

BTI 2010 | Armenia Country Report

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|-------------------------|------|-------------|-------------|---|
| Status Index | 1-10 | 5.75 | # 62 of 128 | |
| Democracy | 1-10 | 5.00 | # 77 of 128 | ↓ |
| Market Economy | 1-10 | 6.50 | # 40 of 128 | → |
| Management Index | 1-10 | 4.36 | # 85 of 128 | |

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

This report is part of the Transformation Index (BTI) 2010. 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 128 transformation and developing countries are evaluated.

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Key Indicators

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|------------------|--------|------|------------------------------|------|----------------------|----|-------|
| Population | mn. | 3.1 | HDI | 0.80 | GDP p.c. | \$ | 5571 |
| Pop. growth | % p.a. | 0.1 | HDI rank of 182 | 84 | Gini Index | | 33.8 |
| Life expectancy | years | 73 | UN Education Index | 0.91 | Poverty ² | % | 43.4 |
| Urban population | % | 63.9 | Gender equality ¹ | 0.41 | Aid per capita | \$ | 116.8 |

Sources: UNDP, Human Development Report 2009 | The World Bank, World Development Indicators 2009.

Footnotes: (1) Gender Empowerment Measure (GEM). (2) Percentage of population living on less than \$2 a day.

Executive Summary

For the past two years, Armenia has continued to struggle with a daunting set of challenges, ranging from serious deficiencies in democratization to significant shortcomings in economic reform. After yet another flawed election, in February 2008, Armenia remains unable to overcome an internal political crisis, as lingering discontent among a much less apathetic population and the government's lack of legitimacy have only fostered a deeper crisis of confidence. Still, the political crisis of the last two years is only a symptom of a much deeper and more troubling impediment to democratic reform in Armenia, and it only magnifies the country's already pronounced democratic deficit.

More specifically, Armenia's unresolved political crisis stems from a polarized stalemate precipitated by a deadlock between the authorities and the opposition. This deadlock can be attributed in large part to both an unpopular government, which stubbornly refuses to recognize the country's new political reality, and an opposition movement, which seems to lack any clear policy alternatives.

At the same time, though, the most serious obstacle facing Armenia's democratic development is rooted less in either the authoritarian government or the marginalized opposition. Instead, it stems more from the structural deficiencies of the Armenian political system. Moreover, the lack of legitimacy and the absence of a popular mandate have only revealed the deeper flaws in the political system itself, including its weak rule of law, a compliant judiciary and an ineffective parliament.

Similarly, Armenia's economic transformation is equally hindered by widening disparities in wealth and equality, which have been caused by an economy distorted by entrenched corruption and the influence of several powerful commodity-based cartels and semi-monopolies. More crucially, the onset of the ongoing global financial and economic crisis has only exposed the deeper structural flaws impeding reform in Armenia. At the same time, in the face of an

unresolved political crisis and hobbled by an absence of political will, Armenia's government seems unwilling or unable to overcome the broader threats to the political and economic transformation of the country.

History and Characteristics of Transformation

Since the collapse of the Soviet Union and its independence, Armenia has struggled to forge new institutions of statehood and to overcome a daunting set of economic, political and social challenges. The most fundamental obstacle has been the necessity of overcoming 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 economic and political institutions for itself that were capable of both defining and defending its independence and sovereignty.

For Armenia, the course of economic and political reform has been especially difficult since it has had to weather the effects of a severe earthquake, a war with neighboring Azerbaijan and the imposition of a virtual blockade. Likewise, Armenia still faces serious challenges, including incomplete democratic reform and uneven economic development.

Several significant characteristics of Armenia's transformation and the limited capacity of the Armenian government to respond to these broader challenges have posed serious obstacles to the course of the country's transformation. First, there has been a dangerous – and still widening – trend of disparities in terms of wealth and income. Although the record of economic reform in recent years has been fairly impressive, most assessments of the Armenian economy concentrate exclusively on Armenia's statistical record of double-digit economic growth and the gradual, though consistent, decline in national poverty. Still, one of the more negative aspects of Armenia's economic reality is the "paradox" of economic growth, whereby several years of double-digit economic growth have resulted in an uneven or partial sharing of both wealth and higher living standards among the overall population. Moreover, widening disparities in wealth and income have only led to a serious socioeconomic divide.

Second, over the past two years, Armenia has experienced a widening polarization in politics. This has been characterized by a newly united political opposition and an increasingly unpopular government, and it has been exacerbated by the socioeconomic divide between a small, wealthy ruling elite and a much larger population with limited economic opportunities and even less political power.

The third characteristic of Armenia's transformation is its increasingly unsustainable economic system. More specifically, in addition to having to deal with the relative "incubation" of the economy resulting from closed borders and its limited links to the broader global economy,

Armenia's economy also has a vulnerability rooted in an inherent structural fragility composed of the following three elements: a dangerous dependence on the influx of remittances from Armenians working abroad; a narrow reliance on the country's service, commodity and construction sectors as the main drivers of economic growth; and, most distressing, its closed "oligarchic" economic network centered on several informal commodity-based cartels and semi-monopolies.

Armenia's government has traditionally pointed to its record of statistical economic growth when claiming legitimacy before both domestic and foreign audiences. Crippled by a lack of popular support and hindered by a record of tainted elections, the Armenian authorities have used economic growth to obscure their lack of a mandate to govern. At this time, however, the combination of structural fragility, entrenched corruption and incomplete reform is posing a threat to the economic system itself and causing many to doubt whether it can sustain itself in the face of mounting challenges.

A fourth key trend over the past two years has been the government's pronounced lack of political legitimacy, which is rooted in the absence of free and fair elections and mounting unpopularity. For much of the last decade, Armenia's population had grown accustomed to fraudulent elections, economic inequality and a lack of democratic governance. Over time, the population grew increasingly disengaged from politics and was gripped by a pronounced and widespread state of apathy. This apathy, as well as the related onset of public mistrust, became the most significant obstacles to meaningful political change and economic development. Likewise, promises of a more prosperous future also increased this apathy because most of the population realized that such prosperity could only be attained by a handful of corrupt people. As a result, the overwhelming tendency was for people to want to be part of the corrupt system rather than change it.

However, the apathy of the Armenian population quickly dissipated when then-President Robert Kocharian handed over power to his chosen successor, Serzh Sarkisian. Although the "awakening" of the Armenian people was triggered by the February 2008 presidential election, it was not the actual vote that was significant. Instead, it was the process of the election campaign that was more revealing owing to its non-level playing field and the closed political system. Indeed, the political crisis of the past two years clearly only confirmed that there is a growing level of discontent, frustration and anger in Armenia over its mounting inequalities and disparities of wealth and income.

Transformation Status

I. Democracy

With only limited progress in political reform over the past two years, Armenia's transformation remains incomplete. The development of a more resilient pluralist and participatory democracy in the country is challenged by the inherently closed nature of its political system and its institutions, each of which lacks sufficient authority or independence to support and sustain true democracy. On a deeper level, the fulfillment of democracy is further hindered by the absence of an underlying rule of law, which has only fostered an "arrogance of power" among the government and allowed corruption to flourish unchecked. These broader trends in Armenia's deficit of democracy have been demonstrated by a lack of good governance, which is characterized by the authorities' ruling rather than governing the country and demonstrated by the fact that public policy is largely driven by self-interest instead of national interest.

1 | Stateness

Owing to the powerful influence of Armenian nationalism in its highly homogenous society, the Armenian state has traditionally enjoyed unchallenged authority. It holds a strong, well-established and unchallenged monopoly on the use of force, which is strengthened by both the stability of civil-military relations and the general absence of weapons among private citizens. The state's monopoly on the use of force has also been bolstered by the professionalism of the country's armed forces, which are completely subordinate to civilian state control and oversight and refrain from assuming any political role.

At the same time, however, the state's monopoly on force and authority has been brought into question in the past two years. Although there is no real threat of internal unrest or political intervention, the excessive use of force by police officers against unarmed civilians on 1 March 2008 and the reliance on army units to quell opposition demonstrations in February 2008 now pose a potential challenge to the state, at least over the medium term.

Monopoly on the
use of force

In terms of state identity, there is an overall consensus on the issue of citizenship, mainly due to Armenia's highly pronounced homogeneity. There is little or no record of ethnic division or discrimination against non-Armenian minority communities (e.g., Kurds, Russians and some Jews). Similarly, several thousand foreign students, mainly from Iran and India, have also enjoyed relatively easy coexistence with native Armenians. In theory, all citizens enjoy the same civic rights, and the Armenian state ensures equal access to education, the courts and public welfare. Nevertheless, there are some signs of a growing discrepancy in rights. For example, the onset of a new political crisis in 2007 – 2008 led to the arrest of several opposition leaders and activists, which suggests that there should be some concern relating to the persecution of individuals based on their political beliefs.

State identity

The Armenian state maintains an officially secular policy of separation between church and state, and religious dogma plays no role in politics. The Armenian Apostolic Church, to which roughly 94% of the population belongs, has long played an important and often vital role in maintaining Armenian cultural identity. This cultural role has also traditionally remained distant from and uninvolved in partisan politics, a fact that remains unchanged in contemporary Armenian politics. However, over the past two years, there have been some calls for the Armenian Church to play a greater public and political role, primarily in the fight against corruption.

No interference of religious dogmas

The protection of the fundamental freedom of religion is incomplete in Armenia and, over the past two years, there have been some cases of discrimination against 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. There have also been fresh signs of the possible enactment of new laws aimed at further curbing the activities of what are categorized as religious sects in Armenia. As of February 2009, however, such legislation had yet to be enacted.

Armenia's administrative system is fairly well-developed. Administrative structures operate on many levels of government, and they are generally viewed as competent. Despite some recent reform efforts in the last four years targeting the civil service, corruption within these structures remains a serious challenge. Administration remains hindered by the legacy of Soviet-era practices, many of which are now inefficient and burdensome for the current Armenian reality. It is also highly bureaucratic and, as a result, often functions with pronounced bias and arbitrary implementation. Although justice is administered reasonably well, adjudication remains contingent on political, personal or financial interference. This can largely be attributed to a fairly weak rule of law combined with a flawed system of law enforcement and a sometimes checkered record of justice, primarily in the less-developed regions of the countryside, but also occasionally in major cities.

Basic administration

Similarly, the lack of an independent judiciary also tends to weaken the efficacy of the state administrative bodies and foster a widespread lack of public trust in the system.

2 | Political Participation

In terms of free and fair elections, Armenia's first election in the early 1990s was its best – but also its last. Likewise, over much of the last decade, the Armenian population got used to flawed elections, economic inequality and a lack of democratic governance. Over time, the population has become increasingly disengaged from politics and gripped by a pronounced and widespread state of apathy. This apathy and the related onset of public mistrust have become the most significant obstacles to meaningful political change and economic development in the country.

Free and fair
elections

Over the past two years, despite electoral and constitutional reforms, Armenia's political system has remained rigid, closed and seriously impeded by entrenched corruption and political patronage. At the same time, though, with the emergence of a new political crisis in early 2008, the polarized stalemate between the authorities and a newly unified opposition has led to a new “awakening” within society, an end of this widespread general apathy and increasing demands for free and fair elections.

International and domestic observers raised serious concerns about the February 2008 presidential election. They reported uneven media coverage of candidates prior to the elections and violations on election day, including campaigning near polling stations, ballot stuffing, vote buying and irregularities in counting and tabulation. Following the election, tens of thousands of supporters of Levon Ter-Petrossian, the main opposition candidate, took to the streets of Yerevan, Armenia's capital city. The protests against the election results continued peacefully for 10 days. On 1 March 2008, violent clashes erupted between the police and demonstrators, and authorities arrested several hundred demonstrators and prosecuted more than 100 opposition supporters. The government declared a state of emergency that same day, temporarily restricting freedoms of movement, assembly and expression as well as access to information. The state of emergency wasn't fully lifted until 21 March. Under pressure from the Parliamentary Assembly of the Council of Europe (PACE), the Armenian authorities have taken steps to establish an independent inquiry into these events, but they have yet to hold anyone responsible for the deaths.

In the face of fundamental flaws in the country's closed political system and the absence of free and fair elections, the Armenian authorities have normally held virtually unchallenged authority. However, over the past two years, there has been a marked change, as the tainted presidential election of February 2008 sparked a serious crisis of confidence that has eroded confidence in the government, which faces a further challenge in the form of public demands for change.

Effective power to govern

Moreover, from this distinctly new political context, insofar as the population has emerged from years of apathy to voice fresh and strident demands for change, the state's ability to govern is now under threat from its lack of legitimacy and lack of any popular mandate or support. The basic impediment stems from within the state itself, however, as the authorities are unable to address the new political reality and remain locked in a short-sighted defensive stance that sees dissent as only a direct threat to the state rather than as something that is the mark of a healthy democracy. Within the confines of the closed political system, there is no mechanism for expressing political discontent, which exacerbates the underlying tensions.

Although Armenia has a vibrant civil society comprised of a wide array of civic groups and NGOs, over the last two years, there have been more restrictions on political groups and parties wishing to exercise their rights to free assembly and expression. These restrictions were introduced in response to the post-election crisis of 2008, but they also reflect a growing trend toward authoritarianism in the country, which was underway well before the February 2008 election.

Association / assembly rights

The noticeable decline in basic civil freedoms in recent years has been matched by efforts to constrain and restrain the Armenian media, which has increasingly 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. This has also encouraged a degree of "self-censorship," according to which the media has limited itself in terms of bolder journalism.

Freedom of expression

In June 2008, the European Court of Human Rights ruled that Armenia had violated Article 10 (related to freedom of expression) of the European Convention on Human Rights in relation to the independent broadcast company A1+, which had been denied a license since going off the air in 2002. In September 2008, the National Assembly amended the law on television and radio to suspend all licensing until the digital switchover scheduled for 2010.

3 | Rule of Law

Several amendments to the Armenian Constitution imposed new structural curbs on the overly dominant powers of the president while enhancing both the legislature and judiciary. However, despite these enhancements, the executive branch still holds a dominant position over the other branches of government and retains control over nearly all of the main instruments of state power. The lack of any effective “checks and balances” or a separation of powers remains the most serious impediment to Armenia’s democratic transformation.

Separation of powers

Officially, although an independent judiciary does exist in Armenia, it is still largely subordinate to and overly compliant to the demands of the executive branch, which is unquestionably the strongest and most dominant of the branches of government. The judiciary is also directly affected by widespread corruption and general incompetence.

Independent judiciary

The abuse of power among Armenian officials remains rampant and unchecked. Reflected in the authorities’ rather crude “arrogance of power,” such abuse of power is matched by the entrenched level of corruption within state institutions.

Prosecution of office abuse

The protection of civil rights in Armenia remains incomplete and far too arbitrary, and these deficiencies mainly result from the weak and arbitrary application of the rule of law. Over the past two years, several more incidents of the state’s blatant violation of civil rights – most of which were related to political issues – have only reaffirmed the need for proper oversight by an independent judiciary. The sole exception has been the appointment of an ombudsman for human rights, who has actively challenged the state’s lack of protection for and even violation of civil liberties.

Civil rights

4 | Stability of Democratic Institutions

Armenia’s democratic institutions are generally underperforming, which reflects their lack of both true democracy and their inherent weakness in institutional terms. Each of these factors is compounded by a lack of legitimacy and an election-based popular mandate.

Performance of democratic institutions

Armenia’s commitment to democratic institutions is limited and largely superficial. However, over the past two years, there has been a new challenge to the state as a newly polarized stalemate between the unpopular government and a newly unified opposition movement has exerted new pressure for real change. More crucially, the deeper flaws in the political system itself (e.g., the weak rule of law, a compliant judiciary and an ineffective parliament) suggest that the current political system is incapable of sustaining itself in the face of mounting pressure from an unresolved

Commitment to democratic institutions

political crisis and a lingering crisis of confidence. This also means that the only way to resolve this crisis is through a new commitment to building truly democratic institutions.

5 | Political and Social Integration

The last two years have been marked by a further deepening of the existing party system. Although this has brought a degree of stability, it has also contributed to a static and limited political discourse defined by narrower parameters. There are also a large number of parties that are officially registered but largely inactive. The core deficiency in the party system is the fact that the main political parties lack ideologies and political platforms and are, instead, defined more by the personality or personal appeal of one or two of their prominent leaders.

Party system

The one exception is the country's sole opposition party, the Heritage Party, which represents a "constructive opposition" and is actively engaged in a broader effort to elevate political discourse by challenging the government on a higher plane of public policy. Unlike the Ter Petrosian-led opposition movement, which remains more marginalized outside the parameters of the political system, the Heritage Party has sought to leverage its position within the political institutions themselves, such as the parliament and the Central Election Commission, to forcefully challenge and confront the government.

Over the past two years, there has been a strengthening of Armenia's civic and community-based organizations. This was sparked by a political awakening among interest groups and other politically active groups, such as youth and student clubs, which are no longer content to be disenfranchised from political power.

Interest groups

Over the past several years, despite frustration from the flawed February 2008 presidential election and the slow pace of democratization, the overwhelming majority of Armenia's population has remained strongly committed to democracy, especially in the wake of a sudden end in its apathy. Public opinion has largely weathered the political shortcomings and, ironically, the public is more committed to the constitutional system than most of the political parties.

Consent to democratic norms

Over the past two years, social and associational activities in Armenia have intensified. This rise, which reflects both a new sense of public engagement in politics and the recent reunification of the formerly divided opposition, has been matched by a corresponding increase in activity among civil society actors.

Associational activities

II. Market Economy

Although the record of economic reform in recent years has been fairly impressive, most assessments of the Armenian economy concentrate exclusively on Armenia's statistical record of double-digit economic growth and the gradual, yet consistent, decline in national poverty. Still, one of the more negative aspects of Armenia's economic reality is the "paradox" of economic growth, whereby several years of double-digit economic growth have resulted in an uneven or partial sharing of wealth and higher living standards among the overall population. Moreover, widening disparities in wealth and income have only led to a serious socioeconomic divide.

Already weakened by a pronounced lack of legitimacy and a prolonged political crisis of confidence, the Armenian government is facing a new challenge from the global financial and economic crisis. The crisis has already led to a sharp decline in the flows of remittance, which provide an essential influx of cash for most Armenians, a sudden downturn in the country's mining sector, which has prompted the loss of several thousand jobs, and a dramatic reduction in the level of Russian investment in the construction industry. Still, the most troubling factor is the Armenian government's rather short-sighted refusal to even recognize the country's vulnerability to the global economic crisis. Although government officials admit that economic activity has already contracted considerably, they have tended to downplay both the significance and the severity of the impact of the crisis.

6 | Level of Socioeconomic Development

The socioeconomic barriers caused by an uneven distribution of wealth and disparities in the living standards among the overall population have been exacerbated by widening inequalities in terms of wealth and income. The resulting serious socioeconomic divide has also been marked by a geographic aspect along urban-rural lines as well as by an over-concentration of economic activity and opportunity in urban centers and the capital. This division has fostered more pronounced regional and rural income inequalities and has been exacerbated by a large degree of variance in the quality of and access to essential public services, such as health care, education and other social services. The infrastructural divide between regions and urban centers has also encouraged greater migration to urban capitals from the country's more remote rural areas. This geographic rural-urban divide is also reflected in the course of political development and democratization, as power is overwhelmingly concentrated in the capital.

Socioeconomic
barriers

| Economic indicators | | 2004 | 2005 | 2006 | 2007 |
|---------------------------|----------|--------|--------|--------|---------------|
| GDP | \$ mn. | 3576.6 | 4900.4 | 6384.5 | 9204.5 |
| Growth of GDP | % | 10.5 | 13.9 | 13.2 | 13.7 |
| Inflation (CPI) | % | 7.0 | 0.6 | 2.9 | 4.4 |
| Unemployment | % | 9.6 | - | - | 28.4 |
| Foreign direct investment | % of GDP | 6.9 | 4.9 | 7.1 | 7.6 |
| Export growth | % | -1.7 | 19.3 | -7.3 | -3.5 |
| Import growth | % | -2.9 | 15.1 | 3.8 | 13.0 |
| Current account balance | \$ mn. | -19.6 | -51.7 | -117.1 | -589.6 |
| Public debt | \$ mn. | 960.6 | 922.5 | 1037.3 | 1272.4 |
| External debt | \$ mn. | 1969.7 | 1842.3 | 2003.9 | 2888.1 |
| Total debt service | % of GNI | 4.6 | 2.7 | 2.3 | 2.0 |
| Cash surplus or deficit | % of GDP | -0.8 | -1.0 | -0.3 | -0.6 |
| Tax Revenue | % of GDP | 14.0 | 14.3 | 14.4 | 16.0 |
| Government consumption | % of GDP | 10.2 | 10.6 | 10.1 | 10.2 |
| Public expnd. on edu. | % of GDP | 2.5 | 2.7 | 2.7 | - |
| Public expnd. on health | % of GDP | 1.7 | 1.8 | 1.9 | - |
| R&D expenditure | % of GDP | 0.2 | 0.2 | 0.2 | 0.2 |
| Military expenditure | % of GDP | 2.7 | 2.9 | 2.9 | 3.0 |

Sources: The World Bank, World Development Indicators 2009 | UNESCO Institute for Statistics | International Labour Organization, Key Indicators of the Labour Market Database | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security.

7 | Organization of the Market and Competition

Over the last two years, the foundations of a market-based, competitive economic system have continued to develop and strengthen, as can be seen in the steady growth of the private economy, which accounts for over 80 percent of GDP. Armenia is consistently rated as having one of the most “open” economies among the former states of the Soviet Union, and it is praised for its positive trade and

Market-based
competition

investment policies as well as its lack of restrictions on capital. However, over the longer term, the country will face a serious problem related to the powerful influence of several commodity-based cartels and monopolies, which restrict free trade and market-based competition.

In terms of economic monopolies and cartels, the Armenian government has fallen woefully short in terms of preventing the rise and dominance of informal commodity-based monopolies and cartels. To date, while the state 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 as well as by a few powerful groups of Russian investors. Many of the economy's commodity-based sectors, as well as the energy and banking sectors, have become closed areas controlled by informal alliances between the political and commercial elites.

Anti-monopoly
policy

Despite having one of the most advanced regulatory systems among the states that were once part of the Soviet Union, Armenia still needs to improve transparency. As things now stand, 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.

Although it has a liberalized trade regime, Armenia's economy still has some very serious vulnerabilities. Despite the relative "incubation" of the economy thanks to its closed borders and limited links to the broader global economy, these vulnerabilities are rooted in Armenia's inherent structural fragility, which is composed of three elements: its dangerous dependence on the influx of remittances from Armenians working abroad; its narrow reliance on the country's service, commodity and construction sectors as the main drivers of economic growth; and, most distressing, its closed "oligarchic" economic network centered on several informal commodity-based cartels and semi-monopolies.

Liberalization of
foreign trade

For the past two years, the Armenian banking system has continued to stand out as the one sector that is most 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 (e.g., total assets are still well below 20 percent of GDP), the infancy of capital markets and their need for greater transparency and regulation.

Banking system

Although there have been some advances in terms of strengthening creditor rights, improving banking supervision and increasing the minimum capital requirements for existing banks (from the current level of \$2 million to \$5 million), there is still a lack of adequate corporate governance. However, there are plans for reform measures aimed at redefining both the separation of duties and rights of

shareholders, boards of directors and executives of banks as well as at enhancing creditors' rights by improving the efficacy of court procedures and enhancing the registration system for secured lending.

8 | Currency and Price Stability

Although Armenia's Central Bank has strictly adhered to a policy of maintaining fiscal discipline and has followed prudent monetary policies aimed at ensuring macroeconomic stability, there are still some unresolved problems. Driven by stronger economic activity, money demand has steadily increased, and a flexible exchange rate regime has been important for mitigating the adverse impact of external shocks. Over the past two years, a questionable appreciation of the national currency (the "dram," or AMD) has raised questions about how appropriate it was for the state to intervene in supporting the value of the currency well beyond normal market considerations. This move has resulted in the dram's appreciation of more than one-third in nominal terms against both the euro and the U.S. dollar, which has weakened external competitiveness and seriously impacted a large segment of the population, which relies on dollar-denominated remittances for basic living expenses.

Anti-inflation /
forex policy

In terms of longer-term macro-stability, the Armenian economy is already facing a new challenge from the global financial and economic crisis, which has already led to a sharp decline in remittance flows, a sudden downturn in the country's mining sector, which has prompted the loss of several thousand jobs, and a dramatic reduction in the level of Russian investment in the construction industry. At the same time, as of the January 2009, the country's trade deficit has soared to a massive \$3 billion, which represents an increase of some 29 percent and is largely driven by a surge in imports and a continued fall in exports.

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 Armenia's transformation, although it was marred by incidents of privileged control and corrupt practices, which partially co-opted the efficacy of the overall privatization program. The government has continued to make progress by reducing state interference in business formation and strengthening property rights.

Property rights

Armenia has a flourishing private sector that has further expanded over the last two years. The Armenian government has also recognized the role of the private sector as the engine for sustained growth and has improved the business environment by

Private enterprise

reducing regulations, improving the bankruptcy law and the administration of customs, as well as strengthening the banking system, though burdensome bureaucratic procedures still tend to hamper private sector commerce.

10 | Welfare Regime

Although the state provides the basic elements of a social safety net, the general over-dependence on external remittances and the related problem of a serious appreciation in value of the national currency (which, in turn, lowered the value of the most common form of the remittances, i.e., the dollar, euro and ruble) have reduced the value and adequacy of the social safety net for most families. Structurally, social assistance in Armenia is based on the provision of limited cash benefits (based on a system of targeting along regional, community and indicator lines) as well as some limited state subsidies for energy (e.g., the “lifeline” utility tariffs). Social insurance (e.g., unemployment and pension pay) are both flat-rate benefits.

Social safety nets

Over the last two years, the problem of overall inequality of opportunity in Armenia has worsened. 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 for doing so. Moreover, the return of a significant number of migrant workers after the onset of the economic crisis in Russia has exacerbated the lack of economic opportunity.

Equal opportunity

11 | Economic Performance

Following the launch of economic reform, the Armenian economy has posted an impressive record of double-digit economic growth over the last seven years. This growth has been accompanied by low inflation and an increasing level of real per capita income. Real GDP grew by 14 percent in 2005 and by over 13 percent in 2006, which makes Armenia one of the fastest-growing former Soviet states. Investment also continued to expand, and there was a substantial expansion of the private sector, which currently accounts for over 80 percent of GDP.

Output strength

Still, there are structural limits to sustaining this output strength, as the global economic crisis now threatens to contract and constrict economic activity as well as reduce investment flows. The Armenian government’s first response to the crisis was neither to step up the fight against corruption nor even to tackle the deeply rooted problem of low tax collection. Instead, Armenia turned to outside sources for urgent help. In late January 2009, the World Bank announced that it would more

than double its loans to Armenia over a four-year period. That one decision will increase World Bank lending to Armenia from \$220 million to at least \$525 million, which will come in the form of low-interest loans between 2009 and 2012. In addition, the World Bank has also promised to consider supplying even more aid through its commercial affiliates.

12 | Sustainability

Over the last two years, the Armenian government has continued to demonstrate that it recognizes the importance of taking environmental considerations into account as part of its overall reform program. The government identified a number of specific concerns related to the overexploitation of natural resources, such as the depletion of water resources, erosion of soil and degradation of biodiversity. The Armenian Constitution also mandates that the state protect the environment and ensure the rational use and exploitation of natural resources. Despite having generally recognized the need for environmental regulations, there has been a noticeable trend of preferring policies that promote growth over those that foster conservation.

Environmental
policy

Armenia's primary obstacle to developing its education and R&D sectors stems from three main factors: 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" during the early to mid-1990s. The decline in state investment in education has led to a decline in the overall quality of Armenian education. Nevertheless, Armenia has succeeded in maintaining its system of universal basic and secondary education. Enrollment rates in both of these are still high, and over 99% of the population is literate.

Education policy /
R&D

Although R&D has long been recognized as an area of strategic importance in Armenia, annual state funding for it has rarely surpassed a ceiling of 1 percent of GDP. The government has created a Research and Innovation Strategic Plan focusing on the following sectors: information and communication technologies (ICT), life sciences, food security and quality, environment and energy, and nanotechnology. The IT sector has also attracted some investment and continues to serve as a strategic priority for the state.

Transformation Management

I. Level of Difficulty

Since the collapse of the Soviet Union and its independence, Armenia has struggled to forge new institutions of statehood and to overcome a daunting set of economic, political and social challenges. For Armenia, the course of economic and political reform has been especially difficult since it has had to weather the effects of a severe earthquake, a war with neighboring Azerbaijan and the imposition of a virtual blockade. Likewise, Armenia still faces serious challenges, including incomplete democratic reform and uneven economic development. Yet overall, it is Armenia's lack of overall good governance that continues to be the fundamental obstacle for the political and economic transformation of the country.

Structural
constraints

Over the last two years, the Armenian government has been unable to sustain its traditional reliance on economic growth as its sole source of legitimacy. As a result of internal weakness brought on by a lack of popular support, and faced with an unresolved domestic political crisis, the Armenian authorities have been unable to manage the country's structural fragility. Likewise, entrenched corruption and incomplete reform now threaten the economic system itself and raise doubts as to whether Armenia can sustain itself in the face of mounting challenges.

Armenian civil society is generally constrained by the state's failure to engage it in a constructive dialogue or to grant it a role in debating or formulating public policy. There is also a second challenge, which stems from a demonstrable lack of equal opportunity. While there is now a greater number of civic and non-governmental organizations (NGOs) dealing with a wider range of issues, only a handful of these organizations operate with any consistency.

Civil society
traditions

The post-election crisis in Armenia, which saw a wave of demonstrations and public protests, has made two things clear. First, the post-election crisis in Armenia is far from over, and – no matter what some of the Armenian authorities may want or claim – there is no chance of going back to the pre-election status quo ante. Second, the crisis revealed and confirmed the growing level of discontent, frustration and anger over the mounting inequalities and disparities in wealth and income (and, therefore, power) in today's Armenia. Lastly, the crisis and the level of popular discontent it has awakened continue to put more and more pressure on Armenia's government.

There is no real evidence of ethnic, religious or social conflict within Armenia. Nevertheless, over the last two years, there has been a new “crisis of confidence,” which has eroded confidence in the government and led to a political crisis unprecedented in Armenia’s recent history. Under these circumstances, the Armenian government’s most basic impediment stems from a distinctly new political context, which has seen the population emerge from years of apathy to voice fresh and strident demands for change. This is at least partially rooted in the opaque nature of the Armenian political system, in which dissent is seen as a direct threat to the state rather than as the mark of a healthy democracy. Within such a closed political system, the lack of any mechanisms for expressing political discontent only exacerbates underlying tensions. This means there can be no return to the pre-election status quo ante, as the Armenian people have expressed a new sense of empowerment.

Conflict intensity

II. Management Performance

14 | Steering Capability

Already weakened by a pronounced lack of legitimacy and a prolonged political crisis of confidence, the Armenian government is facing a new challenge in the form of the global financial and economic crisis. Against this backdrop, the current Armenian government faces a number of external challenges, ranging from a decline in remittances from Armenians working abroad to an economic downturn that seems to only be getting worse and will pose serious challenges to Armenia’s economy.

Prioritization

Even more destructive for Armenia’s long-term economic health is the unique set of internal problems associated with the distortions of its economic system. These problems include deficiencies in tax collection, an inadequate customs regime, an artificial “bubble” in the real estate market and insufficient job creation. But the deeper danger stems from structural shortcomings and the facts that economic growth is overly reliant on limited sectors (e.g., the service industry and diamond-polishing) and economic survival is overly dependent on money coming into the country from abroad.

Although Armenia has established the basic framework for a modern market economy and has demonstrated a significant degree of sound macroeconomic policies, their sustainability now depends on carrying out the next generation of reform. What is specifically crucial to overall sustainability is a greater degree of

Implementation

political commitment to the implementation of these reforms as well as one that is capable of withstanding short-term political tendencies and temptations in pursuit of strategic economic development and reform. The two most glaring areas in need of further reform are the banking sector and the social sector, both of which need policies designed to correct the widening disparities of income and wealth. A related element here would also encompass improvements in the judicial sector that would foster greater efficiency and effectiveness in enforcing contracts and regulating commerce.

One of the most startling lessons from the past two years is the fact that, as it now stands, the Armenian state can no longer maintain its current economic system. Weathering the ongoing economic crisis will require ending the state's reliance on the twin evils of corruption, on the one hand, and oligarchic cartels and monopolies, on the other. Faced with an already visible shortage of political legitimacy, the Armenian state can no longer sustain the closed economic system that has deformed and distorted the country in recent years.

Policy learning

15 | Resource Efficiency

Although the Armenian government has developed a fairly effective resource base and has made some gains over the past two years by implementing broad civil service reforms, the state must now more efficiently use a new generation of dedicated and qualified personnel. To date, the fundamental shortcoming in resource management has centered on both the lack of a meritocracy, which has seen positions and benefits go to those with connections, and an inadequate pay scale, which has fostered a system of cronyism that only reduces the state's ability to effectively utilize its resources.

Efficient use of assets

During the period under examination, one of the most glaring deficiencies in policy coordination has been the lack of a coherent government policy in the face of a new domestic political crisis and the onset of serious external economic pressures. For the Armenian authorities, the past two years have only reaffirmed the overwhelming need for "good governance," including transparency, ethics, accountability and competent administration. The current crisis highlights the urgent need for such reforms.

Policy coordination

Recent shortcomings in Armenia's anti-corruption policies have been most clearly demonstrated by the powerful role of Armenia's small, wealthy political elite, that is, the so-called "oligarchs," who not only exercise commercial and economic power through commodity-based cartels and virtual monopolies, but have also acquired political power by serving as parliamentary deputies. Left unchecked, their wealth and political power only breeds further corruption, threatens democratization and the rule of law, and allows them to further consolidate and protect their informal networks of power.

Anti-corruption
policy

Corruption in Armenia represents a significant impediment to both equitable economic development and good governance. Over the longer term, corruption weakens the state and its institutions by undermining the already meager degree of state legitimacy and public trust as well as by limiting the government's financial capacities by lowering essential tax revenues. While the shortfall in tax collection and other corruption-related activities impose inherent limits on state funding for strategic social programs (e.g., education, health care and pensions), they also strain the government's capacity to meet its even more immediate budgetary obligations and normal operational needs.

Thus, the now obvious link between economics and politics in governance is affirmed by the tendency to implement (or distort) economic reforms that are based on political considerations or vested interests. Although this linkage is a natural feature of many countries, in the case of Armenia, the combination of a closed political system, a lack of effective systemic "checks and balances," and the weak and arbitrary rule of law expose economic and political reform to even greater pressure and undue political influence.

16 | Consensus-Building

While the need for consensus in Armenia is greater than it ever has been, the widening polarization in politics, which is defined by a newly united political opposition and an increasingly unpopular government, makes such consensus even harder to attain. The authorities' capability to forge even the most basic consensus is further challenged by the socioeconomic divide between the country's small, wealthy oligarchic elite and a much larger population inhibited by limited economic opportunity and endowed with even less political power.

Consensus on goals

Although there are 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 type of actor capable of confronting the reformers outside of the confines of the existing system.

Anti-democratic
veto actors

Over the last two years, Armenia has witnessed an unresolved political crisis rooted in the polarized deadlock between the authorities and the opposition. This deadlock is primarily characterized by an unpopular government, which stubbornly refuses to recognize the country's new political reality, and an opposition movement, which seems devoid of any clear policy alternatives. For the government, a lack of legitimacy and an absence of any popular mandate have only exacerbated its tendency to favor authoritarian rule over accountable governance, and they have reinforced a myopic view that sees dissent only as a direct challenge to its authority. Similarly, the opposition movement, which is united behind a broad but disparate coalition led by former President Levon Ter Petrosian, has done far too little to offer any real alternative while voicing its strident criticism of the government.

Cleavage /
conflict
management

In the wake of a domestic political crisis, the Armenian state has only become more resolute in its refusal to engage civil society. This position is also rooted in the opaque nature of the Armenian political system, in which dissent is seen as a direct threat to the state rather than the mark of a healthy democracy. Within such a closed political system, the fact that there is no mechanism for expressing political discontent only exacerbates the underlying tensions.

Civil society
participation

In the absence of any attempt to forge a new national dialogue, reconciliation remains unlikely. But with neither the authorities nor the opposition seeking to enter into a dialogue, the political crisis will most likely remain unresolved and, therefore, continue. However, this clash might lead to a stalemate that can only be resolved by the emergence of a new sense of reconciliation, which could in turn bring about a period of unprecedented change.

Reconciliation

17 | International Cooperation

Over the last two years, Armenia has continued to use outside support and sustain its record of international cooperation. These stem from its economic ties with its diaspora and international institutions as well as its role as a leading recipient of foreign assistance. Yet, at the same time, Armenia has faced a new difficulty in overcoming the linkage between domestic political instability and economics. This was further demonstrated by the decision in December 2008 by the U.S. Millennium Challenge Corporation (MCC) to maintain its suspension of \$236.5 million in economic assistance on the grounds that the Armenian government had failed to address its concerns about the country's "status of democratic governance." The decision followed a similar move in May 2008, when the latest installment in the five-year Millennium Challenge Account (MCA) program was frozen in the wake of Armenia's post-election political crisis.

Effective use of
support

Although Armenia's credibility suffered a serious blow after its handling of the post-election crisis in 2008, it has still managed to secure some help with which it can respond to the global economic crisis. In January 2009, Armenia was able to persuade the World Bank to more than double its loans to the country over a four-year period, which increased World Bank lending to the country from \$220 million to at least \$525 million, which came in the form of low-interest loans between 2009 and 2012. In addition, Armenia has also turned to Russia for help and secured a \$500 million "stabilization credit" to help it deal with the initial impact of the global crisis. However, such external aid is not a cure-all for Armenia's economic woes. For example, the funding is to be used to support the Armenian government's ambitious plans for infrastructure projects and to offer small and medium-sized businesses greater and more favorable access to credit from Armenian commercial banks. The problem with this is that even the jobs that the infrastructure projects may create will not be available for at least several months, which offers little to people in need of immediate help. Likewise, with Armenian laborers already returning to Armenia from Russia, the number of unemployed workers competing for those new temporary jobs will be even higher.

Credibility

In terms of Armenia's cooperation with neighboring countries and regional organizations, there has been no real change in the last two years. Although Armenia seeks greater cooperation, the unresolved conflict regarding the landlocked and blockaded Nagorno-Karabakh region has led to frozen relations with both Azerbaijan and Turkey and continues to be the core obstacle to regional cooperation. The conflict has further isolated Armenia, which would like to restore and normalize regional trade and transport links. However, there is some hope that there can be a breakthrough in Armenian-Turkish relations, which, if successful, would open the long-closed border between the two countries.

Regional
cooperation

Strategic Outlook

Although more than a year has passed since the outbreak of a significant political crisis in Armenia, the country's chances of attaining long-term stability seem as remote as ever. Triggered by yet another flawed election in February 2008, Armenia's domestic political crisis remains far from resolved. Lingering discontent among a much less apathetic population and the government's lack of legitimacy has led to a serious crisis of confidence that only magnifies the country's already pronounced deficit of democracy.

Moreover, the political crisis of 2008 is only a symptom of a much deeper and more troubling impediment to democratic reform in Armenia. More specifically, Armenia's unresolved political crisis stems from a polarized stalemate between the authorities and the opposition. The main features of this deadlock are an unpopular government, which stubbornly refuses to recognize the country's new political reality, and an opposition movement, which seems devoid of clear policy alternatives.

However, the roots of the population's anger and frustration are not only to be found in the politics of selection over election and the fact that it is denied any choice or voice in politics. They are also to be found in the years of widening disparities in wealth and income as well as in a pronounced lack of economic opportunity and, therefore, hope in the future. Unlike it is in other countries, the division between the small, wealthy oligarchic elite in Armenia and the much larger, much poorer general population is obvious, omnipresent and ubiquitous.

This undercurrent of economic discontent is only increasing, especially as the Armenian authorities are now facing the onset of the effects of the global financial and economic crisis. Likewise, although Armenia's record of economic reform in recent years has been fairly impressive, it still does not suffice to sustain and improve the overall situation. Indeed, one of the more negative aspects of Armenia's economic reality is the "paradox" of economic growth, whereby several years of double-digit economic growth have resulted in an uneven or only partial sharing of both wealth and higher living standards among the overall population. Moreover, widening disparities in wealth and income have only led to a widening and worrisome socioeconomic divide.

The most serious obstacle facing Armenia's democratic development, however, is rooted less in either the authoritarian government or the marginalized opposition but, rather, in the structural deficiencies of the Armenian political system. Moreover, the lack of legitimacy and the absence of a popular mandate have only revealed the deeper flaws in the political system itself, including its weak rule of law, its compliant judiciary and its ineffective parliament. Most crucially, these structural flaws demonstrate that the current political system is incapable of sustaining itself in the face of mounting pressure from an unresolved political crisis and a lingering crisis of confidence. This also means that the only viable avenue toward true, sustainable democratic

development in Armenia is through reforming and forcing open the inherently closed nature of the country's political system.

Thus, in order to attain lasting gains in the political and economic transformation of Armenia, the current imperative is to focus on overcoming the internal threats to statehood, which range from a need for leaders who govern rather than simply ruling to an imperative to defeat the "cancer of corruption." Under these circumstances, legitimacy is the key determinant of durable security and stability, as the region's strategic reality is defined more by local politics and economics than by geopolitics. But the most crucial lesson is that, for real democratization, institutions matter more than individuals.