985	(12.6)	(42.1)	(6.7)	(3.4)	(0.6)	(2.8)
1986	(3.7)	(2.6)	(14.6)	1.7	6.1	2.6
1987	0.7	(13.0)	0	3.6	(12.5)	0.2
1988	14.0	20.7	8.9	13.1	0.7	10.9
1989	5.1	38.0	7.4	0.8	2.8	1.2
1990	3.0	(8.5)	5.4	0.8	3.9	1.3
1991	9.9	(9.8)	5.9	(5.8)	(1.9)	4.6

Source : National Accounts, MoFNE, 1977 - 1992

**Table ( 4.2 ) : Annual Average Sectoral Growth Rates**

(Per Cent)

<i>GDP Period</i>	<i>Current Prices</i>			<i>Constant Prices</i>		
	<i>76-80</i>	<i>81-85</i>	<i>86-91</i>	<i>76-80</i>	<i>81-85</i>	<i>86-91</i>
<i>Agriculture</i>	22.7	7.7	(2.5)	5.3	3.4	(0.3)
<i>Mining</i>	28.5	0.2	(0.0)	10.2	(7.4)	0.1
<i>Manufacturing</i>	25.2	(4.9)	13.0	10.4	3.2	4.1
<i>Electricity &amp; Water</i>	64.2	16.6	3.2	37.7	10.5	4.9
<i>Construction</i>	40.0	11.8	(6.0)	30.1	10.1	(0.4)
<i>Trade &amp; Hotel</i>	24.9	(1.4)	4.6	16.2	(1.0)	5.8
<i>Transport</i>	31.0	11.3	(3.1)	29.0	2.7	(3.5)
<i>Finance &amp; Real Est.</i>	41.9	16.4	(2.5)	28.1	25.6	(3.8)
<i>Services</i>	21.5	9.8	5.0	8.6	7.1	8.6
<i>Public Admin</i>	33.3	13.4	4.3	11.2	6.1	6.4

<i>GDP</i>	25.5	3.8	2.1	12.6	0.6	4.2
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*Source : National Accounts, MoFNE, 1977 - 1992*

**Table (4.3) : Sectoral Contribution***(Per Cent)*

<b>GDP Period</b>	<b>Current Prices</b>			<b>Constant Prices</b>		
	<b>76-80</b>	<b>81-85</b>	<b>86-91</b>	<b>76-80</b>	<b>81-85</b>	<b>86-91</b>
<i>Agriculture</i>	1.1	1.1	1.2	1.2	1.3	1.2
<i>Mining</i>	29.1	27.8	18.4	36.0	21.8	18.0
<i>Manufacturing</i>	14.3	12.3	16.4	13.5	16.4	17.7
<i>Electricity &amp; Water</i>	0.6	1.5	1.8	0.9	1.7	1.7
<i>Construction</i>	11.4	9.5	7.1	5.9	6.2	6.3
<i>Trade &amp; Hotel</i>	13.2	10.5	9.8	10.7	12.4	9.9
<i>Transport</i>	8.2	11.6	11.2	10.5	13.5	10.7
<i>Finance &amp; Real Est.</i>	13.2	25.1	20.9	10.3	24.7	23.5
<i>Services</i>	3.9	3.7	5.2	8.3	7.1	8.6
<i>Public Admin</i>	11.6	14.8	21.8	13.6	16.9	21.6

<i>GDP</i>	100	100	100	100	100	100
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*Source : National Accounts, MoFNE, 1977 - 1992*

Table (4.4) : Average Revenue And Expenditure By Sectors

(Thousand B.D.)

Items	1930-1939	1940-1949	1950-1959	1960-1969	1970-1979	1980-1989	1990-1994
1. Revenue	205.2	685.7	5150.7	9642.4	130,802.2	475,556.	536,960
1.1 Oil Revenue	112.1	337.9	3719.7	6718.4	95,211.9	313,322.	339,000
1.2 Non-oil Revenue	93.1	347.8	1,430.4	2,978.0	431590.3	162,234.	197,960
2. Expenditure	160.7	494.0	3,783.7	9,199.0	128,667.7	459,556.	646,774
2.1 Recurrent	144.7	415.2	2,850.9	7,587.2	67,225.9	278,983.	498,859
2.2 Non-Recurrent	16.0	78.8	878.4	1,611.7	61,441.8	150,572.	147,914
3. Budget Balance	44.5	191.7	1,367.0	443.4	2,135	(15,999.5)	(1,184)
4. Infrastructur	25.5	112.1	790.3	2,550.7	60,772.0	177,263.	155.2
4.1 Recurrent	11.6	31.3	262.6	1,209.7	14,428.6	62,468.	80.4
4.2 Non-Recurrent	13.9	80.8	527.7	1,341.0	46,343.4	114,795.	75.1
5. Public Admin.	27.7	95.3	496.0	1,765.4	21,344.9	121,552.	109.4
5.1 Recurrent	28.3	93.7	457.1	1,722.2	18,745.5	108,374.	103.4
5.2 Non-Recurrent	1.4	1.6	39.9	43.2	2,599.4	13,178.	6.1
6. Social Services	14.4	116.1	1,203.7	4,346.5	26,811.8	110,652.	153.5
6.1 Recurrent	13.7	101.5	893.3	4,126.2	30,314.6	98,096.	139.2
6.2 Non-Recurrent	0.7	14.6	309.4	220.3	6,140.8	12,556.	14.3
7. Economic Serv.	0.9	4.7	57.2	179.6	4,546.9	18,901.	20.2
7.1 Recurrent	0.9	4.7	55.4	172.4	1,908.9	8,857.9	12.7
7.2 Non-Recurrent	0.0	0.0	1.8	7.2	2,638.0	10,043.	7.5
8. Transfers & Others	90.1	184.0	1,182.3	356.9	7,963.7	31,186.	46.1

Source : Ministry of Finance & National Economy 1991

B.D 1 = US\$ 2.65

**Table (4.5) : Bahrain Oil Production 1933 - 1992***(000. US. Barrels)*

<b>Year</b>	<b>Production</b>	<b>Year</b>	<b>Production</b>	<b>Year</b>	<b>Production</b>
1933	31,000	1953	10,978,351	1973	24,948,000
1934	285,072	1954	10,994,754	1974	24,597,000
1935	1,364,807	1955	9,196,527	1975	22,309,000
1936	4,644,635	1956	11,013,702	1976	21,231,000
1937	7,762,264	1957	11,691,462	1977	21,236,000
1938	8,297,997	1958	14,873,111	1978	20,192,000
1939	7,588,544	1959	16,473,378	1979	18,741,000
1940	7,074,065	1960	16,500,424	1980	17,653,000
1941	6,794,110	1961	16,444,492	1981	16,862,000
1942	6,241,135	1962	19,445,932	1982	16,068,000
1943	6,571,825	1963	16,502,868	1983	15,273,000
1944	6,710,810	1964	17,999,821	1984	15,289,000
1945	7,309,125	1965	20,787,617	1985	15,301,000
1946	8,009,925	1966	22,520,831	1986	15,484,000
1947	9,410,710	1967	25,370,007	1987	15,369,000
1948	10,914,905	1968	27,597,728	1988	15,675,000
1949	10,985,484	1969	27,973,000	1989	15,585,000
1950	11,015,711	1970	27,973,000	1990	15,357,000
1951	10,994,344	1971	27,347,000	1991	15,373,000
1952	11,004,278	1972	25,508,000	1992	15,123,000

**Source :****B.D 1 = US\$ 2.65**

1- AL-Kawar, A, 1978

2- IMF, 1993

3- Ministry of Development &amp; Industry, 1980

**Table (4.6) : Total Revenue, 1930 - 1994**

(Thousand B.D.)

<i>Year</i>	<i>Revenue</i>	<i>Year</i>	<i>Revenue</i>	<i>Year</i>	<i>Revenue</i>
1930	82	1952	3,206	1974	123,749
1931	80	1953	2,152	1975	135,000
1932	68	1954	6,670	1976	191,326
1933	73	1955	5,903	1977	260,636
1934	77	1956	7,037	1978	273,946
1935	134	1957	7,238	1979	304,186
1936	165	1958	7,839	1980	445,770
1937	434	1959	7,246	1981	436,625
1938	481	1960	7,669	1982	554,785
1939	458	1961	7,222	1983	484,097
1940	490	1962	7,500	1984	511,460
1941	444	1963	7,629	1985	531,433
1942	398	1964	8,286	1986	424,913
1943	547	1965	8,468	1987	427,158
1944	551	1966	11,352	1988	401,293
1945	640	1967	12,399	1989	438,031
1946	667	1968	11,970	1990	432,042
1947	868	1969	13,929	1991	472,000
1948	1,033	1970	14,486	1992	498,000
1949	1,219	1971	22,304	1993	580,000
1950	1,700	1972	24,374	1994	597,841
1951	2,516	1973	38,015		

**Source :**

**B.D 1 = US\$ 2.65**

**1 - MOFNE, 1991.**

**2 - MOFNE, State Budget, 1992 - 1994.**

**Table (4.7) : Total Expenditure, 1930 - 1994**

(Thousand B.D.)

<i>Year</i>	<i>Expenditure</i>	<i>Year</i>	<i>Expenditure</i>	<i>Year</i>	<i>Expenditure</i>
1930	104	1952	2,063	1974	77,856
1931	89	1953	2,487	1975	121,768
1932	78	1954	3,654	1976	201,735
1933	73	1955	4,022	1977	256,309
1934	80	1956	5,422	1978	282,078
1935	101	1957	6,024	1979	250,087
1936	144	1958	6,513	1980	308,133
1937	259	1959	4,283	1981	374,706
1938	311	1960	5,364	1982	453,832
1939	368	1961	5,556	1983	517,875
1940	292	1962	7,350	1984	527,576
1941	316	1963	6,920	1985	508,548
1942	402	1964	7,191	1986	473,424
1943	333	1965	9,583	1987	456,905
1944	331	1966	10,702	1988	478,607
1945	383	1967	12,105	1989	495,962
1946	500	1968	13,031	1990	562,038
1947	678	1969	14,188	1991	600,127
1948	755	1970	18,284	1992	646,155
1949	950	1971	22,583	1993	666,642
1950	1,261	1972	23,228	1994	674,170
1951	1,564	1973	32,752		

**Source :**

**B.D 1 = US\$ 2.65**

**1 - MOFNE, 1991.**

**2 - MOFNE, State Budget, 1992 - 1994.**

## Chapter Five

### The Service Sector

## Chapter Five

### The Service Sector

#### 5.1: Introduction

#### 5.2: Strength and weakness of the Bahrain Economy

#### 5.3: Comparison between Industrial and Service Sectors

#### 5.4: The Prospect of Services Sectors

#### 5.5: The Financial Services Sector

#### 5.6: The Prospect of Financial Services Sector

#### 5.7: Conclusion

## 5.1: Introduction:

Having highlighted economic development, the aim of Chapter Five is to identify the economic sector that has the best potential to stimulate the economic development of Bahrain. It reviews the Bahrain economy in terms of the three major sectors, primary, industrial and service sectors and analyses the strength and weakness of each of the sectors to identify its future potential.

The chapter then undertakes a comparison between the industrial and service sectors to highlight in detail the existing weakness and strength. It gives a general view of historical and recent economic development of the industrial sector and services sector. It also highlights the development of these two sectors in relation to the primary sector, which in the past played the role of the leading sector in the economy.

The industrial sector and services sectors had and have an important role to play in the economic and social development of Bahrain. Both sectors have the potential to take over the role of the primary sector in the economic and social development in Bahrain, although it may be noted that the development of the industrial sector has been closely associated with the development of the primary sector, especially in oil production.

As mentioned in Chapter Four, in the mid-sixties when oil production started to level off, the Government started to adopt an industrial strategy to diversify the economy. Therefore a huge investment and an administrative effort went into the development of the industrial sector. As a result the industrial sector expanded and new manufacturing activities were established. At the same time

the services sector developed and new activities were established, especially in transportation, communication and banking and finance.

The chapter highlights in more detail the role of the services sector emphasising the future role of the financial services sector. The chapter utilises and draws heavily on the detailed data and information about value added, total value of inputs, total value of output, total labour force and other major economic indicators in all sectors.

## 5.2: Strength and weakness of the Bahrain Economy.

The structure of the economy changed significantly between 1976 and 1991. It was particularly so in regard to the services sector. The services sector grew rapidly during the period and increased its contribution to the economy in real terms from 45.5% in 1976 to 70.5 % in 1991. The primary sector on the other hand declined and its contribution fell from 38.9% in 1976 to 17.3% in 1991. The industrial sector also grew, but moderately resulting in its contribution to the economy rising from 20.6% in 1976 to 24.75 in 1991. The different growth rates reveal the underlying strengths and weaknesses of the economy. Table (5.1) and (5.2) in the appendix show the growth and the changing structure of these three sectors at constant and current prices.

### Primary Sector:

The decline in the primary sector reflects the nature of resource endowments in the small island economy with its limited resources. Agricultural activity is necessarily small constrained by the availability of land, and water. The desert climate is not conducive to agriculture, although the date palm cultivation was

predominant in the period of the traditional economy. Date palm is a cash crop, but expansion of cultivation is restricted by the availability of the cultivable area in the country. Growth of vegetable and other crops are limited by the availability of water. The increasing salinity of the aquifer (main natural source of fresh water) through a combination of excessive use and reduced inflow, has reduced the availability of cheap water for agricultural purposes. The prohibitive cost of desalinated water has precluded this from being used for agricultural purposes in Bahrain. These limitations have imposed a limit to agricultural expansion.

As Bahrain is surrounded by water, the natural activity throughout its history has been fishing. Artisan fishing has been an activity widely practised, although the establishment of the refinery drew those artisans away from fishing into industry. The constraint within the sector is the limited stock of fish in the sea surrounding the island. Future expansion of fisheries is thus limited. Agriculture's contribution has remained 1% in real terms over the years.

Future potential therefore depends on the application of new technology in fish breeding, and culture. However the high cost and the high investment needs have not encouraged its expansion. Due to these limitations, the growth of agriculture and fisheries must necessarily be limited. The potential for backward and forward linkages with the other sectors is thus limited.

The rise of the artificial pearl industry in the world, particularly in Japan, further restricted the growth of the primary sector, as natural pearls were competed out in terms of price, and Bahrain lost one source of its profitable external trade. With it, Bahrain also lost its leading sector, of the traditional economy. In spite of active promotion and support from the highest levels, the

prospect for the revival of the pearl industry remains low. Even though imports of artificial pearls are not allowed into the country in order to protect the small trade in natural pearls, principally to tourists, development in this sector remains limited.

The main thrust of growth of the primary sector thus depended on the production of crude oil. The growth in crude oil production has been one of the principal developments of the modern era, and a source of strength to the economy. However, like agriculture it has its limitations. Currently output from the on-shore field is declining and has reduced from around 55,000 bbls a day in 1971 to 38,000 bbls a day in 1991. As a result, its contribution to the economy in real terms has declined to 5% in 1991 from 20.1% in 1976 in real terms. Current indications are that reserves will not last for more than ten to fifteen years.

The strength of the primary sector therefore depends on the off shore oil field, Bahrain's share of which had increased to 100,000 bbls per day in 1991 from 40,000 bbls per day in 1976. This is the principal growth of the primary sector and contributed 8.1 % to the economy in 1991.

The primary sector also includes the natural gas production, which is utilised for production of energy for industrial and domestic use, and to a lesser extent as raw material for LNG production for export. The modest growth in output of natural gas however is a result of limited availability rather than its limited use. Production in 1991 was 288 trillion cubic feet, or 790 million cubic feet per day. Because of limited availability production cannot go beyond 1,100 million cubic feet per day, expected to be reached within the next decade assuming the current rate of growth is maintained. There is therefore no scope for industries

based on gas as raw material, unless Bahrain taps into the regional gas distribution network in the future. Until then increase in gas use has been reserved for utilities (electricity) production.

The growth of the primary sector within the constraints may be determined by the deterioration in the contribution of agricultural and mining and quarrying sectors which have fallen from 1.59% in 1976 to 1.0% in 1991 and from 39.4% in 1976 to 17.25% in 1991 respectively.

Bahrain's entire crude production (avg. 40,000 bbls. in 1991) is refined commingled with imported Saudi crude (Avg. 210,000 bbls. in 1991) contributing significantly to industrial production. Similarly gas is also used in the refinery, production of primary aluminium, and in the production of LNG. These products form the main export products of the country contributing 80% of the exports of the country. Sale of crude oil and gas also contributes 60% of the revenue of the Government.

While the physical limitations restricted growth in real terms, the wide fluctuation in the price of oil in the world market accounted for its fluctuation in its contribution, which transmitted itself throughout the economy. Thus its contribution to the economy was high during the high oil prices and had a favourable impact on the economy. The fluctuation in the price has led to the instability in the economy and to a significant fall in the revenue of the government.

The sector provided employment to 7,979 people or 4.1 % of the total employed.

The constraints in the primary sector have limited potential for backward or forward linkages in the long term. Nevertheless, crude oil production, particularly from the offshore field, remains one of most important contributors to the economy, to its exports, and to government revenue.

The prospects are for the primary sector to decline in the future, both in real and nominal terms. Apart from the decline in real output, the primary sector has shown the extent of its dependency, on the world economy and its limited influence on diversification of the economy. First, it was the pearl industry. Bahrain's income almost totally depended on the export of pearls. International competition in the form of artificial pearls shattered the industry to the extent that it has been reduced to less than a cottage industry. Similarly, oil has to face the effects of the fluctuating price of oil. High oil prices oil boost economic growth, and raise government revenue. Low oil prices however, not only slow growth, but also bring budget deficits and a painful adjustment process.

The primary sector thus reveals the character of a small island economy, with limited resources, and dependent on the effects of the fluctuating international price of hydrocarbons.

#### **Industrial Sector:**

The industrial sector is dominated by large industries, particularly in oil refining, production of primary aluminium and petrochemicals, and

construction. Manufacturing industry contributed 17.1% to the economy in real terms as against the total contribution of the industrial sector of 24.7 % in 1991, indicating the dominance of these large industries in the sector. These industries, oil refining, aluminium production and petrochemicals including LNG production contributed approximately 11% to the economy in real terms in 1991. Construction which reflects the rapid development in infrastructure of the country contributed 6.89 % in real terms in 1991, a level which has been maintained throughout the period.

Bahrain's domestic market is small. It is insufficient to establish a domestic industrial base. To be viable, the industries must necessarily be exported oriented. Opportunities however, exist in the nearby large markets of Saudi Arabia and other GCC countries, Arab countries and in the international market.

In the thirties, when the refinery was established, regional demand was low and internal demand non-existent. Hence Caltex established the refinery to serve the international market particularly in Asia and Africa. This was the backdrop to develop industries in Bahrain. When later other industries were established, Bahrain, given the size of the domestic market similarly, sought to establish large industries with a view to exports. Aluminium, steel and petrochemicals production thus depend heavily on the export market, and its price fluctuates in accordance with the international market. Bahrain thus had to depend on the external market for its industrial development, just as it had to depend on the external market in the primary sector.

Historically refining crude oil had taken a predominant place in industrial production in Bahrain. The large capacity 250,000 bbls per day refinery (75 m

bbls per annum) established in 1936 principally caters to the export market. The local consumption of around 3.2 million bbls per annum even in 1991 was very small. The capacity is also in excess of the Bahrain's crude production, and has therefore to depend on imports of crude oil to profitably operate the refinery. It is thus an export earner as well as an importer of raw materials. The establishment of the refinery provided the main source of economic growth when Bahrain's leading sector, pearl fisheries, declined. The refinery, at first fully owned by Caltex, represented the first large-scale foreign investment in the country. It also represented the arrival of foreign technical know how as well as new managerial techniques to the country.

Historically also, the refinery was the main source of employment. It was also the training ground for skills, both technical and management. Indeed, management cadres in the government during the seventies and eighties were derived from the refinery.

Backward and forward linkages were not so prominent although the refinery depended on the crude production of Bahrain, which formed 16% of the total. The linkages soon started with the trade sector responding to the needs of the refinery, which later grew as the refinery started contracting out its services. In 1981 Bahrain purchased 60% of the shares of Bapco field operations, and assumed full ownership of the oil fields increasing government participation in the oil industry. Royalty payments, and tax payment by Caltex at first, and the income directly from the refinery later, added an important dimension to the receipt of government revenue.

The establishment of the refinery also provided an alternative source of employment, away from the declining pearl industry. It helped to attract the

artisan fisherman to take to regular work in an industrial undertaking. It also provided the training ground for the development of managerial skills among Bahrainis, which later helped the government establish organisations adopting modern management methods and techniques, using the manpower from the Oil Company. The link with the multi-national company thus helped to receive managerial know how, and spread this know how within the country.

The refinery also helped provide the economic infrastructure of the country, which became the base for development as the economy took off following the oil price boom. The refinery developed the social infrastructure, at first catering to the company employees, but later extended to the rest of the country. The establishment of the refinery thus had a ripple effect on the economy.

The establishment of the Aluminium smelter in the late sixties was the principal development after the establishment of the refinery. Based on the utilisation of cheap energy gas, it was also dependent on hydrocarbon, and the principal raw material alumina was imported. The capacity was again based on the needs of the world market, with the output initially exported principally to Japan. Currently the capacity of the smelter is 460,000 tons per year, among the largest in the world. This was also another industrial plant based on foreign investment set up by the private sector initially and later bought over by the government over a period of time.

As natural gas was rich in propane, butane and naphtha, it was extracted and converted into NGL before it was fed to the aluminium smelter as lean gas. It ensured the setting up of another industry based on hydrocarbons. The production of LNG thus became another export-oriented project.

The output of primary aluminium later became the input to several downstream industries, such as the rolling mill, aluminium extrusion, aluminium metal industries, aluminium cables, aluminium powder etc. Currently these downstream industries use about one third of the output of the expanded primary aluminium production facility.

The further development of the industrial sector was based on the utilisation of natural gas. Thus the petrochemical plant established (1986) a joint venture of the countries of the Gulf Co-operation Council, produces ammonia (1000 tons per day), and methanol (1000 tons per day) for export. Currently, the plant is being expanded to produce urea, using the ammonia produced in the plant. The output is to be exported. This plant was set up based on foreign technical and managerial agreements, and marketing agreements for the sale of products.

These industries therefore provided the scope for establishment of large industries based on the materials partly available in Bahrain, on the basis of exporting the entire output. It benefited from the foreign investment as well as foreign technical and managerial know how.

Like the primary sector these large industries also faced highly volatile price fluctuations, which contributed to the cyclical nature of its growth in current terms. Refined oil products prices were based on the international price of crude oil. So was the price of LNG. Petrochemicals, (ammonia, and methanol) prices though not entirely dependent on oil prices, were nevertheless influenced by the price of oil. Aluminium prices were also linked to the industrial output of the world, and prices have revealed a six to eleven year cycle of price movement.

The price movements have significantly affected the economy in nominal terms. While the high prices have contributed to the increasing contribution of the industrial sector, the decline in prices has forced the economy down and contributed to the cyclical nature of the growth of the economy. The contribution of the industrial sector fluctuated in response to these price movements. It declined from 27% in 1976 to 23.8% in 1991.

The industries in the industrial sector are capital intensive in nature. Capital cost represents around US \$2 to 3 million per employee. Either Bahrain has established these industries through receipt of foreign investment, with the partnership of GCC countries or through large scale foreign borrowing. The payback period of these industries has also been long, in excess of 10 years, which meant that the government had to intervene and provide incentives and set up other support mechanism to assist the industries. Currently, these industries do not pay customs duty and benefit from the subsidised price of natural gas.

The high cost of industries has led to heavy involvement of the government. The refinery, aluminium smelter, manufacture of LNG, manufacture of petrochemicals, aluminium rolling mill, ship repairing yard, and manufacture of aluminium powder has been established with government investment. These industries contributed 12.9 % to the economy in real terms in 1991.

The only large industrial undertaking established which is not linked to the hydrocarbon sector directly was the shipbuilding yard (ASRY) set as a joint venture among Arab partners. However, it is related indirectly as this industry caters mainly to the tanker traffic within the Gulf. It has had to go through a

long period of financial difficulty. In 1991 ASRY contributed 0.9% to the economy in real terms.

The iron and steel plant established in 1986 to produce sponge iron is another medium size industrial establishment based on import of scrap iron, and other raw materials, and dependent on the regional market for its product. The plant with a capacity of 190000 tons has had financial difficulties from inception, but has managed to regroup through investment by regional investors, who have linked the markets of these countries for the sale of the output including changing sponge iron into pellets production.

The industrial sector has been a training ground for Bahrainis. The industries set up with help of foreign know how have been able to increase the percentage of Bahraini staff both in the technical and managerial categories. More and more of these now have Bahraini technical managers. In most of the large industries, Bahraini staff now comprises in excess of 80%. Increasing know how in these areas will also help to accelerate industrialisation in the future.

The industrial sector also has several small industries, owned mainly by the private sector. These small industries contributed 5% to the economy. These are small establishments owned by the private sector, catering to the domestic demand and have been established with minimum foreign technical know how, although some of them like the Coca Cola and Pepsi plants involved foreign franchising arrangements. These industries therefore cater to local needs such as food processing, beverages, production of water, carpentry shops and production of simple building materials like building blocks etc.

The ready-made garment factories, which have been established comparatively recently, are a result of the introduction of quotas by the United States. These factories are based on the import of materials to be converted into garments. Although currently a large number of expatriate labours are employed in them, training of Bahraini labour will provide scope for employment of local labour in the future. However, the long-term viability depends on the quota system remaining in place. This is doubtful.

The industrial sector employed 62,541 people or 32.2% of the total employed. Manufacturing represented 22,050 or 35.2% of the total of the sector. Large industries employed 6191 or 31% of the manufacturing sector. The principal activity that provides employment is construction, which in 1991 provided employment to 35,152 persons or 56% of the total industrial sector employment. The industrial sector's contribution was however lower than the 38.4% it contributed in 1976.

As the industrial products are exported, the sector contributed significantly to the non-oil exports of the country. In 1991, manufactured goods formed 90 % of the total non-oil exports or 5.6% of all exports including oil.

The industrial sector is principally based on the use of hydrocarbon as a raw material or for energy. Future development therefore will require new sources of hydrocarbons. The sector is dominated by the large industries, in refining, and aluminium primary production, and petrochemicals. These industries have however led to downstream development. The refinery caters to the sulphur plant, while aluminium has provided scope for the rolling mill, extrusion plant, cable manufacturing plant, and aluminium powder plant. These plants have in turn provided downstream development to aluminium fabrication plants, and

the foil mill. The petrochemical plant is currently building a urea fertiliser plant, which will use the ammonia produced in the plant. A further development in hand is formaldehyde production.

#### Services Sector:

Unlike the industrial sector, the services sector is a high growth sector in Bahrain. Its contribution increased in real terms from 45.5% in 1976 to 70.55 % in 1991. Employment in the sector similarly increased from 53,910 in 1976 to 123,969 in 1991, which represents 63.7% of the total employment in the country.

The main subsectors that comprise the services sector are given in table (4.2). As the table shows, the principal activities composing the services sector are Public Administration, Banking and Real estate, including domestic commercial banks and off-shore banks, Trade, Hotels and Restaurants, Communications, Airport and seaport (including Government transport) and Airline (Gulf Air).

Unlike the industries sector, the services sector is made up small units of production. The large-scale operations are restricted to communication, airline and banking.

The services sector expansion was dominated by the rapid rise of the banking and real estate sector. The establishment of Bahrain as an international offshore banking centre provided the necessary impetus for the growth of the sector. Based on providing financial services to the region, the off shore banking added the most significant link to the region. The banks collected the savings

of this high-income region and also serviced the needs of project investment particularly in Saudi Arabia. These banks are now in the process of providing merchant banking and investment banking services and have developed mutual funds as an addition to their traditional services on project financing.

Off shore banks perform services to the offshore market while the 18 domestic banks serve the needs of the domestic market. These banks have provided Bahrain with a link to sophisticated financial services. The addition of the Bahrain Stock exchange has provided the necessary institution to link the flow of equity and debt capital of the region through Bahrain. The Stock exchange is in the process of establishing links to other markets in the region.

The financial services have also the robust presence of the insurance brokers and reinsurance companies, which provide services to the region. While its contribution to the economy is modest at 1% in 1991, it has provided substantial complementary services in the financial sector.

The strength of the services sector was also provided by the Trade, Hotels and Restaurants, which in 1991 contributed 11% to the national economy. Bahrain's trade has been a traditional strength to the economy. It has been a trading base from ancient times, and has performed as a hub for the regions for a long time until recently when other regional centres developed. The large transit trade has been a significant part of the trading pattern of Bahrain. Until the rise of oil, trade provided the main source of income to the government, through customs duty. Even today, customs duty provides the largest income to the government's non-oil income.

Trade through re-exports to the region provides the greatest scope for trade development. If Bahrain can regain its customary hub services to the region once again, Bahrain can benefit enormously. However, in the presence of new competition, especially from Dubai, it has to reformulate its strategies of servicing the vast market of Saudi Arabia, and the Northern Gulf.

A further development in the sector was the rise of tourism. Bahrain has a free life style in contrast to the rest of the region. This is the attraction for arrivals from the other countries of the region. The opening of the causeway between Bahrain and Saudi Arabia has added to the attraction. Currently over one million visitors arrive in Bahrain over the causeway, which also links other countries of the region and has provided a base for the development of a healthy tourism sub sector.

The provision of communication services has also been a strength of Bahrain. The telecommunication services compare very well with the rest of the world, and have benefited from the changes in technology in recent times, ahead of the rest of the countries of the region. In addition to servicing the banking sector, the telecommunication sector provides excellent support to the services sector like tourism, trade and personnel services.

The Bahrain international airport was another of the provider of international services in the past. Bahrain airport was the hub for the region and provided a convenient stop for airlines going to and coming from the east. But its position has been challenged by the rise of Dubai. It has also to face the challenges of technological improvements in aircraft. Planes which are able to do long haul flying with a minimum of technical stops have obviated the need for stops in

places like Bahrain. In future plane arrivals will depend on the economic development of the region.

The operation of Gulf Air, the largest regional airline, from the Bahrain Airport added to the role as the hub airport in the region. As the headquarters of the airline was located in Bahrain, the utilisation of Bahrain airport for all its services has helped Bahrain to develop as a regional hub.

Provision of port services was another service that Bahrain operated as a hub, before other countries in the region built their own ports. Later it became useful to develop Industrial areas adjacent to the port. The industrial area located near the port has not only increased shipping services; it has also provided convenient locations for industrial activity whether it is warehousing or industrial activity. Bahrain has benefited immensely from the transit trade to the region before other competing ports developed.

The strength of the sector is the communication and the banking and real estate sectors. It has developed over the years, in response to the new opportunities in the region. The Finance and Real Estate sub-sector has grown from being 6.53% in 1976 to 21.4% in 1991 in real terms. In this development, Offshore banking services and investment banking services have played a great part. Transport and communications also grew from contributing 6.52% in 1976 to 10.39% in real terms, principally due to the development of Gulf Air and telecommunication services.

The services sector also includes the public administration sector, which has grown from contributing 16% to the economy in real terms in 1976 to 22.3% in 1991. The growth represents the growth in welfare services provided by the

government. Currently, the state provides health and education free of charge to its citizens. It has also initiated a drive to train its citizens to take over from the expatriates forming a significant proportion of the labour force. The government also has to maintain a large public security service.

Though Bahrain is a small market, its location surrounded by very large countries has provided the scope for the development of services related to the activities of the large neighbours. This is the strength that Bahrain has exploited over the years.

The sector does not earn foreign exchange as much as the other sectors, as principal foreign exchange earners in the sector are Gulf Air and off shore banks, and provision of tourism services. However, the potential for higher earnings is present if the services provided are targeted to non domestic services. The development of the hub concept is based on this principle.

The weakness in the sector is the rising competition in the region for its services. The new ports, airports, and new regional airlines have introduced competition. Technologically, the arrival of long haul aircraft has reduced the attraction of Bahrain, so is the building of mega ships which choose their stopping points based on whether a particular port is within the major routes traversed by the shipping lines. These are new challenges for Bahrain and its services sector.

Nevertheless this sector has provided scope for setting up small and medium scale enterprises, and provided employment opportunities for a large number of the indigenous populations. The increasing output of the sector over the years

in the face of new competition shows that this sector has adopted itself to face the challenge.

The services sector employs the largest number of workers. It increased from 77,553 in 1976 to 123,989 persons in 1991. It thus employs 63.7% of the total manpower of Bahrain. Table (5.3) shows the distribution of the labour force by major sectors.

### 5.3: Comparison between Industrial and the Services sectors.

Making a comparison between the industrial sector and services sector to determine development process is not common. Agricultural and industrial sectors are compared, as productive sectors to determine which should be given prominence in the developmental effort. The theories of balanced growth, or unbalanced growth are also analysed in the context of Industry vs. Agriculture.

The technological state of the economy is also analysed separating into the traditional sector and the modern sector, but still they do not separate the industrial and services sector for similar analysis.

The services sector is considered a sector which complements agriculture and industrial sectors, and its development is naturally linked to the development of the productive sectors. But as has been argued in Chapter One, countries, especially developed countries have started accounting the services sector as a productive sector generating wealth and hence contributing to economic and social development in the country. Later on, this trend has been followed by developing countries, particularly small island countries which are close to the

mainland, who have developed their economy based on servicing the needs of the mainland economies, not necessarily agricultural or industrial sectors. The globalisation process in the international economy has further enhanced such trends.

Bahrain, a small island economy located in close proximity to several large countries, provides an example of a rapid development of the services sector, at rates of growth in excess of the other two sectors. The rise of offshore centres which service other countries do not necessarily serve the industry or agriculture of the domestic economy. It rather focuses on servicing the flow of goods and services in the countries surrounding these centres.

If a service sector, which predominantly serves as servicing off shore centres is analysed it would show a certain imbalance in that the service sector exists not to fulfil the services requirement of the domestic industrial or agricultural base, but the service requirement of other economies, and is thus far in excess of the needs of the domestic economy. These service economies exist to service external flow of goods and services. These services may be financial services or any other.

The Bahrain economy shows this very clearly. The significant feature of the development of the economy of Bahrain during the years 1976 to 1991 was growth the services sector of the economy. The contribution of the services sector in real terms increased from 40.5% in 1976 to 70.5% in 1991, while the industries sector increased its contribution modestly from 20.8% in 1976 to 24.7 5 in 1991, while the primary sector declined from 38.9% to 17.3%. The basis of this growth was the development of offshore services.

Manufacturing, the largest contributor to the industries sector, contributed 15.8% to the economy against the total contribution of the industries sector of 20.8 % in 1976. In 1991, its contribution had increased modestly to 17.5% and the total industries sector to 24.7%. The two big industries refining, and production of primary aluminium further dominate manufacturing, both of which contributed 13.45 % to the economy and 64.5% of the industries sector. As the domestic economy is small, a large percentage of the output is exported (MOFNE, National Account For The State Of Bahrain, 1993).

The services sector on the other hand is not dominated by any one or two activities in such a manner and is more widespread. Thus the Finance and Real estate sector (21% contribution), Public administration (22%), Trade (11%), Transport and communication (10%) and personnel services (6%) share the sector's contribution. These services relate not only to servicing the domestic agricultural and industrial sector but an offshore market. This is especially so in the case of offshore Banking and Gulf Air (Gulf Airline), which together contributed 21.2% to the economy in real terms in 1993 which was the highest. Since then it has declined to 7.5%.

The two industries, refinery and aluminium production were set up before the oil price boom began in 1973. Significantly, the refinery was foreign owned while the aluminium factory was partially foreign owned. Both factories were set up by well-known multinationals in each of the fields. The refinery was set up by CALTEX a company owned by California Oil and Texaco, the well-known companies specialised in hydrocarbons; and a conglomerate, which included Kaiser Aluminium, another giant in the aluminium industry, set aluminium factory.

The principal reason for the setting up of these industries in Bahrain was its raw material resource endowment, principally the availability of crude oil and gas. The relatively free life style in Bahrain as compared to the rest of the region was also favoured by the western investors, as was the availability of a more developed infrastructure, like the airport, and communication facility.

The development of the services sector, particularly offshore banking, however was not based on any domestic resource endowment except Bahrain's location in close proximity to Saudi Arabia. Bahrain was also in the correct time zone between the east and the west. Thus the off shore banking developed because of the opportunities available the regional market. The sub sector was thus serving a market in excess of the needs of the domestic market, and depended on the off shore market just as large manufacturing units were also depending on the external market (BMA, 1992).

However, the off shore banking units did not have to depend on a dwindling resource base or on imported raw material. It fully depended on the service technology of satisfying the need for financial services in the region and elsewhere.

Similarly Gulf Air services were operated on the needs of the regional and international market, and in excess of the needs of the domestic market. Thus the servicing of these markets contributed substantially to the economy of Bahrain. It was again based on serving an external off shore market.

As is normal, agricultural and industrial sectors are analysed in terms of their linkages and the fact that they can be complementary. The agricultural income can provide a market for the industrial goods, and the industries can get

supplies from the agricultural sector. It is also usual to analyse the sectors in terms of productivity so that the development in one would not lead to loss in productivity in the other and affect the overall surplus in the economy.

Bahrain's Industrial sector is dominated by the large industries which are export based. It does not depend on domestic demand. Even though there are downstream industries based on the large industries, the output of these downstream industries is largely exported. Hence the small domestic economy cannot affect the economic profitability of the industries in any significant way.

The industries that serve the domestic economy are the small industries, which produce food, and beverages, metal workshops, carpentry workshops, garages and such other small industries. The total contribution of these industries to the economy in real terms was only 2% in 1991.

The services sector offshore services do not seek such complement and seek to get income, which can provide a market to the industrial and agricultural output. The development of tourism is also similar in that the market is externally dependent and does not depend on the material resources as do agriculture or industry, although tourism creates demand for food and beverages, etc. which have a high import content. This is particularly so in the case of international tourism, especially from the west.

Currently 60% of the income from tourism is currently estimated as imported food cost (Al-Mansoor, 1990). Yet there is the scope for supplies to be produced locally particularly for the requirement of regional visitors.

The Industrial sector is dependent on the resource base of the country to a large extent. Even during the later stages of its development, industrial plants set up were based on the use of gas. The LNG plant was based on extraction of methane, propane and naphtha from the natural gas before the tail gas was sent to the aluminium plant. The petrochemical plant, which produced ammonia and methanol was also based on utilisation of natural gas. These industries were set up in spite of Bahrain's dependence on the dwindling supply of natural gas to meet its energy requirement.

As Bahrain had limited reserves of natural gas, there was a limited potential for these large industries, although its importance in contributing to the export development of the country cannot be underestimated. As the gas extraction limit will be reached in the near future, these industries will require gas imports from within the region not only increasing the dependency of these industries, but also paying market prices for gas.

The dependency is high in both types of industries. The refinery is dependent on an increasing amount of crude oil imports to replace the declining crude production from the Bahrain field. Currently, the refinery gets only about 15% of its requirement of crude from Bahrain. Aluminium production is dependent on the import of alumina as its basic raw material, while the declining gas reserves makes it imperative that an alternative be found. These imported inputs will adversely affect the industries as the price of the material fluctuate in response to international trends. It could reduce the contribution of these industries in the future.

In order to maintain economic profitability these industries will either have to increase their productivity levels in the future, or seek the co-operation of the

countries of the region which have the raw materials, to operate these as joint ventures and supply raw materials and gas at concessionary rates.

The services sector on the other hand does not have such constraints. One of the principal activities of the services sector is off shore banking. By its nature off shore banks depend on the regional and international markets for financial services. But it can develop into a truly international off shore centre if the necessary linkages are made. The gulf region will continue to be an important region so long as the dependency of the world on oil remains. This region will therefore continue to be an important centre for finance. Off shore banking was set up to satisfy the need for financial services in the region which had seen per capita income rising dramatically since 1973. The governments of the region as well as individuals needed specialised financial services, not only to profitably invest their surpluses but also to provide financial services to the increasing off shore trade of the region as well as to service the needs of the various projects being set up in the region particularly in Saudi Arabia. As such the sector would not have to fear the decreasing raw materials or their increase in price. The sector however has to take into account the competition it would face from elsewhere in the region and outside it. Although the off shore banking has not faced competition yet there are possibilities of new centres like Lebanon or Dubai emerging in the future.

The services sector also benefited from the development of tourism, which increased its contribution in real terms from 1.4% in 1976 to 2.4% in 1994 as a result of arrivals increasing, particularly after the opening of the causeway to Saudi Arabia. The Saudi causeway brings around 2.2 million visitors to the island, which caters to the development of the hotels and other leisure

industries. This provides a potential for accelerated development in the future (Ministry Of Information, Bahrain Tourism Statistics, 1992).

The development of the services also had an impact on other services. One that had a very favourable impact was telecommunications. The financial services industry depends heavily on the availability of fast reliable communications. As such, the establishment of off shore banking increased the demand for such communication. Thus communications also grew rapidly in line with the development of the financial services industry. There was steady growth in the output of Bahrain Telecommunication Company (Batelco) in real terms from 1.22 % in 1975, to 3.95 in 1985 when it peaked. In 1991 telecommunications contributed 3.35 % to the economy in real terms.

In terms of growth, both manufacturing industries and off-shore banks have felt the external constraints. The refinery in current terms grew between 1973 and 1986, when the prices of oil increased in the world market, but declined steeply in line with world oil prices. Offshore banking was on the decline after 1985 when the effect of the decrease in oil prices was felt in the region in general. But since then the offshore banks have changed their products to cater to the changed situation emphasising on investment banking rather than project financing and setting up mutual funds. Thus the banks have shown their versatility in responding to a changed situation. It has features of long term durability.

The industrial sector has several downstream industries. The production of primary aluminium has induced the establishment of industries based on the use of primary aluminium. The manufacture of aluminium cables and aluminium powder are the earliest downstream industries that were established.

These industries were followed by aluminium extrusion plants, which further induced the establishment of aluminium products such as aluminium door frames, construction materials etc. The latest of the downstream industries is the Aluminium Rolling Mills Company, which manufactures aluminium sheets used in building and the transport industry. These downstream industries used approximately one third of the aluminium produced in the expanded factory.

The services sector also has similar linkages. The off shore banks contribute to the domestic economy through their contribution to real estate development, the use of communications facilities, and the income spent in Bahrain by the employees of the off shore banks. The operation of Gulf Air similarly contributes to the real estate sub sector as its employees in the head office are housed in Bahrain, as are the crew members.

The dominance of the two manufacturing units, the refinery and the aluminium production has never receded. Even by 1991, the contribution of these two industries had declined to 10.3%, as compared to the total contribution of 17.16% by manufacturing. Refinery capacity remained at the original 250,000 bbls per day, though it increased its production in excess of this up to 267,000 bbl per day, but the aluminium plant capacity was increased several times from its original capacity of 167,000 tons to the present 460,000 tons per annum (MOFNE, Economic Indicators, 1993).

These industries however faced constraints, which appeared to place limits. The declining production of crude oil from the Bahrain field meant that an increasing amount of crude had to be imported to operate the refinery at capacity levels. And the limited availability of gas also meant that future expansion would have taken this into consideration. The latest expansion of

primary aluminium production therefore had to use a combined cycle in producing energy to conserve gas use.

The expansion in other industries since 1976 was through joint ventures with the Gulf and Arab partners. The petrochemical factory producing 1000 tons per day of ammonia and methanol, was set up as a joint venture with Saudi Arabia, and Kuwait. The Gulf rolling Mill Company was a joint venture with Gulf countries and Iraq. The manufacture of LNG facility was a joint venture with Arab Petroleum Industries Corporation, CALTEX and Bahrain. The iron and steel factory producing steel from imported pellets was also a joint venture although it is currently owned by the Kuwaiti private sector.

The joint ventures were however not profitable ventures, so the interest in them waned after the first few ventures. Bahrain therefore had to use other ways to promote growth. Besides the other countries in the Gulf were also promoting industries through the provision of liberal incentives and heavy subsidies. Bahrain also had to follow suit and commenced providing incentives. These incentives amounted to as much as 30.7% of total tax revenue. In 1982, the industries sector contributed around 16.9 % of the tax revenue.

In the light of these constraints, industries are now given assistance. These industries are being given assistance in the form of special incentives, advisory services to help identify and project reports etc. The Bahrain Development bank also provides loans at concessionary rates to these industries. There are also Industrial areas developed by the government and rented at subsidised rates. All industrial machinery comes into the country duty free, the government owned utilities charge special lower tariffs, primary aluminium is

sold at discounted prices to downstream industries, and is eligible for special tariff protection to fight foreign competition.

In spite of the various incentives and assistance, growth of manufacturing has been slow as compared to Services. The competition is also high in this area since all other regional countries are also industrialising within a heavily subsidised environment. Besides, these countries have an advantage over Bahrain in that they have a broader domestic market base, and financial resources to provide subsidies and incentives, unlike Bahrain.

The Services sector on the other hand grew rapidly after the oil boom. The increasing income in the region and the savings that were being accumulated demanded the growth of financial services in the region. Bahrain exploited this opportunity in promoting off shore banking in Bahrain. It was based on receiving and disbursing funds through out the region and in particular to Saudi Arabia. At that time banking services had also not been fully developed in the region. This weakness Bahrain exploited to set up the off shore banks. The rapid increase in the number of off shore Banks to 75 in 1984 within a short period before it declined to 56 in 1989 gives an indication of the rapid rise of off shore banks in Bahrain.

At its peak in 1993 off shore banks were contributing 16.06% to the economy, which was equal to the contribution of manufacturing ( 16.2%) in the same year. There was no special incentive that was given except that the banks were provided with freedom to conduct their business within the guidelines set by the monetary authorities for the purpose of inviting only genuine banking institutions.

Table (5.4) gives a comparison of the industrial sector with the services sector. In terms of value added, the services sector contributed 70.5% in 1991 in real terms while the Industrial sector's contribution was 24.7% in 1991. The table also reveals the higher level of inputs needed for the industrial sector than the services sector. The services sector input in real terms was 27.4% in 1991, while that of the industrial sector was much higher at 60.7%. Significantly, the import content of the inputs of the industrial sector is higher than the service sector, which therefore makes this sector more import dependent.

However, the value of production of both sectors were close, as table (5.4) reveals, though the services sector had a slightly higher proportion at 46% as against 44.7% for the services sector in 1991.

The services sector growth was robust as the table (5.5) production per employee shows. In the services sector, production per employee grew at 16.4% and 11.7% in real terms in 1982 and 1991 respectively, while the industrial sector growth rate was 0.6% in 1982 and was negative (-12.2%). The table (5.3) shows that in terms of employment too the services sector contributed 63.7% in 1991 as against 32.2 % by the industrial sector.

Productivity of the two sectors (Table 5.5) also shows that the value added per capita was consistently higher than that of the industrial sector. The conclusion is clear. It would take a smaller level of input to create value added in the services sector than the industrial sector. The fact that the industrial investment is expensive, in the region of US \$ 2- US \$ 3.0 m per employee, underlies the importance and the necessity to provide encouragement to the services sector.

Tables (5.6) and (5.7) show some national income indicators about industrial and service sectors at current and constant prices. They show that the operating surplus in the service sector has increased at both prices compared with the industrial sector. And the service sector has a positive contribution to the indirect tax while the industrial sector has a negative reflecting the level of subsidy given to the industrial sector.

This is also more emphasised in table (5.8), which sets a comparison between service and industrial sectors in term of employee contribution to the national income at constant prices. The table reveals that an employee in service sector is contributing 30% to 40% higher to operating surplus, wages and salaries and indirect tax compared with one in the industrial sector.

#### 5.4: The Prospect of Services Sectors:

The services sector contributes 70% to the economy in real terms. As such it is one of the most important areas of economic activity in the country. The important sub sectors are Public administration, which in 1991 contributed 22% to the economy, Finance and real estate 21%, Trade 11%, Transport and communication 10%, and personnel services 6%.

Public administration is the largest contributor as Bahrain is a welfare state. The state provides free health and education facilities which included training. The human development is one of the facets of development, which Bahrain has undertaken to produce an adequate number of highly trained people to replace the high number of expatriate workers, and to cater to improvements in technology so as to be prepared for the next millennium. It also includes the contribution made to improve the security and stability of the economy.

The banking and real estate sector has several activities, which include, the Bahrain monetary agency, the commercial banks which cater to the domestic needs, the off-shore banks which cater to the off shore investment banks, as well as insurance services. As a financial centre of the Middle East, the banking sector of Bahrain has all the necessary financial services as required to operate an International Financial centre.

In 1975, this subsector had only the 18 commercial banks catering to the domestic economy, the Bahrain monetary agency that controlled these commercial banks and insurance services. These adequately provided the services needed at the time. From 1976 however, the rapid growth of off shore banking brought international banking to the island. With the establishment of the off shore banking centre the insurance services also developed as the demand for financial services grew. With establishment of the Arab Reinsurance Company, Bahrain became the centre for insurance in the region. The financial centre was enhanced by the establishment of the investment banks, which now catered to investment services off shore. All the leading banks were present which enhanced the reputation of Bahrain as the financial centre of the Middle East. This was the time when Lebanon was facing its internal civil strife, and as such gave Bahrain the pre-eminent position as an international financial centre. The domestic banks however, remained separate as they were not allowed to carry out off shore banking services, and hence their growth remained determined by the growth of the domestic economy.

By the late 1980s the financial centre had matured. The banks, which perceived that the decline in the price of oil would adversely affect them, left

Bahrain. The banks that remained were convinced that Bahrain presented good opportunities for them over the long term.

The Real Estate sector also developed as the oil boom resulted in higher income, and the establishment of the off shore banks brought about demand for good residential housing. The resulting construction boom made sure that the real estate needs were provided in the shortest possible time. However real estate as a financial investment has not yet developed though there is potential if the laws are changed to allow ownership by foreign interest. Currently only citizens of the Gulf Co-operation Council countries are allowed to own property.

The contribution of other the subsector, Trade, Hotels and Restaurant increased from 10% in 1975 to 11.2% in 1991, having peaked at 14.7% in 1993.

Trade was the traditional base of the Bahrain economy. From time immemorial trade passed through Bahrain and made Bahrain a hub for the region. It was already contributing 8.55% to the economy in 1975. Trade consisted of import and exports of Bahrain and re-exports and transit trade. From early days transit trade was an important element. Thus goods destined for the North Gulf as well as to Eastern Saudi Arabia went through Bahrain. Further, International trade was very familiar to Bahrain as it had already dealt worldwide during the pearl era.

However, the pre-eminent position of Bahrain as a trading centre has declined as other countries in the region built their own infrastructure and began trading on their own. But its substantial contribution to the economy continues.

Hotels, which began as providing services to businessmen and stop over traffic from the international airport, began attracting tourists from 1986. The opening of the causeway brought a flood of visitors every day, and new hotels were added to cater to the demand. These hotels and guesthouses have added to the infrastructure and competition to lure tourists into the country is intense. Further, the government strategy of development gives a prominent place to the development of tourism, both regional and international. The potential for development remains bright. Besides the potential for regional tourists is also large, as can be seen by the weekend visitors from the region, seeking a freer lifestyle in Bahrain.

Related to this development is the rise of restaurants. The rise of Bahrain as an off shore-banking centre has brought a lifestyle that is peculiar to the financial trade. The provision for leisure activities has increased to meet the demands of the banking community and the related personnel. The restaurants currently contribute 0.06% to the economy.

The Transport and Communication sector includes the operation of the international airline (Gulf Air, owned by Bahrain, Oman, United Arab Emirates, and Qatar) the provision of telephone services, government transport which includes the seaport, the airport and the public transport operation of the government. This sub sector's contribution was 6.52% in 1975 in real terms, which peaked at 14.5 % in 1982 before declining to 10.39% in 1991.

This sub sector comprises of one of the important services of the service sector. The operation of Gulf Air from Bahrain, with its regional and international links is akin to an off shore centre for the economy. This

contributes significantly to the airport operation, which promotes itself as an important hub for the Middle East. Gulf Air is an important contributor to the economy. From a contribution of 0.31% in 1976, it increased its contribution to 5.15% in 1983 before declining to 2.9% in 1991. Through the operation of the international airline, which is an off shore operation, Gulf Air could operate beyond the scope of domestic demand considerations.

The sector also includes the seaport, which has in the past been an important link between the region and the world, for heavy goods transport. It has important links to the industrial areas, which act as a base for export production, and thus is an offshore centre for industrial goods.

The telecommunications services is the highway through which most of the services of the services sector is undertaken. The provision of communications services by Batelco (the semi government owned monopoly) has been an important factor in the development of the services sector not only in banking but also in the establishment of head offices of companies etc. It is very important to the development of the services sector and the provision of off shore services. The development of information technology, which now includes multi-media services, has enhanced the importance of communication. It is envisaged that the Information highway that is being developed would become a very important route for trading in the new millennium. Further there are new products which are being developed like video on demand, data transfer services etc, which with the help of satellites have provided communications to mobile telephones, and mobile computers. These services are the base for the new era of information technology through super computers that is projected to provide the basis of future growth.

## 5.5: Financial and Real Estate Sector:

The finance and real estate sector grew dramatically between 1976 and 1991. In real terms, the contribution of the sector grew from 6.53% in 1976 to 21.46% in 1991, having contributed 29.9% in 1983. The sector grew rapidly in the initial years when the off shore banking units were set up. Thus in 1976, the sector grew by 97.4%, followed in 1977 by 27%. A further period of growth in real terms was after 1981, when growth once again reached 65.1% in 1983 followed by 42.6% in 1984.

The unprecedented growth in the Finance and Real Estate sector represented the largest contribution to the Services sector of the economy between 1976 and 1991. The contribution of the sub-sectors of the services sector shows the extent of the contribution of the Finance and Real Estate sector.

Contributions of the Sectors within the services sector to the economy 1976 – 1991.

(%)

	1976	1991	Change 1976-1991
Transport & Communications	6.52	10.93	4.41
Trade, Hotels & Restaurant	10.05	11.20	1.15
Social & Personnel Services	3.59	5.14	1.55
Financial & Real Estate	6.53	21.46	14.93
Public Administration	15.01	22.34	7.33

The finance and real estate sector plays an important role in the economic and social development of the country. The sector provides the means and the facilities to speed economic growth. The classical function of the sector is to mobilise national savings and reallocate domestic financial resources among various sectors to reflect investment opportunities. It contributes to expand business activities on both inputs and outputs levels. In the former it takes the form of providing channels for maximising the return on national savings, while in the latter it takes the form of providing the means to finance investment opportunities and hence maximise overall returns on national savings.

Abdul-Jawad stated that " Financial markets act as a filter of information about available resources and as such could significantly affect the use of these resources. They replace personal relationships between savers and entrepreneurs. They provide savers with the chance to diversify their portfolio and enhance their yields, while entrepreneurs will be able to draw on a larger pool of investible resources " ( Gulf International Bank, 1992, pp.7 ).

Development of the sector, especially banking and finance, is being actively pursued in various developing countries. Therefore many countries have invested heavily in developing the necessary infrastructure required for the development and expansion of the sector, such as modern high technology, well-advanced telecommunication systems and well defined rules and regulations. Such investment has paved the way for the private sector, foreign and local, to establish banking systems and financial markets and hence grasp the opportunities created and increase investment in the sector.

The finance and real estate sector consists of the following sub-sectors:

- 1- Commercial banks, which are a mixture of local and foreign, owned, representing 19 banks with 64 branches in 1994. There are six commercial banks which are owned 100 % by Bahrainis, two where joint equal share holding is with Kuwait and Saudi Arabia and one (Grindlays Bahrain Bank) owned 60 % by Bahrain and 40 % by Australia (ANZ Group).
- 2- Offshore banking units (OBUs), which are licensed banks stationed in Bahrain but not allowed to transact with residents of Bahrain with the exception of Government and related Government entities of Bahrain.
- 3- Insurance companies (ICs) included 63 companies, divided into 9 local companies, 11 foreign companies and 43 exempt OBUs companies in 1994.
- 4- Investment banks (IBs), which are specially, licensed institutions with small balance sheets to participate in investment business. There were 22 licensed banks in 1993.
- 5- Real estate, which are companies dealing with sale, rent and representative offices. There are 110 companies, of which 17 are international companies, as well as 600 registered land and property brokers.
- 6- Other activities, which include money brokers and money changers as well as insurance companies.

The development of the banking system and hence the financial sector in Bahrain goes back further than the seventies when there was a huge financial

surplus in the Gulf region due to the increase in international oil prices in 1973. The first international bank to open its doors in Bahrain was a branch of the Eastern Bank, now known as Standard Chartered Bank, in 1921 (Bahrain Government Annual Report, 1925), followed by a branch of the British Bank of the Middle East in 1944 (Bahrain Government Annual Report, 1946). The first locally owned bank, The National Bank Of Bahrain, was established in 1957 and the first Arab bank established, The Arab Bank Limited (of Jordan) was in 1960 (Bahrain As International Financial Centre, 1991).

The establishment of the Bahrain Monetary Agency (BMA) in 1973 marked State efforts to organise the financial sector (Amiri Decree, 1973). Some of the Agency Laws emphasised the BMA's objectives to organise the banking business and control the banking system, to control and direct bank credit so as to realise the objectives of the economic policy of the State and to participate in the creation of a developed money and financial market (Bahrain - An International Financial Centre, 1987).

Thereafter the BMA issued legal and regulatory systems as well as other requirements to obtain licences to operate in the Bahrain market.

In real terms the finance and real estate sector value added increased from B.D 86.6 million in 1976 to B.D 316.1 million in 1991, representing a growth rate of 265 % over the same period. Tables (9) and (12) in the appendix show the contribution of the sector to the GDP and job creation. Tables (13) to (18) in the appendix show the value added, value of production and value of inputs for the financial sector by subsectors at constant and current prices for the period 1976-1991.

As has been said above, the commercial banks were established much earlier in Bahrain compared with the other GCC countries. The number of commercial banks increased from 18 in 1976 to 20 banks in 1993, with branches all over the island (BMA, Annual Report, 1993). For example, the Bank of Bahrain has 21 branches, the Bahrain and Kuwait Bank also has 21 branches, and AlAhli Commercial Bank had 3 branches in 1993. The development of commercial banks can be looked at in two stages. The first stage started with the beginning of this century and the early stages of oil discovery when Bahrain was a focal point of the Gulf region's international trade. The second stage started in the early seventies with the increase in international oil prices and hence the availability of huge funds in the area, as well as an increased role of the GCC countries in international trade and services.

The commercial banks subsector witnessed a substantial development during the second stage. Total assets and liabilities of the commercial banks have increased from B.D 562.3 million in 1976 to B.D 2,048.1 million in 1992. This indicates the development of both the economy and the financial sector. In fact the overall annual average growth was 7.8 % for the period 1976 to 1993. This annual average growth reflects a steady development, with the exception of 1986 when there was a decline in oil prices and 1990, when there was the Gulf war. However such development reflects a sound structure and high confidence in Bahrain as a financial centre. Tables (19) and (20) in the appendix show the total assets and liabilities and sectoral lending for the commercial banks.

Moreover, the establishment of the offshore banking units (OBUs) in Bahrain was a result of a deliberate step taken by the Bahrain government to diversify the economy in 1975. The desire to open the door for this type of banking and

the collapse of the banking industry in Lebanon in 1974 has contributed much to promote Bahrain as a financial centre in the area.

The implementation of such policies came at the right time when there was a period of booming oil prices. This has created an excellent opportunity for banks, especially the international banks, to be represented in the region, to attract deposits from the GCC countries and finance investment projects. According to the terms and conditions applied by the Bahrain Monetary Agency (BMA) the licensing of OBUs does not allow them to transact with residents of Bahrain, with the exception of the government and related government entities of Bahrain.

By 1984, the number of OBUs had increased to 76 units, and then declined to 47 units in 1991 (BMA publication, 1984 and 1993). The growth in OBUs can be attributed to factors mentioned above, such as the open door policy to attract such banking activities, availability of surplus funds in the area and the collapse of the OBU system in Lebanon. But above all these factors is the existence of highly developed and advanced transportation and telecommunication systems, the establishment of a highly skilled regulatory body (BMA), the geographical central location between the West and the East and the availability of skilled Bahraini manpower.

The OBUs subsector has witnessed a substantial development since it was established in 1975. Total assets and liabilities of the OBUs have increased from U.S \$ 6,214 million in 1976 to U.S \$ 69,767 million in 1992, representing a growth of 1122 % over the same period. The overall average growth rate was 20 % per annum for the same period. Table (21) in the appendix shows the assets and liabilities of the OBUs from 1976 - 1992. The growth either in assets or liabilities has contributed to the increase in the inter banks outside

Bahrain which accounted for 72 % in the assets and 64 % in the liabilities in 1992.

Table (22) in the appendix shows the geographical classification of the assets and liabilities for 1976 - 1992. In terms of assets distribution, the share of the Arab countries has declined from 40 % in 1976 to 33 % in 1992, while the North American increased from 0.2 % to 20 % respectively. There is also a slight increase in Western Europe from 20 % in 1976 to 24 % in 1992. On the other hand, the share of the Arab countries in the total liabilities has increased from 41 % in 1976 to 47 % in 1992, while the share of Western Europe declined from 37 % to 20 % respectively. The North American share to the total liabilities has increased substantially from 3 % in 1976 to 18 % in 1992.

The insurance subsector is defined here to include local companies, foreign companies and exempt OBU companies located in Bahrain and conducting insurance and re-insurance in the local market and/or abroad. Although insurance activities in the Bahrain economy started in the fifties, the Amiri decree No 17 for the year 1978 was the first law to regulate insurance activities in Bahrain (Insurance Annual Report, 1989 - 1990). The responsibility of regulating and supervising insurance activities is taken by the Ministry of Commerce and Agriculture (MCA) and known as the Ministry of Commerce. The total number of insurance companies has increased from 32 companies in 1981 to 63 companies in 1991. Table (23) in the appendix shows the growth in insurance companies by categories for the period 1981 - 1991. As can be seen, exempt OBU companies have grown from 9 companies in 1981 to 43 companies in 1991, and represent 68 % of the total insurance companies in 1991.

Table (24) in the appendix shows the balance sheets for local insurance companies for the years 1985 - 1990. The total assets and liabilities increased from B.D 26.6 million in 1985 to B.D 29.1 million in 1990, reflecting an average growth rate of 4.3 % per annum for the same period. On the assets side, investment has increased its share of the total assets from 3 % in 1985 to 30 % in 1990, representing a change in the policy away from fixed assets which have declined from 36 % in 1985 to 13 % in 1990 of the total assets. Such a change in policy reflects the increasing volatility in insurance activities which has forced insurance companies to take higher risks by investing in current investment to make up for losses. At the same time such investment enables the companies to liquidate their assets at short notice.

The investment banks subsector is defined to include mainly institutions with small balance sheets to participate in investment business primarily to generate free income (BMA, 1977). The activities of the investment banks cover all types of securities business, underwriting, investment advice, funds management and funds capital raising. Furthermore, the investment banks accept deposits from non-resident banks inside and outside Bahrain. The total number of investment banks has increased from 17 banks in 1986 to 22 banks in 1992 (BMA, 1993).

The other financial institution subsector includes Bahrain Monetary Agency (BMA), Bahrain Financial Facilities (BFF), 38 offices of representative offices, 5 offices of money brokers and 25 companies of money changers.

The extent of the growth of the financial and real estate sector showed both the extent in growth of the need for financial services as the economy grew, and the success of the deliberate policy of the government to make Bahrain an off shore centre. As the requirements grew, every type of financial service began

to be established, including that of the regulatory body, the central bank. As the following figures show, the offshore banking and investment banking services provided the largest growth as represented by the increase in their contribution between 1976 and 1991.

Contributions of the sub sectors of the Finance and Real Estate sector to the Economy:

	(%)		
	1976	1991	Change 1976-1991
Bahrain Monetary Agency	0.67	2.30	1.63
Commercial Banks	0.56	4.61	4.05
Off-shore Banks	0.0	6.26	6.26
Investment Banks	0.0	3.44	3.44
Tashelat	0.0	0.08	0.08
Money Exchanges	0.0	0.10	0.10
Insurance	0.52	0.73	0.21
Real Estate	4.79	5.42	0.63

Total	6.54	22.43	15.89
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The changes within the Finance and real estate sub-sector represents the fundamental changes that the economy underwent during the period 1976-1991. The establishment of offshore banking in Bahrain was the biggest breakthrough in diversifying the economy. It not only provided the centre for receiving and disbursing the savings in the region resulting from the increase in price of oil, but also established the basis for an economy based on the performance of off shore services. Within a few years, Bahrain became an international financial centre, and the premier Banking centre in the Middle East.

The establishment of the off shore banking services also gave a fillip to a related service that of real estate. The arrival of bank managers and company managers led to a very high demand for real estate, and special housing estates and specialised areas to cater to this was the result. In terms of office space the development also led to specialised area for the development of the services, The Diplomatic Area.

#### Commercial Banking:

Commercial banking commenced in Bahrain in 1920 when the Eastern Bank was established. Three other banks, including the National Bank of Bahrain, between 1944 and 1960 followed this. The main services provided were trade finance and customer deposit services. Commercial banking from the provision of these simple services increased several fold as the economy transformed

from the traditional economy into a service centre. Between 1969 and 1977 fifteen banks were set up to meet the demands of a vibrant economy transformed by the rapid rise in the price of oil, of the total 18 commercial banks, 12 banks were branches of foreign banks.

Between 1976 and 1991, commercial banking grew 3.4 times, as represented by Total Assets, from BD 0.754 billion to BD 2.015 billion. This also represented the increase in domestic activity during this period.

Table: Development of Commercial banking assets.

BD m.

	1976	1991
Reserves	38.5	141.5
Cash	3.6	11.6
Balances with BMA	34.9	129.9
Advances & Credit	271.5	595.2
Foreign Assets	189.9	1,069.5
Balance with local Banks	3.0	33.3
Other assets	23.5	175.7

Contra	192.2	571.4
Total	754.4	2,586.6

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One of the significant features was the increase in foreign assets, as funds sought investment abroad in the absence of adequate investment opportunities domestically. The domestic lending increased only 2.19 times during the period. The principal areas of lending were to trade and construction and later to industry as the following tables reveals. Personal loans became a significant element in lending as salaried persons increased over time and demand from these that had by them become credit worthy, increased.

	1976	1991
Manufacturing	37.5	113.5
Mining & Quarrying	0	29.4
Agriculture	0.5	1.7
Construction	87.8	91.4
Trade	79.2	118.2
Transport	32.0	30.6
Government	3.6	15.0
Personal	21.5	167.2
Other	9.5	28.4
Total	271.6	595.2

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The increase in lending for construction also reflected the desire by the borrowers to construct offices and household catering to the demand from the increasing Banking sector itself. The rate of increase in construction lending however was restrained by directives of the central bank to reduce lending to this sector, which based its activity on the expectation of very high rents. The central bank used moral Suusan to curtail lending to this sector.

The commercial banking sector employed 2036 persons in 1991.

#### Offshore Banking:

Bahrain's offshore banking developed in response to a package of incentives that was given by the Bahrain Monetary Agency in 1975. This included exemption from maintaining reserves and from observing liquidity ratios, and the absence of tax. However, there were conditions which were imposed to safeguard against abuses, like making the obligatory that the OBU has to be a branch of the overseas parent, and that the unit is fully manned.

As the surpluses in the region increased, following the increase in the price of oil, there was an opportunity for these banks to attract savings to Bahrain. Further, as the demand for funds began to rise to finance the rapid development in the region, these banks had an opportunity to lend to these projects.

The response to the opportunities was overwhelming. The assets of OBUs increased from US \$ 6.2 billion to US \$ 72.5 billion in 1989 when it reached its highest level. By 1991 assets fell to US \$ 53.8 billion, its lowest level. The

Bahrain market is an inter-bank market, as well as a regional and international wholesale money centre.

The number of banks increased to 76 in 1984 before declining to 47 by 1991, in response to the recession following the collapse of oil prices.

The sources of funds of OBUs have been from Arab countries and Western Europe. Arab countries contributed 57.5% of the funds in 1990, while Western Europe funds amounted to 19.2% in 1990. Arab countries used a large proportion of OBU funds, and their share in 1990 was 42% of the total. Western Europe used 22% and Northern America 14% in the same year. Apart from recycling the funds in the region, the OBUs were also instrumental in providing a substantial amount of finance to the rest of the world, particularly to the west.

The predominant currency used is the US dollar. The following table gives an indication of the predominance of the dollar in the transaction of these banks.

#### Currency Composition of Assets & Liabilities of OBUs 1989.

	US \$ b.	%
<b>Assets</b>		
US Dollar	58.5	80.6
Regional Currencies	7.1	9.6
DM	2.2	3.0
Swiss franc	.9	1.2
Others	3.9	4.1

## Liabilities

US Dollar	53.9	74.3
Regional Currencies	10.6	14.6
Mark	2.5	2.7
Swiss franc	1.3	1.3
Others	4.1	5.6

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The OBU's have contributed significantly to the development of Bahrain as an international financial centre. It has now established itself as the premier Financial centre in the world acting as a conduit for the Middle East Funds. It has thus become a financial service centre.

Bahrain's direct financial benefit from the OBU's be as follows:

US \$ m.

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Year	Licences fees	recurrent expenses	Total
1985	2.58	205.1	207.7
1986	2.51	200.0	202.5
1987	2.32	288.0	290.3
1988	2.30	183.5	185.8
1989	2.15	160.3	162.4

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It also contributed significantly to the employment of Bahrainis, in new skills attracting a salary level which was very much higher than the average levels of salary in Bahrain.

Year	Bahraini	Foreign	Total % Bahraini
1985	1445	932	60.8
1986	1298	814	61.5
1987	1313	689	65.6
1988	1275	634	66.8
1989	1228	646	65.5

#### Investment Banks.

In addition to the OBUs, Bahrain also gave licence to operate merchant banking services primarily to generate fee income. The services include, underwriting, investment advice and capital raising. These banks can accept deposits from sources outside the country, if those deposits are in excess of US \$ 50,000. In contrast to OBU's however, these banks have to follow liquidity rules, (25%) and the gearing allowed is 10:1 for companies registered in Bahrain.

This is another off shore service that is encouraged in Bahrain. By 1989, the assets of the 21 banks licensed amounted to US \$ 3.9 billion.

#### Insurance

Insurance Companies forms another element of the financial services in Bahrain. Like the rest of the financial services, Insurance has also developed a substantial overseas business. particularly in the late eighties.

Insurance had a very small beginning. In the fifties, an insurance facility in Bahrain started as a means of helping taxi drivers to cover themselves against accident. But in 1980, it started to develop on amore usual lines as offering cover against fire, war risks etc. but the significant development was the Arab Insurance Group which was set up to meet the demand for large scale re-insurance. The heavy cost of insurance on cargo and hull gave the impetus for the development of this Arab Insurance group.

By the end of 1989, the number of insurance companies had increased from 37 in 1983 to 61 in 1989. The structure of insurance companies consisted of 8 Bahraini companies, 15 foreign insurance companies and 38 exempt companies.

The largest increase in the number of insurance companies was in exempt companies, which grew by 17 between 1983 and 1989. Exempt companies are companies established under the provisions of the Resolution No 25 of 1977 of the Ministry of Commerce and Agriculture. These companies are not allowed to conduct any business or to undertake any commercial activity within Bahrain. Hence their activities added significantly to Bahrain as an off shore service centre.

Local insurance companies underwrite fire, engineering, motor, marine, aviation, and general accident insurance.

The domestic market in 1988 as evidenced by premium written amounted to BD 22.1 m (US \$ 58.5 m). Arab Insurance Group on the other hand had an aggregated premium amounting to BD 57.9-m (US \$153.4 m.) in 1988.

#### Stock Exchange:

The stock exchange laws of 1987 gave the legal basis for the establishment of a stock exchange in Bahrain. The law sets out the basic legal provisions necessary to establish and maintain a fair market.

The stock exchange is set the task of developing in such a manner as to serve the economic policy of Bahrain, to rationalise trading, promote ties with Arab and international security exchanges, and to encourage savings and promote investment.

In the relatively short time of its operation, the stock exchange has developed in such a way as to expand its activities to include listing of shares of foreign firms. It has also encourage non Bharaini residents to invest in shares.

Market capitalisation, as at end of 1995 was BD 1.7 billion, around the same amount of the country's GDP.

Having examined the contribution of the finance and real estate sector, we may conclude that the sector has positively contributed to the economy in terms of value added, inputs, outputs, operating surpluses and employment. This has the impact of increasing the share and the contribution of the services in the economy as a whole.

The achievement of banking and financial sector in Bahrain may be attributed to the swift and quick actions by to the government to provide the right ingrain for the development of the banking and financial sector in terms of hard and soft infrastructures in the seventies. Such actions were enhanced by positive contribution and backing of the GCC countries to development of the banking and financial sector in Bahrain.

However, the banking and financial sector in Bahrain is facing a competition from the region and outside. Dubai and Turkey, for example, have announced their intention to establish offshore banks. Other centres like Beirut and Cyprus are still constitute a threat to Bahrain as a financial centre.

Further, the rapidly changing information technology makes it possible that banking services is conducted from the traditional centres. Peter Dicken argued that development of satellite communications systems has been especially important to the development of international financial markets. Warf (1989) reports that in the mid-1980s, 50% of all international financial transactions were made by satellite-link telephone calls. Indeed, as he points out, financial services firms are probably the heaviest users of telecommunications systems (Dicken, 1992, p.361).

Such events put pressure on the government to vigorously pursue policies to diversify the banking and financial sector. The government has already adopted some policies, encouraging the Islamic banking development, setting up mutual funds, credit cards processing and the development of the financial capital market.

As has been argued earlier in the context of the small economy development, leadership in terms of introducing new ideas and establishing new business is

the way out for the small economy. This fact should dominate the thinking of the policy maker in the small economy.

#### 5.6: The Prospect of Financial Services Sector:

The rise of the financial services sector in Bahrain can be attributed to the establishment of the offshore Banks following the guidelines issued by the BMA in 1975. The dramatic rise in the contribution of the sector has already been documented elsewhere in this study. The causes of the rise in off-shore banks are now well known. The civil war in Lebanon had made the international banks to seek an alternative site. Bahrain having the best infrastructure at the time, particularly in communications and being in the correct time zone assisted. Bahrain was also at the time the hub of transport and communication, imported products were entering the gulf through the port of Bahrain, while all planes crossing the middle east had a stop at the Bahrain Airport. In addition the free life styles that was practised encouraged the bankers to reside in Bahrain, which had a repel effect on the development of other services, such as consultancy services, legal and audit offices. Thus the establishment of the offshore banks was a catalyst for the development of all other soft and hard infrastructure of the company in the services sector.

While the location factors and infrastructure helped the establishment of the financial sector in Bahrain, the rapidly increasing income of the Gulf States following the increase in price of oil helped the region to rapidly accumulate surpluses, which presented the opportunities for the banking sector to rise in Bahrain.

The need for development of infrastructure in the region gave rise to enormous opportunities for the flow of financial resources. Once the infrastructure development was fairly developed the Gulf States had a close look at the long-term prospects of depending on the hydrocarbons, and the vulnerability of this to fluctuations in economic development in the long term. This led the governments to engage in agricultural and industrial development. As the gulf region embarked on the period of structural change it created demand for financial services to fulfil the flow of savings and investment throughout the region.

These developments were interrupted only by the fluctuating price of oil. The decline in the price of oil, resulted in the lower savings and a lower investment in the region. But the financial services sector rode through this difficult period by diversifying their portfolio. They are now matured enough to withstand fluctuations resulting from changes in the price of oil.

While the Financial services matured, the economies of the region have also matured. The dependence on the oil has been reduced, as the non-oil sectors grown. The financial services have thus established themselves to serve the needs of the new structure of the Gulf economies. The financial services products thus are now more diversified too to serve the changes circumstance.

At the current time, high oil prices have returned, and have increased the savings of the region, and have also increased the demand for projects across all sectors of the economies of the gulf region. While Bahrain undertook the expansion of primary aluminium production to become the country with the second largest aluminium facility in the world, other countries in the region have announced plans to set up or expand their facilities too. Qatar, Dubai,

Kuwait and Iran have now activated plans to have aluminium plants similar to Bahrain's. Qatar has also entered a period of more openness to foreign investment and has announced plans to utilise its gas reserves using foreign know how. Further establishment of downstream industries based on aluminium has also been announced. Thus Bahrain and Dubai are actively engaged in establishing facilities for the production of petroleum coke which is necessary for the production of aluminium. There are also plans for further investment in refinery and petrochemical facilities in the region including Bahrain. These investment plans have provided the financial sector a further boost. The prospect are that in addition to the products such as mutual funds, etc, which were developed when the oil price declined, the added investment will bring back the opportunities for lending within the region.

The opportunities that the sector have are not dissimilar to the ones that presented themselves in the early seventies. The enormous need for infrastructure development continues, as well as those requirements for the diversification of the economies. The financial services sector can thus look forward to a period of opportunities when the regional states proceed on a further period of structural changes in the economy. Bahrain's financial sector would thus be a very good position to exploit the increasing opportunities in the region. Competition to Bahrain as a financial centre of the Gulf or even the Middle East has not been sufficient to challenge the pre-eminent position of Bahrain. Even though peace has returned to Lebanon, its financial sector has not returned to a position where it could set up a challenge to Bahrain.

During the late eighties, when the Financial services sector declined, the banks made significant changes to their product range. Thus many value-added items based on commission income began to be added. One of the important

products added was a mutual fund. With the help of suitable changes in the law undertaken by the BMA, Banks diversified into investment services, which saw a rapid increase in Bahrain. The banks thus absorbed the surplus in the region in order to invest abroad, while giving an adequate return and security. The prospect for the development of these Funds are encouraging.

The setting up of the Bahrain Stock Exchange (BSE) in 1987 was a landmark in the development of the financial sector. Now the exchange is active and several primary issues have been over-subscribed. The availability of liquid investment opportunities through the stock exchange will help the sector to further develop the flow of invisible funds. The BSE have also has established links with regional stock exchanges, like Jordan, Oman, Kuwait. More links are being planned so that cross trading will be encouraged. These are the first steps towards enhancing Bahrain's role as a financial centre.

The Gulf Countries are also embarking on a programme of privatisation. In early days it was the government which was instrumental in establishing large projects in order to accelerate the structural changes. It is now the policy of these governments to privatise projects so the private sector assumes a significant role in development. Governments have also announced that more and more projects in infrastructure development will be undertaken by the private sector. This has enhanced the prospect of development of the financial sector, in the financing of these projects.

With the emerging needs for funds to finance privatisation, there has also emerged the need for more sophisticated financial instruments. The large privatisation projects are financed not only through straightforward equity and

loan funds, but also through derivatives. Prospects are that these will be traded in the exchanges in the region and in Bahrain in particular.

Bahrain is also actively promoting the establishment of Islamic banking. As the new concepts spread around the world, the traditional banks have introduced an Islamic-banking arm within the organisation. Bahrain is in the forefront of this trend. Bahrain has encouraged the banks to engage in Islamic banking, and as a result a number of banks on Islamic banking has been set up. As the instruments used in Islamic banking are developed there is a prospect of making Bahrain the centre of Islamic banking.

Bahrain has also kept pace with developments abroad, and has in particular encouraged changes now taking place in communication and electronics.

#### 5.7: Conclusion:

The economic structure of Bahrain shows that the resources endowments have limited its capacity for growth. Although in the early years, pearling, and later the discovery of oil provided the main base for the growth of the economy, its inherent limitations have constrained growth.

Bahrain has been the hub of the region for centuries. After the discovery of oil and the dramatic increase in the price of oil in the seventies, and its impact on the income of the countries of the region, Bahrain's position as the hub enhanced. Bahrain, could now overcome the limitations of its domestic market, and expand into the regional market. One that became pre-eminent was the development of banking.

Together with the development of banking, the services sector also developed in a way that its contribution accounted for 70% of the output of the economy. The activities that developed within the services sector were Banking, communication, trade, port and airport services, and personal services and public administration. Significantly, the activities such as banking, airport services and communications, developed as a result of demand outside the country.

The government in deciding to diversify the economy away from oil actively promoted the development of large industries. But the capital-intensive nature, and the limitations imposed by the resource endowments particularly oil and gas, restricted its development. Industry thus could not be made to lead the economic growth of the country. The necessity to create employment opportunities to the rapidly rising indigenous population and the absence of readily available capital funds meant that the industrialisation path has to be through the development of small and medium scale industries.

The catalyst for growth therefore has to be sought in the services sector of the economy. It has already shown its potential over the years. The detailed analysis of the services sector and its future prospects given above shows that the potential of the sector can be made use of to provide catalyst for the growth of the economy. The development of the services sector as the leading sector can generate the required momentum for growth of the economy. Its growth has to be fuelled by linking it to the development of the region. Bahrain could thus become the services centre of the region. Its unique lifestyle further has given the added advantage of attracting investors to set up base in Bahrain. It has also provided basic infrastructure for the development of a vibrant tourism industry. But the biggest potential for growth remains in the development of the Finance and Real Estate sector. Already the finance and

real estasector has served Bahrain to develop as an international banking centre. It has to be further encouraged to take the leading role in economic development.

The soft infrastructure, the regulatory framework, and other basic incentives are already there. What is required I develop the sub sector in a co-ordinated way so all the elements of the activity are developed in such as way as to generate a level of economic activity that it will give the required push for the economy to take off into a self sustained growth path.

In providing the catalyst for growth, the services sector, will be assisted by the current developments worldwide in respect of globalisation. Globalisation has made the world into a "Global Village". Barriers have been broken in favour of free trade. In addition the formation of the World Trade Organisation (WTO) with its stated objective of making trade free has introduced an important dimension to how trade will be made in the future. The information highway, the arrival of super computers, and satellite based communication systems has transformed the production of goods and services in a way not seen before. This has important ramifications to the development of the services industry.

The term that a product is made in X country has no meaning these days, because of the movement of the means of production. These days-other countries make the complements of one product from all over the world. The production (Manufacturing and services) on a world scale is witnessing an interdependence mode of production with a growing and dynamic new division of labour and comparative advantage.

As John Naisbitt (1995) argued since the industrial revolution the production process has witnessed five major separation of functions. He says that the first was when there was a de-linkage between the producer and commodity produced, when the producer in the factory lines did not know for whom the product was intended, or the address of the consumers. The second de-linking happened between the commodity and capital due to the role of the stock exchange in raising capital. The third separation was between capital and enterprise where the owner of capital was not the producer. The fourth happened, when the commodity itself and the need to produce or who demanded was separated through advertising. In the old days consumers based the commodity produced on demand. Nowadays promotion and marketing play an important role in creating needs. The last de-linking was between the commodity and homeland. Thus currently there is no such thing as a 100% American car, or Personal computer or a television set. The components are made from all over the world. These developments have increased the importance of services.

Further, the technological developments in the form of information technology have increased the ability of management to be conducted remotely. The multi-media super corridor, which is being developed, will increase the ability to perform managerial function from a remote site. It has also introduced the possibility of having electronic government, Tele-medicine, distance learning, and cybercities. These have made off shore activities to grow in the future. It is therefore expected that services industry will grow at a higher rate in the future.

Bahrain can therefore benefit from developing its off shore services, taking into account the advantage it has in respect of having a more educated work force. Bahrain will also be able to better manage the inflow of foreign investment in

this regard if Bahrain chooses to open its doors to foreign investment to set up facilities to exploit the opportunities that are now opening in respect of the Information highway.

All these new developments will need financing. Bahrain can therefore come forward as the leading financial centre in the Middle East to service the needs of Finance. The complementary facilities which Bahrain now possesses in the financial services will assist in projecting Bahrain as centre for finance. The developing stock exchange will add to the flexibility of Bahrain to receive and disperse funds regionally and internationally.

Bahrain therefore finds itself in the threshold of a development phase based on provision of services more particularly in financial services. It could become the catalyst for self-sustained growth in the future.

TABLE (5.1) : VALUE ADDED BY MAJOR SECTORS AT CONSTANT PRICES

(THOUSANDS B.D.)

SECTOR	1976	1977	1978	1979	1980	1981	1982	1983
PRIMARY	360,817	409,791	418,225	401,572	408,811	357,084	232,478	236,940
INDUSTRIES	190,769	186,879	224,689	250,061	249,540	239,269	263,001	297,342
SERVICES	329,574	377,948	378,789	422,426	441,199	412,494	392,644	395,264
INPUTTED SERVICES CHARGES	(46,136)	(63,552)	(71,646)	(65,597)	(82,179)	(108,710)	(200,679)	(273,460)
GDP	927,296	1,038,170	1,093,349	1,139,656	1,181,721	1,117,557	1,088,802	1,203,006

SECTOR	1984	1985	1986	1987	1988	1989	1990	1991
PRIMARY	262,783	261,366	276,573	243,724	243,764	252,026	259,119	254,218
INDUSTRIES	316,372	319,252	314,680	318,499	368,307	355,272	360,774	363,778
SERVICES	409,986	338,543	365,963	461,138	533,224	619,738	633,177	671,076
INPUTTED SERVICES CHARGES	(252,697)	(286,893)	(280,721)	(217,085)	(230,684)	(164,956)	(157,023)	(184,000)
GDP	1,241,838	1,206,054	1,237,937	1,240,446	1,375,797	1,391,992	1,410,093	1,473,072

SOURCE : MINISTRY OF FINANCE & NATIONAL ECONOMY , 1977 - 1992

B.D 1 = US\$ 2.65

TABLE (5.1): VALUE OF INPUTS BY MAJOR SECTORS AT CONSTANT PRICES

(THOUSANDS B.D.)

SECTOR	1976	1977	1978	1979	1980	1981	1982	1983
PRIMARY	6,269	6,594	7,489	8,212	10,836	13,426	17,459	22,841
INDUSTRIES	731,226	884,338	756,349	853,153	786,475	878,720	830,362	865,126
SERVICES	168,857	196,714	234,066	258,547	292,980	342,884	379,641	368,696
INPUTTED SERVICES CHARGES	46,136	63,552	71,646	65,597	82,179	108,710	200,679	273,460
TOTAL	952,488	1,151,198	1,069,550	1,185,509	1,172,470	1,343,740	1,428,141	1,530,123

SECTOR	1984	1985	1986	1987	1988	1989	1990	1991
PRIMARY	27,172	30,481	32,951	44,587	52,874	55,918	57,988	57,906
INDUSTRIES	994,900	881,437	862,707	996,409	989,117	998,796	1,054,350	1,151,301
SERVICES	418,594	445,642	417,624	399,465	424,749	456,971	505,078	518,888
INPUTTED SERVICES CHARGES	252,697	286,894	280,721	217,085	230,684	164,956	157,023	167,919
TOTAL	1,693,363	1,644,454	1,594,003	1,657,524	1,697,424	1,676,641	1,774,439	1,896,014

SOURCE : MINISTRY OF FINANCE & NATIONAL ECONOMY, 1977 - 1992

B.D 1 = US\$ 2.65

TABLE (5.1) : VALUE OF PRODUCTION BY MAJOR SECTORS AT CONSTANT PRICES

(THOUSANDS B.D)

SECTOR	1976	1977	1978	1979	1980	1981	1982	1983
PRIMARY	367,087	416,386	425,714	409,784	419,649	370,508	249,937	259,781
INDUSTRIES	921,995	1,071,217	981,038	1,103,213	1,036,015	1,117,990	1,093,363	1,162,468
SERVICES	590,701	701,765	756,147	812,168	898,528	972,799	1,173,642	1,310,880
TOTAL	1,879,783	2,189,368	2,162,899	2,325,165	2,354,192	2,461,297	2,516,942	2,733,129

SECTOR	1984	1985	1986	1987	1988	1989	1990	1991
PRIMARY	289,955	291,847	309,523	288,312	296,638	307,945	317,107	312,123
INDUSTRIES	1,311,272	1,200,690	1,177,387	1,314,909	1,357,424	1,353,934	1,415,124	1,515,079
SERVICES	1,333,973	1,357,971	1,345,030	1,294,771	1,419,159	1,406,620	1,452,301	1,557,965
TOTAL	2,935,200	2,850,508	2,831,940	2,897,992	3,073,221	3,068,499	3,184,532	3,385,167

SOURCE : MINISTRY OF FINANCE & NATIONAL ECONOMY, 1977 - 1992

B.D 1 = US\$ 2.65

TABLE (5.2): VALUE ADDED BY MAJOR SECTORS AT CURRENT PRICES

(THOUSANDS B.D.)

SECTORS	1976	1977	1978	1979	1980	1981	1982	1983
PRIMARY	163,288	196,368	211,940	245,271	414,803	444,015	417,021	366,627
INDUSTRY	148,359	191,200	205,915	268,802	335,273	322,964	322,325	326,369
SERVICES	268,880	352,490	423,629	470,890	532,581	726,923	906,091	1,022,638
INPUTTED SERVICES CHARGES	(30,252)	(47,802)	(67,331)	(75,462)	(114,860)	(184,875)	(271,338)	(276,148)
GDP	550,275	692,258	774,153	909,501	1,167,797	1,309,027	1,374,099	1,439,486

SECTOR	1984	1985	1986	1987	1988	1989	1990	1991
PRIMARY	372,078	415,010	248,173	240,996	211,374	252,219	338,238	311,072
INDUSTRY	364,043	297,992	289,787	299,673	348,591	355,139	375,579	380,161
SERVICES	1,035,174	936,488	867,360	818,021	931,031	949,650	954,737	1,039,837
INPUTTED SERVICES CHARGES	(278,215)	(256,384)	(215,997)	(168,973)	(194,814)	(164,956)	(152,280)	(133,225)
GDP	1,493,080	1,393,106	1,189,323	1,189,717	1,296,182	1,392,052	1,516,274	1,597,845

SOURCE : MINISTRY OF FINANCE & NATIONAL ECONOMY, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.2) : VALUE OF INPUT BY MAJOR SECTORS AT CURRENT PRICES

( THOUSANDS B.D )

SECTOR	1976	1977	1978	1979	1980	1981	1982	1983
PRIMARY	4,849	5,114	6,141	7,109	11,117	13,749	17,522	22,589
INDUSTRY	530,314	689,816	576,978	844,273	1,214,994	1,448,653	1,253,314	1,111,523
SERVICES	114,592	146,372	188,429	223,372	275,244	326,450	369,264	377,436
INPUTTED SERVICES CHARGES	30,252	47,802	67,331	75,462	113,736	182,519	267,405	263,570
TOTAL	680,007	889,104	838,879	1,150,216	1,615,091	1,971,371	1,907,505	1,775,118

SECTOR	1984	1985	1986	1987	1988	1989	1990	1991
PRIMARY	27,664	30,102	32,087	40,602	51,922	55,918	58,596	40,778
INDUSTRY	1,252,974,	1,137,841	749,139	987,859	854,792	998,796	1,286,635	1,359,906
SERVICES	449,867	452,034	418,081	388,946	418,675	437,343	510,203	528,060
INPUTTED SERVICES CHARGES	267,604	239,351	194,242	155,734	176,052	132,943	120,041	114,274
TOTAL	1,998,109	1,859,328	1,393,549	1,573,141	1,501,441	1,625,000	1,975,475	2,043,018

SOURCE : MINISTRY OF FINANCE & NATIONAL ECONOMY, 1977 - 1992

B.D 1 = US\$ 2.65

Table : (5.2) : VALUE OF PRODUCTION BY MAJOR SECTORS AT CURRENT PRICES

(THOUSANDS B.D.)

SECTOR	1976	1977	1978	1979	1980	1981	1982	1983
Primary	168,137	201,482	218,080	252,380	425,919	457,764	434,543	389,216
Industry	678,673	881,027	782,893	985,558	1,891,662	2,193,323	1,887,297	1,341,026
Services	383,472	498,853	612,059	821,779	466,431	631,667	963,697	1,496,940
Total	1,230,282	1,581,362	1,613,032	2,059,717	2,784,012	3,282,754	3,285,537	3,227,182

SECTOR	1984	1985	1986	1987	1988	1989	1990	1991
Primary	399,743	445,110	280,259	281,598	263,296	308,137	396,835	351,850
Industry	1,424,397	1,281,954	918,399	1,219,312	1,179,807	1,338,406	1,653,787	1,735,019
Services	1,677,659	1,542,402	1,405,969	1,275,187	1,373,282	1,422,149	1,473,377	1,572,944
Total	3,501,799	3,269,466	2,604,627	2,776,097	2,816,385	3,068,692	3,523,999	3,659,813

SOURCE : MINISTRY OF FINANCE & NATIONAL ECONOMY, 1977 - 1992

B.D 1 = US\$ 2.65

Table : (5.3) : LABOUR FORCE BY MAJOR SECTORS

SECTOR	1976	1977	1978	1979	1980	1981	1982	1983
Primary	3,918	4,415	4,322	4,250	4,663	5,366	5,818	6,065
Industry	36,116	40,841	41,823	43,704	46,001	48,845	53,362	57,283
Services	53,910	60,568	67,839	72,410	72,553	80,118	86,737	94,189
Total	93,944	105,824	113,984	120,364	128,217	134,329	145,917	157,537

SECTOR	1984	1985	1986	1987	1988	1989	1990	1991
Primary	6,752	6,841	6,836	7,000	6,975	7,028	6,943	7,979
Industry	61,618	61,774	56,317	52,847	51,079	54,079	54,583	62,541
Services	99,191	102,383	108,158	115,291	123,550	123,550	126,207	123,989
Total	167,561	170,998	171,311	175,138	184,657	184,657	187,733	194,509

SOURCE : MINISTRY OF FINANCE & NATIONAL ECONOMY, 1977 - 1992

Table (5.4) : COMPARISON BETWEEN SERVICES SECTOR & INDUSTRIAL SECTOR AT CONSTANT PRICES

SECTOR	SERVICES SECTPR				INDUSTRIAL SECTOR			
	GROWTH %		CONTRIBUTION %		GROWTH %		CONTRIBUTION %	
	1982	1991	1982	1991	1982	1991	1982	1991
VALUE ADDED	26.0	9.7	72.9	70.5	9.9	0.8	24.2	24.7
VALUE OF INPUTS	10.7	2.7	26.6	27.4	-5.6	9.2	58.1	60.7
VALUE OF PRODUCTION	20.6	7.3	46.6	46.0	-2.3	7.1	43.4	44.7
OPERATING SURPLUS	74.1	20.7	74.9	50.1	195.1	1.6	7.7	19.9
INDIRECT TAX	29.7	21.9	84.1	128.1	7.7	-11.7	16.9	-30.7
DEPRECIATION	9.7	5.2	54.4	49.2	5.4	17.1	32.8	42.1
WAGES & SALARIES	6.8	0.0	63.1	72.9	3.2	-6.7	35.0	25.4
PRODUCTION PER EMPLOYEE	16.4	11.7	122.7	110.7	0.6	-12.2	66.1	76.8
EMPLOYMENT	8.3	-1.8	59.4	63.7	9.2	14.6	36.6	32.2

SOURCE: MINISTRY OF FINANCE & NATIONAL ECONOMY 1977 - 1992

**Table (5.5) : PRODUCTIVITY DEVELOPMENT FOR SOME SECTECTED YEARS**

THOUSANDS (B.D)

Years	Services Sector				Industrial Sector			
	Consstant Prices		Current Prices		Consstant Prices		Current Prices	
	Value Added	Output	Value Added	Output	Value Added	Output	Value Added	Output
1976	7,825	10,957	4,988	7,113	5,282	25,529	4,108	18,791
1979	7,646	11,216	6,503	11,349	5,722	25,243	6,151	22,551
1982	9,154	13,531	10,522	11,111	4,929	20,490	6,040	35,368
1985	8,911	13,264	9,150	15,065	5,168	19,437	4,824	20,752
1988	7,644	11,487	7,536	11,115	7,211	26,575	6,825	23,098
1991	8,380	12,565	8,387	12,686	5,816	24,225	6,079	27,742

SOURCE : MINISTRY OF FINANCE & NATIONAL ECONOMY 1977 - 1992      B.D 1 = US\$ 2.65

Table (5.6) : NATIONAL INCOME OF INDUSTRIAL SECTOR

A : Current Prices

( MILLION B.D)

Sector	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Operating surplus	99.9	123.4	108.3	98.7	107.7	42.1	52.2	71.6	120.5	114.5	120.5	111.4
Indirect Tax	5.9	9.8	10.2	6.3	-2.3	-8.3	-21.4	-19.7	-17.8	-2.8	-13.9	-15.3
Dep	47.0	48.3	48.7	62.4	79.0	84.8	87.8	90.4	95.1	89.9	91.4	108.9
Wages & Salaries	128.0	141.6	155.1	159.0	179.5	179.5	171.3	157.3	150.6	153.4	177.4	175.2
V.A	280.8	323.1	322.3	326.4	363.9	298.1	289.9	299.6	348.4	355.0	375.4	380.2

B : Constant Prices

Sector	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Operating surplus	29.3	10.2	30.1	47.1	48.6	51.7	50.8	61.4	113.3	114.5	98.5	100.1
Indirect Tax	4.3	7.8	8.4	5.4	-1.8	-7.1	-18.1	-17.8	-18.0	-14.3	-13.7	-15.3
Dep	52.3	46.8	44.3	56.2	75.2	87.0	97.6	101.0	106.0	90.5	86.8	101.6
Wages & Salaries	163.7	174.6	180.1	188.5	194.1	187.7	184.2	174.2	167.0	162.4	185.6	173.3
V.A	249.6	239.4	262.9	297.3	316.1	319.3	314.5	318.8	368.3	353.1	357.2	359.7

Source : National Accounts, MOFNE, 1977-1992

B.D 1 = US\$ 2.65

Table (5.7) : NATIONAL INCOME OF SERVICES SECTOR

A : Current Prices

( MILLION B.D )

Sector	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Operating surplus	211.9	279.3	376.6	405.0	346.8	268.7	200.9	164.1	241.6	235.7	185.3	250.0
Indirect Tax	35.0	41.0	50.7	56.8	61.5	54.7	50.3	48.9	52.7	51.1	53.1	64.9
Dep	60.6	69.8	81.3	81.7	95.4	99.3	105.3	99.1	107.8	109.5	118.9	127.3
Wages & Salaries	220.2	255.0	309.1	370.7	412.4	421.1	437.3	437.8	459.2	479.6	519.5	512.4
V.A	527.7	645.1	817.7	914.2	916.1	843.8	793.8	749.9	861.3	875.9	875.8	954.6

B : Constant Prices

Sector	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Operating surplus	176.9	171.4	298.4	401.0	330.9	296.3	276.6	228.5	290.0	235.7	207.9	251.0
Indirect Tax	26.1	32.6	42.3	48.5	50.6	46.7	44.6	44.1	53.6	51.1	52.4	63.9
Dep	66.7	67.0	73.5	73.3	90.4	101.8	117.5	111.1	121.3	109.5	112.7	118.6
Wages & Salaries	289.2	303.8	324.6	358.9	381.2	398.6	424.4	444.6	460.5	479.6	497.6	497.7
V.A	558.9	574.8	738.8	881.7	853.1	843.4	863.1	828.3	925.0	875.9	870.6	1,031.20

Source : National Accounts, MOFNE, 1977-1992

B.D 1 = US\$ 2.65

**Table (5.8) : PER EMPLOYEE CONTRIBUTION TO MAJOR NATIONAL INCOME AT CONSTRAINT PRICES**

(B.D)

Year	Services Sector			Industrial Sector			
	Operating Surplus	Wages & Salaries	Indirect Tax	Operating Surplus	Wages & Salaries	Indirect Tax	Indirect Tax Constraint prices
1981	2,139	3,792	407	209	3,575	160	201
1983	4,257	3,810	515	822	3,291	94	110
1985	2,894	3,893	456	839	3,038	-115	-134
1987	1,982	3,856	383	1,162	3,296	-337	-373
1989	1,908	3,882	414	2,117	3,003	-264	-52
1991	2,831	4,014	515	1,600	2,771	-245	-245

Source : National Accounts, MOFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table ( 5.9 ) : MAJOR INDICATORS OF THE FINANCE & REAL ESTATE SECTOR AT CONSTANT PRICES

(THOUSANDS B.D.)

Sector	1976	1977	1978	1979	1980	1981	1982	1983
Value Added	86,591	108,247	121,720	112,482	127,386	152,796	252,992	360,773
Value of Production	120,621	157,333	176,183	176,857	202,460	242,627	365,973	443,680
Value of Input	34,031	49,088	54,462	64,376	75,073	89,831	112,982	82,905

Sector	1984	1985	1986	1987	1988	1989	1990	1991
Value Added	335,756	358,841	363,855	285,814	341,065	290,061	279,875	316,106
Value of Production	433,911	473,584	473,828	389,404	429,699	382,316	378,113	400,536
Value of Input	98,154	114,743	109,973	103,592	88,635	92,254	98,240	84,431

SOURCE : NATIONAL ACCOUNTS, MOFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table ( 5.10 ) : MAJOR INDICATORS OF THE FINANCE & REAL ESTATE SECTOR AT CURRENT PRICES

(THOUSANDS B. D.)

Sector	1976	1977	1978	1979	1980	1981	1982	1983
Value Added	64,853	93,083	123,954	130,546	175,503	260,203	357,567	403,958
Value of Production	85,494	125,041	164,801	181,776	240,571	340,387	454,043	483,164
Value of Input	20,641	31,959	401,850	51,229	65,066	80,185	96,475	97,206

Sector	1984	1985	1986	1987	1988	1989	1990	1991
Value Added	414,112	335,487	288,093	225,185	290,813	290,061	273,447	274,525
Value of Production	510,265	443,698	396,904	327,078	378,828	382,316	372,546	364,571
Value of Input	96,155	108,210	108,811	101,894	81,014	72,626	99,097	90,316

SOURCE : NATIONAL ACCOUNTS, MOFNE, 1977 - 1992

B. D 1 = US\$ 2.65

Table ( 5.11 ) : GDP BY INCOME FACTORS OF FINANCE & REAL ESTATE SECTOR

(MILLION B.D.)

(A) : Current Prices

Items	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Operating Surplus	83.8	133.4	212.4	215.5	202.9	142.8	111.3	69.6	134.4	127.3	90.3	102.2
Indirect Tax	0.9	0.9	1.1	1.1	4.6	4.8	4.4	3.9	3.8	4.0	4.3	3.4
Depreciation	2.5	3.0	3.3	4.9	5.3	9.6	10.9	7.4	11.1	8.6	11.7	9.8
Wages & Salaries	29.1	41.2	52.2	74.1	82.3	85.7	87.9	76.2	71.9	76.6	89.0	73.8
Value Added	116.3	178.5	269.3	295.6	295.1	242.9	214.5	157.1	221.2	216.5	195.3	189.2

(B) : Constant Prices

Items	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Operating Surplus	28.5	34.5	134.4	223.9	187.2	191.3	195.3	130.0	179.2	127.3	111.7	226.3
Indirect Tax	0.7	0.7	0.9	1.0	3.8	4.1	3.9	3.6	3.9	4.0	4.3	3.6
Depreciation	2.7	2.9	3.0	4.5	5.0	9.9	12.2	8.3	12.5	8.6	11.1	9.2
Wages & Salaries	48.4	59.4	59.7	70.9	77.2	84.7	88.3	77.6	76.1	76.6	76.3	69.1
Value Added	80.3	97.5	198.0	300.3	273.3	290.0	299.7	219.5	271.7	216.5	203.4	308.2

SOURCE : NATIONAL ACCOUNTS, MOFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.12). EMPLOYMENT IN FINANCE & REAL ESTATE SECTOR BY SUBSECTORS

(MILLION B.D.)

Sector	1976	1977	1978	1979	1980	1981	1982	1983
Commercial Banks	1,420	1,522	1,635	1,749	1,853	1,887	1,872	1,885
Offshore Banking	110	360	900	1,176	1,428	1,814	1,872	1,845
Insurance Co.	68	115	164	176	220	356	461	479
Real Estate	1,500	1,698	2,043	2,185	2,273	2,820	3,040	3,198
Others	37	45	52	65	86	92	101	102
Total	3,135	3,740	4,794	5,351	5,860	6,969	7,346	7,509

Sector	1984	1985	1986	1987	1988	1989	1990	1991
Commercial Banks	2,075	2,147	2,095	2,029	2,035	2,059	2,152	2,036
Offshore Banking	2,075	2,145	2,095	2,002	1,909	1,874	1,644	1,470
Insurance Co.	491	449	489	541	611	647	697	701
Real Estate	3,462	3,808	4,833	5,208	5,093	6,210	6,350	6,795
Others	120	132	142	142	265	289	286	314
Total	8,223	8,681	9,654	9,922	9,913	11,079	11,129	11,316

SOURCE : NATIONAL ACCOUNTS, MOFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.13) : VALUE ADDED OF FINANCE & REAL ESTATE SECTOR AT CONSTANT PRICES

		(THOUSANDS B.D.)										
Sector	1976	1977	1978	1979	1980	1981	1982	1983				
Commercial Banks	8,992	12,823	16,917	29,682	22,904	22,746	36,130	55,097				
Offshore Banking Units	31,796	41,425	45,928	21,550	37,064	52,303	129,947	193,176				
Investment Banks	0	0	0	0	334	1,424	793	22,010				
Insurance Co.	3,810	5,487	6,513	8,922	11,239	12,150	14,540	12,796				
Real Estate	30,878	34,387	41,187	44,649	47,146	55,347	55,022	60,459				
Others	11,115	14,125	11,175	7,679	8,699	8,826	16,560	17,235				
Total	86,591	108,247	121,720	112,482	127,386	152,796	252,992	360,773				
Sector	1984	1985	1986	1987	1988	1989	1990	1991				
Commercial Banks	63,795	59,957	63,007	59,425	61,983	60,406	54,476	67,842				
Offshore Banking Units	173,620	179,242	127,830	74,340	125,466	54,391	66,760	92,187				
Investment Banks	3,232	8,052	53,340	46,037	52,680	68,961	56,633	50,607				
Insurance Co.	14,454	19,019	26,722	14,226	6,356	5,285	(980)	(10,773)				
Real Estate	62,455	68,861	63,812	66,329	69,338	73,500	76,476	79,768				
Others	18,200	23,710	29,144	25,457	25,242	27,518	26,510	36,475				
Total	335,756	358,841	363,855	285,814	341,065	290,061	279,875	316,106				

SOURCE : NATIONAL ACCOUNTS, MOFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.14) : VALUE OF PRODUCTION OF FINANCE & REAL ESTATE SECTOR AT CONSTANT PRICES

(MILLION B.D.)

Sector	1976	1977	1978	1979	1980	1981	1982	1983
Commercial Banks	19,345	25,503	26,651	39,430	33,546	31,269	44,592	62,897
Offshore Banking Units	36,261	50,771	59,450	40,386	61,979	85,153	163,356	231,542
Investment Banks	0	0	0	0	991	2,206	3,881	26,345
Insurance Co.	16,462	24,434	28,424	35,665	41,525	48,594	70,392	29,852
Real Estate	37,433	42,145	49,966	53,112	55,192	65,885	66,428	75,055
Others	11,430	14,480	11,692	8,264	9,227	9,520	17,324	17,989
Total	120,631	157,333	176,183	176,857	202,460	242,627	365,973	443,680

Sector	1984	1985	1986	1987	1988	1989	1990	1991
Commercial Banks	71,153	70,397	71,103	69,371	72,691	73,112	63,598	77,898
Offshore Banking Units	211,035	223,654	168,680	119,276	164,218	87,753	103,557	134,090
Investment Banks	21,177	34,575	86,007	65,683	67,138	88,589	84,103	54,192
Insurance Co.	33,363	38,314	43,635	32,087	20,198	19,111	12,996	3,976
Real Estate	78,194	81,912	74,398	76,476	79,114	83,395	85,645	90,267
Others	18,989	24,732	30,005	26,511	26,340	30,356	28,214	40,113
Total	433,911	473,584	473,828	389,404	429,699	382,316	378,113	400,536

source : National Accounts, MoFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.15) : VALUE OF INPUT OF FINANCE & REAL ESTATE SECTOR AT CONSTANT PRICES

(MILLION B.D.)

Sector	1976	1977	1978	1979	1980	1981	1982	1983
Commercial Banks	10,353	12,680	9,733	9,748	10,642	8,523	8,462	7,800
Offshore Banking Units	4,465	9,346	13,522	18,837	24,915	32,850	33,409	38,366
Investment Banks	0	0	0	0	657	782	3,088	4,335
Insurance Co.	12,652	18,949	21,911	26,744	30,286	36,444	55,851	17,056
Real Estate	6,256	7,758	8,779	8,463	8,046	10,538	11,406	14,595
Others	305	355	517	584	527	694	764	753
Total	34,031	49,088	54,462	64,376	75,073	89,831	112,980	82,905

Sector	1984	1985	1986	1987	1988	1989	1990	1991
Commercial Banks	7,358	10,440	8,096	9,947	10,708	12,706	9,122	10,56
Offshore Banking Units	37,415	44,412	40,850	44,936	38,753	33,363	36,798	41,903
Investment Banks	17,945	26,523	32,667	19,646	14,459	19,628	27,470	3,586
Insurance Co.	18,909	19,295	16,913	17,862	13,841	13,826	13,976	14,749
Real Estate	15,738	13,051	10,586	10,146	9,776	9,894	9,169	10,499
Others	789	1,022	861	1,055	1,098	2,837	1,705	3,638
Total	98,154	114,743	109,973	103,592	88,635	92,254	98,240	74,441

source : National Accounts, MoFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.16) : VALUE ADDED OF FINANCE & REAL ESTATE SECTOR AT CURRENT PRICES

(THOUSANDS B.D.)

Sector	1976	1977	1978	1979	1980	1981	1982	1983
Commercial Banks	10,452	13,538	16,325	28,398	24,437	29,044	43,185	50,173
Offshore Banking Units	14,799	24,226	39,277	30,424	70,995	122,772	193,314	198,392
Insurance Co.	1,132	1,447	3,396	4,680	6,118	6,655	7,309	6,848
Investment Banks	0	0	0	0	870	3,252	2,197	22,605
Real Estate	32,359	44,078	54,228	56,621	59,255	81,640	88,159	108,180
Others	6,111	9,794	10,728	10,423	13,828	16,840	23,403	17,760
Total	64,853	93,083	123,954	130,546	175,503	260,203	357,567	403,958

Sector	1984	1985	1986	1987	1988	1989	1990	1991
Commercial Banks	58,123	52,229	51,038	49,516	51,598	60,406	52,135	54,079
Offshore Banking Units	203,423	154,869	85,215	44,274	99,390	54,391	63,856	83,991
Insurance Co.	7,469	10,643	25,121	14,823	6,991	5,285	(1,099)	(10,852)
Investment Banks	5,094	3,944	31,447	29,475	42,018	68,961	54,292	35,498
Real Estate	118,998	92,653	73,464	68,112	69,644	73,500	78,173	84,857
Others	21,005	21,149	21,808	18,985	21,172	27,518	26,090	26,682
Total	414,112	335,487	288,093	225,185	290,813	290,061	273,447	274,255

SOURCE : NATIONAL ACCOUNTS, MOFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.17) : VALUE OF PRODUCTION OF FINANCE & REAL ESTATE SECTOR AT CURRENT PRICES

(THOUSANDS B.D.)

Sector	1976	1977	1978	1979	1980	1981	1982	1983
Commercial Banks	17,963	23,681	24,747	37,549	35,343	37,961	52,025	58,404
Offshore Banking Units	18,037	31,698	50,971	48,098	96,516	157,119	228,199	238,857
Insurance Co.	6,474	9,618	16,446	21,008	25,635	31,030	44,202	17,496
Investment Banks	0	0	0	0	1,543	4,069	5,422	27,177
Real Estate	36,687	49,966	61,462	64,150	67,165	92,642	99,994	122,675
Others	6,333	10,078	11,175	10,971	14,369	17,566	24,201	18,555
Total	85,494	125,041	164,801	181,776	240,571	340,387	454,043	483,164

Sector	1984	1985	1986	1987	1988	1989	1990	1991
Commercial Banks	66,070	62,855	59,250	59,458	62,306	73,112	61,327	67,605
Offshore Banking Units	243,814	200,049	126,630	89,168	138,112	87,753	100,915	128,324
Insurance Co.	19,133	22,591	40,419	32,012	20,638	19,111	13,180	4,170
Investment Banks	24,466	30,926	64,566	49,103	56,465	88,589	81,958	39,292
Real Estate	134,926	105,088	83,358	77,299	79,038	83,395	87,358	94,834
Others	21,856	22,189	22,681	20,038	22,269	30,356	27,808	30,346
Total	510,265	443,698	396,904	327,078	378,828	382,316	372,546	364,571

SOURCE : NATIONAL ACCOUNTS, MOFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.18) : VALUE OF INPUT OF FINANCE & REAL ESTATE SECTOR AT CURRENT PRICES

(MILLION B.D.)

Sector	1976	1977	1978	1979	1980	1981	1982	1983
Commercial Banks	7,511	10,143	8,423	9,151	10,906	8,916	8,840	8,231
Offshore Banking Units	3,238	7,472	11,695	17,673	25,521	34,347	34,884	40,465
Insurance Co.	5,342	8,171	13,051	16,328	19,516	24,376	36,893	10,648
Investment Banks	0	0	0	0	673	818	3,225	4,572
Real Estate	4,328	5,889	7,234	7,529	7,910	11,002	11,835	14,495
Others	222	284	447	548	540	726	798	795
Total	20,641	31,959	40,850	51,229	65,066	80,185	96,475	79,206

Sector	1984	1985	1986	1987	1988	1989	1990	1991
Commercial Banks	7,947	10,626	8,212	9,942	10,708	12,706	9,192	13,526
Offshore Banking Units	40,391	45,180	41,415	44,895	38,721	33,363	37,060	44,333
Insurance Co.	11,664	11,948	15,298	17,188	13,648	13,826	14,279	15,023
Investment Banks	19,373	26,982	33,119	19,628	14,447	19,628	27,665	3,793
Real Estate	15,928	12,434	9,894	9,187	9,393	9,894	9,184	9,977
Others	852	1,040	873	1,054	1,097	2,837	1,717	3,664
Total	96,155	108,210	108,811	101,894	88,014	92,254	99,097	90,316

SOURCE : NATIONAL ACCOUNTS, MOFNE, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.19) : TOTAL ASSETS &amp; LIABILITIES OF COMMERCIAL BANKS

(MILLION B.D.)

(A) : Assets :

	1976	1977	1978	1979	1980	1981	1982	1983	1984
Reserves	38.5	25.4	33.9	36.9	37.8	40.8	53.9	36.3	40.0
Cash	3.6	3.0	5.5	3.9	3.2	3.5	3.9	5.1	5.3
Balances with BMA	34.9	22.3	28.5	33.0	34.6	37.4	50.0	31.2	34.7
Advances & Credits	271.5	315.3	341.4	395.2	454.2	495.4	568.6	630.4	727.8
Foreign Assets	189.9	223.6	243.8	236.7	320.0	343.1	358.1	470.1	435.8
Balance with Local Banks	39.0	38.0	28.0	22.0	26.8	15.4	18.4	12.8	25.0
Other Assets	23.5	36.6	45.3	56.0	62.2	65.2	71.3	78.6	99.0
Contra Accounts	192.2	186.1	211.1	185.0	238.9	279.9	455.2	431.7	544.0
Total without Contra Accounts	562.3	638.9	692.4	746.8	900.9	959.9	1,070.2	1,228.1	1,327.6
Total Assets	754.4	825.0	903.6	931.8	1,139.8	1,239.9	1,525.4	1,659.7	1,871.6

(B) : Liabilities :

	1985	1986	1987	1988	1989	1990	1991	1992
Reserves	56.5	47.4	54.1	48.7	53.5	196.7	141.5	116.5
Cash	6.4	5.9	6.5	9.7	9.3	11.3	11.6	11.8
Balances with BMA	50.0	41.5	47.7	39.0	44.1	185.4	129.9	104.7
Advances & Credits	677.5	678.9	713.1	606.6	610.1	635.8	595.2	654.5
Foreign Assets	586.8	694.6	694.3	855.9	1,170.5	941.9	1,069.5	1,004.9
Balance with Local Banks	30.5	22.1	20.8	20.1	28.6	7.1	33.3	35.3
Other Assets	105.3	109.1	138.7	142.8	191.9	89.8	175.7	236.9
Contra Accounts	515.2	532.9	636.3	511.0	514.5	436.2	571.4	614.7
Total without Contra Accounts	1,456.6	1,552.1	1,621.1	1,674.0	2,054.5	1,871.3	2,015.3	2,048.1
Total Assets	1,971.8	2,085.0	2,257.4	2,185.0	2,568.9	2,307.5	2,586.6	2,662.8

SOURCE : BAHRAIN MONETARY AGENCY, QUARTERLY STATISTICAL BULLETIN, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.20) : BANK LENDING BY ECONOMIC SECTORS

(MILLION B.D.)

Sectors	1976	1977	1978	1979	1980	1982	1981	1983	1984
Manufacturing	37.5	43.2	44.5	51.8	57.6	38.9	44.5	61.1	109.6
Mining & Quarrying	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Agriculture	0.5	1.5	1.6	1.7	0.8	1.2	0.9	1.1	1.9
Construction	87.8	130.6	136.3	153.1	162.7	166.2	149.1	196.9	193.1
Trade	79.2	76.1	77.5	96.2	118.0	175.9	145.4	173.8	177.9
Transport	32.0	27.3	18.9	16.5	19.1	12.8	13.8	12.2	20.9
Government	3.6	4.6	16.0	19.4	19.3	23.9	7.9	25.0	30.7
Personal	21.5	25.9	36.3	41.1	51.3	121.3	89.3	128.2	150.4
Other	9.5	6.2	10.3	15.1	25.4	28.4	44.4	32.0	43.1
Total Bank Lending	271.6	315.3	341.4	394.9	454.1	568.6	495.3	630.4	727.8

Sectors	1985	1986	1987	1988	1989	1990	1991	1992
Manufacturing	96.4	80.6	70.1	75.7	85.6	111.4	113.5	132.4
Mining & Quarrying	0.0	0.0	0.5	0.0	15.1	25.1	29.4	26.3
Agriculture	0.6	1.1	1.2	1.2	0.6	0.7	1.7	0.4
Construction	180.3	175.8	145.6	160.4	131.2	99.5	91.4	85.3
Trade	168.1	145.5	113.8	118.1	107.1	111.9	118.2	129.9
Transport	11.3	10.6	17.7	24.0	32.2	63.7	30.6	15.7
Government	34.4	73.6	169.7	61.3	45.7	12.2	15.0	17.8
Personal	147.3	153.0	161.9	139.0	166.8	182.3	167.2	210.2
Other	39.1	38.7	32.6	26.9	25.9	29.0	28.4	36.5
Total Bank Lending	677.5	678.9	713.1	606.6	610.2	635.8	595.2	654.5

SOURCE : BAHRAIN MONETARY AGENCY, QUARTERLY STATISTICAL BULLETIN, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.21) : OUB's ASSETS & LIABILITIES

(MILLION B.D.)

	1976	1977	1978	1979	1980	1981	1982	1983	1984
<i>Assets</i>									
<i>Loans to Non Bank</i>	1,734	3,706	6,166	6,688	8,493	11,242	14,316	15,977	18,392
<i>Interbank</i>	4,426	11,477	16,405	19,961	26,797	35,140	39,558	41,432	41,634
<i>Commercial in Bahrain</i>	136	162	204	200	204	144	270	384	310
<i>Other OBU's</i>	510	2,012	2,792	4,490	6,707	8,771	9,847	8,996	8,521
<i>Outside Bahrain</i>	3,780	9,303	13,409	15,271	19,886	26,225	29,441	32,052	32,803
<i>Other Assets</i>	54	518	870	1,115	2,176	4,352	5,133	5,332	2,666
<i>Assets/ Liabilities</i>	6,214	15,701	23,441	27,764	37,466	50,734	59,007	62,741	62,692
<i>Liabilities</i>									
<i>Non Bank's Deposits</i>	598	3,513	4,786	7,009	8,530	11,968	13,698	14,734	14,872
<i>Interbank</i>	5,536	11,769	17,947	19,837	27,044	35,544	40,995	43,313	43,018
<i>Commercial in Bahrain</i>	87	128	209	198	410	847	885	1,881	1,161
<i>Other OBU's</i>	510	2,012	2,792	4,490	6,707	8,771	9,847	8,996	8,521
<i>Outside Bahrain</i>	4,939	9,629	14,946	15,149	19,927	25,926	30,263	32,436	33,336
<i>Other Liabilities</i>	80	419	708	918	1,892	3,222	4,314	4,694	4,802

SOURCE : BAHRAIN MONETARY AGENCY, QUARTERLY STATISTICAL BULLETIN, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.21) : OUB's ASSETS & LIABILITIES

(MILLION B.D.)

	1985	1986	1987	1988	1989	1990	1991	1992
<b>Assets</b>								
Loans to Non Bank	15,873	13,862	13,097	12,206	11,866	9,405	9,796	11,304
Interbank	38,476	39,056	46,781	52,501	56,622	47,172	39,753	53,052
Commercial in Bahrain	270	232	423	267	474	758	254	231
Other OBU's	7,387	6,379	5,180	4,915	4,751	2,299	1,941	2,394
Outside Bahrain	30,819	32,445	41,178	47,319	51,397	44,115	37,558	50,427
Other Assets	2,456	2,762	3,604	3,417	4,092	3,286	3,833	5,411
Assets/ Liabilities	56,805	55,680	63,482	68,124	72,580	59,863	53,382	69,767
<b>Liabilities</b>								
Non Bank's Deposits	13,097	13,072	15,207	19,455	22,373	17,276	16,853	15,907
Interbank	38,752	37,641	42,833	43,034	44,739	37,665	31,365	47,474
Commercial in Bahrain	1,479	1,581	1,474	1,596	1,215	676	856	804
Other OBU's	7,387	6,379	5,180	4,915	4,751	2,299	1,941	2,394
Outside Bahrain	29,886	29,681	36,179	36,523	38,773	34,690	28,568	44,276
Other Liabilities	4,956	4,967	5,442	5,635	5,468	4,922	5,164	6,386

SOURCE : BAHRAIN MONETARY AGENCY , QUARTERLY STATISTICAL BULLETIN, 1977 - 1992

B.D 1 = US\$ 2.65

Table (5.22) : OBU's GEOGRAPHICAL CLASSIFICATION

(MILLION B.D.)

	1976	1977	1978	1979	1980	1981	1982	1983	1984
<i>Assets</i>									
<i>Arab Countries</i>	2,487	7,065	11,688	14,739	19,770	24,823	28,993	29,370	29,290
<i>North American</i>	13	468	277	477	641	1,003	1,431	2,252	1,965
<i>Western Europe</i>	1,129	3,904	5,301	6,917	9,764	13,257	14,321	15,604	16,541
<i>Offshore Centres</i>	241	1,888	2,971	2,243	2,538	3,857	4,654	6,010	5,614
<i>Other</i>	1,344	2,376	3,204	3,388	4,753	7,794	9,608	9,505	9,282
<i>Assets/Liabilities</i>	6,214	15,701	23,441	27,764	37,466	50,734	59,007	62,741	62,692
<i>Liabilities</i>									
<i>Arab Countries</i>	2,578	8,255	11,666	16,143	24,236	34,075	39,452	41,099	41,147
<i>North American</i>	214	419	1,891	828	358	700	1,287	2,677	2,469
<i>Western Europe</i>	2,277	4,995	7,018	7,873	9,311	11,101	12,296	12,882	13,528
<i>Offshore Centres</i>	923	1,539	1,850	1,936	2,339	2,905	4,371	4,656	4,214
<i>Other</i>	222	493	1,016	984	1,222	1,953	1,601	1,427	1,334

SOURCE : BAHRAIN MONETARY AGENCY, QUARTERLY STATISTICAL BULLETIN, 1977 - 1992

B.D I = US\$ 2.65

Table (5.22) : OBU's GEOGRAPHICAL CLASSIFICATION

(MILLION B.D.)

	1985	1986	1987	1988	1989	1990	1991	1992
<i>Assets</i>								
<i>Arab Countries</i>	26,265	24,926	25,640	27,761	29,956	25,324	21,273	22,756
<i>North American</i>	2,299	3,458	6,098	4,839	7,871	8,472	7,699	14,005
<i>Western Europe</i>	13,310	13,132	15,201	14,163	14,269	13,384	11,891	16,813
<i>Offshore Centres</i>	6,579	6,015	6,197	8,025	7,608	4,931	3,786	5,116
<i>Other</i>	8,352	8,149	10,346	13,336	12,876	7,752	8,733	11,077
<i>Assets/Liabilities</i>	56,805	55,680	63,482	68,124	72,580	59,863	53,382	69,767
<i>Liabilities</i>								
<i>Arab Countries</i>	38,398	37,268	38,323	42,238	45,003	34,439	31,895	32,938
<i>North American</i>	1,882	2,389	3,616	4,668	5,752	8,135	5,051	12,547
<i>Western Europe</i>	11,058	10,561	13,237	11,355	12,716	11,531	8,596	14,289
<i>Offshore Centres</i>	3,952	3,698	5,910	5,724	5,638	3,203	4,250	4,850
<i>Other</i>	1,515	1,764	2,396	4,139	3,471	2,555	3,590	5,143

SOURCE : BAHRAIN MONETARY AGENCY ; QUARTERLY STATISTICAL BULLETIN, 1977 - 1992

B.D 1 = US\$ 2.65

*Table (5.23) : THE GROWTH OF INSURANCE COMPANIES BY CATEGORIES 1981 - 1991*

Sector	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
<i>Local Companies</i>	5	5	6	6	6	7	7	7	8	9	9
<i>Foreign Companies</i>	13	14	14	13	12	13	13	13	13	13	11
<i>Exempt OBUS companies</i>	9	11	17	20	25	27	29	33	36	40	43
<i>Total</i>	22	31	37	39	43	47	49	53	57	62	63

*SOURCE : INSURANCE ANNUAL REPORTS MOCA 1984, 1989 AND 1991.*

Table (5.24) : BALANCE SHEETS OF LOCAL INSURANCE COMPANIES

(B.D. 1000)

Sectors	1985	1986	1987	1988	1989	1990
Current Assets	16,316	18,786	15,178	13,859	11,845	15,916
Investments	824	843	1,059	1,009	9,146	9,282
Fixed Assets	9,491	10,459	11,094	12,803	4,016	3,873
Total Assets	26,631	30,088	27,331	27,671?	25,007	29,071
Current Liabilities	10,481	13,911	10,273	9,108	7,374	7,849
Long-term Loan	1,962	903	387	79	-	-
Insurance Commandment	6,485	6,079	6,612	7,048	5,989	6,939
Shareholding	7,703	9,231	10,059	11,438	11,689	14,283
Total Liabilities	26,631	30,124	27,331	27,673 ?	25,052	29,071

SOURCE : INSURANCE ANNUAL REPORTS MOCA 1984, 1989 AND 1991

B.D I = US\$ 2.65

## CHAPTER SIX

### SUMMARY & CONCLUSION

## SUMMARY & CONCLUSION:

There has been lively debate on the economic development strategy that Bahrain should adopt, to diversify the economy away from dependence on the rapidly depleting oil and gas reserves. While the debate has encompassed a wide section of the population, there has been a significant lack of data to help conclude the debate either way. Whilst it is acknowledged that there is dearth of information on Bahrain at this stage of its development, this study attempts to provide sectoral and sub sectoral data which, it is considered, will be sufficient and will help to conclude the debate on the strategy. Bahrain cannot afford to delay making the choice since it will find itself without oil in the near future.

The study takes into account the special nature of the problem considering Bahrian as a very small island economy, surrounded by wealthy oil rich nations, having its links with Arabian cultural and political traditions of the area. It lays the framework through a study of the relevant theories and literature and highlights the special nature of Bahrain's needs with supporting data from a sectoral and subsectoral analysis to assist in the resolution of the problem of which strategy to be followed. The study identifies the growing importance of the services sector in the economy, which has developed in spite of the absence of encouragement vis-a Vis the industrial sector. Based on identifying a leading sector, and taking into account gains that would be available on regional integration of the economy, and with appropriate commitment and assistance by the government, it is concluded that the services sector provides the best scope

for development for the period when Bahrain will have no oil.

The very rudimentary nature of the available data, and the necessity for better data is highlighted while the study is based on the analysis of available national accounting data, sectoral and sub-sectoral. It is believed that the study will encourage other researchers to build up data on the economy in the future.

This concluding chapter gives a brief summary of the study and its main findings, its weaknesses and suggestions for improvement in future research.

#### Summary:

Chapter One refers to different definitions available to define a small economy and states that Bahrain is a small economy with a population less than one million, occupying a small area, and heavily dependent on one depleting natural product. It has all the characteristics of small economies, and faces the same disadvantages in that they are less diversified, unable to exploit economies of scale, concentrate on a product they themselves find having a comparative advantage, and with limited manpower resources. National and defence policies impose a heavy burden on resources, and people rely on the government for employment, while the government itself has a non-diversified revenue base. It is increasingly marginalised from the world economy. However there are advantages, which it can benefit from, like having greater flexibility to adjust to changes, a smaller public

administration, and receiving more foreign aid and grants. The chapter concludes by pointing out that small economies always need strong political leadership, a flexible economic vision/strategy, diversification policies, developing an export oriented infrastructure, maintaining healthy foreign exchange reserves and a good rating to allow ready access to the capital markets.

Chapter Two sets the theoretical framework for the development of a small economy and refers to the mixed experience of countries in regard to economic development theories. The chapter also analyses the stages of growth theory and refers to the establishment of a leading sector as the most important feature of the stage growth theory. It also analyses the dependency theory, which attempts to explain underdevelopment in terms of impediments to growth. Current progress towards regional groupings, and the desire of developing countries to strengthen economic cooperation is highlighted whether the removal of discriminatory barriers or establishment of a customs union achieves it

This chapter also reviews the developments in recognising the service sector. Dismissed as unproductive by early economists, it was only in the 19th century that the services sector's contribution was recognised. The development of the United States of America has shown the importance of services. After World War II more than half the employed population were in services. Similar developments have been observed in the OECD countries. The study also defines the services sector, and the classification based on the United Nations System of National Accounts is accepted for the purposes of this study.

Chapter Three describes the situation in Arab and Arabian Gulf countries. These countries form a highly interdependent economic group, and have seen the emergence of national movements strongly preferring an industrialisation strategy to become less dependent. Experiments in central planning have been tried out, with disappointing results. These countries have also depended on the oil revenue to finance industrial and infrastructure development and have witnessed fluctuating growth based on the movement in international oil prices.

Gulf Arab countries also form a distinct group and have as their goal coordination of policies for integrated development of this sub region. Bahrain is part of this grouping. The economies of these countries are also based on production and export of oil, but are in the process of diversification of the economy. The limits to investment has been taken note of by these countries, and have made the decision to rationalise the use of oil revenue, by translating them into long lasting physical assets that would generate income in the future. The chapter surveys the problems of industrialisation and limitations of industrial development and the advantages that regional integration offers in promoting developmental objectives as a group, which cannot feasibly be promoted individually. It is seen that regional integration provides a wider market and internal and external economies of scale.

Chapter Four surveys economic development in Bahrain from the traditional activities through developments consequent to the discovery of oil. After enjoying relatively high growth consequent to high oil prices, the economy

reached a watershed in 1980, and was henceforth in relative decline pulled down by the twin forces of declining oil prices and declining oil production. Tracing recent development it is observed that the economy has passed through distinct stages. The years 1976 - 1980 were a period of rapid growth followed by a period 1981 - 1985 when relative decline set in. The period 1986 - 1990 was the period when the real effect of the declining price of oil was felt.

The changes during these periods introduced profound structural changes in the economy, which saw the primary sector decline from being 39.4% of the GDP in 1975 to 18.4% in 1990. The secondary sector showed modest growth and increased from being 20.3% of GDP in 1975 to 26% of GDP in 1990. The tertiary sector saw the largest growth when it increased from being 40.3% in 1975 to 56% in 1990. There was thus a discernible trend towards Bahrain becoming a service economy.

Until 1932 Bahrain had a traditional economy based on small farming and fishery, especially pearl diving, and linked to the world economy through its exports and imports, enhanced by its location, which made it the hub of the Gulf. The early discovery of oil compared with the rest of the GCC countries gave it an advantageous position. The oil revenues provided the country with the needed funds to develop its infrastructure. Formal education and training also started earlier than in the rest of the GCC countries.

This chapter also surveys the impact of changing oil revenue on public finance, and the role of the government during the different stages of the growth of the economy. It highlights the government efforts to diversify the

economy away from oil, using revenue obtained from the high price of oil.

Chapter Five gives a comparison of three sectors of the economy, primary, industrial and service. The chapter uses sectoral and sub-sectoral data from national income statistics, both nominal and constant series, and other available data to analyse the strength and weakness of the three sectors. It further, highlights the prospects of the industrial and services sectors, to determine the future scope of its development.

The data shows that the value added of the services sector has had a strong growth during period averaging 6.4% p.a. ahead of the industrial sector, which grew at 4.7% p.a. Despite the higher growth in value of input in the services sector, the strong growth in demand (value of production) has contributed to the better performance of the services sector. The services sector also showed better performance in employment, which grew by 5.8% as against 3.9% in the industrial sector. The services sector thus has increased the contribution to employment from 57% in 1976 to 64 % in 1991.

Value added per employee is higher in the services sector, although output per employee is lower, which demonstrates that the services sector needs lower inputs than the industrial sector. Similarly the total wages and total operating surplus was significantly higher in the services sector than in the industrial sector. In regard to taxation, the services sector makes a contribution far greater than the negative impact the industrial sector has, due to the prevailing incentives to the industrial sector. These indicators show that the services sector has despite the absence of incentives

outperformed the industrial sector.

## CONCLUSION:

It is explained in detail in Chapter Four, that the discovery of oil brought profound changes in the economy of Bahrain. It transformed Bahrain into a modern economy, with a faster rate of economic growth and a high per capita income. It resulted in a movement of labour from traditional jobs such as in the agriculture and fisheries sectors into modern manufacturing such as oil production and oil refining. It contributed to social changes and to increasing the standard of living, the creation of governmental organisations and the formation of political interest groups.

After thirty years, when oil production started to decline by 1965 Bahrain started to think seriously about the future economic development which very much depended on oil production. Before embarking on a diversification strategy, Bahrain had to face the question of choosing the appropriate future economic path, which at that time was influenced by two main factors. First was the internal situation which needed urgent action, especially in regard to the growing number of Bahrainis entering the labour market with less prospect of getting jobs and the dwindling oil production and revenue. Second was the internal and external political pressures from Nasserism, the emergent national movement, which clamoured for industrialisation as a means of achieving political independence and fostering economic and social development. This was further influenced by the general trend in the fewer developing countries, which also emphasised industrialisation as a strategy to achieve economic and political independence.

In 1967, Bahrain embarked on the first diversification programme selecting the industrialisation strategy. The main emphasis of economic development was on manufacturing industries namely petroleum and aluminum activities. The industrialisation strategy was based on the availability of cheap energy sources, provision of infrastructure and incentives and subsidies provided by the government and the importation of low cost foreign labour as well as foreign technology.

The government invested heavily in providing the required infrastructure such as industrial areas, utilities, natural gas, electricity and other infrastructure for the development and expansion of the manufacturing sector. The government also increased its involvement in the economy by taking an active direct role and investing in setting-up and expanding the manufacturing industries. In addition, the government also provided incentives and subsidies and established a governmental organisation to facilitate the development of the manufacturing sector.

The outcome of the industrial strategy was encouraging as the contribution of the oil production sector to the total gross domestic product (GDP) declined from 37 % in 1973 to 17 % in 1985, while the contribution of the industrial sector to the total GDP increased from 18% in 1973 to 25 % in 1985.

In 1983, however, the situation changed, and government revenue fell significantly due to a decline in international oil and aluminum prices. This in turn limited government ability to finance not only the new industrial

projects and other related expansion but also the infrastructure necessary for the industrial strategy. More importantly, oil production started to decline and natural gas production reached the maximum level of production. The situation was aggravated by the stiff competition that came from the heavily subsidised manufacturing industries of the Gulf Co-operation Council countries.

This situation raised the issue of whether Bahrain could afford to continue to take the same path and develop manufacturing industries. Therefore, Bahrain has been brought to face a crucial decision that will have a great impact on the future economic and social development. How should the future economic and social development in Bahrain take place? Is it financially and economically viable for Bahrain to look at the industrial sector as the leading sector in the future? Can the government continue the role of providing the infrastructure and incentives to facilitate the development of the manufacturing industries? Or should Bahrain search for another economic sector as the basis for future economic development and which economic sector may have more potential in playing the leading role in the future economic and social development?

As has been elaborated in the introduction, these questions have triggered a serious debate in Bahrain among government officials, businessman, academic scholars and other special interest groups. There was only agreement in one thing. That is that the primary sectors, i.e. agriculture and oil production, was not suitable to play a crucial role in the future economic development.

The advocates of the industrial strategy argued that this strategy would increase independence, increase local participation in terms of ownership and would be less fragile in the general political atmosphere. While the service sector strategy was very sensitive to the political atmosphere, it required a political will, increased dependency on the rest of the world and would destroy national pride and ownership. Furthermore, it was very vulnerable to changes in international economic and political relationships.

On the other hand, the advocates of the services sector strategy argued that the recent economic development had shown that the industrial sector had failed to sustain economic growth. With huge government investment, the industrial sector has not lived up to the expectation of creating jobs, increasing value added and increasing government revenue. For example, the contribution of the industrial sector to the gross domestic product increased from 12 % in 1976 to 16% in 1993. On the other hand, Bahrain had already created the conducive environment for the development of the services sector. Bahrain has been ranked third in the world economic freedom index in 1995.

The debate on Bahrain missed out two elements, which were very important in analysing the economy. The first was the knowledge of the special nature and characteristic of Bahrain as small-scale economy, which had limitations on economic choices, unlike the large economies. The second was the non-employment of detailed sectoral and subsectoral data required to research and evaluate the appropriate economic choice.

This research drew heavily on the character and uniqueness of the small

economy and examined in detail the data on sectoral and subsectoral developments in the economy. The research concentrated, analysed and highlighted major issues confronting Bahrain's future economic development. It has provided evidence to conclude the debate, and has pointed out the potential of the services sector.

As stated in Chapter One, the small economy displays special characteristics such as having a small area and tiny population and is less gifted with factor endowments making it less diversified. It is highly dependent on the exports of one or two primary products, and imports all necessities. It is therefore more integrated with regional and international economic systems. In addition, government revenues are the main sources of foreign exchange while government expenditure provides the engine of growth in the economy.

To a great extent, economic development in a small country is determined by external factors and has policy implications in terms of increasing dependence on the outside market, importation of a labour force and regional and international integration.

The question of self-sufficiency and self-reliance for the small economy, as was noted in Chapter One, ignore the actual realities. These nationalistic approaches cannot form a base for future economic development in a small country. This is due to the fact that the country by definition is a dependent one and so the only alternative economic development path to pursue is to concentrate on maximising the benefits of being small and utilise strong economic and political linkage with larger economies, either regionally or

internationally. In his concluding remarks Coles argued that the poor performance of the islands (South Pacific) have suggested a wide range of constraints such as small size, but one of the main causes of slow growth has been the adoption by the island government, of import substituting and domestic self-reliance policies. Instead of an outward looking private sector which had to fight and be efficient in the international marketplace, governments encouraged production for local needs behind tariff walls, and licensing frameworks which supported inefficiency and a lack of entrepreneurial spirit (Cole, 1993).

Unlike the larger economies, the small economy gives less priority to nationalism and ownership of the means of production. Therefore, the role of economic planning within this context is to visualise the role that the country can play to utilise domestic resources most efficiently and to maximise return from its location as well as its economic and political linkages with the larger economies. This is to capitalise on the distinct advantages of the small economy in terms of its ability to mobilise internal resources and the relative ease with which it can restructure the economy.

From a theoretical point of view (Chapter Two) two important conclusions related to the small economy could be established. The first is related to the concept of the leading sector. Because of the nature of the small economy there are one or two activities in one sector that lead the economic growth. The concept of balanced growth for the small economy is totally misleading. The second is related to the importance of economic integration to accelerate the development process in the small economy.

In trying to apply the above analysis to Bahrain, Chapter Four provides description of economic development and highlights the country's efforts to diversify the economy. Bahrain achieved a level in the stage of growth that might be described as the take-off stage by the beginning of the eighties. But the take off into sustained growth did not materialise and can be referred to as an abortive take-off stage. Thereafter, the industrial strategy was applied to bring about sustained economic growth in the economy and create more jobs. However, changes were taking place elsewhere which were fundamental, like the rapid decline in oil production and the appearance of government budget deficits. This meant that the industrial strategy adopted in the seventies could not be sustained in the nineties because of its high costs and its associated lower financial and economic return.

The comparison of the industrial sector and the services sector, in Chapter Five clearly shows the inadequacies of the industrial sector. It may be stated that the industrial sector's performance was not encouraging, despite the fact that the government had invested heavily in its development. Chapter Five explored the possibility of achieving economic development through the development of the services sector, and concludes that the services sector has more potential than the industrial sector and the primary sector to play a leading role in future economic development.

The detailed subsectoral analysis and the evaluation of the services sector given in Chapter Five support the above conclusion. The potential of the activities in the services sector in terms of generating value added and creating jobs is clearly revealed in the analysis of the services sector in Chapter Five. The conclusion of these chapters provides adequate arguments

for the selection of the services sector as a leading sector and its ability to play a leading role in the future economic development of Bahrain.

The future role of the services sector is placed in the context of what has been argued in Chapters Three and Four. The location of Bahrain in the larger context of the Middle East and in the specific context of the GCC countries provides Bahrain with a unique role to play. Bahrain for instance has an open society with a comparatively large share of women in the labour force. The highly advanced infrastructure in communication, transportation and other services is comparable with developed countries. In addition, Bahrain has a well-established and modern soft infrastructure with growth friendly regulations, laws and procedures. It is also an international arbitration centre.

Being small is an advantage to the Bahrain economy in that it could mobilise internal resources and hence adjust quickly and more easily to external shocks than a larger economy. Historically, Bahrain with an advantageous geographical location played the role of servicing the Gulf area. In this respect, the private sector played a major role in economic development. These are comparative advantages of Bahrain over the rest of the countries of the region. These advantages will provide the right mix of factors, which are conducive to the development of the service sector in the future.

As we have seen in the previous chapters, the historical development shows that the service sector was the major source of job creation and value added in Bahrain, confirming what Demetriades, Al-Jebory and Kamperis argued that "the main reason behind the success of small island economies, which

seems to have been overlooked by the early literature, was their comparative advantage on the provision of services of which tourism seems to be the most important one (Demetriades, Al-Jebory and Kamperis, 1993). The study comparing the potential of the industries sector and the services sector have provided evidence of the superior position of the services sector as a leading sector. The requirement for the development of the service sector is more affordable to Bahrain because it does not require much financial resources or natural resources. What it requires is a political will, further development of the soft infrastructure as well as investing more in human resources development such as in education and training.

The adoption of the service sector led strategy will also provide the government with an opportunity to lessen its dominance in the economy in favour of increasing the role of the private sector. This will also enable more financial resources to be released to the social services sector especially for education and training. Therefore such strategy should be policy oriented to encourage the private sector and to attract local and foreign investment.

Based on the above, one of objectives of the research as to the importance of an early conclusion of the debate on industrial strategy vis-a-vis services strategy has been achieved. It is concluded that the services sector led strategy is more viable for Bahrain, given the nature of the economy and limitations on resources.

Petri argued that " the common features of East Asian development lie deeper, in success along three critical dimensions of economic management.

Each East Asian Miracle economy (1) built a stable macroeconomics environment conducive to investment and enterprise, (2) used powerful market or non-market incentives to guide resources and initiative into efficient activities, and (3) found a dynamic engine of growth to provide leadership for development (Petri, 1994).

To summarise the conclusion of this research, it may be reiterated that it is very important for the future economic and social development in Bahrain to conclude the debate on the future strategy. The opportunity may be missed and events taking place in Bahrain specifically and in the region in general, might over-take the issues if there is no clear direction of the economy. The globalisation of factors of production, technological progress and information technology will change and may shift the comparative advantage of Bahrain if it is not ready to deal with these changes.

Whatever conclusion is made, it should be based on coherent data and information. The analysis of the data to evaluate the historical performance is crucial to visualise the future economic and social development. The analysis of the past data has shown that the services sector is the main contributor in the economy in terms of value added, operating surpluses and jobs. Therefore, the services sector has the potential to play the leading role in the future development of Bahrain.

As a small island economy, the services sector development is more applicable for Bahrain. Some countries such as Singapore's economic development experience have shown that it is more feasible as a small economy to concentrate on developing the services sector with proper

macroeconomics and microeconomics policies.

The limited resources, depleting oil and gas reserves, limited fish stocks and increasing salinity of the aquifer, have reduced the possibility that the primary sector can become a leading sector again. The comparison between the industrial sector and the services sector has shown that the industrial sector dominated by the large scale industries and dependent on oil and gas has not got the dynamism to become the leading sector.

On the other hand, the services sector, which is integrated with the regional development, has grown at a very high rate, and has become dominant. Prospects for the sector show that the potential for growth is very high. Further, it is the sector what will gain most through the emerging information technology products. This sector, particularly the financial services sector within it shows the potential for leading growth in future.

Services sector costs are very low, reflecting both the labour intensive nature of the sector as well as the lower capital needs per unit of output. It could grow at a higher rate, producing higher employment opportunities. This research has also found that the Finance and Real Estate sector which is within the Services sector has the potential to become the leading sector, and given the linkages in the economy will provide the correct incentives for the growth of the other sectors of the economy.

The study can be extended in the future to include other small island economies located in close proximity to the mainland, and determine how these countries performed especially in responding to the demand of the

mainland for services. This would add to the body of knowledge on economic development of countries based on providing off shore services. It will also be useful in the future where the comparative advantages of countries are breaking in the face of a developing world economy. The institutional features now in place such as the World Trade Organisation (WTO) would seek to breakdown barriers in its quest to develop a world of "free trade". The technological innovation and the information technology that is unfolding a new highway would bring about new products and a new delivery system. The rise of these serves will enhance the service providers, and thus the services sector of the economy. The services sector can no longer be relegated to a sector that is merely "servicing". Its potential to stand on its own will be enhanced in the future. More research will have to undertaken to bring out the importance of the services sector in economic development and indeed as a catalyst for growth.

Bahrain, just as many of the developing country lack appropriate data. What is available is rudimentary data, which is insufficient to analyse in depth the variables that influence economic development. However, it has substantive information in the form of national income statistics, although details are still lacking on details of investment. When more research is undertaken and the demand for appropriate data increases, it is believed that attempt will be made to improve on the availability of data to analyse the economy. More statistics will also be required for building of economic models to track the development of the economy, and to determine the appropriate path to be follow based on full information and analysis. It is hoped that this work will lead to compilation of more information relevant to economic development.

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