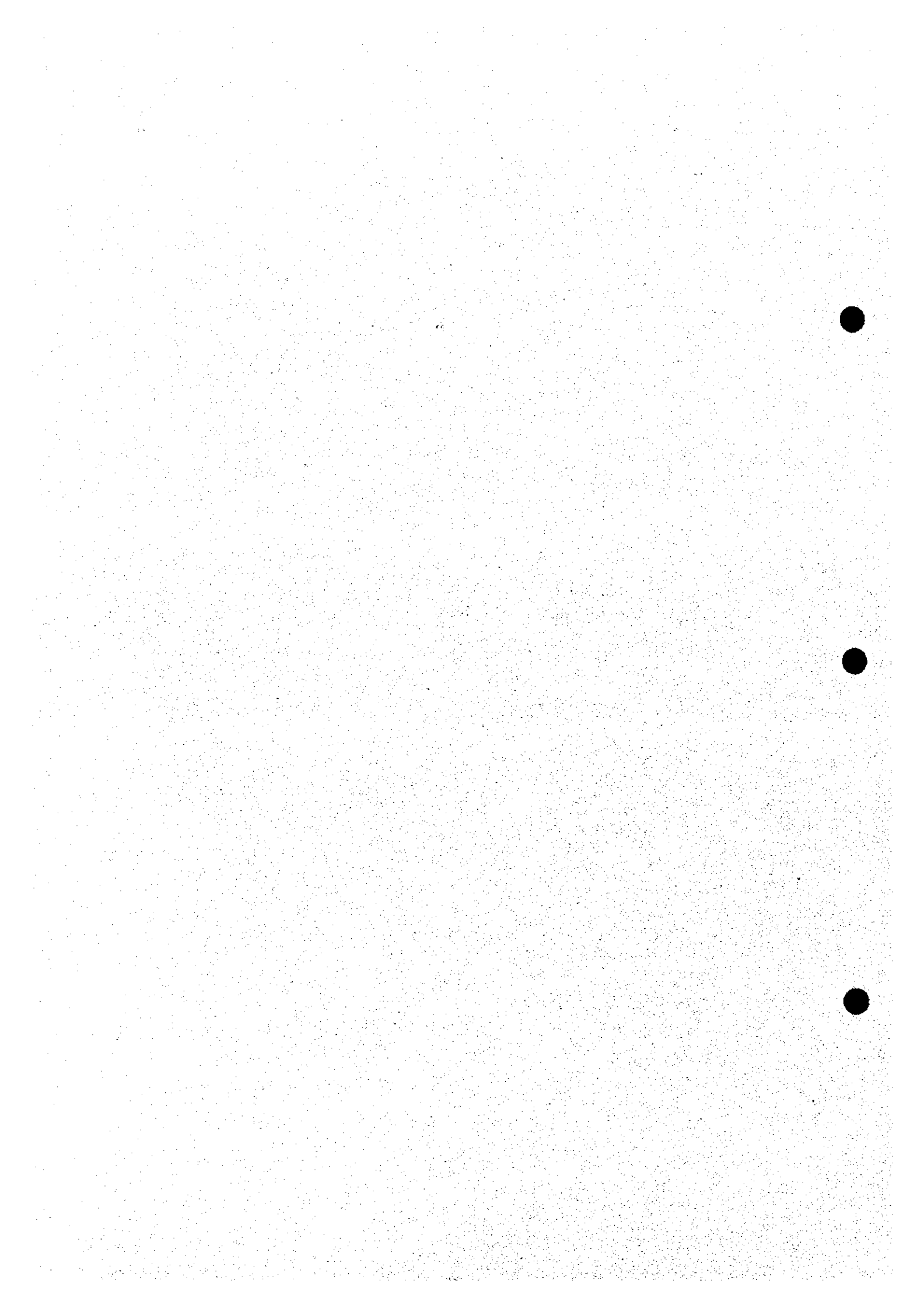


Chapter 5

Policy Recommendations for the Armenian Government



5. Policy Recommendations for the Armenian Government

5.1. Understanding the Background and the Need for the Plan

- In order for the planning and implementation of an economic rebuilding policy to be viable, it is necessary to come to a common understanding among the politicians, administrative officials, business people and majority of the people with regard to the present conditions and the essential issues facing the economy, their roots and the background and the direction and the objectives that must be addressed.
- The principal policy issues facing the government include the reduction of the fiscal deficit, putting an end to the increase in the external borrowings, increase in exports and securing employment.
- The above policy issues can only be achieved through increasing the value added contents of the products and services produced, and increasing the production and exports of all industries.
- The Armenian economy is structurally dependent upon imports for much of the capital and consumer goods, and around two thirds of the effects of increases in exports will result in increase in imports.

5.1.1. Understanding the Background

(1) Share of Development Vision

Over the past ten years, the Armenian people have experienced an unprecedented degree of hardship. Armenia's independence on September 23rd 1991 came against the background of the collapse of the FSU and the conflict with Azerbaijan. Armenia's transition to a market economy based upon democratic principles has been an experience for which there had been no precedents from which they could draw on for guidance and one in which they have had to rely on trial and error.

The efforts that the Armenian government and the people have put forth, with the financial and technical support that were initiated in 1994 including from that of the IMF, the World Bank, other international agencies and OECD donor countries, have produced steady progress. As a result of these efforts, Armenia's GDP in 1998 has recovered to 61.7% of its level in 1990.

Policies, such as the privatization of state enterprises, introduction of new political-administrative-legal systems, changes in people's mentality and joining the international community have resulted in significant accomplishments.

The government having been confronted to a multitude of urgent issues to resolve was too occupied with the resolutions and measures against the issues at hand that it has had no latitude to create plans addressing the medium and longer-term prospects of the country.

Armenia still faces many difficult problems. Because of the drastic reduction in domestic employment and incomes, many young people who are in their prime have had to seek employment outside of the country or have had to emigrate in spite of their deep sense of patriotism to their motherland. The birth rate has also suffered a major decline.

In order to improve these conditions, the government needs to create a realistic **Development Vision** on issues that are close to the heart of the people, including issues of improvements in the employment and living conditions for the development direction of the country. The people must share this vision. As such, the government needs to focus and exert great efforts toward the creation of a country that bears promise for the future.

(2) Understanding Policy Issues

As already examined in Chapter 2.2.2, Armenia is confronted with critical fiscal and economic issues. Fig. 5.1.1.1 below depicts the interrelationships among the principle economic issues that are mutually intertwined.

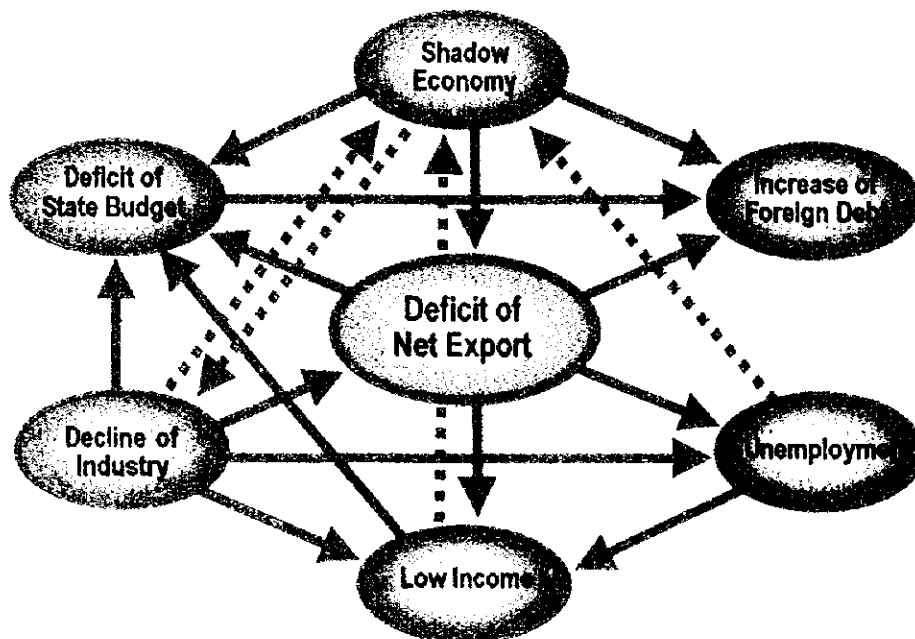


Fig. 5.1.1.1 Causes of Deficits in the Armenian Economy

In order to solve those numerous problems, we need to focus on the most intrinsic issues and ascertain their roots and make practical efforts to remedy to the root issues of the problems. At the state level, planning for measures to eliminate or to remedy to the root issues is the government policy and its implementation is to tackle the issues in a practical and systematic manner.

A unity among the policy makers must be achieved with regard to their recognition of the intrinsic issues facing the economic regeneration in Armenia, the roots and the policy issues confronting the government in the resolution of these issues.

Fig. 5.1.1.1 is a summary of the opinions of the Study Team regarding the principle issues and it would be profitable to have these offered as discussion points among the interested parties.

Fig. 5.1.1.1 requires some additional explanation. The Study Team has categorized the principle problems and the policy issues facing Armenia today into 4 categories as described in the table below.

Table 5.1.1.1 Principal Problems and Policy Issues Facing the Armenian Economy

Principal Problem Areas	Principle Policy Issues	Medium to Long Term Issues
1) Large fiscal deficits	→ Reduction of the fiscal deficits	→ A fiscal balance
2) Increase in external debts	→ Arrest increase of external debts	→ A reduction in external debt
3) Large trade account deficit	→ Increase in exports	→ A balance in trade and services account
4) Low wages and considerable number of effectively unemployed	→ Secure employment opportunities	→ Substantial improvements in Incomes

The policy issues that corresponds to the principle problems listed in the left hand column, are listed in the middle column and the longer term issues are listed in the right hand column. Before each of the issues can be addressed, a determination of the major roots of the issues needs to be made. This has already been touched upon in 2.2. Therefore, a detailed explanation here is abbreviated and below only the rationale will be noted as denoted by arrows: (←).

As it is shown in the following page, the fundamental roots of all economic problems that are interrelated lie in **depressed exports ← production limited to low value added internationally low competitive products and services**. In other words, the **high value added products that are internationally competitive** are not being produced and although the gravity of the problem differs dramatically from the above, the root can be traced also to the **shadow economy → poverty**.

1) Large fiscal deficit	← ① Low fiscal revenues ← ② Low tax revenues ← ③ Unprofitable private sector (depressed industries/unprofitable agriculture/low margin merchant trade) ← ④ Depressed exports ← ⑤ Production of low value added products and services of low international competitiveness (non-existence of high value added production) ← ① People's low income levels ← ② Lack of employment ← ③ Low level of exports ← ④ Production of low value added products and services of low international competitiveness (non-existence of high value added production) ← ① Shadow economy/tax evasion ← ② Economic Mafia ← ③ Economic environment ← ④ Poverty ← ① Issuance of high yield treasury bills ← ② Large fiscal deficits
2) Increase in external debt	← ① Large current account deficit ← ② Large trade account deficit ← ③ Definite shortage of exports ← ④ Shortage of exportable goods ← ⑤ Production of low value added products and services of low international competitiveness (non-existence of high value added production) ← ① Fiscal deficit ← (the same as 1 - ① onwards above)
3) Large trade account deficit	← (the same as 2-② and onwards above)
4) Low wages, considerable number of effectively unemployed	← ① Shortage of employment opportunities ← ② Production of low value added products and services of low international competitiveness (non-existence of high value added production)

Even in the case of the Shadow Economy, which finds its roots in poverty, if the **production and exports of high value added goods and services that are internationally competitive** improved to a level that will achieve a balance in the trade accounts, it will lead to securing employment bringing about improvements in income levels. This will result in a natural eradication of poverty and a formation of an economy in which a need for an extensive Shadow Economy will no longer exist.

Ultimately, the sole root cause that is common to all of the 4 major problems that are described in Table 5.1.1.1 boils down to the lack of production of **high value added goods and services that have international competitiveness**.

Of course, there are other exogenous factors in addition to those described above, such as **blockage, funds and technology**. Blockage is an issue that requires political solution. Funds, although the issue of the absolute amount remains, can be resolved through investments (whether it is domestic or foreign capital). If we consider the issue of technology to be one that can be resolved with mobilization of funds, all of these problems, though important, can be considered to be secondary.

From the above it is possible to conclude that the four major policy issues for the government will be achieved gradually by achieving increases in the production and exports through the increase in the value added commodity in the production of goods and services in all sectors regardless whether it is from the primary, secondary or tertiary sector.

The top priority policy for the government then, must be directed toward enabling increase in the value added of the products and services being produced to make possible increases in the production and exports (including import substitution) of goods that are able to compete internationally.

(3) Understanding the Structure of the Armenian Economy

An additional important issue that must be borne in mind for understanding this case is the issue related to the structure of the Armenian economy.

As it is widely acknowledged, the Armenian industry comprises the following features.

- 1) There are many mammoth enterprises that are remnants of the FSU, premised upon demand under a centrally planned economy, and most of which are not capable of producing and marketing products or services that possess the price and non-price competitiveness required by the market economy.
- 2) Many of the means of production are decrepit or obsolete.
- 3) Armenia depends on imports for capital goods, consumer durable, industrial materials and also many of its daily necessities. Due to this, it is estimated that 65 - 70% of any increases in exports would be diverted toward additional imports.
- 4) Capital for investments is not being formed.
- 5) Due to the small size of the domestic market, it is difficult to foster import substitution industries.

As a result the economic cycles of: increase in export → increase in production → increase in employment → increase in incomes → increase in consumption → increase in production; and, increase in incomes → increase in savings → capital formation → investment → and increase in production have not been realized. Only about one third of the increase in exports lead to an increase in domestic production and the remaining two thirds has the effect of increasing imports.

The above relationship can be diagrammed in Fig. 5.1.1.2.

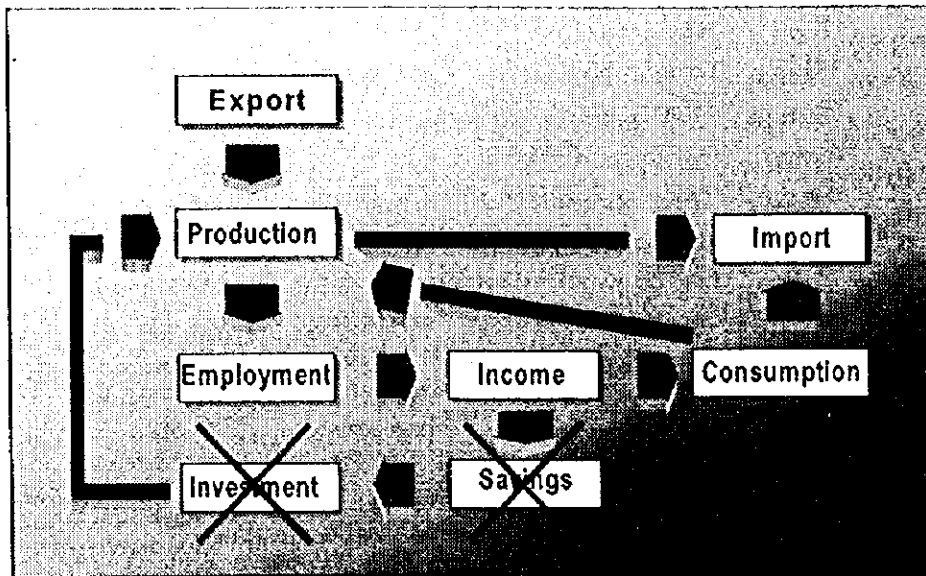


Fig. 5.1.1.2 Effect of Export to the Economy in Armenia

The balance of deposits held at banks, as of January 1st, 1999, increased by 1.8 folds over the previous year and stood at AMD20.96 billion (US\$40 million). However, the bulk of the funds are being held in short term deposits that enjoy high interest rates and it cannot be said that it is contributing to the formation of stable capital for investments.

5.1.2. The Need for the Plan

Many Armenians, although it may not be quite as harsh as rejection, hold negative views of "Planning". For the people who had experienced over 70 years of FSU system with its varied forms of difficulties, suffering, and tragedies and since the independence 9 years ago experienced the transition to democracy and the market economy perhaps the words "5 Year Plan" or "Execution of a Plan" bring back painful memories of the past.

Also, the theory that all should be left to the decision of the market and the government should not intervene in it could be persuasive to the people to some extent after the experience of the past centrally planned command economy.

However, not a person would be found who would agree that the status quo in the Armenian social economy is acceptable. Most people feel that something must be done in order to make Armenia a richer country. Majority of the enterprises has collapsed and the rural areas are becoming impoverished and the effective unemployment rate (according to the calculation in 2.2.1(4)) has reached 32.5%. Already close to 20% of the people have emigrated from the country in search of better income and better lives. Many people are desirous of improving the conditions

and increase employment and income levels so that the people are able to live together in Armenia.

In order for such desire to become a reality, some preconditions must be fulfilled. First whether it be in agriculture, or in industry or in service industries the value added must be enhanced. Secondly, the production level must be increased. Without these new employment opportunities cannot be created and income levels will not be raised.

In the Armenian private sector, as it has been shown in previous chapters, save for the exceptional handful of enterprises that have succeeded, most of the enterprises have effectively gone bankrupt or just short of being bankrupt. One major factor is that the enterprises are not able to operate under normal market conditions. To prepare market conditions that is, to the extent possible, normal for the Armenian entrepreneurs who are ambitious and capable is the responsibility of the government. In order to draw out the potentiality of the country, market conditions that are not in place must be prepared and put in place and the limited resources must be mobilized in an effective manner.

A plan is to provide the vital foundation on which people with torn houses may rebuild and is a necessity for the people and the state to be able to share in the vision for the future of the country.

5.2. Creation of a Vision for a Medium-Term Development Plan

- It is necessary to create a 7-year national development plan "VISION ARMENIA-2005".
- Policy targets for Macro-economic indicators for the period stretching out to the year 2005 must be set and the examination must include all input factors such as human resources, goods, and capital.
- The planning for the VISION will be done by the Special VISION Planning Committee to be established under the President. In order to gather together the best and the brightest from Armenia, a lateral shifting of bureaucrats into member posts will not be allowed but the committee members will be selected and appointed through a public invitation.
- "Regeneration of Armenia through the Rebuilding of the Regions" - Regional policies are important.
- MARZ, the administrative unit, is too small. As a starting point for discussions, examine the feasibility of 5 MARZ + YEREVAN.

5.2.1. Vision for the Medium-Term Development Plan

(1) Preconditions for the Planning

The preconditions that are required for the creation of the development plan are outlined below.

1) The planning period will be on a **medium-term (7 years)**.

There are many uncertain factors in the current state of the Armenian society and economy that long-term plan of over 10 years in horizons are not realistic as the gap with reality could be exaggerated. Development plan that is required in today's Armenia needs to be one that is shorter term within the people's horizon, realizable and a plan that can be modified to meet any changes in the external environment.

2) The base year of the plan will be set at 1998 and the planning period 1999 - 2005.

The plan will be named "**VISION ARMENIA - 2005**".

3) The planning will be undertaken by the "**VISION ARMENIA - 2005**" planning committee formed under the President and backed by a budget especially appropriated for this plan. The most critical part of this project will be the quality of the composition of the committee. The most capable and qualified people must be mobilized for this project.

The selection of the committee members will be based upon the framework and the areas of expertise, academic credentials, number of members, period, selection criteria, remuneration etc.

that will be determined by a small core of original members (3 - 5 members) appointed by the President.

Once the above parameters are determined, the candidates will be chosen from those applying in response to a public invitation to be broadcast using newspapers and TV etc. and those that are the most qualified will be appointed by the President. Those who have interest in the plan, those that are prone to dictate, those who possess old Soviet central planned economy mentality, those who are isolated from society or those who uncooperative theoreticians will not be eligible for membership. Each committee member will be guaranteed a substantial remuneration package, which will be described in the public invitation.

Each member will dedicate 8 - 12 months of time to the planning task, depending upon the task requirements of his particular area of responsibility. However, the committee will guarantee the each member of his/her previous profession. The committee will be given authority to solicit whatever cooperation required from the central and regional administrations.

(2) The Tasks of the "VISION ARMENIA-2005" Committee

1) Setting of Macro-Economic Indicators.

The committee will first set the policy objectives for the macro-economy under each item that are listed in the table 5.2.1.1.

Table 5.2.1.1 is abbreviated for reasons of space but the policy target figures for each of the years 1999 - 2005 must be inputted and a comparison with the base year will be required. In the year 4 as the midpoint of the plan, a review will be undertaken and material changes in the internal and external factors will be examined and will be reflected in the plan as needed for the years 4 and onwards.

In the post independence of Armenia a medium term economic development plan did not exist and the only plan that existed was the annual government budget. This is due to, as pointed out in 5.1, the government had their hands tied with the urgent issues at hand.

At the time of the JICA study, Ministry of Economy and Finance was in the process of preparing a 3-Year Plan, but due to the unavailability of micro economic data on industry from the Ministry of Industry and Trade, in spite of having almost all of the other data in hand, were not able to put the entire plan together.

No doubt parts of this data will provide reference material for this planning exercise.

Table 5.2.1.1 Policy Target Figures

	Base Year	1-st year	4-th year	7-th year	
(Year)	1998	1999	2002	2005	2005/1998
- Economic growth rate					
- Structure of GDP					
- CPI/PPI					
- Population					
- Economic active population					
- Employment structure					
- Unemployment rate					
- Ratio of Budget deficit to GDP					
- Export and import amount					
- Balance of international payments					
- Balance of foreign debt					
- Debt service ratio					
- Investment amount					
- (incl. FDI)					
- Others					

2) Settling Private Sector Development Objective Indicators

Next (in reality it will be conducted in parallel with 1) above) it will be necessary to formulate the growth targets for each of the sectors that comprise the GDP and the required human resources, goods and capital to be input. The same task will be required of each sub-sector making up each sector. Table 5.2.1.2 is an example of target indicators for industry.

Table 5.2.1.2 Target Index of Private Sector Development

	Base Year		Target Year	
	Production Amount	Number of Employee	Production Amount	Number of Employee
Total Amount of Industrial Output				
Public Sector				
Private Sector				
<i>Consumer Goods</i>				
<i>Capital Goods</i>				
- Mining and Metallurgy				
- Machinery				
- Electric and Electronics				
- Chemical (Pharmacy)				
- Light Industry				
- Building Material and Wood-processing				
- Jewelry				

That each sector plan and each sub-sector plan both require numbers to be developed for every year goes without saying.

The figures for each sub-sector are not necessarily trend line projections of present figures. As it has been seen in section 2.1, Armenia has experienced a drastic structural change in its industry in just the past 8 years and transformed from a highly industrial economy to that of a less developed agricultural economy.

There is surplus labor in agriculture, industry and other sectors and naturally also in each sub-sectors. How should the numbers of workers be regarded? In the case of agriculture or in industry, if the enterprise begins to operate efficiently, that is to say, if the revenues and the profits of the enterprises begins to show significant improvements, part of the workforce who are effectively not gainfully employed, will in fact find real jobs.

But the remainder will be restructured out of a job and as a result official numbers of workers in the enterprises may exhibit a decline. It is very conceivable that while the production of a subsector increases threefold, the number of employees remain constant or even decline. This is just an indication of the low level of value added in production and the low productivity levels in Armenia.

The reason for the broad public invitation for the selection of the planning committee is that in order to understand these issues, it is necessary to attract a way of thinking that is not caught up in traditional thought and one that is not bureaucratic.

5.2.2. Strategy and Policy

The future development strategy must be impounded into each of the plans above. They must include a daring structural reform and related critical planning of the industry that is not influenced by the interests of any particular existing power groups. Such restructuring should be based on an analysis and evaluation of Armenia's potential in terms of selection of the future direction for Armenia, priority areas for fostering enhancement and areas to cut loose to allow to collapse.

Short-term outlooks that are published by the IMF, the World Bank and the EBRD contain many foretokens for the future. For example, in the Outlook for the International Balance of Payments for Armenia (Policy Framework paper, Table 4, Armenia: External Financing Requirements, 1997 - 2001), published by the IMF in December of 1998, it forecasts an incremental value of exports in the period 1997 - 2001 to be US\$125 million, incremental import value of US\$145 million resulting in a trade account deficit for the 4 years of US\$2,270 million.

It must be said that these forecast figures rest on some rather optimistic assumptions. The 1998 projection for the exports/imports were US\$249/809 million (resulting deficit US\$560 million)

while the actual figures came in at US\$223/895 million (resulting in actual deficit of US\$672 million), as a result, already in the first year the deficits have overshoot IMF's forecast by US\$112 million.

If such deficits in the trade accounts are allowed to continue and without financial assistance from international agencies and bilateral sources, Armenia will no longer have the capacity to settle its obligations and be bankrupt as a state even before the 7 years are up.

This plan must have as its paramount priority issue, the fostering of export industries that include import substitution industries, and have as its objective the mobilization of every possible practical policy tools to achieve the objective. The effects must begin to gradually surface by 2001 and by the year 2005 drastic improvements must be realized. In terms of the trade balance, the deficits in 1998 of approximately US\$670 million must be reduced to US\$300 million level by the year 2005 and further in the future need to achieve a balance.

The ultimate policy objective is to achieve a **Trade Deficit of US\$300 million or less in 2005.**

The strategy is to examine the realistic feasibility of the objective, "what will it depend on" and "how the target can be achieved". In order to examine the basics of this strategy, an accurate understanding based on broad base of information regarding current production, exports, imports, resource endowments, and demand trends in neighboring markets whether exports are possible is necessary.

Particularly a matrix analysis of the current trade structure, in which almost all merchandise and materials are imported and only paltry number of products are exported, and markets is essential.

On the basis of such analysis establish policy objectives on "what will it depend on".

Without having to look at the export and import figures for 1996 and 1998, it would take nothing less than a miracle to achieve a drastic increase in the exports and restrain the growth in the imports. There in Armenia exists unutilized potential, including human resources. As under economic structure increase of exports involves that of imports, the above mentioned examination must be done, reducing imports by improving prices of domestic products and non-price competition force. Table 5.2.2.1 is the target figures to reduce the trade deficit from US\$670 million of 1998 to US\$300 million in 2005. Table 5.2.2.2 shows the trade target commodity to be increased / decreased.

The target figures below is achieved by increasing exports by approximately US\$560 million and holding down the growth of import to approximately US\$190 million in year 2005 with the resultant deficit reduction by year 2005 of US\$370 million. The target figures for 2002 and 2005 assume implementation of some policies.

Table 5.2.2.1 Target Trade Figure in 2002 & 2005 (Unit: US \$ million)

	1996	1998	2002	2005
Export	290.3	223.4	490	785
Import	861.5	895.7	1,015	1,085
Trade Balance	-571.2	-672.3	-525	-300

Table 5.2.2.2 Trade Commodity to be increased/decreased (Unit: US \$ million)

	Export				Import			
	1996	1998	2002	2005	1996	1998	2002	2005
Total Amount	290.3	223.4	490	785	861.5	895.7	1,015	1,085
Live animals & animal products	0.1	0.1	→	→	67.4	47.5	↘	↘
Vegetable products	0.9	1.3	→	→	114.9	117.8	↘	↘
Prepared products	11.8	16.8	↗	↗	83.0	109.9	↘	↘
Mineral products	19.1	31.7	↗	→	192.2	197.6	↗	↗
Chemicals	5.4	2.2	↗	↗	56.1	74.7	↗	↗
Textile & textile article	9.7	13.6	↗	↗	21.0	31.7	↗	→
Precious stone & metal. Article thereof	140.3	53.1	↗	↗	129.8	45.5	↗	↗
Base metal & article thereof	47.3	40.4	→	↗	10.2	20.4	→	→
Machinery & mechanical appliances	34.3	40.1	→	↗	80.5	78.8	↗	↗
Vehicle. Aircraft. Transport equipment	2.7	3.3	→	→	12.0	47.3	↗	↗
Others		20.8	↗	↗		124.5	↗	↗
New item A (software)		0	↗	↗		0	↗	↗
New item B (Gold & others)		0	↗	↗		0	→	→

- Promote domestic agriculture and substantially reduce the imports of meats and vegetables from Georgia and other countries, which combine to comprise a large share of the imports
- Promote light industry which center on sewing industry rapidly recovering in recent years by the joint venture with foreign capital, and traditionally strong shoe manufacturing industry.
- Promote industries by means of foreign capital or technical tie up utilizing Armenia's knowledge resources such as software industry and computer related industries. Promote also other new business such as production of gold
- Introduction of new technologies (this would result in increase in machinery imports)

Table 5.2.2.2 is just an example of one way of thinking, the actual target by each article must be prepared together with formulation of concrete promotion policy by the planning committee after careful analysis.

Amount and the financing sources of the capital that would be required to be mobilized in order to achieve the target need to be analyzed. Major financing sources can be categorized into 4 groups 1) funds from international financial institutions and aid agencies of donor countries, 2) foreign direct investments, 3) domestic capital and 4) fiscal investments under the government budget.

An analysis of the feasibility of the requirements for such funds must be made. 2) and 3) are the most desirable types of financing and it is critical that conditions to attract such capital are orchestrated.

Another important issue for this plan is the reduction in the fiscal deficit. Increases in the revenue side have already been touched on in section 5.1 and require a structural reform to realize the cycle of increase of exports → increase in production → increase in incomes → increase in consumption → increase in production and imports. In order to restrain the future growth in the expenditure it is necessary to realize a small and efficient government, to which end fundamental administrative reforms are necessary.

“VISION ARMENIA-2005” aims to realize a structural reform in order that not only the economy but also the whole country operates functionally.

5.2.3. Planning Methodology and Implementation

As it is generally known in the planning methodology there are two approaches: macro approach and micro approach. “VISION ARMENIA-2005” and the “Private Sector Development Plan” employs both of these two approaches to develop the target numbers.

Macro policy target indicators in the “VISION ARMENIA-2005” described in Table 5.2.1.1 in section 5.2.1 are first given macro policy target numbers. If the GDP target in the target year 2005 is set at US\$3 billion the average annual economic growth rate would be 7% and if the population (official population) remains constant then the per capita GDP increases from about US\$500 in 1998 to about US\$800 in 2005. Next estimate the possible composition of the US\$3 billion or its desired composition. Similar estimation for the target year should be made for other items taking into consideration the practicability of such estimates.

In a micro approach, on the other hand, starting from the current actual numbers, the target numbers are arrived at by a process of accretion of possibilities on an year by year basis for each item. The differences in the figures resulting from the two approaches are then discussed in the committee to determine the final target number.

Planning process depicted in Fig. 5.2.3.1 appears to be common sense but contain some important points that need to be pointed out.

1) ❶ - ❸ are all important and indispensable but the policies set in step ❸ are all decided based upon the major issues and factors selected in step ❷. ❶ leads to ❷; therefore, the contents of ❷ and ❸ are dependent on the quality of issue recognition and analysis carried out in ❶.

Within the officials and the academics there are those who have a tendency to sit in their offices in Yerevan and pass judgments based on static analysis of existing statistics. In this exercise, dynamic study of living information by field studies covering the state of industry-business, infrastructure, lives of the people in the regional areas must be given weight. The members of the committee will need to make many on site field surveys of factories of all sizes in the regional areas, administrative organs, infrastructure facilities, and living conditions.

2) Development potential of Armenia and each of its regions must be closely examined. It must be impressed upon the members' minds that a mere presence of resources and factories do not necessarily mean the presence of potential, and products and services without buyers are not products.

3) In steps ❷, ❸ and ❹ special care must be taken to avoid being influenced by political pressure from influential people.

4) The decisions of the committee must be products of vigorous debate among the members.

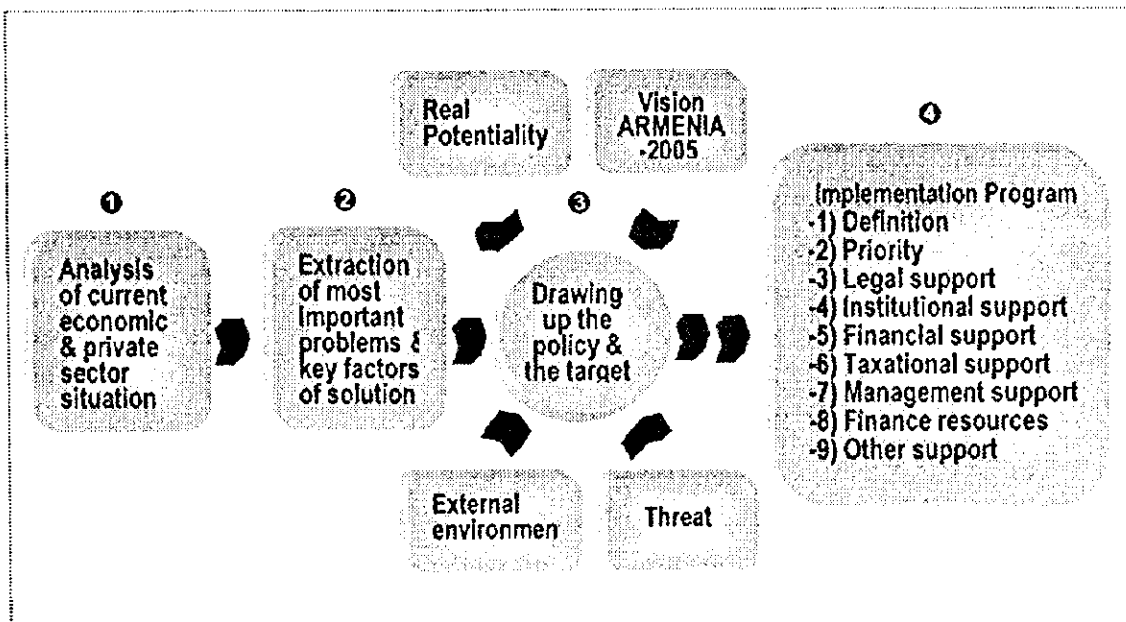


Fig. 5.2.3.1 Process of Drawing of Development Policy

5.2.4. Regional Development Policy

A regional development policy effectively does not exist in Armenia. A Minister for Regional Affairs is appointed but is given no budget and there have been very little organizational efforts toward issues regarding regional promotion. Even looking at official statistics, an emergence of major regional disparities in many issue areas can be seen.

Employment issue is a major problem in many areas. Under the official statistics earthquake casualty district of Shirak and Lori suffers unemployment rates of 20.6% and 14.7% respectively and in Siunik in the south it is 17.8%. In these areas basically the actual workable population is calculated on a low level in relation to economically active population, thus the real unemployment rate likely reaches 50% level.

As it has been shown in section 2.3.1, there has been a recent decline in the newborn. The rate of reduction in the childbirth in Vayots-Dzor is thrice that of Yerevan and in most MARZ the rate of reduction is twice that of Yerevan.

In the earthquake disaster areas such as Gumri, many of the buildings, factories and water and sewage facilities remain in disrepair. The state and issues of each district must be inspected and examined on a region by region basis.

There are MARZ that have too small a population for an administrative unit such as Vayots-Dzor, Tavush, Siunik, Aragatsotn. A minimum size of population and economic size is necessary for a regional administration unit and leads to question the necessity of having 10 MARZ in addition to Yerevan and the appropriateness of the budgetary distribution between the central and regional governments. In the present government individual regional issues are being discussed but such a discussion of a comprehensive regional policy has not taken place.

Each region deriving strength from its particular areas of strengths and specialties to be stimulated ultimately leads to the rebuilding of Armenia. From this "Regeneration of Armenia through Rebuilding of the Regions" makes sense. Authority and budget needs to be allocated in such a way that the state, the issues and the potential of each region are examined on an individual region basis and that each region is able to resolve its own regional problems.

A review of the administrative division is also seen to be necessary from the point of view of achieving simplicity and efficiency of regional governments.

Japan is a country in which the administrative units are fragmented.

Table 5.2.4.1 shows the administrative units of the 3 islands, excluding Honshu that relatively approximate to Armenia in size.

Table 5.2.4.1 Number of Prefectures (Marz)

Island	Population (1,000)	Area (km ²)	No.of Prefecture	Special status city
Hokkaido	5,731	83,452	1 pref.	1 city
Shikoku	4,219	18,798	4 pref.	
Kyushu	13,521	42,157	7 pref.	2 cities
Armenia	3,791	29,800	10 pref.	1 city

From among the 3 islands in Japan above, Armenia is close to Shikoku in area but within Shikoku there are only 4 administrative regions.

The largest prefecture in Shikoku island has a population of 1,528 thousand, while the smallest (Kochi Prefecture) has a population of 814 thousand. The scale of the economy of Japan and Armenia are so disparate that it is difficult to draw any comparisons but, as a point of reference, the annual fiscal expenditure of the Kochi Prefecture is about US\$5.1 billion.

In Armenia, Lori is the largest MARZ with a population of 394 thousand and Vayots-Dzor with 69 thousand and these are too small to be administrative areas.

In order to stimulate the regional economy, it is necessary to concentrate the mobilization of the limited resources efficiently and with some priority. For that it is required to have larger administrative unit and efficient administration, as well as strengthened and well-trained servants of local government.

Table 5.2.4.2 and Fig.5.2.4.1 are one example of possible reorganization of the administrative divisions into 5 MARZ + Yerevan giving due consideration to regional characteristics and existing MARZ. In Armenia GDP figures have not been collated on a MARZ level thus here industrial and agricultural output are used in its stead.

Table 5.2.4.2 An example of reorganization of Marz (Unit: Billion AMD)

	New Marz	Population (1,000)	Output of Industry	Output of Agriculture
1	Shirak + Aragatsotn	526.2	3.4	63.8
2	Lori + Tavush	549.9	5.5	61.0
3	Armavir + Ararat	628.6	29.9	103.7
4	Kotayk + Gegharkunik	604.8	52.7	81.8
5	Vayots-Dzor + Siunik	232.0	10.4	41.1
6	Yerevan	1,249.7	78.3	4.4

Remark: Some items are excluded from Output of the industry.
(Source: Ministry of Statistics)

Below summarizes the ideas and the intentions behind the MARZ reorganization described above.

- ① In Gunri, a place of importance in transport (the border blockage problem with Azerbaijan and Turkey will eventually be resolved sometime), reconstruction of the city and promotion of new industries are important. Once the railroad is reopened, exports of substantial amounts of Tufa, cement and other industrial goods would become possible.
- ② A unique region with scenic areas of forests and canyons, hydroelectricity generation using its water resources (sale of electricity to Turkey), repair and building of irrigation to promote agriculture, resort development using existing facilities.
- ③ High value added agriculture, food processing industries, light industries promotion area and refining gold etc.
- ④ Diamond processing, jewelry production, resort development around Lake Sevan and promotion of related industries, mineral development of gold (ZOD) on east shore of Lake Sevan and other mineral resources.
- ⑤ Redevelopment with foreign direct investment of copper, molybdenum, fruit cultivation, promotion of processing. Also this region may be developed as the processing center of labor concentrated industries for the purpose of re-export of products to and / or through Iran.

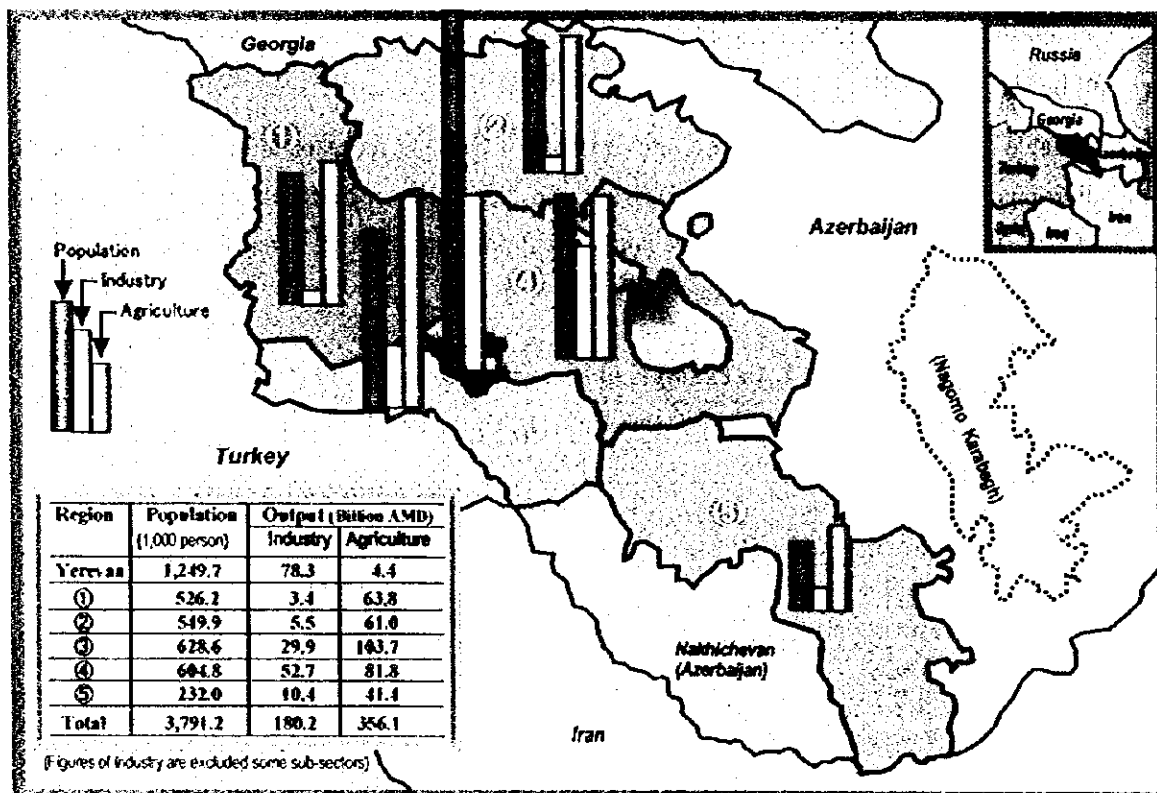


Fig. 5.2.4.1 An Example of Reorganization of Marz

① In Gumri, a place of importance in transport (the border blockage problem with Azerbaijan and Turkey will eventually be resolved sometime), reconstruction of the city and promotion of new industries are important. Once the railroad is reopened, exports of substantial amounts of Tufa, cement and other industrial goods would become possible.

② A unique region with scenic areas of forests and canyons, hydroelectricity generation using its water resources (sale of electricity to Turkey), repair and building of irrigation to promote agriculture, resort development using existing facilities.

③ High value added agriculture, food processing industries, light industries promotion area and refining gold etc.

④ Diamond processing, jewelry production, resort development around Lake Sevan and promotion of related industries, mineral development of gold (ZOD) on east shore of Lake Sevan and other mineral resources.

⑤ Redevelopment with foreign direct investment of copper, molybdenum, fruit cultivation, promotion of processing. Also this region may be developed as the processing center of labor concentrated industries for the purpose of re-export of products to and / or through Iran.

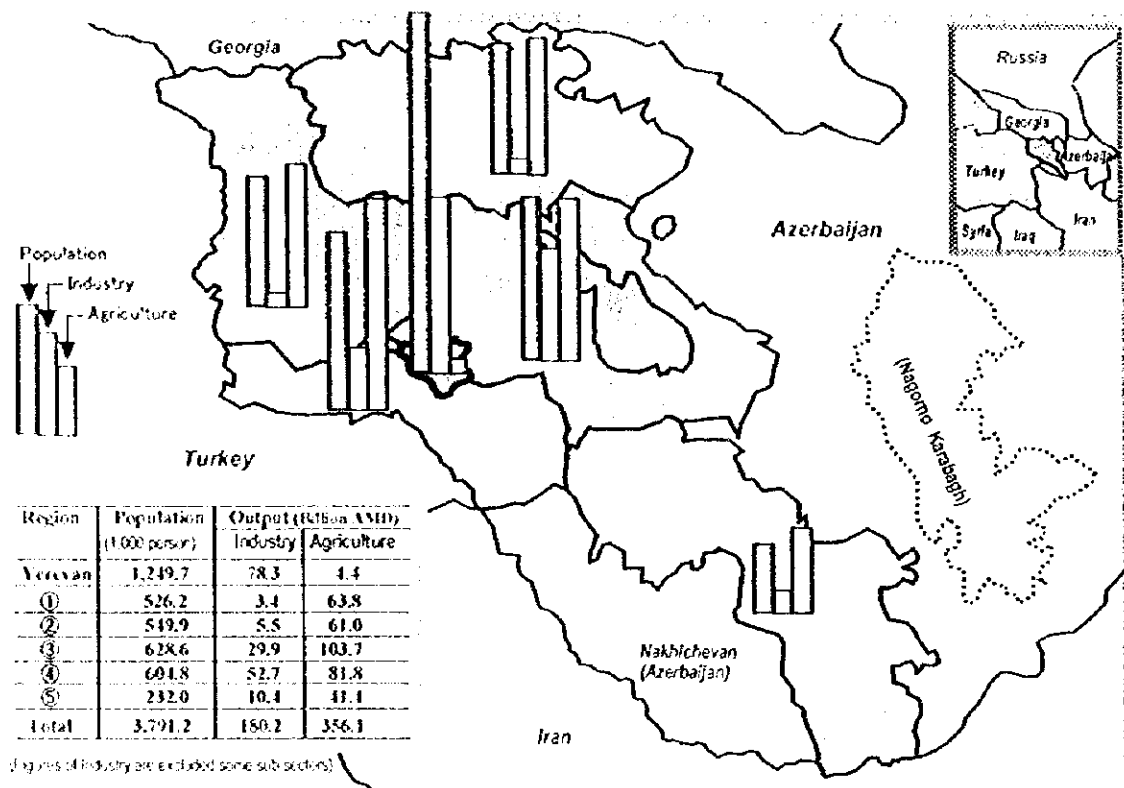


Fig. 5.2.4.1 An Example of Reorganization of Marz

5.3. Private Sector Development Plan

- The private sector development plan will comprise the major component of the "VISION ARMENIA-2005".
- The development of Armenia is dependent upon the active roles being taken by its entrepreneurs. The country's systems and the economic environment must be such that it facilitates the realization of the entrepreneur's ideas.
- All possible political tools must be mobilized in the creation and the implementation of the plan.
- Tax incentives are an important measure to foster industrial development. In order for Armenia that limit transportation measures to achieve its policy objectives such as attracting foreign investments, it should introduce daring tax incentives.
- The lack of development of the non-bank sector is one of the contributing factors behind the high level of interest rates being charged by the banks. The government needs to take measures to promote the development of non-bank financial institutions.

5.3.1. Development Strategy and Policy

The Private Sector Development Plan will be formulated based upon the appreciation of the background outlined in 5.1 and in parallel with the creation of the Medium Term Development Plan Vision outlined in 5.2. The Private Sector Development Plan will form a major component of the vision for the Medium Term Development Plan.

The strategy and the methodology of the planning are basically the same as those outlined in section 5.2 but with the following emphasis.

- 1) The development of the Armenia is dependent upon the entrepreneurs taking active roles. The various systems and structures and the economic environment must facilitate the realization of the entrepreneur's ideas and efficaciously rewarding the entrepreneur's ardent efforts with reasonable results.
- 2) The enterprises in the 3 target sectors that were the subject of the study are all carrying the management legacies of the FSU era and managers who possess the entrepreneurial spirit were in the minority. In the other sectors, however, such as in the food industry or in the merchant area, many energetic and resourceful exist and this has also been confirmed by the JICA Study Team. (The entrepreneurial drive of those in the shadow economy goes without saying). The Armenian economic situation presents too many obstacles for the entrepreneurs and presents difficult challenges. As a result, the entrepreneurs, who have been successful, are forced to resort to

concealing a part of their incomes or having to rely on hidden income elsewhere.

The major role of the government, under this plan, is to eliminate or minimize the obstacles and prepare the economic conditions under which all entrepreneurs and enterprise managers are able to operate and by so doing bring the shadow economy to the surface and to promote the development of strategic target sectors that are essential in the long term development of the country.

Proposed practical measures for the plan related to the above will be outlined in sections 5.3.2 and below.

(1) Development Priorities

The priorities will be placed on 1) export goods and services industry, 2) import substitution industry, and 3) promotion of sectors that play important roles in the long-term development of the country.

Included in the category 1) above are export processing industry which imports raw materials for processing and re-exports the finished product, sectors that provide high quality resources, materials and services to the above 3 areas, research and development sector, contract research activities in the scientific field, software development, tourism and recreation sector that contributes to the foreign exchange revenues.

The import substitution sector in 2) includes producing domestically many products that have the potential of successfully competing with the imports in terms of both price and quality. In some cases, it will include industries that must be fostered to become successfully competitive whatever the means and efforts that are required to achieve such competitiveness.

For example, vegetables, dairy products and meats are being imported from Georgia, and Iran, but Armenia's climate compares favorably to that of Georgia or Iran. In fact, vegetables such as tomatoes and cucumbers and many of the fruits grown in Armenia are, indeed, delicious. In the case of processed foods, except for products that are imported from Europe, most of the imported foods, from the eye of the Study Team, were of low quality and shoddy. Many products that are near their expiration of consumable period or those potential harmful products that the expiration date had already elapsed are being imported.

Many types of yogurts, including German, are being imported. Armenian matsun has the same nutritional value as a health food as the yogurt that is being imported. The bacteria from matsun differ depending upon the region and there are hundreds of varieties of matsun bacteria. Some of the leading companies in the world are studying the beneficial effect on health of the matsun bacteria. If a product can be developed that can meet the consumers' needs, the Armenian

consumers will surely choose matsun.

These products of significantly better quality can be produced in Armenia at the same price level with an investment that is modest but with a proper production process with quality controls being implemented. Light industrial goods that are being imported, except for the small volume of high-end goods (these are also often brand imitations), the quality of the goods are low.

Armenians, from historical times, have dexterous hands and are blessed with delicate and cultured tastes, unlike the people of other FSU countries who tend to be more unrefined in their tastes. High quality hand woven carpets that are of tasteful design are still being made in Armenia. Sewing presents potential opportunities for employment for many Armenian women. Already some foreign enterprises including a Canadian company have begun joint venture production in areas such as Gyumri.

In leather goods, Armenia can manufacture products that are competitive in the international markets. In the shadow economy, some have been resourceful enough to import buttons and accessories from Italy and exporting the completed garment under a different brand name. If the reputation that the shoes and leather jackets that are manufactured in Armenia are of a quality that is equal to those manufactured in Italy but cheaper in price can be implanted in the overseas markets, the products can be sold proudly under the "Made in Armenia" label.

Many of the furniture and the furnishings are being imported, the skill level of the Armenian craftsman who make various cultural carvings are able to manufacture furniture that are of acceptable quality for the domestic markets and also for the markets of the neighboring countries. What is needed is the taking the time to study the designs and the consumers tastes. Importing furniture involves high freight costs and from a price perspective, the Armenian products will be more than competitive.

The various furnishings and accessories made of obsidian, a specialty of Armenia, have a worldwide market appeal. With marketing and development of products that meet the needs of the various markets and undertaking the necessary selling efforts, an export product of high value added using the Armenia's domestic resources and the craftsman can be fostered.

These are examples of what is possible with resources that are near at hand. If the people put their collective wisdom to work many, many more development potential can be discovered.

3) includes a broad array of areas that is closely connected with the promotion of 1) and 2) above. These would include improvements in the social infrastructures including airports (emphasis on the software side including management and provision of user conveniences), roads, communication, hotels. Also included are the development and achieving profitable production of metallic ore

resources such as molybdenum, copper and gold. Enhancement of education from primary level through university education including graduate level studies and improvement in human resources development such as through adult reeducation programs are also included in the 3) category.

(2) Industrial Development Policy

1) Ideal Industrial Policy

The industrial development policy must be consistent with the direction of the medium term national development plan, "VISION ARMENIA-2005" proposed in section 5.2. and it must also be created as a policy for industrial development plan that is realistic. The industrial policy, through sector promotion, must provide the practical underpinning to the "VISION ARMENIA-2005", which may be referred to as the master plan for the medium term national development. The starting point is important in creating the plan.

The state of the Armenian industry must be accurately assessed. It will then be necessary to analyze and evaluate the strengths and weaknesses of the Armenian industry, its development potential and its economic viability taking into account exogenous factors including the physical conditions, international competition, and potential sources for the required funding.

As touched in section 2.2.2.(1), within the Ministry of Industry and Trade there are some departments of policies, however, it appears that, in reality, they are dysfunctional due to the lack of appropriate staff. Thus, tasks required for the planning must be commissioned to staff with the capability and motivation.

In the phase of analysis of the existing conditions through the identification of major policy issues, it would be necessary to reflect a broad spectrum of opinions of the private sector. This process will also be of value in stimulating the future of governmental civil servants. Each enterprise is full of problems with which they are confronted and enterprises are grappling with these twenty four hours a day. Among the successful enterprise some have relied on implementation of their own set of policies based on the belief that government cannot be counted upon to implement policies or support. These enterprise are well aware of the policies that are needed of the government and would be able to be forthcoming with realistic proposals.

One of the most important factors is the structural reform of the industry. The reality of the large industry that thrived under the former Soviet system, in which they produced goods under an automatic order system is that they are now extinct or have become small fragmented enterprises that are barely continuing to survive or being driven into deficits must be accepted as given. Also, the fact that practically Armenia has no leading industry now should be considered as preconditions.

The developmental priorities outlined in (1) can be applied to the industrial policy as they are

almost intact, but specific responses relating to the following critical issues in the management of the state by the promotion of the industry sector (excluding electricity) must be determined:

- How much of the Gross Domestic Production can the sector shoulder?
- How much employment can the sector absorb?
- How much contribution can the sector make to the improvements in the trade account balance?
- What are the most efficacious policy tools to achieve the goals?
- What is the required cost?
- From where will the funding be obtained?

2) Policy Tools

Promotional measures relating to finance, tax system, investments, laws and systems are outlined in each respective section heading.

3) Study of Examples of Industrial Policies of Other Countries (Developing Economies)

Armenia is fully knowledgeable of the transition policies and their processes in Russia and central East European countries especially as they are also receiving assistance and guidance of the IMF and the World Bank. They have, not have been as diligent in their study of development policies adopted by East Asian countries that have evolved from less developed to a developing economy or from a developing economy into an advanced economy.

It would be better for the Armenian development policies to have a wider menu of successful examples to emulate. The study group recommends that the Armenian government studies the industrial policy planning and implementation process adopted by the East Asian economies. Examples that may be subject of such a study would include Singapore, Malaysia and the People's Republic of China.

The above three countries all differ in the timing and the direction of their development strategies. Singapore has focused on becoming the operation center for the financing of trade and had invested in the infrastructure such as the port facilities, communications, roads and offices as well as into the soft areas to put into place a favorable investment climate, all of which have led to the success that they have achieved to date.

Malaysia succeeded through attracting electrical-electronic industries, mostly from Japan. In China, since the Deng Xiaoping's southern peace initiative, each province competed to implement foreign investment inducement policies, particularly for the manufacturing sector, and succeeded in dramatically increasing exports that had been leveraged to produce high rate of economic growth. By the end of 1997, they were able to forge an economic foundation that had US\$140 billion in

foreign currency reserves that was just US\$3.4 billion in 1988. The common threads that runs through the three countries are aggressive introduction of foreign capital and high rates of economic growth. Singapore has achieved a per capita GDP of US\$30,000 in 1996.

As a reference, the trend of foreign capital introduced and the foreign currency reserves of the three countries in the period between 1991 and 1996 are shown below.

Table 5.3.1.1 Dynamics of FDI acceptance in 3 countries (Unit: US\$ Billion)

	(Base)	1991	1992	1993	1994	1995	1996	Foreign Currency Reserve		
								1988	1966	1997
Singapore	Approval	1.4	1.7	2.0	2.8	3.4	4.0	16.9 ↗	76.9 →	71.3
Malaysia	Approval	6.2	7.0	2.4	4.3	3.7	6.8	6.5 ↗	27.0 →	20.8
China	Execution	4.4	11.0	27.5	33.8	37.5	42.3	3.4 ↗	105.0 ↗	139.9

(Source: Economic Planning Agency, Japan)

Outlined briefly below is an example of the policy model adopted by Malaysian government related to the development of the electric-electronic industry in Malaysia.

a) From the initial phase of industrialization in the 1960's, the Malaysian government placed a special emphasis on the promotion of the electric-electronics industry within the manufacturing sector. In the 1970's development of a free trade zone (FTZ) equipped with the necessary infrastructure including electricity, water, telephones, roads and sewage facilities was initiated. Within the FTZ, materials and components necessary for production can be imported free of any duties. The FTZ was established for the export-oriented industries that had exported in excess of 80% of their total production.

b) Malaysian Government provided many attractive tax incentives to investors without discrimination based on the nationality of the investor. These tax incentives were extremely effective in attracting foreign investment. The presence of low cost labor also was a factor in attracting foreign investments.

c) **The semiconductor industry** has been expanding since its initial entry into Malaysia in her initial phase of development over 30 years ago. The present production of semiconductors in Malaysia is principally assembly operations but ranks among the three top production areas in the world. **Consumer electronics** is one of Malaysia's prime industries. Malaysia has attracted many foreign investors, particularly Japanese investors, and has become one of the major producers and exporters of air conditioners, color television sets, and audio visual equipment in the world.

d) Malaysia, in its country building, established long term visions (Design for the Year 2020, New Economic Policy). In addition, Malaysia drew up medium term economic development plans (State

Development Plans) that were each with a 10-year horizon. In addition the short-term plans, 5-year development plans were also drawn up. In addition, two 10 year Industrial Master Plans have been created and were particularly very effective in the development of the manufacturing sector. The electrical-electronic industries had always received emphasis under these economic policies.

(3) Export Promotion Policy

In a drive to promote exports, the most important consideration is the production of exportable products that are able to satisfy each of the export markets. The industrial products that Armenia is able to export are severely limited. The Union of Armenian Businessmen and Industrialists have made a request to the government for the implementation of the following five support items

- Export promotion support
- Introduction of overseas business partners
- Technical support
- Financial support
- Tax relief measures

In addition to the above, transportation problems have also been raised as a current issue and many have pointed to the need for improvements in alleviating the difficulties regarding border crossing in surface transportation. This issue is a problem that is not easily resolved but efforts on the part of the government to foster closer economic ties with Georgia may at least achieve partial improvements.

1) State of the Export Markets

Export markets can be grouped into the following four categories.

- CIS countries
- Neighboring countries (Iran, Middle East, Egypt, other)
- Advanced countries (EU, North America, Japan)
- Undeveloped markets (Southeast Asia, Africa, Central and South America)

These markets all differ in taste of customers, the levels of difficulties to get information, languages, promotion methods and so on.

a) Accumulating Export Business Experience

Enterprises, generally, lack the experience and capability to organize exports. "Trade point Armenia" and ADA are able to provide some basic knowledge and information regarding promotion of exports and investments but due to the lack of budget, human resources, information and experience have not yet developed into institutions that have won the confidence of their

clients. ADA needs to make efforts to gather information on the market size, competition, technology levels and points to keep in mind when importing into the country and provide the information to the clients. There are information sources given by import promotion organizations that are created in most of the developed countries.

In Japan, JETRO (Japan External Trade Organization) is a governmental organization and is charged with the promotion of imports. It provides in the form of VTR and publications market information on import goods of high potential. It also sponsors, on occasions, import trade fairs for promoting imports from developing countries.

b) Features of Markets

- **Markets in the advanced economies** offer opportunities to find strategic partners for marketing, technology, raw materials, OEM and subcontracting relationships. It is also where product quality, pricing, production systems, marketing methods and company organizations can be learned.

- **CIS countries** have been traditional trade partners for Armenia and are customers with which they share the same language and mutual understandings are facilitated. However, with the collapse of the FSU and the difficulties being experienced by all CIS countries during their transition to market economy, market conditions of each country have undergone major upheavals, Especially, the dramatic contraction in demand and uncertainty in payments are major issues for the exporters.

- Armenians are generally knowledgeable of the **neighboring countries' markets**. Many low priced imports are being imported into Armenia from Iran. Further, the issue is that the costs of production of these items are lower in Iran than in Armenia. These markets will provide useful lessons on the importance of achieving competitiveness in both price and quality in developing substitute products for the imports and developing export products.

c) Preparing Export Directory

ADA is currently in the process of preparing an export directory. The list will contain the name of the enterprise and information on the export product. The old faded photographs that have been provided by the enterprises and the unfashionable product presentation might be counterproductive leaving the readers with the impression that Armenia is capable of producing only shoddy products.

ADA does not have adequate budget to produce a directory of a suitable appearance. Updating of information is essential but that it will be time consuming may be a problem. In many cases after the publication of the first issue, updating is forgotten and leading to a loss of confidence in the information on the part of both the foreign importers and Armenian exporters.

d) Participation in Trade Fairs

Participation in trade fairs is valuable not only for the display of products but as an opportunity to gather marketing information at and on the route to and from the fair. The most important thing is to be able to know the technical level of production produced by foreign competitors and the direction of their new products.

e) Search for Partners

Active search for partners regarding exports is necessary. These partners would include import agent, importer, distributor, technical licensor and licensee.

f) Technical Support

Enterprises, in addition to support in marketing, production technology and management, require support in acquiring the skills noted above. ADA needs to consider setting up a training program in which training in trade fair preparation, market research techniques, joint export promotion, customer contacts, and methods for professional follow up would be presented. ADA will likely need to provide follow up support to the participating enterprises after the completion of the training.

g) Financing

This is the single largest problem faced in by the enterprises in exporting. The principal problems lie in the inability to secure raw materials for production due to the shortage of working capital. There are also many cases where there is a shortage of funds for investments in expansion of export capacity.

2) Policy Measures

In order to ameliorate these problems the following policy measures need to be adopted.

a) Enhancement of ADA

In order for ADA to develop into a truly One-Stop-Shop for export promotion and attracting foreign direct investments, its functions, budgetary allocations and human resources need to be greatly enhanced. (For detailed discussions refer to section 5.4 (5))

b) Providing Fund for Development

The government must provide the necessary support for those motivated Armenian enterprises through the creation of a structure which will provide funds that the enterprise require to produce and export products and services (including import substitution) as well as for new product development at reasonable terms. Concrete structure proposals are presented in section 5.4 (1) and (2).

c) Tax Support (refer to 5.3.2.(2).)

d) Fostering of a Modern Trading Company

Armenia has many small trading companies located mainly in Yerevan. In order to expand exports, a fostering of several, modern trading companies are required. The trading companies will be fully knowledgeable of international trading rules and customs and capable of negotiating with trading partners. Equipped with such capabilities, the trading companies will be able to earn the credibility of the trading partners and financial institutions. It will be necessary for the trading companies to be sufficiently capitalized at the inception and be staffed with people that have sufficient knowledge and experience in international trade. It would be an effective measure to provide tax relief against revenues earned through exports and financial assistance proportionately to the scale of their contribution to the exports.

(4) Improvement of Privatization Methodology

1) Valuation

The valuation of small enterprises is done basically according to a calculation based on the surface of the premises and its value according to location. The large international tenders are prepared by investment bankers. The problem of valuation lies with the medium and large enterprises, where the valuation is based on balance sheet value.

The Ministry of Privatization is considering valuations based on profit and on cash flow projections. These valuations, which are widely used in the West, will be difficult to apply in Armenia today because projecting cash flow is very difficult. However, these methods must be put in place because these valuations will become more relevant as the economy and enterprises stabilize. These valuation methods are also applicable for the Stock Exchange. Investment bankers normally make several types of valuations, based on assets, income, growth, cash flow, comparable multiples, etc... The values are all different but they indicate a range of values to consider.

2) Preparation for Privatization

Article 7 of the law on Privatization adopted on 26/12/1997 explains very well the procedure. The ministries responsible are to prepare information about financial status, a plan of logistical and technical activities as well as recommendations for improvement. They may hire audit agencies to identify the causes for the losses and, should the need arise, to set up temporary expert groups to determine directions for implementing structural changes in particular sectors.

This is what needs to be done. It is suggested that a core group be formed in the Ministry of Industry and Trade, the Ministry with the most enterprises. Experts from a good strategy and

restructuring consulting group should advise this group on a long-term basis. They would employ experts on a temporary basis to advise one specific enterprise. Teams to help the enterprises prepare financial statements must be made available.

The implementation of the existing law is problematic because of a lack of qualified management resources. The program should start with 2 or 3 enterprises, then increase as resources do.

3) Management of the 80/20 State Owned Enterprises

In most of state owned joint stock companies, the government owns 80% of shares while employees own 20%. Once a privatization has been started, the law limits the ministries in their actions at the enterprises (Article 8). However, the important consideration is to maintain and possibly increase the value of the enterprise. Therefore, it is important that experts guide the appraisal and strategic direction. The management most apt to implement this strategic direction should be put in place, eventually helped by some outside experts.

4) Installment Payments

From the law of 12/97 it seems that the installment payments of up to 10 years applies only for small enterprises. This provision is good as smaller enterprises don't have access to financing and it allows a fast and fair solution to the problem.

From information published in Privatization announcements, purchasers or bidders have 2 months to finalize the privatization and payment. This must be difficult and probably eliminates some bidders.

Consideration should be given to create a fund (under the jurisdiction of the Ministry of Privatization) to finance share ownership, especially to groups of employees. The money could be allocated from Kerkorian funds and provided through the banking system to investor groups. Employee groups could be organized like an ESOP (Employee Stock Ownership Program). This would open up privatization to more interested and committed parties.

5) Share Options

If positive results were reached in an enterprise, a portion of the State Share would pass on a predetermined basis to the private shareholders or/and employees.

6) Information Published for Announcing Privatization/Time available

The information contained in the newspaper is very skimpy and would not allow an informed outsider to make a judgment on the possibility for him of to invest. For the one offer that I saw translated there was no mention of the sales amount. Normally, a tender would proceed in two steps:

- The first would be a show of interest, confirmed through a letter of intent. This would have been based on some basic information that would have been published.
- The second phase, called due diligence, would provide more detailed information. The scope of this information, the time and process of this phase would have been contained in the letter of intent or annex thereof. The selling party might have required the signature of "non disclosure agreement".

In the case of tender of large and medium size enterprises this may take 35 days for the offer and up to another 2 months for finalization. This short timing does not allow outsiders to bid in knowledge of facts.

7) Liabilities to State Budget

Normally these liabilities are payable immediately and as such discourage some investors. Depending on the circumstances, some payment terms or transformation into long term debt or even into equity may be considered.

8) Securing Transparency

One of the most important element of the privatization process is ensuring that the people are able to have confidence that the process of the privatization from the valuation of the enterprise through the public notices of the tender and to the privatization or completion of the sale had been conducted fairly. In order to avoid incidences and harmful rumors like those described in section 2.2.2. that lead to the loss of public confidence, it is essential that all information be disclosed to the maximum extent possible and increase the transparency of the process. The Ministry of Privatization had expended much effort in this regard but continued and increased efforts are needed.

9) Use of the Proceeds of the Privatization

From the privatization that had been conducted through January 1, 1999 the government netted approximately US\$90 million but the use of the proceeds has not been clarified. Had most of the funds been used to offset the budgetary deficit, it is a matter to regret but not much can be done about it at this juncture.

In the future privatization, however, it would be necessary to ensure that the proceeds be used for purposes that had been agreed upon in advance. The Study Team feels that at least 50% of such proceeds should be expended for the industrial promotion in Armenia. Specifically, it would be most desirable to have the funds allocated to the development bank, SME Support Fund and other funding for support tools for the Armenian private sector as proposed in sections 5.4. (2) and (3).

(5) Investment Promotion Policy

Measures that will promote domestic or foreign direct investments toward industries that can produce goods and services of higher value added than what the current industry is achieving, and that are able to earn or conserve foreign currencies must be of the highest priority.

1) Framework for the Investment Promotion

The investment climate in Armenia, including law-judicial systems, shareholding limits for foreigners, work permit, resident permit, tax system and tariffs, has generally been put in place.

Needless to say, considering the present state and the future of the Armenian economy investments into the private sector regardless of domestic or foreign origin are vital. The government, in its realization that without rectifying the major deficit ridden structure of its current payment balances, the country will be faced with a state of insolvency in its dealings with external countries, must place the highest priorities on foreign direct investments into sectors that fosters exports (including import substitution) of goods and services.

All of these considered the investment policies being pursued to date by the government is not sufficient. In fact, outside of the divestiture of Armentel, the cognac factory, and few hotels there have not been any large foreign investments. There have been little investments into the manufacturing sector. The investment promotion policies have had the effect of attracting investments into small-scale commercial enterprises and domestic consumption oriented industries. Save for the small employment benefits, there is no need to provide policy support for attracting soft drink manufacturers that only contributes to increases in imports and domestic consumption. (these enterprises will likely enter the market regardless of the desirability of their presence)

Conditions that will facilitate foreign direct investments into industries that will lead to increases employment opportunities, increases in exports or reductions in imports must be put in place and the government must make efforts to aggressively court this type of foreign direct investments.

Among the priority items in the necessary conditions are the tax advantages to be offered to the investors. The existing tax scheme is not particularly attractive for investments into the manufacturing sector where the investment amount is relatively long and the gestation period before commercial production and sales are realized is long. (Tax System will be commented upon in 5.3.2 (2))

2) Establish Coordination among Government Departments and Various Governmental Agencies

It is important that there is a good horizontal coordination among each minister between and among government agencies. Each government staff must share the common realization that

foreign investment is essential for the development of the country. Without such consensus, the procedures necessary for the foreign investment could become laborious and time consuming. ADA has explained to foreign investors that it is possible to complete the process of enterprise establishment, opening of bank accounts and obtaining residency permits. However, it is understood that it takes a month or even longer. The reason for the delay is not made clear. The delay imprints upon the foreign investor the impression that the organization of the government is dysfunctional or that the organization is functional but there are inefficient or uncooperative officials within the organization. The foreign investors and businessmen, from experience, have learned that markets that are controlled by inefficient business environment or by lack of transparency in the business environment leads to increased costs due to inefficiencies and increases in visible and invisible indirect costs of doing business and that the investment will not be profitable, thus will judge the market to be unattractive for investments.

In China there are 36 technical development areas established by each province where procedure for establishment of J/V and investment can be completed in one day in one building. There are specialists and interpreters for a lot of questions which investors are interested in such as laws, taxes, finance, construction, medical service, public utility charges etc., and they give all kinds of free consultation to investors.

Formulating simplified procedure will prevent red tape and corruption.

3) The Role of the High-ranked Government Officials

The high-ranked Government officers should always be good salesmen for the country. Whenever they go abroad, officially or even on private, they have to promote Armenia to be a place for foreign companies to invest. For this purpose these people have to be informed with the present investment climate for foreign investors. Sometimes they need to actively organize the investment promotion mission to potential countries. Systems and budget of those countries may be availed of for that purpose.

4) Utilizing the Systems and Budget of developed countries

There are some facilities offered by many of developed countries as their own system(s) that the countries like Armenia having needs for promotion of foreign investment can readily utilize.

In the case of Japan at the request of Armenian government, JICA may dispatch experts of foreign investment or foreign trade to ADA for a given period. Also it is possible to ask JETRO to organize foreign investment seminar in Japan. JETRO may organize a fact finding mission of potential investors from Japan.

5) Tourism Promotion "Visit Armenia"

Armenia is one of the most unknown countries in Asian countries including Japan. More

foreign tourists to the country. They will find out themselves the investment opportunity in Armenia. Year 2001 will be a good chance for tourism campaign (1700th year anniversary of Christendom). Such campaign like "Visit Armenia " should be started now in 1999. There are enough resources for tourism in Armenia such as old churches, mountains, lakes, wine, brandy, fruits and people's hospitality.

6) Diaspora International Network

Strong support network of Diaspora in the US and Europe is being formulated. This network must be very helpful and almost cost free service can be expected. Under the situation that ADA does not have any overseas offices and even not so many Armenian embassies are deployed in the world, this network is important. Armenian government should support their activities by sending them some promotion materials and encourage them by giving them public recognition by Armenian community in both their resident countries and in the home country: Armenia. Otherwise their enthusiasm may fade away. Also Armenian government needs to consider allocating some budget to strengthen their activities in the future.

5.3.2. Improvement and Utilization of Institutional Infrastructure

(1) Legal System and Judicial Environment

Since the Civil Code adopted in July 1998 had yet no English translation available during our visit and we could not evaluate as to their possible impact on business. The comments below are based on peripheral information collected in 1998 from the managers of the enterprises surveyed by the Study Team and findings made by IRIS in a survey to assess the investment climate in Armenia.

The first impression of potential foreign investors is that it is difficult to gather basic information. They want to clearly know their personal rights and obligations, as well as their right to protect their investment and property. In case of conflict or infringement they want to know their problems can be solved or redressed.

The following comments of the Study Team regarding problems are summarized based on information obtained and listed in order of investors' concern.

1) Protection against Monopolies and Guarantee of Free Competition

There is no law on monopoly. There are few consumer protection laws. In the Law on Enterprises & Entrepreneurial Activity, there is one reference for the State to intervene in case of "unfair" competition. However, there is no definition of unfair competition, thus its enforceability is questionable. Free competition should be guaranteed not only by clear definition of "unfair competition" in a clause of laws, but also by procedures of implementation.

2) Intellectual Property

There is a section on Intellectual Property in the new Civil Code, but we have not seen an English translation. In our surveys the lack of laws governing Intellectual Property was mentioned several times. In bilateral agreements between Armenia and the USA of 1992, both agree on the need to protect intellectual property. It is important for business people, especially those with cutting edge technology, to know that their assets are protected.

3) Bankruptcy and Recovery of Debts

Legislation on bankruptcy of 1997 is unsatisfactory. There is a section on Bankruptcy of legal entity in the new Civil Code, but we have not seen an English translation. This registration affects the right to recover unpaid debts. Business must work on contracts that are enforceable, and recovery of debt is a major factor. Until an open and enforceable system of contracts is established it will be difficult to develop the "mutual trust" between parties to give supplier credit or bank financing.

4) Settlement of Disputes

Business people have been demanding a private arbitration system to settle disputes in a fast and fair way. In January the Law on Mediation Courts and Mediation Procedure established such a system. Hopefully this will allow for faster dispute settlements within the spirit of the law. Reportedly, many implementation procedures were missing and we don't know whether in practice this improvement is meeting expectations.

The whole judicial system was revised in January 1999 with the objective to have a system that works faster. Again, this is in the phase of implementation and it takes time to evaluate effect of the system.

5) Starting a Business

All businesses have to be registered and the law stipulates that it must be done within 30 days. There are complaints that registration authorities request documents other than those foreseen in the application package, causing delays and opportunities for bribery.

Some business activities, stipulated by Government Decrees, need to be licensed. The various Ministries have different approaches and the procedures are not clear. This should be consolidated in one law that stipulates all requirements.

6) Land Use

Legal entities and foreigners are prohibited to own land. Leases to foreigners are limited to 10 years. When companies were privatized, the right to use the land has been granted for short or long terms. This situation needs to be clearly defined. Longer lease terms or prescribed steps to acquire

the title to the land must be established. There must be certainty as to the rights and cost to use the premises for business.

There have been many laws adopted in a limited time period. Legislation is often unclear and does not provide the procedures for implementation. New Civil Code needs to have some clauses to keep harmonized relationship with other laws that went into effect prior to that. Business activities of enterprises should be supported by juridical environment with clear definition of laws and their enforceability.

(2) Tax Incentives

1) Overview

Tax incentives are an important measure to foster industrial development. In order for Armenia that limit transportation measures to achieve its policy objectives such as attracting foreign investments, it should introduce daring tax incentives. As shown in section 2.2.3.(2), profit tax is less than 10 % of total revenue. Therefore, if making daring tax incentives in profit tax, it would not cause sharp decrease in tax revenue. Rather, profit tax as a whole, is expected to increase through increase in investments and effect on decrease in underground economy and other wide influence on economy. VAT and individual income tax would increase in proportion to increase in investments.

Clear priorities has to be determined according to its industrial policy, and then, introduction of daring incentives should be considered in those limited areas which have high effects according to the industrial policy. The following are possible tax incentives that should be considered according to priorities of the Armenian industrial policy.

- Tax incentives to promote foreign investments
- Tax incentives to promote investments
- Tax incentives to promote exports
- Tax incentives to enhance technology

Fostering import substitute industries is important as well as export industries. It is technically difficult to put preference in import substitute industries in general. It should be considered that preference is put in import substitute products defined by the Government in tax incentives promoting foreign investments and investments.

When considering tax incentives, it should be recognized that there is a trade-off between fairness or transparency and their effect in respect of industrial policy. As we describe later, Armenia gives tax incentives to all foreign investments over AMD500 million regardless of the field of business. This appears to be very good from the view of fairness or transparency. However,

it results in giving favorable treatment to investments less important to Armenia. For industries more important to Armenia such as manufacturing which require long-term period to be profitable, this is in fact meaningless incentive.

Governmental policy should focus on practical usefulness in sustainable development of Armenian economy, and not on ensuring superficial fairness and transparency. Considering current situation of Armenian economy and importance in investments, especially foreign investments, tax incentives should be considered from a view that several criteria combine into one system.

One of criteria is amount of investments. Criteria of AMD500 million for foreign investment results exclusion of small foreign investments. On the other hand, no consideration is given to introduction of large-scale investments. For example, categorizing into 1) US\$200,000 to 1 million, 2) US\$1 to 10 million and 3) more than US\$10 million would effect in introducing various type of foreign investors.

Other important criterion is categorization based on priority considering direction of development of Armenian economy and importance in industrial policy. Various factors should be considered to make this priority. In case of Armenia, 1) Size of value added, 2) leading edge of technology and 3) contribution to export (inflow or saving outflow of hard currency) should be most important factors. In order to avoid unnecessary complications, three level such as A, B, C in each factor above, may be sufficient.

Investors or enterprises select criteria.

Geographical area and number of employment may be worth being considered additionally. Basically, the unified criteria needs to be decided by due consideration in combination of above two criteria.

This plan described above does not have an idea of segregation of foreign and domestic investment. However, a little more priority can be placed on foreign investments since it brings hard currency, which is deficient to the country.

2) Tax Incentives to Be Introduced

Based on the above idea, outline of our proposal about four types of tax incentives is describes as follows.

a) Tax Incentives to Promote Foreign Investments

Policy intention to give favorable treatment to foreign investments have already been adopted. As we described in section 2.2.3.(2), since January 1998, they changed, giving tax holidays (2 years from time of investments) only to foreign investments over AMD500 million. Level of favor has decreased since they used to be given to smaller amount of foreign investments.

This appears to have been implemented with the intention to promote foreign investments in more important industries such as manufacturing, since past foreign investments were mainly made in areas such as restaurants and shops, which do not need large amounts of investment. However, the purpose of such policy can be achieved more effectively by introducing incentives limited to certain field of business. For example, more favorable incentives might be given to target industries such as biotechnology, computer software, export-oriented manufacturing and import substitute industries.

In the case of manufacturing, a two year tax holiday (and 50% reduction at most for 8 years, 2 years after 2002) may not be as attractive to investors, since manufactures often record losses in the first few years of investment (incorporation). In order to promote investments in manufacturing, tax holiday should start from the year of making taxable profit after applying tax loss carryover. We propose to change to the following system.

Table 5.3.2.1 Example of Tax Holiday-Incentive for FDI

Investment Amount Priority	US\$0.2~1.0 mln.		US\$1.0~10.0 mln.		Over US\$10.0 mln.	
	0%	50%	0%	50%	0%	50%
Profit Tax						
A	3 years	4years	5 years	5 years	5 years	7 years
B	3 years	3 years	4 years	4 years	5 years	6 years
C	3 years	2 years	4 years	3 years	5 years	5 years

Start of tax holiday: the year of making taxable profit after applying tax loss carryover.

In addition, in order to promote continuous reinvestment of foreign enterprises, tax incentives that if foreign investors reinvest profit from invested enterprises, a certain percentage (e.g. 40 %) of profit tax on reinvested amount would be reimbursed should be considered. China and Vietnam have such tax incentives system.

If importance is placed on introduction of cutting-edge technology and its sustainable development, there is an approach to reduce profit tax rate of those target enterprises from 25% to 15 %.

Same approach as table 5.3.2.1 can be introduced in b) and c) described above.

b) Tax Incentives to Promote Investments

Favorable treatment to newly established enterprises in the past was abused in tax evasion by establishing new enterprises one to another and transfer business to those newly established enterprises. There is a need of tax incentives to promote investments in facilities by enterprises rather than investments in enterprises. Tax credit of a certain percentage (e.g. 20%) of investments

is worth being considered. Favorable treatment not given in general, but given to target industries also can be considered.

c) Tax Incentives to Promote Exports

There are no tax incentives to promote exports in Armenia, currently. Favorable treatment to promote exports is essential because increase in exports is very important for Armenia.

One example is a reduction of profit tax (e.g. 50% multiplied by export ratio) to enterprises with high export ratios (e.g. over 60%) ---A method.

Other approaches include giving favorable treatment to enterprises with a large amount of net export (export minus import), not with high export ratio, because enterprises, which Armenia should really give favorable treatments, are those with large amounts of net export, rather than those with high export ratios. However, such treatments are at high exposure to tax evasions since forgeries to decrease imports using dummy companies are easier than forgeries to increase exports using dummy companies. There is a need of some device to avoid such abused application.

For example, giving tax credit of a certain percentage (e.g. 20%) increase in net export can be considered --- B method.

If combining A and B methods, in other words, if such method that smaller amount calculated in the two methods is applied is adopted, system that give favorable treatment to enterprises with a large amount of net export, and exclude high exposure of tax evasion can be realized.

d) Tax Incentives to Enhance Technology

Examples are tax incentives to enhance technology are allowing double deductions of expenses (deducting twice of actual cost in calculation of taxable profit) related to enhancement of technology such as research and development costs or training costs, and giving tax credits based on the amount of increase for those expenses. However, such treatments have exposures to tax evasion, particularly as their accounting system has not been well developed. Risk of tax evasion is lower when focusing on the amount of increase rather than focusing on a definite amount. Such system is popular tax incentives to encourage research and development among other countries.

3) Securing Tax Revenue for Local Governments

Armenia does not have any local taxes. But a part of tax revenue from some taxes such as property tax is allocated to the local governments. In order to pursue regional development policy described in section 5.2.4., enlargement of tax revenue of local government would be important. However, establishing local taxes does not seem practical due to the related issue of collecting taxes. Enlargement of the current system, which allocates a part of the national tax revenue to local governments, can be more practical. Under the structure of the current tax revenue, one possible

method might be the allocation to local funds of a part of the revenue from value-added taxes based on the population.

(3) Financial Sector Reform

1) Overview

Armenia is making effort in nurturing its financial institutions and has succeeded in part, especially with respect to the sound financial condition of such institutions. However, those financial institutions are not contributing well to the financial meditating function. Armenian banks are not eager about lending activities. Their main sources of income are investing in treasury bills and money transfers.

Nature of the problem within the Armenian financial sector is that domestic money circulation has not worked, where surplus funds should be absorbed as bank savings and used in sectors which need money.

This problem can be divided into two parts, lack of savings and lack of deposits. Lack of deposits is generally attributable to lack of confidence by people in financial institutions. Lack of lending comes from the fact that lending is less attractive for banks than investing in treasury bonds with high interest rate and banks' insufficient ability of review credit.

2) Direction of Development of Financial Institutions

Development of financial institutions is essential to the development of the Armenian economy. There should be a major design as to how Armenian financial institutions shall be in the year 2005.

Some banks need to be recognized with certain confidence among world financial market by 2005 at latest. Confidence in an Armenian bank should be enhanced to that level; for example, a beneficiary can accept a US\$10-million-letter of credit issued by a bank without confirmation by a more creditable foreign bank.

There are 35 small financial institutions existing under the name of "bank", most of which do not make any effort to raise fund with deposits, and in fact have very few deposits, and which rely on a high yield of treasury bills and commissions on money transfer. Deliberate reconsideration should be made so that many "banks" are really necessary in Armenia. Some banks are taking very few deposits, in substance they are local usurers. And other banks are only engaged in money transfers with Russia. We think that financial institutions should be divided into the following three categories and encourage development of each type of financial institution.

- a) **Primary Banks:** Engage in general banking activities, including taking deposits, dealing with various kinds of financial instruments, settlements, international trade settlements, including issuing letters of credit, guarantee, lending,

investments, credit card settlements. (5-6 such banks seem sufficient in Armenia.) Such banks should raise their capital to about 100 times in order to support risk taking and to obtain a reputation in the world financial market. We recommend raising capital requirement gradually every year, for example, as a first target, raises of about 20 times by 2005.

b) **Secondary Banks:** Banks who cannot meet capital requirements described above. They engage in limited banking activities. For example, they are not allowed to settle international trades.

c) **Non-Banks:** Other financial institutions, which are not allowed to accept deposits.

The above criterion is a rough example. But we believe that there is need for some radical reform in order to enhance the capital of banks → to obtain confidence from abroad and reliance from users of the banks → to increase deposits, as a result → to form a source of investment and finance.

3) Establishment of Deposit Insurance System

In order to change the situation where people are not willing to deposit at banks and rather keeping cash in their hands, establishing a deposit insurance system should be considered. The system will protect deposits limited to a couple of thousand US dollars per capita, and raise fund through insurance premiums from banks. Variable insurance rates based on capital ratio, or definite amount of capital, can encourage banks to enhance their own capital structure.

4) Unification and/or Merger of Stock Exchanges

There are four stock exchanges in Armenia. Even the biggest one, Yerevan Stock Exchange, does not have a high volume of trade and seems not to function well as money circulation. Reasons for non-active trading in securities are mainly attributable to lower level of understanding and confidence in security market by people. It is not practical to seek financing function for enterprises in security market. Enhancement of indirect financing by banks has more priority.

Although stock exchanges are necessary infrastructure in development of private sector, there is no necessity for four stock exchanges concurrently to exist in Armenia, considering the scale of Armenian economy. Merger or unification of those stock exchanges should be considered.

through insurance premiums from banks. Variable insurance rates based on capital ratio, or definite.

5) Development of Non-bank Financial Institutions

Non-bank financial institutions sector in Armenia that includes financial institutions other than banks, namely, non-bank institutions dealing in financial products including securities companies,

casualty insurance companies, life insurance companies, leasing companies, investment/money trusts, is underdeveloped. There are some 20 companies engaged in casualty, life and medical insurance but the scale is small and the scale of the funds raised is long way from being able to be effectively mobilized in economic activities. The single major factor is the lack of confidence in the institutions. Most people believe that even if insurance is contracted, the contract will not be fulfilled at the time of need.

The lack of development of the non-bank sector is one of the contributing factors behind the high level of interest rates being charged by the banks. The government needs to take measures to promote the development of non-bank financial institutions.

(4) Accounting and Auditing

1) Introduction of New Accounting System

Accounting reform is currently in progress with focusing on establishing new institutional systems for external reporting, such as introduction of new accounting standards and ratification of new accounting laws. After that, important issues could be application of new standards in enterprises and introduction of concepts for management accounting with a large number of enterprises utilizing them to improving their management.

Foster accountants is essential to development of accounting and auditing systems, and to do that, opportunity of taking practical training is necessary. Promoting conversion of accounting system would also result in giving such opportunity to new accountants.

One way to introduce new standards into many enterprises is mandatory application in many enterprises. However, such a mandatory method would cause superficial conversion of the accounting system, which means that at the operational level, old-fashioned methods and approaches will still remain, as a result, could not take sufficient advantage of new accounting system. In Armenia, mandatory application is limited in some regulated business (banks, infrastructure) and in general, application is voluntarily. Such voluntarily conversion would be adequate from a point above. On the other hand, this could lead to delay in conversion, and pose as an obstacle against the development of the private sector. Management may not understand benefits from conversion of accounting and may not place high priority on it since Armenian enterprises have several pending issues. It is necessary to emphasize benefit of the conversion to the management and to achieve steady introduction starting with enterprises having high benefits.

Examples of enterprises with high benefit are those considering foreign partners or bank credit. Foreign investors or banks will usually require the submission of financial statements and a business plan. This could provide the motivation for conversion including introduction of

management accounting. It is expected that conversion will progress at each enterprise level, initiated by foreign investments.

On the other hand, Armenian banks are not active in lending; therefore, this cannot be an engine to introduce new accounting methods. However, the Kerkorian funds and the 2-step-loan program by the World Bank can be a good opportunity to implement the new accounting and management accounting system.

In the credit review of these programs, a detailed business plan is required. The management may initially prepare one since it is obliged. However, it would be a good opportunity for them to realize that adequate accounting information is a basis of operation through analysis of their plans versus the actual.

2) Support of Conversion of Accounting Standards through on Site Assistance

It is effective for enterprises converting their accounting system to be provided on-site technical assistance by consultants who are familiar with both Soviet and international accounting. This assistance can provide practical training to accountants at enterprises as well as support of conversion of accounting system of these enterprises.

One concrete example is to provide technical assistance including management accounting areas for enterprises applying for the 2-step-loan programs. Utilization of technical assistance about conversion of accounting system currently provided by USAID and inclusion of such technical assistance in two-step loan programs could be considered.

3) Importance of Management Accounting

Management accounting used in decision making is necessary for the private sector development as well as a reliable accounting system for external reporting. Although management accounting includes not only past results but also other data such as future estimates and budget, adequate actual accounting records would be a basis. Therefore, when converting accounting system, requirements of both financial and management accounting should be considered. Financial accounting is passive to report to others information required. On the other hand, management accounting is active in getting information the management wants. Emphasis on management accounting may be effective to persuade management and importance in accounting.

4) Fostering Accountants

In order for accounting and auditing systems become closer to international levels, improvement in the operation of systems as well as institutional improvement, such as the setting new accounting systems based on IAS will be required. It is especially important to train a wide range of accountants and to make the management understand this new accounting philosophy. As

described in section 2.2.3.(4), training courses by ACCA have already started. However, practical training is essential to foster accountants, regardless of management accounting or financial accounting, as well as off-the-job training. Foreign investment leads to introduction of new accounting methods, and provides the opportunity to have practical training for those who have undergone the new accounting course. It also provides the opportunity for the management to understand the benefits of the new accounting.

5) Fostering Auditors

Education of financial statement audits has also started. Practical experience is very important in order to be trained as an auditor as well as accounting. Audit practices can only be experienced at international accounting firms in countries whose audit system is not developed enough. At present, only few international firms have offices in Armenia. An increase in foreign investments would cause an increase in the demands for financial audits of foreign enterprises, subsequently lead to an increase in the number of offices and staff of international firms. Armenian accountants who have experience in these firms will be expected to play a leading role in the development of an audit system in Armenia.

6) Enhancement of Accountants' Organization

In order to develop an audit system, enhancement of a professional body, as a self-regulatory agency is necessary. The planned merger of the three accountant associations will be expected to lead to the enhancement of this function. For example, the following functions are required: standard setting of accounting and auditing, setting and revising practical guidance, enhancement of ethical matters and enhancement of education and training. Assistance from the International Federation of Accountants (IFAC), the international organization of accountant bodies, and FEE, the European regional organization of IFAC, can be considered.

(5) Technology Development and Quality Improvement

1) Technology Development

It is needed for enterprises that the Government should implement the following 2 aspects of support simultaneously in technology development:

- a) Improvement of technology: To grade up technology level of enterprises. This means that the enterprises are caused to become internationally competitive in terms of technology, resolving the issues of falling behind situation and outdated equipment due to the past 10 years stagnancy.
- b) Innovation of technology: Initiation by the governmental or public institutions in the research and development activities. Those institutions are to acquire the latest technology

and to engage in the invention of new technology and further to make them for the utilization of enterprises.

Concrete Recommendations:

a) Support for improvement of technology:

- Public examination research laboratories	Technical assistance, examination of product's performance and quality based on the request of enterprises
- Technological advisor system	Qualified advisors are to be registered or certified by Minister of Industry and to render technological diagnosis/assistance, staying at the enterprise issuing the request.
- Training center of technology/skill	To handle technological education and training course for theory learning and skill improvement.

b) Support for innovation of technology

- Advanced technology laboratory	In charge of research and development of advanced technology, such as fine-electronics, mechatronics, etc. with the aim of creating new business in Armenia
- Patent promotion and management	Promotion and management of the patent information is most important items in international business. It is necessary a public institution of patent acquisition, promotion of utilization of effective patent, and guidance to deal with foreign patents, etc. for enterprises.
- Technology innovation fund	This fund is for the support as subsidy for R&D of new product. In addition, the fund for the investment to new equipment is needed for enterprises to start actual production of the new product.

2) Quality Improvement

Generally, the quality of product improves as the level of technology improves. As such, improvement of performance and reliability of product are to be included in above Subsection 1)-a). However, it is very difficult to keep quality always in good condition, because quality is not only dependent on technology, but also on human behavior. Quality is an index of integrated output of all activities (system) of the enterprise in question. This means quality control is a theme of management. ISO9000 is enacted from that viewpoint. Now, among the western countries, ISO9000 is positioned as a criterion to evaluate the enterprise when it intends to deal with others.

- Promoting Dissemination of ISO

In Armenia ISO related matters are being handled by the Prime Minister's control organization, SARM (Department for Standardization, Certification and Methodology of Armenia). The Government is implementing the gradual shift of the national industrial standards HST (Hayastan

standard) from GOST based ones to ISO based ones. Armenia is a member of the member body of ISO and contributing to the Organization in several activities such as CASCO (Committee on Conformity Assessment) and DEVCO(Committee on Developing Country Matter), etc. Also the Government is preparing to adopt ISO 9000 and 14000 in Armenia. However, so far no official institution of ISO certification was established, nor were the activities for dissemination for the adoption by enterprises of ISO standards, though Armenian translation of ISO9000 series was completed. As for the certification, the Government is studying the possibility of having services agreement(s) either with SGS, Switzerland or ITS, U.K. Most of the enterprises are not aware of the importance of ISO9000 in relation to the transactions with firms of western countries and this would become big impediment to Armenia's export promotion. Therefore, the Government is strongly advised to immediately commence the following actions:

a) Dissemination of ISO 9000 to Enterprises

For the acquisition of ISO certification, it would take a considerable time. Most of the applicant enterprises have been experiencing about one year from its commencement of preparation to the acquisition of certificate. Accordingly, the Government is asked to hold the dissemination workshops for the implementing staff of enterprises as well as the seminars for the people in the management.

b) Scheme of Special Subsidy for ISO 9000

For SME it is relatively expensive to acquire ISO 9000 certificate. (If all costs of the preparation, experts services costs and expenses for certification were added up, it would amount to US\$5,000 to 10,000.) Now that ISO is the standard of the world, it is necessary for the Government to recognize the significance of national level support to the acquisition of ISO standards by Armenian enterprises, just the same token as being the member of WTO.

For the implementation of the above, it should be studied that either the financing having high priority and a special low interest rate under the scheme of SME Supporting Fund as the proposition of the Study Team is explained under Section 5.4.(3) be extended to the applicant enterprises, or a special subsidy be given to them as the case may be deemed appropriate.

(6) Human Resources Development

One of the Armenia's greatest resources is its manpower. The following 6 items are suggested for the development of human resources - the greatest factor in social and economic growth.

1) Effectively Implementing the Education Budget - A Drastic Review of the Number of Teaching Staff

One of the biggest problems in the present education system in Armenia is that the budget allotted to education within the already limited national budget is not always used efficiently. The underlying cause is the excessive numbers of teaching staff. It is necessary to significantly reduce these excessive numbers during an initial 2 years phase. For this purpose it is necessary to seek persons for early retirement in this transition period, to help find new employment for these people, and to offer the chance of vocational training, as well as the state bearing their salary burden until reemployment on condition of a maximum of 2 years. At the same time, an environment must be created where the salary of remaining teaching staff is considerably increased, and where they are highly motivated to educate.

These measures are painful for the retiring teaching staff, and temporarily increase the burden on the state budget, but they are thought to be an indispensable first step towards improvement of the quality of education.

2) Preventing the Hollowing Out of Education in Rural Areas

To prevent education in rural areas from hollowing out as seen in Section 2.2.3.(5), it is necessary to examine policies such as increasing the salaries of teaching staff working in rural areas.

At present, the Diet is discussing a bill of "state order" aimed at nurturing specialists such as local public servants and lawyers, and which includes a clause obliging students to work in their special field of study for a certain period of years after graduation, instead of the burden of school expenses being shouldered by the state. This system must be utilized to secure teaching staff to work in rural areas.

3) Establishing Initial Education Standards

To establish initially the status of private schools where demand is expanding, it is first essential to set the education standards that will be used as a judgement standard for authorizing private school licenses. According to a top official at the Ministry of Education and Science, it will take a further 2 years to set these standards. However it is recommended that order that this work can be completed at an earlier date by means of increasing the staff working on this project.

4) Effective Utilization of University for Re-qualification of Working People

In accordance with the change of the national system, a new value system must be introduced. Furthermore, with the globalization of economic activity, the legal system, management and accounting must be brought into line with international standards. Given such changes, it is important to re-educate the working population so that it can adapt to the changing times. Universities should open up their classrooms and offer working people the latest expertise following international guidelines. For this purpose, one can also request for teachers in fields

lacking content to be dispatched to foreign aid organizations.

5) Retraining Teachers

The retraining of teachers is also essential. Using training abroad programs currently being run by American support groups, the practice of new educational methods based on teacher retraining and model schools should be diffused widely.

6) Reform and Reorganization of Vocational Technical Schools

The ratio of teaching staff to students at vocational technical institutions was mentioned in Section 2.2.3 (5). These institutions must revive themselves into schools able to provide education to match the new needs of Armenia. This implies saving a small number of schools and selling the majority to the private schools. The teaching staff is to be discharged except for a small number of the best personnel who are able to adapt to the new technology required in this age. Profits from the sales of school should be directed into procuring top-rate instructors and for improving training facilities. Human resource development should have as its ultimate goal the education and production of manpower adapted to meet the qualitative needs of Armenian society, and that will resultantly benefit both the individual and society as a whole. Armenia must gravitate towards creating a healthy flow of:

Production of High Quality Manpower → Revival of the Economy → New Demand for Manpower

Opportunities to fulfill the desires of those people hoping to have occupations where they can really put their specialized knowledge to the practice will no doubt increase with the development of the Armenian economy.

(7) Reorganization of Scientific Research Institutes (SRI) and their Effective Utilization

In order to develop scientific technology and research and development in Armenia, the following three policies are necessary.

- There are many scientific research institutes to industrial development of all over FSU. Curtailment of those research institutes is necessary according to domestic needs.
- It can be considered that promoting cooperation with foreign enterprises and/or SRIs such as contracted research work and joint research work in order to resolve lack of funds. It is necessary a system to promote such cooperation.
- There are many SRIs that perform at high levels of study. It is necessary to promote starting-up of business utilizing such studies.

1) Reorganization and Down-scale of SRIs

Many scientific SRIs have been located in Armenia, since Soviet rule. Some SRIs have little

necessity to exist in Armenia following the independence of the Soviet Union. For example, some SRIs were related to industries located in other areas of Soviet Union and not to industries located in Armenia. Even with SRIs closely related to an industry in Armenia, these industries might have been completely destroyed with the collapse of the Soviet Union, and have no plans for restoration. Practically, it is impossible to retain all SRIs currently existed in Armenia considering the scale of government budget in Armenia. Armenia has not performed any fundamental reorganization and/or downscaling, and is allocating very limited research budgets to each SRI, almost an even amount, and as a result, all SRIs are suffering from a severe lack of funds.

We believe that SRIs remaining from the Soviet time need to be reorganized and curtailed according to the industrial structure and scale of the national budget. They should then be allocated limited funds related to promises to industries for future development of Armenia. For example, priority could be placed in biotechnology, computer science and electronics.

2) Cooperation with Foreign Enterprises and Research Institutes

Cooperation with foreign enterprises and research institutes is one way to secure research funds under a limited governmental budget. Currently, there are some SRIs who do some research work entrusted by foreign enterprises and/or SRIs. However, such cooperation was primarily started by personal and accidental relationships between scientists.

In June 1999, a Japanese world-famous company placed orders on joint research works to 2 SRI in Armenia in field of microbiology and biochemistry under the Study Team's persistent recommendation.

There might be some SRIs that have high potentiality but cannot find the opportunities to bring their ability into full play since they are unknown to foreign countries. As for foreign enterprises and/or SRIs, such cooperation with Armenian SRIs would be very beneficial since they can use talented scientists at lower cost than their home countries. Especially, fundamental research, in which exchange of various ideas is very important and areas where large numbers of scientific workers are required to perform experiments appears most beneficial.

One example of cooperation is currently in progress where a Japanese university has invited an Armenian scientist, a leader of a research group in a SRI researching epoch-making. The lead scientist and Japanese scientists conduct research work together, and simultaneously the Armenian SRI perform experiments according to instructions via e-mail. If an Armenian remarkable scientist is just invited, the Armenian SRI might become hollow. This example could provide the remaining research workers with an opportunity to continue their study and maintain or develop the ability of Armenian SRIs.

In order to foster cooperation with foreign enterprises and SRIs, it is necessary to establish a system to introduce organization, number of staff, contents of study (e.g. summaries of articles) of Armenian SRIs. To starting with any contracts of research work or joint-projects is important, even they are small. If high level of potentiality is confirmed through these small projects, bigger projects or closer relationship could be followed.

UNDP has designed an aid program, "Marketing of Hi-tech Intellectual Resources". This program is worth being considered.

The program is summarized as follows:

- a) Evaluation and selections of hi-tech R&D organizations (HTRDO)
- b) Identification of the world markets for intellectual resources
- c) Institutionalization of the hi-tech R&D exporting mechanism
- d) Commercialization of selected HTRDO and their potentiality as well as organization of business partnership
- e) Commercialization of education and training process

3) Industrialization and Commercialization of Research by SRI

SRIs that perform at high levels of study are potential seeds for industrial development of Armenia. However, there are few successful examples of industrialization or commercialization. The followings are obstacles for industrialization or commercialization of results of studies by SRIs.

- a) Lack of funds necessary for industrialization or commercialization
- b) Limited methods to find partners (e.g. foreign enterprises) for industrialization or commercialization of their study. Scientist and engineers are not accustomed to "selling" their products, since direct contact with foreign enterprises or SRIs was very limited under the Soviet Union.
- c) Under the Soviet Union, fundamental research was generally considered higher work and applied studies were considered lower work. Even currently, this tendency continues and applied studies are underestimated.

In order to assist in industrialization or commercialization, the following measures are needed.

Especially, information dispatch abroad should be strengthened. Utilization of the current "Trade-point" and the introduction of contents of studies conducted by the SRIs to foreign enterprises are worth being considered. In addition to enterprises and their products, SRIs and their contents of study could be exhibited in trade fairs.

- a) Educate Scientists

Train scientists, who are not accustomed to commercialization of their results of study, as to

knowledge necessary for commercialization, such as intellectual rights in the world. The UNDP program is a good reference.

b) Financial Support

Financing is provided by Development Bank to assist in starting-up of business with hi-tech intellectual resources.

5.3.3. Infrastructure

(1) Overview

As explained in section 2.2.4., infrastructure needs a lot of improvement to be comparable to that of developed economies and even some developing economies. The lack of available resources and the decision of where to use the scarce resources available for the best results are two of the main problems for the Government of Armenia.

Instead of discussing the establishment, construction, improvement, procurement, and the like for each item of infrastructure here, we shall state what approach should be taken when working on improvements.

(2) Overall Approach

Scarce resources will be used effectively by developing a master plan and positioning or integrating within it the projects that are being carried out independently.

There are several programs with different levels of funding in place for the development of Energy, Agriculture, Irrigation, Tourism, Transportation and Education. A clustering of several programs around a single strategic direction could produce larger and more lasting results than done separately without significantly increasing costs or foregoing established objectives.

Of particular importance is the perspective on tourism development. This is because although roads and several other infrastructure components are a cost burden to the government, their use for tourism would bring about the following positive economic spillover effects.

- First, tourism development would bring long-term external income to the country.
- Second, it would foster many related industries and create employment. In conjunction with that, the quality of agriculture would be raised through the provision of food.
- Third, it would bring income and employment to regions with tourism resources.
- Fourth, providing services that satisfy foreigners would raise the quality of service industries. Better services would in turn make further advances in the tourism industry possible.

(3) Anti-monopoly Policy in Infrastructure

In order to improve quality and cost of infrastructure, anti-monopoly policy should be introduced.

As described in section 2.2.3.(1), there is lack of anti-monopoly law at present.

For example, as for telecommunications, Armentel was sold to OTE, a Greek company with a 15-year exclusive right. Such exclusiveness would have negative effects on the improvement of quality and cost, then would be likely to have negative effects on development of the private sector. If OTE raises its fees substantially to recover its investment early, the competitiveness of all Armenian industries would suffer.

(4) Improvement in Operation

Improvement of the physical condition of infrastructure, such as railroads and roads is very important. However we emphasize the importance of the operational aspect, for example, free of bribery at the border, customs and even on the road, which are reportedly seen currently very often. Such lack of transparency is one of the key factors disturbing foreign investments and international trade.

(5) Improvement through Fostering Tourism

There are some common factors between a good business environment, especially for foreign businesspersons and a good environment to attract tourist. We recommend that improving infrastructure such as hotels and international and domestic transportation by implementing policies to foster tourism.

A clustering of several programs around a single strategic direction could produce without increasing costs larger and more lasting results than done separately. Tourism is to be considered a major direction in the improvement of infrastructure.

Armenia has many assets that can make it an appealing tourist destination. Tourism is generally one of the popular ways to gain hard currency in developing countries. Many tourists seek:

- 1) Something new, old historical things (Armenia's excellence in tradition and cultural heritage), beautiful scenery
- 2) Art, culture, interesting things, encounters with people
- 3) Clean and pleasant lodgings and transportation
- 4) Delicious food and beverages with strong regional character
- 5) Ease in using international communications such as telephones, faxes, and email (directly from their hotel rooms)
- 6) Full installation of satellite TV (CNN, BBC, etc.), Cable TV receivers, etc.
- 7) Shopping fun (items peculiar to Armenia, folk art, ethnic design clothing with good fashion sense, accessories, gifts and souvenirs, duty-free shops selling world brands, etc.)
- 8) Safety
- 9) Quality and low prices that exceed expectations

10) The minimum time for procedures at airports and the like (tourists don't visit just to be kept waiting for hours)

If involved parties review and evaluate the current states of the foregoing items (actually broken down into smaller categories), establish goals on how and to what extent to make improvements by a target year, and organize a large-scale, sustained campaign, it would likely clear up many problems and inadequacies.

2001 is appropriate as the first target year because it is the 1700th anniversary of Christianity in Armenia, and many foreign travelers are expected to visit.

Armenia's tourism experience comes mainly from the former Soviet Union era in terms of both facilities and services. While facilities are of course important, it is first of all necessary to fundamentally change the perceptions of the people, including managers, working at tourism-related facilities. Some airport and hotel employees act as if they themselves are the people of central importance. Each workplace will have to thoroughly train its employees.

A shortcut would be to send Armenian tourism industry people to tourism facilities in developed and developing countries that depend heavily on tourism and have them work there and learn the ropes directly.

5.4. Building a Government Agency for Implementation of Development Plans and Business Support Systems

In order for the Armenian economy to recover and get on track on a sustainable development path, the export industries and the import substitution industries must be fostered and the goods and services produced by these industries must be given competitiveness in price, quality and other conditions to withstand the rigors of international competition.

As it has been shown, compared with their counterparts in other market economy countries the private sector in Armenia, due to its historical evolution, has been saddled with countless handicaps that are beyond their abilities to bear, including difficulties in their ability to raise the required financing.

In order for the government to attain an ability to reduce the fiscal deficits, substantial increases in fiscal revenues – tax revenues are essential. The only way that this is possible is by having the private sector enterprises develop into profitable and internationally competitive enterprises and increasing the income levels of the people. The responsibility of building and implementing a system to remedy the principal external environment that is impeding the development of the private sector lies with the government.

The Study Team believes that for the fostering of the Armenian private sector the following six structures or systems must be put in place with some urgency.

(1) Creation of the Ministry for Economic Development and Planning

In June 1999, for various considerations, the Ministry of Economy and Finance was split into two ministries, Ministry of Economy and the Ministry of Finance. The original amalgamation of the Ministry of Economy and Ministry of Finance that inherited the former GOSPLAN, lacked the logical necessity in putting together the planning and the fiscal functions, thus it could be said that the breakup was inevitable.

This organization has gone through various transformations in the name, GOSPLAN → Ministry of Economy → Ministry of Economy and Finance → Ministry of Economy, function and make up since the days of the breakup of the FSU. During the transformations, a part of the organization had been shifted to the Ministry of Industry and Trade.

We have not been able to ascertain the actual functions of the newly created independent Ministry of Economy nor for which state operations it has responsibility but if it only involves the simple separation of the Economy section of the old Ministry of Economy and Finance, the roles

and responsibilities of the newly independent Ministry in the economy have not been clarified. On the other hand, this Ministry is staffed with some capable economists.

As we have pointed out in the various sections of this chapter, for the rebuilding of the Armenian economy, like "VISION ARMENIA-2005" the preparation and the implementation of state medium term development plan is necessary and this requires capable economists. Centralization of the coordination function and a focal point for the acceptance and request for foreign assistance is necessary.

The Study Team, considering the above, propose that the existing Ministry of Economy be reorganized and form, de novo, a **Ministry for Economic Development and Planning ("MEDP")** for the implementation of the functions described below.

MEDP in addition to its Think-Tank related functions would assume responsibilities for the following functions.

1) Establishment and Monitoring of Short and Medium term Economic Development Plan

- The agency will act as the administrative office for the "VISION ARMENIA-2005" Planning Committee created directly under the presidency, as recommended in section 5.2, and it will be engaged in the creation of "VISION ARMENIA-2005". In addition, it will be engaged in the planning and monitoring of annual plans and will undertake the review of the plan in the fourth year.

2) Study of Diaspora and Formation of a Diaspora Network

- Examine the Diaspora who are dispersed across the world and systematically organize a network to link with the Diaspora. (The Prime Minister's Office may become involved but because a great deal of the work would involve a long term and persistent investigations and network building a permanent organization with experts who have accumulated the information is required, an organization such as MEDP, close to the political center yet only slightly tainted by political influence would be the most suited.

3) Coordination and Acceptance of International Assistance

- It was observed that the prime government office to handle coordination among the various ministries for acceptance of international assistance that would be selected in conformity with the prioritized order by the government's policy, was not clearly assigned, while the technical assistance extended by international institutions and other donors had been implemented through the International Cooperation Division of the Ministry of Finance and Economy, the Ministry of Foreign Affairs and some other governmental agencies (from time to time).

- In the formulation and implementation of "VISION ARMENIA-2005", effective utilization of the assistance from international institutions and other donors is indispensably significant.
- MEDP is assigned to be a window of the government for requesting and receiving assistance and coordinate the various ministries' interests and also formulates a request for prioritized and effective assistance (draft) with a view toward the implementation of the "VISION ARMENIA-2005".
- It receives foreign specialists, dispatch trainees for overseas training, and undertake examinations of assistance agencies and the details of the assistance.

4) Coordination of Projects with Involvement by Multiple Government Agencies

- The Ministry, in addition to the above, will coordinate development/investment projects that have the involvement of multiple government agencies for a timely and effective implementation.

5) Formulation and Promotion of the Implementation of Regional Development Policies

- The Ministry will formulate National Comprehensive Regional Development Plan and have it well coordinated with the development programs of the respective regions.

6) Interface for the Acceptance of 2-Step Loans from Donor Countries and International Agencies

- It will act as the external interface for the 2-Step Loan extended as international assistance, and it will be responsible for undertaking the negotiations and determination of the basic framework for the acceptance and implementation of the 2-Step Loans.

7) Publish Economic White Paper

- The agency will prepare the White Paper on the Economy and upon receiving the approval of the cabinet, publish the White Paper.

(2) Establishment of Armenian Development Bank

1) Reasons

There are three essential reasons for the need for the establishment of the Armenian Development Bank ("Development Bank").

a) The requirement for the creation of the Development Bank has been pointed out in many various sections of previous chapters. The Armenian financial sector is still in its infancy stage and still very fragile and has no capability to provide the private sector, particularly the manufacturing and export related industries, with the required funds quantitatively or in the amount of financing or

qualitatively in the conditions of the financing. In addition, as it has been noted in 2.3.1 and 2.3.2 in Chapter 2, the private sector financial institutions are effectively guaranteed risk free income (effectively income transfers) through purchases of high yield Treasury Bills that bear average interest rates ranging from 45% to 60%. Excluding the short term loans granted at high interest rates, they have no interest in providing short and medium term funds that is the lifeline of industry at reasonable conditions required by the users.

b) The long term aid credits that have been granted by international financial institutions, other aid agencies and funds have not always been utilized as the credit had been intended.

For example, the World Bank has extended Enterprise Development Project Credit (US\$16.75 million, term 35 years, interest free, fee 0.75%) with the government as the borrower. In spite of the favorable interest rate at the front end, the end user private sector enterprise pays interest rate of 15 - 21% as under the scheme, the government levies an interest rate of LIBOR + 2% when lent to the private sector bank who in turn adds 8 - 11% when the final loan is made to the user. The user is also required to provide a collateral equal to 200% of the amount of the loan and the users are required to assume the foreign currency risks associated with the loan.

The first point that needs to be made is that the World Bank financing is intended to provide financing for the promotion of private enterprises and not intended for the provision of opportunities for the government and the banks for profit taking. In other developing countries the prevailing fees extracted by the government for this type of credit is about 3%. The government's responsibility is to provide the environment where the chicken can lay eggs and the government and the financial institutions must not eat the feed intended for the hen.

The banks are provided with other people's money for which they have not incurred any cost in raising and exert no efforts in the formation and there is no rationale for the banks in charging exorbitant commissions. The Armenian political economy, as pointed out above, favors the banks one-sidedly.

LINCY (Kerkorian) Fund (US\$10 million) is funding provided by Mr. Kerkorian at zero interest cost for fostering small and medium sized enterprises; however, the actual interest that is paid by the borrower is 15%. At the outset, the foreign exchange risks were borne by the borrower, but as a result of many criticisms from various sources, including the Study Team, the burden of the foreign exchange risks was transferred to the government. In this case the government's fee is 3% but the private sector banks levy an additional commission equaling 12%. In addition, the borrower is required to provide a 200% collateral coverage.

In order for the aid credits from international agencies to be able to function as a **2-Step Loan** according to the original intentions and be able to contribute to the development of the private sector enterprises, a receptacle - public implementation agency to eliminate the extortionist middle margins, such as those described above, is required.

e) To promote the private sector, a provision of financial services that are not currently being provided by the financial institutions such as production finance and trade finance is required.

2) Outline of the Development Bank

a) Status: JSC - State Controlled Bank

b) Capitalization: US\$30 million

c) Investors: Central Bank - 40%, Government - 40%, public - 20%

(NB 1) For the government investment appropriate funds raised through the sale of state owned enterprises in the privatization program

d) Loan Funds: 1) Own funds

2) Long term credits in the form of **2-STEP LOAN** from aid agency. The government must make every effort to obtain such financing from international agencies or donor countries. If the government is able to obtain a US\$20 million long term credit with a 30 year final maturity with a grace period of 10 years at concessional rate, for example, by mobilizing the funds on a revolving basis it can effectively create the effect of a project support of over US\$300 million.

3) (After a period has passed since the beginning of its operations and has gained some international credibility) Issue debentures in the international financial markets under a guarantee from an aid agency. (This is not outside the realm of possibilities if the President and the Prime Minister visit with countries and agencies that hold some promise and diligently make requests and appeal the necessity)

e) Objectives: Promotion of the private sector with particular emphasis on promotion of exports and important substitution of goods and services, and promotion and development of industry and technology that have been positioned as being high target sector in the country's development

f) Functions: For project that meet with the above objectives, in addition to incorporating a function of an export-import bank, will have financing and guarantee function as listed below:

① Financing for purchases of production technology-equipment

- ② Financing purchases of raw materials and components
- ③ Financing the production from receipt of export order through collection of the receivable
- ④ Financing and provision of credit guarantee relating to execution of deferred payment provision under an export-import contract
- ⑤ Financing for required capital for development of new technologies or products.
- ⑥ Other projects that effectively contributes to the development of the country or the private sector

g) Loan Limits: 20 - 80% of the required project funds

h) Loan Terms: ① Currency: foreign currency or foreign currency denominated AMD

- ② Loan Amount: US\$100,000 – 3,000,000 per project
- ③ Interest Rate: 6 - 8% (Depending on the project details)
- ④ Collateral: Will accept varied forms of collateral. For example if the financing is for the purchase of machinery, the machinery purchased (100%), if to finance an export contract, an assignment of the export contract.

i) Syndication: Promote syndication with commercial banks. The combined amount of the loans will not exceed the above loan limits and the Development Bank will hold the first mortgage over the collateral. If the minimum interest rate that the commercial banks (funded out of own resources) are able to charge for their portion of the loans exceeds 8% per annum, then the Development Bank will, to the extent possible, make adjustment in their interest rates in order that the ultimate cost to the borrower is not excessively unfavorable.

For example, if the borrower wishes to finance a purchase of a machinery costing US\$1,000,000, the loan that would be available from the combination of the two sources would be US\$800,000 or 80% of the purchase price. If the commercial banks were to extend US\$200,000 of the amount at an interest rate of 10% per annum, the Development Bank's portion of US\$600,000 would be lent at an interest rate of 7.3%

By using such type of syndication approach, an attempt is made to mobilize the private sector banks. Exclusively the Development Bank will do the credit evaluation and the monitoring of the loan after execution. The commercial banks, therefore, are able to obtain client who is relatively safe at a minimal cost expended for credit evaluation or credit control.

j) Other: In addition to the items above, there are many issues that need to be considered in preparation for the establishment and the operations of the Development Bank. These would include method of establishment, organization, functional authorities and responsibilities, recruitment and compensation of staff, method of evaluation of loan projects, process of loan decision-making, loan agreements, collateral, and methods of monitoring of the borrowers. It is necessary to prepare a planning memorandum for the establishment of the Development Bank that takes into consideration all relevant issues. The planning memorandum should be neutral with no bias and should be prepared by an experienced specialist. If a request for technical assistance is made regarding this, it is likely that a cooperation from a donor would be forthcoming.

3) Examples of Developing Countries

Many developing countries have policy financing system as a tool to implement the development policies. Below are the institutional financial organizations in the Asian countries that play a role in the promotion of industry and export.

Table 5.4.1 Institutional Financial Organizations in Asian Countries

Country	Name of Bank	Main function
Korea	Korea Development Bank	Finance in projects of economic reconstruction
	Export-Import Bank of Korea	Promotion of Heavy Industry Products export
	Korea Long-Term Credit Bank	More than 3 years credits to private banks
Singapore	Development Bank of Singapore	Mainly finance to SME
Thailand	Export-Import Bank of Thailand	Promotion of export & import
	Industrial Finance Corp. of Thailand (IFCT)	Medium/Long-term credit to manufacturers
Malaysia	Industrial Development Finance Berhad	Medium/Long-term credit for development of Industry
	Pembangunan dan Infrastruktur Malaysia Berhad	Long-term credit for infrastructure develop.
	Bank Industri Malaysia Berhad	Long-term credit to capital-intensive industry
	Export-Import Bank of Malaysia	Medium/Long-term credit for export & foreign investment
Indonesia	(Bank of Pembangunan Indonesia)	The bank was absorbed by the State Bank Mandiri in 1998 due to Financial crisis of the country
Philippines	The Development Bank of the Philippines	Industry support, Counterpart of 2-step loan
Vietnam	Bank for Investment & Development of Vietnam	Medium/Long-term credit to industry
	Vietnam Export-Import Bank	Promotion of export & import
India	Industrial Development Bank of India	Long/Medium-term credit to industry

Note: China has the State Development Bank, Export-Import Bank, Agriculture Development Bank

(3) Establishment of SME Financial Supporting System

Most of the small and medium sized enterprises (hereinafter "SME") in Armenia face three types of problems in fund raising. Firstly, due to the poor state of their management and financial condition, they lack the ability to obtain credit. Secondly, consequently it is difficult for the SME to borrow from the private sector financial institutions. Thirdly, even if the credit were available the interest rate is so high that it is rendered effectively impossible to avail themselves to the credit.

Even if the enterprises were privatized with the huge factories that they have inherited, by their current state of management, most of these enterprises are equivalent to SMEs. For the regeneration of the Armenian economy, it would be necessary to bring about the regeneration of these SMEs and a development of new SMEs.

SME Supporting Fund formed in tandem with the scheme to augment the SME's credit outlined below has the objective of meeting the small ticket financing requirements of the SMEs on terms that the SMEs can realistically utilize. This involves establishment of three institutions as outlined below.

1) Create SME Supporting Fund ("Fund") (①)

- The initial size of the Fund will be US\$10 million and will be invested entirely by the government. The funding for this will be from the funds raised through the sale of state owned enterprises. (In the future, through the issuance of tax free debentures increase the private capital portion. It would be more desirable that the capital from Kerkorian Fund will be added to it.)
- The principal purpose of the loans will be short term working capital such as purchases of raw materials or production financing with a per loan limit set at US\$100,000.
- The interest rate will be set at 7 - 10% per annum (It varies with the content of the project, the implementation time and period of loans.).
- Enterprises wishing to borrow under the facility must become member of the Credit Guarantee Association outlined in ② below.
- At the time of obtaining the loan the beneficiary must pay the premium for the insurance provided to ② outlined in ③ below.

2) Create Credit Guarantee Association ("Guarantee Association") (②)

- The Guarantee Association will provide the Fund a guarantee of repayment under the loan agreement on behalf of the borrower

- The initial capitalization will be shared 80% by the government and 20% by the private sector. The amount of capitalization shall be determined by the estimated gross guarantees to be issued. The government's investment will be funded out of the proceeds of the sale of the state owned enterprises.

3) Create State SME Insurance Institution ("Insurance Institution") (③)

- Original establishment with initial fund of US\$1 million invested wholly by the government
- **Insurance Institution** provides a risk hedge for risk of subrogation under the guarantee provided by the **Guarantee Association** to the **Fund**. (The borrower borrowing from the Fund is required to pay the Insurance Institution the insurance premium)
- The operating expenses of the Insurance Institution shall be defrayed by the premia (for the insurance provided by the Insurance Institution for the Guarante Association) paid by the beneficiary (the borrower).

This system provides in the place of credit or collateral that the SMEs are not able to provide against the loans with:

- **Guarantee Association** becomes a guarantor for the obligations on the behalf of the obligor to the Fund
- **Insurance Institution** via insurance provides a risk hedge for the Guarante Association
- **Beneficiaries** (borrowers from the Fund) pays the insurance premium

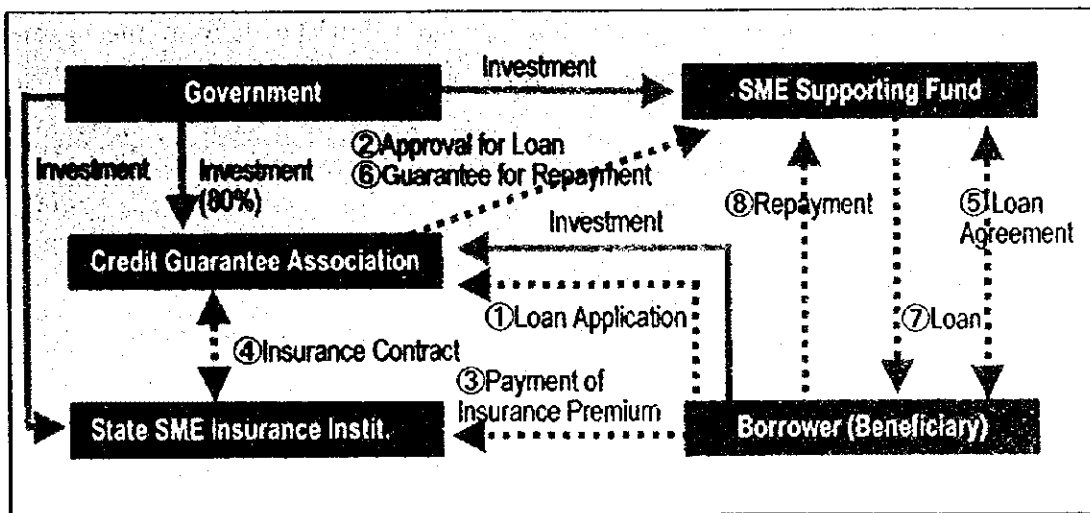


Fig. 5.4.1 Financing Scheme of SME Supporting Fund

The mechanism provides support to facilitate SME's small ticket borrowings from the Fund. The **Borrower** (the Beneficiary) submits a loan application addressed to the Fund to the

Guarantee Association. The Guarantee Association performs the evaluation of the credit, determines the terms of the loan, and reports the results to the Fund. The process from application to execution diagrammatically would be as shown in Fig. 5.4.1.

If the repayment of the borrowing is in arrears for longer than a specified period, the Guarantee Association will pay to the Fund under subrogation. The Guarantee Association will be compensated by the Insurance Institution for 90% of the amount of the obligations thus repaid. The obligation for the recovery of the loan is assumed by the Guarantee Association from the Fund and amounts recovered by the Guarantee Association are repaid to the Insurance Institution.

(4) Creation of Foreign Trade Insurance System

Many of the companies have had their problems multiplied due to the inability to collect payments for exports to Russia.

Trade Insurance provides coverage for these types of risks that are not covered under normal insurance programs to enable the exporters to export and import activities free from these concerns.

There are two types of risks in trade activities.

- **Political Risk:** Risk of the counterpart country experiencing internal revolt, revolution or wars. The risk of counterpart government suspending remittance of proceeds by enacting prohibitions against imports or through currency restrictions.
- **Commercial Risk:** Risk of a trading partner experiencing situations such as bankruptcy.

The risks that Armenia should be most concerned are the "risk relating to recovering or export proceeds" and "risks relating to advanced payments for imports of raw materials".

Type of Insurance	Risks Recoverable Under the Insurance (Political Risk, Commercial Risk)
1) Export Proceeds Recovery Insurance	- In case there is a valid export contract and goods have been produced but unable to export - Export proceeds become unrecoverable after the shipment
2) Advanced Payment Insurance	- Funds advanced for the importation of goods become unrecoverable

Through the introduction of this insurance system, enterprises involved in exports can go on with their business without undue concerns regarding these risks. Provision of such security will play an important role in the development of the export industry in Armenia. This will be of particular value for trade with countries that have high country risk such as the Russia, CIS states, and some neighboring countries.

Trade insurance, by its very nature, is not amenable to the private sector and, in most countries, such insurance schemes are operated directly by the government or by an equivalent agency. In the case of Japan, it is managed by the Ministry of Trade and Industry, in the United States it is managed by the US EXIM Bank, in the United Kingdom by the ECGD, in Germany by HERMES, and in France by COFACE. The coverage ranges from 80 - 97% of the contract value.

The funding for the insurance will, as a matter of course, will be from the Armenian national budget.

(5) Enhancement of ADA

ADA has been created based on the recognition of the importance of the role of exports and foreign direct investments for the reconstruction of the Armenian economy; however, ADA has been given a meager budget and it cannot even afford repairs to copying machines, let alone pay staff expenses. As a result, it is given a respectable organization chart but only a small number of small groups are functioning and it is being supported through the patriotic sacrificial efforts of the few management and middle management staff.

In order for ADA to become an "ONE-STOP-SHOP" for the foreign investors and domestic exporters, this situation must be remedied immediately.

- 1) The status and the function must be enhanced.
- 2) The operating budget must be increased.
- 3) The quality and the numbers of the staff must be enhanced.
- 4) Must be furnished with information and data.
- 5) Be equipped with a functional international communication facility.
- 6) Have the capability to formulate policies.

Below we discuss the requirements in some detail.

1) Enhancement of the Status and the Functions

ADA, in addition to being the implementing agency of the investment and export development policies under the SIPPB, that is chaired by the Prime Minister, is under the direct jurisdiction of the two ministries that equally invest in ADA. This severely constrains the independence of its actions. In the present situation, if ADA makes a policy proposal that the Deputy Minister of the Ministry of Industry and Trade supports, but if the Deputy Minister for Ministry of Economy opposes the policy proposal, under the existing arrangements there is little ADA can do. Jurisdiction over ADA should be limited to a single supervisory body and given the importance of ADA's future role for Armenia, it should be placed under the direct supervision of the Prime Minister. As for its role, ADA must be provided with the authority to and functions to enable it to

provide its services relating to foreign direct investments and export promotions in an integrated fashion.

2) Increase of Operating Budget

Although under the current deficits of the Armenian government fiscal system securing a budgetary increase must be difficult, but at the least, sufficient budget to pay salaries to all staff and equip the agency to provide a normal business environment (office equipment, desks, chairs and stationary) must be secured. The copying equipment has not been maintained and just about ready to break down. Under such conditions normal business operations are not possible. Government's understanding and taking of appropriate measures would be anticipated.

3) Enhancement of Staff

Enhancing the quality of the staff is critical. It is necessary to supplement the staff with specialists from the fields below who have understanding of the real economy and business in both domestic and overseas markets.

- Foreign investment advisor2 (specialist with wide ranging knowledge of investment climate of Armenia, full time)
- Legal specialists.....2 (provision of explanation to foreign investors, response to queries, part-time)
- Tax consultant.....1 (provide explanation of tax system, tax amount calculation and consultation about tax problems to foreign investors, full time)
- Industry-Enterprise specialists...several (full time), several (part-time)... those who working for private enterprises in various sectors
- Development specialists.....2 (policy planning of promotion of foreign investment and trade ... invite proper people, full time)
- Trade specialists.....2 (well versed in the practice of international trade transactions, provide counseling to exporters, full time)
- Marketing specialist1 (full time)

There are capable staffs with the several consulting firms and one possibility is to recruit them to work as advisors on a part time basis.

It is also important to upgrade the quality of the existing staff. Particularly the younger staff needs training in the basics of business. It is also necessary to have the staff obtain a first hand experience in the production and sales in the business environment. They must learn to appreciate through experience the importance of profit and risk management before they are able to provide useful advice to the foreign investors or domestic exporters.

ADA has been deploying much foreign ODA budget to human resources development but there are areas where more can be done. JICA has the system of both short term and long term training programs (receiving trainees and sending specialists) and JETRO also offers trainee system, which ADA had taken advantage of last year. JETRO carries out an investment promotion business and they send and receive missions and prepare investment guidebook in Japanese.

4) Preparation of Information and Data

ADA lacks information and data regarding Armenia's economic conditions and investment climate. There have been attempts to create a database, but due to the lack of staffing a useful database still does not exist. (It may be worth to consider attracting a capable staff from the Ministry of Statistics, State Register and Analysis. This will facilitate access to the data prepared by the Ministry.)

5) Normalization of International Telecommunication Facility

Sending a facsimile to ADA is a challenge. The fax and telephonic functions are shared and the switch over from telephone to fax mode is done manually so that when sending one must first call up and talk to whoever answers the phone to switch over to the fax mode and then press "send" to initiate the transfer. (There are very few countries where such equipment is used in a business environment). If there is no one in the ADA office, the fax cannot be sent during working hours.

This type of reception will give an unfavorable impression and might be sufficient to deter potential foreign investors. ADA should be equipped with at least two dedicated facsimile machines. Giving notice of a move or change of location and numbers for telephone and facsimile is considered an international etiquette.

ADA had introduced a LAN last year-end within the organization but the system has the following flaws:

- Due to the capacity of the server, the speed is slow and frequently cannot transmit complex data. The server must be replaced by a computer with sufficient capacity.
- The computers operating in Armenia are full of computer viruses. This is due to many people using the computer or the Internet without using virus checks or vaccines. ADA communicates worldwide and widely exposed to viruses and at the same time has many occasions to spread the virus worldwide. ADA should contract with a virus vaccine provider to have all computers download periodically the newest virus vaccines.

6) Policy Formulation Capacity

ADA must have the capacity to collect and analyze data and information that include overseas information and formulate and present to the government a policy (draft) to prepare the investment

climate in Armenia for foreign investment and exports that are outlined in sections 5.3.1 and 5.3.2.

For this purpose, it is necessary for ADA to have an Advisory Committee composed of experts including academics, businessmen in addition to having in-house expertise.

(6) SME Venture Activities Support Center

The feature of a phenomenon based on clusters and networks of independent but interdependent SMEs is to promote the effective utilization of technology as the whole sector through optimal division of labor by the respective enterprises, while each enterprise is to retain a competing relation with other enterprises, rather than the specialized technology being dispersed by individual enterprises only for their own use. Through the creation of the SME Venture Activities Support Center on the government's initiative, this cooperative relationship among the enterprises will be developed and enhanced to provide counseling support (including financial assistance of small amount) for new venture activities or for common concerns relating to management or technology shared by SME managers and create the environment for the promotion of the industrial sector.