Armenia

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Investment Profile 2001

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EBRD ANNUAL MEETING

Contents

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Introduction

After a year of political uncertainty, Armenia has to renew its commitment to drive through structural and institutional reforms to enhance efficiency and improve the investment climate. However, it has maintained a good macroeconomic record, resulting from firm monetary discipline, and by making progress with energy sector reform has secured the support of the World Bank and IMF for further programmes. The unresolved issue of Nagorno-Karabakh remains a major obstacle to trade and economic development.

Thanks to adequate fiscal and monetary policies, as well as continued structural reforms, the Armenian economy has recorded growth for several years in succession, with low inflation and a relatively stable currency. Despite this **macroeconomic stability**, the economy has proved vulnerable to external shocks, such as the terrorist assassination of the Prime Minister and other leading government officials that occurred in October 1999, after which growth lost momentum and investment declined. The current account and government budget both have high deficits, the latter requiring better tax discipline, but not at the expense of essential public services in a situation where poverty is widespread, public wages are in arrears, and unemployment high.

Following the parliamentary assassinations, the government was quick to restore order, but there has been **political volatility** ever since, which has prevented the realisation of the deep-rooted structural reforms needed to underpin the economy, if it is to have good long-term prospects. Between the last parliamentary elections in May 1999 and the beginning of 2001 the government was reshuffled five times by three different prime ministers. Short-lived governments have been reluctant to push through controversial reforms. Longer-term political stability will depend on the efforts of a special commission appointed to propose constitutional amendments on the distribution of power among the people, the parliament and the government.

Sectoral reform is of critical importance to strengthening the economy and attracting foreign investment. In 2000, disbursements of World Bank credits and the conclusion of a new IMF programme were delayed by the slow pace of progress on vital energy sector restructuring and the privatisation of the country's four power distribution companies. Eventually, a special law was adopted in July 2000 and the search for strategic investors has resumed. The sale of the distribution companies is expected to be concluded in late March 2001. The momentum must now be kept up with the sale of generation companies. In the financial sector, Armenia has made progress with tighter regulatory requirements, but despite a rapid growth in assets the sector is still small and weak, and concentrated in the capital. Timely restructuring and privatisation of the Savings Bank (the only remaining state bank) through sale to a strategic investor, expected this summer, would increase competition, strengthen the sector and send a positive message to the international business community. A new law on Securities Market Regulation introduced in July 2000 is a positive advance for the underdeveloped capital markets, providing independent regulation and better investor protection.

Privatisation is making progress, though slowly. There has been a positive change of approach to privatisation, which was formerly characterised by insider deals and a lack of transparency, but which is now focused on cash sales to strategic investors. This gives a much better guarantee that restructuring will take place and corporate governance will be respected. Apart from the energy sector, the national airline is slated for sale in 2001, but a number of other large strategic companies have yet to be sold, such as the Nairit industrial complex. The government has adopted a list of 14 industrial giants that are to be sold or liquidated in 2001. All operate below capacity, while some are idle, but all have potential based on past traditions. With the help of foreign consultants, these companies are now starting to be sold to strategic investors, albeit at low prices, but with commitments to invest, introduce new technology and know how, and develop new markets.

Besides specific sectoral action, **improvements to the investment climate are required** to encourage entrepreneurship and increase investor confidence. Key issues that need to be tackled include the fight against corruption, the removal of inconsistencies, lack of clarity and gaps in the legislation, and the simplification of cumbersome bureaucratic procedures. Substantial progress has been made to improve the taxation system, especially through new legislation effective 1 January 2001. An anti-corruption law is under consideration. In January 2001 a commission was established, headed by the Prime Minister, the responsibilities of which include drawing up a programme to combat corruption through legislative reform, an action that earned the praise of the OSCE and other agencies. However, it will take time and firm commitment – as well as a more stable political environment – to push through all the necessary institutional reforms, until when investment will be deterred and private sector development obstructed.

The support of international financial institutions resumed in December 2000 following progress in the privatisation of the energy sector, which was a condition for the completion of a World Bank Structural Adjustment Credit and for the agreement, in principle, of a new IMF Poverty Reduction and Growth Facility. The decision to resume financing was made in principle at the time of a special donors' conference organised by the World Bank in Yerevan in October 2000. The conference was designed to discuss the need for budgetary and structural reforms and to address the issue of poverty, and was attended by 30 agencies including the IMF, the EBRD, the UN Development Programme, the EU and a number of bilateral donors.

Armenia heavily depends on **external financial assistance**, notably the support of its large worldwide Diaspora, which ensures a continued flow of transfers and remittances. However, if it is to reduce external imbalances such as the current account deficit (the highest in the CIS) and a high level of external debt, it needs to increase domestic savings and improve export competitiveness. Despite a relatively open trade regime, the export sector is hampered by a weak infrastructure and poor customs administration, but most acutely by the absence of trade relations with Turkey and Azerbaijan following the Nagorno-Karabakh conflict (see box below). It has been estimated that the blockade prevents Armenia from having direct access to over 40 per cent of its immediate trading neighbourhood.

Armenia was accepted as a member of the **Council of Europe** in January 2001, at the same time as Azerbaijan. Membership in the Council will help to firm up Armenia's democratic record (including, for example, improvements to electoral procedures) and lead to closer integration with Europe.

In 2001 Armenia is celebrating the **1700th anniversary** of its conversion to Christianity. The authorities hope that the year-long celebrations will give the country a much needed moral (and economic) boost.

Nagorno-Karabakh

Nagorno-Karabakh is a disputed enclave within the borders of Azerbaijan, populated by ethnic Armenians, which claimed independence and was the object of a war between the two countries in the early 1990s. Although a cease-fire has been in effect since May 1994, a permanent peaceful solution has not yet been found. As a result, Azerbaijan and Turkey have imposed an economic blockade on landlocked Armenia, whose main export routes are cut off and whose opportunity for integration into the world economy is seriously limited. In the past couple of years regular meetings have taken place, including at the presidential level, with both President Kocharian and Azerbaijan's President Aliyev expressing their commitment to a settlement of the conflict. Their latest (and fifteenth) meeting took place in March in Paris, when they said they hoped to pursue their talks to find "an acceptable solution" to the long-running dispute. France, along with Russia and the United States, is co-chairman of the Minsk Group of the Organisation for Security and Cooperation in Europe (OSCE) which is attempting to broker a solution to the dispute. However, a swift resolution is unlikely, as negotiations of a detailed settlement and its implementation on the ground will take some time. The main point of contention for Azerbaijan is that it does not recognise the self-proclaimed sovereignty of Nagorno-Karabakh. For Armenia, the main issue is that Nagorno-Karabakh should not be subordinate to Azerbaijan. Armenia and Nagorno-Karabakh initially backed a proposal of the OSCE Minsk Group for Azerbaijan and Nagorno-Karabakh to form a common state, but Azerbaijan did not agree with the concept of a common state.
More recently, preparations for autumn elections in Azerbaijan interrupted negotiations. It is hoped that the recently concluded Council of Europe membership for both countries will provide a stronger platform for continued peaceful negotiation.
Settlement of the Nagorno-Karabakh issue would make a significant contribution to Armenia's medium-term growth prospects by facilitating the regional integration of key infrastructure networks – roads, railways and pipelines. This would enhance the competitiveness of all the countries in the region, and would allow Armenia to save money currently earmarked for infrastructure investments designed to get round the blockade. An end to the blockade would reduce transport costs, enhance export prospects and boost sectors mainly engaged in export, and reduce uncertainty for investors.
Resources would also be saved on military expenditure.
Armenia has been Nagorno-Karabakh's main economic partner since its de facto secession from Azerbaijan in the late 1980s. The enclave has its own president, government and parliament, and the Armenian dram is the official local currency. Armenia plans to make investments in agriculture, food processing and banking within the region and has strengthened its transport links.
However, Nagorno-Karabakh's economy is largely paralysed with a large part of its budget covered by subsidies from Yerevan.


Georgia
to Akhalkalaki
to Tbilisi
to Tbilisi
Georgia
Alaverdi
R.Debet
Stepanavan
Spitak
GYUMRI
Vanadzor
Dilizhan
Berd
Azerbaijan
Sevan
Hrazdan
Kamo
LAKE SEVAN
Nagorno-Karabakh
Vardenis
Echmiadzin
YEREVAN
R.Araks
Turkey
Stepanakert
Ararat
Nakhichevan Republic (Azerbaijan)
Islamic Republic of Iran
Kafan
Meghri
R.Araks
This map has been prepared exclusively for the convenience of readers. The denominations used and the boundaries shown on this map do not imply any judgement on the legal status of any territory or any endorsement of such boundaries.
4822 IP01 Armenia map
Scale km
0 10 20 30 40 50

Economic summary

The economy continues to enjoy positive growth and low inflation, with a stable currency. However, unemployment is rising and the current account deficit remains high. Budget revenues are insufficient, requiring action to restore tax discipline. To qualify for much needed IFI support to meet the expected budgetary shortfall, the government urgently needs to address further structural reforms.

GDP growth

Since 1994 Armenia has enjoyed seven consecutive years of positive economic growth, with growth in 2000 at 6 per cent, and an average annual growth of 5.4 per cent. The positive result in 2000 is due to a strong recovery toward the end of the year. In the first part of the year performance was severely affected by the long-term effect of the October 1999 assassinations, followed by a record drought. Independent forecasts predict real growth of around 5.5 per cent for 2001. The official government budget for 2001 sets a target of 6.5 per cent.

Inflation and exchange rate

Armenia is experiencing a period of extremely low inflation. Since January 1999 the price level has remained virtually stable, with mild deflation of less than 1 per cent on average in 2000. The dram, which is allowed to float more or less freely, depreciated moderately in 2000, but remains clearly within the expected bounds. The 2001 budget sets an inflation target of 3.5 per cent.

Current account, trade balance and external debt

At 14.9 per cent in 1999 and 30 per cent in the first half of 2000, Armenia's current account deficit is the highest in the region, and is only sustained by substantial remittances from the large Diaspora. External debt remained constant over the first half of 2000, and as a proportion of GDP shrank from 47 per cent to 44.5 per cent. Efforts to reduce external imbalances have so far not been successful. Savings rates remain low, and exports only account for about 17 per cent of GDP. Although exports grew by over 28 per cent over 2000, in absolute terms this increase was offset by an even larger rise in imports (which increased by about 9 per cent).

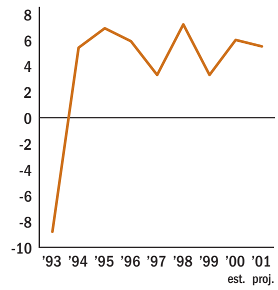
Foreign Direct Investment

FDI in 2000 is estimated at US$ 150 million, a slight improvement on 1999. The government aims to increase FDI to US$ 350 million by 2002. However, even with Diaspora support this target will only be achieved if the investment climate undergoes substantial improvement, political stability continues and Armenia's regional isolation is brought to an end by a resolution of the Nagorno-Karabakh issue.

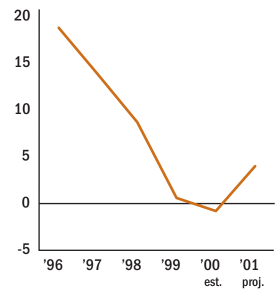
Government balance

Despite a strengthened tax administration, tax collection remains problematic and, as in 1999, revenue shortfalls forced the government to cut expenditures. In 2000, state revenues from taxes and duties were 12 per cent below target, despite a markedly improved performance towards the end of the year. The government has reacted to revenue shortfalls by cutting expenditures to a minimum and allowing arrears to grow. Most public sector workers have not been paid for several months. To meet its growing deficit, the government relies heavily on external support, in particular

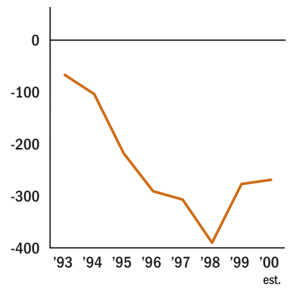
GDP
% change



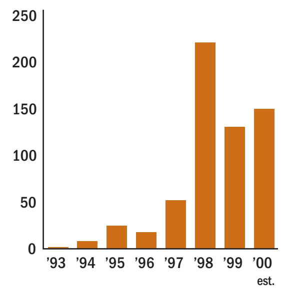
Consumer prices
Annual average, % change



Current account
US$ millions

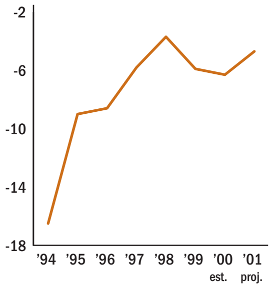


Total FDI
US$ millions, cash receipts, net



Source: EBRD, 2001

General government balance
% of GDP



Source: EBRD, February 2001

from the World Bank. World Bank budgetary support was, however, affected by the lack of progress in the sale of the power distribution companies (see below). The draft of the 2001 budget law was adopted by parliament in December, and sets a budget deficit target of 4.8 per cent of GDP. It sets both revenue and expenditure at lower rates than in 2000. A package of tax amendments was adopted along with the budget, aiming to lower the tax burden and stimulate exports. However, they may also lower revenue from income tax, and offsetting the loss will depend on boosting revenue from VAT on imports by collecting that tax at the state border. (See *Investment climate: Investment and tax policy* below.)

World Bank and IMF agreements

The last US$ 5.4 million disbursement of the World Bank's SDR 46.2 million Structural Adjustment Credit-III (SAC-III) was delayed by almost a year, and finally made in December 2000, once progress had been made on energy privatisation. In February 2001 negotiations were concluded for a new SDR 38.4 million SAC (SAC-IV), the first tranche of which is likely to be disbursed in April 2001.

The IMF's last programme, a US$ 150 million three-year Extended Structural Adjustment Facility (ESAF), expired in December 1999. Negotiations for a US$ 90 million three-year Poverty Reduction and Growth Facility (the successor to the ESAF) were concluded in January 2001, with the first disbursement likely to be made in April. The IMF praised the government for its economic achievements, but made it clear that the Fund expects further progress in tax collection and a more effective fight against corruption this year. The PRGF aims to reinforce macroeconomic stability but has a greater focus on reducing poverty and other social problems.

Selected economic indicators

	1993	1994	1995	1996	1997	1998	1999	2000 est.	2001 proj.
GDP (% change)	-8.8	5.4	6.9	5.9	3.3	7.2	3.3	6.0	5.5
Consumer prices (annual average % change)	3,732	5,273	176.7	18.8	13.8	8.7	0.6	-0.8	4.0
Current account (in US$ millions)	-67	-104	-218	-291	-307	-390	-277	-269	na
General government balance (% of GDP)	-54.7	-16.5	-9.0	-8.6	-5.8	-3.7	-5.9	-6.3	-4.7
Trade balance (in US$ millions)	-98	-178	-403	-469	-559	-578	-462	-490	na
FDI (in US$ millions, cash receipts, net)	1	8	25	18	52	221	131	150	na
External debt stock (US$ millions)	na	200	375	614	786	812	855	836	na
Unemployment (end-year, % of labour force)*	6.3	5.8	8.4	10.1	11.3	8.9	11.6	10.7	na
Exchange rate, annual average, drams per US$	9.1	288.7	405.9	414.0	490.8	504.9	535.1	539.5	550
Gross reserves, excluding gold (end-year, US$ millions)**	14	32	100	156	229	315	319	318	na

* *Registered unemployment. Unofficial estimates indicate substantially higher unemployment*
** *Calculated based on current exchange rates. The Special Privatisation Account is included, IMF related assets are based on IMF data.*
Source: EBRD, February 2001

Investment climate

The investment climate is slowly improving, with a strong government commitment to attracting FDI, including work to refine the legislative framework. Efforts are under way to improve the judiciary and to remove deterrents to investment. Meanwhile, most foreign investment is through privatisation, which is gradually progressing, through cash sales to strategic investors. Forthcoming WTO membership will open up new trade opportunities.

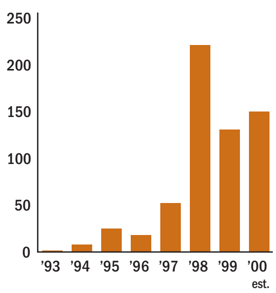
Foreign direct investment

Foreign direct investment (FDI) in 2000 is estimated at a net total of US$ 150 million, of which over US$ 100 million came in during the first half of the year, a 22 per cent increase over the same period the year before. However, FDI is at a low level, partly because of the threat of political instability following the parliamentary assassinations of October 1999. Cumulative investment since 1993 had reached only US$ 606 million by the end of 2000. Privatisation is the main source of FDI, with the sale of electricity distribution companies due to go ahead in March 2001.

By 1 January 2001 there were about 1,770 partly or fully foreign-owned companies registered in Armenia, most of which are involved in trading activities. Several multinational companies have a presence, including Coca-Cola (US), Huntsman (construction), Marriott (US, hotels), ABB (Sweden-Switzerland, engineering), Alcatel (France, telecoms), GlaxoSmithKline (UK, pharmaceuticals), HSBC (UK, banking), KPMG (UK, consultancy) and Pernod Ricard (France, beverages).

The sectors to attract most direct investment were telecommunications (mainly into Armentel, see *Major sectors of the economy: Telecommunications* below), power engineering, gas and water supplies, wholesale trade, food processing, hotels and services, and construction. High technology is a rapidly growing sector offering strong prospects and is expected to attract high levels of investment in the near future. Other sectors with potential are diamond and jewellery production (in which Armenia specialises), mining and metallurgy, chemicals and pharmaceuticals, and light industry. One of the country's most attractive assets is its highly skilled workforce, including specialists in technology and engineering.

Total FDI
US$ millions, cash receipts, net



Source: EBRD, 2001

The Armenian Development Agency (ADA)

The ADA is a non-profit governmental organisation set up in March 1998 to promote foreign investment and stimulate export production in Armenia. The ADA acts as a "one-stop shop" for investors and exporters, and promotes Armenia as an attractive investment destination. The ADA also aims to enhance the competitiveness of Armenian business in Armenia and elsewhere. The agency supports the government of Armenia with the implementation of investment and export development and promotion policy, and is building up a worldwide network of representatives and agencies in markets attractive to and attracted to Armenia.

The ADA has 16 Board members, including eight from the public sector (with the Prime Minister as Chairman), and eight from the private sector.

Main functions of the ADA:

- Support for the development and implementation of investment and export projects and programmes.
- Marketing and research to support the development projects and programmes, public relations and public awareness support for particular projects and policy.
- Development of investment and export networks, of partner organisations in other countries, and of Armenian professional bodies.
- Logistic support for investors and exporters.

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The ADA is also the secretariat of the recently established High-Level Business Council, which aims at promoting business and investments and eliminating administrative barriers to investments. It is appointed by and reports to the President of Armenia. It is headed by the Prime Minister and its members include the Chief Economic Adviser to the President, the Ministers of Industry and Trade, Finance and Economy, the Mayor of Yerevan, and the Executive Director of the ADA (as the executive secretary of the Council), in addition to six representatives from the business community on a rotating basis.

The most active investors come from the Armenian Diaspora communities in the US, Russia, Iran, France, Greece, the UK, Germany and Syria.

The government is concerned at the low level of foreign investment and is taking active steps to promote Armenia as a destination for investment. In previous years it has organised several international conferences targeting potential investors. Perhaps more encouraging for investment has been the lasting ceasefire with Azerbaijan. Further investment conferences are to take place in 2001, including one at the Plaza Hotel in New York on 9-11 May.

The Lincy Foundation

The worldwide Armenian Diaspora is an important contributor to the national economy, and most major foreign investors are of Armenian origin. The largest commitments have come from the Lincy Foundation, headed by Diaspora Armenian Kirk Kerkorian. Since June 2000, the government has identified seven major uses for donations from the Lincy Foundation worth US$ 165 million. These are:

- The International Loan/Investment Programme makes loans for local businesses to create jobs, as well as loans and equity investments for large foreign corporations to encourage them to establish operations in Armenia (US$ 30 million);
- Credit line for SME development (US$ 44.8 million);
- Housing programme for the completion of the reconstruction of urgently needed housing in the Spitak earthquake zone (US$ 15 million);
- The Road Renovation Programme for new construction and improvements to 30 per cent of the existing network of roads (US$ 38 million);
- Facilities Ancillary to Tourism and Foreign Investment for construction of new hotels and other tourism-related infrastructure, including the renovation and expansion of Zvartnots airport, a new hotel at Lake Sevan and development of the Tsakhkadzor ski resort (US$ 20 million);
- Cultural Revitalisation Programme for renovation of 27 cultural institutions such as the Opera House, museums, theatres, concert halls and sites of historical interest (US$ 10 million);
- Yerevan Renovation Programme for renovation of central Yerevan, creating a pedestrian mall with retail, office and residential space (US$ 7 million).

Investment and tax policy

Armenia's investment policy is among the most open in the CIS. Foreign companies are encouraged to reinvest and are entitled by law to the same treatment as nationals. No restrictions apply to current or capital account transactions. The government hopes to attract some US$ 400 million in FDI in 2001.

New tax legislation was introduced in late 2000, effective from 1 January 2001. Specific privileges apply to corporate taxation if the foreign investment in a company exceeds AMD 500 million (about US$ 900,000). Exports are not subject to customs duties, and VAT on goods and services exported is refunded. A recent amendment to the foreign investment law ends the across-the-board customs duty exemption on items brought into the country by investors. A list is to be drawn up stating what items may still be imported duty-free, although as a general rule intermediate products (raw materials, equipment, etc.) are not subject to import duty. A new excise tax law was approved in July 2000, designed to help bring revenue out of the black economy and into the state budget. The new law has switched to specific rather than ad valorem rates, and has also narrowed the base to only tobacco, alcohol and fuel products.

New tax rates from 2001

Tax amendments introduced with the adoption of the 2001 budget law in December include a lower rate of income tax and compulsory social security contributions. Formerly, employers had to withhold and transfer to the budget at least 15 per cent of the salary bill as income tax, and to pay 28 per cent as compulsory social security contributions. Depending on the actual size of the salary, these payments could even exceed 50 per cent of the salary bill. Under the new laws the integral rate of these two payments is 28 per cent for all ranges of salaries above AMD 20,000 (about US$ 36) per month. This is likely to cover a large proportion of the population, as the official average monthly salary is slightly higher than AMD 20,000. The threshold for VAT liability has been raised from AMD 3 million to AMD 10 million of annual turnover. The progressive corporate profit tax, which ranges from 15-25 per cent, has been replaced with a flat rate of 20 per cent. A number of tax privileges have been abolished, including VAT exemptions on drugs and infant food, and interest on bank accounts has been made subject to taxation. These changes aim to establish a fairer taxation system with a lower tax rate and a larger tax base, with the ultimate objective of promoting business and investments.

Legislation for investors in brief

The main law governing foreign investment is the 1994 Law on Foreign Investment, which is in the process of being amended for greater clarity. At the time of writing, the High Level Business Council was to participate in discussion of the new draft law on investments at its next meeting in April 2001. In principle, 100 per cent foreign participation is possible in any sector of the economy, although both foreign and domestic companies need a licence to operate in certain sectors, such as banking and insurance, and exploitation of natural resources is only possible through a concession agreement with the government. Foreign participation is allowed in the form of fully foreign-owned companies, joint ventures, through purchase of securities, or by buying the right to use land or Armenian natural resources with the participation of an Armenian company. Foreign investors wishing to establish a new business may form a general partnership, a limited partnership, a joint-stock company (either public or private) or a limited liability company. The registration process is estimated to take about a week, with amendments to the registration legislation being introduced to simplify and streamline the registration procedures.

There is protection against nationalisation, and expropriation and confiscation by the state are only foreseen in extreme circumstances, in which case full compensation is provided by law. In the event of changes to the foreign investment legislation, existing investments are protected by a five-year grandfathering clause. In the event of a dispute between the state and a foreign investor, arbitration must be sought in Armenian courts. Disputes not involving the state can be settled outside the local court system. New laws on trademarks and copyright were passed in 1999. Enforcement of intellectual property rights is weak, though improving and expected to be strengthened further with WTO accession (see *Markets and trade* below). Ownership and property rights are defined by law.

There are virtually no limitations on currency conversion and transfer of funds abroad, and domestic financial institutions are adequate. The right to full repatriation of property, profits and assets after taxes is guaranteed. The dram is fully convertible. Foreign individuals may only lease land, but all Armenian business entities, including foreign-owned ones, may own land.

A competition law was introduced in 2000, filling one of the few gaps in Armenia's comprehensive commercial legislation. The law defines market dominance as the holding of over a third of market share, and includes a definition of unfair competition, as well as a merger notification system and anti-price-fixing provisions. Monopolies will only be able to retain their rights if they do not abuse their dominance. However, failure to bring the black economy into the formal sector undermines fair competition. A bankruptcy law was passed in late 1996, but due to inconsistencies with the Civil Code, which was adopted at a later date, it is not always effective. Draft legislation has been submitted for parliamentary approval in order to remove the existing inconsistencies and to make the bankruptcy law fully effective. A new law on public procurement effective from 2000 aims to reduce costs and create greater transparency in procurement procedures, and establishes a separate government agency for public procurement. A new company law is being drafted with the help of the IFC.

There are no free trade zones at present. Plans to establish several industrial parks, possibly at Zvartnots airport, or on the site of large electronics companies, are being investigated. There are several private commercial bonded warehouses throughout the country.

Political risk insurance

The US government-sponsored Overseas Private Investment Corporation (OPIC) is operational in Armenia, offering insurance against political violence and expropriation. Armenia is a member of the World Bank's Multilateral Insurance Guarantee Agency (MIGA). MIGA has appointed a commission to lead preparatory work for the privatisation of companies in mining, manufacturing, construction materials and hotels.

Issues for the investment climate

The present investment climate is hampered by some cumbersome administrative procedures, irregularities in their application, inconsistencies in the regulatory and legal framework, and some unclear legal procedures. The poor protection of creditors' rights in particular has deterred investors and exacerbates existing difficulties in gaining access to finance. Shareholders' rights are only partly protected and insider ownership undermines the development of competitive corporate governance and restructuring. Tax laws and procedures are often perceived as over-complicated. As an initial step in this respect, a new simplified tax code for small enterprises was approved in summer 2000, allowing small enterprises to replace existing taxes with a flat tax on sales revenues. Additional steps to streamline taxation were introduced with the tax reform package adopted in late 2000.

The issue of corruption is firmly addressed by the government, which is taking steps to develop new legislation to put a stop to it through a comprehensive action plan. Several donors provide technical assistance to help address the problem. The Civil Code and Criminal Procedures Code adopted in 1998 both address corruption directly, setting out tough penalties for abuse of power, exceeding one's authority, and bribery. There is talk of introducing an anti-corruption law, among other measures. However, much firmer action is clearly needed as bribery is believed to remain widespread in all areas of government procurement, registration, licensing and land allocation. Part of the problem is the highly discretionary nature of the tax and regulatory system. A draft civil service law, expected to be passed within 2001, sets limitations on the participation of state officials in business enterprises, and a draft on financial disclosure law, also expected to be adopted within 2001, is designed to increase transparency in government officials' decision-making. Private businesses are also inclined to bend the law, with much tax fraud and unregistered business activity.

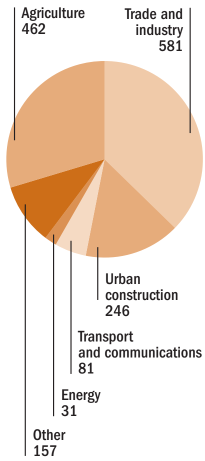
Judicial reform

The judiciary in Armenia still faces a steep learning curve due to inexperience in modern commercial law. The World Bank is sponsoring a judicial reform programme at a cost of US$ 11.4 million, which will help to develop an efficient, independent and accessible judiciary. The project includes establishing a modern court administration system, rehabilitation of court facilities, assistance to the Judicial Training Centre in cooperation with the EU, improved enforcement of court decisions, better access to legal information, and the development of public awareness of the country's legal institutions. In general, Armenian courts are becoming more independent, with the Ministry of Justice no longer involved in civil cases.

Privatisation and restructuring

The bulk of Armenian state assets have been privatised over the past decade, with the private sector now accounting for over 75 per cent of the country's GDP. However, the privatisation process has slowed over the last two years as the emphasis shifted from quick sales towards attraction of suitable strategic investors and cash sales only. The change in strategy was caused by a recognition that the insider-led privatisations of the past did not result in the desired inflow of capital and know-how. In 2000 15 companies were privatised by tender, about the same as in 1999 (16). Three of the large remaining state-owned enterprises, namely the Shogakn diamond-processing plant, Almast, a producer of diamond processing tools, and the Transistor electronics enterprise, were offered for privatisation during 2000. Shogakn was sold to an Israeli investor, but the other two are pending (see *Major sectors of the economy* below).

Privatised companies by sector
as at 1 February, 2001



Source: State Property Management Ministry

Several other high profile strategic enterprises, such as the Nairit industrial complex, are also still awaiting privatisation. With the privatisation programme for 1998-2000 coming to an end, enterprises that were not sold in 2000 have been shifted to a new privatisation programme for 2001-03. Companies that cannot be sold in three attempts are now liquidated, in accordance with the privatisation law. Some 190 medium and large enterprises, as well as about 520 small objects have already been or are currently being liquidated.

The privatisation of the country's four electricity distribution companies has been delayed and is scheduled to be completed in March 2001, following the adoption of a special law in July 2000. (See *Major sectors of the economy: Energy* below.) Armenian Airlines is also due to be offered for privatisation in the first half of 2001.

In the latter half of 2000 the government adopted a new plan to privatise (or failing that, liquidate) 14 state industrial giants described as of strategic significance for the country's economy, including: Mars, Hayelektrameqena, Armenmotor (all electronic equipment and machinery); Sapfir (precious stones); Ararat Cement, Hrazdan Cement, and Artik-Tuf (all construction materials); Hayapaki (also known as Armsteklo or Armglass, sold to a local entrepreneur in February 2001 for US$ 265,000 with a pledge to invest US$ 455,000 over three years and assume debts of US$ 1 million), Armavirapaki (also known as Armavirsteklo or Armavirglass, sold to a US investor early in 2001); the Yerevan Jewellery Plant (the restructured part of which was sold to Russian and German investors in early

2001); Hayvoski (also known as Armzoloto or Armgold, gold mining); Gyumri textiles; a spinning mill (sold to the workers in early 2001 with a commitment to invest about US$ 1 million in 2001, and offer 350 jobs during 2001, with a subsequent annual increase of 50 jobs up to 2005); and the Dvin hotel in Yerevan. These firms have been and are undergoing restructuring to make them more attractive, and are being sold to strategic investors during 2001. (For more details, see *Major sectors of the economy* below.)

USAID has funded International Business & Technical Consultants Inc (IBTCI) to help the government with these sales. IBTCI has focused on developing an appropriate legal and institutional framework for efficient, fair and transparent privatisation. It has helped in drafting legislation for valuation procedures, liquidation, tender processes, auctions and disclosure requirements. It has conducted a public awareness campaign to promote support for reforms, and also helped to perform groundwork for the sale of the energy distribution companies.

Each of the 14 enterprises are submitting initial data reports to the Ministry of State Property Management, which is in the process of valuation of the state property and publishing general information on the enterprises in the press. An interdepartmental commission, headed by the Minister of State Property Management, has been set up to decide on the readiness of each enterprise for privatisation and then to submit it for final government approval.

Useful web sites

The Armenian Development Agency (see page 7) provides a Privatisation Guide with full details of the privatisation procedure and policy – see ***www.ada.am***. A full list of companies on the latest privatisation list is available on the Ministry of State Property Management web site, ***www.privatization.am***. It carries information on tenders, and details of certain enterprises and properties being offered through various privatisation methods.

The industrial sector is only slowly undergoing restructuring, with little new investment, and few improvements in corporate governance. For the year 2000 as a whole, industrial output grew by 6.4 per cent year-on-year. Several industrial flagship enterprises have restarted production. However, these positive results mask continuing structural weaknesses in the sector. Insolvent enterprises continue to operate, owing to the tolerance of tax arrears and ineffective bankruptcy enforcement. Moreover, the insider-dominated privatisation process has left enterprises with little access to finance for investment and no injection of new management skills.

Initial steps to reform the social safety net

To improve the financial sustainability of the state pension system, the government has reformed the system of compulsory social insurance contributions, and has harmonised it with the existing personal income tax structure. With help from donors, efforts are under way to improve the pension administration, including a better system to monitor individual contributions, which would replace the current system with payments made in proportion to contributions. Under the current system, pensioners receive a uniform payment. The family benefit system is also being reformed so as to target and improve services for the most needy.

Markets and trade

Negotiations to join the WTO are nearing completion, and accession is expected to take place in the second quarter of 2001. The main remaining stumbling block in the negotiations is the level of competition in the telecommunications sector. In addition, a series of legal and regulatory adjustments (e.g. on intellectual property rights) is needed to bring Armenian laws into compliance with WTO standards. Another issue concerns taxation of agricultural products, where rights for local producers and importers need to be equalised. WTO membership will consolidate Armenia's open trade policies, and may in the medium term help to re-establish regional trade links. However, the immediate impact of trade liberalisation on domestic competition and market access will be limited due to Armenia's remoteness and its current regional isolation related to the Nagorno-Karabakh conflict.

Main export and import markets, 2000, % of total

Export Country		Import Country	
Belgium	25.2	Russia	14.9
Russia	15.0	Belgium	9.5
USA	12.7	USA	11.6
Iran	9.3	Iran	9.4

Source: National Statistical Service

Main export and import commodities, 2000, % of total

Export		Import	
Precious metals, stones and their manufactures	40.8	Mineral products	20.5
Non-precious metals and their manufactures	14.9	Equipment and machinery	13.2
Mineral products	11.5	Precious metals, stones and their manufactures	12.8
Equipment and machinery	10.4	Food products	7.9
Food products	9.2		

Trade volumes by region, 2000

Region	Export, US$m	Export/GDP, %	Import, US$m	Import/GDP, %
Total	297.5	15.6	885.1	46.5
CIS countries	72.8	3.8	168.3	8.8
Non-CIS countries of which:	224.8	11.8	716.9	37.7
EU	107.0	5.6	302.6	15.9
USA	37.9	2.0	102.7	5.4
Other	79.9	4.2	311.6	16.4

Source: National Statistical Service

Major sectors of the economy

Armenia specialises in high-tech industries such as diamond cutting, electronic production and software development. The mining and metallurgy sectors are also important and have been undergoing restructuring. The chemicals sector offers potential, with a strong pharmaceuticals sector. The infrastructure sectors are in need of investment and will gain a boost with the forthcoming privatisation of energy distribution companies.

Jewellery and diamond processing

In 2000, precious or semiprecious stones and precious metals accounted for about 40 per cent of all Armenian exports. A large proportion of these exports are polished diamonds, imported into Armenia in their rough state for finishing, taking advantage of Armenia's low wage costs and skilled jewellers.

Diamond cutting is one of Armenia's most successful sectors, with total production worth US$ 110 million in 2000. Opportunities for the export of raw diamonds to Armenia for processing have risen in the past decade, boosted by government action to privatise the industry which has led to foreign investment. Investors, in particular, are attracted by highly qualified diamond cutters for reasonable wages, modern equipment at the existing plants, no taxes on the import of raw materials or the export of finished products. Despite significant investments attracted to the sector so far, there is still vast potential for suppliers of raw diamonds.

Although most of Armenia's rough diamonds used to come from Russia, since 1993 the supply has all but stopped and Armenian diamond cutters have turned to western suppliers. The first foreign company to set up in Armenia was the **Arslanian Cutting Works**, owned by a Belgian businessman of Armenian origin. In 1992 the same entrepreneur also set up **Lori Ltd**, Armenia's first private diamond cutting enterprise, in which he has invested some US$ 2 million since 1995. Lori has state-of-the-art technology and employs over 400 highly skilled workers. On the basis of an agreement with the Arslanian Cutting Works, the Belgian firm supplies raw diamonds to Lori for processing, and then receives them back for distribution on world markets. Lori also has a US supplier/distributor, the Cora Diamond Company. Lori's specialised staff are trained in Belgium, and the firm also has its own training centre for diamond cutters. In 1999 Lori produced processed diamonds to a total value of approximately US$ 20 million, and had almost doubled its production in 2000. Arslanian Cutting Works supplies other Armenian cutting plants, both private and state-owned. Another foreign supplier of raw diamonds to the Armenian diamond processing industry is Tashe (also Belgium). Tashe and Arslanian Cutting Works have recently set up a joint venture in Armenia and are building a new diamond cutting plant.

One of Armenia's biggest refiners of precious stones is the **Diamond Company of Armenia** (DCA), bought by investment group Furfano Limited (UK) for US$ 5.8 million in 1998. The company has had rapid growth since then, cutting and exporting diamonds worth US$ 28 million in 2000. DCA has invested about US$ 7 million in its Yerevan plant, which is equipped with the latest technology and employs some 600 highly qualified diamond cutters. It processes 8,000 carats of rough diamonds each month, supplied by South Africa's De Beers monopoly via Di Amdel NV (Belgium).

In July 2000 the **Shogakn diamond processing company**, one of the largest firms still in state hands, was sold in its entirety to Israel's LLD Diamond Ltd for the equivalent of US$ 370,000. This purchase is expected to take the workforce up to 1,330 (from 150) within two and a half years, when nearly 30,000 carats of diamonds will be cut each month and average wages will rise to US$ 300 per month. The plan foresees a 10-fold production increase for a total investment of US$ 2.3 million. This is expected to raise Armenia's annual income from diamond processing to US$ 200 million, which, if the current situation in the international market were preserved, could lead to a figure approaching US$ 500 million in 2005.

Ongoing privatisations in this sector include the sale of a 62.8 per cent share in **Almast**, a leading producer of synthetic diamond powders in the Soviet era, when at full capacity it made 50 million carats of diamond powder each year and employed 900 people. Almast is now much reduced, but retains a skilled workforce and offers potential for expansion. The tender for the sale was announced in July 2000, with bids due in by the end of August. California-based Olympia Tools, with annual sales of US$ 60 million, expressed interest in buying the share, but its first bid was rejected and a new tender is currently in progress. Almast also produces high quality diamond-based instruments for industrial

Armenian Jewellers' Association

In 1998, following a gathering of Armenian jewellers from all over the world, the Armenian Jewellers' Association (AJA) was founded, and is one of the country's first international trade and development associations. The AJA's aim is to bring Armenian jewellers together to develop the country's jewellery industry. It has regional representatives on the west and east coasts of the USA, in Europe, the Middle East and Armenia. The AJA plans to set up a regional jewellery trade centre in Yerevan. The AJA web site is at ***www.aja.am***.

purposes including cutting, grinding and polishing. **Sapfir** (or Sapphire), the first state-owned plant to be established to process Soviet diamonds, has also been offered for privatisation, and by mid-March eight initial bids had been submitted. The government intends to announce a tender by the end of March for the privatisation of the company.

Yerevan Jewellery Plant, which is also on the privatisation list, is the main production unit for jewellery, but the enterprise only operates at about 30-40 per cent of its capacity. Its activities cover all stages of jewellery production, including design, melting, refining, cleaning, grinding, polishing etc. The plant is estimated to require some US$ 10-12 million in investment to bring it up to capacity, mainly through the purchase of raw materials, of which the main ones used are gold and precious stones. Russia is the main supplier of refined gold to Armenia, as well as – until 1998 – the main sales market for golden jewellery items. The Yerevan Jewellery Plant sells mainly to western countries (88 per cent), Russia (10 per cent), and locally only 2 per cent. Its markets include the US, where its products compete well due to low price for good quality. In November 1998 a jewellery making joint venture known as Armengold was formed by Diaspora Armenians from the US and Israel and the Yerevan Jewellery Plant. US$ 10 million is being invested in Armengold, with the Yerevan Jewellery Plant providing its production facilities, technology and labour force. The Armenian side also provides the raw materials, including gold supplied through leasing. Production is to be distributed on western markets. Part of the Yerevan Jewellery Plant was restructured and sold to Russian and German investors in early 2001.

Electronics and Information Technology

Among the most promising sectors for investment are the fast-growing electronics and software industries. In the Soviet era Armenia specialised in high-tech defence industries, and has a wealth of highly trained engineers and well equipped plants. The larger electronics factories are being privatised, including Mars and Transistor, through international tender. Other plants may provide opportunities for the assembly of electronic and consumer goods (e.g. television sets, VCRs, computers and related equipment such as electronic chips and circuit boards), for subsequent export to third countries. Active sub-sectors include chip testing, Internet applications and stock market data processing.

The best opportunities in the production of chips and other electronic components are offered by the Mars and Transistor (Ashtarak) plants, built and equipped in the 1980s by UK firms. Both of them are on the list for privatisation, as are Armenmotor (maker of small electric motors, Sapfir (machine tools), Vanadzor Technosark (electro-technology) and Hayelektrameqena. Vanadzor Technosark makes precision machinery and is being offered for sale in its entirety. The plant is currently idle, though in the past it was a monopoly serving Soviet and local markets and employing some 2,050 people. Armenmotor makes small motors used in various types of machinery, water pumps and generators. Its products meet EU standards and compete with similar CIS manufactures. It has a joint venture with a Chinese company to make consumer heaters and fans. It has markets in Russia and the US.

Transistor, one of Armenia's largest electronic enterprises, may be sold to Syn Crystal, a Russian firm, for US$ 1.2 million. Syn Crystal has expressed an intention to purchase the Ashtarak branch of Transistor, where the enterprise's main production assets are located. Syn Crystal is offering a three-year investment programme worth US$ 10 million and intends to create 180 workplaces during the first year.

Software engineering is a growing investment sector, with a number of foreign investors in place. The biggest software firm is HPL Armenia, a subsidiary of Silicon Valley-based Heuristics Physics Labs Inc, employing about 95 specialists. Other leading software firms are Brience, Hailink, Yeretron and Credence. The low start-up costs and availability of highly skilled but inexpensive labour make the IT industry a very strong prospect for investors and for the country's future economic growth.

Natural resources

Armenia is rich in copper, molybdenum, gold, silver, lead and zinc. There are also substantial deposits of iron, pumice, marble, tufa, perlite, limestone, basalt and salt, as well as an abundance of precious and semi-precious stones. Work has been under way to revive the mining and metallurgy sectors, where technology is gradually being replaced and production is increasing. However, substantial investment is still needed to bring the industry up to its potential capacity.

Copper and molybdenum

The largest producers of copper and molybdenum concentrates are the Zangezur and Agarak Copper-Molybdenum Combines, followed by the Kapan and Akhtala Mountain-Enrichment Combines. In 2000, output of both metals at the country's mining enterprises increased by 40 per cent year on year. Production worth some US$ 65 million was produced during the year. In 2001 the four leading enterprises plan to produce almost 7,500 tonnes of molybdenum and 45,000 tonnes of copper concentrates. Russian companies such as Norilsk Nickel and Russian (Siberian) Aluminium have shown some interest in investing in the Zangezur, Agarak and Kapan Combines. Metal Prince (Romania) has been investigating opportunities for joint activity at the Kapan and Agarak plants, while Agarak has also drawn the interest of US firm Mercury Alliance. The Akhtala processing plant has been idle, but resumed operations in spring 2001 thanks to an investment of US$ 480,000 made by Metal Prince to renovate it.

The Agarak plant has recently been revived with the installation of new technological processes, allowing it to produce 200 tonnes of ore. The Kapan plant has also increased its earnings in the past year, producing copper, zinc and lead concentrates from raw materials mined at Shahoumian, which also produces gold and silver as by-products.

Manes & Vallex, an Armenian-Liechtenstein joint venture, was established in 1997. Conveniently located near copper deposits, the enterprise operates the Alaverdi copper smelting plant, which produces blister copper for export to Germany, Belgium, Austria and Italy. The raw materials are provided by the Kapan mining complex. Manes & Vallex produced about 6,000 tonnes of blister copper in 2000, and plans to double its production by the end of 2001. Manes & Vallex revived the Alaverdi plant with investments of US$ 6 million. The company is now seeking investors to help upgrade existing facilities further and to install new technologies, and has approached the IFC and the EIB. Once expanded, the smelter will have a refining capacity of 20,000-25,000 tonnes of copper to go on stream in 2004, rising to 50,000-60,000 tonnes of copper and 20,000 tonnes of zinc each year by 2010. The first stage will cost an estimated US$ 60 million, of which Manes & Vallex shareholders are expected to provide one quarter.

Gold

First Dynasty Mines (Canada) has a joint venture with Hayvoski, the state gold mining enterprise, to recover gold from the Zod and Meghradzor mines and process the ore at the Ararat gold refining factory. The joint venture is known as the Ararat Gold Recovery Company and is 50 per cent owned by First Dynasty, which is entitled to 70 per cent of profits until its investment has been recovered. The Zod mine has now restarted activity, and aims to produce 500,000 tonnes of ore per year. The Ararat factory cost US$ 12 million to build and began gold production in February 1998. Current gold production is forecast at 30,000 ounces per year at a cash cost of US$ 200 per ounce. However, in view of the reserves at the Zod mine, First Dynasty estimates that the joint venture will have the capacity to expand production to 160,000 ounces of gold per year and plans to invest a further US$ 35 million. Once Zod is fully operational as an open pit, work will begin on underground mining at Zod and Meghradzor.

Aluminium

In July 2000 aluminium foil production restarted at the Kanaker factory (also known as KanAZ) as a result of the creation of Armenal, a joint venture 44 per cent owned by Russian (Siberian) Aluminium and 56 per cent by the Armenian government. Armenal will produce almost half the foil for the CIS market. By the end of 2000, following complete renovation, the plant was producing at a rate of 21,000 tonnes of foil per year, and aiming to reach a capacity output of 26,500 tonnes. In 2001-02 Russian Aluminium plans to invest US$ 7.5 million in further development of the plant.

Chemicals and pharmaceuticals

Armenia has a well-developed chemical industry, which until 1990 made and exported chemical products to countries within and beyond the Soviet Union. The main products are plastics, chemical fibres, caustic soda, paints, lacquers and other coatings, rubber and latex. Chemical production, and in particular exports, grew rapidly in 2000. One of the largest plants, Nairit, is slated for privatisation. Nairit produces chloroprene rubbers, latex, synthetic acetic and technical formic acids, and caustic sodium. The IMF has recommended urgent action to speed up the restructuring/privatisation of Nairit, as it is a major loss-maker, putting strain on the state budget, and now the company is starting to operate with profit.

The Vanadzor Chemical plant specialises in the production of carbamide, melamine and synthetic crystals. In November 1998 Russia's Zakneftegazstroy-Prometei announced a plan to invest up to US$ 60 million in Armenia's chemicals industry, including restructuring of the Vanadzor plant. Zakneftegazstroy's contract includes plans to restore production of ammonia and carbamide. After a suspension of production and major reconstruction work, the Vanadzor plant partly resumed operations in October 2000.

There are also a number of successful companies producing **pharmaceuticals** and vitamins, an area that has attracted foreign investment. There is a well-established countrywide distribution network for pharmaceuticals, almost entirely in private hands. Armenian scientists have developed a drug known as Armenicum, which is thought to have positive medical effects on AIDS sufferers. An experimental clinic has been opened to provide the treatment.

In 1998, UK-Armenian joint venture Pharmatech established a pharmaceutical manufacturing facility in Yerevan, producing IV solutions using equipment installed by a subsidiary of Bristol-Myers Squibb (UK). The company also acts as an international distributor of pharmaceutical products for Bristol-Myers Squibb as well as for GlaxoSmithKline (UK) and insulin maker NovoNordisk (Denmark). Pharmatech is successfully developing its exports to CIS countries, in several of which its products are now registered. Once its export markets are fully established, the company plans to develop its manufacturing activities to include tablets and injections.

Glass factory privatisations

Hayapaki (also known as Armglass or Armsteklo) was sold to an individual purchaser in late 2000 for almost US$ 265,000, or about 25 per cent of its book value. The buyer is committed to invest about US$ 455,000 over three years, including about US$ 182,000 in the first year, and to offer 350 jobs in the first year, 500 in the second and 700 in the third. Finally, the buyer must assume company debts of just over US$ 1 million. Hayapaki was one of the largest glass bottle and crystal goods makers in the FSU. It was sold at the third attempt. Armavirapaki (Armavirsteklo or Armavirglass) was also recently sold to a US investor, with a commitment to invest US$ 300,000 during the first three years, and to offer 70 jobs during the first year. The company will be used to make molybdenum bricks. It used to be the largest maker of glass jars and bottles in the Caucasus, and currently has annual capacity of 10 million glass bottles and jars.

Agriculture and agribusiness

Agriculture is the largest employer in the country and accounts for about one quarter of GDP. However, only 17 per cent of Armenian land is arable, and the sector does not contribute significantly to exports. The agricultural sector suffers from a lack of investment and a lack of availability of long-term credits. Action is being taken to start addressing these problems.

The country produces grain crops, vegetables and superior quality fruits including grapes, figs, pomegranates, apricots, peaches, potatoes, sugar-beets, tobacco, cotton, grains, essential oils (such as geranium), rose, peppermint and speciality teas. In the Soviet era, fruits and grapes provided 25-30 per cent of budgetary revenues, but in the early transition years they were partly replaced with cereal crops. Grapes traditionally brought income from wine exports (up to 10 million decalitres a year), and fruits were either canned or exported fresh. By 1998 the area cultivated with cereal crops had grown by over 50 per cent, to the detriment of orchards and vineyards. One of the motives was to replace the import of cereals with self-sufficiency. With adequate supplies of pesticides, fertilisers and high-quality seeds, the potential exists to increase cereal production to 340,000 tonnes a year by 2005.

In 2000 the entire region was hit by a severe drought, leading to a substantial drop in agricultural output and an estimated loss of income of US$ 40 million, which had a negative effect on GDP. In September the UN World Food Programme sent a mission to assess the impact of the drought, along with provision of winter wheat seeds and an emergency operation to distribute food to the worst affected areas. The drought was most severe in the mountainous north, where rainfall was 70 per cent below the normal level in some important agricultural areas. Livestock were also affected by the subsequent lack of fodder.

The development of the agricultural sector is constrained by land fragmentation, the lack of adequate distribution and transport infrastructure, inadequate irrigation and an as yet underdeveloped food processing industry. The World Bank is to finance an SDR 10 million irrigation development project through the International Development Association. It is also funding a US$ 14.5 million Agricultural Reform Support Project to help the development of private sector farming, agro-processing, and agricultural institutions and services. The project aims to develop an agricultural credit system and target the needs of small farmers in agricultural research and market information.

Land reform project

USAID has provided support to the development of a real estate market with a project to streamline title registration. The project also gave assistance to new and existing private sector real estate stakeholders, provided public information on rights to real property, and supported the transfer of state-owned land to the private sector. The project's achievements included enactment of a Law on State Registration of Rights to Property, completion of a streamlined electronic title registration system, an electronic archiving system for paper title records and supply of equipment to the State Cadastre Committee. Substantial assistance is also being provided under the European Commission's Food Security Programme, the Title Registration Project financed by the World Bank, and the Programme for the Development of a Cadastre System in Armenia financed by SIDA, as a result of which surveys for title registration of over 500,000 units and distribution of over 250,000 Certificates of Title have been completed.

Food processing

The main products are soft drinks, mineral water, cigarettes, alcohol, canned fruits and vegetables, milk and dairy products, meat and meat products, mixed feed, flour and bread. With modern processing and packaging technologies, Armenia's fruit and vegetable products will have the potential to enter international markets.

Investors have established joint ventures to produce tomato paste, fruit juice, and packaging for domestic and export markets. New packaging technologies and capital for long-term investment are needed to unlock the sector's potential. Most of Armenia's food processing plants and canneries are actively looking for foreign partners to increase their exports. A programme to reconstruct four large canneries at a cost of over US$ 6 million is being implemented under the World Bank and other programmes.

Wine and brandy

Armenia has an ancient wine-making tradition, and the industry was well developed in the Soviet era. At the start of transition vineyard areas decreased, but there is now a revival in evidence and new production facilities are being established. The World Bank is assisting the government in developing grape growing with a US$ 2.8 million loan. The main centre for grape-growing and wine production is the Vayots Dzor region, which produces Black Areni grapes, used for red table and semi-dry wines. There are several privatised wineries in the area, all of which have financial and technical support from the US Department of Agriculture's marketing assistance project, which is helping them to buy modern bottling equipment.

Mineral water and fruit juice

Armenia is rich in mineral water sources, which have value as table water or for medicinal purposes. Of over 500 springs nationwide, eight are licensed and in production. The main bottling centre is at Jermuk, where the local mineral water is famous for its healing properties, and where there are a number of medical spas. The companies centred on Jermuk produce some 20 million bottles each year. The largest are Jermuk Group and Jermuk JSC, the latter of which is owned by western investors. Both are equipped with modern bottling lines and export their products to the CIS, Middle East and the US. Another leader is the Bjni mineral water bottling plant, a joint venture with BGI, a member of the Castel Group (France). Bjni produces various carbonated soft drinks in 0.5 and 1.5 litre bottles and has leased the Bjni mineral water springs for 25 years. It too exports to the CIS, US and Middle East. Coca Cola bottles local water under the brand name Bonaqua and sells it through its own distribution channels.

Armenia's abundant fruit crops are used by the growing juice processing industry, which in recent years has been renovated with new processing and packaging lines. The major private firms include Sardarapat, which has a new production line financed by a World Bank credit that produces 4,500 litre packs of juice per hour, Euroterm, which in November signed a contract with Tetrapak (Sweden) for a new US$ 2 million production line to produce fruit concentrates. This is the company's second Tetrapak line and will be installed by May 2001, enabling Euroterm to process 15,000 tonnes of fruit annually and double its workforce from 70 to 140.

Tobacco

Armenian tobacco sales average about 8,000 tonnes per year. Canadian-Armenian enterprise Grand Tobacco controls about half of Armenia's cigarette market and is investing US$ 5 million in its Yerevan joint venture. Armenian-Greek tobacco fermenting and processing joint venture Masis-Tabak started operations in November 2000 and has a capacity to process 10,000 tonnes of tobacco per year, for export chiefly to Russia, Ukraine, Belarus, Georgia and European countries. The new venture is providing up to 1,200 jobs, and is making an important contribution to thousands of families in rural communities where tobacco is grown.

Yerevan Brandy Company

Armenia is justly proud of its brandy, which has a long tradition and a high quality, as well as great promise for the export economy. In 1998 Pernod Ricard (France) bought the Yerevan Brandy Company (YBC), and has since improved production, raised quality and launched a major sales effort.

YBC dates back to 1887, when it was founded as the Ararat Wine and Brandy Factory. YBC enjoys strong recognition under its Ararat brand name (three or five-year-old brandy) and produces six other branded brandies ranging from seven to 20 years old. Its main factory is in Yerevan, but it also has six wineries across the country and three distilleries. In 1998 and 1999 Pernod Ricard spent significant amounts on developing viniculture and buying grapes, and in developing the winery itself. YBC now sets new quality standards for the industry and its brandy production standards comply with the national standards for Armenian brandy as adopted by the authorities. As the leading European producer and distributor of alcoholic drinks and the fifth largest worldwide by sales volume, Pernod Ricard has a very strong track record in launching “new world” brands, such as Jacob’s Creek (the first successful Australian brand) as well as Chilean, South African and Georgian wines.

YBC was hit by the Russian economic crisis of 1998 and by trademark forgery, but since being bought by Pernod-Ricard it has launched marketing campaigns in the CIS to advertise its products. Ultimately, this advertising will extend worldwide. YBC’s products are now made distinct with special seals and holographic stamps to protect against forgery. The idea is to make the public familiar with these features so that they avoid substitutes.

Following its acquisition by Pernod Ricard, YBC has developed new export markets and increased its sales in the Russian market, thanks to a significant marketing and advertising effort, and since the economic situation has recovered from the 1998 financial crisis. YBC exports its products to 20 countries, of which Russia is its largest single market.

In March 2000 the EBRD approved a loan of US$ 20 million to YBC to enable it to continue to upgrade its production facilities, improve quality standards of its export-driven brandy, and restructure its balance sheet by replacing short-term with long-term debt. This was the EBRD’s first investment in an Armenian private sector company, and in the agribusiness sector. This reflects its confidence that brandy production has enormous potential as a hard-currency earning export item that can benefit the Armenian economy. Further, the loan will have a demonstration effect in supporting the restructuring of a privatised company and the strengthening of this company as a key market player. Another reason for the EBRD to provide the loan was that as YBC is the largest purchaser of Armenian grapes, the project has strong upstream linkage to that sector and will help to boost it.

In 1999 the EBRD co-invested with Pernod Ricard in the Georgian Wines and Spirits company, Georgia’s leading wine producer and exporter.

Energy

Armenia's installed generation capacity is 3,200 megawatts (MW), of which 1,754 MW is thermal, 1,006 MW is hydropower, and the rest (440 MW) is produced by the Medzamor nuclear power station, which is to be decommissioned by 2004. About one third of total capacity is currently in operation. The country has been a pioneer in the Caucasus region for energy sector reform, which is now well advanced.

A progressive Energy Law passed in 1997 has enabled the restructuring of the power sector, allowing for the creation of an independent regulatory body, the Energy Regulatory Commission, which approves energy tariffs and licenses the generation, transmission, supply and distribution of electric and thermal energy. The Energy Law also led to the unbundling of the electricity sector into one transmission company (Armenergo), several generation companies and the four distributors. In addition, the market for electricity was organised on the "Single Buyer" model, with generation companies selling to the Single Buyer through commercial contracts at regulated prices, while distribution and supply monopolies buy power from the Single Buyer at regulated prices.

The Energy Law of 1997 has facilitated the development of the energy sector. However, it places some limitations on liberalisation of the sector. To address this issue, the government prepared a new Energy Law which was adopted by parliament in March 2001. The new law defines the main concepts of the electricity market and responsibilities for its development. The law also defines the principles of state policy in the sector. It attempts to establish an attractive field for hydro- and alternative energy, in particular by guaranteeing full purchase by the electricity market of electricity generated by new alternative and small hydro power stations for 15 years. Under the new law, the government's right to allocate revenues in the case of partial collections has also been eliminated.

Gradually, third party access is to be introduced, as well as bilateral contracts between generation and distribution companies and large consumers. The World Bank and USAID are helping the government with the structure and implementation of the power market. Energy tariffs for the population are not to be increased until 2004, but after that will gradually rise until 2010.

The next stage has been privatisation, which started with an action plan adopted in December 1998. The World Bank and USAID have assisted with privatisation, and disbursements under the World Bank's Structural Adjustment Credit IV are to be linked to progress with privatisation. The distribution companies are being privatised first (see overleaf), to be followed by generation facilities. Thirteen small hydropower plants were privatised in advance in 1997-98.

Despite the tasks ahead, Armenia is already benefiting from the energy sector reform and is the region's only energy exporter, lately supplying electricity to Georgia as it suffers its worst power shortage for years. When Armenia suffered its own energy crisis in the early 1990s, following the 1988 earthquake, the break-up of the USSR and the imposition of embargoes by Turkey and Azerbaijan, its only resort was to reopen Unit 2 of the Medzamor nuclear power plant, closed after the earthquake for safety reasons. Medzamor supplies one quarter of the country's energy. USAID has supplied US$ 5.4 million for a nuclear safety programme at Medzamor, but the various IFIs and other agencies involved in energy sector reform see restructuring and privatisation as a route to the timely closure of Medzamor. The government is concerned that alternative sources of electricity be guaranteed before it is closed.

The government recognises the country's huge hydropower potential, and that only about 30 per cent of it is being used. It plans to increase hydroelectric generating capacity through a development programme which will use private sector

Oil and gas supplies

With no oil reserves or refineries of its own, Armenia depends on imports of refined products, which, for lack of pipelines, mainly come by rail or road from the Batumi refinery in Georgia. It also receives its natural gas from both Turkmenistan and Russia via the Russian and Georgian pipeline networks. Armenia has been trying to diversify its sources by exploring options to buy gas from Iran. This would involve up to US$ 120 million for a pipeline linking the Armenian and Iranian gas grids, for which Armenia has sought funding. Greece has also expressed an interest in participation, though financing of the project has yet to be finalised. If implemented, the project would earn Armenia valuable transit income. Although the EU is prepared to consider the pipeline within its INOGATE (Interstate Oil and Gas Transportation to Europe) programme, the US government is opposed to it as part of its general opposition to investments in Iran.

Privatisation of distribution companies

The sale of the country's four regional electricity distribution companies, originally scheduled for spring 2000, was delayed following political disagreement over the course of power sector reform. However, the issue was resolved with the adoption in July 2000 of a special law on power distribution privatisation, and the government resumed the search for strategic investors to buy at least 51 per cent stakes. The four distribution companies are being sold in two packages, the Yerevan and northern networks, and the central and southern networks. By the autumn, a shortlist of four qualified operating companies had been prepared and conclusion of the transaction is expected for spring 2001. The shortlisted firms were Union Fenosa (Spain), AES Corporation (US), Electricite de France and ABB Energy Ventures (Sweden-Switzerland), all pre-selected on the basis of their financial strength and business experience. Electricite de France pulled out in December. Bids from the remaining firms are due by the end of March 2001.

In December 2000 the EBRD agreed that when the sale goes through it will buy a share of up to 19.9 per cent in each of the four distribution companies. The EBRD's main aim is to catalyse effective and successful privatisation. Its presence enhances credibility and transparency by requiring that a competitive tender be held for the sale, and also mitigates political and regulatory risks, providing comfort for the strategic investors. The government has shown its strong commitment to the privatisation process by acting swiftly to overcome the delay and adopt the special law, and has had broad international support for its reform efforts, not only from the World Bank, USAID and the EBRD but also the IMF and the EU.

Privatisation is to be achieved without tariff adjustments in the short term and the government is expected to assume most of the sector's outstanding obligations. Total debt in the energy sector amounts to about US$ 180 million. Tariffs currently cover costs, but without substantial efficiency gains they will not be sufficient to finance the full rehabilitation programme. However, the Armenian power sector has a relatively strong collection record, with the distribution companies collecting nearly 88 per cent in 1999. Areas for greater efficiency include the aged network, which results in high technical and commercial losses, and inadequate billing and metering systems. The sector has also suffered from a lack of investment, and is robbed by illegal connections. Privatisation is expected to improve management and provide much needed investment to reduce the technical and commercial losses and improve the sector's financial performance, and well as the quality of supply to consumers.

Efforts for the sale of generation assets also continue, including the privatisation of the Hrazdan thermal power plant, for which the EBRD is providing technical assistance funding. The EBRD contributed US$ 58.5 million in 1995 towards construction of Unit 5. Completion of construction of Unit 5 has been held up by the need for more financing, and the remaining proceeds of the EBRD loan are funding works to conserve the partly completed unit. If completed, the block would be the most efficient thermal electricity-producing unit in Armenia, as its equipment is more advanced than that of similar units in the region. Several small hydropower dams were sold to private investors earlier.

investment of US$ 300 million. The programme includes a plan to build 38 small and three large power plants with a total capacity of 296 MW. IFIs such as the EBRD and the World Bank are being approached for financing.

Telecommunications

Average telephone density is about 17.7 per 100 persons. International connections to other FSU republics are by landline or microwave, and to other countries by satellite and by leased connection via the Moscow international gateway switch. Private TV broadcasting stations, cable networks and Internet providers are increasing in number.

Reform in the telecommunications sector was an early priority for the Armenian authorities, and state telecommunications company ArmenTel was offered for privatisation in the early stages of transition. With 50 per cent foreign ownership, the company went through a restructuring phase, followed soon after by the sale in 1997 of a 90 per cent share to a strategic investor, OTE of Greece, for which it paid US$ 142 million. The government retains 10 per cent. However, Armentel has faced difficulties ever since. Two lingering tax disputes were settled during 2000, primarily in the government's favour. The 15-year monopoly in international telecommunications services enjoyed by Armentel has affected Armenia's negotiations to join the WTO. It is also critical to an EBRD post-privatisation equity and debt investment, which would benefit ArmenTel's corporate governance and financial strength. Disagreements also continue over the level of investment that has occurred since OTE took over Armentel in December 1997. OTE is behind schedule in the US$ 100 million investment programme agreed during privatisation.

In November 2000 the government and OTE announced their intention to revise the privatisation agreement. OTE itself is seeking a strategic investor to purchase 15-20 per cent of its shares. One of its most attractive features is its strong presence in the Balkans, where it has stakes in telecoms operators and mobile firms.

ArmenTel is the main provider of Armenia's long distance, cellular and paging services, and has engaged in an ambitious project to modernise the country's entire telecom network. This involves installing fibre optic cable, digital telephone switches and cellular and paging services. Work to digitalise 70 per cent of the telephone network is proceeding, with 230,000 subscribers expected to be switched to digital services by the end of 2001. In the first stage of the modernisation, 80,000 subscribers in the Yerevan area were switched over by the end of 1999. In 2000 work began on the installation of the 240-kilometre fibre-optic trunk line linking the north and west regions of the country. This cable will provide 150,000 digital lines of which 102,000 will be in Yerevan and 48,000 in regional centres. The total cost of the project is estimated at US$ 56 million, of which US$ 33 million will pay for switchboards (from Siemens and Greece's Intracom) and US$ 10 million will pay for cable and auxiliary equipment.

International connections

In November 1999 a 230-kilometre fibre-optic trunk line was opened between Armenia and Georgia. An agreement has been signed for a 140-kilometre fibre-optic line between Megri and the Iranian town of Marand, near the border. This line is being laid by Hellascom (Greece) with investment from ArmenTel.

Caucasus Optical Cable

The EC is financing the implementation of the Caucasian railways telecommunication network, covering installation of underground optical cable in all three Caucasian states, to allow for a direct connection with Europe (as part of the Trans Asia-Europe cable running from Frankfurt to Shanghai). Part of the capacity of the so-called Caucasus Optical Cable will be used by Armenian Railways to improve the management of its operations and to increase traffic. The remaining capacity will be made available to private operators, improving the Armenian telecoms market.

Transport

As a landlocked country, Armenia is vitally dependent on transport links through its neighbouring countries for imports and exports. Until the Nagorno-Karabakh dispute is resolved, only links through Georgia and Iran are open. The country therefore relies mainly on aviation and a few low-capacity land connections via Georgia and Iran. The Georgian city of Poti is the nearest seaport, and is a primary gateway for Armenia, for both imports and exports. Both road and railway routes are gradually undergoing much-needed upgrading, with the financial help of the World Bank and also of Diaspora billionaire Kirk Kerkorian.

Armenia has made an agreement with Russia to establish a special ferry link in the Black Sea, enabling Armenian cargoes to bypass the Abkhaz section of the Georgian railway, which is blocked by ethnic unrest. The ferry link will run from Georgia's Poti port north along the coast to Novorossiysk in Russia, and will cost US$ 6 million.

TRACECA: The Great Silk Road Revival

TRACECA stands for the Transport Corridor Europe Caucasus Asia, the EU-sponsored umbrella programme to coordinate the development of transit routes between east and west. The transport corridor runs from Europe across the Black Sea, through the Caucasus and the Caspian Sea to Central Asia, and links up with the EU's Trans European Networks (TENs), which cover the transport system for EU countries, and its Pan-European Transport Corridors, which cover the rest of Europe.

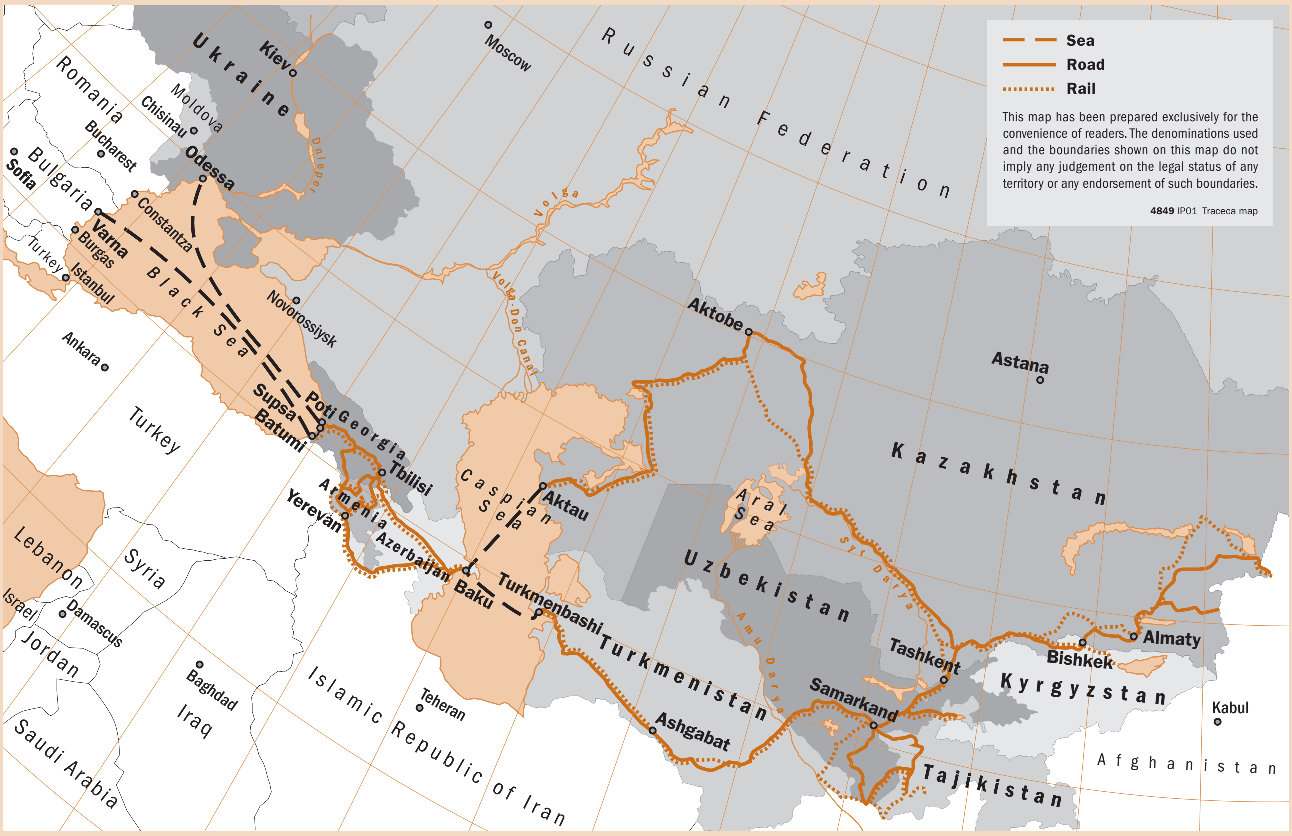
Under the TRACECA programme, in 1998 the relevant countries signed a multilateral agreement on transport ("MLA"), which aims to help develop economic relations, trade and transport communications in the region, ensure access to world markets by road, rail and sea, ensure safety and environmental protection, harmonise transport policy and legal structures, and create equal conditions for competition in transport operations. The signatory states are: Moldova, Ukraine, Georgia, Armenia, Azerbaijan, Uzbekistan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkey, Romania and Bulgaria. Mongolia and Turkmenistan have yet to sign.

TRACECA's work includes:

- financing technical assistance for transport infrastructure, legal and regulatory issues and management training, all to help catalyse investment projects;
- cooperation with IFIs on major infrastructure investment projects;
- financing of investment projects at key points to remove bottlenecks;
- fostering and coordinating regional cooperation in transport.

There are two supporting structures, the Intergovernmental Commission at ministerial level, and the Permanent Secretariat, based in Baku. The Intergovernmental Commission, including heads of government and transport ministers, first met in Tbilisi in March 2000, where they adopted rules of procedure and an action plan listing projects to be financed by TRACECA. They identified priorities such as to harmonise tariff liberalisation and simplify customs and border procedures. All the participants recognise the importance to regional development of reviving the ancient "Silk Road" through mutual cooperation. The Working Group of national secretaries has since met every few months to move the priorities forward. Three priority programmes established for 2001 are harmonisation of frontier procedures, establishment of a common legal basis for transit haulage, and elaboration of a common policy for the imposition of transit duties. These are to be financed through EU technical assistance funding.

For Armenia, projects that come under the TRACECA umbrella include the Caucasus Optical Cable, the World Bank transport project, and a number of TACIS-funded projects involving railway rehabilitation and terminal equipment.



Roads

Armenia has a relatively well developed road network, serving all areas of Armenia's economy with a road density of 257.6 kilometres per 1,000 square kilometres. The road network consists of 7,700 kilometres of interstate roads, inter-republican roads (regional) and local roads. Of these, 1,400 kilometres are interstate roads, 2,520 kilometres are inter-republican roads, and 3,780 kilometres are local roads.

The Armenian government has undertaken to renovate roughly one-third of the 1,500 kilometres of main roads in Armenia. Reconstruction of a bridge over the Araks River, completed in December 1995, has improved road access to Iran and facilitated the supply of consumer goods.

The World Bank helped to prepare a project to rehabilitate strategic road links to Georgia and to improve road sector cost recovery, which was funded by the IDA. The World Bank is now working on a second transport project at a total cost of US$ 47 million, covering road, rail, and urban transport. The government is contributing about US$ 6.4 million, US$ 40 million is IDA funded and the rest will come from grant co-financing. As far as roads are concerned, this includes rehabilitation of interstate trade routes, engineering supervision for road and bridge upgrades and a road safety programme. Armenia has also been the recipient of many TRACECA studies whose main theme has been improving transport links northwards to the trans-Caucasian corridor in Georgia.

Railways

There are 883 kilometres of railways (excluding industrial lines). Of four international rail connections (via Georgia, Azerbaijan, Iran and Turkey) only the one to Georgia, giving access to the Black Sea ports of Poti and Batumi, is presently in operation, due to the trade embargoes imposed by Azerbaijan and Turkey. The World Bank transport project includes financing for the rehabilitation of tracks and bridges, and to buy new locomotives. It is also contributing to institutional strengthening of the Armenia Railways Department and the companies responsible for infrastructure management, and freight and passenger services.

In July 2000 a new rail cargo terminal was opened in Yerevan, following modernisation financed by the EU within the framework of the TRACECA programme, with the participation of the government. The terminal is expected to contribute to an increase in transit freight from Iran to Russia and on to Europe. The EU provided US$ 1 million for equipment, while the government financed construction work for US$ 0.25 million.

Air transport

Aviation is one of the government's priority areas for development. Modernisation, including replacement of practically all airport equipment, and purchase or lease of passenger aircraft is needed. Civil aviation infrastructure consists of three international airports, at Zvartnots, Erebuni, and Gyumri, and nine local (non-military) airports, although most of the domestic airports are not functioning.

In 1994 the EBRD made a loan of US$ 22.8 million for the construction of a cargo terminal at Zvartnots airport, which serves Yerevan. The terminal, which cost US$ 27.8 million to build, was opened in early 1998. Apart from building a new warehouse, the project included the construction of new taxiways to accommodate cargo aircraft and the procurement of necessary cargo handling equipment. (See *EBRD activities* below.) Management of Zvartnots airport is to be privatised, including responsibility for the passenger and cargo terminals, but not air traffic control. The government is seeking an experienced buyer willing to make investments to upgrade airport facilities.

The state carrier, Armenian Airlines, is to be offered for privatisation in the first half of 2001 by international tender. Scheduled Armenian Airlines flights operate between Yerevan and Amsterdam, Athens, Beirut, Dubai, Frankfurt, Istanbul, Kiev, London, Moscow, Paris and Teheran, among other destinations. British Mediterranean Airways, the British Airways franchisee, is now offering direct flights from London twice a week. Swissair operates a twice-weekly flight between Zurich and Yerevan. A twice-weekly flight is operated between Yerevan and Teheran by Caspian Air, and 17 regular flights are operated by various Russian airlines to Russian cities. Austrian Airlines is to start twice-weekly flights between Vienna and Yerevan by 1 April 2001.

Construction materials

Two large cement plants are on the list of 14 strategic companies to be privatised. However, the sector is not large. Ararat Cement, located near the Turkish border, is the country's largest cement producer. It produces about 200,000 tonnes of cement per year, but has an annual production capacity of 1.2 million tonnes. In July Ararat Cement made an agreement with Siemens (Germany) on modernisation of the enterprise at a total cost of about US$ 20 million. The project aims to increase production to 500,000 tonnes of cement per year and to make concrete railway sleepers. Further financing partners are being sought, and talks have been held with the EBRD on possible participation. Hrazdan Cement is also being offered for sale.

Tourism

Tourism offers some of the most attractive privatisation opportunities in Armenia. Before the break-up of the Soviet Union, tourism was an important economic activity in Armenia, attracting about 500,000 tourists each year, of whom about 100,000 came from outside the Soviet Union. Armenia's main tourist attractions are its warm climate, Lake Sevan set in the mountains, an Olympic skiing base at Tsakhkadzor, many archaeological sites, churches, monasteries and historical monuments, historical and cultural heritage, and health spas in Jermuk. There are facilities for many sporting activities, spa resorts centred on medicinal springs, and opportunities for "ecotourism".

In order to help boost prospects for the sector, the government is actively encouraging foreign companies to invest in tourism. A licensing procedure and general tourism law have been proposed. Six zones have been identified for tourist development, including Yerevan and its neighbourhood, the Vayots Dzor district including the spa town of Jermuk, the Lake Sevan area, mountain areas and lakelands.

In 2001 Armenia is celebrating 1,700 years since the adoption of Christianity as the state religion, and tourist numbers are expected to exceed 120,000, bringing hard currency income of some US$ 120 million. Officially sponsored events include religious services, festivals, exhibitions, concerts and theatrical performances. Work to upgrade the tourism infrastructure in advance is being financed by the Lincy Foundation (run by Armenian-American billionaire Kirk Kerkorian), which has provided US$ 20 million, and the Cafesjian Foundation, another Diaspora charity, which has provided US$ 2 million. Hovnanian International (US), run by another Diaspora Armenian, is undertaking a US$ 17 million project to build 200 tourist cottages at cultural and historical sites all over the country.

Hotel privatisation

There are more than 70 hotels in Armenia, with over 7,000 beds. Most (28 per cent) are in Yerevan. Several new hotels have been built or are under construction in Yerevan to meet the expected tourist boom. The Hotel Armenia, Hotel Ani and Hotel Yerevan, three of the largest in Yerevan, have been privatised and are being refurbished. In 1999 the Overseas Private Investment Corporation (OPIC, US) provided a loan of US$ 18 million to AK Development (US), purchaser of the Hotel Armenia, for its refurbishment. The IFC is also considering a US$ 3.6 million equity investment in the hotel. However, for lack of credit guarantees the renovation has been delayed. Once fully renovated, the hotel will become part of the Marriott International chain. Ani Enterprises LLC (US), which bought the Ani Hotel, is investing US$ 10 million in its renovation and has renamed it the Hotel Ani Plaza.

Several more sizeable hotels are due to be privatised, of which the **Dvin Hotel** is the first to be offered. The 14-floor Dvin is one of Armenia's largest hotels, with several restaurants, and enough space to build a parking lot and swimming pool. The hotel is fully operational. Several dozen more hotel properties throughout the country have been approved or identified for privatisation, in prime locations in Yerevan and other main cities, tourism centres such as Sevan, Vayots Dzor (Jermuk), and Kotayk. There are also some opportunities to invest in uncompleted construction sites.

Water and waste water

The World Bank is considering an SDR 15.2 million project to improve water and waste-water services in terms of coverage, quality and cost, with a focus on areas outside Yerevan and special emphasis on service to the poor. The project is expected to include a management contract for the Armenian Water and Sewerage Company (AWSC), including incentive bonuses, an investment fund to support the strengthening of AWSC and systems in participating communities, and technical assistance to prepare and monitor the management contract and help the government to establish sector law and regulation. The loan would be on IDA terms, and would follow on from a previous US$ 30 million loan designed to modernise Yerevan's water supply system, making water available round the clock. The management contract for Yerevan's water supply company was awarded to ACEA Spa of Italy. Bringing in international operators is designed to help establish sustainable, efficient water and sewerage systems, increasing the availability of water, reducing losses, saving electricity and increasing payment collection.

Financial sector

Armenia's financial sector has developed rapidly, with banking sector capitalisation more than doubling in the last three years and sound regulation and supervision in place. Yet the sector remains small in relation to the size of the economy and has a low lending capacity with high interest rates. Non-bank financial institutions are at an early stage of development.

Banking sector

Following the adoption in 1996 of fundamental banking laws, a reliable framework has been created for the operation of commercial banks. The Central Bank of Armenia (CBA) has adopted further regulations to enable implementation of the legislative changes and to ensure the compliance of existing standards with the new laws. It has consistently continued to tighten regulatory requirements and imposes sound standards of financial discipline, developed under the guidance of the international financial institutions.

Since April 1999 required reserves have had to be held in domestic currency only, while from January 2000 limits on open foreign exchange positions were lowered to 25 per cent of capital. Minimum capital requirements for existing commercial banks increased to US$ 1 million from January 2000, and will gradually rise to US$ 5 million (which already applies for new banks) during 2001-05. From 1 July 2001 the requirement will rise to US$ 1.3 million.

Banking supervision has improved, with all banks adhering to International Accounting Standards (IAS) since a new chart of accounts was introduced in January 1998. Since 1996, when it established a new regulatory framework, the CBA has been a strict supervisor, imposing penalties for violation of prudential regulations. Strong supervision will be vital to the future development of the banking system within an increasingly competitive environment, and is already showing its value.

Currently, the CBA intends to strengthen its prudential regulations to enhance further the soundness of the banking system. The CBA is due to establish new banking regulations and concepts regarding: (i) improving the capital adequacy requirement through clear definition of capital; and (ii) classification and appraisal guidelines to determine the overall quality of banks' investment portfolios. The CBA and the government intend to issue and implement a loan classification system, which is in accordance with international best practices, and takes into account the capacity of borrowers to service their loans. The CBA and the government also intend to introduce a new "watch" category to the loan classification system and to provision for loans in this category by a greater amount than for standard loans. The CBA will further develop valuation methodologies with respect to loans and collateral and introduce new provision rules that are consistent with international best practices, and more closely tailored to the risks prevailing in the Armenian economy. The CBA has already issued guidelines for the measurement and management of foreign exchange, interest rate and liquidity risk by commercial banks, and intends to issue guidelines for credit risk. The CBA has also decided to establish a credit bureau alongside the banks, to fill the gap in credit information about companies.

Capacity of the banking sector

The Armenian banking sector enjoyed considerable growth in 2000, with total assets increasing by 24 per cent in real terms. By the end of 2000 the total capital of all Armenian banks amounted to AMD 33.6 billion (about US$ 60.9 million). Total assets on 31 December 2000 amounted to AMD 236.3 billion (about US$ 428 million, up from US$ 365 million at the end of 1999). As a result of banking sector reform strategy implementation pursued by the government and the CBA, the

Armenia's top banks in terms of assets, as at 31 December 2000

Bank	Total assets, AMD millions	Total assets, US$ millions	% of total banking sector
HSBC-Armenia	31,211.6	56.5	13.21
Armimpexbank	21,458.7	38.9	9.08
Ardshinbank	21,000.0	38.0	8.89
Credit Yerevan Bank	19,165.6	34.7	8.11
Converse Bank	17,888.9	32.4	7.57
ArmAgrobank	10,610.1	19.2	4.49

Armenia's top banks in terms of capital, as at 31 December 2000

Bank	Total capital AMD millions	Total capital US$ millions	% of total banking sector
HSBC-Armenia	4,845.5	8.8	14.42
Armimpexbank	2,368.2	4.3	7.05
Ardshinbank	1,796.5	3.3	5.34
Credit-Yerevan Bank	2,006.0	3.6	5.97
Armagrobank	1,069.2	1.9	3.18
Converse Bank	1,170.4	2.1	3.48

Source: Central Bank of Armenia

role of the banking system in mobilising savings and financial intermediation will continue to increase. During 2001 banking system liabilities increased by 28 per cent and amounted to AMD 202.7 billion (about US$ 367.1 million). The increase in banking capital, assets and liabilities is due to substantial progress made in banking system restructuring, and in adopting and implementing tighter prudential regulation measures.

The banking sector is concentrated in Yerevan, with five major banks accounting for some 47 per cent of total assets. The leading bank is HSBC-Armenia, which has the largest capitalisation and maintains a leading market position. As a foreign-owned bank (see box), HSBC-Armenia has access to international capital markets via its UK parent bank.

Further consolidation is likely to result from the gradual rise in minimum capital requirements and from falling interest rates. At the end of 2000, several of the banks were making an effort to increase their capital by negotiating with foreign investors and planning share issues.

Banking privatisation and restructuring

Following a loan provisioning programme, at the end of 1997 the commercial banks were able to write off all pre-1996 non-performing loans, and did not accumulate a burdensome number of new bad loans in the wake of the Russian financial crisis of 1998. In January 2001 overdue loans accounted for about 14.4 per cent of all loans. Thanks to vigilant supervision by the CBA, the banks have also set up sizeable provisions against classified loans.

All state-owned banks had been sold by June 1999 except for the Savings Bank, which is to be privatised by the end of 2001. In August 2000 the government announced the first stage of the privatisation, when 51 per cent of shares worth about US$ 1.9 million (equivalent to the value of the bank's working capital) will be sold to a strategic investor. The search for a strategic investor started at the beginning of 2001, with applications due by the end of the first quarter. The buyer will be expected to maintain the Savings Bank's network of branches, which is one of the largest in Armenia, as well as to make investments.

Foreign investment in the banking sector

There are no restrictions on the establishment of foreign-owned resident banks, as long as CBA licensing and prudential requirements are met. There are no restrictions on both inward and outward capital flows for non-residents, or on the payments system, the inflow of foreign currency, or the import of securities reflected in foreign currency. Resident legal and physical entities may carry out operations on current and capital transfers from accounts with banks without any restriction.

There are 13 banks with foreign participation in Armenia. The foreign share of statutory capital in the entire banking sector at the end of 2000 was 42.6 per cent. Five of the 31 commercial banks are foreign-owned. These include HSBC-Armenia (formerly Midland-Armenia, UK), Armenia's largest bank in terms of capital, Menatep-Yerevan (Russia), Mellat Bank (Iran), Areximbank (Russia), and the International Commercial Bank (ICB), which is majority-owned by the Commercial Bank of Greece, with the EBRD holding a 25 per cent stake.

Non-bank financial institutions

Non-banking financial institutions, such as leasing organisations, insurance companies and investment funds are at a very early stage of development.

A Securities Market Inspectorate was established in November 1998 and the recently established central depository is expanding its operations and is materially compliant with G-30 requirements. A new law on securities market regulation was approved by parliament in June 2000. The new law foresees the creation of an independent securities market regulator, which was appointed in August 2000. The new law also improved rules on information disclosure and better investor protection. According to the law, stock exchanges and the Central Depository of Armenia (a centralised registry, depository, clearing and settlement facility) operate as self-regulatory organisations. It is hoped that the new law will increase market efficiency, reduce system risks and lead to an increase in trading volume.

So far, legislation and regulatory interference for non-bank financial institutions is limited. The government has focused on establishing the main legal and regulatory pillars for capital market development. The new Securities Commission is making a substantial effort to finalise the overall legal and policy framework, to develop and strengthen the supporting institutions needed for the growth of capital markets, and to create an environment to encourage market activities.

In order to develop the financial system, the government has been working on a Capital Markets Development Programme, with assistance from USAID and PriceWaterhouseCoopers (PWC), to build the securities market infrastructure necessary for capital market development.

The overall aim of the project is to develop a commercially viable, systemically sound, open and fair capital market. Within this main aim lie several key objectives:

- Give citizens the opportunity to participate by buying or selling securities;
- Allow enterprises to issue corporate securities to help further develop their business; and
- Promote the concept that citizens can invest and participate in the market as a long-term savings method.

With assistance from PWC, the Ministry of Finance and Economy and later the Securities Commission have been developing the legal and regulatory infrastructure to support and promote a transparent market, including drafting of the new securities law and implementation of the regulations.

Stock market

Volume on the capital markets has modestly increased, and the regulatory framework is mostly complete. The independent regulator is taking thorough measures to ensure that newly adopted laws and regulations are enforced efficiently.

The four existing stock exchanges in Armenia had failed to reorganise into self-regulatory organisations before their licences expired under the terms of the current legislation. However, the overwhelming majority of member firms of the former exchanges joined forces in an effort to consolidate the market and established the Armenian Stock Exchange (“Armex”). Armex was registered by the Securities Commission in February 2001. Armex is a membership-owned self-regulatory organisation based on the principle of “one member – one vote”, with the power to adopt and enforce regulations governing its members’ activities. Armex has 22 member brokerage firms which in 2000 conducted about 98 per cent of transactions (including OTC). Armex has two trading boards and is working hard to increase the number of listed companies. USAID is to provide the stock exchange with an automated trading system (RTS, or Russian Trading System) to improve the price setting process. Foreigners may freely invest on the stock exchange. The number of firms listed on the largest exchange before consolidation had increased from nine in 1996 to about 100 by the end of 2000. Listed firms included the Abovian brewery and the Armavir machine tool plant. Total capitalisation was about US$ 17 million. Most of the companies are expected to be listed on the new exchange and to comply with disclosure requirements.

Trading volumes are low and are concentrated in Treasury bills (T-bills). The equity turnover of the brokerage firms in 2000 amounted to US$ 6 million in corporate securities, while turnover in T-bills was about US$ 240 million. A T-bill market has been in operation since September 1995. T-bills are offered at twice-weekly auctions, and primary auctions are limited to banks and non-bank financial institutions complying with specific requirements only. Primary market participants may act on behalf of investors as well, and there are no limitations for the secondary market of T-bills. A “Treasury direct” system is also in operation, allowing individuals to purchase T-bills directly from the Treasury. The T-bill market provides a source of budget financing and allows the CBA to conduct open market operations.

Investment funds

At the end of 1994 an Investment Fund Decree was adopted, whereby investment funds may own up to 40 per cent of shares in any given enterprise. Most of the existing investment funds deal in short-term government securities.

Insurance

The insurance industry is regulated by the Law on Insurance, adopted in November 1996, and insurance services are growing, albeit slowly. The most developed types of insurance are for property, accidents and health, aviation, and cargo. The Ministry of Finance and Economy is responsible for supervision of the insurance industry and for regulating it. Over 20 insurance companies offer coverage for financial risk, deposits, credit, exchange transactions, transportation of cargo, etc. Foreign insurance companies may advertise their services in Armenia, and if established and licensed in the country, may sell insurance policies. There are no restrictions on reinsurance or on foreign insurance companies establishing business in Armenia.

Selected sources of financing for SMEs

The development of private sector small and medium-sized enterprises (SMEs) is held back by lack of access to credits. To support the sector, in the summer of 2000 the tax regulations for SMEs were simplified, with a flat rate replacing all major taxes. Implementation of the new system has been proceeding well, leading to better tax collection. Some initiatives to provide access to credits for SMEs are described below.

In September 1999 the EBRD launched a **Multi-Bank Framework** Facility, designed to provide up to EUR 10 million in financial support to the best performing and best managed banks, and through them longer term funding to small and medium-sized enterprises (SMEs). The Facility will provide equity capital and credit lines for the country's top five or six banks, for on-lending to SMEs which lack access to short and medium-term borrowing. The banks will benefit not only from stronger economic status, but also from management know how transfer and strengthened corporate governance through an EBRD technical assistance programme. In September 2000 the first agreement was signed with Armeconombank, which will benefit from a US$ 1 million credit line for on-lending to private SMEs. Twelve business plans are currently under consideration, two of which have already been approved.

The Lincy Foundation, established by US Diaspora billionaire Kirk Kerkorian, is providing an SME credit line worth a total of US$ 44 million, which is being disbursed in tranches of US$ 10 million. Loans from US$ 100,000 up to US$ 1 million are provided to SMEs with a maximum non-resident stake of up to 20 per cent, administered through 14 local Armenian banks at an average annual interest rate of 15 per cent in local currency for a maximum term of three years.

Shorebank Advisory Services (SAS) is implementing the **Caucasus SME Finance Programme** (CSFP) in Armenia, a five-year programme funded by USAID that supports SME development in all three Caucasus countries. The primary focus of the programme is to create and promote financial products and institutions that meet the financing needs of SMEs. To this end, SAS cooperates with a number of institutions in Armenia, and by March 2001 had disbursed over US$ 2.2 million in Armenia since the summer of 1999.

The German Technical Cooperation Agency (GTZ) runs an SME support programme to help develop legislation for SMEs and organises business seminars. It is helping to establish the necessary infrastructure for SME development. Another initiative, the **German-Armenian Fund** (GAF), was set up in 1998 by Kreditanstalt für Wiederaufbau (KfW) within the framework of German-Armenian financial cooperation. Initially worth € 3,067 million, the Fund is expected to be increased to a total of € 7,158 million in March 2001. It is funded by the German government and distributed through the Central Bank to partner banks, which on-lend the funds in the form of micro and small loans to businesses. The loans are made in Armenian drams exclusively. The GAF aims to develop SME activities by strengthening the lending skills of local banks and widening the range of their services. From September 1999 to the end of 2000 over 1,000 loans were made, worth the equivalent of € 5.5 million. New loans are to be provided to enterprises with up to 50 employees for a maximum three-year period at monthly interest rates of 1.58-2.5 per cent. The GAF has opened four offices in the Armenian provinces. In 2001 new partner banks are expected to join the programme, and it will spread to more provinces. In February it raised the ceiling for the largest loans to AMD 33 million (about US$ 60,000) and lowered annual interest rates. It is estimated that about 1,000 jobs have been created through KfW-funded projects.

The World Bank's **Enterprise Development Programme** included a US$ 13 million SME credit line. The programme started operating in November 1997, and is now fully committed between banks. Under the programme, loans were made from the government to commercial banks, which on-lent to enterprises at commercial rates (usually between 15-24 per cent annually). Loans ranged between US$ 20,000 and 400,000, with maturities from 1-5 years.

EBRD activities in Armenia

As at 31 December 2000, the European Bank for Reconstruction and Development (EBRD) had approved seven investments in Armenia totalling € 141.8 million. It had signed six transactions for some € 104 million and disbursed around € 75 million. The portfolio consists of four private sector projects in banking, energy and agribusiness and three public sector operations in energy, transport and agribusiness.

EBRD key objectives

EBRD key priorities include: institutional strengthening of the telecommunications sector; restructuring the energy sector project portfolio; developing the financial sector; strengthening and financing local small and medium-sized enterprises (SMEs); and identifying investments that will facilitate the privatisation of large enterprises.

Energy

The EBRD supports the government's effort to reorganise the energy sector along more commercial lines, to address current and projected needs and to achieve the timely closure of the Medzamor nuclear power plant. While financing conservation measures in the partly finished Hrazdan 5 power plant, the EBRD will assist in the government's preparations for privatising the Hrazdan power complex (units 1 to 5).

The Bank is also playing an active role in the privatisation of Armenia's electricity distribution companies. The EBRD and the government have agreed that the Bank will purchase shares upon privatisation of the companies to a strategic investor. The privatisation process is already quite advanced, with a draft schedule for privatisation aiming to close the transactions with strategic investors by the end of March 2001. The Bank would purchase up to a 19.9 per cent share in each of the four distribution companies, subject to a maximum investment of US$ 20 million.

The Armenian Privatisation Tender Commission, the government and the President have approved the EBRD's Direct Sale Agreement, which was signed in December 2000. However, the Bank's purchase of the shares is conditional upon a transparent tender process and the selection of strategic investors acceptable to the Bank.

Financial sector development

The EBRD aims to develop and support financial institutions that can serve as intermediaries in financing SMEs. The strategy also focuses on the institutional strengthening of private banks. This will enhance their capacity for intermediation by broadening their capital base, for example.

The approved Multi-bank Framework Facility of € 10 million is providing local private banks with equity capital or credit lines for on-lending to SMEs. A € 750,000 technical cooperation package is being provided for the administration of the facility and for developing local commercial banks and their SME clients.

The EBRD's role in the financial sector will include the establishment of a privately managed venture capital fund aimed at providing currently unavailable capital in the form of direct investment to SMEs with growth potential.

Private sector development

In view of the small to average project size in the private sector, the EBRD will pursue the promotion of SMEs via specialised credit lines and direct capital investments through suitable intermediaries, including venture capital funds. Additional support to SMEs will be given through enhanced policy dialogue with the government aimed at improving the business climate in Armenia.

Although most private sector support is expected to be provided through intermediaries, there may also be opportunities for direct Bank financing. In March 2000 the Bank made its first investment in an Armenian private sector company, when it approved a loan of US$ 20 million to Yerevan Brandy Company. The project was signed in October and the funds were disbursed in November 2000. Preliminary proposals concerning industrial and manufacturing projects have been presented to the Bank, and cooperation with foreign partners is being explored. The chemical, electronics and pharmaceutical industries show some promise.

Technical assistance

The EBRD will support legislative measures that are intended to encourage and facilitate the creation of an improved legal environment for the conduct of commercial transactions, especially facilitating foreign direct investment.

EBRD-managed technical assistance currently addresses the regulatory strengthening of the telecoms sector by advising on the creation of an independent regulatory body. Further assistance will address the institutional strengthening of local banks. Advice is also being provided to the government on energy sector restructuring issues while specific advisory work is being conducted on the privatisation and conservation techniques of the Hrazdan power generation company.

Approved projects as at 31 December 2000

International Commercial Bank – Armenia

In December 1999, under an existing multi-project framework facility with the Commercial Bank of Greece, the EBRD signed a € 1 million equity participation in ICB-Armenia, a start-up commercial bank with a full banking licence.

Multi-bank Framework Facility

In July 1999 the EBRD approved a Multi-bank Framework Facility of € 10 million (see above). In September 2000 the first agreement was signed with Armeconombank, which will benefit from a US$ 1 million credit line for on-lending to private SMEs.

Yerevan Brandy Company

In October 2000 the EBRD made a loan to the Yerevan Brandy Company (YBC) for US$ 20 million. The loan will enable YBC to continue to upgrade its production facilities, improve quality standards of its export-driven brandy, and restructure its balance sheet by replacing short-term with long-term debt.

Armenia Power Distribution Privatisation

In December 2000 the EBRD agreed to purchase up to 19.9 per cent of shares in four Armenian electricity distribution companies for a maximum aggregate price of US$ 20 million once they are sold to a strategic investor.

Hrazdan Unit No 5

In April 1993 the EBRD approved a sovereign loan of € 60 million to complete construction of a new 300-MW gas-fired power station. The loan supports the Armenian government's strategy in the energy sector and is helping to increase the country's power generating capacity, improve the efficiency of the electricity supply and reduce any negative environmental impact.

The loan was supported with technical assistance to help with regulatory reform of the energy sector, electricity tariff reform, installation of modern accounting systems in the Armenian electric utility, preparation of a medium-term plan for the power sector, and development of modern oil and gas contracting practices. Project disbursements are now limited to the financing of approximately US$ 4.5 million for conservation measures (including installation of boiler pressure parts to prevent accelerated corrosion of the unfinished boiler). As part of the new strategy towards completion of the project, the government and the EBRD are considering privatising the Hrazdan Units 1-5 power plant as a whole. At the government's request, the Bank has provided technical cooperation funding for a privatisation advisor.

Yerevan (Zvartnots) Air Cargo Terminal

In November 1994 the EBRD approved a loan of € 24 million to finance modern landing and loading facilities at Zvartnots Air Cargo Terminal. Zvartnots is the airport for Yerevan. The new facilities are vital in view of Armenia's transport limitations. As a landlocked country, it is dependent on unreliable and only partially available routes through its neighbouring countries.

The EBRD loan was used to construct buildings, apron and taxiways and to purchase equipment. Technical assistance was also provided to introduce professional and market-oriented management practices for the air cargo handling operation. Other objectives for the project included proper registration, control and monitoring of imports and exports, and the introduction of recognised procedures for the handling of civilian goods requiring special attention. Following the construction phase, the government will receive EBRD technical assistance to organise a tender to award a long-term operation contract for the terminal.

Wholesale market

The EBRD has approved a loan of € 0.8 million to:

- help the Armenia Wholesale Market Company (WMC) establish a modern wholesale market facility in Yerevan, with six related farmers' collection and assembly markets in rural areas; and
- provide a credit facility to be on-lent through a local bank to small private food marketing businesses.

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Approved projects, as at 31 December 2000 (in € million), exchange rate as at 31 December 2000

Operation name	Sector	Total cost	EBRD Debt	EBRD Equity	EBRD Total
Private sector					
Multibank Framework Facility	Finance	9.6	9.6	0	9.6
Armeconombank		1.1	1.1	0	1.1
International Black Sea Bank	Finance	1.1	0	1.1	1.1
Yerevan Brandy Company	Agribusiness	53.7	21.5	0	21.5
Armenia Power Distribution	Power and Energy	21.5	0	21.5	21.5
Sub-total		***87.0***	***32.2***	***22.6***	***54.8***
Public sector					
Hrasdan No. 5 Unit	Power and energy	96.1	42.5	0	42.5
Zvartnots Air Cargo Terminal	Transport	29.9	24.5	0	24.5
Wholesale Market	Agribusiness	3.4	0.8	0	0.8
Sub-total		***129.4***	***67.8***	***0***	***67.8***
Approved projects total		**216.4**	**110.0**	**22.6**	**122.6**
of which private					40%
of which public					60%

Notes