

USAID - Armenia  
**SME SECTOR ASSESSMENT**

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### Glossary of Terms

AATA/ASTA	Armenian Association of Tourist Agents / American Society of Tourist Agents
ACBA	Agricultural Cooperative Bank of Armenia
ACDI/VOCA	Agricultural Cooperative Development International / Volunteers for Overseas Cooperative Assistance
ADA	Armenian Development Agency
AMD	Armenian Dram
AED	Academy of Educational Development
AFIC	Association for Foreign Investment and Cooperation
ADR	Alternative Dispute Resolution
BMZ	German Ministry for Economic Cooperation and Development
BSC	Business Support Center
BSO	Business Support Organizations
CBA	Central Bank of Armenia
CoP	Chief of Party
EBRD	European Bank for Reconstruction and Development
EU	European Union
FINCA	Finance for International Community Assistance
FSMB	Foundation for Small and Medium Businesses
GAF	German Armenian Fund
GBTI	General Business Trade and Investment
GoA	Government of Armenia
GTZ	German Technical Cooperation Agency
IESC	International Executive Service Corps
IFAD	International Fund for Agricultural Development
IFC	International Finance Corp.
IMF	International Monetary Fund
IOM	International Organization for Migration
IPC	International Projekt Consult
JICA	Japanese International Cooperation Agency
KfW	Kreditanstalt für Wiederaufbau (German Bank for Reconstruction and Development)
MBO	Member Based Organization
MFE	Ministry of Finance and Economy
MSME	Micro, Small and Medium Enterprises
PVO	Private Voluntary Organization
PwC	PricewaterhouseCoopers LLP
SEF	Small Enterprise Fund (World Vision)
SME	Small and Medium Enterprise
SOE	State-owned Enterprise
SOW	Scope of Work
TACIS	Technical Assistance for the Commonwealth of Independent States
TTT	Train-the-Trainer
UMBA	Union of Manufacturers and Businessmen of Armenia
UNDP	United Nations Development Program
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development
WB	World Bank

## 1. EXECUTIVE SUMMARY

### USAID's Goals for This Activity

As outlined in its overarching, strategic goal, USAID Armenia seeks to address wide-spread poverty in Armenia by supporting the creation of new jobs, “both through improvements in the business and investment environment and through increased attention to grassroots efforts to create jobs, whether through small and medium enterprise (SME) growth or other experimental approaches to be explored over the strategy period.”<sup>1</sup>

USAID has developed two Strategic Objectives, which directly and indirectly address this strategic goals:

- **SO 1.3 Growth of a Competitive Private Sector; and**
- **SO 1.4 Investment Increased.**

USAID, in its Scope of Work (SOW) for the SME Sector Assessment for Armenia, specified three tasks.

1. Conduct a comprehensive SME review to identify sectors and sub-sectors that are either growing or have the potential for near-term, rapid growth and can be expected to generate significant employment, income and export growth over the next three to five years.

Within this task, USAID/Armenia stated two objectives in supporting SME development; the first was to identify where Armenia's economy is growing or could grow in the near-term, in order to design and implement programs that will increase and sustain this growth for short- and medium- term impacts. The second was to ensure that the sectors and sub-sectors identified as SME growth areas have the scope for significant employment expansion and will be well placed to take advantage of any easing of political and structural barriers.

2. Review and assess the specific constraints that the identified sectors and sub-sectors face, including both constraints that are common across growing sectors and sector-specific constraints.
3. Make specific recommendations for design of new USAID-financed SME initiatives that complement the current USAID SME portfolio.

### The SME Environment

Much of the hope for real and rapid economic transformation rests with the emerging new small business sector. Much of Armenia's small businesses are **newly-created** SMEs. Despite this, the government has yet to develop a legal definition of SMEs. As a result, few laws or regulations that are specific to SMEs have been enacted.

Based on its analysis, the Team also determined a number of systemic barriers to SME development, including both environmental barriers and firm-level barriers. The impediments will have to be addressed for any of the SME sectors (and sub-sectors) to thrive.

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<sup>1</sup> USAID/Armenia, *Strategic Plan FY 1999 – FY 2003*, Yerevan, Armenia, March 1999, p.7,8.

Barriers to the SME Enabling Environment	Barriers to SME Firm Development
<ul style="list-style-type: none"> <li>• Legislative Barriers</li> <li>• Lack of Strategic Planning for SME Sector</li> <li>• Educational System Failures</li> <li>• Border Blockade</li> <li>• Closed Sky Policy</li> <li>• Emigration</li> <li>• Country Profile</li> <li>• Under-developed Civil Society</li> </ul>	<ul style="list-style-type: none"> <li>• Business Skills Gaps</li> <li>• Weak Business Support Systems and Information Gaps</li> <li>• Corruption / Lack of Corporate Governance</li> <li>• Lack of Investment &amp; Finance</li> <li>• Limited Domestic Market Demand</li> <li>• Unexploited Export Opportunities</li> <li>• Under-served Markets - Women-Owned and Non-Yerevan Firms</li> <li>• Communication Barriers (ICT)</li> </ul>

### The SME Sectors and Sub-Sectors

Based on an initial review, the follow sectors were selected for review and SWOT analysis:

- Manufacturing/Light Industry
- Handicrafts
- Services
- Construction Materials
- Tourism
- Jewelry & Gem Processing
- R&D
- Communications

The SME Assessment Team conducted a full analysis of these sectors, in order to identify those with the greatest potential for both economic and labor-growth potential. After its analysis, the team determined that the following sub-sectors show the most promise in terms of targeted support are:

- Textiles and Shoe Manufacturing (sub-sector of Light Industry);
- Jewelry & Gem Processing;
- Tourism;
- IT & Software Design (sub-sector of Communications Industry).

### Potential Solutions

The SME took all the information gathered in the environmental analysis and the sectoral analysis, and determined where USAID could have the biggest impact in terms of driving further development of the SME sector. The team has developed several concept papers to address that seek to address cluster-specific issues (these are included at the end of this document).

1. The Armenian Competitiveness Initiative
2. Textile and Shoe Subsector Cluster Project
3. Jewelry, Gem Cutting and Stone Processing Subsector
4. A Focus on Tourism
5. Equity & Debt Funding
6. Training on Socio-Economic and Gender Analysis

## 7. OBJECTIVES AND METHODOLOGY

### 1.1 USAID SOs and IRs

As outlined in its overarching, strategic goal, USAID Armenia seeks to address wide-spread poverty in Armenia by supporting the creation of new jobs, “both through improvements in the business and investment environment and through increased attention to grassroots efforts to create jobs, whether through small and medium enterprise (SME) growth or other experimental approaches to be explored over the strategy period.”<sup>2</sup>

USAID has developed two Strategic Objectives, which directly and indirectly address this strategic goals:

- **SO 1.3 Growth of a Competitive Private Sector; and**
- **SO 1.4 Investment Increased.**

Within SO 1.3, USAID has developed a number of individual IRs that directly support increased competitiveness including improving business skills (IR 1), improving the business climate (IR2), and increasing access to broader markets (IR3). Likewise for SO 1.4, has attempted to create an enabling environment through the development of specific IR activity; IR 2, increased access to financial capital will clearly work in concert with SO 1.3 to ensure that Armenia’s private sector has the financial wherewithal to support increased competitiveness. It is these SOs and IRs that the SME Assessment team will consider in developing appropriate results package frameworks.

### 1.2 Project Objectives

USAID, in its Scope of Work for the SME Sector Assessment for Armenia, specified three tasks.

4. Conduct a comprehensive SME review to identify sectors and sub-sectors that are either growing or have the potential for near-term, rapid growth and can be expected to generate significant employment, income and export growth over the next three to five years.

Within this task, USAID/Armenia stated two objectives in supporting SME development; the first was to identify where Armenia’s economy is growing or could grow in the near-term, in order to design and implement programs that will increase and sustain this growth for short- and medium- term impacts. The second was to ensure that the sectors and sub-sectors identified as SME growth areas have the scope for significant employment expansion and will be well placed to take advantage of any easing of political and structural barriers. In particular, the review would:

- a) Outline major exports, including to what extent the lack of ISO 9000 certification might affect their competitiveness;
- b) Review joint ventures that have been established and the sectors and markets that they are exploiting;
- c) Identify geographic growth basis;
- d) Detail items currently produced for the local market;
- e) Identify what types of businesses are being established;

<sup>2</sup> USAID/Armenia, *Strategic Plan FY 1999 – FY 2003*, Yerevan, Armenia, March 1999, p.7,8.

- f) Conduct key informant interviews;
  - g) Assess areas where Armenian produced goods are or can compete most effectively with imports
  - h) Describe and assess the focus of current credit and technical assistance programs;
  - i) Identify particular sectors and sub-sectors with high SME development potential that are growing and why; and
  - j) Outline the involvement of women or vulnerable groups in the identified sectors.
5. Review and assess the specific constraints that the identified sectors and sub-sectors face, including both constraints that are common across growing sectors and sector-specific constraints.
  6. Make specific recommendations for design of new USAID-financed SME initiatives that complement the current USAID SME portfolio.

### 2.3 Methodology

The Armenia SME Sector Assessment Team adopted the following methodology to best accomplish USAID's stated objectives.

Initially, we undertook a review of current USAID Armenia economic reform activities relating to SME development. Next, we assembled and reviewed over one hundred documents (including assessments, studies, strategies, reports, sector and sub-sector surveys) provided by a range of Armenian national organizations, international donors and fund providers.

Using the collected data, the levels of stakeholder involvement (in terms of donors, government agencies, and private sector players) were defined; next stakeholder groups were further analyzed and divided into Macro, Intermediate and Sectoral segments (the sectoral level was further divided into industry sectors and sub-sectors).

#### A. Macro Environment Analysis, including:

- Government of Armenia (GOA) Ministries and Agencies
- International, Multilateral Donor Organizations
- Bilateral Donor Organizations

#### B. Intermediate Analysis, including:

- Financial Institutions
- Business Support Providers
- Business Associations & Supporting NGOs
- Enabling Environment activities

#### C. Sectoral and Sub-sectoral Analysis, including:

- Manufacturing & Light Industry
  - Textiles
  - Shoes
  - Furniture
  - Machine Tool Production

- Electronics
- Pharmaceuticals
- Communications
  - ICT
    - Computers
    - Internet Providers
    - Software Production
  - Media
    - Telecommunications
- Services
  - Printing
  - Advertising
  - Real Estate
  - Consulting (audit, accounting, legal, financial, training, trade promotion and firm level technical assistance)
  - Transportation
  - Trade & Commerce
  - Café & Restaurants
  - Social/Community
- Construction Materials
- Research & Development
- Jewelry/Gems/Stone Processing
- Handicrafts
- Tourism
  - Hotels
  - Travel Agencies
  - Tour Guide Services

The team supplemented the document review with meetings with over 150 representatives of the three segments, ranging from an Advisor to the President and various Ministers at the macro level, organizational representatives at the intermediate level, and actual owners and managers of firms at the sectoral level. At the Macro and Intermediate levels, we interviewed representatives in order to better understand their organizations and functions, as well as to determine where short-term opportunities and constraints within an SME development context. At the sectoral level, we asked similar questions of firm owners and managers, as well as questions regarding the specifics information about their own businesses. In the case of both associations and enterprises, a standardized questionnaire was developed in order to provide uniform information and quantify responses.

While results of this data review cannot be considered statistically significant because population numbers within each sector and sub-sector were limited (geographically and quantitatively) by the time availability constraints, we found that the results were generally consistent with responses at the Macro and Intermediate levels as well as within the individual sectors and sub-sectors. In each case, the SME Sector Assessment Team utilized a SWOT analysis (one Macro-level SWOT; two Intermediate-level SWOTs, and ten sector and sub-sector level SWOTs) to focus on issues within each sector and sub-sector. The process also allowed a broader review and

evaluation of the SME climate existing within Armenia so that designs for potential resulting projects could be developed.

#### *2.4 Yerevan Focus*

The SME Sector Assessment for Armenia, by implication, must include an overview of specific economic reform activities throughout Armenia relating to SME development. Because travel to the regions was limited to two days of travel time in Vanadzor, however, few of the interviews or industry analysis was done outside of Yerevan. The reasons for the geographic limitation were:

- broad agreement that at least one half of the Armenian population physically resides in Yerevan;
- the team's ability to review current USAID/Armenia, World Bank, TACIS (particularly SODETEG) and other donors, as well as donor and documentation on SME development while based in Yerevan;
- the need to broad spectrum visits with various GOA officials, ranging from the Economic Advisor to the President, to various ministers who influence SME development, all of which are located in Yerevan;
- the team's ability to review legal and regulatory issues while in the capital;
- the need for cross-sectoral visits and interviews with a sampling of business support providers, associations and actual SMEs all within the city;
- a limited number of relevant SME sector players outside of Yerevan; and
- time and budgetary constraints attached to the Scope of Work (SOW), stating that no more than three days should be allotted for travel outside of Yerevan.

## 2. BACKGROUND

### *2.1 The Role of SMEs in Development*

Despite the attention paid to the restructuring of large enterprises, in Armenia, much of the hope for real and rapid economic transformation rests with the emerging new small business sector. Much of Armenia's small businesses are **newly-created** SMEs. These firms have been at the forefront of the country's economic transformation; they have in common that many were fortunate enough to have strong leadership, and in many cases access to Western partners' expertise, technology and capital. This is true throughout the region; in fact, most of the region's growth has been attributed to newly created private companies with access to Western technologies and information, not the former state sector.<sup>3</sup> The restructuring and development of the privately-held companies is critical to Armenia's development. Firm-level performance over the next decade will largely dictate how Armenia will continue to develop.

### *2.2 Country Overview*

Armenia is a small, landlocked, mountainous country with few natural resources covering an area of 29,800 square kilometers. It is situated in the Caucasus Region, surrounded by Georgia, Azerbaijan, Iran and Turkey. The population is now officially estimated at three million people and is overwhelmingly comprised of ethnic Armenians. Armenia has had a troubled relationship with some of its neighbors, including a continuing conflict with Azerbaijan over the ethnic Armenian enclave of Nagorno-Karabakh located inside Azerbaijan. Although a cease-fire has held since 1994, Armenia continues to face a trade embargo and closed borders with both Azerbaijan and Turkey, in effect since 1989.

In a referendum in September 1991, Armenian voters opted for independence from the Soviet Union. In addition to an escalation of its geopolitical problems, independence coupled with the break-up of the Soviet Union brought an end to the commercial ties and protected markets which had helped to make Armenia among the most prosperous of the former Soviet republics. With the end of low Soviet prices for energy, transport raw materials and guaranteed markets for its products, the Armenian industrial sector collapsed. A severe energy shortage and economic turmoil precipitated a new humanitarian crisis in a country then still recovering from the economic and social fallout of an earthquake in 1988 that resulted in the deaths of over 25,000 people and rendered 500,000 homeless. Over a decade after the disaster, more than 30,000 families still live in temporary shelters in the earthquake zone.

Initial public enthusiasm for economic reform and democracy was high in 1991. However, Armenia's checkered post-independence election history in combination with continuing economic stagnation, declining living standards, crumbling public services and endemic corruption have undermined the public's confidence in government and engendered widespread cynicism regarding the democratic process. Unemployment and underemployment together may affect 50-70 percent of the workforce and over half the population is estimated to live below the poverty line. The state financed social safety net is weak, and the education and health systems have deteriorated considerably as state support has diminished.

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<sup>3</sup> The spectacular industrial growth Poland has experienced in the last six years, for example, has been a function of the explosive growth experienced by newly-created private companies, not due to growth among the newly privatized firms. In 1994 the output of the new private sector in Poland grew by over 35 percent, while that of the former state sector contracted by six percent.

## A. Economic Restructuring

Armenia was one of the most industrialized republics of the Soviet Union, exporting industrial, military and high technology goods, mainly to other Soviet republics, and in turn relying heavily on them for key inputs. During the 1970s and 1980s industry accounted for more than two-thirds of Net Material Product (NMP) and employed half a million workers. A major setback to the industrial sector occurred in 1988 when nearly 40 percent of production capacity was lost as a result of the earthquake. The subsequent break-up of the former Soviet Union (FSU) combined with the collapse of its trade, payments and financial system dealt a crippling blow to Armenia's industry. Armenia's Gross Domestic Product (GDP) is reported to have decreased by an estimated 60 percent between 1991 and 1993 and was accompanied by the decline of a number of large industries, which employed the majority of the Armenian workforce.

Although market-oriented reforms were initiated in January 1992, further progress was delayed due to the conflict in Nagorno-Karabakh and the trade blockade imposed on the country. Unsustainable public expenditures and freely falling revenues combined with monetary chaos in the ruble zone to balloon Armenia's budget deficit to 48 percent of GDP in 1993. Armenia's reform efforts regained momentum in 1994 with the implementation of austere fiscal and monetary policies complemented by the introduction of the dram as the new national currency. These policies reduced inflation from almost 11,000 percent annually, in 1993, to about 32 percent at the end of 1995. Substantial progress has been made since 1994, both in structural reforms and macroeconomic stabilization.

Since 1994, there has been sustained reduction in the budget deficit and inflation has been reduced considerably -- reportedly 8.7 percent on average for 1998. Armenia's implementation of a suitable macroeconomic policy framework has been rewarded by positive GDP growth in successive years: 5.4 percent in 1994, almost 7 percent in 1995, 5.8 percent in 1996, 3.1 percent in 1997 and an estimated 5.5 percent in 1998. The first six months of 1998 witnessed a narrowing of the trade deficit, though this favorable trend is likely to have been reversed in the latter part of the year as the Russian economic crisis began to unfold. Since independence, external debt accumulation has grown rapidly but is expected to be manageable over the medium term. Foreign direct investment may have been as high as \$140 million in 1998 compared to \$51 million in 1997.

In order to consolidate its stabilization gains, the GOA has moved to address, albeit unevenly, a comprehensive agenda of structural reforms. The focus of its 1999 development program is on continued progress in the areas of privatization, financial sector reform and energy sector restructuring. Simultaneously, emphasis is being placed on the reform of the health and education sectors in order to preserve Armenia's human capital base and ensure that the costs of the transition are socially sustainable.

The Armenian Gross Domestic Product (GDP) was placed at US\$ 1.6 billion for 1997. Real GDP growth for 1998 was 7.2 percent, with the crisis in Russia during the latter half of the year slowing the growth considerably. This growth was largely based on high growth in agricultural output and investments due to privatization and industrial restructuring. Growth for 1999 was expected to slow due again to the Russian crisis—a 4.0 percent projected for the year. For 1997, the composition of GDP was 25.2 percent from Industry, 30.1 percent from Agriculture, and 24.7 percent from Services and other.<sup>4</sup> For 1998 the composition of the GDP was placed at 31.1 percent from Industry, 34.5 percent for Agriculture and Forestry, 28.3 percent for Services, and 6

<sup>4</sup> Armenian Development Agency, *Country Profile – Armenia*, 1999. (Data source is EBRD).

percent for construction. The European Intelligence Unit (EIU) forecasts a 1999 growth rate of 8 percent.

In spite of the generally positive economic indicators and forward progress on structural reform, unemployment and poverty continue at very high levels, and the gap between the rich and the poor has increased substantially. In 1999, per capita GDP fell by 2.6% from 1998, to US\$ 488. The average monthly nominal wage was 18,526 drams (approximately US\$ 35), which is well below the subsistence level of approximately US\$3/day established for the region of Central and Eastern Europe.<sup>5</sup> Poverty affects both rural and urban areas and has had the most profound impact on women, families with children and the elderly. In addition, massive layoffs and forced retirements from state-owned enterprises have had a significant impact on economic growth rates as well as the country's rate of unemployment. Unemployment is particularly high for those 30 to 50 years of age and women (who account for 64.4% of the unemployed), and unemployment is often long-term, with almost of 60% of its ranks remaining without a job for more than one year. The average monthly unemployment benefit is USD 6, or less than 5% of the subsistence level.

The former Soviet industries, with their high employment rates, are not likely to return. Thus, a key problem facing Armenia since its independence is how to initiate and sustain appropriate new industries, technologies and services that will grow, create new jobs, raise living standards, and allow the country and its citizens to flourish with them as part of a broader regional and international community. Private sector operations in Armenia are a new phenomenon, and there is a generalized lack of market-wide as well as firm-specific knowledge, understanding, and systems that will support the growth of the private sector at the present. In addition, despite several recent years' work, there remains an inadequate and incomplete "enabling environment" which will encourage private investors to participate more actively and productively in the economy. It is clear that many people survive via the informal sector, the characteristics and scope of which is undocumented.

While efforts to address both firm-specific and "enabling environment" problems will eventually help to reduce the currently high levels of unemployment and underemployment, and, hence, the high incidence of poverty in Armenia, these will not provide immediate (i.e., within the next 2-4 years) relief to the very tangible and widespread problems of unemployment and resultant low standards of living. In the absence of other, more immediate interventions, unemployment, underemployment and poverty levels -- and, with them, public cynicism and apathy -- can all be expected to remain high, though begin to decline modestly, over the coming five years.

Meanwhile, domestic growth is severely constrained by the closure of Armenia's borders with Azerbaijan and Turkey, both of which could be significant trading partners and transit routes for Armenian goods and services. The conflicts over Nagorno-Karabakh continue and, absent a political settlement, even the best policies and reforms can have only a limited impact. There is recent evidence, on the Armenian side at least, of a willingness to support efforts at regional approaches, which could bring the parties closer to resolution and foster greater regional integration.

Unfortunately, Armenia's economic prospects have been further damaged by 1998's financial meltdown in Russia. Over the past several years, many Armenian families have been able to survive at least in part on remittances sent by Armenians working abroad. According to some estimates, there are approximately 1.5 million ethnic Armenians residing in the other countries of the CIS, with the majority located in Russia. Unrecorded remittances from Russia alone may have

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<sup>5</sup> The European Commission, *Economic Trends, Quarterly Issue: Armenia, Oct.-Dec. 1999*, May 2000.

been in the range of \$150-200 million (8-10% of GDP) annually. However, since late August 1998, Armenia began to experience adverse impacts as a result of the sharp economic downturn in Russia. In addition to the reduction in private transfers, there has been cancellation of some Russian private investment and Armenian exports to Russia have also fallen sharply, since the financial crisis began. As a result, many Armenian families are seeing a drop in available income, which is likely to worsen, perhaps significantly, depending on the situation in Russia, before it begins to improve.

## **B. Democracy and Governance**

Although the government has taken a broad array of steps to transform the economy, independent Armenia has not progressed as far in developing the necessary institutions for a democracy. Perhaps this should not be surprising given that in earlier years much human and financial capital was focused on the Nagorno-Karabakh conflict and dealing with the humanitarian emergency. Still, many of the institutions necessary for a functioning democracy are either in place or plans to create them are underway. Moreover, citizens are learning their roles and responsibilities in a democratic system. Despite instances of human rights abuses and some political repression of dissident voices, post-Soviet Armenia has generally been free of the worst excesses of authoritarian power. The greatest disappointment to date has been the flawed elections at the national level.

Although Armenians have participated in three national elections since independence, none has been free from criticism by international observers. Problems included unequal access for candidates to the media, improper voting by the military, ballot stuffing, and tampering with official results. Political parties have weak structures and organizations, are highly personalized and, therefore, have tended not to present serious opposition to incumbent candidates.

Despite the problems surrounding elections, Armenia has taken some critical steps forward in democratization. The Armenian Constitution, adopted through a national referendum in 1995, declares the establishment of a government based on the rule of law and the separation of the executive, legislative and judicial branches of government. In addition, the more specific legal basis and principles of democratic local self-governance have been formally established by separate legislation. Nonetheless, the flawed parliamentary elections of 1995 resulted in a National Assembly primarily composed of deputies more loyal to the powers who helped engineer their election rather than constituents. Similarly, at the local government level, accountability towards the citizenry appears to be low. Furthermore, local administrations are severely constrained by inadequate financial resources. Transparency and citizen participation also tend to be weak in local government decision-making.

A major constraint on Armenia's democratic, economic, and social transition has been the pervasive embrace of corrupt practices at all levels of government. Despite severe penalties, bribery is widespread and the most common form of corruption. In addition, collusion between officials at various levels and private sector actors has hindered competition and fostered the emergence of powerful "clans." Legal, regulatory and judicial reform efforts together with substantive civil service reform are needed to reduce the extent of the problem. Substantial effort is being made at present to put these necessary reforms in place.

Despite these reform efforts, citizens still do not trust the legal, regulatory, or judicial systems to apply or administer justice impartially. Corruption exists throughout government systems and will take years to overcome. Laws are not yet being consistently applied or adjudicated.

Enforcement agents, procurators, advocates, judges, and other government personnel need training and support so that they can function more effectively. In addition, enforcement of court judgments must be addressed so that courts decisions are upheld.

A major legacy of the former Soviet Union is a largely passive and alienated population. Furthermore, in Armenia, widespread unemployment, poverty, and disillusionment with the length of time required for the transition process and discouragement with such inhibitors to an effective transition as corruption have contributed to a deep strain of cynicism within the citizenry. Most citizens do not know how to work within the current system to advocate for changes. Elected officials and their appointees also do not yet understand why or how to address citizens' concerns. There are also not yet appropriate formal mechanisms in place for citizens to effectively petition government. In addition, accurate information about the government's plans or activities is not readily available; therefore, people are often forced to rely upon rumors, which can be false or misleading.

Improvements have been gradual. It will take many years for many Armenians to embrace fully their rights and responsibilities in a democracy. However, there are currently over 1,700 NGOs registered with the Ministry of Justice. Although many of these groups are not particularly active, about 20-30 of these have gained the skills to advocate effectively for change, as well as to strengthen their organizational capacity. Independent broadcast media, while not yet financially viable, is also able to provide objective news coverage that may be critical of the government without fears of being suppressed.

### **C. Social Sector Reform**

A very high level of poverty characterizes Armenia at present. As noted above, over half the population (54.7%) is estimated to be below the poverty line and more than a quarter (27%) below the food line. This high level of poverty is to a large degree a consequence of economic and social problems precipitated by the collapse of the former Soviet Union (FSU). These problems have been exacerbated by the devastation of the 1988 earthquake and the economic embargo imposed by Azerbaijan and Turkey over Nagorno-Karabakh.

The incidence of poverty in Armenia is clearly and closely linked to the high levels of unemployment and underemployment in the country at the present time and is seriously amplified by the inadequacy of the basic social safety net to respond to the now widespread needs of the population. The former Soviet system of universal "cradle to grave" social service coverage and utilities subsidies has collapsed. At the same time, there is no recent tradition of the private provision of social services. While the Government of Armenia is struggling to provide a minimum coverage package for those most in need, its narrow revenue base is seriously constraining the public sector's ability to respond adequately. In addition, the health and education sectors can no longer be fiscally sustained without major restructuring efforts.

In the health sector, public perception of poor service at a relatively high cost has significantly reduced the demand for medical care. This development in tandem with the difficult socio-economic environment has contributed to a worsening of adult health status, poor maternal and child health, and the re-emergence of poverty related diseases. Consequently, the government has taken steps to reform the health care system, which is a legacy of the former Soviet model of central coordination by a powerful Ministry of Health. The system is characterized by chronic under-funding, low efficiency of services, low quality, and inequitable access to services.

Armenia's education system, which was well regarded during the Soviet era, has been subject to erosion in quality that threatens to reduce both near- and long-term human capital potential in the country. In 1999, the government has embarked on implementation of a strategy to reform the finance and management of school education and is beginning to study means for reforming higher and post-secondary technical education.

#### **D. Commitment to Reform**

While Armenia has been internally stable since its independence (with the obvious exception of the events of October 1999), the potential for political instability is large in the face of widespread poverty and corruption. If the economic, political and social problems are not addressed and the perceived inequities are not remedied quickly, the potential for political unrest, particularly from forces hostile to free market and democratic reforms, needs to be acknowledged. While the current government may not be a democratic ideal, it is committed to economic reform; there are no guarantees that a successor government would offer an equally reformist outlook.

#### **E. Employment Background**

First, it should be recognized that many established Armenian businesses and government units have low productivity levels due to excessive employment. In the short term, the creation of efficient and competitive private enterprises and government units offering sustainable employment will necessitate the elimination of redundant employment which, in the short run, will work against decreasing unemployment overall.

Second, progress toward this strategic goal is highly dependent on Armenian firms reaching beyond the limited domestic market and selling to the 50 million consumers in the neighboring region. Continuation of the blockade, however, cuts off roughly half of the potential population in this regional market and adds to the transport costs of selling Armenian goods to other parts of the market. Hence, political resolution of the Nagorno-Karabakh dispute is essential to Armenia's near and long-term prosperity.

While the economic growth rate has been fairly robust since 1994, it is clear that poverty is chronic. High unemployment rates and low wages for those who are employed place the already weak social safety net under extreme pressure. Structural and economic reforms have added to the population's distress by the required elimination of most subsidies, deregulation of prices on items such as bread and some transportation, and steadily increasing tariffs for utility services. These changes, while economically appropriate and necessary, have extracted a significant personal toll on much of the population.

The following reflects the condition of Armenia's people:

- ✓ In 1997, wages comprised 26 percent of household income compared to 76 percent in 1985. Primary dependence for many now is on humanitarian aid, both from Government donors and NGOs, and from relatives including the Diaspora and Armenians working abroad.
- ✓ In 1998, the average wage in the state sector was \$34 per month, barely 20 percent of the estimated minimum required for a family of four.
- ✓ Each year between 40,000 and 50,000 graduates of secondary and tertiary institutions enter the labor force. There are roughly 25,000 retirees each year, but many, probably the

majority, of their positions will never be refilled, as government and industrial entities attempt to streamline and downsize their workforce. According to the GOA, the economy generated only approximately 8,000 new jobs in the first 10 months of 1998. Judging from these statistics, likely only half of these graduates will find employment.

- ✓ A survey of 1,200 households conducted by the Ministry of Statistics in November 1996 revealed that 62 percent of unemployed had been in search of jobs for more than one year.
- ✓ State support for those registering as unemployed is \$5 per month. Moreover only 15 percent of those registered actually receive these payments.
- ✓ While Armenia was justifiably renowned in the Soviet Union for high educational and skill levels, educational and training facilities are severely under-funded or relying on outmoded subject matter and teaching techniques or both. Armenia's greatest asset, its human capital, is eroding both absolutely and relative to many of those with which Armenia must compete.

From economic, political, and social standpoints, both collectively and individually, this situation is potentially destabilizing without the safety valve of continuing out-migration. Those possibilities have become more limited by the economic crisis throughout the FSU where most emigrants have traditionally found work. Addressing the problems of unemployment and underemployment must be faced, both directly (through firm and community level assistance) and indirectly (through legal, policy, regulatory and financial sector reforms).

Employment growth has been and will continue to be in the private sector. Job creation has largely been confined to small businesses, chiefly in the trade and distribution sectors. While employment in some of the now privatized state industries may recover, job creation in the future will come largely from growth in newly created private enterprises. Hence, fostering favorable conditions for private enterprise growth is fundamental to raising employment.

Upon the collapse of the Soviet Union, employment in Armenia's state owned industries plummeted and income dropped to a third of prior levels. While economic growth returned in 1994, job creation has largely been confined to new, small, private businesses. To support private sector growth, major reforms already have been undertaken by the GOA:

- ✓ Privatization of agricultural land and housing
- ✓ Substantially complete privatization of small enterprises
- ✓ Price and trade liberalization
- ✓ Adoption of a civil code creating the legal framework for property rights
- ✓ Contract enforcement
- ✓ Legal and institutional framework for commercial banking

While employment in some of the now privatized state industries may recover, job creation in the future is most likely to derive largely from continued growth in newly created private enterprises. Since Armenia is a country of only three million people (officially), enterprises need to reach out to export markets to grow and realize economies of scale. However, overall exports were stagnant between 1994 and 1997 and their share of GDP declined. Armenia's "near abroad" region includes 50 million people and a purchasing power parity approximating \$100 billion. While the blockade impedes trade to roughly half of this area, there are still major opportunities for export in the immediate region. From a macroeconomic (as well as a more micro employment) standpoint, export growth is critical; remittances and transfers are declining both as a result of the Russian crisis and as concessional assistance is reduced. Without substantial growth in exports, Armenia will be unable to finance the current volume of imports. Indeed, the level of Armenia's current account deficit (now roughly 28 percent of GDP) cannot be sustained into the future.

For new private enterprises to survive and grow, they must be able to compete both in export markets and the domestic market where barriers to imports have deliberately been set low to force Armenian industry to be economically competitive. To maintain a competitive edge, Armenian enterprises need access to the skills and training required to make their marketing and production operations efficient and profitable. In addition, a favorable and supportive business climate is essential to fostering creation of new enterprises and the growth of existing ones.

#### **F. National Resources:**

Armenia's overall natural resource endowment is poor. The country does possess some mineral wealth, such as gold, iron, copper, and building stone, but these are insufficient to support growth. Due to its dry climate, high altitudes, and generally poor soils, Armenia's agricultural potential is limited. While there is some scope for agriculture-based specialty products, such as brandy, wine and fruits, Armenia is and will continue to be a net importer of foods and fibers. Finally, Armenia's energy resources are poor. As has already been discussed, Armenia's greatest resource is its human capital (particularly in natural sciences and engineering, but also in the arts as well as wide variety of other fields), but this advantage is eroding under current circumstances.

Historically, Armenia has been a crossroads for trade and travel. This historically strategic location is currently severely constrained by the closed borders to both Turkey and Azerbaijan, which effectively eliminate east-west trade opportunities for Armenia at present. Its history may offer Armenia some potential in the form of niche tourism, particularly among Diaspora Armenians.

The Diaspora of Armenians scattered worldwide is another, often underestimated resource for Armenia. Concentrated in the United States and France, but found throughout the world, many Diaspora Armenians are highly educated and skilled, have personal financial wealth, and considerable interest in helping the "homeland." However, they have been reluctant to undertake major economic investment given the problematic investment climate and concerns about the rule of law in Armenia.

#### **G. Infrastructure:**

As is generally true throughout the FSU, Armenia's capital stock is often outmoded and poorly maintained. This is true both for the infrastructure - water, energy, transport, communications, education - and for production facilities. Lack of investment, poor management and maintenance systems, and lack of market-based pricing/tariff structures all contribute to the continuing deterioration in capital stock. A key constraint to private sector growth is lack of a well-maintained infrastructure such as roads, railroads, telecommunications and water/wastewater, are also extremely important inputs to private sector growth and development (as well as increased investment) in Armenia.

#### **H. Domestic Market:**

Armenia's domestic market is exceedingly small and, by itself, will be able to attract and support only limited development. Under current circumstances, even Armenia's limited domestic market potential is seriously underdeveloped. Based on its purchasing power parity GDP, the Armenian

economy is equivalent to an U.S. city of 325,000; based on the dollar value of its GDP (which is probably a more relevant measure for foreign investment and trade), the Armenian economy is equivalent to an U.S. city of 57,000. Thus, there is significant room for growth within the current domestic economy, but, even under the best of circumstances, this domestic economy will never be sufficient to support the country. In isolation, Armenia will remain poor. It must seek external market opportunities to succeed.

### **I. Levels of Investment & Trade:**

Investment levels are poor in Armenia. The EBRD reports that total investment equals 8.8 percent of GDP, among the lowest in the FSU and Eastern Europe (see Figure 3). The very low investment rate is particularly surprising in view of the very large volume of assistance to the country. As a percent of GDP, Armenia receives more official development assistance (ODA) than any other nation in the FSU and Eastern Europe. In Armenia ODA is twice the magnitude of investment. In addition to ODA, Armenia receives large cash infusions from the Diaspora and remittances from Armenians working abroad. Clearly, the very large majority of these infusions is being used for current consumption, often on imports, or is leaking out of the economy as capital flight, rather than being used for investment. In other words, domestic saving/investment rates are actually negative. Unless the inflow of funds from ODA, the Diaspora, and remittances is considered permanent, Armenia is not only poor, it is living beyond its means.

In addition to a low overall investment rate, investment by foreigners is low. In 1997 there was \$51 million in foreign direct investment (FDI) in Armenia. In terms of GNP, Purchasing Power Parity GDP, or on a per capita basis, this is one of the lowest FDI rates in the FSU.

Armenia's external trade performance is also poor. Exports as a percent of purchasing power parity GDP are shown for twenty small nations with narrow resource bases. Armenia's exports are only 2.5 percent of its purchasing power parity GDP. Moreover, Armenia's external trade performance is deteriorating. Between 1994 and 1997, export levels were stagnant, while imports more than doubled. Armenia now imports nearly four times the value of its exported goods and services. It is highly doubtful this is a sustainable situation and, even if sustainable, it cannot lead to prosperity.

The positive impacts of any program to improve Armenia's economy are significantly lessened by the current blockade. The international political situation related to Nagorno-Karabakh and other reasons for friction between Armenia and both Turkey and Azerbaijan have a negative effect on the economy. Uncertainty, reduced trading opportunities, and increased transport costs combine to reduce domestic and foreign investments and lower both the amounts and dollar-for-dollar benefits of international trade. For example, it is estimated that Armenia's exports in 1997 were \$62 million lower than expected with open borders because of virtually eliminated trade with Turkey and Azerbaijan.

Measures needed to attract investment and business activity in Armenia by members of the Diaspora are the same, as those needed for Armenian nationals and non-Diaspora foreigners. In all cases, such activities are encouraged by improvements in the consistency and transparency of laws and regulations and their application, political stability, and access to credit and information. For Armenia to realize sustainable growth the primary source for investment and business activity must be the Armenians themselves and the business environment must be attractive to all-potential foreign participants, Diaspora and non-Diaspora alike.

Given high transport costs from this landlocked nation to most major markets, and North America, and its poor resource base, it seems certain that initial investments in the Armenian economy will gravitate toward labor-intensive goods and services with relatively low transport costs and requirements per unit value. This will include light consumer goods, such as textiles and clothing, small appliances, some processed foods and drinks, jewelry, pharmaceuticals, and handicrafts; some intermediate goods, such as chemicals, software and other computer-related services, electronics components, and small machinery; and services, such as niche tourism.

If and as the political situation allows increased trade with its neighbors, expanded production of more transport-intensive goods will be possible, such as building stone, cement, large appliances, and heavy machinery. As the level of sophistication of Armenia's economy increases, the relative importance of higher valued goods and services, such as electronics and software development and financial services, will grow relative to those lower in value.

Investment and trade are the engines that can provide employment opportunities for the Armenian people. Unfortunately, Armenia's performance to date regarding investment and trade is poor.

#### **J. Private Enterprise Development:**

Despite a large and growing number of small registered private enterprises (40,000) and a network of business support centers assisted by a variety of donors, training and information support for business is generally inadequate be it in entrepreneurship, business start up, business operations improvement, marketing, etc. Self-help business and enterprise start-up literature is generally not available, in stark contrast to the plethora of such literature in Central and Eastern Europe (CEE) and other Newly Independent States (NIS) transition economies. Small business entrepreneurs, 70 percent of whom have university degrees, site marketing and advertising as their highest priority for training followed by financial management and business planning.

In order to capitalize on Armenia's prime asset of an well-educated and readily trainable workforce, and to insure competitive enterprises, skills must be brought to comparable levels. This is especially true in the areas of overall business management, marketing and sales management, cost accounting, finance, product design, technical production, and other areas of modern business practice and production. Universities typically do not offer training in these skill areas apart from the MBA program at the American University of Armenia (AUA), the recently started, USAID-supported accountancy training, and, reportedly, some smaller, newer private schools of business. Continuing education in business skill areas, entrepreneurship, business plan development, and related areas is not widely available. Use of outside expertise to supplement lack of experience or training within firms is rare. The knowledge and experience base of the Armenian trainers and consultants furnishing enterprise advisory services is limited. Hence, improving training of business skills is critical to fostering private sector growth and productivity. The development of appropriate vocational skills for young people not bound for universities or similar institutions is also a crucial ingredient for private sector growth.

#### **K. Privatization:**

Continued movement on privatization will demonstrate government commitment to private sector development and open further opportunities for private sector development. Despite substantial progress on privatization, the program is far from complete. Out of an original inventory of some 10,000 state owned enterprises, unfinished construction, and other facilities; some 3,000 remain

in state hands and are programmed for privatization. These remaining resources locked up in state owned enterprises, including industrial land, need to be released through privatization or liquidation so that they can be put to more productive use in the private sector.

If Armenian private enterprises are to expand, existing and new export markets need to be tapped to their full potential. To date, most new private Armenian enterprises have focused on sales almost exclusively to the domestic market; of total sales by Armenian owned enterprises, only an estimated three- percent is exports. Information support to Armenian enterprises is generally inadequate. Information on taxation, customs clearance, registration requirements, and legal changes is only sporadically available. Further, businesses have little market information available to them; surveys show that businesses rely heavily on general media and family and friends for market information rather than detailed business sources.

In both urban and rural areas, local governments have limited ability to raise revenues and deliver services. Resources of the fledgling domestic NGO sector are quite limited and tend to be focused on the needs of the larger urban areas. As the market economy develops, there is a danger that smaller communities (as well as marginal urban communities) will become increasingly isolated from the mainstream economy as it develops. Already many of the young people have left to try their luck in Yerevan or abroad.

Increased investment both by and in the private sector and in public sector infrastructure is essential if the private sector is to grow and create jobs. Current levels of overall investment at roughly 10 percent of GDP are totally inadequate given Armenia's dilapidated stock of fixed assets and obsolete production techniques. While considerable progress has been made in putting into place the legal framework for markets to work, that framework is not yet complete. Further, inconsistencies in existing laws, coupled with a lack of transparency and unpredictable administration of laws (most especially of those applying to customs clearance and taxes), creates uncertainty which discourages business investment.

#### **L. Impediments to Business Development:**

Access to financial capital is also essential to increasing investment in the efficient production and sale of goods and services and public infrastructure. The banking sector requires further deepening if it is to serve its role in meeting the savings and credit needs of businesses and households. Equally, Armenia's nascent capital market requires substantial investment in infrastructure and significant improvement in the underlying level of economic activity before it can function effectively. A singularly important impediment to further development of Armenia's financial sector and improving access to financial capital remains the low level of domestic savings and a government deficit that absorbs what little deposits there are in the banking system and generates high interest rates. Armenia's external debt of some \$800 million represents a comparatively large (48%) proportion of GDP, but given that most of it comprises loans made on a concessional basis, debt service remains low as a proportion of exports of goods and services (15% in 1997). Nonetheless, debt service as a percent of export earnings is slated to increase; hence it is all the more important that insofar as possible, future investment be financed domestically, as the room for servicing further external debt is limited.

Given Armenia's small size and limited resource base ready access to input are vitally important to all Armenian business. However, Armenian and foreign businessmen uniformly cite the uncertainty of treatment and delays in customs clearance as a major barrier to business expansion and hence increasing investment. Similarly, investor confidence is adversely affected by lack of

clarity and consistency in interpreting and applying tax provisions with a resulting wide disparity in determinations of tax liability. While many of these problems are caused by inconsistent application, inconsistencies and disincentives to investment persist within the tax code itself.

The availability of domestic savings for investment is severely constrained. Drastic cuts in household income levels, the past erosion of household savings by hyper-inflation, and the past closure of banks all have contributed to extremely low (if not negative) household savings and a marked lack of confidence in financial institutions. While government expenditures have been cut, tax revenues remain low and the government's fiscal deficit (even after substantial foreign grants) remains high at 5-6 percent of GDP. The resulting financing of the deficit absorbs the limited pool of domestic savings available within the financial sector, bids up the price of money, and crowds out the ability of the private sector to obtain formal financial sector financing. Raising the future level of domestic savings in the formal sector is highly dependent on continued growth in personal incomes (hence employment creation is so necessary) and creating the financial institutions, instruments, incentives, and regulatory oversight that will mobilize households savings. Further, increased tax collections would provide resources for needed public investments and reduce public sector borrowing and the squeeze it puts on resources available for private sector investment.

Increased levels of domestic savings in formal financial institutions will raise the availability of funds for financing. Improving access to finance, however, requires the development of financial market institutions and instruments. Their development, in turn helps to raise the level of domestic savings and can, in addition, stimulate the flow of foreign investment. First, by creating a financial market and instruments with sufficient liquidity to be of interest to foreign portfolio investors. Second, by making it possible for foreign direct investors to tap local financial resources for working capital and expansion needs.

Armenia's current four stock exchanges do little to increase access to finance because of their low level of activity, low transparency and lack of liquidity. Activity on the stock exchanges is further hindered by the absence of an integrated capital market structure, including a share registry, clearance and settlement system, depository, and trading system that centralizes all bids and offers. The lack of liquidity will be more difficult to overcome, and will require development of a shareholder base among the general public plus institutional investors, notably investment and pension funds.

Finance for business is limited given the low level of deposit mobilization; most business financing is only available through commercial bank implemented donor credit programs for small and medium business. In addition to the resources extended to support private sector growth, the value of these programs lies in inculcating credit appraisal skills in bankers and demonstrating the profitability of lending to smaller, private businesses. Bank training reinforces these skills. However, for the demonstration effect to hold and banks to make such loans out of their own resources, default rates on these loans must be kept low, and penalties on default enforced.

Other barriers to obtaining bank finance relate to the lack of a framework for pledging land or other assets as collateral for loans. While the recently enacted civil code provides the essential legal framework for commercial transactions, other essential laws to assure surety in property rights and commercial transactions are not yet in place or enforced. Further, although agricultural land has been privatized, as have most apartments, registration of property title is only now beginning, as is a system for registering mortgages and other pledges on property. Without such a system and well defined procedures to foreclose on pledged properties and an

active land market which allows for reasonable estimation of value of pledged land and ready liquidation of pledged assets, banks find it difficult to lend their own funds against property.

The high costs of funds further tighten available finance. With Treasury bills commanding rates in excess of 50 percent, share offerings on a stock exchange will be difficult to place and access to bank finance is limited to comparable rates. Improved tax collection is thus vital to increasing access to finance, for without collection improvement, public sector borrowing will not be reduced and the pressure on domestic savings relieved.

Armenia is landlocked, blockaded, and poorly endowed in agricultural, energy and other natural resources. For these reasons, it is all the more necessary that the costs imposed by these poor resource endowments and isolation are not raised even higher by inefficient delivery of energy, communications, water, transport, and other infrastructure services needed by the private sector operating in a global open economy.

## **M. Corruption**

Armenia, like most of the countries of the former Soviet Union, is characterized by widespread corruption. This corruption is a key constraint to Armenia's economic, political and social development. It interferes significantly in: the efficient and effective creation and growth of a free market economy; the transparent and equitable operations of the government; the implementation of free and fair elections; and the efficient and effective creation of equitable provision of social services.

There is widespread agreement among both Armenians and expatriate observers on the main causes of corruption in Armenia:

- ✓ Tradition;
- ✓ Low wages;
- ✓ Low risk incurred to those engaging in corrupt practices;
- ✓ Weak professional bureaucracy.

## **N. Nagorno-Karabakh**

Beginning in 1988, ethnic Armenians residing in the Soviet republic of Azerbaijan in a region known as Nagorno-Karabakh (NK) began to request greater autonomy and closer links to their ethnic relations in the Soviet republic of Armenia. With the collapse of the Soviet Union in 1991 and the resultant independence of both Armenia and Azerbaijan, this quest for autonomy turned into full-scale war. The conflict continues unresolved today, albeit under cease-fire conditions. As a result, both Turkey and Azerbaijan have imposed an economic blockade on Armenia.

## **O. Gender**

Armenia's history has been dominated by despotic external (non-Armenian) rule (Russia, Ottoman, Iranian, etc.). What has allowed Armenians to survive as a culture -- in fact, what has defined Armenians as a culture -- has been the family unit. In fact, in the face of frequent foreign domination, Armenia has, for much of its history, existed only at the level of families and small, relatively unconnected communities. Thus, the family unit has been the main guarantor of

Armenian culture for hundreds of years. It is in this historical context that gender in Armenia must be viewed: gender is closely tied to the family unit which, in turn, is strongly tied to the Armenian social system and ethnic survival. This historical background is critical in explaining the Armenian approach to gender: even a relatively benign attempt to change gender roles is seen as an attack on the family and thus on the system of Armenian cultural preservation.

In the Armenian view of gender linked to family linked to social preservation, the men are traditionally the primary breadwinners and decision-makers and the women are traditionally the primary childcare providers and homemakers. This having been said, however, it is a mistake to assume that women are (or, historically, have been) blatantly oppressed by men. Concurrent with domestic subordination, Armenian women traditionally seem to have had a streak of strength and stubbornness. While men are seen as the head of the family and the breadwinners, women are also strong in how the family is presented to the outside world (which has brought, among other things, an emphasis on women's education as bringing status to the family).

The Soviet period, with its ideology of formal gender equality), had some impact on traditional Armenian gender roles such as bringing more women into the urban workplace, though typically in more "feminized" sectors such as health, education, and the arts. It is clear the Soviet rhetoric on gender equality sometimes remained only that and did not translate into a change in more traditional mentalities. Thus, with independence, it is equally clear that more traditional gender relations have continued to drive society rather than the Soviet ideal of gender equality. Consciously and unconsciously, these traditional gender structures, which were incompatible with the Soviet model of gender relations, have re-emerged with independence. Given the uncertainties of the post-Soviet period, one could argue that this re-emergence of traditional gender roles and relationships has been a social self-defense mechanism, i.e., the traditional has emerged to fill the vacuum left by the collapse of the Soviet system. It is also possible that abiding by gender traditions is a way of asserting ethnicity and nationalism in a culture that has often felt its survival threatened.

The family, with traditional gender roles, has provided social stability during the economic difficulties since independence. However, the inability of many male heads of household to retain the role as the main breadwinner in the face of high unemployment has added to the already difficult economic circumstances of many families. By example, many men have had difficulty coping with their inability to fulfill their traditional family role. Migration of men in search of work abroad has been one method of adaptation, thereby leaving a number of female-headed families. Many men who have remained in Armenia are unemployed. Women have helped to meet the increased financial needs of the family through increased participation in economic life, typically in relatively low-wage jobs, while also continuing to do household work and maintaining a traditional domestic division of labor along gender lines. While increased economic participation by women, even in lower wage jobs, has helped families to survive economically during the transition, it (coupled with the inability of men to fulfill their traditional roles) may have had some destabilizing effects on the Armenian family (e.g., an increased rate of divorce).

There has been a general reassertion of traditional Armenian gender divisions of political power since independence. The new organizations that have come to dominate political life after the collapse of the Soviet Union have not actively sought female participation; at the same time, women have not, for the most part, tried to push their way in. Anecdotal evidence suggests that there is greater female involvement in local political and social institutions such as educational boards, electoral commissions, and NGOs. As noted throughout the strategic plan, Armenians as a whole, both male and female are largely alienated and perceive themselves to be powerless.

Until representatives are more accountable to their constituencies, until the electoral process improves, until the influence of patriarchal clans is reduced and until the democratic process itself becomes stronger, women will continue to be underrepresented.

There is no compelling evidence to suggest that gender is a determinant of poverty. However, refugee women and women whose husbands are abroad as migrant workers do form an important at-risk poverty subset. There is increasing anecdotal evidence of a spreading phenomenon of the establishment of “parallel families” by migrant male workers in their new locations, resulting in the effective abandonment of wives and children left in Armenia, leaving them even more at risk. While overall health indicators (such as life expectancy) for both men and women have declined during the transition period, women's health has been especially affected. This is largely as a result of the high costs of health care such as an increase in home childbirth and a decrease in prenatal care to save money have resulted in increased maternal mortality. In education, women continue to graduate at higher rates than men from both secondary school do and university do and have lower dropout rates than boys.

## **P. Environment**

Armenia, like many of the countries of the former Soviet Union, is characterized by a poor environmental profile. Competing demands for scarce financial resources, a still limited environmental consciousness among both the general population and national (public and private) leadership, and a reviving economy will challenge the country to reduce pollution emissions and ambient levels, many of which substantially exceed U.S. and European Union levels. It will probably take a decade or more for policy improvements, market-based incentives and improved finances to reach a level of sustainability. Nevertheless the government is taking action, changes are taking place, and progress is being made. For example, Armenia's draft National Environmental Action Plan, produced with the support from the World Bank, focuses attention on two priorities: improved water supply and utilization; and phasing out lead in gasoline and mitigating exposure to lead, especially among young children.

An August 1998 environmental assessment outlined a number of serious environmental problems in Armenia, which could benefit from donor attention. Among them:

- ✓ incomplete legislation and lack of enforcement;
- ✓ lack of public and institutional awareness of environmental issues and their intersection with economic recovery;
- ✓ contamination of drinking water distribution systems;
- ✓ poor wastewater treatment facilities and procedures;
- ✓ over-extraction of water from Lake Sevan for hydropower and irrigation;
- ✓ air pollution from unleaded gasoline;
- ✓ lack of farmer awareness of safe pesticide practices and the resultant passing of pesticides through the food chain;
- ✓ water logging and salinization in agricultural areas;
- ✓ heavy metals contamination of agricultural soils;
- ✓ nuclear safety from the Armenian Nuclear Power Plant;
- ✓ lack of separation of domestic and industrial waste.

## Q. Selected Statistics

	1996	1997	1998	1999	2000 <sup>6</sup>
CP Inflation (% per annum) <sup>7</sup>	18.8	13.8	8.7	.06?	2 (estimated)
Dram/US\$ Exchange rate <sup>8</sup>	413	490	505	535	530 (in April) 545 (in July)
GNP per capita US\$			480		
GDP per capita			500		
GDP (US\$ Billion)		1.6		1.8	
Real GDP growth <sup>9</sup>	5.8	3.1	7.2	3.3	NA
Imports (US\$ Billion)					
Exports (US\$ Billion)				0.26	
Imports growth	26.9	4.4	1.0	-10.5	NA
Exports growth	7.1	-19.8	-5.2	4.5	NA
Tourism (US\$ Billion)				0.03	
Tourism as % from exports				12%	
Poverty % of population below poverty line					
Urban population			69%		
Foreign Investment (US\$ million) (ADA)		cumulative 1991-1997 102.8	228		
External debt (US\$ million)			790		

## Main Exports, 1998

Item	US\$ millions
Precious and semiprecious stones, precious metals and their products	53.1
Base metals and their products	40.4
Machinery and mechanical appliances	40.1
Mineral products	31.7
Prepared foodstuffs	16.8
Other	41.3
Total	223.4

<sup>6</sup> 2000 figures are projections, rather than actuals.

<sup>7</sup> Source: Ministry of Statistics of RA; Armenia Economic Trends

<sup>8</sup> Source: Central Bank of Armenia; Armenia Economic Trends; Armenian Capital Markets magazine.

<sup>9</sup> In 1998, 75% of the GDP growth came from the private sector (Bisnis Bulletin, Aug/Sept 1999). To date about 75% of medium and large enterprises have been privatized; more than 85% of small businesses have been divested (World Bank, *Country Brief: Armenia*, April 2000). GDP composition by sector: agriculture: 35%; industry 30%; services 35% (CIA-*The World Factbook, Armenia*, 1999).

## Main Imports, 1998

Item	US\$ millions
Mineral products	197.6
Prepared foodstuffs	109.9
Vegetable products	117.8
Machinery and mechanical appliances	78.8
Chemical products	74.7
Live animals and animal products	47.5
Vehicles, aircraft, vessels and associated transport equipment	47.3
Precious and semiprecious stones, precious metals and their products	45.5
Other	176.6
Total	895.7

## Leading foreign partners, 1998

Country/Region	US\$ millions
Non-CIS	674.2
USA	97.9
UK	69.1
Iran	63.8
Turkey	56.6
Belgium	54.6
UAE	54.1
Others	278.1
CIS	221.4
Russia	182.7
Georgia	26.8
Ukraine	8.9
Other	3.0

Source: ADA

### 2.3 Legal Environment Review

The Republic of Armenia instituted reformation of its legal system following the proclamation of independence in 1991. After the adoption of the Constitution by referenda on July 7, 1995, a number of legislative developments were initiated. For example, Armenia adopted free market oriented laws before the enforcement of the Constitution as well (Privatization Law, Law on Enterprises and Entrepreneurial Activities, etc). It should be noted, however, that no laws specific to SME have been adopted to date. The main development of the free market legislation was conditioned by the enforcement of the Civil Code of the Republic of Armenia. The Civil Code was enforced on January 1, 1999, and codified the guiding provisions on the legal-structural organization of the business in Armenia; it does not provide a definition of SMEs.

At the same time, Chapter 5 of the Civil Code defines the provisions on legal persons: the definition of a legal person, the types of legal persons, the creation of legal persons, the legal capacity of a legal person, etc. The Civil Code requires the adoption of the relevant statutes establishing legal and regulatory framework for each type of legal person. Unfortunately, no statutes have been adopted thus far by the National Assembly. Armenia, as a NIS (CIS) member-country, ratified the NIS (CIS) Agreement on Promotion and Development of Small Entrepreneurship in NIS (CIS) countries signed in Moscow on January 17, 1997. Based on this agreement, the Consultant Board was established by the NIS countries (each country has one

member). Every two years, the Board shall draft a report on the stage of the development of international cooperation on SMEs issues as well as provide NIS countries with proposals for SME promotion and support.

### A. Relevant Legislation

Hereunder is presented a summary of the relevant legislation for small and medium businesses.

#### 1. *Business legislation in general*

As mentioned above, Armenia has enforced the Civil Code, which is considered to be market-oriented and well drafted. Nevertheless, the main statutes enabling the implementation of provisions of the Civil Code have yet to be drafted and adopted. The Civil Code recognizes the contractual freedom (Article 437.1 of the Civil Code) and codifies basic provisions on the contracts and transactions. Furthermore, it contains governing provisions for each type of the contract. From this standpoint, one can note that the Armenian legislature created all conditions for the development and governing of the contractual relations in the country within the framework of the free market.

The Republic of Armenia recognizes private property (ownership) right of both physical and legal persons (Part VI of the Civil Code). The adoption of the Civil Code resulted in the repeal of the Property Law, which was in force prior to the enforcement of the Civil Code. Currently, property issues are resolved and regulated under the requirements of the Civil Code and other related laws and regulations. Civil Code distinguishes the regulation of the ownership of the various types of property, including and not limited to the ownership of the land.

The Civil Code also codifies provisions on intellectual property and copyrights (Part X). These provisions were later detailed in the RA Law on the Copyright and Related Rights adopted by the National Assembly and enforced on January 12, 2000. This law was drafted under the requirements of the WTO (World Trade Organization) guiding documents and corresponds to the internationally adopted and enforced standards on copyright. It shall be noted that Armenia ratified a majority of the international conventions regulating the issues of intellectual property and copyright. It is anticipated that the process of the accession of the Republic of Armenia to WTO will be completed by the end of this year.

The Civil Code provides basic regulation to the issues of collateral and pledge (Chapter 15). Nevertheless, this legislation has yet to be developed and enforced. The Civil Code just sets the basic regulative framework for the collateral and pledge, which shall be later detailed in the relevant statutes.

#### 2. *Bankruptcy legislation*

Bankruptcy legislation in Armenia was enforced prior to the adoption and promulgation of the Civil Code and Civil Procedure Code. Bankruptcy legislation is comprised from the RA Law on Bankruptcy of the Banks and RA Law on Bankruptcy and Financial Recovery of the Legal Persons, Enterprises without the Status of Legal Person and Private (Individual) Entrepreneurs. It should be noted that the mentioned legislation contains several provisions, which contradict to the recently enforced Civil Procedure Code (effective January 12, 1999). Due to legal inconsistencies and contradictions, the Council of Court Chairmen issued a recommendation for the Courts to stop any

bankruptcy-related procedures until the elimination of contradictions and inconsistencies. Again, it should be noted that the RA Law on Bankruptcy of the Banks is enforced by the Central Bank of the Republic of Armenia and is considered to be efficiently operating legislation. While Central Bank is considered to be the authority entitled to initiate the bankruptcy process for banks (as outlined in Article 4 of the RA Law on Bankruptcy of the Banks), the final decision on an individual bank's bankruptcy is taken by the court upon the application (claim) filed by the Central Bank. This process is regulated and enforced in accordance with the laws mentioned above.

### 3. Securities legislation

Armenia's securities market is underdeveloped and fragmented (for instance, there are four stock exchanges – a large number for such a small country). Due to the lack of updated and properly developed legislation, the securities market is poorly regulated. Securities market is regulated under the requirements of the RA Law on Circulation of Securities of 1993. Currently, PwC/USAID Capital Markets Development Project in Armenia assists the Armenian government in the drafting of the Securities Market Regulation Law and institutional development of the securities market.

Newly drafted Securities Market Regulation Law, which was adopted by the National Assembly of Armenia in the first reading on June 26, 2000, provides detailed regulation of the securities market, establishment and activities of the independent Securities Commission, requirements for the licensing, certification and activities of the professional participants of the securities market, formation and activities of the Self-Regulatory Organizations (SROs), establishment of the Central Depository and cetera. This draft requires the passage by the National Assembly in the second reading for the final adoption and enforcement. The second reading of the law was passed on July 4-5, 2000. The concept of the regulation of the securities market in Armenia was developed in accordance with the IOSCO (International Organization of Securities Commissions) principles. Legislative experience of the U.S. Securities Act of 1933 was taken into consideration during the drafting of this law as well.

### 4. Banking legislation

The banking legislation of the Republic of Armenia is considered to be highly developed. Banking legislation is comprised from the following laws: RA Law on Central Bank, RA Law on Banking RA Law on Bankruptcy of Banks, and RA Law on Banking Secret. The banking legislation recognizes the exclusive role of the Central Bank in regulating and overseeing activities of the banks. The Central Bank regulates banking activities in Armenia through the adoption and issuance of relevant regulations and economic norms (requirements). Further, banking legislation has established firm guarantees for the defined activities of commercial banks, thus safeguarding their activities from inappropriate intervention by governmental bodies. Armenia has also established a universal banking system.

### 5. Lease legislation

Lease legislation is currently being development, in accordance with the requirements of the Civil Code (Chapter 35); no statute on leasing has been drafted and enforced yet. The issues related to leasing are governed by the Civil Code; the Armenian legislature recognizes the following types of lease: the leasing of immovable property, rental (with term less than one year), operating leases (lease of transportation means), leasing of building and structures, leasing of housing premises, and finance leasing (leasing). Leasing is seen as an important part of free market legislation, and so it shall be

developed further; this should have a positive impact on SME promotion in Armenia. It should also be noted that the draft law on the Finance Lease (Leasing) has been developed and shall be adopted later (no timing is available).

#### 6. Taxation

Armenia's Taxation Legislation includes the following laws: RA Law on Income Tax, RA Law on Profit (Corporate) Tax, RA Law on Value Added Tax, RA Law on Fixed Payments, RA Law on Taxes, RA Law on Excise Tax, RA Law on Property Tax, RA Law on the Compulsory Social Security Payments, RA Law on Simplified Tax. Currently, under the requirements of the WTO Armenia Accession Program, a newly drafted Customs Code is under the consideration of the National Assembly. Many parliamentarians favor the adoption of the unified Tax Code as well. Nevertheless, there is no reliable information whether the relevant activities directed at the drafting and adoption of the unified Tax Code have been initiated or not.

For SMEs, the RA Law on Simplified Tax is applicable. This law was recently put into place (June 19, 2000); it regulates the issues of the payment of the simplified tax by the relevant entities. A simplified tax replaces the VAT (value added tax) and income (profit) tax. This tax legislation is mostly applicable for SMEs. Under the requirements of the Article 4.1 and 4.2 of this law, entities which delivered services and products during the year preceding the reporting (taxable) year in total of the amount not exceeding 30,000,000 AMD (equivalent to 54,545 USD) are considered to be entities (legal or physical) subject to the simplified tax (excluding entities which are defined under the requirements of Article 4.3 of the same law). The law established a taxation rate for the simplified taxpayers in the following manner (Article 8 of the law):

- 4% of the total amount of the services provided by the trade organizations (shops, etc.) for each reporting period;
- for other taxpayers – in the following amount:
  - 7% of the total amount not exceeding 30,000,000 AMD;
  - 12% of the total amount in case it exceeds 30,000,000 AMD.

Thus, the Armenian legislature established the simplified system for the taxation of the entities, which render services not exceeding in total amount of 30,000,000 AMD per year. It shall be noted that mostly small and medium enterprises, including private (individual) entrepreneurs will be covered by this clause. Furthermore, the tax rates differ substantially from the rates enforced under the RA Laws on Value Added Tax, Income Tax, and Profit (Corporate) Tax. This seems to favor the development of small and medium business in Armenia.

#### 7. Anti-corruption legislation

Corruption hinders the proper economic and political development of the country. It has its negative impact on the SME development as well. The Armenian Government has announced that it is initiating a fight against the corruption. Nevertheless, much needs to be done to effectively combat corruption. To this end, it will be necessary to adopt a new Penal (Criminal) Code and Anti-Corruption Law, which would define the program and the measures to be implemented by the government in order to combat the corruption most efficiently.

Another steps to be taken by the government is adoption of new registration and licensing laws with an aim to eliminate corruption and illegal activities in the official bodies carrying out the registration and licensing of the business. The mentioned laws are drafted and currently under the consideration of the interested agencies. It is anticipated that by the end of this year both laws will be adopted and enforced. This would definitely promote the SME development, bearing in mind that the whole licensing and registration procedure will be clearly defined in the law and efficiently implemented by the centralized (in case of registration) government authority.

#### 8. Tourism legislation

Currently, Armenia has no legislation specific to tourism. According to the information received from the Ministry of Industry and Trade (Tourism Regulation Department), the draft law on tourism was prepared back in 1998, and even received approval of the Government. Nevertheless, it seems that this draft is not currently under the consideration on this stage. Based on the information, received from the Legal Department of the Government, the mentioned draft was reviewed there and received no support due to the lack and impossibility to identify the subject of the regulation. There is no reliable information on the probability and timing of the adoption of this draft law by the National Assembly.

### **B. Legislative Procedure in Armenia**

Laws are adopted by the National Assembly (parliament) of the Republic of Armenia, and shall be signed within 21 days by the President of Armenia of that adoption, and published in the official journal to be enforced. The President has the right to veto any law adopted by the National Assembly. If the National Assembly overrides the President's veto, the latter has up to five days to sign and publish the law. Draft laws are presented for the adoption by the National Assembly either by the government (under the process of the government legislative initiative) or by the National Assembly itself (through the legislative initiative of the parliamentarians).

Under the requirements of the RA Constitution (Article 73), the National Assembly shall elect six permanent Standing Committees. The National Assembly is entitled to form temporary committees for the discussion and provision of the conclusions on the issues of interest for the National Assembly. The Standing Committees review the draft laws delivered to the National Assembly and provide their comments and conclusions on the presented draft laws and decisions. Activities of the National Assembly is regulated by the RA Constitution and RA Law on the Regulations of the National Assembly.

SME-related (economic) laws are mostly reviewed by the NA Standing Committee on Finance, Loan, Budget and Economic Issues. The government presents those draft laws for the adoption by the National Assembly, which were approved during the government session, which are usually conducted on a weekly basis on Thursdays. Prior to that the relevant ministry (governmental authority) shall put the draft law into the circulation and gather all proposals and suggestions from other ministries and agencies.

There is no legally adopted practice of NGO and other non-governmental institution involvement in the drafting process, and to date little is understood of the lobbying process. Nevertheless, some draft laws were published for the public consideration prior to the adoption by the National Assembly and interested persons were provided by the opportunity to comment on the proposed

draft either through the media or directly during the work in the relevant committee/group dealing with the draft.

Trade associations (chambers of commerce) provide comments on the presented draft laws on *ad hoc* basis in case of having particular interest. There is no adopted practice of the comments on the draft by the mentioned entities.

### C. Business Structures in Armenia

The Civil Code defines the all-inclusive list of the commercial (for-profit) organizations, which could be incorporated in accordance with the Armenian legislation. The following legal forms of business organization are recognized under the provisions of the Civil Code:

- Business Partnerships:
  - Full Partnership;
  - Limited Partnership;
- Companies:
  - Limited Liability Company;
  - Company with Supplementary Liability;
  - Joint Stock Company;
- Cooperatives.

Most businesses in Armenia are incorporated as Limited Liability Companies. Cooperatives are special legal persons, which could be incorporated both as commercial (for-profit) and non-commercial (non-for-profit) organizations under the requirements of the Civil Code. Only issues of joint stock company are regulated by the separate statute (law), which was enforced before the implementation of the Civil Code. JSC statute shall be either redrafted or amended in order to comply with the requirements of the Civil Code.

Many SMEs are incorporated as Limited Liability Companies (LLC). There is no statute governing the issues of the LLC but the decision of the RA Government approving the model charter of LLC. The adoption of the statute is pending and there is no reliable information on the terms of its adoption and enforcement.

It shall be noted that SMEs, which were incorporated as private (individual) entrepreneurship, shall be restructured under the requirements of the Civil Code into LLC or other legal entity defined by the Civil Code. The Civil Code recognizes organization of the business in the form of private (individual) entrepreneur, but the updated statute which will replace the old RA Law on Private Entrepreneur (1993) is pending its adoption by the National Assembly. There is no information on the timing of its adoption.

**SUMMARY DATA ON REGISTERED ECONOMIC ENTITIES  
AS OF JANUARY 1, 2000<sup>10</sup>**

a) By legal form

TYPE	Total registered as of January 1, 1999	New entities registered in 1999	Total registered as of January 1, 2000
Individual enterprise	10558	0	9319
Family business	766	0	684
Full economic partnership	2138	0	1798
Limited economic partnership	19	0	11
Separated subdivision of enterprise	505	151	638
Subsidiary	1778	0	1444
Production cooperative	6007	53	5991
Consumer cooperative	71	0	70
Peasant owned collective farm	322	0	286
Limited liability company	14956	2217	18656
Closed joint-stock company	2500	294	2838
all stocks owned by the state	1162	125	1293
all stocks owned by local public entities	301	27	338
Open joint-stock company	1137	18	1185
State enterprise	(484)	0	(407)
<b>TOTAL</b>	<b>41241</b>	<b>2733</b>	<b>43327</b>
Individual entrepreneurs	47223	6033	49666
Unions of legal entities <sup>11</sup>		14	14

**Liquidated Economic Entities**

Legal entities	1094	496	1590
Individual entrepreneurs	5414	3775	9189

<sup>10</sup> Ministry of Statistics, State Register (Registration) and Analysis, *Social and Economic Situation in the Republic of Armenia in January-December 1999*, Yerevan, Armenia, July 10, 1999.

<sup>11</sup> Associations which in fact are not economic entities

## b) By consolidated industries (branches)

Consolidated industries	Total registered as of January 1, 1999	New entities registered in 1999	Total registered as of January 1, 2000
Agriculture, hunting and forestry	2208	175	2335
Fishing	134	12	144
Mining and utilization of open deposits	7300	491	7785
Processing industry	382	36	380
Energy, gas and water supply	2275	112	2331
Construction	21551	1134	22169
Wholesale and retail trade, repair of vehicles, motor- cycles, household appliances	1042	75	1178
Hotels & restaurants	1147	155	1318
Transport, warehouses and communication	123	17	133
Real estate transactions, leasing and commercial activities	2136	252	2373
Government / defense / social insurance <sup>12</sup>	58	3	57
Education	465	30	492
Health care and social services	781	79	849
Public utilities, other social and individual services	1576	153	1699
<b>TOTAL</b>	<b>41232</b>	<b>2731</b>	<b>43313</b>

## c) By type of ownership

Type	Total registered as of January 1, 1999	New entities registered in 1999	Total registered as of January 1, 2000
State property	2803	216	2802
Cooperative property	24326	2207	27433
Armenian residents' property	11495	7	10216
Foreign property	1267	8	1233
Mixed property	564	160	743
Property of joint ventures	786	149	914
<b>TOTAL</b>	<b>41241</b>	<b>2747</b>	<b>43341</b>

## d) Investments of legal entities and separated subdivisions registered in 1999

	During January -December 1999	
	Number	Investment amount (mln. drams)
Total registered legal entities and separated subdivisions	2747	57537
Enterprises with foreign investments	309	17077
Joint ventures (foreign + local)	149	16436
Enterprises owned by foreigners	160	640

<sup>12</sup> Armenians' and foreigners property.

REGISTERED ECONOMIC ENTITIES BY LEGAL FORM  
(as of January 1, 1999)

Location	Organization				
	Individual enterprises and family businesses	Full and limited economic partnerships	Separated subdivisions of enterprises	Subsidiaries	Production cooperatives
Yerevan	4606	1390	247	858	2676
Aragatsotn	264	17	19	58	217
Ararat	390	68	21	90	443
Armavir	626	81	19	89	319
Gegharkunik	1122	29	23	97	276
Lori	1011	47	46	165	464
Kotaik	982	389	40	124	462
Shirak	583	31	38	146	386
Syunik	861	70	24	77	456
Vayots Dzor	162	25	9	32	54
Tavush	717	10	19	42	254
Total in RoA	11324	2157	505	1778	6007

NUMBER OF LEGAL ENTITIES WITH FOREIGN INVESTMENTS IN THE REPUBLIC  
OF ARMENIA (BY MARZES) AND THEIR FOREIGN FOUNDERS

Location	Total number of legal entities and separated subdivisions	Selected percentage of total	With foreign investments		
			Total	Selected percentage of total	Total investment (million drams)
Yerevan	1401	84%	1684	86%	
Aragatsotn	15		20		917
Ararat	24		23		3
Armavir	26		31		1,182
Gegharkunik	7		9		16
Lori	43		43		503
Kotaik	52	3%	74	4%	2,192
Shirak	61	4%	49	2%	75
Syunik	20		19		340
Vayots Dzor	8		10		5
Tavush	6		5		13
Total in RoA	1663		1967		123,672

## D. SME Legislation

Currently no laws that are specific to SMEs exist in Armenia. The Ministry of Industry and Trade developed draft legislation, but it has not been promoted further. A draft SME law was presented for the consideration of the government on June 28, 2000. The Government session underlined the necessity for the approval of this draft, but by the request of the representatives of the Ministry of Industry and Trade it was not presented for voting. It was decided to introduce some amendments and modifications to the draft and deliver for the government session's approval later.<sup>13</sup> The law is entitled On the State Support to the SME. It contains 5 Articles and provides the definition of the SME (See Attachment 3) and framework of the SME activities in Armenia. Hereunder is presented brief summary of the draft.

Article 1 defines the purpose and subject of this law. According to this Article, the law shall ensure the implementation of targeted, market-oriented policy directed at the support of SME. The law defines main features of the persons (subjects) considered SME and guiding directions of the state policy on SME. Article 2 defines the SME subjects (provides SME definition). It sets forth the requirements for the subjects to be considered SME for the purposes of this law. Following persons are considered to be SME under the requirements of this law:

- Commercial organizations with less than 5 employees and private (individual) entrepreneurs. These persons are considered to be mini-enterprises;
- Commercial organizations are considered to be small enterprises, if the number of employees is as follows:
  - 6 – 40, if the organization (enterprise) is enrolled in the industry and related business;
  - 6 – 26, if the organization (enterprise) is enrolled in the building business;
  - 6 – 15, if the organization (enterprise) is enrolled in the transportation, trade and provision of other services.
- Commercial organizations are considered to be medium enterprises, if the number of employees is as follows:
  - 41 – 80, if the organization (enterprise) is enrolled in the industry and related business;
  - 26 – 50, if the organization (enterprise) is enrolled in the building business;
  - 15 – 30, if the organization (enterprise) is enrolled in the transportation, trade and provision of other services.

Article 2.2 codifies the list of the organizations, which cannot be considered SMEs: financial, insurance and investment companies, professional participants of the securities market, persons conducting the activities on the organization of casinos and lotteries, as well as dependent and subsidiary companies.

Article 3 defines the substance of the state support to the SME promotion. The following comprises main directions of the SME promotion state policy (strategy):

- Financial and investment support to the SMEs, including provision of guarantees;
- Establishment of the SME related infrastructure and its development;
- Provision of the information and consulting support to the SMEs;

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<sup>13</sup> This information was received from the SME Department of the Ministry of Industry and Trade.

- Promotion of the foreign economic activities of the SMEs;
- Support to the innovative activities of the SMEs;
- Implementation of the relevant taxation policy promoting the SME development;
- Organization of the training and qualification courses for the SME professionals;
- Establishment and development of the cooperation between the SMEs;
- Increase of the SME competitiveness;
- Simplification of the system of financial reporting and accounting for the SMEs.

Article 4 refers to the issues of the state program on the SME support and promotion. Under the requirements of this Article, the state program on the SME support and promotion comprises part of the State Budget. Following the adoption by the National Assembly of the State Budget, the government shall within one month approve the state program on SMEs. The program is implemented by the state bodies. The Article foresees the establishment of the specialized organizations for the effective implementation of the program or constituting part (parts) of it.

Article 5 codifies the “grandfather clause” for the SME. Under the requirements of this Article, the SMEs are entitled to implement the legislation of the date of their incorporation (establishment) for three years from the moment the mentioned legislation was “negatively” amended.

Thus, the presented draft contains the regulatory framework for the SME activities in Armenia. It codifies main guarantees for the SME promotion (grandfather clause), SME definition and requirements for the state policy and program on SME development and support. Nevertheless, the draft does not include any provision on the relevant authority responsible for the development of the state policy/strategy and program on the SME. At the same time, this issue could be resolved either through the codification of the relevant provisions in this draft or through the adoption of the appropriate sub-legislative documents.

It is obvious that for the purposes of the proper SME development in Armenia the adoption of the relevant law providing regulatory framework for the SMEs is necessary.

#### **E. Legal incentives for the promotion of SME**

Taxation legislation does not incorporate any provision on the tax allowances for start-up businesses. To change this, taxation legislation could be reviewed in order to draft the relevant provisions; these changes would assist in the promotion of the SME development.

Registration of a new legal entity costs around 400-500 USD with the involvement of the consulting (legal) company or 200-300 USD if the registration is conducted without the involvement of the legal consultant. The registration process can take up to two weeks, though usually it is completed conducted within a week of the submission of the relevant documents. It should be noted that the registration procedure will be reformed shortly in accordance with the Civil Code. Required payments (state duty, charter capital, etc.) amount to 120 USD. Thus, the registration process takes some efforts and funding (quite a considerable amount, considering the current economic and social situation in Armenia) of the applicant and shall be considered while developing the strategy for SME development.

Finally, the involvement of the traditional banking sector in SME development shall be encouraged. As it was pointed out during the recent meeting in USAID, most commercial banks

are not willing to provide the loans due to the low liquidity of the pledge and complicated legislative regulation of this issue (use of inefficient and time-consuming court mechanism, which could require several months of process, thus, negatively resulting at the price of the pledge). Development of the ADR (Alternative Dispute Resolution) mechanism could provide some solution to this problem.

### *3.4 Women in the SME sector in Armenia*

The Government of Armenia has joined the Beijing Platform of Action and elaborated a “National Plan of Action on the Improvement of the Status of Women and Empowerment of their Role in the Society.” However, as indicated in the UNDP Women Status Report, Impact of Transition, Armenia 1999, “the process of implementation has been controversial and continues to remain subject to heated debates”.

As in other countries in transition, Armenian women are educated and in the past used to occupy high positions both in the economy and in government. This situation has deteriorated over the last ten years and it is an accepted view that women have suffered most from the transition process.

There is a general lack of up to date statistics in Armenia, especially those related to business. In addition, like in many countries there are very few disaggregated statistics available. This situation is further aggravated by the existence of the shadow economy and the continuous trend of Armenians leaving the country to find jobs elsewhere or emigrating. Consequently it is hard to know how many women business-owners exist; their participation in different sectors of the economy; their assets; the number of working employees in the private sector; etc.

#### *Selected employment data for women*

Women account for over half of the unskilled labor force (55%), which represents one eighth of total female employment. Over half of the women are employed in three sectors: natural sciences and health (where they account for 85.6% of employment); education (83.5%) and entrepreneurship and personnel management (83.5%). They occupy less than a third of qualified jobs (29.3%). Women account also for less than a third of vendors and marketing personnel (28%). Their share of jobs in the law sector and in government is remarkably low (5.6% and 18.8% respectively). Only in the trade and the agricultural sectors are pay scales (between men and women) nearly equal. In the banking sector, where average salaries are 3.3 times higher than the average in the economy, women’s wages are slightly over a third of men’s (37.4%). The average wages of women employed in all sectors of the economy amounts to 48.1% of men’s salaries.

#### *Women’s unemployment*

Economic restructuring marginalized women who account for an increased share of the unemployed. At the end of 1998, statistics indicated that for every 100 unemployed men there are some 240 unemployed women.

#### *Statistics for women entrepreneurship*

Women entrepreneurs in Armenia have been increasing over the last years – a global trend. According to recent surveys quoted by UNDP<sup>14</sup> in its 1999 Women Status Report, there are few women-owned businesses in production (6.3% of enterprises surveyed).

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<sup>14</sup> UNDP, *Women’s Status Report*, 1999.

Women entrepreneurs are mostly active in the MSME sector, i.e. in trade and services (15% and 16.3% of enterprises, respectively). A countrywide survey of 1,200 households indicated that 7.9% of women have self-employed status and only 0.2% have status of employer (versus 23.4% and 2.4% respectively for men). About 3.7 of the women surveyed attempted to establish a private business compared to 23.5% of men. According to UNDP Armenia, SMEs account for over 95% of the total number of registered enterprises. Of those, women represent 17.2% of entrepreneurs in Yerevan and 3.1% in the regions. In the microfinance arena, a recent survey indicates a conservative market potential of 20,000 microentrepreneurs in Yerevan alone. Only up to 20% of this market is served as of today.

*Constraints for the development of women entrepreneurship in Armenia*

Both men and women entrepreneurs encounter difficulties, as Armenia has not yet designed an environment conducive to the development of entrepreneurship. However, women entrepreneurs face additional problems compared to men, due to lack of opportunities for training and time for entrepreneurship development.

The Business Women NGO (Gortsarar kin) conducted in 1997 a survey of women entrepreneurs. Over half of the women interviewed (65%) indicated that in Armenia women entrepreneurs face problems that men do not have. Those include household chores and childcare (for which no sufficient infrastructure exists), societal stereotypes regarding the place and the role of women and a lack of a favorable social climate, expressed in a negative attitude towards women entrepreneurs. In addition, there is a perceived lack of needed skills, knowledge and information; networks and access to credits. Only 30% of the women entrepreneurs interviewed expressed confidence in the future of their businesses.

As of this year, the National Statistical Service continues to gather gender-disaggregated statistics of all established and closed enterprises in the country.

## 4. ENVIRONMENTAL ANALYSIS

### 4.1 Macro Environment

As part of its analysis of the SME environment, the Assessment team looked at the variety of Macro-stakeholders. This included a full examination of the multilateral and key bilateral donor agencies, as well as a range of GOA ministries and agencies, including the President's office, numerous governmental ministries and agencies, and various international donor organizations working with the GOA within Armenia.

#### A. International donors

##### *The International Monetary Fund (IMF)*

Conducts monthly meetings with all multilateral and bilateral donors in Armenia. Since the end of 1999 has started a closer cooperation with the World Bank with the objective of reducing poverty.

- The IMF's Poverty Reduction Government Facility (PRGF) is a three year program, whereby the IMF is focusing on the macro reform including fiscal and external accounts, the World Bank is concentrating its efforts on the structural reform including the privatization and the IFC focusing on the development of the private sector. The SME sector is considered to be a priority and the government seems to be moving ahead with the process of removing barriers. Several projects monitored by the IMF are under way:
  - conduct civil servant reform;
  - set into place financial disclosure of public servants;
  - streamline enterprises' registration procedures;
  - define the profile of ADA;
  - lend to the Central Bank to finance budget deficits including conditionality on poverty reduction.

##### *The World Bank (WB)*

Total IBRD/IDA commitments to Armenia as of July 1999 were US\$607 million for 20 operations. Armenia became a member of the WB in 1992 and of IDA in 1993. Currently there are 15 WB financed operations underway and five others have closed. Since 1995 the bank has approved four adjustment credits in support of Armenia's economic reform program and three technical assistance projects to assist the implementation process. In 1997 an IDA credit was approved to support private investment, banking reform and private enterprise development. The following are relevant projects to the development of the SME sector:

- Enterprise Development Project (EDP) US\$16.75MM, started in 1997 is implemented by the Ministry of Finance via six banks and aims to finance small production enterprises;
- Study of administrative barriers for the development of SMEs in Armenia. Was started in February 2000 as part of Poverty Reduction Strategy (PRS) via the Ministry of Finance.
- Anticorruption issues are a priority on the Bank's agenda: the elimination of causes for corruption such as low salaries to public servants; the elimination of barriers to investment, export promotion and job creation.

- Judicial reform project: reform and train judges. Subcontract to local consulting companies; civil servant law is under preparation (to be completed in the fall of 2000);
- Support to tourism sector via the Institutional Development Fund of up to US\$371,000 for developing a concept of cultural/ecotourism for the entire Caucasus region, including Azerbaijan and Georgia.

*The International Finance Corporation (IFC)*

The IFC supports the SME sector in Armenia by providing technical assistance in Corporate Governance. This involves training related to boards and shareholders issues; development and dissemination of publications including a Corporate Governance Manual and advisory services to the government to improve legislation on corporate governance. Further, the IFC has contracted Shorebank Advisory Services (SAS) to do a feasibility study for a Small Business Equity Investment Fund in Armenia. Shorebank submitted the final report in May 2000, and the project is currently under review.

*United National Development Program (UNDP)*

UNDP supports the SME sector through the following projects:

- Export Development Project started in 1998 and is co-financed by UNDP and the Ministry of Industry and Trade (MIT) from WB resources. MIT has not made a contribution as yet. The project is implemented by the Armenian Development Agency (ADA). Its objective is to contribute to Armenian economic development through the promotion of exports. The project is linked to the International Trade Center, established by the WTO in Geneva. ADA focuses its efforts on the development of light industry. Using ITC consultants, UNDP has surveyed 127 companies in 7 sectors throughout Armenia. The SME employment definition used was: micro 20 or less; small 20 to 50; medium 50 to 200; and large 200 or greater. Three sectors were selected to receive technical support: machinery and electronics, software development and textile/garments. Of these, ADA selected three companies that showed a high export potential. ADA will provide them with marketing support, will arrange meetings with importers and will follow-up with contacts. ADA produced an export directory; a credit card scoring system tool for evaluation of enterprises; it organized Train the Trainers seminars in information technology and communications. ADA plans to foster further linkages with other SME support programs such as ProSME/TACIS whose focus is on software development.
- The Microfinance Forum: US\$12,000 to support microfinance institutions in Armenia in their efforts to lobby the government for the creation of an enabling environment for the microfinance sector.

*European Bank for Reconstruction and Development (EBRD)*

EBRD supports the SME sector through the following projects:

- Multibank Financing Framework Facility, Euro10MM. Started in 1999, it is designed to invest equity and debt into the Armenian financial system. Armenian banks have to pay high interest for funds, i.e. LIBOR+6, which brings their cost of funds to 10-12% per annum. Banks on-lend these funds to SMEs at terms and conditions that they judge appropriate. EBRD doesn't impose any restrictions regarding loan terms and conditions upon banks.

- EBRD has subcontracted Bannock to implement a credit expertise building project for Armenian banks. The project cost is US\$10million and it includes a fund that will be given to eligible banks as lines of credit for on-lending to SMEs. The project has also a Technical Assistance/Consulting component. Terms of conditions of the loans are negotiated individually with each bank. The project started in 1999 and it is likely that it will continue past the initial deadline of end 2000. 4 banks have been identified so far. EBRD/Bannock will be involved in the lending decisions. Bannock's involvement will decrease gradually while lending know-how will be transferred onto the banks through training.
- Direct SME investment facility: to start this year; this involves both equity and debt. EBRD can take up to one third equity position (although during the first year of investment it can go up to 49%, provided this would be reduced to the required ceiling mentioned above within one year). No collateral is required from the SME side. On the debt side EBRD will lend directly to SMEs, not through banks. The bank hopes to attract other investors in this program. One project is currently under scrutiny, in the due diligence phase. SMEs themselves approach the bank, in other words the program is demand driven. Qualifying SMEs have to be bankable and the bank's investment lasts 5-7 years at the end of which the bank pulls out completely. EBRD has produced a strategy paper that identifies as priorities the energy, financial and agribusiness sectors. However the banks do not envision adhering strictly to these sectors.
- Indirect provision of equity funds through a US\$8MM investment in the Caucasus Fund.

*EU – Technical Assistance to the Commonwealth of Independent States (TACIS)*

Armenia received at the end of 1999 over Euro 200 million of grants and technical assistance and Euro 86 million in loans from the European Union. Among the ongoing projects to support the private sector are Armenia's WTO accession and an agreement with MIT to identify and support the 11 subsectors of the economy deemed to have potential for growth. These are: Machine Tools and Machine Building Industries; Construction and Building Materials, Information Technologies; Chemicals and Pharmaceuticals; Food Processing; Loan Schemes Assessment; Electronics; Garment and Textiles; Leather and Footwear; R&D and Tourism.

In addition to these multilateral donors, there are several bilateral agencies working in Armenia. These include the following.

*Canada: Canadian International Development Agency (CIDA)*

CIDA disbursed over C\$130,000 to support Armenia's economic reform. A major part of this aid was geared to enhance Armenia's export capacity with the participation of the Trade Facilitation Office in Canada.

*Germany: BMW (KfW and GTZ)*

Through KfW Germany committed DM 65 million to a number of projects including an SME credit facility while GTZ is supporting, among others, a technical assistance program, ProSME.

*Japan: JICA*

Japan provided Y5.8 billion for project and non-project related grants as well as over US\$1.5 million to a technical cooperation fund administered by the World Bank. The

Japan-Europe Cooperation Fund has provided Y99.52 towards the development of the financial sector while the Japanese International Cooperation Agency (JICA) is implementing a study for a Private Sector Development Master Plan.

*UK Department for International Development (DFID)*

The DFID-administered Know-How Fund in Armenia has various projects that support the development of the SME sector including advisory on customs and tax; support for the Banking Advisory Center, a review of the Armenian handicraft industry as well as support focused on vulnerable regions.

*USAID*

In 1998 the total USAID budget totaled US\$135million (71% programs and 29% humanitarian). It included US\$11million for a market reform program (tax, regulatory, legal, fiscal and accounting reform); US\$10million for education and institutional building; US\$7.4million for judicial reform and law enforcement and US\$6million to support private sector growth in agriculture and agribusiness. In 1999, USAID programs focused on the following:

- ✓ Micro-credit Program (Finance for International Community Assistance);
- ✓ Direct, Technical Assistance to SMEs (International Executive Service Corps - IESC);
- ✓ The Caucasus SME Finance Program (Shorebank Advisory Services)
- ✓ Armenia Enterprise Accounting Reform (Sibley International)
- ✓ Agri-business Enterprise Development (Agricultural Cooperative Development International/Volunteers in Overseas Cooperative Assistance)
- ✓ Small Business Loan Program (Eurasia Foundation)
- ✓ Association Development Program (Eurasia Foundation)
- ✓ Armenia Bank Supervision Project with the Central Bank of Armenia (Barents Group)
- ✓ Tax Policy Reform Project (Barents Group)
- ✓ Capital Markets Development (PricewaterhouseCoopers)
- ✓ Land Reform (Ronco Consulting Corporation)

## **B. Private Sector Players**

In addition to these donor agencies, and donor-supported projects, there are several private sector players who provide financial support to businesses in Armenia. These include the following equity fund.

*The Caucasus Fund, LLC (The Fund)*

Established in 1998 by two venture capitalists, J. P. Morgan and Junction Investors, the Caucasus Fund won a tender from OPIC to support emerging markets by creating an equity fund. The Fund's pledged equity totals US\$92 million (including US\$60 million from OPIC) and it is going to cover four countries in the Caucasus region including Armenia. Today, the available funds total about US\$30,000, including US\$8 million that EBRD contributed. The Fund was established in Armenia in 1999. It now employs six people in Yerevan, and thus far two projects are 90% approved.

There are primarily five fields for investments by the Fund: real estate; transportation; agribusiness; financial services and telecommunications. The fund requires 50% equity participation by the client. If a third party foreign investor has an equity participation, the total share of the foreign partner and The Fund should be over 50%. Requirements include a three year payback and an internal rate of return of minimum 30%. Minimum equity participation by The Fund is US\$1million, and the maximum is US\$5-6million.

#### ***4.2 Intermediate Environment***

The next phase of the team's analysis focused on the intermediate environment, particularly the direct providers of support and assistance to the SME sector. These included financial providers, business support providers (including donors, for profit and non-profit organizations), and associations facilitating the SME development throughout Armenia.

#### **A. Financial Providers**

It is clear from our assessment, and from others, that Armenian SMEs lack easy access to affordable financing (credit and venture capital). In terms of credit provision, local banks lack experience in lending to private enterprises. Armenian banks have difficulty securing commercial funds or deposits from the population, which further incites them to adopt very conservative lending practices. Basically, banks have not made credit decisions based on traditional lending criteria including business plan analyses, cash flow projections, and market projections; rather, Armenian banks tend to be very conservative and only engage their own funds in very short-term and highly collateralized lending (sometimes up to three times the loan amount). Their high collateral policy combined with high interest rates (24-36% per annum) and rather bureaucratic procedures do not encourage SMEs to borrow funds. This is especially hard for smaller businesses who lack the collateral required by banks and who are forced to borrow from friends and family or use moneylender funds which command very high interest rates.

##### *The Central Bank of Armenia (CBA) and the Armenian banking system*

CBA is responsible for regulating the banking system in the country. It is perhaps one of the most professional public institution in the country partly thanks to its policy of paying considerably higher salaries to its employees as compared to the rest of the economy. This has ensured lower turnover than in most other public sector offices. CBA maintains a liberal policy towards the provision of banking licenses.

The minimum capitalization requirements for existing banking institutions is US\$1million plus the obligation of meeting prudential requirements; this will increase to US\$2 million in 2005, and US\$5 million by 2005. Newly established banking institutions, however, now have a required capitalization of US\$5 million, plus the obligation of meeting prudential requirements.

From the 30 banks in operation today only two meet these criteria. The others are undercapitalized, and will probably have to face the challenge of closing down if they do not meet in due time the required level of capital. Although small, the banking sector has been restructured and provides a basis for development. There is only one state owned bank, SavingsBank, which is about to be privatized. The government owns negligible stakes in 2-3 banks (up to 4%). Up to 90% of the Armenian banking sector is in private hands. The banking sector in Armenia is transparent, the best regulated sector in the

economy. All banks are universal, there are no specialized financial institution in the country.

Banks are not equipped to serve well the needs of SMEs: they do not have a full range of services for SMEs. In the mid-1990s Armenia went through a banking crisis: bankruptcies; depositors lost their money. There was no legislation in place. The current legislation was established starting in 1996. The Armenian banking technology does not favor SMEs loans: the cost of processing loans is too high to entice banks to lend small amounts. Banks do not give loan proceeds quick enough; they check the borrower's enterprise to determine whether to release each tranche of the loan. They do not operate lines of credit. The monitoring system is too costly for too small loans. The only exception is ACBA, which makes small loans and is the fastest growing bank in the sector. Through GAF, several Armenian banks are also learning how to make smaller loans.

There are nine foreign resident banks in Armenia with no limit on foreign shareholding. Foreign banks are subject to the same regulatory regime as the local banks. Midland Armenia Bank was established as a foreign resident commercial bank in 1996, US\$10MM capital (a member of the HBSC Group, UK). Other banks with significant foreign participation include Rossiiskyy Credit Armenia (Russia); Menatep-Yerevan (Russia), Mellat Bank (Iran) and the International Commercial Black Sea Bank of Greece. All bank assets total US\$370MM.

The T-bill rate in May-June 2000 was 18-19% in AMD. Interbank lending rate is 22% in US\$. CBA repurchasing transactions bear a 17% interest rate in AMD. Banks pay a 10-15% deposit rate. Lending from bank sources is done at 26-36% pa.

- Insurance is regulated by the Ministry of Finance. To date there are no specialized agencies dedicated to leasing.
- Guarantee funds: there is a draft law in Parliament concerning deposit insurance funds.

#### *Agricultural Cooperative Bank of Armenia (ACBA)*

ACBA appears to be the strongest and fastest growing bank among the local banks in the country. Created with support from TACIS after the European cooperative bank model (Credit Agricole, France; DG, Germany and Rabobank, The Netherlands) in 1995, it is the only cooperative bank in the country. It covers today 340 villages, that is over 40% of the number of existing villages nationally in six regions. It has 15,000 active clients; US\$10million in assets; US\$5million in capital (the 2<sup>nd</sup> bank in the country, after HBSC). Loans are made individually but the village associations guarantee individual borrowers.

Like its model banks, ACBA has a three layer structure: 1) village associations; 2) regional unions of village associations (apex organizations) and 3) a central point in Yerevan. The regional unions are the shareholders; they hold approximately equal parts.

Last year profits totaled US\$800,000, which makes ACBA the most profitable bank in Armenia. ACBA's portfolio includes 80% rural clients and 20% urban; 9% of the total clients are women. The breakdown of borrowers between Yerevan and the regions is 30-70%. Approximately 25% of the clients are women. ACBA employs 100 people, women constitute 15% of the management of the bank. About 70% of the employees

have participated at training sessions abroad. ACBA is currently implementing credit schemes for EBRD, IFAD, WB and the German Armenian Fund.

Terms and conditions: US\$1,000 for first time borrowers, repeat borrowers can access loans of US\$5-10,000, maximum loan amounts are US\$40,000. Average term is 7-8 months, maximum 24 months. ACBA has only two projects that have longer terms (4 and 6 years respectively). Interest rates are 24-30% in ADM and 16-20% in US\$. Repayment rates are 100%.

#### *Microfinance Institutions in Armenia*

The population served by these institutions is not part of the scope of our present mission. Although successful so far, the Armenian experience in microfinance is too recent to allow for drawing conclusions. Based on other countries' proven experience in microfinance, up to 8% of the microentrepreneurs clients "graduate", i.e. become owners of growing enterprises that are bankable. It will be interesting to see the trend that develops in Armenia where microentrepreneurs tend to be more educated (99% literacy rate) than in the regions where microfinance was born (SE Asia and Latin America).

Over the last years a number of microfinance institutions were established in Armenia to address the borrowing needs of very small entrepreneurs. This was made possible by bilateral donor funds channeled through several international non governmental organizations (INGOs) such as CARE, CRS, FINCA, OXFAM, Save the Children and UMCOR. Donors include GTZ, Open Society Institute, USDA (including direct credit provision), and USAID. In addition other such institutions have been established in Armenia by-NGOs or UN agencies to address the needs of populations that are not within the target group for this mission (agricultural producers or groups of entrepreneurs considered vulnerable, etc.). The latter include IOM/UNDP.

#### *Donor supported credit programs*

There are several donor established lending programs, mostly operated through local banks set up in response to SMEs' need to have increased access to finance. Under various of these programs several Armenian banks have started to access funds for on-lending to SMEs. However, as banks often take 100% of the lending risk<sup>15</sup>, many of the programs allow the banks to determine loan terms and conditions; this often results in very high rates, and less-than-desirable loan conditions. In practice, newly established SMEs or those that lack adequate financial resources cannot gain access to these funds.

Many SMEs have expressed their frustration at what they perceive to be programs that mostly strengthen the financial institutions not the SMEs themselves. As a result, few companies respond to the selection criteria of these programs thus relatively few loans have been made to date. The following table summarizes the characteristics of the various credit schemes available to SMEs and the number of loans outstanding. SMEs have shown a moderate interest for these credits which they find unsustainable because of their high interest rates, heavy collateral obligations and sometimes cumbersome application and loan extension procedures.

#### *The Lincy Foundation (LF) Loan Agreement*

The program is intended to provide opportunities to the private sector in Armenia to develop private businesses. It encourages productivity growth, export promotion, quality

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<sup>15</sup> For the Eurasia Foundation program and the USAID / Shorebank Advisory Services program for example.

increase and employment growth. In addition it aims to develop foreign and local markets and to strengthen the participating banks. The program is effective for 6 years, starting in July 1998. The program consists of the following: the Lincy Foundation makes a non interest-bearing loan to the GoA.

The implementing government agency within the Ministry of Finance and Economy has established a commission whose role is to approve the participating banks; the loan agreements to be signed by the GoA, the CBA and the local banks based on the recommendation of the implementing agency; review and approve monthly and annual reviews on the program implementation and monitor the program and keep LF informed of program related developments.

*The Izmirlian-Eurasia Foundation Small Business Loan Program*

The Izmirlian Foundation is Eurasia Foundation's financial partner in this program to provide credit to Armenian SMEs. Borrowers' business sectors include: manufacturing, services and agribusiness. Excluded areas are: trade, alcohol and tobacco production, gambling and military and activities deemed to be harmful to the environment. Borrower companies have to be 100% privately owned (joint ventures are excluded).

Applications are submitted initially to the partner banks and then to Eurasia Foundation's credit committee who makes the final decision. Processing time takes on an average one and a half months. Operational costs of EF are covered by EF in the US. In fact EF US is the lender of record: funds are kept in the US and loan repayments are transferred to EF, US on a monthly basis. Program partner banks are: Anelik Bank, Armagrobank, Credit Service Bank, LendBank, and ShirakinvestBank.

CBA is establishing a training program with material created by EF. It is based on modules of different lengths: ½ days to 1-2 weeks of training.

*The Caucasus SME Finance Program/USAID*

Is a program to implement a small and micro business investment fund in the Caucasus. The fund provides financial services to microentrepreneurs through FINCA International and SME loans through Shorebank with financing of the USAID. The latter are implemented with the help of Shorebank Advisory Services (SAS), Shorebank's advisory and consulting arm. The main focus of the program is to provide financial resources and technical assistance to partner financial institutions and SMEs. Eligible SMEs have approximately 50 employees; are engaged in production of consumer goods and services, business services and trade; are willing to commit their own funds to the project they seek to finance and are private enterprises minimum 51% owned by Armenian citizens.

Shorebank implements the program directly with private commercial banks to whom it provides training on lending methodology. Shorebank's work aims to create sustainable commercial lending expertise in Armenia. Shorebank began its partnership with the first financial institution in 1999 and now works with Armenian Development Bank, INECOBANK and Small Enterprise Fund (SEF)/World Vision.

Shorebank has two lending products in Armenia:

- The Developing Enterprise Loan (DEL)
- The SME Loan

The DELs amount to US\$1-12,000 (average loan amount is US\$4,500) and the SME loans to US\$10-75,000 (average loan amount US\$40,000). Terms are 3 to 24 months. Interest rates vary by institution but are maximum 21% pa for SME loans and 48% for the DEL Program. All loans are denominated in US\$. Repayments made out of interest and principal are made monthly. Grace periods may be granted when deemed appropriate. Purpose of the loan: purchase of machinery and equipment, capital improvements, purchase or renovation of real estate; of inventory and/or working capital. Collateral utilized: real estate; equipment and machinery plus personal guarantees from owners and managers. The breakdown by sector of both DEL and SME Program is: production: 34%; services 31%; trade 35%. Future plans include to use an existing affiliate of Shorebank, Shore Overseas Loan and Guarantee to manage direct lending and to create a guarantee fund from which to identify additional investors by the end of 2000. The guarantee fund is planned to guarantee up to 70% of the lending risks which is expected to encourage banks to enlarge their lending capacity.

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## Donor supported credit lines for SMEs

	World Bank EDP	Lincy Foundation (LF) (Kirkorian)	German Armenian Fund/KfW	Izmirlian EURASIA Foundation/ USAID	Caucasus SME Finance Program/ USAID
Year started	1997	1998	1999	1995	1997
Number of loans disbursed	70	13	401	186	46 11 SME loans 35 DELs
To women-owned businesses	?	?	10% 25% by design	10%	9%
Portfolio at risk	?	?	<2% >30 days	1%	3% DEL 0% SME
Total amount disbursed	US\$11MM	US\$7.5MM	US\$2.6MM	US\$4.8MM	US\$.56MM
Loan capital	US\$16.75MM	US\$100MM	US\$3MM for 40 years, 10 years grace period	US\$35,000 100,000	US\$2MM
Loan amount		US\$ equiv.	US\$ equivalent	US\$	US\$
▪ Average	?		6-7,000;	35,000	4,500-40,000
▪ maximum	US\$500,000	1,000,000	25,000;	100,000	75,000
▪ minimum	?	100,000	1,000	?	1,000
Interest rate per annum	defined by banks	maximum 15%	19-30% in the future will drop to 24%	up to 18% 15% for repeat clients	21% (SME) 48% (DEL)
Cost of funds for banks	LIBOR + 2%	3%	NA	?	?
Term	up to 7 years	up to 3 years	up to 3 years	average 18 mos	3-24 months
Currency	AMD	AMD	AMD	US\$	US\$
Collateral	as defined by banks	As defined by banks	130% of loan amount	100%	As defined by banks
Borrowers' location	Yerevan, regions	?	50% Yerevan, 30% Echmiadzin 5% Artashat, Vanadzor; in the future Gyumry and Syunik Marz	40% Yerevan, 60% in Syunik and Lori Marzes	19% of approved loans are outside Yerevan
Implementing agency	Ministry of Finance and Economy	Ministry of Finance and Economy	apex unit in CBA and IPC (6 staff)	EF Yerevan and US	Shorebank and FINCA International
Role of implementing agency	Apex unit lends to banks; banks make final decision	Approves business plans; LF, US makes final decision	Apex unit lends to banks and bears exchange rate risk; IPC trains bankers and participates in the credit committee	Trains bankers and makes final decision	Trains bankers and makes joint credit decision
Methodology	SMEs apply directly to banks; banks take 100% lending risk	SMEs apply directly to banks; banks take 100% lending risk	Lending via banks that bear 100% lending risk.	50-50% risk	Lending via banks who bear risk
Number of participating banks	12 banks	13 banks selected so far from a total of 14 banks	3 banks selected so far; 3 more in the process of being approved	4 banks	3 banks and an NGO, World Vision
Marketing	Verbal, advertising by banks, press conferences	Verbal, advertising by banks, press conferences	Verbal, advertising by banks; press conferences	Advertising by banks; press conferences	Verbal

*German Armenian Fund/ KfW (BMZ)*

The main objective of the German Armenian Fund (GAF) is to develop and strengthen Armenian financial institutions providing financial services to SMEs. The lending is processed through the commercial banks approved to participate in the program. The GAF provides loans in drams (AMD) for two types of programs:

- The microloan financing program
- The small loan financing program

The microloan program extends loans of up to the equivalent of US\$8,300 for up to 3 years. Eligible borrowers employ maximum 20 people. Depending upon the type of business, interest rate is 2-3% per month. The small loan program extends loans from US\$8,300 – 40,700 equivalent and is available for businesses with less than 50 employees. The life of the loans is up to 3 years and interest rates vary from 2-3% monthly. All loans must be secured by collateral. If of smaller size, collateral is stored in a warehouse during the time of the loan. Loans are repaid in equal monthly amounts and grace periods are available only on an exceptional basis.

The GAF program entails training of bank officers and general provision of technical assistance aimed to strengthen the institutional and technical development of partner banks and lead to profitable micro and small enterprise lending. The following banks have been approved for participation in the GAF: Armagrobank, Bank Anelik, Agricultural Cooperative Bank of Armenia (ACBA) and Armeconombank. 37 loan officers have been trained in credit analysis and streamlined procedures. On the job training lasts one year. Special GAF units have been established in the participating banks. The first three banks are covering all their administrative costs related to the GAF operations.

While initially focused on the urban clientele of Yerevan the GAF is covering rural areas as well. The latter is conducted with ACBA. Rural loans range typically from the equivalent of US\$100-5,000. There are no restrictions for selecting borrowers other than environmental constraints; no casinos, real estate; stock speculation. The portfolio is distributed by loan amount as follows: 73% loans less than US\$5,000; 10% loans between US\$5-10,000; 9% loans between US\$10-30,000 and 8% loans over US\$30,000.

## B. Business Support Providers

Business Support providers are defined as those firms or organizations that provide direct technical assistance or consulting services to SMEs. They include donor organizations and programs, for-profit firms, and non-governmental organizations (NGOs).

### *Business Consulting Companies*

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ Well equipped (PC, copiers, etc., )</li> <li>✓ Well informed on donor funding sources (grants and credit lines)</li> <li>✓ Have access to Internet</li> <li>✓ Majority of the managers have personal contacts with the donor organizations and government officials</li> <li>✓ Experienced in business plan and grant proposal writing</li> <li>✓ Managers and most of the consultants have good educational background, speak English and are under 40 years old</li> </ul>	<ul style="list-style-type: none"> <li>✓ Major clients are international donors and the government</li> <li>✓ Managers and most of the consultants have little personal business experience and professional education as consultants</li> <li>✓ Lack of appropriate diagnostic tools in analyzing client firm's business operations</li> <li>✓ Avoid long-term, responsibility sharing success fee relationship with client firms</li> <li>✓ Lack of technology transfer and intellectual property commercialization expertise which are important issues of export oriented industrial companies</li> </ul>
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ Training and follow-up consulting services that SMEs can afford are in high demand both in Yerevan and provinces</li> <li>✓ In some subsectors SMEs are stepping into development stage and are planning investments in new technologies which opens a new niche in consulting – technology transfer marketing</li> <li>✓ Foreign investment match – making for SMEs another consulting service niche emerging in post-privatization Armenia</li> <li>✓ International donors are increasing training of trainers and consultants programs which may increase professionalism of local consulting companies</li> </ul>	<ul style="list-style-type: none"> <li>✓ Local consulting companies are not and will not be for the next 3-5 years self-sustainable without donor clients</li> <li>✓ Local consulting companies do not specialize in specific sectors of business or industries and as a result they can not compete successfully with foreign consulting companies who are increasing their presence in Armenian market</li> </ul>

### *Analysis*

Estimates are that approximately 40 business consulting companies are registered in Armenia. However of those, only 20-25 firms are operational, and most of them are receiving grants or other types of assistance from USAID and other donors agencies that help to sustain them. As an example, a key project was implemented by AED, under the sponsorship of USAID, in 1999 using a bid mechanism to select business consulting firms for participation in a train-the-trainer and SME training program. Of the bidders, 18 firms were selected to provide SME training in

two areas: basic business skills development (implemented by 14 firms); advanced business skills development (implemented by 4 firms). In 2000, the program was further refined and the number of participating business consulting firms was reduced to 7. The training programs were also combined into a single SME business skills development program, which is currently ongoing. In fact, the program has been extended until spring of 2001.

The Armenian business consulting companies surveyed ran the gamut in terms of size, staff experience, services provided, and financial stability/sustainability. The one thing they all seemed to share was knowledge of how to apply for and obtain donor grants and to keep that funding flowing i.e. when one donor grant expired another was engaged. Many, if not most, of these firms would not be sustainable without donor grant support. This is despite the fact that many of these companies have been support recipients for up to 5 years. There are several factors contributing to this situation: the absence of any prior institutional basis for business consulting/service oriented firms; the consequent long-term development required from start-up to full operation of facilities; the professional staff training needed to provide the requisite business skills being offered to SMEs; the functional skills development needed i.e. marketing/sales/pricing/etc. of services to develop a paying clientele network.

A long-term view must be taken in evaluating whether and how to continue donor support to business consulting/service companies so that they can become independent, self-sustaining organizations. There are a few firms that are already operating professionally and sustainably. Perhaps those are the firms which could be selected as a core for future development of this sector overall.

## C. NGOs and Associations

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ SMEs need basic training and industry specific information that may attract them to become members if these services are provided</li> <li>✓ There are many unemployed educated and experienced specialists in every industry to seek jobs in associations</li> <li>✓ There are many donor organizations willing to support, train and provide grants if the association has a good project</li> </ul>	<ul style="list-style-type: none"> <li>✓ Though formally there are elected board members most associations are governed by a boss instead of leaders</li> <li>✓ Lack of transparency on the budget and financial issues even for the regular members</li> <li>✓ Lack of regular services (information, training, consulting etc..) offered to members</li> <li>✓ Membership fees are not collected regularly or at all which result in total financial dependence of donors both international and local</li> <li>✓ Lack of skills and understanding of fundraising opportunities</li> </ul>
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ There are many SMEs mostly in provinces who represent potential interest groups and if provided competent guidance may become efficient business associations or informal clubs</li> <li>✓ If strong ethical norms are introduced and implemented these interest groups may form the core of local community life</li> </ul>	<ul style="list-style-type: none"> <li>✓ Business associations mostly are ignored by the government officials both in Yerevan and in province</li> <li>✓ Lobbying in Armenia is becoming the privilege of individual businessman and not the business association</li> </ul>

*Analysis*

While many business associations exist, none have been providing member services or have become articulate advocates for representing business interests before government. If momentum is to be sustained in economic reform and business laws are to be equitably, transparently, and predictably administered, businesses need to be active in monitoring and lobbying government actions. They need to broaden the base of public support for continued economic reform and pressure the government to take action in support of broader access to markets which will allow private business to grow and, with them, increase employment opportunities.

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### 4.3 Sectoral Analysis<sup>16</sup>

Before looking at particular industry sectors and sub-sectors for Armenia's SMEs, it is worth reviewing what is meant by competitive analysis and how this differs from comparative analysis, as we have applied competitive analysis in developing our SWOTs of these sectors.

#### *Comparative vs. competitive analysis*

Much has been written about making countries or industries competitive. In contrast to *comparative advantages*, which are nationally based, natural and static, *competitive advantages* are inherently sector-specific, human or societal, and dynamic. While comparative advantage is often inherited, can rarely be applied to other areas, and lost only over extended periods of time, competitive advantage is created within a sector, can be exported to or copied by another sector (or even country), and can be lost as quickly as it was gained. Thus, competitive advantage needs to be fostered and nurtured, by a combination of technological advancement and continuous improvement in the human capital base, physical infrastructure, and so forth.

Competitive analysis seeks to understand how the industry cluster is configured, how the players interact within and outside the cluster, and how decisions regarding investments in education, training, management, products and so forth, are being made and affected. Competitive analysis requires a thorough understanding of the value chain in a cluster, and how each player contributes to and is affected by other parts of the cluster. By understanding these elements we begin to understand how competitiveness is gained and maintained over time.

In scientific sectors, such as electronics, pharmaceutical, or software, competitive advantage is often maintained by investments in research and development, to preserve the "edge" over possible competitors "catching up". In addition to research, many of these investments are also directed to higher education, to keep the flow of qualified individuals that will hopefully continue the innovation process and improve on the existing advantage.

For service sectors, such as tourism, commerce, banking or transport, competitive advantage is developed by the quality of service itself. Even though "service" could be codified to the level of a science, service is ultimately provided by humans. While investments in infrastructure (hotels, technology, roads, airports, etc.) are necessary, investments in areas such as education (or training) become especially important as a means for sustaining competitiveness in this sector. In a few countries, such as Singapore or Switzerland, "high-quality service" is engrained at all educational levels. These countries have built world-class service industries where there was little natural (or comparative) advantage.

For example, in the case of tourism, competitive advantage builds on existing natural advantages such as beaches, forests, mountains, game, etc. Even so, globalization has also reached the tourism industry. The relative "cheapening" of travel costs in relation to personal income in developed economies and the increased ease of travel has fueled the growth of mass tourism (both business and leisure) to an extent not seen before. Even when a country has some unique attraction (natural or otherwise) to offer, the palette available to individuals is varied enough that tourists can now afford to be "choosy". Thus, sustained competitiveness in tourism still requires the additional value-added of high quality service. The dramatic decrease in tourism revenue in

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<sup>16</sup> In addition to 58 site visits to functioning SMEs, the PwC team took part in four focus groups involving 34 participants. Individual formatted profiles (like those utilized for site for individual site visit) for participants are included in Appendix E and outputs of discussions were factored into the sector SWOT analysis indicated.

Kenya and the parallel increase in neighboring Tanzania is a good example of this concept of building competitiveness.

### A. Manufacturing/Light Industry

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ Footholds in foreign markets.</li> <li>✓ Production aspects generally well managed.</li> <li>✓ General flexibility to market conditions.</li> <li>✓ Generally adaptable to manufacturing demands for change.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Dependence on imported raw materials.</li> <li>✓ Lack of sizable domestic market.</li> <li>✓ Limited knowledge of organization development principles, overall management information systems, and market development.</li> <li>✓ Training related to limited assess and knowledge of computer systems, especially for alternative cash flow analysis, quality and inventory control.</li> <li>✓ Lack of information on GOA law and regulation related to SMEs</li> <li>✓ General lack of awareness regarding HR issues particularly related to women's development.</li> <li>✓ ISO certification only somewhat limited.</li> </ul>
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ Market expansion, mainly to Russia at present.</li> <li>✓ Knowledge base of firms, particularly in production technology adds to attractiveness for potential joint ventures.</li> <li>✓ Relatively large, well-educated labor pool.</li> </ul>	<ul style="list-style-type: none"> <li>✓ GOA lack of Strategic Plan for SME development.</li> <li>✓ GOA lack of consistency or fully transparent laws and regulations regarding taxes, customs, etc. perpetuates bribery and the gray economy.</li> <li>✓ GOA continued lack of 'open sky' policy increases transport costs of import and export and limits new market development opportunities.</li> <li>✓ Inter-regional border issues severely limit new market development opportunities both in terms of ground transportation (infrastructure) and politically related issues.</li> <li>✓ Increasing risk of competition from foreign markets.</li> <li>✓ Restrictive bank policies: high interest rates, short term of loans, poor understanding of business cycles.</li> </ul>

*Analysis*

The breadth of the Manufacturing and Light Industry Sector is fairly expansive, though the sub-sectors share many of the same strengths, weaknesses, opportunities and threats. Nearly all held major market shares within the FSU and contributed greatly to Armenia's enviable position as a major supplier of high quality goods. Since the Soviet collapse, and subsequent wave of domestic privatization, these sub-sectors in particular have suffered from lost economics-of-scale (the behemoth plants now needing to be lean and efficient), a major shift or exodus in population demographics (gutting them of the best of their human resources), and an absolute requirement that long held attitudes and beliefs about basic production and markets be changed to accommodate new domestic and foreign potential.

In general terms, the sector has the potential to provide a tremendous foreign export market while the current reality is that only the Textiles Shoe, Electronics, and (to a lesser degree) Special Equipment Production sub-sectors are realizing the potential. That the Pharmaceutical sub-sector lags behind, is partly a reflection of its inability to adapt to western standards. It is also partly (certainly in the case of pharmaceuticals) an uphill battle to compete with western giants that are an increasing force globalization of the sector; only domestically, is their market for current output.

The main producers in the pharmaceutical sub-sector are "Phatmatech Ltd." (producing gemodez, Nacl, and glucose); "LIQVOR Pharmaceuticals" (producing blood substitutes); "NAREX Ltd." (producing an acid-milk product); "Yerevan Vitamin Plant, OJSC; and "Yerevan Chemical-Pharmaceutical Plant, OJSC. None of these firms demonstrates high capacity, and many are currently under-reporting personnel figures. Further, none have effectively working marketing and sales functions, and all are facing difficulties in adjusting production to internationally-accepted standards (a requirement for export). No specific statistics are available on the pharmaceutical sub-sector.

That said, Textiles, Shoes, and to a lesser extent, Special Equipment Production, subsectors are well poised to compete. The historical Russian market is huge and offers the most immediate opportunity for economic gains. There is realization that capitalization of that market is key to regain economic independence, though an eye is also cast on joint venture opportunities on the rest of the world either as a initial supplier or as a intermediary value added participant. Strong evidence of generally well managed operations (at least at the production level) by well educated owner/managers who's flexibility and adaptability to market condition and manufacturing demands are definitive across the board strengths. Unfortunately, there is very limited domestic focus on production, an understandable situation given local economic conditions.

On the down side, a dependence on nearly all imported production materials, small domestic market and the often repeated limitations of limited organization development, management information, and market development skill are major weakness that hamper growth. The lack of computer training and all that it entails is also a major constraint. Few owner/managers have computers and fewer still know how to utilize them to accomplish basic cash flow analysis, inventory and quality controls. The ability to do so severely limits responsiveness to fluctuations in cost of materials, change in demand, supplies on hand and planning for future market adjustments that impact basic breakeven and cost per unit. These confines, with the lack of fully understandable, consistent GOA laws and regulations (especially as they related to SMEs) combine to create an ongoing atmosphere of uncertainty within the sectors.

Financially, these sectors are also threatened by a near impossibility to obtain badly needed loans for capital expansion and working capital, in some cases even when offset by long term contracts with internationally reliable buyers. Restrictive bank policies, high interest rates, short term of loans, and an abysmally poor understanding of business cycles force too often force owners to either turn to the ‘gray economy’ or to continue losing ground to competitors.

## B. Communications

### *ICT Sub-Sector:*<sup>17</sup>

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ Significant involvement with foreign joint ventures or alliances</li> <li>✓ Well managed operations with a solid vision to the future</li> <li>✓ Willingness for flexibility and adaptability to existing and future market conditions and the demands for change both domestically and internationally</li> <li>✓ Limited dependence on imported materials</li> <li>✓ Minimal transportation related issues</li> </ul>	<ul style="list-style-type: none"> <li>✓ Small population with limited purchasing power</li> <li>✓ Historic ties are often with economically disadvantaged nations</li> <li>✓ Impact of ArmenTel monopoly</li> <li>✓ Knowledge of organization development principles and, in some cases, market development</li> <li>✓ Access to adequate numbers of fully trained IT professionals, updated to current demand requirements</li> </ul>
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ Significant global market expansion, except as restricted by ArmenTel, in all areas, particularly in software development and production</li> <li>✓ Knowledge base adds to attractiveness for potential joint ventures</li> <li>✓ Relatively large, well-educated, trainable labor pool</li> </ul>	<ul style="list-style-type: none"> <li>✓ Competition from foreign markets</li> <li>✓ Need to have strong collaborative effort between GOA, private sector, educational institutions and donor community</li> <li>✓ Restrictive bank policies: high interest rates, short term of loans, poor understanding of needs</li> </ul>

### *Analysis*

In many respects Armenia finds itself in a very disadvantaged position from a number of perspectives. First, it has a relatively small population with minimal purchasing power such that its own demand for products/services is at present not sufficient to be self-supporting with regards to stimulating any significant economic growth from within. It must reach outside the country to those countries with more purchasing power.

Secondly, it is landlocked, making it more difficult to reach markets outside the country in order to secure and expand its export business. This is exacerbated by its neighboring countries either do not have much purchasing power or which have trade restrictions due

<sup>17</sup> Refer to Appendix F, *The Republic of Armenia, ICT Assessment Report*, for expanded detail.

to historical and currently unresolved conflicts. It is difficult to gain access to global markets without having strong regional trade. Thirdly, during its recent history Armenia has been tied to the FSU, and as a result its international linkages outside the region are with those countries that in recent years have themselves suffered economic problems. And lastly, ArmenTel has a monopoly on the country's telecommunications capabilities—further limiting the country's opportunity and costs for linking to the global market electronically. This is further impeded by weaknesses in the local legal system that are not normalized with many emerging international standards aimed at promoting expanded trade via E-Commerce.

Nevertheless, Armenia does have a history in the high-tech arena that reflects the potential for success in entering and expanding its participation in the ICT arena. The IT/ICT markets are expanding worldwide and there's every reason to believe that the citizens of Armenia and the private sector can actively participate not only in growing the local ICT market, but also in the international dynamics unfolding through globalization.

In fact, it is already underway. There are several Armenian software firms already established exporting their products. There are also several U.S., European, and Russian companies that have established local subsidiaries in Armenia in an effort to fill their shortages of trained ICT personnel and lower their costs—thus increasing their competitiveness in the world market. To a considerable degree, these enterprises leverage off of the skills/knowledge-based developed during the Soviet era.

There are considerable differences that must now be added to the current situation if these new firms can have ultimate success. Firstly, the demand for products and services are from the world market, not the soviet state. This requires the need to update business practices to include new business models that seeks to participate internationally by marketing local skills/knowledge resources. Secondly the skills/knowledge need to be updated. While the engineering and logic fundamentals are the same, the tools and approaches are different. Retooling of current human capacity in the workforce is needed and retooling the educational system (public and private) for training the future workforce is essential. And thirdly, the roles of government and private sector must be realigned—with the government providing the stable, predictable, and business-friendly environment, and the private sector providing the financing, risk-taking, and ultimate economic engine in their updated business practices.

The need exists for the private sector to collectively establish a marketing approach that creates an Armenian presence in each of the target countries—for each of those sectors seeking economic expansion. This is not simply the ICT sector: it applies to tourism, jewelry and gems, handicrafts, etc.

With regards to strengthening and expanding the ICT sector, there is the need for the private sector to establish a strong certificate-based education capability to feed the growing demand. This should include establishing curriculum, etc. In addition to a full curriculum there is the need for vendor-specific certified training and a formal certification process with Armenia.

There is also the need for a strong collaborative effort between the GOA, the private sector (those within Armenia and those in the U.S. and Europe), the educational institutions (both public and private), and the donor community. This is needed to create an enabling local environment, provide the needed incentives for investments, the

investments themselves, upgrade the ICT-related skill base, and provide production and marketing linkages with the U.S., European, and FSU countries.

**Broadcast Media Sub-Sector:**

Private provision of television and radio are varied but limited to small companies, struggling to provide their services to impoverished regional areas of Armenia. Typically, 80% of their funding comes from advertisers, with 20% from NGOs, religious groups and the state. Though (in one such company in Vanadzor) one minute of airtime costs from \$1-5) approximately \$15 is needed to breakeven which clients generally can't pay. The result is an industry that is at risk for its existence.

While management attitudes are very open, positive, progressive and creative and personnel well trained, the ongoing financial situation makes daily programming a challenge. In that there are no specific laws regulating the sub-sector, stations are also subject to bribery by police and tax officials, the result of their own ignorance. Transmitter capacities are also low and electricity often intermittent. Realistically, there are few growth opportunities at least within the current economic climate.

**C. Services**

**Trade and Commerce Sub-Sector:**

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ Generally well managed.</li> <li>✓ Flexibility and adaptability to changing market conditions.</li> <li>✓ Local focus allows high degree of individual service.</li> <li>✓ Generally limited dependence on imported raw materials.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Small size of domestic market.</li> <li>✓ Lack of SME incentives for startup or expansion</li> <li>✓ Limited knowledge of organization development principles, overall management information systems, and market development.</li> <li>✓ Training related to limited assess and knowledge of computer systems, especially for alternative cash flow analysis, quality and inventory control</li> <li>✓ Lack of knowledge/information on GOA law and regulation related to SMEs</li> <li>✓ General lack of awareness regarding HR issues particularly related to women's development</li> </ul>

OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ Niche markets</li> <li>✓ Relatively large, well-educated labor pool.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Restrictive bank policies: high interest rates, short term of loans, poor understanding of business cycles.</li> <li>✓ GOA lack of consistency or fully transparent laws and regulations regarding taxes, customs, etc. perpetuates bribery and the gray economy.</li> <li>✓ GOA continued lack of ‘open sky’ policy increases transport costs of import and export and limits new market development opportunities.</li> <li>✓ Inter-regional border issues severely limit opportunities in terms of ground transportation related issues</li> <li>✓ GOA lack of Strategic Plan for SME development</li> </ul>

### *Analysis*

Firms visited were well managed and progressive. In all cases, they were flexible and adaptable to local market conditions, which allowed a high degree of individual service. They were involved with various support organizations but in all cases, fully self-sustaining. With some exceptions, firms have a limited dependence on imported raw materials, giving them the ability to be more competitive in the local markets they serve. Their greatest opportunity is to further develop niche markets in which they can naturally expand. That they can draw from a relatively large, well-educated labor pool for their own service provision needs is an additional opportunity. Their dependence on a small domestic market is weakness, although that is what provides them the ultimate in flexibility for niche market development.

All cited the lack of incentives for startup or expansion as a general weakness that SMEs faced. All were also well aware of their limited knowledge of organization development principles, overall management information systems, and market development. Training related to limited assess and knowledge of computer systems, especially for alternative cash flow analysis, quality and inventory control is needed (and acknowledged) if they are to sustain themselves over the long term. While most have the basics down, even the most basic alternative planning is cumbersome without it. Most, in one way or another, indicated that they were not well informed or versed in GOA law and regulation related to SMEs and were further ignorant of where to seek out such information. Though a high percentage of the total workforce in the sector is female, most were unaware of women related issues, particularly with to personal development.

Stated threats were generally as stated in other sectors: restrictive bank policies leading to high interest rates, short term of loans, poor understanding of business cycles were recurring themes. So too, GOA lack of consistency or fully transparent laws and regulations regarding taxes, customs, etc. perpetuates bribery and the gray economy. While the other outlined issues were also raised, the absence of a GOA Strategic Plan for SME development as fairly consistent.

Other Services Sub-Sector (includes Services Industries: Printing, Advertising, Real Estate, Consulting, Transportation, Trade & Commerce, Public Food Service, Real Estate and Consulting are relatively new sectors in Armenia.

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ limited competition with the exception of Real Estate and Public Food Service</li> <li>✓ openness and interest to change and improve, especially the younger generations</li> <li>✓ highly educated in general</li> <li>✓ market is expanding as many sectors are applying specialized, sophisticated technology to media communications</li> <li>✓ many sectors are also upgrading technology equipment regularly</li> </ul>	<ul style="list-style-type: none"> <li>✓ lack of customer service mentality in some sub-sectors</li> <li>✓ lack of specialized expertise in some fields</li> <li>✓ lack of specialized training institutions and adequate Vocational Education and Training programs</li> <li>✓ lack of fair competition in several sub-sectors</li> <li>✓ lack of specialized training available locally</li> <li>✓ limited access to information in most sub-sectors</li> <li>✓ lack of networking capabilities</li> <li>✓ no access to financing (or limited, expensive and cumbersome)</li> <li>✓ domestic market is limited in non-ICT activities</li> <li>✓ for printing, high dependence upon imports</li> <li>✓ poor management skills</li> <li>✓ lack of enabling legislation for SMEs</li> <li>✓ antiquated equipment</li> </ul>
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ access to specialized training in different trades, business administration, management development</li> <li>✓ improving marketing skills</li> <li>✓ create conditions for larger participation by women</li> <li>✓ create dialogue/exchange opportunities with similar businesses in industrialized countries</li> <li>✓ publicize business successes and push for good role modeling</li> <li>✓ promotion of ethical business approaches/attitudes</li> <li>✓ market expansion, domestically and internationally</li> </ul>	<ul style="list-style-type: none"> <li>✓ Restrictive bank policies: high interest rates, short term of loans, poor understanding of business cycles.</li> <li>✓ GOA lack of consistency or fully transparent laws and regulations regarding taxes, customs, etc. perpetuates bribery and the gray economy</li> <li>✓ GOA continued lack of ‘open sky’ policy increases transport costs of import and export and limits new market development opportunities</li> <li>✓ Inter-regional border issues severely limit opportunities in terms of ground transportation related issues</li> <li>✓ GOA lack of Strategic Plan for SME development</li> </ul>

*Construction Materials*

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ Highly skilled labor force</li> <li>✓ Low labor costs</li> <li>✓ High quality roof tiles competitive with imports</li> <li>✓ Large supply of high quality, available clay with chemical properties suited to roof tile production</li> <li>✓ Unique production system to lighten weight of tiles</li> <li>✓ Production flexibility – styles, colors, forms</li> <li>✓ Well diversified product line for various market segments</li> <li>✓ Existing Union of Building Material Importers               <ol style="list-style-type: none"> <li>1. Networking , member collaboration</li> <li>2. Lobby for price discounts on imported materials</li> <li>3. Try to &gt; markets for all industry to re-establish it</li> <li>4. Established distribution networks - regionally</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>✓ Declining sales – general economic environment, &lt; financing, emigration reduces demand...small, shrinking local market</li> <li>✓ Seasonal business</li> <li>✓ Lack of information on all fronts</li> <li>✓ Poor functional business, esp. marketing, skills</li> <li>✓ Transportation               <ol style="list-style-type: none"> <li>1. High costs</li> <li>2. Long delivery times (overland/sea/overland)</li> <li>3. Border transit, customs, visa problems</li> </ol> </li> <li>✓ &lt; in overall capital investments on production and construction sites               <ol style="list-style-type: none"> <li>1. GOA investments</li> <li>2. Private capital inflows – domestic &amp; foreign</li> </ol> </li> </ul>
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ Earthquake Zone Rehabilitation- &gt; in construction from humanitarian aid</li> <li>✓ Import substitution at lower prices</li> <li>✓ Export potential regionally</li> <li>✓ New business potential based on full vertical integration of building matls. through construction               <ol style="list-style-type: none"> <li>1. Design, production, installation of all materials</li> <li>2. Total construction of buildings/homes</li> </ol> </li> <li>✓ Open borders with Turkey &amp; Azerbaijan               <ol style="list-style-type: none"> <li>1. Turkey – improve transportation access &amp; costs</li> <li>2. Azerbaijan – could be important export market</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>✓ Continued &lt; in demand due to:               <ol style="list-style-type: none"> <li>1. Emigration</li> <li>2. &lt; investment by domestic residential market (low wages, un/under-employment,</li> <li>3. &lt; investment by private foreign entities</li> </ol> </li> <li>✓ GOA high taxation, customs policies – push prices of import inputs artificially high negatively impacting total prices</li> <li>✓ Corruption, bribes 2 ways at border crossings</li> <li>✓ Absence of regulations/laws on distribution issues</li> <li>✓ Uneven playing field re pricing, transportation and distribution costs, etc. due to GOA inconsistencies</li> <li>✓ Open border with Turkey - &gt; competition via dumping of cheaper products = &lt; market share for local firms</li> <li>✓ Continuation of artificially low pricing of domestic products to maintain domestic market share               <ol style="list-style-type: none"> <li>1. depressed profits and lack of capital to reinvest in business development</li> <li>2. reduces ability to import necessary inputs because of negative impact on pricing</li> </ol> </li> </ul>

*Analysis*

The building materials and construction sector was traditionally one of the leading economic and employment branches of Armenia under the FSU. However following the

collapse of the FSU and subsequent political and financial problems, this sector lost its main export markets leaving an ever shrinking domestic market as its base. In addition to the general economic and enabling environment circumstances affecting all sectors reviewed by the Assessment Team, the building materials/construction sector is particularly vulnerable to the economic and transport blockade which impacts the availability and price of import inputs and its ability to export competitively. Additionally, low working capital in both private and public sectors, unemployment, low wages and emigration have contributed to the decreased investment in this sector at both commercial and residential levels. For example, the share of capital investment in production sites to total investment amounted to approximately 44% in 1999 vs. 65% in 1996.<sup>18</sup>

Interestingly, there has been a shift recently in the share of construction represented by agriculture vs. industry. The former increased from 8.3% to 14.0% of total in 1999 vs. 1998 while the latter fell to 7.2% vs. 12.9% in the same period. Housing, at 33% of total, continues to represent the majority of construction although that level is a decline from 43.9% a year earlier.

Foreign investment has also declined from an average of 40% in 1995-97 to 25.8% in 1999 reflecting both the Russian financial crisis and the decrease in privatization related projects. Humanitarian aid contribution to construction for the “Earthquake Zone Rehabilitation 1999-2001 Program” increased to 21.5% in 1999 vs. 16.7% YA. And construction works in the Zone were 33.5% of the total zone works compared to 19.3% YA.

Despite all of the aforementioned impediments, the small sampling of firms with whom we met demonstrated ingenuity in design, product development and production uses of building materials in residential and commercial construction application. The sector is rooted in engineering and technically skilled labor. The firms are optimistic while recognizing that they face numerous macro issues hindering their development, most important of which are the closed borders and resulting transportation, pricing, raw material availability inefficiencies.

There is a Union of Building Materials Importers which is trying to grapple with the problem of raw material imports availability, pricing, etc. and also help reinvigorate the overall industry. The firms also stated a need for assistance with marketing, market information access, training in new technologies, etc. as necessary for improving their growth potential. This could perhaps be done under the auspices of existing training programs sponsored by USAID/AED’s roster of Business Consulting firms. Nonetheless, until the overriding macro issues are resolved, this sector’s growth potential is more limited than that of the others reviewed by the team.

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<sup>18</sup> AET based on data from the Ministry of Statistics.

*R & D Sub-Sector*

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ Highly skilled labor force, with transferable skills</li> <li>✓ Adaptability of researchers</li> <li>✓ Diversified in R&amp;D spheres</li> <li>✓ Strong educational background</li> <li>✓ World-wide contacts, especially in CIS</li> </ul>	<ul style="list-style-type: none"> <li>✓ Non – commercial attitude to R&amp;D</li> <li>✓ Ignorance in intellectual property rights protection</li> <li>✓ Self – centered</li> <li>✓ Poor management skills</li> <li>✓ Negative demographics as a result of high emigration rate</li> <li>✓ Limited access to latest technology developments in high tech industries</li> </ul>
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ Contributions in high technology import</li> <li>✓ Consultants, advisers and information services providers for SMEs</li> <li>✓ Capability of breakthrough inventions in certain areas</li> </ul>	<ul style="list-style-type: none"> <li>✓ Desperation, leading to further “brain drain”</li> <li>✓ On-going economic stagnation</li> <li>✓ Short-term development and survival orientation</li> <li>✓ Under-financed</li> <li>✓ Potential loss of R&amp;D function within Armenia</li> </ul>

There are 96 state-owned and budget-financed R&D organizations and 93 registered in the State Registry as private R&D organizations. These private R&D organizations are predominantly registered as limited liability companies.

According to government-provided statistical data, the number of operating R&D organizations decreased from 125 in 1991 to 96 in 1999. In 1998, 8133 people were involved in the implementation of scientific technical activities in the public sector. By far the average age of researchers in the R & D sector is over 50, and that trend is unlikely to change, as there are few Ph.D. candidates under the age of thirty.

Additionally, the following reflects the status of the R & D industry.

- 6000 inventions registered by the residents of the Republic of Armenia and published in the official inventions’ bulletin of the USSR from 1980 to 1992; and
- 709 inventions, registered from 1993 to 1999 in Armenia.

*Jewelry and Gems-Processing Sub-Sector*

<b>STRENGTHS</b>	<b>WEAKNESSES</b>
<ul style="list-style-type: none"> <li>✓ Inherited good name and reputation of Armenian jewelers and diamond-processors</li> <li>✓ Qualified work force, i.e. artisans and jewelers.</li> <li>✓ Hand-made highest quality products</li> <li>✓ Large variety of design works from classic to modern.</li> <li>✓ Positive image/experience among CIS countries</li> <li>✓ High quality of Armenian obsidian and gems</li> <li>✓ Government support</li> </ul>	<ul style="list-style-type: none"> <li>✓ Taxation – high, assessed 20% VAT and 15% excise tax. Complicated accounting</li> <li>✓ Limited domestic market with low purchasing capacity.</li> <li>✓ Dependence on imported raw materials, unstable market of raw materials</li> <li>✓ Country image non-existent outside of CIS countries.</li> <li>✓ Out-of-date equipment and tools</li> </ul>
<b>OPPORTUNITIES</b>	<b>THREATS</b>
<ul style="list-style-type: none"> <li>✓ No or low custom duties on imported raw materials and exported products</li> <li>✓ Simplified procedure of gem registration and evaluation</li> <li>✓ Jewelry exemption from the excise duties</li> <li>✓ Market expansion to countries beyond CIS.</li> <li>✓ Transfer to IAS facilitates the cooperation and joint ventures establishment.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Absence of Law on Precious Metals and Stones</li> <li>✓ GOA lack of strategic plan on jewelry industry promotion</li> <li>✓ Lack of the system of International Evaluation Standards within CIS countries</li> <li>✓ Underground/gray production of poor quality and at less expensive prices</li> <li>✓ Custom regulations               <ol style="list-style-type: none"> <li>1. Importing raw materials – expense, lengthy processing time, cumbersome procedure of Evaluation Inspection, etc.</li> <li>2. Exporting products – VAT repayment, evaluation documentation/procedures push prices.</li> </ol> </li> <li>✓ Financing: inadequate credit/loan terms.</li> <li>✓ GOA – constantly changing officials, no consistency</li> </ul>

The demise of the central planning system of the USSR and independence for Armenia brought the necessity to face the demands of the market economy and to embrace new commercial concepts and criteria. Armenian Jewelry industry lost traditional markets, ceased to have regular access to raw materials and suffered an energy crisis. In the late 90's industry experienced some positive changes, such as increase in total sales and export volumes with the picks observed in 1997. However, most of SMEs operated in this sector depended mostly on the domestic market that was influenced by decreasing purchasing capacity.

Today, the market is dominated by the large number of gray market producers that offer poor quality at lower prices. Underdeveloped customs regulations lead to prolonged and cumbersome procedures of imported raw materials' evaluation inspection, as well as high taxes such as 20% VAT.<sup>19</sup> This decreases the competitiveness of registered jewelry producers both in domestic and external markets. Problems with VAT repayment on exported products are very frustrating for potential partners or investors and have already led to some lost investments per surveyed firms.

Currently the industry experiences moderate-to-slow growth. Due to declining incomes over the past three years, companies lost the possibility of reinvesting profit; that resulted in obsolete equipment. This problem does not exist on the large state owned enterprise "Yerevan Jewelry Plant," which is the main production unit for jewelry. Nonetheless, the small and medium sized enterprises of the jewelry industry are still able to compete by producing hand made items of high quality and by offering unique, western-oriented designs.

From centuries the jewelry has been a traditional trade for the Armenian people. Hand made items have always decorated the royalty in the region, as well as in the world. Armenian jewelers have had a very good reputation for their highly professional skills. As a prove of this Armenian jewelers have won grand prix in many USSR and international trade shows. A major part of this highly skilled jeweler labor force is not working now. However, the sector still possesses excellent technology not only in jewelry, but also in stone-processing. The recognition of Armenian jewelers among CIS countries helped them to reestablish former links. But they still possess neither financial nor information resources to access new markets.

Total exports of both gems and precious metals has seen growth over the past three years, but has not matched the peak exports of 1996. Influencing factors include both the decline of the Dram, and fluctuations in the world market. Import of industrial inputs (including uncut stones) has generally matched export activity.

### Exports of precious or semiprecious stones, precious metals (1995-1999, mln USD)

<b>EXPORTS</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999*</b>
<u>Total</u>	<b>89.5</b>	<b>140.2</b>	<b>55.2</b>	<b>53.06</b>	<b>99.9</b>
Diamonds, whether or not worked, but not mounted or set.	-	-	<b>47.3</b>	<b>47.0</b>	<b>83.9</b>
Gold (including gold plated with platinum) unwrought or in semi-manufactured forms, or in powder form.	-	-	<b>0.3</b>	<b>1.5*</b>	<b>NA</b>
Waste and scrap of precious metal or of metal clad with precious metal; other waste and scrap containing precious metal or precious metal compounds, of a kind used principally for the recovery of precious metal.	-	-	<b>2.0</b>	<b>1.1*</b>	<b>NA</b>
Articles of jewellery and parts thereof, of precious metal or of metal clad with precious metal	-	-	<b>4.5</b>	<b>0.7*</b>	<b>NA</b>

\* Jan-Sept

<sup>19</sup> As of July 1, 2000, Jewelry exports are no longer subject to the 15% excise tax.

Imports of jewelry industry production inputs (1995-1999, mln USD)

<b>A. IMPORTS</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>
<b>Total</b>	62.4	129.8	47.4	45.5	86.7
Diamonds, whether or not worked, but not mounted or set.	-	-	45.5	43.8	80.8
Gold (including gold plated with platinum) unwrought or in semi-manufactured forms, or in powder form.	-	-	1.5	0.8*	NA

There are two major associations operating in this sector: Association of Goldsmith and Jewelers of Armenia (AGJ) and Union of Stone-Processing Specialists of Armenia. The AGJ is one of the country's first international trade and development associations. The AGJ's aim is to bring Armenian jewelers together to develop the country's jewelry industry. The AGJ is now participating in trade fairs at international centers, and is setting up its own trade center in Yerevan. The Union of Stone-Processing Specialists was separated from the AGJ in order to concentrate their efforts in the promotion of semi-precious stone activities.

Although these associations are operating and providing support to their members, they are seemed to be governed by a single or several major players, who use the umbrella of associations in order to promote their own businesses.

*Handicrafts Sub-Sector*

<b>STRENGTHS</b>	<b>WEAKNESSES</b>
<ul style="list-style-type: none"> <li>✓ Valuable footholds in foreign markets (best firms).</li> <li>✓ Production aspects well managed (best firms).</li> <li>✓ Adaptability and flexibility to market demands and conditions (best firms).</li> <li>✓ Willingness to produce high quality products to buyers specifications (best).</li> <li>✓ Knowledge of organization development principles, overall management information systems, and market development (best firms).</li> <li>✓ Full knowledge of information on customs law and regulation related to importing and exporting (best).</li> <li>✓ Attention to detail, follow up and long term planning (best)</li> <li>✓ Creative packaging and shipping arrangements with purchasers (best).</li> </ul>	<ul style="list-style-type: none"> <li>✓ Dependence on imported raw materials</li> <li>✓ Dependence on small domestic market, mainly for traditionally ethnic items (poorest)</li> <li>✓ Limited knowledge of organization development principles, overall management information systems, and market development (poorest).</li> <li>✓ Limited knowledge of computer systems, especially for alternative cash flow analysis, quality and inventory control (poorest).</li> <li>✓ Lack of information on GOA law and regulation related to import/export and SME development (poorest).</li> <li>✓ General lack of attention to HR issues particularly related to women’s development (all).</li> </ul>
<b>OPPORTUNITIES</b>	<b>THREATS</b>
<ul style="list-style-type: none"> <li>✓ Further international market expansion.</li> <li>✓ Knowledge base for best-prepared firms.</li> <li>✓ Potential attractiveness for potential international alliances.</li> <li>✓ Relatively large, highly skilled labor pool.</li> </ul>	<ul style="list-style-type: none"> <li>✓ GOA lack of consistency or fully transparent laws and regulations especially regarding taxes, customs, etc. perpetuates bribery and the gray economy.</li> <li>✓ GOA continued lack of ‘open sky’ policy increases transport costs of import and export and limits new market development opportunities.</li> <li>✓ Restrictive bank policies: high interest rates, short term of loans, poor understanding of business cycles</li> </ul>

*Analysis*

Handicrafts firms run the range from impressive to disappointing. The best have managed to transform the traditional “cottage industry” into a valuable creator of high quality export goods. Their standards, both for imported raw materials and resulting output, are exacting in their attention to detail regarding customs and tax issues, packaging, shipping and service follow-up on quality control. Their innovative approach to international market development has literally paid off in the form of ongoing contracts from some of the most prestigious retail outlets in the west. On the other hand, the worst produce a jumble of products, generally on traditionally ethnic themes. They have only vague standards for both raw materials and output, with little to no vision or plan as to where they hope to go with their efforts.

The sector is highly significant to SME development because, in many ways it serves as a microcosm of possibilities. First, the entire effort is demand driven. Second, ultimate success must be highly dependent on the vision, drive and personal attention to every detail by the entrepreneur. Those waiting for someone to do their legwork for them are likely to be disappointed. Third, SMEs of various sizes, in various sectors, can utilize the formula as a blueprint to tapping the export market in the current environment.

*Tourism Sector*

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ People               <ol style="list-style-type: none"> <li>1. Inherently friendly, warm, hospitable people</li> <li>2. Natural service-orientation to “host guests”</li> <li>3. Resourceful, entrepreneurial attitude</li> </ol> </li> <li>✓ Natural, unspoiled scenic beauty and landscapes</li> <li>✓ Rich ancient history, culture, traditions</li> <li>✓ Monuments, churches, monasteries, etc. (estimated #s):               <ol style="list-style-type: none"> <li>1. 44 historical sites per Protection of Monuments Comm</li> <li>2. 15,000 1<sup>st</sup> class sites (US Embassy estimate)</li> <li>3. 40,000 est. unrecorded sites (US Embassy estimate)</li> </ol> </li> <li>✓ Religious heritage               <ol style="list-style-type: none"> <li>1. 1<sup>st</sup> to adopt Christianity</li> <li>2. 1700th Anniversary of Christianity celebration in 2001</li> </ol> </li> <li>✓ Spa resorts based on medicinal springs/health cures</li> <li>✓ Scientific Observatories</li> <li>✓ Positive tourism image/experience among CIS countries</li> <li>✓ More stable of CIS countries per Armenian travel entities</li> <li>✓ Historical links to ancient “Silk Road”</li> <li>✓ Large, committed Diaspora sending significant financial funding</li> <li>✓ Privatization and renovation of Yerevan hotels by foreign investors, some of whom are Diaspora</li> </ul>	<ul style="list-style-type: none"> <li>✓ Country Image               <ul style="list-style-type: none"> <li>- Either non-existent image or negative among many foreigners outside CIS</li> <li>- Security/safety concerns</li> <li>- Political instability concerns</li> <li>- Limited Medical care – availability, quality</li> </ul> </li> <li>✓ Expensive and inconvenient destination for many travelers               <ul style="list-style-type: none"> <li>- high airfare and hotels</li> <li>- long distance with inconvenient air schedules</li> </ul> </li> <li>✓ Visas and customs – expense, lengthy processing time through Embassies, cumbersome procedure/documentation, etc.</li> <li>✓ Infrastructure poor, inadequate or non-existent: airport &amp; facilities, roads, transportation (i.e. buses to sites), inadequate or non-existent hotels/facilities (especially at tourist sites) with proper standards, services, staff</li> <li>✓ Existing hotels               <ul style="list-style-type: none"> <li>- Insufficient room capacity for increased tourism influx</li> <li>- Expensive</li> <li>- Service not to international standards</li> <li>- telecommunication either non-existent or expensive</li> <li>- sometimes uneven playing field w/tour operators (sell rooms in blocks, operators resell at discount)</li> </ul> </li> <li>✓ Telecommunications – expensive, access problematic</li> <li>✓ Financing               <ul style="list-style-type: none"> <li>- loans w/unacceptably high rates/terms</li> <li>- no guarantees or incentives for investments</li> </ul> </li> <li>✓ Poor enabling environment               <ul style="list-style-type: none"> <li>-Taxation - high, assessed 20% VAT, bribes</li> <li>-Laws – lack of legislation, regulations, etc.</li> <li>-Corruption and bribes</li> <li>-Lack of statistically accurate data</li> </ul> </li> <li>✓ Old Soviet era attitude both at GOA (national, municipal, local – latter two are worse) and some private sector levels</li> <li>✓ Plethora of ineffective, conflicting associations – not demand driven by industry entities</li> <li>✓ No training institute for hotel mgt., travel agents, tour guides               <ul style="list-style-type: none"> <li>On the job learning from inexperienced managers</li> </ul> </li> <li>✓ Limited number of Diaspora travelling here compared to other countries, including neighbors, and relative to its size</li> </ul>

OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ Public education/marketing campaign Domestically               <ol style="list-style-type: none"> <li>1. create awareness of economic importance of tourism</li> <li>2. promote positive attitude/support for its development with private and public sectors</li> <li>3. Change old Soviet era mentality and negativism</li> </ol> </li> <li>Internationally               <ol style="list-style-type: none"> <li>1. market to Diaspora</li> <li>2. developing unique “branding for Armenia”</li> <li>3. target both tourist and business tourism appropriately</li> <li>4. revitalize CIS tourism</li> </ol> </li> <li>✓ Prioritize and develop key tourism markets: historical and cultural; religious w/possible pilgrimage potential; business-orientation; eco-tourism; adventure travel; Diaspora</li> <li>✓ 2001 celebration of 1700<sup>th</sup> Anniversary of Christianity represents opportunity to create awareness of Armenia as unique tourism destination</li> <li>✓ Integrate into regional travel tour packages i.e. Turkey, Georgia, possibly Middle East for that clientele</li> <li>✓ Training to international standards for all travel related entities</li> <li>✓ Development of infrastructure – airport, roads, transport, hotels in Yerevan and regionally, site facilities (services, WC, etc.), communication, visas, customs, airport transit, etc.</li> <li>✓ Educate, train GOA on private sector tourism realities, need for strategic and tactical support in facilitating industry’s development including GOA’s role</li> <li>✓ Establish National Tourism Development Center/Organization with private and public sector participation to address all of above strategic and tactical issues</li> <li>✓ Association Umbrella to provide proper membership services, representation with various entities and advocacy efforts</li> </ul>	<ul style="list-style-type: none"> <li>✓ Unrealistic attitude toward and understanding of requirements &amp; resources (human, financial, time) required to properly address critical infrastructure issues necessary to tourism development, as cited above under weaknesses. “Say it and it will happen”</li> <li>✓ Absence of GOA and private sector master plan:               <ol style="list-style-type: none"> <li>1. objectives, strategies, tactics</li> <li>2. long term (i.e. 10 yr.) and annual programs and budgets</li> <li>3. identifying key tourist segments, country markets, tourist profiles/target audiences</li> <li>4. danger of damaging monuments, natural environment without proper planning &amp; destroying tourism strengths</li> </ol> </li> <li>✓ Inadequate planning, at all levels, for 2001 celebration of 1700<sup>th</sup> Anniversary for Christianity – could backfire damaging future tourism prospects due to possible negative experiences emanating from unmet high expectations by visitors.</li> <li>✓ No concrete, operational Tourism Dept. w/n GOA               <ol style="list-style-type: none"> <li>1. Under reformulation but not vetted by GOA</li> <li>2. Little to no real collaboration b/w GOA and private sector w/a few special exceptions i.e. “who you know”</li> </ol> </li> <li>✓ No laws on tourism, licensing/certifying travel and tour operators, etc.</li> <li>✓ GOA               <ol style="list-style-type: none"> <li>1. Impediment often hindering development or engaging in conflict of interest activities</li> <li>2. constantly changing officials, no consistency</li> <li>3. no real action taken only lip service given to tourism development</li> </ol> </li> <li>✓ Closed Sky Policy – Armenia Air has monopoly on intl flights into country and all issues accruing to monopoly i.e. pricing, service, etc.</li> <li>✓ Banking Sector – Credit programs not aligned with industry realities and development needs</li> <li>✓ Continued blockade and closed borders</li> </ul>

### Analysis

Globally, tourism is a significant, and often primary, economic and employment growth sector for many industrialized and developing countries. The World Tourism Organization estimates that 10% of worldwide gross product, investments, employment and consumer expenditures are

derived from tourism. Further, they project that over the next ten years, tourism inflow should approach USD\$ 1,100 billion, double the current amount.

Tourism in Armenia has the potential to become an important growth sector in the long-term. Currently, however, it is at a nascent stage, rebuilding and reorienting itself on all levels following the collapse of the USSR and Armenia's primary tourism role therein. In the late 1980's, it's estimated that Armenia hosted between 500,000 – 800,000 tourists annually, 100,000 of which came from outside the FSU. The FSU's dominance was largely attributable to the centrally controlled tourism industry, customized tour packages to FSU regions, absence of competition/choice, economics, and favorable Armenian image. In 1992-93 the number of visitors is estimated to have declined to 4,000-5000 as a result of the USSR's collapse, the economic blockade, the Nagorno-Karabakh civil war and attendant problems.

Nonetheless, tourism has continued to grow modestly each year and in 1999 was estimated to have reached 40,745 tourists (per The Ministry of Trade and Industry; Customs places the number at 47,000; and it could be as high as 60,000 as there are no reliable statistics). Approximately 70% of tourists are the Armenian Diaspora; 30% are foreigners from Europe, North America and Asia.

While this continued growth is encouraging, tourism is not presently a significant sector and will require a major, long-term commitment by the GOA, private sector and international donors/organizations to be developed into an employment and economic engine for Armenia. This will necessitate the dedication of: both financial and human resources; creation of the necessary macro enabling environment; development and implementation of a clearly defined, specific and comprehensive master tourism development plan, including establishment of a neutral implementation organization; the will, vision and determination to follow-through both short and long-term by all participants.

## 5. CONCLUSIONS AND RECOMMENDATIONS

### 5.1 Conclusions Regarding the SME Environment

An enabling environment can be described as an atmosphere in which potential for development could be improved to heighten the prospect for success. In terms of SME development in Armenia, this should include attention to the following broad-based issues:

- regulation of business related activities, including collateral liquidation, non-banking financial services, business registration, and licensing;
- political constraints, including unstable and/or inconsistent government law and/or regulation and matters related to Turkey and Azerbaijan;
- implementation of an open-sky policy, which would enable more-free flow of goods and services across the Armenia border;
- governmental factors, including taxes, and weak rule of law;
- market constraints, including infrastructure, import/export regulations, availability and cost of raw materials, and demographics;
- business to business services;
- management, marketing and organization development of SMEs; and
- targeted services, to increase the participation of women in economic activities.

Further, the major external threats to potential expansion of the sectors can be generally categorized as falling under the responsibility of the GOA. The lack of a Strategic Plan for SME development is a highly significant stumbling block, as is the lack of consistency and/or fully transparent laws and regulations regarding taxes and customs. The latter perpetuates bribery and the gray economy. All should contribute to an enabling environment for SME development but fall short. A restrictive policy on 'open sky' increases transport costs on all imports and exports (nearly all of which is currently shipped by air) and severely limits new market development opportunities. The current inter-regional border issues practically stop new market development opportunities both in terms of reasonably priced ground transportation alternatives by truck and rail. This is particularly evident with the furniture and building materials subsectors that, because of weight of required inputs, are especially burdened.

### SME Environment Analysis

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ continuous economic growth for the last five years (see statistics on GDP, CPI, exchange rates, etc.)</li> <li>✓ low inflation</li> <li>✓ predictable, not volatile exchange rate</li> <li>✓ GoA committed to reform</li> <li>✓ liberal trade policy</li> <li>✓ tax incentives for foreign investors in banking and other sectors</li> <li>✓ privatization makes progress</li> <li>✓ well regulated, transparent banking system</li> </ul>	<ul style="list-style-type: none"> <li>✓ lack of information to SMEs and entrepreneurs and the population in general</li> <li>✓ lack of coordination and networking</li> <li>✓ low paid public servants hence corruption</li> <li>✓ lack of dedicated public servants who understand the needs of the private sector</li> <li>✓ high turnover of officials</li> <li>✓ difficulties inherent in the transition process from a FSU province into an autonomous market economy</li> <li>✓ blockade with Turkey and Azerbaijan</li> <li>✓ although banking sector is well-regulated, it is not performing a traditional intermediary role</li> </ul>

OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>✓ GoA approves in the near future necessary measures that create an enabling environment for SMEs</li> <li>✓ GoA is willing and has the technical know-how to support efficiently strategic SME sectors: ITC, tourism, light industry</li> <li>✓ create jobs</li> <li>✓ create well paid jobs</li> <li>✓ enhance exports</li> <li>✓ regain lost market share in Russia</li> <li>✓ open new markets (Japan, etc.)</li> <li>✓ create joint ventures with companies from industrialized countries</li> <li>✓ attract foreign investment</li> <li>✓ involve women in political decision-making process</li> <li>✓ design effective measures to promote women entrepreneurship</li> </ul>	<ul style="list-style-type: none"> <li>✓ continuous exodus of the brightest</li> <li>✓ population loses faith/hope/heart</li> <li>✓ blockade lingers on</li> <li>✓ GoA doesn't perform</li> <li>✓ increased animosity towards and from neighboring countries</li> </ul>

Much of the hope for real and rapid economic transformation rests with the emerging new small business sector. Much of Armenia's small businesses are **newly-created** SMEs. Despite this, the government has yet to develop a legal definition of SMEs. As a result, few laws or regulations that are specific to SMEs have been enacted.

Based on its analysis, the Team also determined a number of systemic barriers to SME development, including both environmental barriers and firm-level barriers. The impediments will have to be addressed for any of the SME sectors (and sub-sectors) to thrive.

### *5.2 Conclusions Regarding SME Sectors and Sub-Sectors*

As evidenced by the above text, a broad spectrum of sectors was included in the team's SME assessment effort. As a result of extensive data analysis and interviews at every level, SWOT analysis was used to identify sectors or subsectors offering (in addition to other important but less dynamic factors) the greatest potential for increased employment opportunities, expanded domestic and international markets, and the ability to compete in an open market economy.

The SME Assessment Team conducted a full analysis of these sectors, in order to identify those with the greatest potential for both economic and labor-growth potential. After its analysis, the team determined that the following sub-sectors show the most promise in terms of targeted support are:

- Textiles and Shoe Manufacturing (sub-sector of Light Industry);
- Jewelry & Gem Processing;
- Tourism;
- IT & Software Design (sub-sector of Communications Industry).

The first three (Textiles and Shoes; Jewelry, Gem and Stone Cutting; Tourism), have been included herein with specific recommendations for potential project design. ITC has been left to

our highly specialized sector-specific ICT Team colleagues whose recommendations can be found in Appendix F.

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>✓ good history/reputation as a strong industrialized exporter to SU from the past</li> <li>✓ strong education in general and in special areas of special interest in today's context: IT</li> <li>✓ well educated labor force</li> <li>✓ well regulated, transparent banking sector that can be a solid basis on which to build modern banks adapted to the needs of SMEs</li> <li>✓ influx of donor money (check comparative statistics with other countries in the region) but mostly humanitarian aid, only recently shift to economic development</li> <li>✓ support from Armenian Diaspora</li> </ul>	<ul style="list-style-type: none"> <li>✓ general lack of business skills, including private sector mechanics, lack of marketing skills and knowledge of foreign markets</li> <li>✓ lack of managerial skills</li> <li>✓ lack of business education (American University, best B-school in Armenia)</li> <li>✓ antiquated educational material and equipment</li> <li>✓ lack of specialized institutions for Vocational Education and Training (hotel, restaurant, etc.)</li> <li>✓ general dearth of relevant information</li> <li>✓ government doesn't disseminate information, especially in the regions</li> <li>✓ lack of coordination between different government bodies</li> <li>✓ major problem: continuous emigration</li> <li>✓ border blockade, result: investors shy away</li> <li>✓ disenchanting Diaspora</li> <li>✓ scarce and inaccessible financing</li> <li>✓ banks lack products/services targeted to SMEs (terms too short; rates too high)</li> <li>✓ inability to settle collateral issues in court, resulting in more cumbersome loan terms</li> <li>✓ poor business planning, and loan packaging skills for firms seeking equity/debt</li> <li>✓ obsolete equipment, machinery</li> <li>✓ block borders resulting in transportation difficulties</li> <li>✓ closed sky policy</li> <li>✓ high transportation costs</li> <li>✓ lack of infrastructure including telecommunications</li> <li>✓ high unemployment (over 40%) small, limited, illiquid internal market</li> <li>✓ lack of enabling legislation for SMEs</li> <li>✓ development of dependence to humanitarian aid</li> <li>✓ corruption</li> <li>✓ discrepancy between the regions and Yerevan (unequal economic development)</li> <li>✓ lack of a developed sense of community</li> <li>✓ underdeveloped civil society</li> <li>✓ lack of knowledge on why and how to lobby the government</li> </ul>

### 5.3 Critical Success Factors for SME Initiatives

Based on both best practice in terms of SME program development world-wide and the specific needs of Armenia, the SME Assessment team has determined several critical success factors (CSFs), which we believe are essential to the development of appropriate and effective programs.

- **Be Locally-Driven.** In order to ensure improved results, the project (or projects) should be designed specifically for the Armenian market, and should be driven by local, private sector stakeholders. This will require getting their involvement in the development of specific technical assistance interventions and in ensuring their continued involvement throughout implementation.
- **Link to Specific SOs and IRs, for the Armenia Mission and the Region.** The Armenia mission has created an overarching strategic goal of creating increased employment opportunities; all results packages should include this goal as the basis for programmatic design. Further, SO 1.3, *Growth of the competitive private sector* and SO 1.4, *Investment Increased*, are also critical sub-texts to any appropriate programmatic design. We believe there could be a great deal of cross-synergy between USAID these SOs and a number of the applicable IRs
- **Coordinate with Other Donor Initiatives.** As demonstrated above, there are a number of donor-funded initiatives going on in Armenia that directly relate to the development of the SME sector. Coordination between donors (and their contracting agents) is critical to limiting programmatic overlap and potentially conflicting goals, as well as improving the overall impact of all the programs implemented. To that end, USAID may want to take the lead in establishing a facilitated working group for all donor stakeholders currently working with SME projects.
- **Use a Sectoral-Based Approach.** Industry sectors have been found to be useful units of analysis and an effective mechanism for developing local momentum for broader, competitiveness efforts to improve productivity and industry competitiveness. In particular, the industry sector structure serves to establish or foster a coalition of private sector firms, associations, and other support organizations, with a common understanding of and a shared commitment to the actions required to address the challenges hindering the industry's prospect for growth. Further, it ensures that results are more clearly identifiable and measurable.
- **Be Rooted in the Principle of Increased Competitiveness.** The focus of many SME projects in this region has been business skills development and increasing access to funding; however, this may not be enough. Even if entrepreneurs have the business skills, the knowledge, the funding and the drive to make it work within their firms, their enterprises may flounder because the industry sector as a whole does not function. What good does it do the entrepreneur to have an excellent business idea (e.g. produce an Armenian version a specific software program, for instance), and to develop it into an excellent product, if the rest of the value chain (from adequate skills and resources to provide the accompanying manuals and instructions for the software, to packaging, to marketing logistics, to exporting, etc.) is non-existent or heavily strained? Good project design recognizes the interconnected nature of business in an increasing global economy, and seeks to assist firms by addresses industry-wide issues of competitiveness.

- **Have Demonstrable and Measurable Impact and Defined Sustainability.** Critical to the success of any program is to define the desired outcome from the start, so that results measures can be built into the project design. This means ensuring that if the desired result is increased competitiveness, that there be a clear link between the goal and the activities (increased exports by sector, for example or higher margins in specific market within a sector), that the measures be determined before the program's start, that baseline data be collected at the beginning of the project, and that results be used to create a demonstration effect for other like-minded projects.

Further, sustainability must also be considered an integral part of program design. It should be promoted by the early and continued involvement of stakeholders throughout program design and implementation, and through the development of realistic goals based on the limits of the local market. In addition, good program design works to develop the technical, managerial, and professional skills of the local professionals, so that they can operate and sustain supporting activities long beyond our involvement in the project. U.S. advisors should assist in establishing a solid foundation for Armenian firms and business support organizations, especially during the first year of a project.

- **Identify and Reach Typically Under-Served Markets.** There are several under-served markets with the Armenian SME context; these are women-owned and women-managed businesses, and other firms working in urban markets outside of Yerevan. The best of programmatic design will include efforts to target these markets as an integral (not add on) feature of the results package.