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Foreign Direct Investments in Armenia: Opening the Doors is Not Enough to Attract Investment

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Abstract:

FDI continues to be an essential contributing factor to Armenia's economic development. The Government of Armenia, having recognized the importance of FDI in the economy, officially announced an "open-door policy" since its independence. While this policy was positively reflected in several global indicators assessed by international organizations, there had not been tangible outcomes related to foreign investments in the economy, a fact explained by several strong objective and subjective factors related to the current global economic situation. These trends will continue in the absence of proactive and aggressive FDI generation and export promotion policies in the country.

An Open Door Policy

The Government of Armenia officially announced its "open door" policy for FDI and foreign trade at the beginning of its independence in 1991. Thus, the government has continuously been working on improving the country's business climate, which has resulted in improved positions in different international ratings.

No limitations are placed on foreigners making investments in Armenia, with the exception of land ownership, though foreign-owned companies registered in Armenia have the right to buy and/or own land. Several free trade zones have been established as an additional tool for foreign investment promotion. In these residents are exempt from VAT and profit tax and benefit from a "one window" principle for government services. Recently, the government re-organized the FDI promotion agency—the Development Foundation of Armenia (former Armenian Development Agency)—to be better equipped technically and professionally to generate investments and promote exports. By law, foreign investments in Armenia cannot be nationalized or confiscated except to serve national interests and must be accompanied by full compensation at current market prices.

Membership in the Eurasian Economic Union has, however, brought several uncertainties to Armenia's business environment, leading to negative impacts on domestic and international economic indicators. The situation became even more severe due to Russia's current economic and political situation in the international arena. Armenia's economy is strongly dependent on transfer inflows, imports of energy resources, and exports of consumer products to Russia.

The major disadvantages of Armenia's business environment include corruption, lack of transparency and frequently changing regulatory system, although the government has introduced several reforms and improvements have been made.

After a quarter of a century of independence, it appears therefore that an "open door" policy to attract

investment does only half of the job. This article will review some international indicators on the business environment of Armenia. It will then show the necessity of examining in detail what the barriers are to a more consistent and stable investment flow, explaining thereby why Armenia is still dependent on Russia.

International Indicators Measuring Armenia's Business Environment

The three South Caucasus countries have achieved various results on international indicators. (For a list of the ranking used, please see the Recommended Reading section at the end of this article.)

In 2015, Armenia's economic freedom score was 67.1 ranking the country in 52nd place out of 186 countries. Azerbaijan ranked 85th and Georgia ranked 22nd.

The Corruption Perception Index for Armenia in 2015 ranked it 95th among 168 countries. The rank of Azerbaijan was 119 and the rank of Georgia was 48. Corruption is an area that Armenia's government has to continue to improve.

Another measure of the business environment widely used in the international arena is the Doing Business Ranking, which measures business regulations across countries. For 2016 Armenia improved its position from 45th place to 35th out of 189 economies, although Armenia in 2015 became a member of the EEU, the members of which have worse positions.

Investors are looking into risks, too, especially political risks. Armenia and Azerbaijan have disputes related to the Nagorno-Karabakh region, which can easily escalate into a full-scale conflict as no experts see a resolution in the short-run. For example, the political risk assessment made by Delcredere|DuCroire, the Belgian public credit insurer, was pessimistic.

Even though the Global Innovation Index placed Armenia 61st out of 141 countries in 2015, it is the leading innovator for the high tech sector in the region. There is strong interest among foreign companies, cur-

rently dominated by the U.S. in Armenia's IT sector, as well as qualitatively high-level investments in this sector. There are several reasons for the competitiveness of this sector in Armenia:

- Armenia was considered to be a "Silicon Valley" during the Soviet era;
- There were developed schools with more than 50 years history for IT specialists;
- And the existence of over 7 million Diaspora all over the world with a major concentration in the USA and Russia.

None of these factors, however, can be attributed to private sector development policies. Rather these strengths are inherited from the Soviet era and from Armenia's history. As the rest of the article will show, Armenia's economic development still very much depends on external factors and especially Russia. Thus, Opening the door is insufficient to attract enough FDI to generate sustainable economic growth.

Armenia's Macro-Economic Indicators

Armenia has a population of 3 million. It does not have large reserves of any natural resources that would impact world market prices. Besides being landlocked, it is blockaded by Turkey and Azerbaijan, with only two access routes to the world market: through Georgia and through Iran.

Since its independence, Armenia has taken serious actions to transform its centrally planned economy into a market-oriented one. As a result, Armenia's economy started to register a double-digit growth rate with a tangible level of FDI. The positive trends in the economy lasted until the global economic crisis in 2008, followed by Russia's economic crisis. After the global crisis, the economy slowly started to recover registering a 2.6 percent growth rate. The economy continues to be strongly dependent on unfavorable external factors, with limited opportunities to implement expanding fiscal tools.

The Armenian economy in 2015 started with positive macroeconomic movements. The GDP growth rate for the first nine months of 2015 was 3.3 percent, which was mainly due to double-digit growth in the agricultural sector at 11.3 percent. For the same period, FDI in Armenia increased by 16.8 percent, followed by a 0.9 percent and 26.6 percent decrease in exports and imports, respectively. Although the economy was registering positive trends at the beginning of 2015, forecasting for the whole year remains pessimistic taking into consideration the situation in the world political arena and in the economy of Russia.

In 2014, GDP increased by 3.5 percent. All major sectors of the economy contributed to growth except the construction sector, which registered a 4.3 percent

decrease. The agricultural sector registered a 7.2 percent increase followed by the service sector (7.8 percent), industry (2.7 percent), and trade (1.6 percent) increases.

Armenia joined the WTO in 2003. In 2015, Armenia became a full member of the EEU, thereby backtracking on signing a deep and comprehensive agreement with the EU. In mid-2015, Armenia and the EU announced their readiness to work toward closer economic relations within the context of the EEU.

Armenia's major trade partners continue to be Russia, the EU, the US, Canada, Iran, China, Georgia, and Turkey. Positive trends in Armenia's foreign trade come from increased diversification, while in the near past Armenian exports and imports were dependent on just a few countries.

Overall, the Armenian economy is greatly dependent on external factors due to the high level of remittances, a low level of domestic production compared to imports, and the absence of a solid economy. The economic downturn experienced by Russia means that the net inflow of remittances from this country will decrease (it constituted almost 80 percent of total remittances in 2014, while remittances accounted almost 13 percent of GDP in 2014), which will lead to weak private consumption constraining economic growth. The dramatic reduction in oil prices will inflame the situation even more as Russian consumption will also decrease, while this market constitutes almost 20.3 percent of all exports for Armenia. Russia's problems will have negative impacts on FDI inflow as well, because free access to the Russian market is considered one of the major incentives for making investments in Armenia, while decreased consumption there could mean non-profitability of the investments in Armenia.

Foreign Direct Investment Structure and the Business Environment of Armenia

The level of FDI is a direct reflection of any country's economy. Armenia is not excluded from this rule. Armenia conducts a relatively open-door policy for investment promotion. Currently, there are no restrictions on the volume and type of foreign ownership, access to financial sources, conversion or repatriation of capital and earnings including branch profits, dividends, interest, royalties, or management/technical service fees, wire transfers, and staff recruitment, including the number of foreign employees, according to the laws and regulations of Armenia.

The only limitation is related to land ownership, which means that a foreigner cannot buy and/or own land in Armenia as a physical entity. However, a legal entity registered in Armenia has the right to buy and/or own land. In addition, foreign companies have the

same rights as domestic companies. There are also no sector-specific restrictions.

Foreign investments could not be nationalized, confiscated, or expropriated except in cases of natural or state emergency, although in all cases fair and market-oriented compensation would be implemented according to the legislation of Armenia.

Armenia's relatively stable economy is a key factor for FDI promotion, despite the facts of erratic economic growth, inflation and dependency on external factors. This situation can be explained by the strong willingness of Armenia's government to integrate into the world economy, officials' activities improving the business environment, as well as by strong relations with the IMF, which supports Armenia's economic policy.

In 2015, the government reformed the investment generation and exports promotion agency, offering foreign investors a one-stop shop for assistance. The newly reformed agency is called the Development Foundation of Armenia and provides consolidated services for (potential and acting) foreign investors and exporters.

The strongest advantage of the foreign investment environment is the quality/cost relation of the Armenian labor force. Most of the young labor force is trilingual and freely speaks Armenian, Russian, and English. Moreover, the labor force is mostly natural science oriented and the country has developed schools for IT specialists since the Soviet times, which explains why the software development sector constituted more than 3.5 percent of total FDI in Armenia for 2014.

Membership in the EEU is another incentive for foreign investors as "Made in Armenia" products have free access to Russian, Kazakh, Kyrgyz, and Belarusian markets. The Iranian market could also be considered an incentive for foreign investors, especially after the lifting of sanctions on Iran imposed by Western countries. Currently, Armenia's regional strategic partners are Russia and Iran, which is mainly explained by mutual political interests in the region. Armenia needs to create mutually beneficial conditions for the economies of Armenia and Russia and/or Iran to avoid the risk of diminished access to these markets.

Another positive factor that will influence the Armenian economy is the lifting of sanctions on Iran by the US and the EU. Armenian businessmen now have the green light to work in the Iranian market, as do Iranian investors interested in free access to the Russian consumption market.

After the global crisis, the level of FDI in Armenia in 2013 decreased to about a third of its previous level, to \$370 million down from \$944 million in 2008. The main country investing in Armenia in 2014 was Russia, which sought to control the electricity, gas, steam,

and air conditioning supply sector of the economy. In 2013 and 2012, France took the lead in making investments in Armenia. The targeted sector for France was mainly telecommunications with the launch of Orange. Investments from Germany were mainly in the mineral products sector.

In 2015 Swiss investment went to the mining sector, while investments from Luxembourg and Russia went to electricity, gas, steam, and the air conditioning supply sector. Both France and the UK were interested in alcohol production. The UK has also shown interest in investing in Armenia's mining sector.

At the same time, several free trade zones (FTZ) have been established as an additional tool for foreign investment promotion, where residents are free from VAT, property tax, customs duty and profit tax followed by "one window" principle government services. FTZs are located in different cities throughout the country including the capital of Armenia.

Currently, the major sectors targeted for attracting FDI by the Government of Armenia include:

- Wine (with Tierras de Armenia and Pernod Ricard as major foreign investors);
- Pharmaceuticals (with Darmantest Laboratories and Fruitsmax as major foreign investors);
- Tourism and hotel construction (with Marriott, Golden Tulip, Best Western, and Hilton hotels as major foreign investors)
- And the IT sector (with Microsoft, Sun, and Synopsys as major foreign investors).

Renewable energy, food processing, R&D, jewelry, and clothing sectors are also considered targeted sectors for FDI promotion in Armenia. The sectors' development strategies were prepared with the main stress on FDI generation and exports promotion. At the same time, several international exhibitions were organized in Armenia with the strong assistance of the government, including co-financing for the participation of domestic producers representing the targeted sectors in international exhibitions outside of Armenia.

With strong advantages for FDI promotion, there are also several disadvantages in Armenia's business climate. The major disadvantages of the business environment of Armenia are a lack of transparency in the regulatory system and a relatively high level of corruption, although the Government of Armenia has introduced several reforms and tangible improvements. Monopoly is another issue, but it is more or less related to the strategic and natural resource oriented sectors of the economy. The government has taken limited measures in this area, such as establishing the anti-monopoly State Committee on the Protection of Economic Competitiveness in 2001.

Despite the current international political and economic climate, Armenia can guarantee a stable and strong capital inflow into its economy by implementing proactive foreign investment generation activities. Armenia can act as “a window” to the markets of Russia and Iran, suggesting mutually beneficial conditions for all three countries. Otherwise, the Armenian economy will continue to be dependent on the external environment with little or negative growths in all sphere of the economy.

In conclusion, having an open door policy is an important, but obviously not sufficient condition for effective FDI inflow into the economy of the country. Armenia is the best example of it. The Government of Armenia had to continue to improve the business environment, stressing transparency of the regulatory system, fighting against corruption, and stressing diversification of investments by sector and by region with a proactive investments generation and exports promotion policy and actions. This kind of policy will have tangible positive impacts on the economy by increasing employment, income levels and independence from external factors.

Conclusion

Armenia is characterized as being a small country in all economic characteristics, starting from area of land and population and ending with the existing volume of natural resources. Armenia is also a landlocked country that

is blockaded by Azerbaijan and Turkey. Moreover, the Armenian economy is strongly dependent on the external environment, especially the Russian economy, making Armenia vulnerable to changes within Russia’s economic, political, and social areas.

Despite these negative aspects, Armenia has a good pool of qualified labor, which is the major reason for the inflow of FDI into the country. There are two strong factors for foreign investors as well: 1) EEU membership, allowing foreign businessmen to export “Made in Armenia” products without any obstacles into the Russian market, and 2) the lifting of sanctions on Iran—another market for “Made in Armenia” products—which will permit Iranian investments in the Armenian economy to freely reach the Russian market.

In addition, the attitudes of international organizations could be summarized as being medium positive yet more inclined to higher levels.

Thus, to use all these opportunities, the Government of Armenia should be proactive in investment generation and export promotion, stressing improvements in legal transparency and a decrease in corruption levels in all arenas of the country. Proactivity also requires continued, interlinked and interrelated actions by all bodies of the government related to the actions of country-image building in the targeted market of investments generation and exports promotion.

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The opinions expressed in this article are the authors’ own and do not necessarily reflect the view of the institutions with which they are affiliated.

Recommended Reading

- <www.eaeunion.org>
- <www.armstat.am>
- <www.comtrade.un.org>
- <www.delcredereducroire.be>
- <www.doingbusiness.org>
- <www.fitchratings.com>
- <www.globalinnovationindex.org>
- <www.heritage.org>
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