

Armenia

Status Index (Democracy: 5.20 / Market economy: 6.43)		5.81	Management Index		4.93
HDI	0.759		Population		3 m
GDP p. c. (\$, PPP)	3,671		Population growth¹		0.3%
Unemployment rate	n/a		Women in Parliament		5.3%
UN Education Index	0.90		Poverty²		n/a
			Gini Index		37.9
Source: UNDP: Human Development Report 2005. Figures for 2003 – if not indicated otherwise. ¹ Annual growth between 1975 and 2003. ² Population living below \$ 1 (1990-2003).					

A. Executive summary

Since gaining independence in the wake of the fall of the Soviet Union, Armenia has struggled with a daunting set of fundamental economic and political challenges. The course of Armenia's transition to a market economy and a pluralistic democracy has been particularly difficult in recent years, and the country has also been hindered by the constraints inherent in its unresolved conflict with neighboring Azerbaijan over the Armenian-populated enclave of Nagorno-Karabakh. The conflict has led to a long standing economic and transport blockade of Armenia by Azerbaijan and Turkey. For landlocked Armenia, this east-west blockade has exacerbated its isolation by excluding it from several major opportunities of regional integration and development.

In addition, Armenia is seriously challenged by significant internal problems. The Armenian state is weakened by the internal impediments of corruption and a mounting internal instability stemming from a political confrontation between the ruling government and a largely fractured group of opposition political parties, demonstrably heightened during presidential and parliamentary elections in February and May 2003. This political confrontation is further exacerbated by the rise of a new, wealthy political elite, so-called "oligarchs" who have managed to secure seats in the new Armenian parliament and who now threaten to gain serious influence in the formulation of public policy and may indeed garner substantial leverage over the course of governmental policies.

The priority issue in Armenian politics is the question of presidential succession. With the current president prevented by the constitution from seeking a third term in the looming presidential election in 2008, there are two similar dynamics underway featuring competition among the ruling elite for selection as the elite's chosen candidate and among the opposition for their chosen opponent.

Although the Armenian economy continued to post positive growth through this period, the country's widening economic inequality and income disparity also continued to expand. Although the official percentage of Armenians judged to be living at or below the official poverty line has declined slightly, to under 50% of the population, the long-term impact of such widespread poverty seriously threatens the country's overall development and potential for sustainable growth. There is also a serious and unresolved challenge posed by the combination of a lack of a resilient institutionalized democracy and a weakened rule of law that threatens to undermine and, perhaps, derail much of the course of Armenian economic and political reform.

B. History and characteristics of transformation

As with all states of the former Soviet Union, Armenia suffered a profound and abrupt decline in output following independence in 1991. Armenia's real GDP fell by more than 50% in the initial period of 1991-1993. Once this early phase of economic shock stabilized, the Armenian economy began to slowly recover, posting positive growth in 1994 and continuing this upward trend in resumed growth, averaging a healthy 5.5% from 1994 to 2002.

The transformation to a market economy was initiated in the early 1990s, with Armenia quickly emerging as one of the strongest reformers of the former Soviet states. Structural reforms were introduced, starting with a comprehensive privatization program and the establishment of a transparent legal framework for the development of an emerging private sector, with an early focus on opening the banking and energy sectors. During this early phase of transition, the well-educated Armenian workforce, many with specialized technical skills, played an important role and provided an important impetus for accelerating the reform program.

In 1994-1995, the Armenian government implemented a serious macroeconomic stabilization program that yielded a reduction in inflation from four-digit to two-digit levels. Macroeconomic policies have successfully bolstered the value of the national currency, the Armenian dram, and helped to stabilize the economy against two major shocks: the 1998 Russian financial crisis and the political crisis from the assassination of the prime minister and parliamentary chairman in an attack on the Armenian parliament the following year.

Given the limitations of its geography and an absent natural resource base, the economic development of small, landlocked Armenia depends to a large degree on the normalization and restoration of regional trade and transport links that have been

disrupted for over a decade by an East-West blockade of the country (imposed by neighboring Turkey and Azerbaijan). Two key factors have helped to compensate for this limitation - the promotion of an open and liberal trade regime and the utilization of Armenia's most significant long term potential in human capital. This second factor, leveraging the human (and financial) capital of its large Diaspora, has resulted in a significant inflow of private remittances and official aid. These transfers have accounted for roughly 11% of Armenian GDP for 1995-2000, with more than 50% of this coming from private remittances from the Diaspora alone.

The main challenge to Armenia's transformation centers on the imperative to overcome and reverse, if possible, its severe demographic decline. With emigration having reached a disturbing ten-year level of a 20% decline in overall population, this Armenian "brain drain" greatly hinders the ability to leverage the country's full economic potential. It also exacerbates the already mounting social and economic divide between a small wealthy elite and a larger, impoverished segment of the population. It is this challenge that will undoubtedly preoccupy the Armenian leadership for the next several years. The very real promise of economic and social stability in Armenia will fundamentally rest on how the rather inexperienced Armenian leadership handles this challenge, with much of the population depending on a successful outcome.

C. Assessment

1. Democracy

1.1. Stateness

As the most homogeneous state in the region, the Armenian state is generally secure and stable. The concept of the state has been largely bolstered by an already strong sense of national identity, although this is not always a positive factor, given a marked tendency toward entrenched nationalism. The negative implications of this homogeneity and incidents of an overtly aggressive nationalism are not reflected in state policy, however, and are limited to the margins of society.

The state holds a strong, well-established and unchallenged monopoly on the use of force, which is also demonstrated by stable civil-military relations. With the Armenian armed forces completely subordinate to civilian state control and oversight, and becoming increasingly professional, there is no threat of internal unrest or politicization. The incorporation of all militia and paramilitary groups into the armed

forces following the cessation of hostilities with Azerbaijan during the Nagorno-Karabakh conflict has removed any challenge to the state.

With such a pronounced homogeneity, there is a general consensus on the issue of citizenship, with the only exceptions limited to small numbers of refugees from Nagorno-Karabagh and for a small number of Armenians from the diaspora seeking citizenship. There is little or no record of ethnic division or discrimination faced by the non-Armenian minority communities (Kurds, Russians and some Jews). In both theory and practice, all citizens share the same civil 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 uncontested separation of church and state, with no overt religious influence in 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 avoided partisan politics, a fact that tends to enhance its absence from political discourse in today's Armenia. There have been some cases of influence by Church officials during this period, although limited to urban planning issues stemming from the substantial land and property holdings of the Church.

Freedom of religion is not always fully protected under existing law, however, and is especially uncertain for non-traditional groups and sects such as the "Jehovah's Witnesses," with some subjected to harassment, sometimes violently. All churches apart from the Armenian Apostolic Church must register with the government, and proselytizing is forbidden by law. The government's policy toward conscientious objection is in transition, as part of Armenia's accession to the Council of Europe.

Armenia's record on discrimination toward the few ethnic and religious minorities is generally good. There is also a fairly healthy acceptance of Islam, with a mosque in the Armenian capital Yerevan standing as a manifest example of this tolerance. This positive attitude toward Islam can be readily explained by the centuries of good relations between Armenians and the Islamic world, and by the current dispersion of Armenian communities throughout much of the nearby Arab states (most notably Syria, Iran, Lebanon, Egypt and Iraq).

The country's administrative system remains highly bureaucratic and, as a result, often functions with pronounced bias and extreme inefficiency. The administrative infrastructure is, however, fairly extensive and well-developed and has been able to exercise unquestioned authority. 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 moderately weak rule of law, matched by a flawed system of law enforcement and a sometimes checkered record of justice, primarily in the less developed rural regions, but not excluding incidents in the major cities.

1.2. Political participation

On a general level, Armenia has the basic requirements for a functioning democracy. There is universal suffrage for all Armenian citizens above the age of 18, elections are held regularly and are fairly secure as the only avenue to power and leadership. Political groups and parties generally enjoy the right to assemble freely, and there is an expanding civil society.

Although the course of democracy in Armenia was marked by an initial period of popular support and optimism, this has been eclipsed in the past few years by a mounting trend of apathy and general discontent with the political process. Initially, the Armenian population was mobilized by the innovations of democracy. 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 democratic, multi-candidate presidential elections the following month.

These early achievements in Armenian democracy were quickly squandered, however, as the combination of a series of questionable privatization deals and the emergence of significant corruption fostered an atmosphere of distrust and disdain among much of the population. The governing Armenian political elite interpreted this mounting apathy as a situation to be welcomed, and not to be addressed, since it only encouraged a greater absence of accountability and transparency.

Another factor contributing to this retreat of democracy was the nationalist appeal from the conflict with Azerbaijan over Nagorno-Karabakh. The conflict served as a convenient distraction from the country's growing deficiencies in democracy and, perhaps most importantly, granted the political elite a degree of unearned legitimacy.

This further provided an opportunity to delay or even dismiss the imperatives of

institution building that was an essential precondition to a cementing of democracy in this period.

Thus, despite the emergence of a new nationalist alternative in Armenian politics, the 1990s was a decade of lost opportunity, as a small political elite garnered an effective monopoly on power and participation. This was matched by a political opposition that was confined to the margins of the political arena and already hindered by a narrow appeal, based on personality over political agenda.

Against the backdrop of the conflict with Azerbaijan over the Armenian-populated Nagorno-Karabakh region and a blockade imposed by both Azerbaijan and Turkey, a more entrenched variant of militant nationalism was used by the state to deflect any direct confrontation or challenge. This also gave rise to an increased tendency of exercising power through the threat of political violence, and the use of extralegal and arbitrary rule.

With the election of President Robert Kocharian in March 1998, however, the downward trend in Armenian democracy gradually abated. Having come to power in the wake of the forced resignation of former President Levon Ter Petrosian, Kocharian sought to establish a new perception of government, and brought in a new political elite. Although both the presidential and parliamentary elections of 1998 and 1999 respectively failed to fully meet international standards, they did represent an improvement in terms of both fairness and efficiency.

Such shortcomings in Armenian democracy continued in the two-round presidential election of February and March 2003, and were further evident in the May 2003 parliamentary elections, each of which garnered criticism by the United States, the Organization for Security and Cooperation in Europe (OSCE) and other international observers. The 2003 election period served to only solidify the divide between the government and the opposition and bolstered a degree of public apathy and distrust of the political process.

The Armenian government governs from a powerful political base and is largely free of undue or improper influence from outside actors. The election of a significant group of wealthy businessmen, so-called “oligarchs,” in the 2003 parliamentary election has led to the emergence of a new political power center, endowed with a potential for influencing and obstructing the formulation of public policy. Elected to the parliament as candidates in single-mandate constituencies, this new power base has been able to leverage its wealth and connections to the ruling elite. Generally supportive of the government, these oligarchs have yet to oppose government policy,

but have garnered a disturbing degree of political power and influence. With little or no ethics legislation, a lack of accountability has allowed them to operate with relative impunity.

The politicization of these oligarchs, as seen by their election to parliament, is a matter of concern. This suggests that this powerful class of businessmen has discovered the utility of the parliamentary immunity offered to deputies, an important consideration for many businessmen with questionable ties and investments. Moreover, these new Armenian politicians cum businessmen have demonstrated an appreciation for using political power to maximize their links to the expansive shadow economy, which has already assumed an entrenched position within the Armenian economy.

This trend may suggest even greater cooperative relations between the oligarchs and President Kocharian and his cabinet in pursuit of short-term profit. This cooperation will be seen in the next stage of the country's privatization program and, even more damaging in the longer term, an acceleration of the "assets-for-debt" arrangements with Russia, whereby an increasing number of Armenia's relatively few strategic assets and resources are transferred to Russian ownership and control.

In many ways, the incorporation of this new elite into the government and political system has actually served to contain and constrain the power of the business interests, thereby, helping to co-opt the threat posed by such special-interest power.

There is a second, less likely danger that the military may emerge as a power center of its own, however only if internal political tension escalates beyond the parameters of democratic discourse or in the event of a renewed conflict with neighboring Azerbaijan. This potential for military power is rooted in the popularity and stability of the armed forces, coupled with its self-perception of a role as defender of the constitution. Yet this danger is largely dependent on the emergence of extraordinary events.

The role of independent political and civic groups is generally accepted and tolerated, although the effectiveness of such non-partisan organizations is inherently limited by the overwhelming power of the authorities. The state has, at times, exerted severe pressure on such groups, by preventing or forcibly disrupting public rallies and demonstrations. Although this pressure has largely been concentrated against the political opposition, several smaller independent political groups and civic organizations have also suffered from a rather indiscriminate crackdown by the authorities.

There is a wide range of civic and non-governmental organizations (NGOs). As of 2003, there were nearly 3500 NGOs officially registered, dealing with a wide range of issues including human rights and women's rights, health care, peace and conflict resolution, and the environment. However, the NGO community and civil society organizations remain largely marginal in terms of impacting society on a serious scale, and public participation in consultation and decision-making processes is minimal at best.

Moreover, 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.

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. 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. There are, however, some notable exceptions to this timidity, offering some hope for the development of a more effective and resilient media in the near future.

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. This problem has become even more serious since the closure of the country's largest independent, privately owned television station, A1+, in April 2002. There has been a series of high profile murders and assaults against journalists, although accompanied by a notable decline in such occurrences in 2003 and 2004.

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 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.

1.3. Rule of law

Some of the most pressing challenges facing Armenia stem from serious structural deficiencies in governance and the rule of law. These structural deficiencies are reflected by the absence of any real balance between the branches of government in Armenia. Consequently, the country's system of operational checks and balances in government is ineffective and without adequate support, remains vulnerable to manipulation.

The parliament adopted a set of government-drafted constitutional amendments in April 2005, which are still subject to a national referendum. After pressure from the Council of Europe, the government proposed to correct this imbalance through constitutional amendments that would decrease the power and authority of the executive branch. Although there is a degree of an important lessening of the power of the presidency, the scope and scale of the proposed changes remain insufficient to effectively restore a balanced multi-level system of governance. The lack of any real equilibrium among the branches of government remains a structural challenge and is a prerequisite to further political reform and democratization.

The executive branch is 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. In reality, however, the Armenian judiciary is hostage to the will of the executive branch and is directly affected by widespread corruption. The judiciary is subject to a further degree of intimidation and outright control, through direct appointment of judges by the executive. Specifically, although the judiciary is formally independent of the executive and the legislative branches, the president appoints four out of nine judges of the Constitutional Court and presides over the Council of Justice, which in turn makes recommendations on judges' appointments.

There is also a serious lack of accountability in governance, commonly stemming from a general lack of political penalties for public officials who abuse their positions, an essential deterrent in the fight against corruption. Instead, the lack of prosecution for abuses of power has helped to create a more permissive environment allowing for the spread of institutional corruption. Several high profile cases of such abuse during this period have fostered a general perception that the government rules with an “arrogance of power” and from a disregard for the general population. Positions within the state apparatus are also seen more as avenues toward personal power and profit than as opportunities for public service.

Civil liberties and human rights are not seen as primary issues of concern in Armenia, although there have been isolated incidents that have attracted international attention. There have been cases of torture and mistreatment by state officials, albeit isolated cases without any evidence of a systemic pattern or practice, as well as the imprisonment of conscientious objectors to compulsory military service. Despite some improvement in the enforcement of civil liberties through this period, the fundamental shortcomings posed by corruption and an absent rule of law have combined to marginalize the impact and extent of such gains.

1.4. Stability of democratic institutions

Adopted in July 1995, the Armenian constitution established a system of governance based on the division of power between the executive and legislative branches. Executive power is personified in the presidency and is implemented by the prime minister, who is directly appointed by the president, and the cabinet, which is appointed by the premier. The legislative and oversight powers are held by the 131-seat parliament (National Assembly) and by an independent Constitutional Court.

The current system of government reflects the 1995 constitution that established the relationship between the president and the parliament, with the balance of power in favor of the directly elected President. In reality, the strong executive also clearly dominates the other two branches of government. This is due in large part to an over-concentration of powers in the presidency, but can also be traced to the ineffectiveness of the legislature and the rather subordinate and submissive judiciary. Despite this structural imbalance, there is a record of cohesion and cooperation among state institutions and agencies in the implementation of government decisions and policies. There is also a demonstrable lack of friction or even competition in this performance.

The head of state is the president of the republic and is directly elected to a five-year term. Currently, President Robert Kocharian is in his second term as president, after securing re-election in a two-round contest in February-March 2003. Administratively, Armenia is divided into ten regions (a region is known as a *marz*), including the capital Yerevan that holds status as a separate *marz*. The regions are run by governors (*marzapets*) appointed directly by the president, although local governments are elected.

Although there is an impressive degree of overall institutional stability in Armenia, the country's disturbing trend toward authoritarian rule stems in large part from the structural composition of Armenian governance. Institutionally, Armenia resembles the Russian model, marked by a dominant executive, a compliant judiciary, an ineffective parliament with much less power, and a restricted and intimidated media.

The noted institutional stability in Armenia has survived a substantial challenge, however, suggesting a deeper resiliency capable of overcoming the trend toward authoritarianism. This institutional stability is most clearly demonstrated by the system's ability to manage the crisis of the October 1999 attack on the Armenian parliament by armed gunmen that resulted in the killings of several senior government officials. Fortunately, this proved to be nothing more than a violent aberration in the generally steady course of Armenian democratic development.

The sole exception to a general recognition of the democratic credentials and legitimacy of the institutions of government is seen in the opposition's campaign to force the resignation of the Armenian president and in its boycott of parliamentary sessions. But this is more a political strategy in response to the tainted elections of 2003, rooted in an attempt to gain power, rather than as any reflection of illegitimacy.

The relevant social actors such as political parties, the military and even most civic associations all share an acceptance of and more or less support Armenia's democratic institutions, although political and legal integration with society is somewhat constricted by the stifling effects of the socioeconomic and political divide in the country.

1.5. Political and social integration

There is a stable party system with a number of parties representing a fairly broad spectrum of political ideologies and social issues. All share a respect for the

democratic process and have followed a civil course of debate and dialogue with no incidents of violence or aggression.

A notable example is the prominent role of such parties as the Armenian Green Party, which advocates an environmental agenda with issues of social justice. There are also new networks of interest groups, such as human rights and media “watchdog” groups that have contributed to a deepening of civil society.

With no party structure or organization, Armenian President Kocharian has ruled from a powerful, yet narrow power base comprised of oligarchs and influential power brokers. This reliance on a powerful elite has led to an increasingly authoritarian, clan-based rule that has done little to strengthen democratic institutions or the rule of law. This has allowed a clan-based network of power to emerge, with the potential to eventually counter the traditional political party system.

The great divide in Armenian polity is now defined not by the government and the opposition, but by a small group of powerful elite against a much larger but powerless and economically less secure segment of civil society. This divide has only solidified the apathy and discontent of the general population that threatens to fuel a much more dangerous and volatile period of potential instability.

The Armenian population is strongly committed to democracy, despite a high degree of apathy. Public opinion has largely weathered the political competition between the government and the opposition. Ironically, the public is more committed to the constitutional system than most of the political parties.

The dominant political question in Armenian public opinion is the question of presidential succession, as the current president is unable to seek a third term in 2008. The public is increasingly attentive to the dynamic competition among the ruling elite and within the opposition that will result in the emergence of a main candidate for each camp. It is precisely this public attention that will help to ensure that the competition for electoral power does not exceed the limits of the existing institutionalized democratic processes. This also contributes to the country’s fundamental stability and offers some potential for a stronger civil society.

Armenia’s trend of civic self-organization has strengthened during this period, but remains impeded by a general sense of marginalization and apathy. Despite a pronounced commitment to democracy and loyalty to the constitution, the population suffers from the cumulative effect of being disenfranchised from the real practice and process of political power.

There is a related limitation to civic activity and organization, stemming not from a lack of trust or freedom, but from an overriding importance of economic considerations. The need to provide direct family support within a broader context of labor market problems and widespread poverty has fostered a decline in newspaper circulation, a lessening of political involvement and an unwillingness and/or inability to devote time and energy to civic efforts.

2. Market economy

2.1. Level of socioeconomic development

The successful macroeconomic stabilization program and introduction of a broad spectrum of structural measures since 1994 led the way to sustained economic growth. Nonetheless, the Armenian economy continues to face some formidable challenges: per capita income remains low by international standards; rates of unemployment are high, the financial system remains rudimentary, and domestic savings and foreign investment need to increase significantly to maintain an ailing infrastructure and provide for solid long-term growth.

The proportion of the population living below the official poverty line has steadily declined, from 56% in 1998-1999 to 49% in 2001-2002. According to government estimates, poverty has been even further reduced, to roughly 43% of the population. There is a significant degree of regional disparity in poverty, however, and unemployment is a continuing problem. Although official figures report a national unemployment rate of around 10%, the findings of several household surveys actually place the figure much higher, at between 25-30%, with a sizable level in rural areas of the country.

Given the complex nature of these problems, vigilance is required to sustain the momentum of recent fast growth and to maintain macroeconomic stability. Achieving faster and broader-based growth require improvements in public sector governance, which could be implemented through capitalizing on the nation's skilled labor force, and the human, intellectual, and financial potential of the Armenian Diaspora.

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.

The Armenian government adopted a Poverty Reduction Strategy Paper (PRSP) in August 2003. Based on a projected real GDP growth rate of 6% over the medium term, the strategy focuses on redistribution issues, and addresses sustainability and the sources of future economic growth. Job creation among new small- and medium-sized business is the core element in the strategy to meet poverty reduction targets, but there is added emphasis on public sector improvements and greater budget priority and spending on education and social programs.

2.2. Organization of the market and competition

The foundations of a market-based, competitive economic system are steadily consolidating in Armenia. Armenia is endowed with the most open economy in the region, the most open to trade and investment policies of all former Soviet states, and presents no restrictions on capital. Over the longer term, the Armenian economy is poised to reap some of the benefits from globalization and integration in the world economy. These structural characteristics are important milestones in the course of economic reform and bolster the pro-market policies necessary to overcome the country's external blockade and the disruption of regional trade links.

There are, however, some significant obstacles to the development of an open and fair economy. State policy remains too focused on Soviet-era legacies of protectionism and favoritism, with key enterprises and strategic sectors of the economy (most notably the energy sector) receiving unwarranted subsidies and favored policies that impede competition.

Although Armenia has one of the most advanced regulatory systems in the former Soviet Union, there is still a need to improve transparency. The country lacks critical laws and effective enforcement, particularly in the area of anti-monopoly or anti-trust laws. This weakness is exacerbated by excessive state control over some key sectors of the economy. Although officially "open," the aviation, telecommunication and, increasingly, the energy sectors all maintain near monopolies that are difficult to overcome. A lack of adequate laws and measures to combat corruption often undermines free and fair competition.

Armenia has pursued a consistent course of market reform and trade liberalization for over a decade. Bolstered by Armenia's admittance to the WTO in 2003, trade liberalization has been a central focus of government policy. It was further recognized as a necessity in the face of Armenia's landlocked location and meager natural

resource assets. With a small share in world trade, in part reflecting a level of insufficient integration into global trade networks, Armenian trade is very concentrated, both on a sectoral and regional basis. This is confirmed by the trend in trade, as five principal trading partners account for 80 % of its total trade.

Although the European Union is Armenia's first import and export partner, accounting for some 38 % of total trade, EU bilateral trade with Armenia remains low. After the European Union, Russia and Israel are the country's second and third trading partners, accounting for 13 and 10 % of total trade respectively.

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 or quantitative restrictions on exports. Armenia's WTO accession process that started in 1993 was completed in 2002. The country currently has preferential trade agreements with a number of trading partners, including free trade agreements with Georgia, Kyrgyzstan, Moldova, the Russian Federation, Tajikistan, Turkmenistan and Ukraine.

As a result of the trade and transport embargo of Armenia by neighboring Azerbaijan and Turkey, Armenia continues to be excluded from the benefits of liberal and open trade with its neighbors. The impact of this closed regional trade regime continues to hinder the natural development of the Armenian economy. According to World Bank estimates, the disruption and closure of normal trade routes has imposed a cost of between 10 and 18 % of GDP in 2003. These economic losses for Armenia include direct costs of inflated transport and indirect costs stemming from a higher risk premium on foreign direct investment.

The Armenian banking system is in need of continued and deeper reforms. There are three obvious challenges inherent in the country's banking reform plan: the small size of the country's financial sector (total assets are under 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 and the Central Bank has amended its system of risk weights, making it consistent with Basel Committee recommendations under the standardized approach and tightened related-party exposure and large exposure limits. Further reforms include measures to expand financial intermediation, improve banking supervision, and increase the minimum capital requirements for existing banks from the current level of \$2 million to \$5 million. Authorities are expecting that these measures will strengthen the banking sector and see the introduction of higher

regulatory requirements as an avenue toward improved resource allocation and risk management, as well as to further consolidate the banking sector.

There are also plans 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.

2.3. Currency and price stability

While macroeconomic policies aim at ambitious growth targets, the government has also pursued fiscal consolidation and prudent monetary policy to ensure that macroeconomic stability is maintained. Money demand has steadily increased, driven by stronger economic activity and increased confidence in the country's banking sector. Reserve money and broad money were estimated to have increased by 4 and 15 % respectively for 2004. The flexible exchange rate regime has been important to mitigate the adverse impact of external shocks. However, these policies have not been implemented without slippage and difficulty. Fiscal consolidation was followed by an accumulation of domestic expenditure arrears, with the fiscal deficit projected at 1.3% of GDP in 2004.

Since price liberalization was first initiated, Armenia has reached the level of most industrialized economies, with administered prices accounting for only about 8% of the consumer price index. Of this 8 %, this is largely found among the country's "natural monopolies" within the energy, telecommunications and water sectors. The government is, however, committed to the gradual introduction of staged increases in water and irrigation tariffs. Additionally, upon accession to the WTO in 2003, Armenia pledged to introduce a value-added tax (VAT) on domestic agricultural production by 2009.

Bolstered by generally sound policies and structural reforms, the external current account balance and debt ratios have also continued to improve. Following deterioration in 2003, the current account balance (export less imports plus net transfers and factor income) was projected to decline to 5.6 % of GDP in 2004. Although this decline was rooted in higher worker remittances, the overall decline was significant and marked by a trend of a sustained single digit level from a peak of 30-35 % in the stages of transition. Again, this was largely due to large external flows, and the current account continues to be largely financed by non-autonomous sources. The volume of foreign direct investment remains small as well.

2.4. Private property

Armenian property rights and the acquisition of property are adequately defined and soundly defended. With an impressive early stage of privatization in the initial phase of Armenian transition (1991-1994), state companies have continued to undergo reform and were further privatized over the past several years. Since 1995, Armenia has privatized almost 7000 small firms and over 1500 medium and large-sized enterprises. Although this initial phase of the privatization process was one of the first such efforts of all former Soviet states, it was also tainted by serious incidents of privileged control and corrupt practices that partially co-opted the efficacy of the overall privatization program.

The private sector accounts for roughly three-quarters of Armenian GDP. As of mid-2004, the privatization program has resulted in a sizable number of formerly state-owned firms, consisting of some 7230 small enterprises and about 1900 medium and large-scale enterprises.

The Armenian government has made some progress in the easing of state interference in business formation and with a strengthening of property rights. According to recent enterprise surveys cited by the World Bank, the average time and cost to establish a new business and complete the official registration process was reduced from 27 days and \$109.00 in 2000, to 21 days and \$92.00 in 2001, respectively. Other surveys conducted by the World Bank and the European Bank for Reconstruction and Development (EBRD) have also noted an improvement in perceptions of governance by the Armenian private sector, with a reported drop in both the frequency of corruption and the average time spent by company management on dealing with public officials.

Structurally, the private sector is divided between a largely informal economy of self-employment and small enterprises and a heavily concentrated formal economy. Armenia has successfully implemented a wide range of first-generation structural reforms to address the private sector, however, and according to 2004 World Bank data, has implemented measures for the efficient regulation and promotion of business start-ups, the enforcement of commercial contracts and the registration of property. Armenia must now focus on enhancing corporate disclosure and governance, as well as improve bankruptcy and audit provisions.

The constitution guarantees free economic competition and there are laws to prohibit anti-competitive agreements. These laws have also led to the creation of a new seven-member, enforcement authority (appointed by the president), the State Commission on the Protection of Economic Competition. The commission is empowered to

adjudicate, issue warnings, impose sanctions and penalties and initiate court proceedings. Although nominally independent from other state bodies, the commission lacks the administrative capacity and resources to effectively enforce legislation.

2.5. Welfare regime

Statistically, Armenia's economic growth and performance over the past five years is quite impressive. The economy has posted an average growth rate of 5.5% for every year since 1994. But this growth is primarily a result of a general recovery from the devastating contractions in the early 1990s, as Armenia's GDP is still not even 70% of its 1990 level, despite such impressive growth figures. Current economic growth is also somewhat misleading, as much of the growth fails to demonstrate any improvement in investment, exports or job creation.

This statistical performance is also seriously undermined by the lack of any matching reduction in poverty or real improvement in the overall standard of living. Although the share of the population living in poverty has officially declined, the improvement was slight (from an all-time high of 55% in 1998-1999 to 43% in 2004) and remains marked by a regional and rural-urban divergence. Thus, this has only reinforced Armenia's "economic paradox," whereby much of the economic gains has largely benefited the wealthy and exacerbated an already serious income inequality, while doing nothing to reduce widespread poverty.

For Armenia, the basic outlines of a social safety net to compensate for poverty and other such risks are in place and there have been considerable efforts to expand this safety net to meet the needs of the population living below the poverty line. As a low-income country, social assistance is generally 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.

There is moderate-quality, inclusive and generally affordable health care. Apart from the state safety net, there are also some close-knit private solidarity networks and providential mechanisms. Equality of opportunity and access to public services are available, in principle, within this homogeneous society. But there is a widening gap in coverage for the disabled or other of the country's most disadvantaged.

Armenia continues to suffer from an inequality of opportunity. Although there have been gains in this period in gender equality and in terms of the role of women within

state institutions (and in the parliament), there is a serious record of inequality. This is not necessarily a gender-driven inequality, however, but 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 will correct this inequality, there are no practical or direct avenues of redress. There is a pronounced absence of either policy or institution that would provide recourse and, what is just as troubling, the wealth and income disparities further impede the equality of opportunity and access within the education sector.

2.6. Economic performance

Following independence in 1991, Armenia suffered one of the most severe contractions of all transition countries. The economic crisis of the early 1990s resulted in a period of hyperinflation, rising unemployment and inequality and consequently increased poverty. Per-capita income fell by over 50% in 1992, and decreased from \$1,800 to \$560 per annum between 1991 and 1993. The introduction of its own currency, the dram, in late 1993 in the aftermath of the collapse of the ruble zone, combined with deteriorating fiscal and external balances, brought forth serious policy challenges. While it is common for transition countries to compare their current GDP with its 1990 level, as the pre-transition level of GDP, the relevant year for Armenia would be 1987, that is, prior to the beginning of the Nagorno-Karabagh conflict and the December 1988 earthquake.

Since 1994, the government has maintained a program of macroeconomic stabilization and pursued a program of structural reforms. Substantial progress has been achieved in six key areas:

1. reducing inflation to low single-digit levels;
2. consolidating the fiscal position and strengthening fiscal management;
3. addressing external imbalances;
4. privatizing state-owned enterprises and land;
5. liberalizing prices, trade and the exchange rate; and
6. strengthening institutional capacity.

All these policy efforts have been supported by multilateral financial institutions, the donor community, and by the diaspora, helping Armenia to garner reputation as a leading reformer in the former Soviet Union.

In most aspects, Armenia has demonstrated the benefits of a decade of reforms, with real economic growth averaging 9% over the past six years. This growth was matched by low inflation and an increasing level of real per capita income. These growth rates were further significant in the face of the Russian financial crisis of 1998, political instability in 1999, and the continuation of embargoes by neighboring Azerbaijan and Turkey. The economy's performance has become more robust in recent years, led by significant expansion of exports. Real GDP grew by over 13% in both 2002 and 2003, and over 10% in 2004, making Armenia the fastest growing CIS economy. Investment grew in line with real GDP growth. National savings turned positive in 1999; consumption is lower than GDP for the first time in a decade. This growth performance has also been accompanied by a substantial expansion of the private sector, which currently accounts for 75% of GDP and total employment.

2.7. Sustainability

Within this period, environmental considerations have been increasingly recognized as important elements of the overall reform program. The Armenian government established a Ministry of Nature Protection several years ago and finalized a national environmental action plan in 1998 that targets the excess exploitation of natural resources, including the depletion of water resources, erosion of soil and degradation of biodiversity. Other specific concerns are the deterioration of the water table of Lake Sevan and the decreasing forest coverage. A National Environmental Health Action Plan was approved in 2002 and the 2003 Poverty Reduction Strategy Paper also identified the environment as a priority area. The Armenian Constitution also requires the state to protect the environment as well as to ensure the rational use and reproduction of natural resources.

The Armenian government has also been working to harmonize its environmental legislation with the Council of Europe and has introduced a pollution fee system by which taxes are levied on air and water emissions and solid waste disposal, with the resulting revenues used for environmental protection activities. Recent environmental legislation have included such measures as permits, public participation, seismic safety, mineral research, environmental fees as well as environmental education. Also during this period, there have been sector-specific action plans and strategies addressing desertification, biodiversity and specially protected areas, ozone-depleting substances, integrated water resource management and persistent organic pollutants. An action plan on Lake Sevan has been adopted in 1998 and a draft law on water policy has been presented to the parliament.

Additional environmental problems include soil pollution (mainly from the extended use of the DDT pesticide, now banned in the West) and, in terms of natural hazards, occasional droughts that plague Armenian agriculture. Armenia is a signatory to several international treaties and agreements on international environment standards, including the Bio-Diversity, the Nuclear Test Ban, the Wetlands Treaties, and has acceded to the Kyoto Protocol on climate change.

Despite this overall record of environmental recognition, there has been a notable priority for policies to promote growth over policies of conservation. The most obvious example of the secondary importance of environmental concerns is the country's Soviet-era nuclear power plant. The Medzamor nuclear power plant, consisting of two Soviet-type VVER440 pressurized light water reactors, was closed in the wake of the 1989 earthquake, but one unit was restarted in 1995 after the severe energy shortage resulting from the blockade of the country. Accounting for between 35-40 % of Armenian energy needs, the plant remains a serious environmental concern, however, especially given the region's vulnerability to seismic activity.

The facility is nominally owned by the Armenian Ministry of Energy, but is managed by the Russian United Energy Systems (UES) group. The European Union considers the Medzamor facility outdated and has determined that any necessary upgrade to meet internationally accepted nuclear safety standards would be too costly. In turn, the European Union has provided financial assistance for nuclear safety and decommissioning measures, and has funded studies to develop a long-term energy strategy for Armenia. A law on the use of nuclear energy for peaceful purposes is in force and was recently amended to establish a decommissioning fund. Armenia also operates two nuclear research facilities, at Yerevan and Analitsark.

Through the decades of the Soviet period, Armenia held a leading role in education and science. The main challenge to maintaining and leveraging this national asset has been 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, and was evident in shortages of teaching materials, books and a delay in even the most basic upkeep of school facilities and has resulted in a decline in the student-teacher ratio in basic education, from 11.7% in 1990 to 8.7% in 1997. In the longer term, this is especially harmful for the preparation of a new generation of young entrants to the workforce and means that an entire group of school-age children are already under-prepared for the emerging market economy.

Armenia has continually strived to maintain its system of universal basic education,

although public expenditures on education were limited through much of the last decade. At its lowest level, state spending on education was a mere 2 % (or less) of Armenian GDP. Spending on the education sector has increased during this period, however, from 2.2 % in 2002 to 2.7 % of GDP in 2004. The increased spending included higher teacher salaries and increased training, and on early childhood education programs. Secondary school enrollment remains high in Armenia, with a ratio equally that of the Baltic states, 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. The Armenian Academy of Science is responsible for the implementation of the research policy, utilizing its network of 40 research institutes and staff of around 4,000 researchers.

3. Management

3.1. Level of difficulty

Governance is constrained by a degree of structural difficulties. For this period, these structural difficulties include two main challenges, one external and one internal in nature. Specifically, the embargo against small, landlocked Armenia denied the country its natural strategic trade, transport and energy links and reinforced a mounting over-dependence on its Georgian neighbor to the north for crucial access to Russia. The blockade also continues to distort natural trade and economic development.

Internally, the level of difficulty is especially enhanced by the malignant presence of corruption and its distortion of economic and political policy. Following the model of each of the former Soviet states in transition, corruption in Armenia denies the state a substantial amount of tax revenue, fundamentally weakens the rule of law and inhibits important democratic reform, thus posing a deeper fundamental challenge to state legitimacy and authority.

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 combined with a general trend of public apathy to form a negative, mutually

reinforcing dynamic of inactivity and frustration. While the tradition of civil society is further limited by the Soviet legacy of Communist party control, there is a degree of optimism, however, as this period has seen the emergence of a few small but vocal civic actors that have inspired a greater following and could signal an eventual emergence of a society fed up with corruption and a lack of good governance.

In terms of Armenia's developing civil society, the number and work of civic and non-governmental organizations (NGOs) has significantly expanded in recent years. As of 2003, there were nearly 3500 NGOs officially registered, dealing with a wide range of issues including human rights and women's rights, health care, peace and conflict resolution, and the environment. It should be noted, however, that 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.

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 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 unrest. 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.

Profile of the Political System

Regime type:	<i>Democracy</i>	Latest parliamentary election 25.05.2003 Effective number of parties 8,79
System of government:	<i>Semi-presidential</i>	
Head of State	<i>Robert Kocharyan</i>	
Head of Government	<i>Andranik Margaryan</i>	

Source: BTI team, based upon information by country analysts, situation in July 2005. Effective number of parties denotes the number of parties represented in the legislature, taking into consideration their relative weight (Laakso/Taagepera index) = $1 / (\sum p_i^2)$; p_i is the share of parliamentary mandates controlled by party i .

3.2. 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 poverty reduction and against corruption), there is a promising prospect 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.

Specifically, the tension between the government and the opposition, within both parliament and society as a whole, threatens to destabilize the situation in the face of looming elections in 2008. Moreover, the potential threat to sustained and sound reform posed by the "oligarchs" now well entrenched within the political system mandates a new commitment by the government.

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, deepening and acceleration of reform. Specifically, a greater degree of political commitment to the implementation of these reforms is crucial to overall sustainability and, as confirmed in other post-Soviet economies, must be able to withstand 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.

Within the context of pursuing the twin goals of high economic growth and reducing poverty, there are four key policy challenges facing Armenia in the coming years. The Armenian state budget and expenditures must preserve the country's hard-won macroeconomic stability, improve fiscal transparency, and meet the strategic imperative of poverty reduction priorities of social and infrastructure spending. A second challenge stems from the need to improve both the application and enforcement of tax revenue collection, with an eye to a more equitable and level approach toward taxpayers.

A third challenge is the need to continue financial sector reform, with specific measures to improve corporate governance and banking sector modernization. Lastly, there is a fourth essential challenge of confronting corruption in a much more systematic and effective manner. A related element here would also encompass improvements to the judicial sector, to foster greater efficiency and effectiveness in enforcing contracts and regulating commerce.

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

3.3. Resource efficiency

The Armenian government has effectively built up its resource base and has a new toolbox of measures at its disposal. There is added optimism in the recent civil service reform effort, 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. The real test for the use of these resources is, however, the fight against corruption.

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.

The rather poor record of the parliament is another flaw in the overall resiliency of Armenian democracy and confirms the need for reforming and modernizing the campaign finance laws. A second fundamental component to these government efforts lies in civil society. By utilizing the positive contributions of non-governmental organizations, citizen groups and other public civic associations, for example, the anti-corruption effort can present a broad front to counter the scope of the challenge.

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.

3.4. Consensus-building

All major political and social actors agree on the goal of the reform and strive to continue efforts to build a market-based democracy. There are no actors with anti-democratic veto powers. A crucial element in consensus-building that is unique to Armenia is the need to mobilize the potential of “human capital” from the Armenian diaspora.

The role of the diaspora brought optimism and hope for a stable recovery, sound development and integration into the world economy. The diaspora was viewed as the important “push factor” in terms of economic reforms and democratic change. Since the devastating earthquake of 1988, the diaspora has provided massive humanitarian aid to Armenia. To this date, however, the character of the diaspora’s assistance and the diasporic link remains largely humanitarian and cultural.

With the exception of a few scattered attempts of large-scale business ventures, the economic and business agendas of the diaspora remain underdeveloped. Much more work needs to be done to enable Armenia to capitalize on the intellectual and financial capital of the diaspora.

Within the parameters of the Armenian political and economic system, the so-called reformers’ hold an overwhelming and vastly dominant position. This stems in large part to the wide degree of acceptance of the need for democracy and market reform. There is no real or even potential anti-democratic force on the scene in Armenia.

Political division in Armenia is mainly centered on the confrontation and competition between the strong, ruling elite and the fractured political opposition. The disparity in power and potential has tended to diminish all sizable divisions and has allowed the authorities to effectively manage and contain all aspects of this divide.

For Armenia, social capital is contingent on a widening of the basic outlines of a social safety net to compensate for poverty and other such risks. Although there has been considerable efforts to expand this safety net to meet the needs of the nearly

45% of the population living below the poverty line, until the social benefits can be more effectively and evenly distributed, there can be no real expectation of social capital. As a low-income country, social assistance is generally comprised of limited cash benefits, based on a system of targeting along regional, community and indicator lines, and a limited and gradual phasing-out of state subsidies for energy (known as “lifeline” utility tariffs). Social insurance (unemployment and pensions) are both flat-rate benefits. Not enough is being done to improve the equality of benefit availability.

Civil society is viewed in very limited terms by the authorities. Some observers have categorized Armenia as an “ambiguous regime,” suggesting that the country’s troubled democratic record makes it stand apart from other liberal democracies while also failing to meet even less stringent standards and norms that would qualify it as an “electoral democracy.” Others have noted the unique challenge in the democratic transformation facing former Soviet states like Armenia, however, and have pointed to the generally under-appreciated emergence of a vibrant civil society, the development of economic pluralism, and the growth of an independent and opposition media. The non-governmental organization Freedom House more accurately defines Armenia as a “transitional government” or “hybrid regime,” mainly as a result of its recognition of the country’s complicated and contradictory mix of democratic shortcomings and accomplishments.

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 segments of society. Until there is a degree of such advocacy, there will be no demand for reconciliation.

3.5. International cooperation

Armenia is somewhat hindered by a continued reliance on foreign assistance. Faced with limited prospects for attracting foreign direct investment, Armenia utilizes relations with multilateral institutions, such as the World Bank and the International Monetary Fund (IMF), and relies on the diaspora for financial flows. There is concern over the reliance on such external aid and the resulting structural vulnerability inherent in such a policy.

Rooted in Armenia’s long record of engaging the IMF and the World Bank in reform efforts funded by concession-based funds and large-scale technical assistance, Armenia has been able to cement its profile as a credible partner. This was also

demonstrated by the mid-2004 World Bank approval of a new Country Assistance Strategy which focuses on promoting private sector-led economic growth. Armenia is also eligible for grants from the U.S. Millennium Challenge Corporation and has submitted a proposal seeking funding for new investment in rural infrastructure and to finance increased social sector spending.

In terms of cooperation with regional and international 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. A meager natural resource base and the need for a normalization and restoration of regional trade and transport links that have been disrupted for over a decade by an East-West blockade of the country (imposed by neighboring Turkey and Azerbaijan) are the main motivations for Armenian pursuit of greater cooperation. The unresolved Nagorno-Karabakh conflict is, nevertheless, a serious obstacle to region cooperation.

4. Trend of development

4.1. Democratic development

The pattern of recent democratic elections notwithstanding, the development of democracy in Armenia has achieved neither significant progress nor substantial setbacks. Overall, there is no firm guarantee yet of a resolute advance in Armenian democracy, particularly in the light of structural shortcomings in the institutions of governance. A much more dynamic and balanced system of government needs to be allowed to develop further. The very nature of the Armenian Presidential Republic, by virtue of the concentration of powers in the executive branch of government, demands a balanced counterweight from a strengthened and responsible legislature and a more independent judiciary. Just as important as a balanced system of government is the need for greater accountability and transparency. Accountability is vital for the creation of an effective deterrent to the temptation of political corruption and bribery, and transparency, and informed public debate, is also in short supply in governmental decisions and legislative actions.

Institutional stability has also roughly stayed the same, with a mixed record of some reform offset and limited by their lack of sufficient depth and degree. And given the looming period of political transition as the incumbent president is prevented from seeking a third term, it seems likely that any significant improvement to fundamental reforms will be delayed until after the elections of 2008.

4.2. Market economy development

Armenia's macroeconomic performance continued to be strong in 2004 and early 2005, with real GDP growing by 10.1 % in 2004, mainly driven by a boom in agriculture and continued private construction activities, despite a marked drop in the diamond processing industry. Consumer price inflation decreased, aided by tight monetary policy, and the labor market showed signs of recovery in 2004. Poverty and inequality indicators fell notably in recent years, owing mainly to higher salaries, private transfers from abroad and state social assistance.

There was also a significant reduction in the overall poverty rate, from around 50% in 2000–2001 to 42.9% in 2003, and extreme poverty dropped from 16% in 2001 to 7.4% in 2003. Income inequality also fell during this period, as measured by a reduction in the Gini coefficient of income concentration from 0.535 in 2001 to 0.434 in 2003. This was attributed to faster than anticipated progress to double-digit economic growth, the increase of labor income, and the increase in social transfers through a well-targeted family poverty benefits program.

Despite significant progress in the strengthening of the institutional framework for market-based action, reforms remain fairly incomplete and several vulnerabilities mandate renewed commitment. Specifically, there is a need to consolidate macroeconomic stability, mobilize domestic revenue, and enhance the business climate. Moreover, the balance of payments remains vulnerable, notwithstanding the narrowing of external current account deficits in recent years. In particular, the diamond trade is susceptible to changes in contract terms, and official transfers are likely to decline over time in the light of Armenia's strong economic performance. While the exchange rate appreciation has seemingly not affected the trade balance so far, going forward, the balance of payments could be negatively affected.

Armenian economic growth has gradually and consistently accelerated since 1999, posting a 13.9% increase in GDP in 2003. The composition of GDP has also adapted to economic reforms, with significant increases in construction and trade, while the more traditional agricultural sector has declined, although still accounting for some 21.5% of GDP. The expansion of the country's industrial production sector has been driven by new investment in the areas of metallurgy, mining, diamond polishing and food processing. The Armenian government has also specifically targeted several new areas for potential growth and development. These new areas include information technology (IT) and tourism.

Table: Development of macroeconomic fundamentals (2000-2004)

	2000	2001	2002	2003	2004
Growth of GDP in %	6.0	9.6	13.2	13.9	10.1
Export growth in %	16.6	20.8	29.3	29.5	7.4
Import growth in %	5.1	1.2	13.2	27.0	7.3
Inflation in % (CPI)	-0.8	3.1	1.1	4.7	7.0
Investment in % of GDP		19.8	21.7	24.7	23.9
Tax Revenue in % of GDP	14.8	14.3	14.6	14.0	14.1
Unemployment in %	11.7	10.4	10.8	10.1	9.4
Budget deficit in % of GDP	14.6	9.5	6.2	6.8	4.7
Current account balance in million \$	-278.4	-200.0	-148	-191	-167

Source: International Monetary Fund (IMF); World Bank; Armenia State Statistical Service.

D. Strategic perspective

Given the well-entrenched power of the ruling elite within the apparatus of state power and institutions, the status quo in terms of continued economic reform and political stability will most likely remain for the next two years. With presidential and parliamentary elections set for 2008, this status quo period of stability will most likely be replaced by a flurry of political jockeying for position and power in the year leading up to the election.

The most significant developments will center on Armenia's external relations and foreign policy. On a broader level, the course of relations with its traditional ally Russia is now subject to some degree of revision, mainly in light of Armenia's pronounced turn to the West. This is most clearly evident in the country's deepening relationship with the United States, NATO and the European Union. Armenia's turn West will also be reinforced by the impact of recent changes in the governments of Georgia and Ukraine, with any future shifts in other areas of the former Soviet Union sparking a similar Westward orientation.

On a more limited level, there is an additional promise of regional security as the Nagorno-Karabakh peace process continues. Although there is only a limited degree of opportunity for settlement prior to the elections in both Armenia and Azerbaijan, there is a medium-term window of opportunity for finally moving beyond the now outdated parameters of this conflict.

Armenia faces several new internal developments that compound the need to reexamine its concept of national security. These internal challenges, in many ways the hardest to overcome, range from a worrisome trend in authoritarianism and a widening deficit of democracy, to an erosion of self-sufficiency and independence stemming from a dangerous over-reliance on Russia. As previously argued, the most serious threat to Armenian national security comes not from Azerbaijan, nor Turkey, but comes from within. It is posed by the internal threat of corruption and all of its derivatives, from the rise of the powerful oligarchs to a “rule of law” that has degenerated into a “law of the rulers.”

The real threat to Armenian democracy is most clearly demonstrated by the tendency for governance by strong individual leaders over strong institutional leadership. This dominance of “strongmen over statesmen” has emerged as one of the most formidable obstacles to conflict resolution and regional reintegration. The challenges of a mounting social divide, marked by widening disparities in wealth and income constitute “economic security.” These economic and social components of national security, exacerbated by a cancer of corruption, constitute a threat to Armenia’s internal stability and security that has been ignored for far too long.