



FDI AND EXPORTS IN ARMENIA

POLICY PAPER

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Introduction

Armenia is a small, yet relatively open economy. Prior to the pandemic, trade openness in Armenia, measured by the sum of exports and imports of goods and services relative to GDP, had increased to 93.4% of GDP in 2019 from 67.4% in 2010, benefitting from strong growth in exports. That allowed the country to climb the openness ladder vis-à-vis peer countries in the EU Eastern Partnership region, second only to Belarus and Georgia. However, the pandemic affected the country's export sector dearly, with nominal exports collapsing by more than 30% in 2020, which led the trade openness measure to fall back to the same level exhibited a decade earlier. Border conflict may have also contributed to export downside and overall uncertainty.

Armenian exports are undermined by political circumstances. Armenia, a landlocked country bordering four countries, is currently unable to trade via Azerbaijan and Turkey. Furthermore, trade relations with Iran, at the southern border, are also constrained despite ongoing efforts to increase trade ties not only between the two countries, but also at the Eurasian Economic Union level. Exported goods are thus essentially shipped overland through Georgia, the northern border, or by air. The main export markets for Armenian goods are the Commonwealth of Independent States (CIS), the European Union (EU), Switzerland, and China. Together these markets absorbed 75.5% of Armenian goods exports in 2020. Compared with a decade ago, Armenian exports have pivoted away from the EU into the CIS, namely Russia, and China.

Mining products dominate Armenian exports of goods. Copper tops the list of Armenia's revealed comparative advantages. And the share of mining products in total goods exports has risen to 28.9% in 2020 from 12.4% in 2010. Exports of precious stones and metals have also risen strongly. These trends have resulted in a greater degree of export concentration around certain categories of goods. Armenia's export sector is thus increasingly focused on less complex products, risking the potential for structural economic transformation through international commerce. Yet bright(er) spots have also developed, such as services rendered to foreign customers within information and communication technologies (ICT) which have boomed.

The ICT sector has played a role in the attraction of foreign direct investment (FDI), but other sectors are also relevant. Between 2003 and 2017, 54% of total FDI went into ICT, finance, and business services. In addition, metals and mineral products absorbed 17% of total, and the renewable energy sector 9%. Inward flows of FDI have gradually declined over the past decade. This general trend has been attributed to divestments in the banking industry, and to a reduced scope for privatisation-led transactions. Yet the FDI stock, at 42.5% of GDP in 2020, remains slightly above the median level observed amongst peer countries. Moreover, FDI dynamics are seemingly changing. In 2020, about 40% of new FDI went into electricity production.

Russia is Armenia's critical partner in both trade and FDI. Goods exports to Russia grew to 28.0% of total in 2019 from 15.4% in 2010. Russia is also Armenia's main foreign investor, having represented 37.0% of total FDI in 2019. Nowhere in the EU Eastern Partnership region is Russia as relevant to a host country than in Armenia. Cyprus, where a large Armenian diaspora is present, ranks a distant second in the list of top investing countries, having accounted for 9.5% of total FDI in 2019. Exports and FDI have played a subdued transformational role in Armenia, especially at the level of small and medium-sized enterprises (SMEs). The share of exporting SMEs is low. And the participation of Armenian businesses in global value chains is also small.

Policy Proposals

Update FDI legislation. The 1994 Law on Foreign Investments is outdated and requires reform. FDI laws must be competitive and up to date with best practice. Yet Armenia's long-standing legal framework does not acknowledge the role of investment promotion. This should change so that the legal framework can provide a working context for public agencies active in the field. In addition, regulation should also play a role in opening-up protected sectors, such as electricity, railways, as well as oil and gas, which operate as "de facto" monopolistic markets, to competition and foreign investors. Regulation should on the other hand provide for increased investor protection by allowing arbitration procedures to occur outside Armenia, not just locally.

Involve private sector representatives in the agenda of knowledge creation. The success of Armenia's ICT sector, wherein exports of services grew between 2010 and 2020 at an annual rate of approximately 10%, has been moulded by the country's strong human capital base in ICT. This example should inspire policymakers in building additional knowledge bases to support the economy's growth in other domains. In this regard, interviewees have suggested that there is a mismatch in the supply of, and the demand for, labour skills across different sectors, such as in agriculture or tourism. To address the mismatch between supply and demand, market-oriented operators in the private sector and policymakers in charge of education initiatives should team-up in defining curriculums, boosting knowledge transfer, and designing an internship system.

Develop a plan to support better logistics and transport infrastructures. Armenia has improved in international rankings as regards trade facilitation and logistics performance. Yet difficulties persist such as the (lengthy) time to clear exports through customs, and a relative inability to track and trace cargo consignments, and untimely shipments in reaching their destination. Unsurprisingly, road and airport connectivity are also poor. Export performance, as well as FDI attraction, benefit from efficient background conditions in these domains. A support plan should thus include investments aimed at enhancing transport infrastructures, streamlining export and import procedures, digitising customs, and improving border management.

Support SMEs in the digital transition. Armenia outperforms peer countries in terms of the population covered by 4G mobile network technology. And internet access from home is also a reality for more than three quarters of all Armenian households. Nonetheless, the business penetration of ICT remains limited. The employer association, by raising awareness on the digitisation of business, and building capacity at the SME level to make the most of the worldly opportunities provided to small business and the self-employed by digitalisation, would likely contribute to facilitating export growth as well as making Armenia more attractive to outside investors. Such an effort, in conjunction with the Government, would also ease the obstacles associated with being a landlocked country enduring under challenging political circumstances.

Eliminate the administrative friction acting against FDI. On the surface, Armenia is relatively well placed amongst peer countries in relation to regulatory restrictiveness, an indicator that usually depicts the level of regulatory hurdles businesses face sector-wise to setup and fully operate. Regulations for starting a business, registering property, enforcing contracts, or protecting property rights are thus seemingly simple. However, the sheer density of the legal framework in Armenia, characterised by a multiplicity of laws and lengthy regulations (such as the tax code), coupled with low availability of English translations, justifies a note of caution. Furthermore, some sectors of the economy remain beyond FDI reach.

Adopt internationally accepted technical standards. Armenia's standing in global value chains (GVC) is weak, which acts against both export growth and economic diversification. Following the creation of the customs board at the Eurasia Economic Union level, and the mutual recognition of member countries' standards, Armenian goods exports have drifted eastward. That trend has fomented a gradual distancing of Armenian products away from the European Union, with whom Armenia also has a partnership relation, where different standards apply. As a result, Armenia is left at a disadvantage in GVC integration led by Western firms or those following the same technical regulations and standards adopted in the European Union.

Incentivise government supported e-solutions to promote exports and GVC integration. The provisioning of e-government in Armenia is broadly in line with the median level observed across the EU Eastern Partnership region and has significantly improved over the past decade. Overall, the level of e-participation in public administration, and between the government, households, and the private sector, has increased vastly. Making the government a driver of innovation via public procurement of promising digital solutions, to address public policy challenges, could perhaps stimulate a closer collaboration between government and the private sector in overcoming existing logistical obstacles (as discussed above).

Make export promotion and investment promotion two fundamental, yet separate pillars of public policy. Armenia's export public policy is outdated, having been adopted in 2011. While there are ongoing discussions regarding a new 2020-2024 strategy, this one has not yet been adopted by the government. Export promotion is thus managed by the Export Insurance Agency of Armenia, which focuses on the niche segment of export insurance, and by Enterprise Armenia, the investment promotion agency. Export and investment promotion should be clearly separated and provided with formal status. Critically, managing agencies need a clear mandate, as well as adequate resources.

Develop an export readiness assessment tool. Export promotion agencies usually provide for such a service. And a properly designed export readiness tool would address different business profiles, from first-time exporters to already exporting businesses, separately. Assessing export readiness involves making judgement on management practices, product or service fit to new markets, and knowledge or experience in dealing with different import regulations and local idiosyncrasies. In addition to a digital self-assessment tool, an active export promotion agency would also deliver free-of-charge webinars focusing on explaining international trade terms as well as available financing and risk management options. Export promotion agencies could also leverage bilateral trade agreements by partnering with similar entities in other countries.

Partner with the Armenian diaspora. The diaspora plays an important role in Armenia, by opening-up investment and knowledge networks. Armenia is a beneficiary of large remittances, valued at 11% of GDP in 2019, placing the country within the world's top-20 list of recipient countries. Russia, where many Armenia, settle for work is the largest foreign investor in the country. Cyprus, where another large Armenian community resides, is the second largest foreign investor in Armenia. And ICT services exports to the US, accounting for almost half of total, are also likely not indifferent to the large presence of Armenians in America. Interested nationals living abroad can act not only as local investors and business mentors, but also as facilitators in accessing foreign markets. These business and cultural ties are an important element of a country's soft power and should be nurtured by all relevant institutional stakeholders.

Leverage Armenia's participation in regional trade agreements. Armenia has been a member of the Eurasia Economic Union since 2015. And made effective in 2021, also a member of the EU

Partnership Agreement. This places the country at a regulatory crossroads in many ways, however, it also places the country closer to two major economic blocks. Armenia, being a small yet open economy, should thus take the opportunity in making the most of such plentiful opportunities. For example, public policy could provide a diagnostic tool to assess the level of preparedness of Armenian SMEs in entering GVCs, and it could create incentives leading SMEs to engage collaboratively and cooperatively when accessing new foreign markets.

Bullet line summary

- Update FDI legislation.
- Involve private sector representatives in the agenda of knowledge creation.
- Develop a plan to support better logistics and transport infrastructures.
- Support SMEs in the digital transition.
- Eliminate the administrative friction acting against FDI.
- Adopt internationally accepted technical standards.
- Incentivise government supported e-solutions to promote exports and GVC integration.
- Make export promotion and investment promotion two fundamental, yet separate pillars of public policy.
- Develop an export readiness assessment tool.
- Partner with the Armenian diaspora.
- Leverage Armenia's participation in regional trade agreements.