

BTI 2008 | Armenia Country Report

Status Index	1-10	6.41	# 41 of 125	
Democracy	1-10	6.00	# 65 of 125	➔
Market Economy	1-10	6.82	# 32 of 125	➔
Management Index	1-10	5.14	# 56 of 125	

scale: 1 (lowest) to 10 (highest) score rank trend

This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	3.0	HDI	0.77	GDP p.c.	\$	4,400
Pop. growth ¹	% p.a.	-0.3	HDI rank of 177	80	Gini Index		33.8
Life expectancy	years	73	UN Education Index	0.91	Poverty ³	%	31.1
Urban population	%	64.1	Gender equality ²	-	Aid per capita	\$	64.1

Sources: UNDP, Human Development Report 2006 | The World Bank, World Development Indicators 2007 | OECD Development Assistance Committee 2006. Footnotes: (1) Average annual growth rate 1990-2005. (2) Gender Empowerment Measure (GEM). (3) Percentage of population living on less than \$2 a day.

Executive Summary

Over the past two years, the most serious threats to Armenia's democratic and economic transformation have stemmed from internal factors. These internal deficiencies range from widespread and systemic corruption to widening socioeconomic disparities. Despite an official commitment to combating corruption, many of the most glaring incidents demonstrating the linkage between corruption and state officials have gone uninvestigated and unpunished. The country has also witnessed a widening social and economic division between a small powerful elite and the much larger majority of the population. Thus, the core challenge to Armenia's transformation consists of a dual paradox, defined politically by an outwardly authoritarian state that is, at the same time, increasingly weakened internally by endemic corruption and an inadequate rule of law. In economic terms, this dual paradox includes the mounting contradiction between several years of impressive economic growth and widening disparities in wealth and income among the majority of the population.

Politically, the country is facing an important period in its transformation. Over the two years under review, Armenia has become increasingly concerned with preparations for a new round of elections, with parliamentary and presidential elections set for 2007 and 2008. While the looming election cycle has fostered a degree of increased political activity, with the formation of several new political parties, a change in the composition of the governing three-party parliamentary coalition, and a resurgence of tactical alliances and bargaining sharing, all this has been contained to within the country's narrow, closed political system. This has further distanced the ordinary population from the ruling political elite, widening an already serious divide between governed and governing and exacerbated by general apathy and distrust. The country is facing a looming test, as parliamentary elections set for May 2007 represent a crucial

milestone in Armenia's transformation. Given the country's checkered electoral record, with nearly all prior elections tainted by some degree of voting irregularities and violations, Armenia is now under much greater pressure for real electoral progress. Unlike past elections, however, this contest is much more significant for Armenia's overall course of democratization, as Armenia has reached a decisive stage following the introduction of electoral reforms and the adoption of constitutional amendments in late 2005. Armenia is now held to even higher standards and greater expectations, with the elections posing a crucial test amid a degree of impatience, among both its population and within the international community, over the slow and still incomplete course of Armenia's transformation. Through 2006, the Armenian economy has enjoyed double-digit growth for the past five years. Yet even with this impressive record of economic growth and reform, the stark reality is that the Armenian economy is only about 92% of its pre-reform level of 1989. But it is also important to note that the Armenian economy of today is starkly different than that of 1989, with an altered economic structure that defies any real comparison in output.

Although the record of economic reform in Armenia is impressive, capped by a half-decade of double-digit economic growth and a gradual, yet consistent decline in national poverty, the country remains poor, with a GDP per capita that is only about a quarter of that in the Baltic states, and is plagued by a serious economic polarization of society. The most disturbing aspect of the Armenian economy is the paradox of several years of positive economic growth that is only partially shared by the overall population, marked by a disturbing widening of economic inequality and income disparity. This socioeconomic divide is magnified by a labor market that has become rigidly divided between a small number of organized workers and owners enjoying rising wages from impressive productivity gains, and a larger informal labor market that has become stranded in a stagnant and immobile, largely service-based sector of the economy.

History and Characteristics of Transformation

As with each of the countries to emerge as independent states in the wake of the collapse of the Soviet Union, the political and economic transformation of Armenia has been marked by a daunting set of economic, political and social challenges. The most fundamental obstacle was the imperative to overcome the economic constraints and political challenges inherited from seven decades of Soviet rule. This Soviet legacy, which included a centrally planned economy and centrally governed political system, forced Armenia to quickly find and forge its own economic and political institutions capable of both defining and defending its independence and sovereignty. In contrast to the other former Soviet states, the initial stage of its economic and political transformation was especially difficult, however, as it struggled to overcome the

impediments of a severe earthquake, an unresolved conflict with neighboring Azerbaijan over the Armenian-populated enclave of Nagorno-Karabakh, and the isolation from a long standing economic and transport blockade of Armenia by Azerbaijan and Turkey. For landlocked Armenia, the resulting isolation from the disruption to its traditional trade and energy links has only been further exacerbated by its exclusion from several major projects of regional integration and development. This early period of independence was marked by a drastic decline in standards of living, a rapid surge in unemployment, and the onset of triple-digit inflation, which combined to spur large-scale emigration from the country. These factors forced Armenia to implement strident economic reforms, ranging from land privatization to an expansion of the private sector, which now accounts for more than 80% of GDP.

Transformation toward a market economy was introduced in the early 1990s. Given its geographic limitations and absent natural resource base, Armenia's economic development depends significantly on the restoration of regional trade and transport links that have been disrupted for over a decade by a blockade imposed by neighboring Turkey and Azerbaijan. The promotion of an open and liberal trade regime has helped to compensate for this limitation. Successful macroeconomic policies stabilized the economy against two major shocks: the 1998 Russian financial crisis and the assassination of the prime minister and parliamentary chairman in an attack on the Armenian parliament in 1999. Armenia continues to suffer from severe demographic decline in urgent need of reversal. Emigration has reached a disturbing ten-year level of a 20% decline in overall population. Armenia's brain drain has exacerbated the growing divide between a small wealthy elite and the larger impoverished segment of the population.

Democratic transformation in Armenia was marked by an initial period of popular support and optimism. This was most evident in the country's 1991 national referendum on independence, in which an overwhelming 99% of the population endorsed Armenia's withdrawal from the Soviet Union and participated in the first democratic elections. These early achievements were quickly squandered. The nationalist appeal of the conflict over Nagorno-Karabakh with Azerbaijan contributed to this retreat of democracy. The conflict served as a convenient distraction from the growing deficiencies in democracy and provided an opportunity to delay or even dismiss the imperatives of institution building. With the election of President Robert Kocharian in 1998, the downward trend in Armenian democracy gradually abated. However, both the presidential and parliamentary elections of 1998 and 1999 failed to fully meet international standards. This was also true for the 2003 election period.

Transformation Status

I. Democracy

Despite some gains in political reform in the last two years, participatory democracy in Armenia remains hindered by the closed nature of its political system and political institutions that are still too weak and fragile to support and sustain a fuller democracy. A related obstacle is seen in the weak state of the rule of law, which has fostered an atmosphere of corruption, crime and complicity. This is matched by a lack of good governance, as demonstrated by the tendency for Armenian leaders to rule rather than govern, where public policy is also formulated more from self-interest than from national interest. Thus, within this political stage of transition, the predominance of individuals over institutions poses one of the more fundamental challenges to Armenia's transformation.

1 | Stateness

The Armenian state faces no obvious threat to its power or authority. This unchallenged concept of the Armenian state stems from the fact that the country is highly homogeneous and is due to the entrenched popular appeal of an already strong sense of national identity. With a demonstrable tendency for extreme nationalism, however, there are negative implications from such homogeneity and pronounced nationalism, although such obvious signs of aggressive nationalism or xenophobic posture are not reflected in state policy and, when seen, are generally constrained to the margins of society. The state holds a strong, well-established and unchallenged monopoly on violence that is both demonstrated and defended by the country's stable civil-military relationship. With the Armenian armed forces completely subordinate to civilian state control and oversight, and increasingly professional, there is no real threat of internal unrest or political intervention. The incorporation of all militia and paramilitary groups into the armed forces following the cessation of hostilities with Azerbaijan during the Nagorno-Karabakh conflict in the mid-1990s has removed any such challenge to the state.

Monopoly on the use of force

Due to Armenia's highly pronounced homogeneity, there is an overall consensus on the issue of citizenship. There is little or no record of ethnic division or discrimination facing the non-Armenian minority communities (Kurds, Russians

State identity

and some Jews). In both theory and practice, all citizens share the same civic rights and the Armenian state ensures equal access to education, the courts and public welfare. The government does not restrict internal or international travel and has upheld legal provisions protecting media and civil liberties for the country's minority groups and communities. The authorities have also implemented a comprehensive integration policy for a number of refugees and displaced persons from Azerbaijan and Nagorno-Karabakh.

The state maintains an official and uncontested secular policy of separation between church and state, with religious dogma having no role within the political sphere. The Armenian Apostolic Church, which accounts for roughly 94% of the population's religious affiliations, has long played an important and often vital role in maintaining Armenian cultural identity. This cultural role has also traditionally eschewed partisan politics, a fact that tends to enhance its absence from Armenian political life. There have been some calls over the past two years for a greater political role for the Armenian Church, mainly in terms of the Church playing a more public role in combating corruption in the country. The protection of the fundamental freedom of religion is incomplete in Armenia and, over the past two years, there have been cases of discrimination of non-traditional religious groups and sects, such as the "Jehovah's Witnesses." All formal churches and religious groups (other than the Armenian Apostolic Church) are required to officially register with the government and proselytizing is forbidden by law.

No interference
of religious
dogmas

There is a well-developed system of Armenian administrative structures operating on many levels of government. Despite some recent reforms of regulations governing the work and authority of the civil service in the last two years, corruption within these structures remain a serious challenge. It is also highly bureaucratic and, as a result, often functions with pronounced bias and extreme inefficiency. There is a reasonable administration of justice, although there are many incidents where the adjudication process is contingent on political or financial interference. This is largely related to a fairly weak rule of law, matched by a flawed system of law enforcement and a sometimes checkered record of justice, primarily in the less developed regions of the countryside, but not excluding incidents in the major cities.

Basic
administration

2 | Political Participation

Despite electoral and constitutional reforms over the past two years, the country's political system remains rigid and closed, seriously impeded by entrenched corruption and political patronage. Within this context, it is difficult to leverage the public support, pressure and engagement necessary for real democratic reform, as voter apathy has fostered an environment of distrust and disgust among

Free and fair
elections

the Armenian polity. Armenia has a troubled record of elections, with international observers routinely noting problems in vote counts, voting irregularities and voter intimidation. But the country has held multiparty elections in a timely and legally defined manner, with each contest open to all candidates that meet the legal requirements for registration regardless of political affiliation and little demonstrable evidence of political violence. Each of these elections, despite their other violations, has been held by secret ballot with equal and universal suffrage.

In addition, there have been some positive developments. Most notably, the Armenian parliament adopted several key amendments to the country's electoral code in May 2005. These changes were designed to correct some of the problems that arose in past elections and, in conformity with the recommendations of the Council of Europe, sought to limit the presidential power to appoint members of the electoral commissions, both local and national. They also aimed to reduce the opportunity for voter fraud by creating a new national database or registry of the country's eligible voters, thereby ending the previous practice of simply relying on the use of Soviet-era identification cards. The adopted reforms to the electoral law also increased the number of parliamentary seats to be elected by party list, or proportional system, from 75 to 90, and lowered the number of single-mandate seats elected on the majoritarian system from 56 to 41. This change represented an attempt to reduce the incidents of electoral corruption and the practice of "vote buying" in parliamentary elections.

Since the May 2005 adoption of important electoral reforms, progress in meeting the requirements for holding free and fair elections, however, has been mixed. In contrast to the promise of the new electoral code provisions, the local elections held in September and October 2005 demonstrated ongoing concerns regarding implementation of more democratic standards. The local elections were subject to greater scrutiny than previous local contests, stemming in part from a greater interest in assessing the new electoral reforms. The election was marred by an organized boycott by the opposition, although there was a greater degree of truly competitiveness. Several Armenian NGOs reported widespread bribery, blatant "vote buying" and inaccurate voter lists. But international observers deployed by the Council of Europe found the election "satisfactory" and "generally in keeping with the Council of Europe's electoral standards." Observers also noted significant improvement in the elections over past ballots and an improved commitment by electoral officials to institute and follow the newly revised regulations.

Less than two months after the election, initial optimism on progress was watered down by an indication that the coming elections may continue to be marred by voting irregularities and fraudulent ballot tabulation. Such an indication arose from both the conduct and verdict of the national referendum on a set of proposed

amendments to the Armenian constitution in November 2005. In terms of the conduct of the referendum, the Armenian government engaged in a blatant campaign to exert significant pressure on the population to adopt its proposed constitutional amendments. The referendum also reflected the divisions within Armenian politics, as the country's opposition parties were strongly opposed to the constitutional changes, arguing that the government's draft proposals were too insufficient and limited in scale and scope to achieve true reform.

After the heated campaign for passage by the government and an organized boycott by the opposition, the actual vote on the referendum was largely a letdown as the official announcement showing a massive yes vote was generally accepted as no surprise. But although the passage of the referendum was widely seen as a foregone conclusion, especially given the intensity of the government's campaign for its passage, the official results sparked widespread skepticism. The results, which reported that the constitutional referendum had been approved by an overwhelming 93.2% of some 1.5 million voters, with a voter turnout of 65.4 %, stood in stark contrast to the media reports and televised coverage of the vote that showed virtually empty polling stations. The figures fueled speculation that the Armenian government resorted to vote count manipulation to ensure the referendum's passage. However, there was also a sense of public indignation over the scale of manipulation, interpreted as an insult to the public's intelligence and to the voter's integrity. The reaction was confirmed by the findings of a delegation of monitors from the Parliamentary Assembly of the Council of Europe (PACE) that reported observing ballot-box stuffing first hand and counted few voters. Even the country's parliamentary speaker at the time, Artur Baghdasarian, challenged the government in December 2005 by alleging "serious ballot-stuffing" during the referendum vote.

There are two specific trends that are revealed in the wake of the Armenian constitutional referendum, with each related to the growing pains of the country's democratic development. First, it reveals a deeper trend that spans the issue of electoral conduct to include the broader state of the rule of law. For Armenia, both the formulation and passage of the constitutional reforms demonstrate an important step forward. Yet the conduct of the referendum, including the vote itself, does little to counter concerns over the country's coming cycle of parliamentary and presidential elections. Ironically, the poor performance in the referendum's voting process may actually lead to even greater scrutiny and the imposition of a higher threshold of democratic standards for the next elections in Armenia.

The second trend stems from considerations of the efficacy and commitment of the government to both confirm and conform to the new constitutional measures that have effectively rebalanced the distribution of power in Armenia. This is particularly pressing as the current Armenian president is constitutionally

prevented from running for a third term in 2008, which means that the successful implementation and the subsequent enforcement of the new constitution will rest on a new leader. And it is here that the issue of political will and commitment comes into play, as the country's next leader will need to demonstrate a firm political will capable of carrying out democratic reforms that may at times directly challenge the vested interests of the very same political system that put him into power.

With fundamental flaws in the country's closed political system and the absence of free and fair elections, elected rulers hold virtually unchallenged authority. There are no groups holding any real veto power and both the military and security services remain both removed and aloof from politics. But this lack of legitimacy poses a serious question to the right of leaders to govern.

Effective power
to govern

Generally, Armenia is endowed with political groups and parties with the right to assemble freely, and there is an expanding civic society. There is a wide range of civic and non-governmental organizations (NGOs). As of 2006, there were nearly 4000 NGOs and civic groups officially registered, dealing with a wide range of issues including human rights and women's rights, healthcare, peace and conflict resolution, and the environment. However, civil society remains limited in its impact on society and public participation in the decision-making processes is minimal at best. There is also a trend toward a strengthening of institutions of state power at the expense of opportunities for emerging rivals from a more populist and grassroots level. This trend has been matched by a lack of any social movement or campaign and an absence of any attempts by civic groups to impose transparency, accountability and "good governance" in Armenia.

Association /
assembly rights

Reflecting the noticeable decline in basic civil freedoms in recent years, the Armenian media has been subject to a troubling pattern of state control and intimidation. Over the last two years, the state has moved even more assertively against media seen as too critical or even independent of the authorities. Although freedom of the press and speech are guaranteed, the government maintains an overt monopoly over television and radio broadcasting. The main strategy of state influence over the media has been to adopt the tactics of economic pressure and arbitrary control of state licenses for media outlets. It has also fostered a practice of self-censorship and a general timidity among journalists to investigate or expose cases of wrongdoing among the ruling elite. Overall, the state of the Armenian media remains marked by a dominant state-run broadcast and print media, set against a financially vulnerable and harassed opposition or independent media. While new legislation to improve media independence was passed, the Armenian media climate has not improved and violent attacks on journalists continue. This trend of media intimidation was also encouraged by several disturbing policies implemented by the Armenian government in recent years. The most blatantly repressive policy centered on the punitive legal

Freedom of
expression

measures concerning “insulting the dignity and honor” of elected officials, a legal framework providing strict parameters that effectively curtails media coverage and analysis of the local and central government. Restrictions on press freedoms and cases of outright intimidation have combined to further inhibit an Armenian media already weakened by severe declines in circulation and purchasing power of the average consumer. The fundamental fragility of the media on the whole has also encouraged the rise of the now dominant, private outlets owned by the new wealthy elite closely associated with the ruling political elite. And this lack of alternative or dissenting media has significantly stilted political reforms and efforts at democratization, a crucial shortcoming for a state in transition. These obstacles and dangers facing the Armenian media have also minimized the effectiveness of the media playing an important role in the fight against corruption.

3 | Rule of Law

The amended constitution imposed new structural changes that included measures curbing the overly dominant powers of the president while enhancing both the legislature and judiciary. Specifically, it replaced the presidential appointment of the Council of Justice, which serves as a supervisory and disciplinary body within the judiciary, with an election by members of the judiciary. But in practice, the executive branch remains in near complete control over the main instruments of state power and influence. A separate incident in May 2006 confirmed the rigid rules of the closed Armenian political system. After an open dispute with senior government officials that included a clash with the president, Armenian Parliamentary Speaker Artur Baghdasarian was forced to resign from his post, resulting in the withdrawal of his Orinats Yerkir (Country of Law) Party from the ruling three-party coalition and sparking a series of defections of ministers and parliamentarians from his own party. Although not publicly acknowledged, the dismissal was seen as linked to the speaker’s outspoken remarks condemning voting irregularities in the December 2005 referendum on the constitutional amendments. This also revealed that the ruling elite could easily enforce their own closed rules and punish dissent from any quarter, no matter how influential or publicly visible. In practice, there has been a significant narrowing of the avenues to political power. There has been a marked trend toward strengthening the institutions of state power and authority at the expense of opportunities for any emerging rivals from a more populist, grassroots level. This trend has been matched by a lack of any social movement or campaign and an absence of any attempts by civic groups to impose transparency, accountability and good governance in Armenia.

Separation of
powers

Despite the progress in the constitutional changes during this period, the executive branch remains unquestionably the strongest and most dominant branch, while the judiciary branch can best be described as overly compliant to the demands of the executive, and the parliament as generally ineffective. Officially, an independent judiciary branch does exist in Armenia, but it is still hostage to the will of the executive branch and is directly affected by widespread corruption, as well as subject to intimidation by the executive.

Independent
judiciary

Although there are punitive measures in place for incidents of abuse or corruption among state officials, there is little public expectation that such crimes are either reported or prosecuted due to a serious lack of accountability for state officials. This has led to a culture of impunity that has only increased after several leading businessmen, with reputed ties to the country's informal or illegal economy, were elected to parliament in May 2003. Thus, the linkage between the political and economic elite is perceived as an interrelated obstacle to good governance and to fighting against corruption.

Prosecution of
office abuse

Additionally, access to the country's highest judicial body, the Armenian Constitutional Court, which interprets and enforces basic law and ensures the constitutionality of legislation, would be broadened to provide ordinary citizens with the right to challenge the constitutionality of legal provisions applied against individuals. The protection of civil rights in Armenia remains conditional on the weak and arbitrary application of the rule of law. Over the past two years, several incidents of blatant violations, related to the state's seizure of private homes and the eviction of tenants on the basis of "state need" for commercial redevelopment, have seriously marred civil liberties.

Civil rights

4 | Stability of Democratic Institutions

Although there is still an impressive degree of overall institutional stability, there is a longer term, growing threat posed by a trend toward authoritarianism. Institutionally, Armenia has survived earlier challenges, however, suggesting a deeper resiliency capable of overcoming the trend toward authoritarianism.

Performance of
democratic
institutions

Armenia's democratic institutions are generally accepted by all political parties, although the opposition has routinely used an informal boycott of both parliamentary sessions and of elections as tactical expressions of protest. Such moves have consistently failed to either garner popular support or advance their political issues, however, as the existing system is widely held as the only appropriate political arena, and the public is largely skeptical of either public rallies and demonstrations and call on parties and figures to work within the existing political system.

Commitment to
democratic
institutions

5 | Political and Social Integration

The last two years has seen a deepening of the existing party system. Although this has conferred a degree of stability, it has also contributed to a static and limited political discourse defined by more narrow parameters. There are also a large number of parties that are officially registered but that are largely inactive. The core deficiency in the party system is the lack of an ideology or political platform among the main parties, which are defined more by the personality or personal appeal of one or two prominent leaders. The most significant development in recent years is the emergence of a new political party in 2006 that threatens to upset the traditional balance among the small but dominant pro-government political elite. This new party, (Bargavach Hayastan) or Prosperous Armenia Party, was established in early 2006 by Gagik Tsarukian, one of Armenia's wealthiest and most powerful men and a close friend of the president. The party, whose membership has been steadily increasing through late 2006 to an estimated 300,000 members or nearly nine % of the Armenian electorate, is widely expected to garner a substantial number of seats in the May 2007 parliamentary elections.

Party system

The country's traditionally strong degree of civic and community self-organization strengthened during this period, but remains impeded by its lack of empowerment and by a general sense of marginalization and apathy. Despite its adherence to the political system, interest groups and other politically active groups, such as the youth and student clubs, are disenfranchised from political power. There is a related limitation stemming from economic considerations, as the priority of providing family support has inhibited both political and civic activity and even awareness, as demonstrated by the country's seriously low levels of newspaper circulation.

Interest groups

Despite the frustrations over a record of tainted elections and from the slow pace of democratization over the past several years, the overwhelming majority of the population remains strongly committed to democracy, despite a high degree of apathy. Public opinion has largely weathered the political shortcomings and, ironically, is more committed to the constitutional system than most of the political parties. The dominant issue in current public opinion is the question of presidential succession, as the current president is constitutionally prohibited from running for a third term in 2008.

Consent to democratic norms

Social capital has continued be locked on a downward trajectory over the past two years, with signs of a slight but worrisome increase in crime and a notable level of mistrust among the population. This social tension has more recently acquired a new heightened level of confrontation beyond the confines of a public versus state arena to a broader individual-based conflict.

Associational activities

II. Market Economy

The Armenian economy holds a record of impressive growth in recent years, with official statistics showing that the economy achieved double digit growth for the previous five years. Despite this positive statistical growth, the Armenian economy still faces a number of challenges, including the ongoing blockades by Turkey and Azerbaijan, widening inequality and systemic corruption. Furthermore, the combination of a lack of a resilient institutionalized democracy and the weakened rule of law has tended to impede the course of Armenian economic reform.

6 | Level of Socioeconomic Development

Armenia has continued to post important gains in reducing poverty, which has fallen from over half the population five years ago, to one-third today, and extreme poverty from over a fifth of the population five years ago, to only about six percent for 2006. But the statistical achievements obscure the significant expansion of disparities in wealth and income in the country. There is a serious and deepening of economic polarization within Armenian society, as well as pronounced signs of regional disparities in poverty, exacerbated by continued unemployment and under-employment. Although official figures report a national unemployment rate of only slightly more than 8% in 2005, the findings of several household surveys actually place the figure much higher, at between 25-30%, with a sizable level in the rural areas of the country. The imperative for the Armenian government over the medium term is to tackle the fundamental social exclusion related to socioeconomic disparities that have polarized Armenian society into two camps: a small, powerful wealthy elite and a larger impoverished underclass. Although variations in gender-based employment and educational opportunities are much less significant factors in Armenian socioeconomic development, the lack of an effective poverty reduction program, coupled with rising corruption and weakened rule of law, pose the most basic challenges to Armenia's development.

Socioeconomic
barriers

Economic indicators		2002	2003	2004	2005
GDP	\$ mn.	2,376	2,807	3,577	4,903
Growth of GDP	%	13.2	14.0	10.5	14.0

		2002	2003	2004	2005
Inflation (CPI)	%	1.1	4.7	7	0.6
Unemployment	%	-	-	-	-
Foreign direct investment	% of GDP	4.7	4.3	6.1	5.3
Export growth	%	35.8	29.1	-1.7	15.9
Import growth	%	18.9	26.5	-2.9	11.7
Current account balance	\$ mn.	-147.9	-189.4	-161.6	-193.3
Public debt	\$ mn.	818.5	877.2	960.7	922.5
External debt	\$ mn.	1,385.5	1,769.5	1,872.9	1,860.7
External debt service	% of GNI	3.4	4.3	4.9	2.8
Cash surplus or deficit	% of GDP	-	-0.7	-0.8	-1.0
Tax Revenue	% of GDP	-	14	14	14.3
Government consumption	% of GDP	10.0	10.2	10.2	10.6
Public expnd. on edu.	% of GDP	-	-	-	-
Public expnd. on health	% of GDP	1.3	1.3	1.4	-
R&D expenditure	% of GDP	0.3	-	-	-
Military expenditure	% of GDP	2.7	2.7	2.6	2.7

Sources: The World Bank, World Development Indicators 2007 | UNESCO Institute for Statistics | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security

7 | Organization of the Market and Competition

The foundations for a market-based, competitive economic system have continued to develop and strengthen, as seen by the steady rise of the private economy, now estimated to account for roughly 80% of GDP. Armenia is consistently rated as having one of the most “open” economies among former Soviet states and is credited with positive trade and investment policies, with no restrictions on capital. But over the longer term, the country must focus on improving and redressing its lack of ties to the globalized marketplace and seek greater integration with the global economy. Such isolation is already a serious concern given the country’s trade and transport blockade and the disruption of the regional market.

Market-based
competition

In terms of economic monopolies and cartels, the Armenian government has fallen woefully short in preventing the rise and dominance of informal commodity-based monopolies and cartels. While state policy to date has publicly vowed to combat corruption, a related but more serious threat is posed by the protectionism and favoritism enjoyed by domestic cartels and monopolies and by a few powerful Russian investor groups. Much of the commodity-based sectors of the economy, as well as the energy and banking sectors, have become closed areas controlled by informal alliances between the political and commercial elites. Despite having one of the most advanced regulatory systems in the former Soviet Union, there is still a need to improve transparency as Armenia lacks the necessary combination of critical laws and effective enforcement, particularly in the areas of anti-monopoly and anti-trust laws. This weakness is exacerbated by excessive state control over some key sectors of the economy.

Anti-monopoly
policy

Foreign trade has been significantly liberalized during the country's earliest period of transformation and has continued to be strengthened by Armenia's ascension to the WTO and as a state priority. Related to the obstacles of only a minor share of world trade and insufficient integration into global trade networks, Armenian trade is overly concentrated, both on a sectoral and regional basis, as reflected in the terms of trade, with five principal trading partners consistently accounting for 80 % of its total trade. The Armenian government maintains a liberal trade regime with about one-third of imports subject to a single tariff of 10% and the remaining goods imported duty-free. The country has a rating of 1 (i.e., most liberal) on the IMF's trade restrictiveness index and there are no taxes on exports or quantitative restrictions.

Liberalization of
foreign trade

Over the past two years, the Armenian banking system has become the one sector in need of reform and development. The banking and financial services sectors are fundamentally limited by the small size of the country's financial sector (total assets are still well below 20% of GDP), the infancy of capital markets and the need for greater transparency and regulation. There has been a degree of progress, albeit at a slow pace, in the strengthening of creditor rights, improving banking supervision and by increasing the minimum capital requirements for existing banks from the current level of \$2 million to \$5 million. There is a lack of adequate corporate governance as well, although there are reform measures planned to redefine the separation of duties and rights of shareholders, boards of directors, and executives of banks, and to enhance creditors' rights by streamlining court procedures and improving the registration system for secured lending.

Banking system

8 | Currency and Price Stability

The Armenia Central Bank has followed a strict adherence to maintaining fiscal discipline and has continued to follow prudent monetary policies aimed at ensuring macroeconomic stability. Money demand has steadily increased, driven by stronger economic activity and a flexible exchange rate regime has been important to mitigate the adverse impact of external shocks. Over the past two years, a steady and significant appreciation of the national currency (the “dram”) worsened as a result of increasing foreign exchange inflows. This trend that, as of mid-2006, led to an appreciation of more than 33% in nominal terms against the U.S. dollar, has weakened external competitiveness and seriously impacted a large segment of the population that relies on dollar-denominated remittances for income or living expenses.

Anti-inflation /
forex policy

Due largely to sound policies and structural reforms, the external current account balance and debt ratios have continued to improve, marked by a decline of the country’s external debt ratio from 46.6% of GDP in 2002 to 22.2% of GDP in 2006. The priority focus of Armenia’s fiscal reforms through 2006 and 2007 target the goals of reducing tax privileges and loopholes, and improving tax collection and customs administration.

Macrostability

9 | Private Property

Armenian property rights and the acquisition of property are adequately defined and soundly defended. This stems from an initial focus on private property during the early stage of privatization in the initial phase of Armenian transformation, although it was marred by incidents of privileged control and corrupt practices that partially co-opted the efficacy of the overall privatization program. The Armenian government has made some progress in the easing of state interference in business formation and with a strengthening of property rights.

Property rights

There is a flourishing private sector in Armenia that has further expanded over the last two years. The Armenian government has also recognized the private sector as the engine for further growth and it is the center of its growth strategy. For this reason, the state has improved the business environment by reducing regulations, improving the bankruptcy law and customs administration, strengthening the banking system and through cases of official bureaucracy tending to hamper businesses and private sector commerce.

Private
enterprise

10 | Welfare Regime

Although there are basic outlines of a social safety net to compensate for poverty in place, the over-dependence external remittances and the related problem of a serious appreciation in value of the national currency (which in turn reduced the value of the most common form of the remittances- the dollar, euro and ruble) have seriously infringed on the efficacy of the social safety net. Structurally, social assistance in Armenia is comprised of limited cash benefits (based on a system of targeting along regional, community and indicator lines), and a limited and gradually phasing-out state subsidies for energy (“lifeline” utility tariffs). Social insurance (unemployment and pensions) are both flat rate benefits.

Social safety nets

Armenia continues to suffer from an inequality of opportunity. This is not necessarily a gender-driven problem, but is an inequality that reflects a disparity in wealth and income. The social division is the defining core element of both the distortion of access to state benefits and services and the uneven availability of opportunity. Although there are some elements of the country’s economic reform and poverty reduction strategies that seek to correct this inequality, there are no practical or direct avenues of redress.

Equal opportunity

11 | Economic Performance

The country has continued to reap the rewards from over a decade and a half of reform, posting double-digit economic growth for the last five years. This growth was matched by low inflation and an increasing level of real per capita income. Real GDP grew by 14% in 2005 and over 13% in 2006, making Armenia one of the fastest growing former Soviet states. Investment also continued to expand, accompanied by a substantial expansion of the private sector, which currently accounts for over 80% of GDP.

Output strength

12 | Sustainability

Within this period, environmental considerations have been increasingly recognized as important elements of the overall reform program. The Armenian government identified specific concerns from the over-exploitation of natural resources, including the depletion of water resources, erosion of soil and degradation of biodiversity. The Constitution also requires the state to protect the environment as well as to ensure the rational use and reproduction of natural resources. Despite this overall record of environmental recognition, there has been a notable priority for policies to promote growth over policies of conservation.

Environmental policy

The main challenge to the country's education and R&D sectors centers on an inability to sustain adequate investment and state spending, a decline in the modernization of facilities, and the severe effects of the country's "brain drain," or sizable loss of human capital during the early- to mid-1990s. The decline in investment in education has led to a compromise in the overall quality of Armenian education. Armenia has continually strived to maintain its system of universal basic education and secondary school enrollment remains high in Armenia, and literacy is still at a level exceeding 99% of the population. Research and development (R&D) in Armenia has long been recognized as an area of strategic importance. Annual state funding for R&D, however, has rarely surpassed a ceiling of only 0.9% of GDP. The government has created a Research and Innovation Strategic Plan focusing on eight target sectors: information and communication technologies (ICT), life sciences, food security and quality, environment and energy, and Nanotechnologies.

Education policy
/ R&D

Transformation Management

I. Level of Difficulty

The Armenian leadership remains constrained in its ability to govern effectively. This is due to the inherent limitations imposed by an absence of civil society as a partner or stakeholder in the governing process and due to an increasing narrow set of external policy options available to the country.

Structural
constraints

Civil society in Armenia is constrained by the overwhelming dominance of the state and a demonstrable lack of equal opportunity. This absence of a level playing field has combine with a general trend of public apathy to form a negative, mutually reinforcing dynamic of inactivity and frustration. While there has been continued progress in both the number and activity of civil society, with greater numbers of civic and non-governmental organizations (NGOs) dealing with a wide range of issues, only a handful of these operate with any consistency. Furthermore, there is a definite need for Armenian NGOs to receive more support on the local level and from the Armenian government. At present, there is more than enough foreign support, which has brought with it goals that are often different from local needs and methods that are not always applicable to those who are being targeted. Greater involvement in NGOs by local people could also result in a more influential force in the fight against corruption, but at this point there has already been a dangerous decline in public satisfaction with democracy and confidence in the democratic institutions in Armenia.

Civil society
traditions

Internally, there is no real evidence of ethnic, religious or social conflict. Yet there is a serious looming undercurrent of general social dissatisfaction, which has been spurred by the widening disparities in wealth and income. The real test for the Armenian authorities is whether they can design and implement effective policies with a sufficient commitment and political will to counter this growing level of social tension. The state does have some time to deal with this challenge, however, as no political party of figure has yet emerged to exploit this social divide and polarization.

Conflict intensity

II. Management Performance

The country's lack of overall good governance continues to be a fundamental obstacle for the transformation of the country into a functioning and transparent market economy and institutionalized democracy. For this period, the structural difficulties facing the country center on an external and an internal challenge. Externally, the continued blockade of landlocked Armenia is reinforcing a mounting over-dependence on Russia as its main partner for trade, energy and economic development. Internally, the level of corruption and shortcomings in the formulation and implementation of economic and political policy poses serious threats. Corruption in Armenia denies the state a substantial amount of tax revenue, fundamentally weakens the rule of law and important democratic reform, and poses a deeper fundamental challenge to state legitimacy and authority.

14 | Steering Capability

The Armenian government's strategy for economic reform clearly reflects prudent strategic priorities: continued economic recovery and a further expansion of democracy. Having recognized the two essential shortcomings (in socioeconomic inequality and against corruption), there is a promising outlook for the government's commitment to meeting these challenges. Yet, the political will necessary to meet this potential is another factor exacerbating the level of difficulty. And the outlook for such a political will is uncertain, as the country faces looming elections in 2007 and 2008.

Prioritization

Although Armenia has been able to establish the basic framework for a modern market economy and has demonstrated a significant degree of sound macroeconomic policies, sustainability depends on the continuation and acceleration of reform. Specifically, a greater degree of political commitment to the implementation of these reforms is crucial to overall sustainability, capable of withstanding short-term political tendencies and temptations in pursuit of strategic economic development and reform. The two most glaring areas for further reform are banking sector reform and social sector policies designed to correct the widening disparities of income and wealth. A related element here would also encompass improvements to the judicial sector, to foster greater efficiency and effectiveness in enforcing contracts and regulating commerce.

Implementation

The Armenian leadership has generally demonstrated a degree of flexibility and policy innovation that has enabled to withstand internal challenges and hold on

Policy learning

to power for the past few years. With no serious opposition candidate or party capable of mounting a direct confrontation on the ruling political elite, the only current threat to the regime is derived from their own miscalculation.

15 | Resource Efficiency

The government has effectively built up its resource base and has made gains during this period from implementing broad civil service reform, enabling a more efficient utilization of a new generation of dedicated and qualified personnel ready and willing to serve the Armenian state. The fundamental shortcoming in resource management has been a lack of meritocracy, as positions and benefits have flowed to those with connections, and an inadequate pay scale.

Efficient use of assets

A prerequisite to forging a coherent government policy among competing and conflicting factors is the need for “good governance.” Transparency, ethics, accountability and competent administration are essential for good governance in Armenia. These prerequisites are notably lacking, especially in the current system of a strong executive that dominates a weaker judicial branch and has marginalized a rather ineffective legislature. There needs to be a determined effort to strengthen judicial independence and restore meritocracy over favoritism in governance.

Policy coordination

There are some important measures that the Armenian government may implement to help in accelerating the campaign to combat corruption. In order to achieve some realistic impact on corruption, such measures must be formulated within an overall package designed to strengthen the state and ensure the rule of law. A careful combination of enhancements of key elements of the state structures is needed, starting with a focus on creating and strengthening regulatory agencies and bodies. In contrast to blanket measures granting the executive branch of government more powers, the fight against corruption must be carried out by bodies to supervise privatization, the emerging securities markets and to police the economy for monopolies, cartels or trusts. Such bodies should be independent from, but accountable, to the government and need to be empowered by supporting legislation. The related introduction of new mechanisms of transparency and oversight are also crucial to bolstering these regulatory bodies.

Anti-corruption policy

16 | Consensus-Building

Within the context of the political and economic fields, there is an overwhelming degree of acceptance of the need for further democracy and market reform.

Consensus on goals

There is no real or even potential anti-democratic force present in the country. Yet the level of mounting social tension over general inequality may trigger some form of open dissent later, however.

With no real “anti-democratic” actors present in the country, the real battle is more of a power competition between political and economic elites. This struggle may devolve or expand to include some new form of actor capable of confronting the reformers outside of the confines of the existing system.

Anti-democratic veto actors

Political cleavage in the Armenian case is mainly centered on the confrontation and competition between the strong, ruling elite and the fractured political opposition, with both sides as vested interests maintaining their position as elites. The disparity in power and potential has tended to diminish all sizable cleavages and has allowed the authorities to effectively manage and contain all aspects of this cleavage.

Cleavage / conflict management

Civil society is viewed in very limited terms by the authorities, with no accepted mechanism for their engagement. Moreover, the Armenian government uses economic growth as an element of power and legitimacy, in both foreign and domestic eyes, and to justify and defend both its policies and politics in the face of limited popular support and standing, instead of reaching out to the civil society as a stakeholder in the process.

Civil society participation

In terms of reconciliation, internal Armenian politics is largely immune from anything beyond the excessive use of injustice in external affairs. Specifically, the issues of injustice and victimization are missing from the current dynamic, mainly due to the fact that no political party has articulated or defended the interests of the marginalized segment of society. Until there is a degree of such advocacy, there will be no need for reconciliation.

Reconciliation

17 | International Cooperation

Armenia has long used economic growth to garner legitimacy, in both foreign and domestic eyes, and to justify and defend both its policies and politics in the face of limited popular support and standing. There is also a degree of international support for reforms through the application of pressure and expectations. For example, the coming May 2007 and 2008 elections comes as the first political test for Armenia since the country signed the “action plan” with the European Union (EU) as commitment to the new EU “European Neighborhood Policy.” The elections are also the first of its kind since the country’s inclusion in the Millennium Challenge Account (MCA), a new U.S. foreign aid program that includes important new considerations and prerequisites for democracy and electoral performance. And despite the powerful influence of

Effective use of support

the Armenian diasporan organizations over the annual adoption of U.S. foreign assistance in Congress, Armenia's position as a recipient of this MCA aid may be endangered by any setback in the coming elections.

The country is widely held as a credible and reliable state within the international community. Armenia is a signatory to several international treaties and agreements, and has led the way in the region for international environment standards, including signing and supporting the Bio-Diversity, the Nuclear Test Ban, the Wetlands Treaties, and has acceded to the Kyoto Protocol on climate change.

Credibility

In terms of cooperation with neighboring countries and regional organizations, there has been significant willingness and even some initiative for greater cooperation. This willingness for cooperation stems in large part from the external isolation and limitations of Armenia's geography. But the reality of isolation rooted in the unresolved Nagorno-Karabakh conflict has led to frozen relations with both Azerbaijan and Turkey. But Armenia faces further isolation as a result and needs a normalization and restoration of regional trade and transport links. This need is the main motivation for Armenian pursuit of greater cooperation, as the unresolved Nagorno-Karabakh conflict is the core obstacle to regional cooperation.

Regional cooperation

Strategic Outlook

With an approaching set of elections in May 2007 and early 2008, Armenia is facing a crucial milestone in its political transformation. This coming test for the country reveals more of the fundamental flaws and deficiencies in the overall course of political, and economic, transformation. Specifically, like other former Soviet states, Armenia inherited its independence in the wake of the abrupt collapse of the Soviet Union. This has inheritance also included an inherent set of burdens, ranging from the need to overcome the constraints from seven decades of Soviet rule to the necessity to bolster inadequate and infant institutions. In this context, institutions, not individuals, are key to achieving durable stability and security.

Armenia's political transition is marked by a daunting set of internal challenges, ranging from a deficit of democracy to a still weak rule of law. Armenia suffers from a form of "disabled democracy," stemming from the closed nature of its political systems and political institutions that are still too weak and fragile to support and sustain a fuller democracy. Moreover, the population is marginalized within this closed political system, demonstrated by the fact that the Armenian citizen is more a spectator than an actor in representative democracy and has limited choice, and even less voice, in governance. There is also a serious problem related to the rule of law. The rather arbitrary and incomplete state of the rule of law has fostered an atmosphere of corruption, crime and complicity, matched by a lack of good governance, as demonstrated by the tendency for leaders to rule rather than govern. Public policy is also formulated more from self-interest than from national interest. Thus, within this political stage of transition, the predominance of individuals over institutions, of personality over platform, poses one of the more fundamental challenges to the Armenian state.

Additionally, in terms of economic transition, Armenia faces two underlying obstacles to sustainable growth and sound development. First, widening disparities in wealth and income (as well as power) foster a growing divide within Armenian society. Second, the sheer scope and scale of socio-economic injustice in Armenia can not be fully obscured by the past few years of statistical economic growth or by a dependence on foreign remittances. Moreover, these factors further impede the emergence of a vibrant middle class in Armenia, which most importantly, is essential for real democracy. Thus, what is needed most for the country to weather this transformation is a comprehensive strategy comprised of four core pillars.

First, there is need to correct the structural shortcomings in the institutions of governance by leveraging the promise of the constitutional reforms. While those reforms reduced the formal power of an overly dominant presidency, the measures did not go far enough as the executive is still far too powerful in practical or informal terms. A much more dynamic and balanced system of government, with a parliament and judiciary endowed with even greater power and authority is required to restore a balance in the distorted system of governance.

Second, greater accountability is vital for the creation of an effective deterrent to corruption and bribery, and informed public debate and civic engagement is crucial. Here too, civil society needs to be granted the access to the public policy process and allowed to emerge as true stakeholders in the country's overall transformation.

Thirdly, Armenia's external relations and foreign policy is in need of adjustment, as an over-reliance on its traditional ally Russia requires a new degree of revision and reassessment, mainly in light of a new and more pronounced engagement by the West. And a tendency for governance by strong individual leaders over strong institutional leadership must also be stressed for conflict resolution and regional reintegration.

Fourth, despite significant economic growth, reforms remain fairly incomplete and several vulnerabilities mandate renewed commitment. Specifically, there is a need to enhance transparency, combat corruption and address the informal monopolies and cartel-based nature of the business sector. Moreover, the economy remains vulnerable to its reliance on external remittances and to the challenges of a mounting social divide, marked by widening disparities in wealth and income constitute "economic security."