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**INVESTMENT CLIMATE IN ARMENIA**  
**COUNTRY REPORT\***

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\* This paper has been prepared by Mr. Kubat Umurzakov, ESCAP consultant. The views expressed in it are those of the author and do not necessarily reflect the views of the United Nations secretariat. Mention of any firm names and commercial products does not imply the endorsement of the United Nations.

This paper has been issued without formal editing.

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## I. INTRODUCTION

The Investment Climate Report on Armenia was prepared for the Regional Round Table on Foreign Direct Investment for Central Asia, which is organized by UNESCAP in cooperation with UNCTAD and the Government of Tajikistan in Dushanbe on 3 and 4 April 2003. The ESCAP Consultant visited Armenia from 1 to 4 October 2002, with the support of the United Nations Development Programme.

The consultant held meetings with relevant government officials, and members of the business and international investment community based in Yerevan. Foreign companies were interviewed to provide their perspective on the investment climate in Armenia. The consultant would like to express his gratitude to all those who provided their time and information to assist him.

The paper is structured as follows. In section II trends in economic activity against the background of Armenia's reform objectives towards a market-oriented economy in the period after gaining independence are reviewed with particular focus on the role of foreign direct investment (FDI) and the country's current performance in attracting investment. Taking into account investors' views expressed, the country's strengths, weaknesses and opportunities are identified and reviewed.

Section III reviews the policy and legal framework for FDI in Armenia, along with an analysis of specific standards which apply to foreign investors and relevant laws and policies which are of particular interest or concern to foreign investors including implementation practices. Finally, an overall assessment is made of the policy and operational framework.

Based upon the findings of this analysis, section IV presents some recommendations for the Government of Armenia to consider core issues for improvement of the climate for FDI. The recommendations address policy and administration issues concerning regulatory system reform including improvements in governance, transparency and accountability of governmental and local agencies, judicial system as well as institutional design of investment related bodies.

## II. NATIONAL OBJECTIVES AND COMPETITIVE POSITION

### A. The national economy

#### 1. Economic performance and reform

Since gaining its independence in 1991, Armenia has implemented a comprehensive stabilization and structural reform programme. It has a very liberal trade regime, no foreign exchange controls, and in December 2002 acceded to the WTO. In the process of macroeconomic stabilization, a flexible exchange rate system has been achieved and inflation has been reduced. With land privatization accomplished in 1991 and small and medium-sized enterprises (SMEs) mostly privatized, large-scale privatization has been accelerated since 1998. Substantial progress in tightening fiscal and monetary policies has been made, while reform of the banking sector is under way.

##### a. Macroeconomic performance and economic growth

Real GDP declined severely during the 1990-1995 period in all the CIS economies - GDP fell by about 40-60 per cent in Armenia, Tajikistan, Kyrgyzstan and other Central Asian countries (see table 1). In Armenia, the drastic decline in industrial output and a devastating inflationary spiral were finally brought under control starting in 1994 when a cease-fire ended open hostilities in a conflict with Azerbaijan over the disputed territory of Nagorno Karabakh. Economic growth has since been comparatively strong, reaching 8 per cent during the last three years. In the last five years, the most dynamic sectors were food processing, diamond cutting, jewelry and construction.

**Table 1. Real GDP trends in selected CIS countries (1991 = 100)**

Country/region	1995	2000	2001
Armenia	60	77	84
Azerbaijan	42	59	65
Kazakhstan	69	78	88
Kyrgyzstan	55	72	76
Tajikistan	41	41	45
Uzbekistan	82	99	103
CIS	63	68	72

*Source:* CIS Statistical Committee.

The government economic programme supported by the IMF and World Bank has resulted in an improved macroeconomic picture. As a result of the tight monetary policy, the inflation rate declined from 32 per cent in 1995 to 0.4 per cent in 2000 before rising moderately to 3 per cent in 2001. The Armenian currency, the dram is stable. The external current account deficit narrowed significantly from 21.3 per cent of GDP in 1998 to 14.5 per cent in 2000 and 9.5 in 2001 based on strong export growth and subdued import demand. The country has traditionally

been able to finance external imbalances through remittances from the Armenian diaspora and support (on concessional terms) from the IMF and the World Bank. Nevertheless, Armenia's balance of payment situation still remains vulnerable, and measures to promote export and encourage domestic saving are needed. The public external debt at the end of 2001 amounted to around US\$ 905 million or about 43 per cent of GDP and close to 129 per cent of exports of goods and services on net present value terms. Armenia's external debt situation is less precarious than that of some Central Asian countries. However, strict discipline in assuming new indebtedness is, nevertheless, essential and the IMF has recommended that the country should not incur further non-concessional debt.

#### b. Privatization

While most of the privatization agenda was completed during the first few years of transition, a number of enterprises remain under state control. A rather ambitious privatization programme for 2001-2003 covers practically all remaining state-owned enterprises and sets out a plan for finalizing privatization by 2003. While some large state-owned enterprises have been privatized in 1998-1999, including the national telecom company Armentel, Yerevan Brandy Company, Hotel Armenia, Hotel Ani, and the Armenian gas distribution network, the privatization process has slowed recently, mainly because remaining assets are less attractive and their sale tends to be more controversial.

Unfortunately, privatization has not always resulted in the required restructuring, as many assets were sold to investors who had no relevant experience and/or sufficient funds, particularly in the early days of mass privatization. Consequently, the inflow of capital and know-how expected from the privatization process has not really materialized, and many enterprises are only kept afloat because of tolerance of arrears and poor bankruptcy procedures.

The lessons learned during the privatization process include the sale of the telecom operator, Armentel, at present 90 per cent owned by a Western telecommunications company. The Armentel deal was marred by serious weaknesses in the decision to grant Armentel a monopoly in international telecommunication services including fixed line market and mobile communications for 15 years.

Privatization of the four electricity distribution companies (EDCs) has been on the agenda for the last few years. After initial failures to privatize and a subsequent reduction of the proposed sale price, the authorities are currently finalizing negotiations on privatization of the EDCs. As it may be difficult to find a suitable new owner in the energy sector, the authorities are discussing the possibility of a management contract to a qualified operator.

Aimed at improving the current situation in the transport infrastructure, particularly air transport, the Government put the whole Yerevan airport, including the cargo terminal, under management by an Argentinian company.

#### c. Financial sector reform

Armenia's banking system comprises 28 banks, three of which are foreign-owned. There are no state-owned banks. The last state-owned bank, the State Savings Bank was privatized in September 2001. The foreign banks operate subsidiaries incorporated in Armenia; there are no

branches of foreign banks. The largest five commercial banks (by asset size) account for 50 per cent of total assets of the system, 43 per cent of loans, and 57 per cent of deposits. The banking sector remains fragmented and the level of financial intermediation is low. The total capitalization of the country's banking system is now about US\$ 35 million. To strengthen financial stability and accelerate consolidation of the fragmented financial sector, minimum capital requirements for existing banks were increased to US\$ 1.65 million in July 2002. They will be raised to US\$ 2 million in mid-2003 and to US\$ 5 million (the same level as for new banks) in 2005. The authorities are also planning to introduce a deposit insurance scheme that will begin collect premiums from banks in mid-2003.

In an effort to ensure consolidation of the banking system and enhanced banking supervision, the central bank launched a banking restructuring in the late 1990s. As of mid-2002, eight of the 28 banks of the system were placed under interim administration. These eight banks account for 18 per cent of total assets of the banking system, 26 per cent of total loans, and 32 per cent of total deposits. The authorities plan to revoke the licences of the five smallest banks under the interim administration and hand them over to the courts, conduct least-cost analyses and formulate resolution strategies for the remaining three banks, and resolve the situation of the largest bank under the interim administration by end-June 2003.

#### d. Structural reforms

In the last two years, the Government has continued implementation of a series of structural reforms designed to make the transition economy more market-oriented and to improve governance. However, much work remains to be done. Armenia remains a particularly difficult place to do business given inconsistent implementation and interpretation of laws and regulations, a weak court system, an inadequate legal/regulatory environment, a widespread system of massive corruption, and arbitrary tax and customs administration.

In 2001, the IMF approved a new three-year Poverty Reduction and Growth Facility (PRGF) programme. The objectives of this programme include increasing the transparency and governance in the public sector, improving expenditure control, budget management, and tax and customs administration. It will also support banking and energy sector reform, accelerated privatization, and civil service reform. The authorities are addressing governance and transparency concerns. Following the adoption of the Financial Disclosure Law in 2001, they began publishing the incomes of government officials. In 2002, the Ministry of State Revenue and Customs administration adopted codes of conduct for their staff. Furthermore, the Government established an anti-corruption strategy group which prepared a time-bound action plan to be discussed with key stakeholders. Suggested measures include streamlining legislation, enhancing the business climate, downsizing government entities and, in some cases, replacing them with regulatory bodies.

The Government is also implementing the World Bank's Country Assistance Strategy Programme which will address public administration and the business environment, public enterprise restructuring, and energy sector reform. If completely implemented, the reforms envisaged by the programmes of the international financial institutions (IFIs) could substantially improve Armenia's investment climate.

## 2. Economic structure and national development objectives

Armenia possesses substantial natural resources, including copper, molybdenum, zinc and gold, several other non-ferrous metals and minerals. The country is also rich in construction stones (tuff, marble, granite, basalt, limestone, etc.), semi precious stones (obsidian, agate, jasper, etc) and other materials. Agriculture accounts for 25 per cent of GDP and is the source of essential raw materials for downstream industries.

The main objectives of the country's development are contained in the Interim Poverty Reduction Strategy Paper (IPRSP) for 2001-2003. This paper will serve as the basis for the development of a National Poverty Reduction Strategy which was expected to be finalized by the end of 2002. This document outlines a medium-term strategy which aims at maintaining high economic growth and reducing poverty. Under this approach, the Government is designing and defining its vision for the next few years with the active participation of key domestic actors – parliament, civil society, the business and international communities – and is developing a national strategy for poverty reduction.

The main pillars of the Poverty Reduction Strategy are: i) sustainable and equitable growth; ii) social development, including measures to mitigate the negative consequences of structural reforms; and iii) the establishment of an efficient public and corporate governance system. The IPRSP recognizes that institutional reform and higher investment in the economy are crucial to generate higher output growth. To this end, the Government places high priority on additional reform efforts and measures that would ensure a major improvement in the business and investment climate to create new jobs.

The Government has identified the following priority development sectors: light manufacturing, services (including information technology and banking), mining and natural resources, tourism, and agro-processing. Box 1 discusses the IT sector in Armenia.

### Box 1. Information technology (IT) sector.

The IT industry could play a leading role in Armenia's economic development. It is a versatile technology and there are no areas of product or service where IT cannot be applied and benefits obtained. IT also has multiplier effects on other economic activities. Given the regional constraints to the country's trade, the significance of IT development, especially e-commerce applications, cannot be overemphasized.

Armenia's IT industry development programme is based on its comparatively large supply of qualified IT professionals, the relatively short durations of IT projects, relatively low capital requirements, low wage rates and benefits in terms of high value added products. In the former Soviet Union Armenia was one of the main scientific centres of the country with special focus on the IT industry. There were about 40 Research and Development (R&D) companies active in the field, the biggest of which, Yerevan R&D Institute of Mathematical Machines, had about 10,000 employees and was producing both hardware (mainframes, computers mostly for Soviet military industry needs) and the corresponding software (operating systems, applications).

Despite the country's economic and physical hardships experienced since its independence in 1991, the IT industry has survived and has even developed. Since 1997, the IT industry - with three sub-sectors: i) hardware, ii) software, and iii) media for collection, storage, processing, transmission, and presentation of information - has been advancing at an accelerated pace. More than 200 companies, including about 20 American and European companies, are currently operating in the IT sector in Armenia employing local specialists.

Because job opportunities are limited, a large number of programmers are unemployed or work as computer maintenance specialists or operators, rather than for software firms. However, software development has become so popular in Armenia that many mathematicians and physicists are changing their specialties to become software professionals. Armenia has approximately 6,000-7,000 specialists in the field, with 300 graduating every year from the State University's applied mathematics faculty and the Engineering University.

The biggest software company in Armenia is HPL Armenia, a subsidiary of Silicon Valley-based HPL Inc. which employs about 150 programmers. Software exports alone amounted to an estimated US\$20 million in 2000.\* In support of IT development, the Government declared the IT industry as one of the priorities for Armenia's economic development by a decree adopted in December 2000. This decree should result in the improvement and reforms of the relevant regulatory framework. The concept of IT industry development was endorsed by the Government in April 2001, while the sector development programme is currently under preparation.

\* National Human Development Report, Armenia, UNDP, 2001.

## **B. Objectives, trends and performance in relation to FDI**

### **1. FDI objectives**

The Government has expressed its long-term commitment to attracting FDI in order to help generate and sustain economic growth and ensure reduction of poverty. In this regard, the Government puts emphasis on foreign investment as a means to develop new industrial activities as well as to modernize existing ones. Another priority for economic development in the medium-term is the need to ensure the diversification of industry, with higher degree of value-added and finished production in manufacturing. The creation of favourable conditions for FDI, therefore, is a crucial issue of development strategy. A business-friendly environment and increased FDI will also facilitate development of domestic private sector companies which is one of the country's priorities.

### **2. FDI inflows**

Net annual FDI flows to Armenia increased from US\$24 million in 1995 to US\$ 232 million in 1998, with a gradual reduction observed in consequent years to US\$ 130 million in 1999, US\$ 104 million in 2000 and US \$70 million in 2001. The 1998 and 1999 levels of investment can be attributed mainly to the privatization of several comparatively large enterprises. When compared to its Central Asian and Caucasus neighbours (all rather weak FDI performers with the exception of oil-rich Azerbaijan and Kazakhstan), Armenia's 1993-2001 average per capita FDI inflows ranked third highest (US\$ 168m) after Kazakhstan (US\$ 872m) and Azerbaijan (US\$ 472m). In contrast, average per capita FDI flows to the Eastern European

countries were significantly higher. This underscores the difficulties that relatively remote and largely landlocked Central Asian and Caucasus countries face in competing for foreign investment flows.

**Table 2. FDI inflows, Central Asian countries (net)**

Country	1993-2001		2001		
	Total US\$ million	Per capita	Total US\$ million	Per capita	Percentage of GDP
Armenia	640	168	70	18	4
Azerbaijan	3,773	472	227	28	4
Kazakhstan	12,104	872	2,760	185	15
Kyrgyzstan	453	92	22	4	0.7
Tajikistan	127	20	22	4	2
Uzbekistan	987	40	71	3	0.9

*Source:* UNCTAD, IMF, central banks.

### 3. Sources of FDI

Russian companies, including Gasprom and energy corporation Itera, and OTE (Greece) are among the main investors in the country comprising 26.7 per cent and 26.6 per cent respectively of the total cumulative investment during 1998-2000. The third largest foreign investor is Canada, with about 11 per cent of total investment, followed by the United States with 10 per cent of the total cumulative investment (table 3). France, Luxemburg, the United Kingdom, Cyprus, Italy, Belgium, and Switzerland are other large investors in the country.

**Table 3. Sources of FDI in Armenia, 1998-2000**

(percentages)

Region/country	FDI flows
Russian Federation	26.7
Greece	26.6
Canada	11.0
United States	10.0
France	9.3
Others	16.4

*Source:* National Statistical Service of Armenia.

#### 4. Sectoral distribution of FDI

The largest amount of FDI has been connected to privatization and realized in the energy and gas distribution and telecommunications sectors which accounted for about 27.7 per cent and 25.9 per cent respectively of the cumulative total of US\$ 491 million gross FDI over the 1998-2000 period (table 4).

**Table 4. Sectoral distribution of FDI stock in Armenia, 1998-2000**  
(percentages)

Sector	FDI stock
Mining	8.7
Energy	27.7
Industry	16.6
Construction	0.4
Trade and Catering	13.0
Transport/Telecoms	25.9
Others	7.7

*Source:* National Statistical Service of Armenia.

#### 5. Performance of FDI

The impact of FDI inflows in Armenia on the economic growth, and on improvements in trade balance and balance of payments has been positive. FDI has had some impact on the development of exports, although mainly in terms of products heavily reliant on raw materials. On the other hand, the two largest investment programmes implemented in Armenia have resulted in newly created monopolies in the area of communications and gas, with all the ensuing consequences. FDI can stimulate technology transfer and technological capacity building, as well as human resources development. At the same time, the impact of established FDI on the local economy in the sense of backward linkages is not well recognized as the results are mixed.

However, FDI in the agri-processing sector has in several cases stimulated technology transfer and changes in the production pattern. For example, one of the largest privatization deals involved the sale of the Yerevan Brandy Factory (YBF). Despite some difficulties, it was one of the successful deals in the country. The privatization of the YBF opened a new stage in relations between farmers and buyers of agricultural produce. For the first time, at least in the recent decade, farmers began to receive sizable sums for the grapes they had grown and, most importantly, they received them immediately. Contractual relations began to take shape between the factory and farmers, which is a novelty in Armenia and is likely to result in other local factories having to follow suit and pay for the products they purchase on time. Positive results were also brought with restructuring of vineyards as the factory declared that it would buy only 4-5 types of grapes to maintain the required quality.

## C. Strengths, weaknesses and opportunities

### 1. Strengths

The following factors were highlighted as Armenia's strengths by representatives of foreign companies and independent observers.

#### a. Attractive natural resources endowment

Armenia possesses substantial natural resources, including copper, molybdenum, zinc and gold, several other non-ferrous metals, is rich in construction stones, semi precious stones and other materials.

Armenia has also much potential for development of tourism because of its natural beauty and ancient history. The country offers a variety of activities for tourism including cultural, rural, eco, adventure, religious, and health-related tourism.

#### b. Educated, skilled and inexpensive workforce

The highly trained and skilled workforce in the country is widely recognized by established foreign investors. Being relatively inexpensive, with an average monthly salary of about US\$ 40, the local workforce presents a clear comparative advantage.

#### c. Stable macroeconomic situation

Prudent macroeconomic policy and an overall stable macroeconomic situation in Armenia, and stable currency are generally viewed as positive factors by investors.

#### d. Armenian diaspora

Armenia has a very sizable diaspora living abroad of about 4.7-5.3 million – primarily in the Middle East, the United States, Russian Federation and Western Europe – compared to the country's population of about 3.8 million. These individuals certainly form a potential pool of investors who might be more willing to invest capital in their home country. It is clear that the vast majority of FDI in the country is closely linked to diaspora interests with only a small share of projects – especially larger ones associated with international brand names – being truly foreign. Box 2 discusses some Armenian diaspora projects undertaken by the Lincy Foundation.

#### Box 2. Armenian diaspora projects

Of all the programmes carried out by diaspora organizations, those conducted by the Lincy Foundation (Lincy)\* are the largest and longest running, and they have become a decisive factor in the country's economic development.

In 1998, an investment programme was signed by Lincy, the Government and the Central Bank which was directed at the development of SMEs. Businessmen could obtain credit for not more than 15 per cent per year. The main goal of the programme was poverty reduction, job creation, production growth and the development of the services industry. A new programme was signed between Lincy and the

Government in 2000, according to which new financial resource were added to those as yet unspent. The programmes' overall cost was US\$ 165 million (US\$ 75 million are credit resources and US\$ 90 million – grants). Within this framework, two credit programmes and five grant programmes are underway.

For the first credit programme, which was designed to develop SMEs, US\$ 20 million of the resource portfolio (US\$ 45 million) were allocated. As of July 2001, 44 programmes had been financed, the majority of which belonged to the industrial sector. Projects financed by the Lincy Foundation have contributed to job creation (directly about 2,000 jobs and several thousand indirectly) not only in Yerevan but also in several provinces. The second credit programme (US\$ 30 million) strictly focuses on promotion of foreign investment in the country's economy. Investors who plan to set up business in Armenia may apply for credit.

\* The Lincy Foundation, based in the United States, was established by businessman and philanthropist Kirk Kirkorian to support private sector and infrastructure development in Armenia.

## 2. Weaknesses

### a. Geopolitical situation

The unresolved conflict over Nagorno Karabakh still constitutes the main external problem, which has resulted in Armenia's continued partial isolation in the region and is considered a main obstacle to the country's economic development. Armenia's attractiveness for export-oriented investment is severely diminished by restricted access to a regional market with a population of approximately 50 million. This restricted access to the region also significantly limits its access to Western European markets. With its borders to Azerbaijan and Turkey effectively closed, the flow of goods into and out of Armenia by low-capacity road and rail links is limited to routes through Georgia for goods going West or North, (via the Black Sea) and through the Islamic Republic of Iran (via a single road). To compensate for the limited overland access, the Government has sought to upgrade its roads and expand air transport. As a result, Armenia's geopolitical problems, small domestic market, as well as the potential for political instability domestically as well as renewed conflict with neighbouring countries present clear disadvantages for investors considering Armenia as a potential destination for their projects.

### b. Difficult business environment

Not uncommon in most transition countries, Armenia particularly suffers from excessive use of business practices outside the formal legal and administrative procedures that usually guide the relationship between civil servants and the private sector. Making facilitation payments is a common feature. Combined with a weak court system, inconsistent implementation and interpretation of laws, widespread corruption, wide discretionary powers given to tax and customs authorities, bureaucracy and red tape, these factors contribute to the unpredictability of doing business in the country.

These and other related problems are currently recognized by the Government and efforts have been made to solve them.

### **3. Overall assessment of current competitiveness and FDI**

Armenia possesses substantial natural resources, including non-ferrous metals and minerals, construction and semi-precious stones and other materials; opportunities for expanding processed food products exports; and considerable potential for the development of the eco-tourism industry. However, Armenia is facing the highly challenging task of reducing poverty and ensuring sustainable economic growth, taking into account existing constraints to the development of the private sector, slow progress in structural reforms, fragile macroeconomic situation, difficult investment climate, and the country's limited sovereign borrowing capacity because of the relatively high level of foreign debt.

Armenia has the potential to ensure sustainable economic growth. However, this is not an easy task, and it will take a long time to effectively implement the necessary structural reforms, including strengthening of the financial sector, effective restructuring and privatization of large state companies, and to arrive at a more diversified economy through the modernization of its priority sectors and development of its physical infrastructure. In developing priority sectors and ensuring sustainable growth, the sizeable Armenian diaspora could play an important role. The Government also has to work hard to improve regional cooperation in order to reduce the negative consequences of the country's isolation from neighbouring countries.

In turning these opportunities into reality, Armenia is facing serious constraints in the form of weaknesses in the regulatory and administrative regimes governing business. These weaknesses are major obstacles to attract serious foreign investment and develop the country's priority sectors. In this regard, the economy has to become more attractive to international investors with the implementation of necessary measures to realize civil service reform, to reduce corruption and illegitimate practices, and to strengthen the judicial system.

## **III. POLICY AND OPERATIONAL FRAMEWORK FOR FDI**

### **A. The overall legal framework**

The general legal framework has undergone a series of changes and reforms. However, creating amendments and enacting laws is relatively straightforward. The real test comes with the implementation, interpretation and enforcement of new or amended laws. In case of Armenia, there are a number of problems and bottlenecks in the implementation of the new laws. The inconsistency, especially in terms of the implementation and interpretation of laws, adds yet another layer of uncertainty when potential foreign investors undertake their investment appraisal.

The Armenian Foreign Investment Law (1994) provides for non-expropriation, currency convertibility, the right to repatriate funds, guarantee of stability in the legal regime, and some customs privileges and tax incentives.

The law provides for, *inter alia*, guarantees for national treatment and non-discrimination among foreign investors. However, restrictions exist on foreign ownership of land in Armenia (see section on Land Law).

Other provisions are as follows:

1. Nationalization/expropriation

The Investment Law protects foreign investors against nationalization or expropriation of property, except in extreme cases of a natural or state emergency, upon a decision by the courts, and with full and mandatory compensation. The Armenian constitution goes as far as to require that the compensation for expropriated property be paid in advance, before the property is taken away from the owner.

2. Repatriation of funds

Under the current legislation, there are no restrictions on the conversion or repatriation of capital or earnings including branch profits, dividends, interest, royalties or management or technical service fees. Foreign investors may freely repatriate their property, profits or other assets that result from their investment after payment of all due taxes.

3. Incentives for foreign investors

There are a few provisions in the Armenian legislation that secure incentives solely for foreign investors, namely: i) tax holidays contingent on the amount of foreign investment in the charter (equity) capital of a company/enterprise, and ii) exemption from customs duty on certain property/commodities imported by an enterprise with foreign investment.

The former incentive is provided by the Law on Profit Tax. This law stipulates that from 1 January 1998, if the amount of foreign investment in the charter capital (equity capital) of a resident company (except banks) is at least 500 million Armenian drams (approx. US\$ 850,000), full exemption from the profit tax is provided for the next two years after the investment is made, and a 50 per cent reduction of the profit tax rate is provided from the third to the eighth year. The 50 per cent profit tax reduction period is set to decrease over time (and to be eliminated by 2003).

The latter incentive is provided by the Foreign Investment Law. According to this law, property imported into Armenia as part of the charter capital (equity capital) of the company with foreign investment is exempt from customs duties.

4. Settlement of disputes

The Investment Law stipulates that investment-related disputes in which the State is a party shall be settled in Armenian courts. All other disputes to which the state is not a party can be considered by the Armenian courts or other bodies for economic dispute settlement, including mediation courts.

The exclusion of international arbitration options in disputes involving the Government clearly is unsatisfactory for foreign investors. However, the Bilateral Investment Treaty (BIT) signed by the United States and Armenia provides that in case of a dispute that arises between an American investor and the Government of Armenia, the investor may choose to submit the dispute for settlement by binding international arbitration. Furthermore, almost every other BIT signed by Armenia contains the same provisions allowing for the engagement of internationally

established tribunals (for instance, an *ad hoc* arbitral tribunal set up according to the arbitration rules of the United Nations Commission on International Trade Law Arbitration Rules, or the International Center for the Settlement of Investment Disputes) for resolution of commercial issues, specifically in cases when the Government of Armenia is a party to the dispute. As ratified international treaties are legally considered superior to domestic legislation – with the exception of the country's Constitution – it seems that all foreign investors from countries which have a BIT with Armenia actually do have the right to resort to international dispute settlement mechanisms. Since 1991 Armenia has signed 23 BITs. Sixteen of them, including only six with OECD countries (Canada, France, Germany, Greece, United Kingdom, and the United States), were ratified by Armenia and are currently in force<sup>1</sup>.

#### 5. Performance requirements

Performance requirements, in some cases, are central to privatization and concessions contracts. Companies are frequently required to pay back wages, implement renovation programmes, and meet certain production targets. Foreign investors are not required to purchase from local sources or export a certain share of output. There are no legal requirements for employment of host country nationals as well.

#### 6. Foreign exchange arrangements

Armenia has a liberal exchange system, and, in general, there are no restrictions on converting or transferring funds associated with an investment into freely usable currency and at legal, market-clearing rate. Foreign exchange is widely available, and the local currency, the dram, is freely convertible.

#### 7. Taxation

Legislation on taxation was substantially reviewed between 1997 and 2000 when fundamental new laws on taxes were adopted, based predominantly on international standards. Taxation relations in the country are regulated by the laws on taxes: income tax, profit tax, property tax, land tax (direct taxes); VAT, excise tax, and simplified tax as well as by the law on fixed duty (which substitutes profit and value added taxes).

The changes in taxation legislation at the end of 2000 created two major groups of taxpayers: i) fixed and simplified taxpayers, and ii) those taxpayers who prefer paying profit tax: thus the final choice was left to the taxpayer, excluding any pressure from the State. The company profit tax rate is 20 per cent. The personal income tax varies between 10 to 20 per cent on monthly income depending on the level of income. The standard VAT rate is 20 per cent.

Taxpayers carrying on entrepreneurial activities could be subject to simplified tax instead of income tax, profit tax and VAT, if their total net turnover of goods and services supplied during the previous year does not exceed 30 million Armenian drams (about US\$ 51,000), and providing they meet certain other terms. The rate of simplified tax is implemented on the entire

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<sup>1</sup> Other ratified BITs : Argentina, Bulgaria, China, Cyprus, Georgia, Islamic Republic of Iran, Kyrgyzstan, Lebanon, Romania, Ukraine and Viet Nam.

sales turnover at 4 to 7 per cent, irrespective of the actual amount of profit. 3 to 5 per cent of expenses are deductible for simplified tax. Some types of activities (banks, insurance, investment, consulting, etc.) cannot be taxed by simplified tax.

However, the implementing regulations of laws and regulations tend to be missing, while civil servants lack training to implement new regulations. This translates into uncertainty among investors, with civil servants unable to provide clear interpretations. Instead, inspections and audits seem to be used as the primary tool for enforcing compliance, generating additional budgetary resources as well as bribes. Finally, the option of tax reimbursement for profit, VAT and excise tax formally exists, but effectively seems to barely ever work. Tax collection is further constrained by the existence of a significant shadow economy (box 3).

### Box 3. The shadow economy in Armenia

Currently the shadow (unregistered) economy is a serious obstacle for implementing reforms and economic development in Armenia. Generally, there is a common belief that the main reason for the shadow economy's existence is avoiding mandatory payments. However, sometimes people are engaged in illegal activities and therefore they do not declare their incomes to tax authorities, thus violating the law twice. The tough and inefficient taxation and customs policies, governmental regulations and restrictions, as well as corruption occupy a prominent place among the factors contributing to the creation and expansion of the shadow economy. According to an expert evaluation, the volume of the shadow economy in Armenia in 2000 was equal to 60 per cent of GDP.\*

Compared with other countries, the Armenian shadow economy has a number of peculiarities, some of which are as follows:

- The shadow economy is relatively non-criminal and is mostly not linked to criminal gangs. This can be explained by the high level of corruption in the country. The major representatives of the shadow economy have different "umbrellas" and protectionists in different state structures and therefore they do not need to maintain large criminal groupings.
- Since shadow phenomena are wide-spread, many types of shadow activities became "normal" in society (for example, receiving unregistered high salaries). In this sense, shadow and criminal activities are separated and are perceived differently by people.
- The shadow economy segment is quite visible. Because of the difficult social conditions within society, the State implements a mild policy vis-à-vis many types of shadow activities.

\* National Human Development Report, Armenia, UNDP, 2001.

## 8. Land law

Foreign citizens and entities are still not allowed to own land, including farmland. The regulations allow 10-year leases on property.

## 9. Main investment agency and other agencies

The Ministry of Trade and Economic Development is responsible for the review and development of investment policy. The Ministry is also responsible for coordinating state agencies in their activities in this field. The Investment Policy Department is dealing with a

variety of investment related issues within the Ministry of Trade and Economic Development. The functions of this body are as follows:

- Formulating the national investment policy and monitoring of its implementation, with necessary links to national economic development programmes; and drafting amendments to the existing investment legislation;
- Consideration of proposals on possible accession to multilateral conventions and drafting bilateral investment agreements;
- Implementation of the country's policy on foreign investment attraction through economic policy instruments.

The Armenian Development Agency (ADA) was established by the Decree of the Government in April 1998 with the responsibility for promotion of foreign investment in the country. The legal status of the ADA is that of a Joint Stock Company operating in accordance with the relevant country's legislation. The functions of this body are as follows:

- Promotion of investment;
- Export promotion;
- Development and implementation of strategic projects;
- Providing one-stop shop service to investors and exporters.

ADA acts as the working secretariat for the Business Support Council (see box 4). Moreover, ADA is also implementing different technical assistance projects in the area of export promotion and enterprise development funded by IFIs. However, it is observed that ADA is experiencing lack of funding from the state budget to cover operating costs for its primary function, investment promotion. In view of budget constraints, it was decided that ADA generates funds to cover operating costs by charging for investor services and providing business consulting services. Because the volume of business and flow of FDI are minimal, efforts to generate funding have failed. Furthermore, charging incoming investors for basic services is not feasible and consistent with international practices, and provision of fee-based consulting services to investors raises conflict-of-interest issues. Currently the ADA is providing all services to investors free of charge. However, taking into account the remaining lack of funding, the existing weakness of the Agency is hampering its efficiency in implementing its main function of promoting and facilitating investment.

In view of the unfavourable business climate in Armenia, significant improvements in investment facilitation and promotion are necessary, and the institutional framework in this area must be strengthened. In this regard, the functions of ADA are to be reconsidered, and the institutional capacity of the Agency enhanced.

#### 10. Free trade zones

The Government is planning to establish a free trade zone located near Yerevan airport, exempting exporters operating in the zone from profit taxes. The authorities are confident that the incentives provided for exporters will be attractive for new investors that would otherwise not have come to Armenia. Supposedly, the administration of this new zone will implement the

necessary investment promotion and facilitation measures and most prominent administrative barriers to businesses in the new location will be removed.

#### Box 4. The Business Support Council

The Business Support Council (BSC) was established by decree of the President in December 2000, with the aim of providing support to entrepreneurship, promoting investments and eliminating administrative barriers in Armenia. The Council is chaired by the Prime-Minister. The members of the Council are the Chief Adviser to the President on Economic Issues, the Minister of Trade and Economic Development, the Minister of Finance and Economy, the Mayor of the city of Yerevan, the Executive Director of Armenian Development Agency, and the representatives of the business community on a rotation basis. The Armenian Development Agency acts as the working secretariat for the council.

The objectives of the Council are as follows:

- Promote investments.
- Elimination of unnecessary administrative barriers to business.
- Creation of efficient mechanisms of collaboration among business and state bodies.
- Assist in the formulation of a favorable legislative framework regulating business.

Among the issues discussed in the plenary sessions of the Council were amendments to tax legislation, customs administration issues, business environment improvement, licencing, and reduction of other administrative barriers.

## 11. Trade policy

Armenia has made considerable progress in liberalizing its trade regime. These efforts culminated in the country's successful accession to the WTO in December 2002. It has one of the most liberalized trade regime among the CIS countries.

As WTO membership requires that domestic policies be consistent with international practice, the legal framework of the country has been substantially improved introducing better legal standards. Finalizing preparations for accession, Parliament in 2002 passed a number of laws bringing the country into compliance with WTO rules on access of foreign goods and services to the Armenian market in such areas as customs duties, taxes, intellectual property, export and import licencing and domestic market protection. As a WTO member Armenia is also under obligation to develop domestic institutions and reduce the role of the Government in the economy.

Armenia applies a unified and relatively simple tariff regime on imports, avoiding imposing quantitative restrictions on imports and exports. Two tariff rates are applied on imports: 0 and 10 per cent. Armenia does not impose taxes on export.

Almost all imports in Armenia are free of any prohibitions, quotas, and licencing. Import restrictions are limited with reference to security, health, and environmental considerations. The items affected are weapons, components necessary for weapon production, explosives, nuclear materials, poisons, and narcotics. Export restrictions are limited to products covered under the Agreement with the European Community on Textiles.

Armenia is part of a free trade area with Georgia, Moldova, Kyrgyzstan, Russian Federation, Tajikistan, Turkmenistan and the Ukraine. Customs duties do not apply to goods imported from countries member of this free trade area.

The Partnership and Cooperation Agreement between the European Union and the South Caucasus countries, including Armenia, Azerbaijan and Georgia, came into effect in 1999. The agreement aims at improving economic cooperation and trade within the region and with the European Union.

## **B. Administrative procedures and practices**

### **1. Procedures for implementation of FDI projects**

#### a. Entry process

The legislation governing company establishment is basically regulated by the Law on State Registration of Juridical Persons which has been in force since 2001, and by the Civil Code which has been in force since 1999. Registering a legal entity requires a state registration with several state authorities including State Register, the tax authorities, the State Pension Fund, State Patent Office, and National Statistical Service. Getting a special or a sectoral licence from a relevant state agency may also be necessary for starting operations of the company. The overall registration process is burdensome and involves a high degree of red tape. Although efforts have been made in recent years by the Government of Armenia to streamline the registration process, from the investors' perspectives there are still many loopholes in the system, which can make the entire registration process time-consuming and costly.

According to a follow-up regulatory and administrative costs survey conducted by the Government, in partnership with the World Bank, business registration in Armenia in line with existing regulations may take up to 35 days,<sup>2</sup> in contrast to for instance New Zealand's streamlined start-up process which takes only 3 days.

#### b. Customs procedures

The companies engaged in export/import operations should register with the Customs Offices to obtain customs file necessary to conduct foreign trade operations.

Armenia has adopted the Harmonized System of Tariff classification. Import tariffs are set at either 0 or 10 per cent *ad valorem*. The 10 per cent tariff is levied on 57 out of 150 items consisting mainly of consumer goods and luxury items.

Documents required in support of goods declarations include shipping documents, commercial invoice, certificate of origin, contract, tax registration certificate, tax payment certificate, and copy of export declaration from export country. In addition, particular types of goods require the usual quality/safety certificates.

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<sup>2</sup> Follow-up Regulatory and Administrative Costs Survey: Armenia, December 2002.

However, customs clearances can be problematic and time-consuming. The delays in refunds for VAT and excise taxes on imported inputs have acted as major obstacles for small and medium-size exporters. While some progress has been made, further efforts are needed to eliminate these delays. One of the most persistent problems reported was the arbitrary nature of valuation. Although Armenia has adopted WTO standards for valuation, the implementation of these methods appear arbitrary in nature. Invoices are routinely rejected for being undervalued. Customs officials then revalue the invoice, generally on the basis of perceived local market values.

In general, there are no established channels for appeals or for filing complaints if an investor has a problem or difficulty with customs clearance procedures. A lack of institutionalized and objective mechanisms for dispute resolution and appeals also increase the potential for “facilitation” fees.

c. Other administrative procedures

Legislation governing the licencing of enterprises’ activities is contained in the Law on Licencing which entered into force in 2001 and the Civil Code. There are about 70 different types of economic activity in Armenia which require a sectoral licence prior to starting operations. Licencing, as in other CIS countries, has been a big problem for years for business in Armenia as the number of licences required from them is too high, and the process of issuance in many cases is cumbersome and unclear. Furthermore, there are no guidelines or procedural outlines available from any agencies defining all procedural and document requirements, and investors frequently find themselves re-applying for the same licence or continuously submitting additional information. The list of licences required is frequently revised by the Government leading to greater confusion and ambiguity in the process.

## 2. Implementation practice

The Government in the last two years has made significant efforts in creating a favourable investment climate. However, much work remains to be done in this area.

Major concerns regarding investment implementation include the following:

a. Transparency and corruption

All studies of the investment environment in Armenia of recent years indicate corruption and particularly administrative obstacles as major factors deterring attraction of investment. For example, 78 per cent of investors in this regard mention administrative red tape, 90 per cent admit that for the successful operation of their businesses it is extremely important to cooperate with significant political and economic groupings (being under their “umbrella”/roof), 87 per cent think that illegal “facilitation fees” or bribes are an inalienable part of the business.<sup>3</sup>

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<sup>3</sup> National Human Development Report, Armenia, UNDP, 2001.

The Foreign Investment Advisory Service (FIAS), a joint facility of the World Bank and the IFC has made a recent detailed analysis of administrative barriers considered as a major obstacle for investment development in Armenia<sup>4</sup>. They have identified four major weaknesses - excessive use of business practices outside the formal legal and administrative procedures; inconsistent implementation and interpretation of laws and regulations; lack of institutional capacity and suspicious attitude towards the private sector. On the basis of their findings, they have recommended to the government to adapt the current business environment in Armenia much closer to international conventions and practices and in a number of cases to improve significantly the existing legislation.

According to this study, facilitation payments and use of so-called “roofs”, i.e. influential people who intervene in case of emerging problems, have developed into a normal element of the business environment and these practices pose serious problems for foreigners. Most serious investors will be unwilling to tie the fate of their investment to personal relations at the risk of becoming engulfed in serious legal difficulties because of corruption or illegitimate practices. This includes the possible punishment of investors for corrupt practices in their own countries, as the Governments in most OECD countries adopted legislation providing punitive measures against bribery and corruption committed by multinational investors in the countries in which they operate.

Another survey conducted by the World Bank among 175 countries on Governance Research Indicator for 2000/2001 indicated that Armenia’s rate for Government effectiveness is lower than the rate of 86 per cent of countries surveyed, the rate for regulatory quality is lower than that of 77 per cent of countries surveyed, and the rate for control of corruption is lower than the rate of 77 per cent of countries surveyed.<sup>5</sup>

These and other related problems are currently recognized by the Government and steps have been taken to solve them, though much work still remains to be done. The Government has declared improvements in governance and implementation of an anti-corruption programme as a top priority among its development objectives.

#### b. Judicial system

The effective and transparent enforcement of legislation is just as crucial as the existence of good laws. But, despite the ongoing judicial reform efforts, the court system presently is not accepted as a viable option of legal recourse by the majority of investors. Little trust exists regarding the objectivity of courts decision, driven by the fear that the involvement of “roofs” and corruption are likely to determine the outcome. On the other hand, in the opinion of investors, judges are typically not well trained to competently handle the whole spectrum of different commercial issues. In addition, poor conditions in the courts further hamper effective access to justice and affect the transparency and integrity of the judiciary. Establishing the country’s courts as an efficient mechanism for the fair and transparent enforcement of rights and settlement of disputes will be crucial in the process of convincing foreign investors that the country can serve as a reliable investment location.

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<sup>4</sup> Armenia, Administrative Barriers to Investment, FIAS, 2000.

<sup>5</sup> Governance Research Indicator Country snapshot, World Bank Institute, 2002.

Indeed, the difficult business environment in the country is so different from investor expectations and international best practices that enormous efforts are needed to improve this environment to make it more business-friendly and attractive.

### **C. Overall assessment of policy and operational framework**

The principal findings of this review of the policy and operational framework in Armenia are:

1. By law, Armenia has a relatively open and liberal investment regime but in practice foreign investors have encountered many problems in the implementation of their projects.
2. The foreign investment laws contain important assurances of protection and rights to the foreign investors. However, the judicial system and existing system of enforcement of legal rights remain very poor. The private sector currently has no confidence and trust in domestic legal system. The court system is weak and corrupt. Despite existing legal provisions, there are no effective means of guaranteeing property and contractual rights.
3. Taking into account the lack of confidence in the court system, settlement of investment disputes through international arbitration is very important for foreign investors. However, free access to international arbitration as a mechanism for resolving investment disputes is not clearly envisaged by the country's legislation.
4. Facilitation payments and the use of so-called "roofs" are a well-established practice in Armenia. Private sector businesses typically use a combination of these two practices as a means of problem-solving or mediation. However, corruption and the use of illegitimate business practices present a serious legal offence for foreign investors, not only in Armenia but also possibly in their own home countries, and are competitive disadvantages relative to companies for which such practices are absent or considered normal.
5. The business environment in the country is non-transparent, inconsistent, corrupt, costly and presents a relatively high-risk for investors. Major administrative obstacles to investment include lack of transparency in the regulatory system, burdensome administrative procedures, and uneven application of laws. Frequent changes in the laws and delays in the implementation of rules and regulations lead to inconsistency in the interpretation of laws.
6. According to experts' evaluations, the shadow (unregistered) economy constitutes about 60 per cent of the country's GDP. Having diverse implications, the shadow economy is present almost in all sectors of the economy, creating serious obstacles to the effective implementation of economic policies and ultimately preventing foreign investment inflows.

Effective implementation of structural reforms, anti-corruption measures and enhancing transparency and accountability of the public sector are measures expected to shrink the shadow economy.

7. The key investment agencies are the Ministry of Trade and Economic Development which is responsible for formulation of foreign investment policy and its execution, and the Armenian Development Agency (ADA), responsible for investment promotion. In view of ADA's existing organizational weakness, the execution by the Agency of its main function consisting of promoting and facilitating investment is not adequate and needs to be reviewed.

#### **IV. POLICY OPTIONS AND RECOMMENDATIONS**

##### **A. Principal recommendations: a way forward**

As a result of the civil war and political instability, FDI in Armenia has been later than in other CIS countries. However, in recent years, Armenia has made good progress in macroeconomic stabilization and implementation of structural reforms.

Despite this progress, Armenia's investment climate remains poor as far as investors are concerned. The country still faces considerable challenges in sustaining macroeconomic stability and building the institutional infrastructure needed to support private sector development and sustained FDI inflows. In order to ensure sustainable economic growth, the Government has to implement the necessary structural reforms, including strengthening the financial sector, privatization of remaining large state companies, improving governance and transparency, reducing corruption and restoring public confidence and trust in Armenia's legal system. Much work has to be done in creating an attractive investment climate and enhancing the capacity of the relevant institutions enabling them to implement proactive measures in the attraction, promotion and facilitation of FDI.

##### **B. Recommendations for government action**

Investor perceptions of Armenia as a destination for investment mirror the difficult investment environment and the economic and geopolitical factors discussed above. No doubt, the transformation of the business environment of Armenia towards a more business-friendly one is a challenging task. The Government might therefore, while implementing structural reforms, be well-advised to focus its attention on some of the following core issues related to policy and the operational framework for FDI.

1. Of utmost importance will be the eradication of practices related to unofficial payments and the use of so-called "roofs" as a means to get around the country's legal and administrative system. In this regard, the Government's comprehensive anti-corruption strategy should be effectively implemented with active participation of state officials and the private sector. The emphasis of such a campaign should be on removing opportunities for corruption through improvements in transparency and accountability. On the other hand, extensive

efforts of the Government are needed to increase awareness in society at large about the main features of its anti-corruption strategy. These efforts have to continue and gain momentum, and get support of the public, especially support of business.

2. Thus far, the Government has not been able to establish the rule of law sufficiently to generate acceptable levels of domestic and foreign investment. As a part of the anti-corruption campaign, a set of measures has to be implemented to develop an effective and reliable judiciary that has the trust of the public. This may include also an extensive capacity building programme for the judicial system including extensive training on commercial issues.
3. Anti-corruption measures may also include necessary corrections in the legislation and the introduction of more effective law enforcement mechanisms that will lead to the shrinking of the shadow economy. This would contribute to strengthening legitimate practices needed to attract foreign investment.
4. Based on the results of recent surveys of administrative barriers to investment in Armenia, the Government has to develop new approaches to address the existing problems in this area taking into account best practices of countries which have been successful in attracting and retaining foreign investment.
5. In order to provide foreign investors' free access to international arbitration in case of investment disputes, it is recommended that the existing legislation be amended to include such a provision.
6. Taking into account that investment promotion and facilitation in the country must be considerably enhanced and expanded, the functions of the Armenian Development Agency (ADA) should be reviewed with the aim to eliminate fee-for-service functions and to strengthen pre-approval and after-care services, including an effective approach to one-stop servicing. The institutional capacity of the agency needs to be enhanced with the assistance of relevant international organizations and clear support from the Government.

### **C. Recommendations for subregional and regional cooperation**

Based on the findings and recommendations in this report a medium-term programme of technical assistance for Central Asian and Caucasus countries can be proposed.

The main objective of the programme would be to promote economic cooperation among the Central Asian and Caucasus countries through cooperation in investment attraction and promotion.

Taking into account present needs of regional countries, as well as the low level of present economic cooperation in the region, the main modules of the programme would be:

- Coordination of national investment strategies of host countries.
- Removal of administrative barriers, improvement of business environment.
- Liberalization of trade policies including gradual removal of tariff and non-tariff barriers in the region, and establishment of free trade area.
- Joint capacity building in specific investment promotion policies.
- Joint coordination of investment policies of Central Asian countries with possible creation of common investment area in the region.

UNECE, UNESCAP, UNCTAD, UNDP, IDB, and USAID could be proposed as potential donors. Taking into account that regional technical assistance programmes in the area of trade and investment in Central Asia and Caucasus are planned and implemented by different donor organizations, a strategic partnership would be developed with other technical assistance providers to ensure synergy effects and tap the experience gained by other institutions in this field.

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