

AMERICAN UNIVERSITY OF ARMENIA

**A STUDY OF FOREIGN DIRECT INVESTMENT
IN ARMENIA**

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Abstract

The main purpose of the paper is to analyze current condition of Foreign Direct Investments (FDI) to Armenia, discuss the major factors that affect it, find the existing gaps and offer some solutions for the improvement of FDI in the future.

The paper starts with the discussion of the international experience and emphasizes some economic and political factors that are internationally recognized to influence the FDI. Then the paper tests these economic and political factors specifically for the Armenian case and shows that the international practice is not coinciding with Armenian reality.

Next the paper discusses the influence of Armenian Diaspora in involving FDI, a factor that is unique and that explains Armenian case better than other factors do.

The paper also discusses the opinions of experts involved in the sphere on the general advantages, disadvantages and the favorable sectors for FDI in Armenia.

Finally the paper presents a set of recommendation to government on further development of Investment climate in the country for further increase in FDI flow to Armenia.

Introduction

Foreign direct investment (FDI) reflects the objective of obtaining a lasting interest by a resident entity in one economy in an entity resident in an economy other than that of the investor's with significant degree of influence on the management of the enterprise. (OECD Benchmark definition of FDI, 1999) Generally there is a threshold of 10 percent for the host company's voting stock to be managed by the foreign investor in order for it to be considered a direct investment. FDI is different from the foreign portfolio management which is generally an investment into the stock market of a foreign country in the sense that it is more stable and the small shocks in the host economy do not lead the foreign direct investors to withdraw their money from the host economy immediately unlike the foreign portfolio investors. (The World Bank Group Glossary, 2004)

FDI is a very useful economic factor and largely contributes to the economic development in the host country as it brings foreign equipment and technology, capital, knowledge, developed mechanism and of course foreign money into the economy and somewhat innovates and promotes it. Although this is not always the case as the development levels of the host economy's financial and economic markets might not always allow to absorb the positive effects of FDI, anyhow generally the positive effects are very visible and largely recognized. (Alfaro et. Al, 2006)

Armenia being a small open developing economy is trying to bring more foreign direct investors to Armenia and use the FDI for further development of economy since the very early years of its independence. But the importance of this issue in Armenia has increased recently and the year 2011 can be marked as a stage of new and more coordinated approach to it: this year the new Minister of Economy of the Republic of Armenia Tigran Davtyan has emphasized FDI as one of the priorities of the Armenian economy and as soon as he came to the office he created a new department in the ministry, the Department of

Investment Policy, which is to develop a detailed and ongoing policy on how to increase FDI flow to Armenia both by legislative and practical means. This paper is based on the internship conducted at the mentioned department.

Unfortunately there is not much research conducted concerning the real determinants of the FDI in Armenia, because not all the determinants that are considered to influence FDI work in Armenia but on the other hand Armenia has a major determinant that is not studied by the international community, namely the Armenian Diaspora, because it is very specific for Armenia. This determinant has not been properly studied and it is also very difficult to study as there is no record kept concerning the ratio of Armenian nationals who invest in Armenia to the number of total foreign direct investors and no statistics can be run.

Taking into consideration all the mentioned above, there is a need to study the Investment environment in Armenia with a major emphasis on the determinants that influence the FDI flow to Armenia, their current condition and the policies necessary to improve them in order to improve the FDI in general.

Literature Review

There is significant research conducted concerning the determinants that influence FDI involvement in a country. Some of them are contradictory concerning some of those determinants but in general there are some that the researchers agree upon. Not much research is conducted on Armenia, but still Azam has recently conducted a research on the determinants of FDI in Armenia, Kyrgyz Republic and Turkmenistan and has studied three major determinants for each country, namely the Gross Domestic Product (GDP), inflation and the official domestic assistance. This research has shown that FDI in Armenia has a statistically significant relationship with all three. The regression test has shown that an

increase in each unit of GDP leads to an increase in FDI by 1.57 units. On contrary a unit increase in inflation leads to 0.31 unit decrease in FDI, and a unit increase in official development assistance from abroad leads to 1.24 decrease in FDI. (Azam, 2010)

Sethi et al. show in their research that while making investments in a country the enterprises generally choose not a single country but a stable region as a whole, and they pay a great attention to a healthy mix of liberal market and state regulations, investment-friendly policies, GDP, the infrastructure of the country, technological development, skilled and cheap labor. (Sethi et al., 2003)

Shamsuddin has examined the determinants of FDI in less developed countries and came to the conclusion that the determinants that mostly affect the FDI in such countries are the low cost of the labor, per capita debt of the host country, per capita assistance received from other countries and international organizations, instability of prices and the presence of energy resources in the country and independence from other countries in terms of energy supply. (Shamsuddin, 1994)

According to the research conducted by Demirhan and Masca who have studied the FDI flow to the developing countries the major determinants that affect the FDI flow to the developing countries are market size and market growth rate, that is GDP and GDP growth rate, market openness, that is the ratio of imports and exports to the overall GDP, labor cost and labor effectiveness, political risk, which is mainly referred to as political instability, the quality of existing infrastructures in the host country, both in terms of material and institutional infrastructures, and the tax systems. (Demirhan and Masca, 2008)

The importance of such determinants as the agreements on the regional free trade and the proper regulations of the host countries customs unions, openness of the market to foreign trade, level of the workforce efficiency, low production and labor costs in the host country, political and what is more important military instable and dangerous atmosphere, and the

level of the protection of human rights for the attractiveness to the foreign direct investors have been described in the work of Keillor et al. The study also describes the importance of not only the characteristics of the population of the host country but also the number of population, especially for the foreign direct investors who seek consumption markets for the goods they produce. (Keillor et al., 2009)

Bevan and Estrin have studied the determinants that influence the FDI flow to transitional economies and found out that one of the most important factors is the risk in the host country meaning both microeconomic and political risk. Macroeconomic risk is connected to the condition of financial institutions and the development level of financial influence and transferring mechanisms. Political risk is measured mostly by the level of the corruption in the country and the balance in the government. Among other important risks here again are market size, cost of the labor, and the development level of private sector. (Bevan and Estrin, 2000)

L da G be g a e a ed e e a be ee FDI a d f e g e c a g e a e a d f d a e c a g e a e a a fac f FDI a , f e ab e e e a e ce e e f e e ab e e e a e ea f e e e c . T e e f e , e a e c a f e c e c e c fa a b e f FDI a e e ed e da g g e . (G be , 2006)

O e a d e e a f FDI c d e a fac , c e a ed b e e e a c a d d f a e c a e a e be f a e ec ded e e a a (F , 2008); effec e e ga e c e a ed b e e e ce f e a a e g a e a d e f f FDI e c b a b e e e e e a d c a a d e ce (Pe , 2001).

Data available in the database on FDI in Armenia is limited due to the lack of data on some of the determinants of FDI. The data available in the database is not sufficient to conduct a comprehensive analysis of the factors affecting FDI in Armenia. The data available in the database is not sufficient to conduct a comprehensive analysis of the factors affecting FDI in Armenia. The data available in the database is not sufficient to conduct a comprehensive analysis of the factors affecting FDI in Armenia. (Ghazarian, 2010)

Research Questions

Summing up all the mentioned above, and also taking into consideration the lack and limitations of availability of data on some of the determinants of FDI, this paper will try to answer the following Research Questions:

- ✓ **RQ1.** Is there a relationship between *gross domestic product* and *FDI* in Armenia?
- ✓ **RQ2.** Is there a relationship between *gross foreign debt* and *FDI* in Armenia?
- ✓ **RQ3.** Is there a relationship between *inflation rate* and *FDI* in Armenia?
- ✓ **RQ4.** Is there a relationship between *country risk* and *FDI* in Armenia?
- ✓ **RQ5.** Is there a relationship between *foreign exchange rate* and *FDI* in Armenia?
- ✓ **RQ6.** Is there a relationship between the *level of trade openness* and *FDI* in Armenia?
- ✓ **RQ7.** Is there a relationship between *Armenian Diaspora* and the *FDI* in Armenia?
- ✓ **RQ8.** Is the *Armenian legal system related to the FDI* appropriate for FDI attraction to Armenia?
- ✓ **RQ9.** What are the *general advantages* of Armenia regarding FDI?
- ✓ **RQ10.** What are the *general disadvantages* of Armenia regarding FDI?
- ✓ **RQ11.** What *sectors of Armenian economy* are more *favorable* for FDI?

Methodology

In order to study the mentioned research questions first we need to conceptualize the concepts we are going to study. First of all we need to conceptualize *FDI* as we deal with it in almost all our RQs. For the purposes of this study FDI will be measured as total annual amount of Foreign Direct Investment to Armenia from all possible locations. For RQ7, where a correlation will be studied between FDI and Armenian Diaspora, FDI will be defined below. In order to study the correlation between *gross domestic product (GDP)* of Armenia and FDI, GDP will be taken as annual total number, not per capita, that is officially announced by the authorities of the Republic of Armenia. *Gross foreign debt* will be measured as a total annual number of debt that Armenia has towards international organizations, other countries or enterprises located in other countries. Here again the official numbers announced by the authorities of the Republic of Armenia will be taken. *Inflation rate* is the rate of Consumption Price Index percentage annual change in Armenia that is officially announced by the authorities of the Republic of Armenia. For the purposes of this study *country risk* will be defined as existing political and macroeconomic risks in the country and will be measured by two important factors: the level of corruption in the country and economic freedom. In order to get as fair numbers on these measures as possible, the data will be taken from two international indices that are accepted worldwide and are considered to be impartial: Heritage Foundation Index of Economic Freedom and Transparency International Annual Corruption Index. The *foreign exchange rate* is the rate at which Armenian Dram is exchanged with other currencies. For the purposes of this study exchange rates of three important currencies will be studied as most of the investments come from the countries where these currencies operate, namely US Dollar, EURO and Russian Ruble. The official Exchange Rates announced by the Armenian authorities will be used. The *level of trade openness (LTO)* is the ratio of foreign trade to the GDP, which is counted annually

according to this formula: $LTO = (\text{Import} + \text{Export}) / \text{GDP}$. To measure LTO the official numbers announced by the authorities of the Republic of Armenia will be used. All these mentioned data will be taken for the last 11 years starting from 2000 to 2010, with the exception of Transparency International Corruption Index Ranks, as they are counted for Armenia only since 2003.

RQ7 is measured in a different way. There is no record kept about the number of foreign direct investors who are representatives of Armenian Diaspora, so this research question will be measured indirectly: the countries will be compared by the number of Armenians in the Armenian Diaspora of those countries and the number of FDI that Armenia has received from those countries. *Armenian Diaspora* is the total number of Armenian nationals who live in other countries. For the purposes of this study the most recent numbers for Armenian Diaspora in other countries will be taken as these numbers have not changed significantly during the latest decade. The official data provided by the Ministry of Diaspora of the Republic of Armenia will be used. For the purpose of the RQ7 the concept *FDI* will be measured in a different way. The cumulative number of the FDI since independence will be taken by countries. Pearson's Correlation test will be run on SPSS for all the Research Questions from 1 to 7 after the data is collected through detailed research of necessary official documents. There was no possibility to run regression tests for FDI as the studied period for which the data was available was short and trend-specific and described general transition period of Armenian economy.

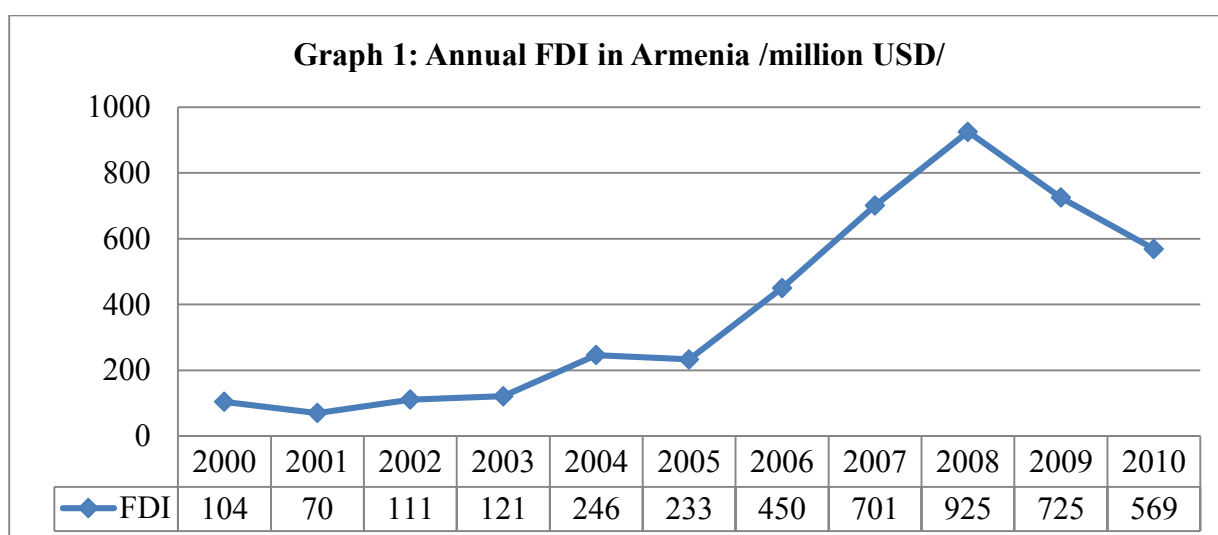
For the purposes of this study the *legal system related to FDI* is conceptualized as the laws and regulations that refer in any way to FDI and regulate the investment environment in Armenia, mainly Law of the RA "On Foreign Investments", Law of the Republic of Armenia "On Privatization of State Property" and all the laws concerning the taxation of the

businesses that may refer to investors. *General advantages* of Armenia regarding FDI are all those factors that contribute positively to the flow of FDI to Armenia and should be emphasized by Armenian authorities and businesses to attract foreign investors. *General disadvantages of Armenia regarding FDI* are all those factors that affect negatively the FDI flow to Armenia and should be somehow improved or changed in order to make Armenia a more attractive location for FDI. The *sectors of Armenian economy favorable for FDI* are those sectors of Armenian economy that have a high potential of FDI involvement and are not related to any major problems or disadvantages.

The concepts of the Research Questions 8-11 are of qualitative nature and not quantitative. These research questions are not of theoretical nature and are not connected to any data. They have a practical nature and need a different method of study. In order to answer these research questions in-depth interviews were conducted with experts and businessmen related to the field, namely employees from upper management of enterprises that operate on FDI, and employees of specialized organizations who provide consultative, accounting, legal and other services to a large number of foreign direct investors who are willing to invest in Armenian companies. As long as there is no full list of foreign direct investors or consulting companies and the choice was very subjective, in-depth interviews were conducted with the representatives of largest businesses from various spheres of operation that are the most popular in Armenia for Foreign Direct Investors, namely IT, connection operators and food industry, as well as four large consulting companies that are highly reliable. The names of the organizations and the interviewees are confidential and will not be listed in this paper. After conducting 7 in-depth interviews saturation point was reached and no new valuable information was received during the last interview. Therefore, no more interviews were conducted. The detailed questionnaire of the in-depth interview is presented in the Annex 1 of the following research paper.

Findings and Analyses

The most important findings of this research paper are the data of FDI to Armenia as they are referred to in nearly all the research questions. The data on FDI was discussed in two different ways: annual FDI to Armenia for the research questions 1 to 6 (See Annex 2 Table 1), and cumulative FDI to Armenia since independence by countries for the research question 7 (See Annex 2 Table 2). Graph 1 shows the general trend that was found for the annual FDI flow to Armenia. We can see that FDI to Armenia grew slightly in the period between 2000 to 2005. From 2005 up to the year 2008 FDI to Armenia had a very significant growth. But year 2008 was a breaking point and FDI started to decrease. The most probable reason for this decrease is the international financial crisis.



Research Questions 1, 2, 3, 5 and 6 tried to find out whether there is a relationship between annual FDI flow to Armenia and several macroeconomic factors of Armenia, namely Gross Domestic Product (GDP), gross foreign debt, inflation rate, exchange rate and level of trade openness correspondingly. The detailed data on all the macroeconomic factors is presented in Appendix 2 Table 3. After Pearson's Correlation test was run between each of them on the one hand and FDI flow to Armenia on the other hand, statistically significant relationship was found in most cases.

First of all in the **Research Question 1** statistically significant strong positive correlation was found between annual FDI and GDP, and Pearson's correlation coefficient was 0.940, which means that these two economic factors have gone almost in parallel with each other. But the relationship between GDP and FDI is complex and can be explained in two ways: first of all, as already mentioned changes in GDP influence FDI attraction to a country because they show how the country's economy is changing: if GDP is increasing then the economy of that country is developing and the investors see the country as a favorable destination for their investments; on contrary, the decrease in GDP generally speaks about problems in the economy, making it not a favorable FDI destination.

On the other hand let us not forget what GDP is. The famous formula for counting it is $GDP=C+I+G+NX$, where C is the level of consumption, I is the level of investments, G is the level of Government spending, which represents the difference between Government spending and the taxes, and NX is the net export, that is the level of foreign trade which shows the difference between the exports and the imports. (Taylor and Weerapana, 2010) As we can see from the formula the investments are a composing part of GDP.

It is also worth mentioning that when we speak about changes in GDP influencing changes in FDI, we must keep in mind that the influence will work not immediately but with some time lag, as the investor will make the decision of investing or not investing based on the previous GDP records. So for example, the increase or decrease in GDP of this year will have its influence on FDI of the next year. On the other hand, any change in investment will influence the GDP immediately. Taking into consideration all these, we can say that although we have found strong positive correlation between GDP and FDI, the correlation test does not give us a chance to tell which of the factors most probably influences the other one, and as already mentioned, unfortunately we do not have a timeline long enough to run a regression test to find out the cause and the effect.

The **Research Question 2** was testing whether there is a correlation between the gross foreign debt of Armenia and FDI flow to Armenia. The Pearson's Correlation test was run, and statistically significant correlation was found between the gross foreign debt and FDI. Pearson's correlation coefficient was 0,616 that mean that the correlation is strong.

But the relationship between gross foreign debt and FDI is also complex. On the one hand as we have already mentioned gross foreign debt has a negative effect on FDI. If the country has a very high rate of foreign debt, the country's economy is considered weak and not capable of sustaining itself, therefore the investors do not consider it as a reliable destination for their investments. In this case, the same way as in the case of GDP, the investor is making a decision on whether to invest in a country or not based on the countries previous records of gross foreign debt. Hence, if we examine the relationship from this point of view, we can logically assume that a time lag most probably will occur between the changes in the gross foreign debt of a country and the FDI flow to that country. Moreover, according to this, the relationship between the two economic factors would be a negative one and not a positive one that we have.

On the other hand, let us examine what gross foreign debt itself is: it is the overall debt that a country has towards other countries. The National Statistical Service of Armenia calculates the gross foreign debt of Armenia as the summary of the following: debt of state governing bodies, debt of monetary regulating authorities, debt of Armenian banks, debt of other sectors and foreign direct investments. As we can see, as it was in the case with GDP, here again FDI is a composing part of the economic factor we are relating it to. When we examine the relationship from this point of view, we can assume that an increase in FDI will cause an increase in gross foreign debt without any time lag and the relationship between the economic factors will be positive. Unfortunately, here again we cannot test our assumption on a regression test due to the lack of data.

The **Research Question 3** tried to find out whether there is a relationship between the annual inflation rate in Armenia and the FDI. The Pearson's Correlation test was run and positive correlation was found between the two economic factors with a Pearson's Correlation Coefficient being 0,601. But the statistical significance of the correlation is debatable. Generally in political science we consider a correlation to be statistically significant at the level of 0.05 that is at the level of deviation of one standard error. In our case the significance is at level of 0,051.

In any case the positive correlation is not what was expected as the result of the scientific research. As already mentioned, an increase in inflation rate generally leads to a decrease in investments. This is because of the fact that an investor is seeking a stable market where his money will be safe and will bring him more income. When the inflation rate increases in the host country the money that the investor is bringing there is depreciating in a higher rate and the investor is losing a larger part of it. On contrary, when the inflation rate decreases the investor's money is depreciating in a lower rate, and in case of deflation, the negative inflation rate, it is even appreciating. Therefore, the general logic is that inflation rate and FDI should be in a negative correlation with each other, and not in a positive one that we have in our case.

While analyzing the findings of the RQ3, it should be mentioned once again that the period for which the data on macroeconomic factors in Armenia is collected is very trend-specific period and describes the general transition of Armenian economy. During this period the majority of the economic factors in Armenia show the same trend of moderate economic development of 2000-2005, rapid economic development of 2005-2008 and the economic decline of 2008-2010 which was conditioned by the world economic crises. The positive correlation between inflation rate and FDI might therefore be a sign of both of them being related to other economic factors, namely general economic growth.

The **Research Question 5** tried to find out whether there is a relationship between foreign exchange rate and the FDI flow to Armenia. Pearson's Correlation test was run and statistical significant negative correlation was found between the exchange rate for 1 USD and the FDI. The Pearson's Correlation Coefficient was $-0,964$ which means a very high correlation. Between exchange rate for 1 Euro and FDI no statistically significant relationship was found. Another statistically significant negative relationship was found between exchange rate of 1 Russian Ruble and FDI. The Pearson's Correlation Coefficient was $-0,939$ which again means a very high correlation.

The fact that no statistically significant correlation was found between the exchange rate for Euro and the FDI, can be explained best by the fact that Euro itself was going through certain transition during this period, and was stabilizing as a newly established currency. The true correlation between these two economic factors can be studied in the future when there is enough data available about the exchange rate of Euro after its stabilization.

The statistically significant negative correlation for two other currencies is what the generally studies on the relationship between exchange rate and FDI tell it to be. When the exchange rate of a foreign currency has a decreasing tendency, it means that the local money is getting stronger and from day to day costs more compared to the foreign currency. In this case the investor is willing to put his money work in that country and appreciate with time. Investing 1 dollar when it costs 500 drams, for example, means that in a year when 1 dollar costs 400 drams, the investor will have 1.25 dollars invested in Armenia, and it is an additional way of gaining income besides the income that the invested 1 dollar will bring as the result of a business activity. When the foreign exchange rate of a currency increases the reverse happens.

But here again, we should keep in mind the strong multicollinearity between all the economic factors, which means that the two variables can be dependent on some other one.

The **Research Question 6** tried to find out whether there is a relationship between the level of trade openness of Armenia and the FDI flow to Armenia. First of all the level of trade openness for Armenia was measured by calculating the ratio of imports and exports to the GDP. Later Pearson's Correlation test was run between level of trade openness and FDI and statistically significant negative correlation was found between the two economic factors. Pearson's Correlation Coefficient was $-0,879$ which means that the negative correlation is very strong.

The results of this test are the reverse of what was expected. Generally when the level of trade openness increases in a country it means that the country is getting more open for the foreign trade and more integrated to the international market. Countries like this are considered to be a very favorable destination for the foreign investors. On contrary, when the level of trade openness decreases, it generally means that the country is running a more closed economic policy and is implementing some foreign trade restrictions, a fact that makes it both more difficult and more unfavorable for the foreign investor to bring his money to that country.

Nevertheless, it is worth mentioning that in general the level of trade openness is very high, even the decrease of it during the examined period keeps it on a very high level. This is mostly because Armenia does not have enough amounts of neither the rough material, nor the final consumption goods that the population has the demand for. The additional demand is satisfied by importing the rough material and the goods from other countries. The slight decrease of the level of trade openness is due to general development of Armenian economy and the increase in GDP rather than the decrease of imports and exports of Armenia. The increase in GDP during this time period was mostly conditioned by the development of service sector in Armenia. Therefore, here we once again deal with the strong economic trends in Armenia and not the direct relationship between the two examined variables.

Apart from comparing the FDI flow to Armenia with major factors of Armenian economy the paper tried to find out the relationship between FDI and the internationally recognized rankings that Armenia has in the fields of corruption and economic freedom, namely the Transparency International Annual Corruption Index and the Heritage Foundation Index of Economic Freedom. The detailed information on Armenia's rankings discussed in the **Research Question 4** is presented in Annex 2 Table 4.

In order to find the correlation Pearson's Correlation test was run for both of the Indices but no statistically significant relationship was found in any case. This is a very strange finding. As we have previously discussed investors generally pay significant attention to the country risk which includes the risks in political and economic aspects. These risks are best evaluated from outside of the country while comparing it to others under the same criteria. In order to find a correlation we have taken two internationally recognized indices that are mostly referred to when talking about corruption and economic freedom. Therefore, the investors should be real rank-lovers.

So does the absence of statistically significant correlation then mean that investors do not pay attention to the level of corruption or the level of economic freedom in Armenia? The answer is difficult to be given. On one hand the answer is yes, that is what the tests say, no matter how the rankings of Armenia change according to those indices the investment flow to Armenia independent from them. Hence the investment flow to Armenia depends on other more important factors.

On the other hand, these rankings generally have very slight changes from year to year and they show the changes not only within the country but also in the global context, how the countries positions change compared to other countries. Moreover, these indices started to include Armenia only recently, some starting only from 2003, and the timeline we compare is even shorter here: the results are not very reliable.

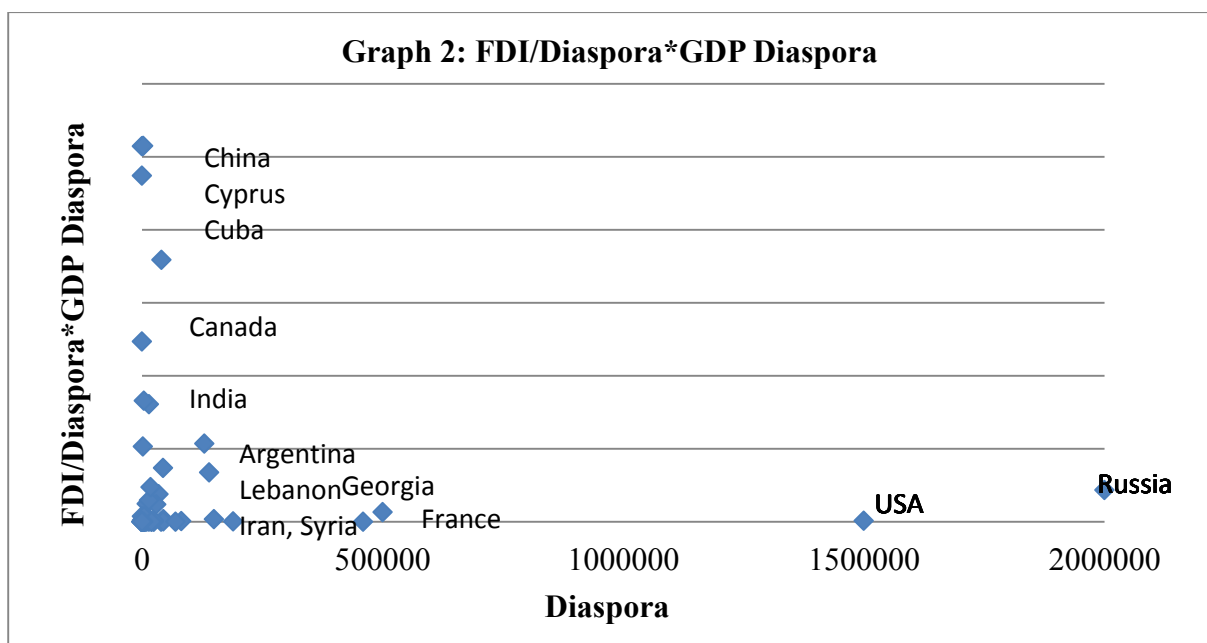
An important part of the findings comes for the **Research Question 7**. The paper tried to find whether there is a relationship between Armenian Diasporas around the world and the locations from where FDI flows to Armenia. In this context the FDI as a variable was taken not as an annual number, but as a cumulative one for the period since independence to the year 2010 and it was divided by countries (see Annex 2, Table 2). As already mentioned no track is kept on the nationality of investors so it is not possible to say what the exact share of Armenian nationals is in the total FDI to Armenia. Therefore, a proxy measure was taken instead, namely the size of Armenian Diasporas around the world (see Annex 2, Table 3).

After Pearson's Correlation test was run between the two variables, statistically significant strong positive correlation was found between them and the Pearson's Correlation Coefficient was 0.831. What conclusions can be drawn from here? First of all, it is obvious that FDI flow to Armenia is highly interrelated to Armenian Diasporas, although no regression test was run to find the cause and effect relationship, it is still hard to imagine that the connection can be reverse and that FDI can influence somehow the formation of Diasporas. Moreover, according to the fundamental rule of Cause and Effect Cause always precedes the Effect in time (Fletcher and Fletcher, 2005): Armenian Diasporas in various countries have been formed during centuries, while we take the FDI of the past two decades. Although we cannot exclude the fact that some third factor might have influenced both FDI flow to Armenia and formation of Armenian Diasporas it is still unlikely and not very logical.

Nevertheless, it is very important to mention, that although there is a very strong relationship between FDI flow to Armenia from certain locations and the presence of Armenian Diasporas in there, we cannot conclude that the Armenian nationals from Diaspora are the ones who invest: the investors can be their friends, colleagues, neighbors or just people who became familiar with Armenia and its economy as the result of good work carried out by the Diaspora communities. Moreover, Armenia being not a very rich country

and not capable of having its Embassies in all the countries around the world, is generally establishing Embassies and Consular Representations in countries where there are Armenian interest that is there are Armenian nationals living. These institutions promote the development of relations between the host countries and Armenia in political, economic, cultural and many other aspects. Therefore, the strong positive relationship between variables can be seen as a sign of institutionalized approach towards the countries were Armenia has large Diasporas.

Based on the mentioned above, countries where Armenia has Diasporas have a good potential of being involved in investing in Armenia. In order to see how much the potential of each country to involve investments to Armenia is realized let us divide the amount of FDI received from each country by the number of Armenians living in that country. In order to clear the social differences among the countries the result for each country was divided by the GDP of that country. The scatter plot we have as a result is presented in Graph 2. As we can see from the graph the two countries where we have the largest Armenian Diasporas, namely Russia and USA have a very low level of potential realization. We will come back to this scatter plot in the recommendations.



From quantitative findings of Research Questions 1-7 let us go to the discussion of qualitative findings of Research Questions 8-11. The paper intended to find out with **Research Question 8** whether the Armenian legal system is appropriate for FDI attraction to Armenia. The logic might say that the most important law regulating the field should be the Law of the RA “On Foreign Investments”. It was adopted in 1994 and it states several important points concerning investments such as the policy of “open doors” which insures that the foreign investors obtain equal rights with Armenian businessmen. Moreover, according to this law the foreign investor can be the owner of an enterprise in Armenia and their property cannot be taken away by Armenian state authorities.

Nevertheless, in practice this law is not much referred to. The interviewees mentioned that the law has a very declarative character and does not practically regulate the field. The scope of the law is also not satisfying because Armenian economy has developed significantly since 1994. Hence there is an urgent need to adopt a new law on Foreign Investments. Unfortunately, no work is carried out on this currently.

The laws that are mostly referred to by the foreign investors are mostly the ones related to the taxes. On one hand most of these laws prescribe advantages for the businessmen to invest in Armenia which will be discussed in more details in the next Research Question. On the other hand, the laws concerning the taxes are a big mess. Different types of the taxes are regulated by separate laws that sometimes are not coordinated with one another: they use different terminology and might even say different things on the same matter. The presence of many laws to be dealt with confuses the investors and the interviewees mentioned the necessity of having a common tax code that will regulate all the issues concerning the taxes. Unlike the new law on Foreign Investments, the new tax code is recognized as a necessity by Armenian state authorities and is already being developed.

The **Research Question 9** tried to find out the general advantages of Armenia while attracting FDI. As already mentioned during the previous Research Question Armenia has certain advantages related to taxes. The import of rough materials to Armenia is not taxed. If the price of the imported goods exceeds 300 million AMD the payment of VAT is delayed by three years. In case of export no limitations and fees exist.

Another privilege of Armenia is the presence of qualified cheap labor. Armenian workforce is referred to by foreign investors as a skilled and educated one. Nevertheless the average salaries of Armenian employees are far below the European standards and even neighboring countries in the region, making it highly competitive. Armenian laws also do not prescribe any limitations to employee involvement based on nationality: the workforce of an enterprise can include foreign citizens only if preferred so by the owner of the enterprise.

The ownership of enterprise is also a very significant advantage. The Foreign Investors can hold 100% of the enterprise ownership without any limitation which is not true for many other countries. Moreover, although foreign citizens cannot own land in Armenia directly, it is possible for the foreign enterprise to rent land for long time periods extending up to almost a century.

There are free economic zones in Armenia. Any activity in these zones is levied from corporate income tax, VAT and other duties and fees. Armenia has free exchange regime of foreign currency, no limitations on money transfers from abroad, as well as no local or geographical limitations for the investments.

Finally, a good advantage for Armenia to involve FDI is the presence of certain natural resources. Armenia is rich with natural metals including even gold which has led to the development of mining industry and establishment of several Foreign Enterprises in the field of gold mining in Armenia which will be referred in more details when discussing Research Question 11.

But the field of Foreign Investments in Armenia has not only advantages and privileges. As a newly developed phenomenon this field still has certain gaps and some things work as a disadvantage when involving FDI to Armenia. **Research Question 10** tried to find out some of the major disadvantages that Armenia has.

One of the most significant disadvantages of Armenia is that the country is geographically landlocked: it is a small country which has no access to any sea. Being landlocked creates problems with transportation of goods both to a country and from it. In addition to being landlocked Armenia is in a situation when two out of four borders with neighbors are closed due to political reasons. This makes the situation even tougher. The transportation of goods to Armenia and from Armenia is very expensive and it is not profitable for foreign businessmen to invest their money in the field of production of any goods that later need to be exported or that need import of significant rough materials unless it is a production in the field of light industry when the price of a good exceeds the transportation price several times.

Tightly related to the mentioned above is another disadvantage of Armenia namely the bad quality of infrastructure. The interviewees mentioned as a disadvantage nearly every type of infrastructure starting with roads and railroads, the weak development of air transportation which limits fast movement and ending with weak internet connection.

Another major disadvantage is the political and economic situation in Armenia. Any sign of political or economic instability is making a country a not favorable destination for FDI. According to interviewees the high level of corruption and bureaucracy in the country, as well as the high rates of inflation are among the most important disadvantages for investing in Armenia. Nevertheless both the level of corruption and the level of inflation have been tested by this paper and no statistically significant relationship has been found between them on one hand and FDI in Armenia on the other hand.

And finally the **Research Question 11** tried to summarize the general advantages and disadvantages of Armenia in the field of FDI and suggest certain fields of Armenian economy that have the best potential of being developed as the FDI involvement fields.

As already mentioned the privileged sectors of the Armenian economy for FDI are those that do not require transportation of large amount of goods for final consumption to other countries or transportation of large amounts of rough materials to Armenia for production. Therefore the investing in industry in Armenia is not very profitable for foreign businessmen. Nevertheless, the light industry sector is considered to be one of the most favorable sectors. The jewelry production, watch production and other related sectors are among those that are recording rapid development recently.

Tourism is another advantageous sector for FDI. Armenia has an ancient history, numerous cultural and religious monuments that date back to centuries and other places to be visited. According to the interviewees what Armenia lacks in the sector of tourism is the proper commercial abroad. If Armenia is presented well enough it has the potential of becoming a tourist center in the region.

During the recent decade the sector that has recorded the most development in Armenia is the sector of IT technologies. Several large enterprises have been established in Armenia by the means of foreign direct investments and the sector is now developing with even a higher pace. IT technologies require mostly human resources that Armenia has and they do not create any problems with transportation.

The final important sector as already mentioned is mining. The mining industry in Armenia is developed mostly by the means of foreign investors. There are several enterprises that are involved specifically in gold mining. The export of rough gold material is not taxed and the transportation costs relative to the future profits are not significant. All these makes investing in gold mining very attractive for foreign businessmen.

Conclusions

As we have seen the general rules that work for attracting Foreign Direct Investment to countries do not necessarily work for Armenia. We can say that this paper has dealt with Armenian as a special phenomenon from the perspective of FDI attraction.

First of all, as the paper has shown the time period for which the FDI was examined can best be described as a transition period in the economy of Armenia with strong trends. Armenian economy has started to develop almost from the ground after the independence from Soviet Union. It was not possible to discuss the economy since the very beginning due to lack of data on it; therefore, the last decade was mostly discussed. Since 2000 up to 2005 Armenian economy was developing moderately and was recording slow growth. In 2005 the economy started a significant growth due to reasons that are not a subject of this paper. The development would most probably continue further if not the global financial and economic crises due to which Armenian economy was also affected and started a slow decline from 2008 up to 2010. The same trend was true for nearly all economic factors of Armenia discussed in this paper.

Due to this strong trend the findings were very difficult to analyze. The statistically significant relationships between FDI on one hand and Gross Domestic Product, Gross Foreign Debt, the exchange rate for foreign currencies and the level of trade openness are not necessarily a sign that any of the mentioned economic factors really influence FDI. Moreover, as we have seen in some cases the direction of the relationships were opposite to what was expected after studying the international experience. Instead of some of them to influence others they were most probably all influenced by the general economic growth and decline. Due to this strong multicollinearity between economic factors it became also not possible to run any regression tests.

The same is true for the fact that no statistically significant relationship was found between FDI on one hand and inflation and country risk on the other hand. These factors are thought to be the most important ones while determining the destinations where the FDI will go. They were also mentioned as important disadvantages by the interviewed businessmen. But in case of Armenia they seem not to have a relationship with FDI.

What was the most important finding of the paper was that the FDI in Armenia are most closely related to the Armenian Diaspora around the world. The statistically significant strong positive relationship between Armenian Diasporas and destinations from where FDI flows to Armenia shows that Diaspora even if not involved in investing directly plays significant role in presenting Armenia as a favorable destination for FDI. The paper analyzed the potential of each Diaspora in attracting FDI and came to the conclusion that the potential of the largest Diasporas is used very weakly compared to some small ones.

The qualitative findings were not as surprising at the quantitative ones. The paper discussed the legal system of Armenia and its appropriateness for attracting FDI and came to a conclusion that although the existing laws prescribe certain advantages for foreign investors they are not very practical and are very confusing: there is a necessity of adopting a new law on Foreign Investments and a new Tax Code that will deal with all taxes in one place.

The general advantages and disadvantages for FDI in Armenia are very closely related to the sectors of economy that are more favorable for FDI attraction to Armenia. Being landlocked and having close borders with neighbors it is more favorable for Armenia to attract investments in the fields related to light industry where Armenia has the advantage of cheap labor cost and can also involve the natural resources that it has. Here it is possible for Armenia to overcome the major disadvantage of expansive and not fully available access to the world market. Therefore, the most favorable sectors are the IT technologies, tourism, mining (particularly gold mining), as well as jewelry and watch production.

Recommendations

Taking into consideration all the discussions and analyses above, the paper makes recommendations to the Government of the Republic of Armenia for the following:

- ✓ There is a need in developing a new law on Foreign Investment that will be more practical in use. For the implementation of this the Government of Armenia can assign the ministry of economy, particularly the department of Investment Policies to develop a new law on Foreign Investments in cooperation with other state bodies involved in the sphere and the already established enterprises that work on Foreign Investments.
- ✓ There is also a need in a common Tax Code that will collect all the existing laws on various taxes in one place. The Government of Armenia has already started the development of the Tax Code involving in that various state bodies and should continue its support for the creation of the Code.
- ✓ There are several sectors of Armenian economy that have the potential for investment attraction to Armenia. The Government of Armenia could offer tax and sector-specific privileges to the businessmen who will invest in those sectors. This will also help Armenia to further develop these sectors.
- ✓ The free trade zones attract businessmen to organize productions and sell them without being taxed. The Government of Armenia is already working on the creation of new free trade zones and the development of the existing ones. If this tendency remains in the future Armenian economy will gain significantly and Armenian will sound a more favorable place for FDI.
- ✓ Armenia currently does not have a certain “Menu” of the projects that need investments. The creation of such a “Menu” will ease the process of finding Investors because the projects might themselves sound attractive.

- ✓ Sectors like tourism work mostly on proper PR and commercials. Armenian Government should start a proper PR for Armenia in the world, presenting Armenia in its full beauty. This can be achieved best by involving in the PR the Armenian Embassies abroad and the potential of Armenian Diaspora in general.
- ✓ Closely related to the previous point is the realization of Diasporas' potential in the countries where Armenia has large Diasporas. As we have discussed previously the two countries that have the largest Armenian Diasporas, namely Russia and USA, where 2 million and 1.5 million Armenians live correspondingly, have a very low level of use of Diasporas' potential. The government of Armenia can try to use the experience of Armenia's relations with the Diaspora's that have a higher level of use of potential and develop a model for the others.
- ✓ Finally there is a need for a working economic model of FDI determinants in Armenia because the international models do not match the Armenian reality. The Government can assign state agencies to work on such economic model with newest economic tools clearing the trends and observing the Armenian economic connections without them.

Armenian Government has already reached significant improvements since the independence. Being only a 20 year old Republic after the collapse of Soviet Union Armenia already has a stable economy and is recording significant developments annually. Moreover, relative to its GDP Armenia already has a high level of FDI performance. The development of Investment climate in Armenia will lead to the further development of the economy and will become an integrated part of it.

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ANNEX 1: Questionnaire for interview with Foreign Direct Investors

1. Name of Business _____
2. Contacts _____
3. Sphere of Performance _____
4. Number of Employees _____

1. What is attracting foreign direct investors to invest their money in Armenia, why have they chosen Armenia? According to them, what are the relative advantages of Armenia?
2. Which are the main problems that occur while investing in Armenia, particularly what issues occur while founding business in Armenia, and what issues during the process of further activities?
3. What solutions would you suggest to the mentioned problems? According to you, what measures could improve the investment environment in Armenia?
4. How would you evaluate the existing legal system of Armenia related to FDI? More specifically how would you evaluate Law of the RA "On Foreign Investments", Law of the Republic of Armenia "On Privatization of State Property" and the laws concerning the taxation of the businesses that may refer to investors?
5. Why have foreign direct investors chosen that particular sphere for investment? According to them, what are the relative advantages of Armenia in that particular sphere? What potential do they consider Armenia to have in that sphere?

Annex 2: Findings

Table 1: Annual Foreign Direct Investment to Armenia*

Year	Annual FDI to Armenia /million USD/
2000	104,2
2001	69,9
2002	110,7
2003	120,5
2004	245,6
2005	232,7
2006	450,1
2007	701,0
2008	925,2
2009	724,8
2010	569,0

Source – National Statistical Service, Yearbook 2010

Table 2: Cumulative FDI to Armenia 1991-2010 by Countries*

Country	FDI received from the country	Country	FDI received from the country
Argentina	257 969,3	Israel	4 600,0
Australia	18 429,0	Italy	56 514,9
Austria	57,5	Kaiman Islands	4 620,2
Bahamas	971,7	Kazakhstan	17,3
Belarus	197,0	Kuweit	154,6
Belgium	25 404,6	Latvia	2,1
Bulgaria	252,6	Lebanon	141 737,7
Canada	145 128,6	Liberia	647,2
China	1 309,5	Lichtenstein	6 160,5
Cuba	967,5	Luxemburg	54 743,3
Cyprus	98 346,9	Monaco	378,1
Czech Republic	21,2	Netherlands	28 576,9

Country	FDI received from the country	Country	FDI received from the country
Denmark	496,6	Panama	6 526,6
Egypt	150,1	Poland	0,2
Finland	23 464,0	Romania	0,2
France	647 763,3	Russia	2 284 230,9
Georgia	22,8	Slovakia	58,5
Georgia	0,8	Slovenia	214,7
Germany	319 061,5	Spain	3 219,2
Great Britain	81 964,6	Switzerland	39 100,5
Greece	93 285,1	Syria	260,5
Hungary	452,0	Turkey	1 785,9
Iceland	0,2	Turkmenistan	2 713,5
India	115,9	Ukraine	3 813,9
Iran	5 498,2	United Arab Emirates	4 353,6
Ireland	16 051,7	USA	225 868,2

*Source – National Statistical Service, Yearbook 2010

Table 3: Annual data for macroeconomic factors in Armenia*

Year	GDP	GFD	Inflation Rate	ER for 1 USD	ER for 1 Euro	ER for 1 Ruble	LTO
2000	1031,3	859,5	-0.8	539,52	498,52	19,05	0.62
2001	1175,9	905,5	3.1	555,08	497,06	18,97	0.58
2002	1357,0	1025,5	1.1	573,35	541,66	18,24	0.63
2003	1624,6	1097,7	4.7	578,76	653,76	18,83	0.70
2004	1907,9	1182,9	7.0	533,45	662,28	18,52	0.58
2005	2242,9	1099,2	0.6	457,69	570,39	16,19	0.57
2006	2656,2	1205,6	2.9	416,04	521,20	15,29	0.50
2007	3149,3	1448,9	4.4	342,08	467,87	13,37	0.48
2008	3568,2	1577,1	9.0	305,97	450,24	12,35	0.47
2009	3102,8	2966,7	3.4	363,28	507,35	11,50	0.47
2010	3509,6	3299,0	8.2	373,66	496,03	12,32	0.51

*Source – National Statistical Service, Yearbook 2010

Table 4: Armenia's Rankings in Heritage Foundation Index of Economic Freedom and Transparency International Annual Corruption Index*

Year	Corruption level (0-10)	Economic freedom (0-100)
2000	.	63.0
2001	.	66.4
2002	.	68.0
2003	3.0	67.3
2004	3.1	70.3
2005	2.9	69.8
2006	2.9	70.6
2007	3.0	68.6
2008	2.9	69.9
2009	2.7	69.9
2010	2.6	69.2

* Sources - Heritage Foundation Index of Economic Freedom, years 2000-2010, Transparency International Annual Corruption Index, years 2003-2010

Table 5: Armenian Diasporas around the world*

Country	Number of Armenians	Country	Number of Armenians	Country	Number of Armenians
Albania	576	Indonesia	84	Russia	2 000 000
Argentina	130 000	Iran	150 000	Saudi Arabia	300
Australia	45 000	Iraq	22 000	Senegal	15
Austria	3 000	Ireland	76	Serbia	2 000
Bahrain	120	Israel	10 000	Singapore	80
Bangladesh	80	Italy	4 000	Slovakia	1 500
Belarus	25 000	Ivory Coast	20	Slovenia	500
Belgium	15 000	Japan	160	South Africa	400
Brazil	40 000	Jordan	5 000	South Korea	12

Country	Number of Armenians	Country	Number of Armenians	Country	Number of Armenians
Bulgaria	45 000	Kazakhstan	25 000	Spain	25 000
Canada	40. 505	Kuwait	5 000	Sudan	1 500
Chile	1 000	Kyrgyz Republic	3 000	Sweden	3 000
China	350	Latvia	5 000	Switzerland	5 000
Columbia	500	Lebanon	140 000	Syria	190 000
Cuba	165	Lithuania	2 736	Tajikistan	6 000
Cyprus	2 740	Mexico	560	Thailand	40
Czech Republic	15 000	Moldova	7 000	Turkey	82 000
Denmark	4 300	Monaco	400	Turkmenistan	30 000
Egypt	8 000	Morocco	35	Ukraine	150 000
Estonia	2 300	Netherlands	10 000	United Arab Emirates	4 600
Ethiopia	300	New Zealand	1 000	United Kingdom	18 000
Finland	2 000	Nicaragua	2 907	Uruguay	25 000
France	500 000	Norway	2 000	USA	1 500 000
Georgia	460 000	Pakistan	200	Uzbekistan	70 000
Germany	44 000	Peru	250	Venezuela	3 000
Ghana	15	Philippines	8	Vietnam	8
Greece	35 000	Poland	10 000	Yemen	1 000
Hungary	2 000	Qatar	400	Zambia	80
India	200	Romania	3 000	Zimbabwe	230

* Source – The Ministry of Diaspora of RA