



CRISIS & OPPORTUNITY


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ARMENIA IN 2008

CRISIS & OPPORTUNITY

A Report by
The Civiltas Foundation
Yerevan, Armenia



ARMENIA IN 2008. CRISIS AND OPPORTUNITY.

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PREFACE

The young independent Republic of Armenia continues to benefit from the engagement and involvement of hundreds of international organizations and institutions, both large and small, from the tiniest European church-affiliated charity to the international giants – the UN Development Program, the US Agency for International Development, the UK Department for International Development, the German Development Agency, and of course the European Commission. Armenia, and the Caucasus in general profit both from the hands-on and practical activities of foreign experts, and from their advice and recommendations.

Reports on Armenia and the Caucasus – some one-time and others regular and periodic – are produced by international agencies and organizations, as well as by private entities, to provide a guideline by which to understand Armenia and its current political and/or economic situation. The decision to produce another such publication therefore requires explanation.

The Civilitas Foundation believes that in addition to the insights provided by international experts, it is time to assess Armenia's global, regional, and domestic political and economic progress from a uniquely Armenian perspective.

This report, the product of discussions and consultations, proposes objective thinking about Armenia's own political and economic realities, as well as its role in the region and the world, but from the inside looking in. We want to show how Armenians themselves identify and prioritize the country's problems and how we see the solutions. We want to appraise the evolution of our institutions, because they are the true indicators of serious political and economic responsibility, accountability and stability. We want to objectively assess what is already being done and point out what can and must be tackled next.

In essence, such periodic reviews of Armenia's political and economic development would amount to an assessment of the country's progress in political and economic democratization. It is for that reason that the UK Department for International Development has supported the publication of this first report. By accurately and fairly describing Armenia's current situation and commenting on the opportunities and challenges of the last year, while looking ahead to the next, we are in fact offering an "Assessment of Armenia's Progress Towards Democracy."

ARMENIA: CRISIS AND OPPORTUNITY

This publication is intended to be an annual overview of the political and economic situation in Armenia, as well as those global and regional developments that affect Armenia and the region. 2008 began with a political campaign season, moved on to the presidential election in February, then the tragic events of March, which colored all subsequent domestic political and social processes for the rest of the year.

Economically, expectations were that 2008 would be a difficult year in which to try to sustain the double-digit growth of years past and begin to make some real headway in reducing economic disparities by introducing second generation reforms. Those expectations were fulfilled and compounded when the US financial crisis mushroomed into a global emergency that also infected Armenia.

Regionally, the aggravated relations between our neighbors and the rest of the world took their toll on Armenia's economic and political progress throughout the year. Tensions between Iran and the West continued to simmer. Early in the year, the seemingly dormant conflict with Azerbaijan over Nagorno Karabakh threatened to erupt anew. The military clash between Russia and Georgia in August had immediate political and economic repercussions for Armenia.

In this light then, it is understandable why we would call this period one of crisis. Regionally and domestically, politically and economically, crises drove Armenia's life.

Yet, these crises offer significant openings to review the processes that led to each crisis and the leadership and institutional gap that allowed them. The resulting grim economic and political circumstances have created a sense of urgency that offers opportunities to take actions that could not have been taken before.

Actions that once appeared optional, risky, unacceptable, suddenly seem essential. Moves that might have been made at a cautious pace have become necessary and desirable in the short-term. If we squander the opportunity that these crises create to propel Armenia's development out of this critical period, and instead return to business as usual, the troubles will remain and haunt us.

This is as true regionally as it is domestically. There are opportunities as well as challenges in the deep and unavoidable interconnectedness of our age.

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It would not be an exaggeration to affirm that 2008 has proven a watershed year for the South Caucasus, politically, economically, and geo-strategically.

Even before the global financial crisis hit in late summer, all three countries were struggling with inflation and rising food prices that risk impacting on the poorest and most vulnerable strata of their respective populations. Azerbaijan was, in addition, confronted with plummeting world oil prices.

Flawed elections in all three South Caucasus states (Georgia in January and May, Armenia in February, and Azerbaijan in October) underscored yet again how far all three countries have to go to meet internationally recognized standards for a free and fair ballot.

And the five-day Georgian-Russian war in August demonstrated not only the vulnerability of all three states to disruptions in cross-border transportation, and specifically of the Azerbaijan-Georgia-Turkey energy corridor, but also Russia's readiness to intervene when it feels its interests are threatened, and also the paucity of international mechanisms for containing an unexpected military escalation.

Frustrated by the ongoing uncertainty over its prospects of joining the European Union, **Turkey** since 2005 has shifted its foreign policy focus from west to east, for tactical reasons, with the aim of capitalizing on its potential as a regional power, as well as an energy hub. Speaking in Ankara on August 11, just days after the start of full-scale hostilities between Georgia and Russia, Turkish Prime Minister Recep Tayyip Erdogan floated the idea of a Caucasus Stability and Cooperation Pact, modeled on the Balkan Stability Pact created in 1999 in the wake of the Kosovo conflict, and that would comprise Armenia, Azerbaijan, Georgia, Russia and Turkey.

Excluded from that potential regional forum, **Iran** is threatened with further isolation from trans-regional energy projects by the rapprochement between Azerbaijan and Turkmenistan and by the rapidly waning prospects for the planned NABUCCO gas pipeline. That isolation may impel Iran into closer relations with Russia. Russian Foreign Minister Sergei Lavrov announced in Moscow in October that he explored with Iranian officials Tehran's desire to be included in "discussions" of the situation in the Caucasus.

Frustrated by the ongoing uncertainty over its prospects of joining the European Union, Turkey since 2005 has shifted its foreign policy focus from west to east, for tactical reasons

The progressive deterioration in **Russian-Georgian** relations since the election of Mikheil Saakashvili as Georgian president in January 2004 derived partly from Russia's hostility to Saakashvili's unequivocally pro-Western orientation, in particular to Georgia's aspirations to join NATO; partly from ensuing resentment and suspicion of perceived US penetration and consolidation in a strategically crucial region that Russia continued to regard as part of its sphere of influence; partly from a visceral mutual antipathy between Saakashvili and then-Russian President Vladimir Putin; partly from Russia's role in the deadlocked conflicts between the Georgian central government and the breakaway republics Abkhazia and South Ossetia; and partly as a result of Saakashvili's decision to use in Abkhazia and S. Ossetia, the same kind of confrontational and quick-fix approach that seemed to work in Ajaria.

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By early 2008, most of the populations of both regions had availed themselves of the offer of Russian passports, thus justifying Moscow's later military intervention in South Ossetia to protect the population from the Georgian military.

At their Bucharest summit in early April, NATO members declined to offer Georgia and Ukraine the Membership Action Plan for which the Georgian leadership was fervently hoping. Three weeks later, the Russian president issued a formal directive to the Russian government to intensify ties and cooperation with Abkhazia and South Ossetia. A German initiative in July intended to remove the threat of a new war between Georgia and Abkhazia proved unacceptable to both sides.

The **Georgian** leadership's precipitous military attack on Tskhinvali during the night of August 7-8 following several weeks of low level exchanges of fire, and the devastating Russian response have dealt a crushing blow to Georgia's economy, and undermined both international and domestic support for Georgian President Saakashvili. An estimated 35,000 Georgians, some 20,000 from South Ossetia, fled during the fighting and have still to return to their homes.

The lackluster performance of the Georgian military during the five days of fighting, have effectively demolished Georgia's chances of joining NATO in the next few years

The still-unclarified circumstances of the decision to launch hostilities, and the lackluster performance of the Georgian military during the

five days of fighting, have effectively demolished Georgia's chances of joining NATO in the next few years. The Georgian armed forces proved far from battle-ready. Dozens of rank and file servicemen and a handful of senior officers left their posts or deserted. Much of Georgia's military infrastructure, including the military airfield at Marneuli, south of Tbilisi, was badly damaged, and tanks, artillery and other hardware destroyed.

The August 15 ceasefire agreement brokered by French President Nicolas Sarkozy in his capacity as European Union President and the September 8 protocol that supplemented it paved the way for the deployment of unarmed EU monitors in Abkhazia and South Ossetia, but in practice the monitors' access to both regions has been blocked. In South Ossetia, the partial Russian pullback of troops has left informal Ossetian militant groups at liberty to continue sporadic low-level targeting of Georgian-populated villages.

Russia's formal recognition on August 26 of Abkhazia and South Ossetia as independent states has transformed the geopolitical landscape of the South Caucasus. Despite the EU-mediated talks on security issues that began in Geneva in mid-October, the two regions are likely to remain beyond the control of the central Georgian government. Moscow has already signed and ratified agreements on friendship, cooperation and mutual assistance with both and has announced plans for establishing military bases in South Ossetia and Abkhazia, with at least 3,700 servicemen stationed in each; there are also plans for a naval base at Ochamchira on the Abkhaz Black Sea coast. Those facilities are likely to put Russia in clear violation of the Treaty on Conventional Forces in Europe, compliance with which it unilaterally suspended last year.



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Since recognizing Abkhazia and South Ossetia as independent states, Russia has, contrary to some analysts' expectations, treated the two regions identically. That approach not only ignores the very large differences in size, population, and economic potential between the two, but is a direct repudiation of the affirmed hopes of many Ossetians for unification of the Ossetian nation within the Russian Federation. The Russian leadership may, however, be unwilling to endorse any such territorial merger of the two Ossetias lest by doing so it fuel demands by the Adygs and Cherkess for a redrawing of internal borders in the North Caucasus to create a separate republic comprising those districts of Adygeya, Karachayevo-Cherkessia and Kabardino-Balkaria where they constitute a majority of the population.

At first glance, of the three South Caucasus states, **Azerbaijan** appears to be least susceptible to domestic upheaval. The fractious opposition has been sidelined, and western demands for liberalization of election legislation ignored, to the point that major opposition contenders saw no point in participating in the October presidential ballot. Incumbent President Ilham Aliyev was reelected with 88.7 percent of the vote; the ruling Yeni Azerbaijan Party is pushing for constitutional amendments that would remove the limitation on the number of consecutive presidential terms he may serve. Revenues from the sale of Caspian oil have been channeled into improving some infrastructure and massive defense spending intended to intimidate Armenians into making major concessions over Nagorno-Karabakh.

Yet, Azerbaijan does face internal threats, in the first instance poverty; the growing disparity between living standards in major cities and rural areas; and the government's heavy-handed and

counter-productive response to the perceived threat of Islamic fundamentalism, including the penetration over the past several months into northern districts of Islamic militant groups from neighboring Daghestan. Renewed expressions of support during the early summer of 2008 in response to allegations by Azerbaijan's small Avar, Lezgin and Tsakhur minorities of forced assimilation may herald efforts by outsiders to fuel inter-ethnic unrest in northern Azerbaijan.

In Azerbaijan revenues from the sale of Caspian oil have been channeled into improving some infrastructure and massive defense spending intended to intimidate Armenians into making major concessions over Nagorno-Karabakh

On the economic front, plummeting world oil prices cannot fail to curb Azerbaijan's remarkable economic growth. The 2009 budget drafted in September was predicated on a price of \$70 per barrel.

Whether out of resentment at US criticism of human rights violations and the near-total absence of media freedom, or sheer self-preservation instinct, the Azerbaijani leadership was increasingly tilting away from the West and towards Moscow even before the Russia-Georgia war. The cool reception given to US Vice President Dick Cheney during his brief visit to Baku in early September, and Aliyev's subsequent immediate departure for Moscow for consultations with Russian President Medvedev, served to underscore Washington's dwindling leverage.

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President Saakashvili's precipitate action in starting a war that resulted in the (albeit temporary) suspension of Azerbaijani oil exports cannot but have affected the relationship between Saakashvili and Aliyev

Also, President Saakashvili's precipitate action in starting a war that resulted in the (albeit temporary) suspension of Azerbaijani oil exports cannot but have affected the relationship between Saakashvili and Aliyev, and the already complex Georgian-Azerbaijani relations:

- The two countries share interest in deriving the maximum financial benefit from the export via Georgia to Turkey of Azerbaijani oil and gas. Disputes in early 2000 between Tbilisi and Baku over transport tariffs Georgia would receive from the export of Azerbaijan's Caspian oil delayed the final agreement on construction of the Baku-Tbilisi-Ceyhan pipeline and were ended only by a major concession on the part of then Azerbaijani President Heidar Aliyev. Subsequent accords were similarly preceded by protracted and acrimonious bargaining and complicated by the need to balance the rival demands of Georgia and Turkey
- Azerbaijan's suspicion and resentment of any cooperation between Georgia and Armenia that could benefit the latter
- A long-standing dispute over their common border, specifically over rival claims to the historic Davit Gareja monastery complex
- The existence in each country of a minority from the other that has for decades alleged systematic discrimination also color Azerbaijan-Georgia relations. Up to half a million Azeris live in the districts southeast of Tbilisi that border on Azerbaijan. They have alleged discrimination for decades, and in the late 1980s launched an unsuccessful campaign for a separate republic. The far smaller Georgian minority in Azerbaijan has waged a similar battle for the right to Georgian language education in schools and for the opening of a Georgian church
- Georgia and Azerbaijan express solidarity when it comes to the self-determination movements that confront their governments. This shared position is an important reason for the existence of GUAM – the alliance of Georgia-Ukraine-Azerbaijan-Moldova – and a key issue on their agenda
- Finally, Turkey's cooperation since the early 1990s with Georgia and Azerbaijan over the export of Azerbaijan's Caspian hydro-carbons via Georgian territory has been paralleled by intensive cooperation in other economic spheres and by massive military aid to both countries. Turkey has long been Georgia's second largest trade partner (after Russia); a free trade agreement between Turkey and Georgia came into effect on November 1, 2008. Turkey has assisted both Georgia and Azerbaijan in restructuring and raising the professional qualities of their respective armed forces to meet NATO standards, and also of the



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Georgian Interior Ministry troops and border guards, supplying both equipment and funds. The most recent Turkish-Azerbaijani agreement on military cooperation dates from February 2007.

The Russian-Georgian clash reinforced one more dividing line in the Caucasus on top of that existing between Armenia and Turkey, and the other separating Armenia and Azerbaijan

ARMENIA, NEIGHBORS AND BEYOND

It is in this context that Armenia has been conducting its bilateral relations. Armenia's relations with its four neighbors — **Turkey, Georgia, Iran and Azerbaijan** — and with the three power centers — **Moscow, Washington and Brussels** — have always been the most consequential, and this year was no different. Changing perceptions and increased expectations of Armenia (and other transitional countries) affected, even altered, Armenia's relations with the three main international players. In addition, major domestic and global transformations impacted on the four neighboring states and, by extension, on Armenia's bilateral relations with each of them.

The Russian-Georgian clash reinforced one more dividing line in the Caucasus on top of that existing between Armenia and Turkey, and the other separating Armenia and Azerbaijan, running

through Nagorno Karabakh. It even changed the context for bilateral relations among neighbors, and for Russian, American and European relations with each country in the Caucasus. Each of those three players took a new look at the region as a whole, and at each individual country within it, and reviewed policies and attitudes.

The big picture and the actual geopolitics of the region however did not change. Thus, choice remained limited in Armenia's foreign policy. Still the crisis brought new opportunities for Armenia, and for Georgia and Azerbaijan, too. The challenge is whether each of these countries will be able to review the path it has chosen to achieve its national interests, to put short-term, immediate gains aside, and to look at the bigger picture that is being created, and the broader opportunities it brings. This is especially true with European interests and the region's European aspirations in mind, which together can have more positive impact in the long term on each country.

Of course, each country's ability to seize the opportunity to think big and take risks depends not only on its definition of its national interests, but perhaps more importantly, on the domestic political situation. Domestic strength and stability will increase a government's options internationally. The international community criticized the elections held in all three Caucasus states this year, and accepted the results with reservation. All three have to contend with angry oppositions and manifestations of social discontent which will affect their ability to make bold moves on conflicts and neighbors.

Armenia and Turkey

At the beginning of the year, it appeared that Armenia-Turkey relations were at a standstill. The

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border between the two countries remained closed, and there were no formal diplomatic relations despite occasional high-level meetings between ministers, and a quieter, mediated round of meetings at the deputy ministerial level.

The intention of the Armenian side remained the establishment of diplomatic relations and the opening of the border. Turkey, too, expressed an interest in normalizing relations and articulated the issues that it considered obstacles to doing so. For Turkey, there are two sets of such concerns – direct bilateral problems between Armenia and Turkey, and issues which indirectly affect those relations such as the Nagorno Karabakh conflict resolution process.

Pointing to an ongoing process would allow Turkish leaders to say, as they have done recently, that third parties do not need to become involved in Armenia-Turkey issues

Armenia sees these direct bilateral issues as a package of four elements:

- Signing a protocol on diplomatic relations
- Affirmation of each state's internationally recognized current borders
- Opening of borders and
- The establishment of a commission to discuss all problematic, unresolved issues between the two countries and peoples, including the events of 1915.

Of course, this approach would only work if Turkey wants serious bilateral progress and is willing to de-link Armenia-Turkey bilateral relations from Azerbaijani pressures. International observers as well as those from within Armenia and Turkey are unclear about the Turkish intent.

While the administration of President Robert Kocharian conducted negotiations, it did not engage in high-profile meetings or activities. This was the result of its concern not to engage in process for process's sake, and not wanting to support Turkish attempts to feign progress without a commitment to results.

For Turkey, however, progress of any kind, even if it is merely more process, is useful and necessary. In other words, if progress for Armenia can only be measured in terms of open borders and normal relations, progress for Turkey can come in the form of meetings, events and activities of an official or non-official nature. Given its European Union accession issues, and the need to demonstrate its ability to conduct all-around good neighborly relations, any sign of activity between Armenia and Turkey would satisfy Turkey.

Pointing to an ongoing process would allow Turkish leaders to say, as they have done recently, that third parties do not need to become involved in Armenia-Turkey issues, since Armenia and Turkey are already talking. It would allow them to try to fend off, or actually divert and allay international efforts to seek broader genocide recognition. Turkish Prime Minister Recep Tayyip Erdogan's 2005 letter proposing a historical commission, and his subsequent refusal to acknowledge receiving a response can be viewed within such a strategy.



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Armenian President Serzh Sargsyan's approach has been visibly different. He has not shied away from high-profile meetings. On the contrary, in June, in Moscow, at a community event, Sargsyan publicly announced his intention to invite the Turkish President to Yerevan so that they could watch the Turkey-Armenia FIFA football game together, in September. Perhaps the warm congratulatory letter he received from President Abdullah Gul was the trigger.

The Armenian president made another announcement, which on the surface, appeared to be a change in policy. There was no opposition to the idea of a commission, once borders are open, Sargsyan said, otherwise, such a commission might simply become an endlessly delaying tactic – or process for process's sake.

Taken literally, this statement sounded like a contradiction of the Armenian position that a commission only to study history is unacceptable, not only because that's tantamount to acknowledging that the historical facts are open to question, but also because that puts the focus of the problem between the two countries on history, rather than on the urgency of normalization and diplomatic relations. Whether intentionally different, or a slip of the tongue, the phraseology was modified over the next few weeks (either under pressure or voluntarily) and the Armenian side again began speaking of a bilateral intergovernmental commission that would tackle all issues – but again, only once the border is open.

Even as the meaning of this nuanced difference was debated, the Armenian side received considerable diplomatic credit for issuing the invitation to Gul. It was heralded as a new opening in relations, a new thaw.

By August, when the geopolitical situation in Turkey's neighborhood had changed and Turkey offered a proposal for a Caucasus security platform, Turkey had achieved legitimacy to engage in the Caucasus, particularly with Armenia.

By August, when the geopolitical situation in Turkey's neighborhood had changed and Turkey offered a proposal for a Caucasus security platform, this gave Turkey legitimacy to engage in the Caucasus, particularly with Armenia

The world, too, started looking differently at the region, especially at the closed Turkish-Armenian border, and at frozen Turkish-Armenian relations. Russia became more interested in seeing that border open, to provide alternatives to the Georgian transit network, thereby undermining Georgia's importance. Russia also owns the Armenian railway network and would therefore benefit from open functioning transport corridors, including the non-functioning Kars (Turkey)-Gyumri (Armenia) railroad.

The US, too, had an interest in seeing borders opened. They sought improved relations between neighbors, and thus expected Armenia's real or perceived dependence on Russia to be reduced. The European Union shared that perspective. This conflation of the positions of Brussels, Moscow and Washington, albeit for differing reasons and interests, gave Turkey cover to work toward improved relations – such as it defined them. President Sargsyan's invitation gave them the opportunity.

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When the Turkish president finally did accept, barely days before the scheduled game, the accolades poured in. The international community, eager to see positive movement in relations and anxious for Ankara to shed its irrational approaches towards Armenia and Armenians, welcomed the gesture.

President Gul visited Armenia for just six hours, and the presidential jet which brought him kept its engines running. In private meetings and in interviews with journalists, the two presidents basked in self-satisfaction.

But it quickly became apparent that the groundwork had not been done to assure positive steps would follow the feel-good meeting. According to President Gul, there was no talk of opening the border, or even beginning to operate the Kars-Gyumri railroad. Instead, the Turkish foreign minister soon went on record as saying, “If we succeed in quickly registering progress, then there won’t be a need for third countries’ parliaments to comment on this issue. We’ll be able to say to them, go concentrate on your own affairs, Armenia and Turkey are talking to each other.” President Sargsyan stated that Armenia has no territorial demands on Turkey. Although previous administrations had found ways to make clear that Armenia had no such intentions, they had hesitated to make such an overt one-sided statement without receiving some sort of solid gesture from the other side.

According to President Gul, there was no talk of opening the border, or even beginning to operate the Kars-Gyumri railroad

Domestic commentators seemed to agree.

The Armenian Revolutionary Federation-Dashnaktsutyun, a junior member of the four-party coalition government, rejected one-sided concessions and insisted that the issues between the two countries are of a political, not a historic nature.

By November, President Sargsyan was formulating the Armenian position in terms of the four elements outlined above. Regarding the historical commission, he said, “That is not a necessity. We don’t believe it will solve anything. We want diplomatic relations without preconditions, open borders, and after that we can explore all outstanding issues between the two neighboring countries at the inter-governmental level. Recognition of the Genocide by Turkey is not a precondition for establishing relations. We want relations, but not at any price.”

Therefore, the same question remains regarding Turkey’s intent. Either Turkey truly has had a change of heart, has determined to de-link bilateral relations with Armenia from the Nagorno-Karabakh issue, and wants to normalize relations, open its border with Armenia, and establish formal diplomatic ties.

Recognition of the Genocide by Turkey is not a precondition for establishing relations. We want relations, but not at any price

Or, Turkey maintains its policy of benefitting from a process, continues to link Armenian bilateral relations to Nagorno-Karabakh, and has no intention – even if it is indeed in a position to do so – of opening the border with Armenia until the Karabakh conflict has been resolved to Azerbaijan’s satisfaction.

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Nagorno Karabakh Conflict

The negotiation process to resolve the Nagorno Karabakh conflict continues under the aegis of the Organization for Security and Cooperation in Europe (OSCE) with mediation by the Minsk Group co-chair countries – US, France and Russia.

After four years (2004-2007) of foreign-ministerial level negotiations which came to be known as the Prague process, the sides, with the ambassadors of the US, France and Russia drafted a document called the Basic Principles which was submitted to the OSCE Depository in Madrid during the OSCE Ministerial in November 2007. This non-binding document reflects, according to the co-chairs, the concerns and priorities of both Armenians and Azerbaijanis.

The document is based on give and take on the four basic components of the conflict:

- the future status of Nagorno Karabakh
- the return of territories around Nagorno Karabakh currently controlled by the Armenian side
- the return of refugees
- and security provisions.

The Armenian side has said that the document provides a comprehensive approach to all problems, with a phased implementation. The new Armenian president, following his election, said he would continue to negotiate on the basis of that document. So too did Azerbaijan. At the same time, both Azerbaijanis and Armenians continue to express reservations about specific provisions of the document. The co-chairs, too, recognize that the document is not complete.

There is an understanding among those who want peace, that peace will become possible only if and when there is definite agreement regarding the status of Nagorno Karabakh, the need for a geographic link between Nagorno Karabakh and Armenia, and the return to Azerbaijan of the territories surrounding Nagorno Karabakh.

There is an understanding among those who want peace, that peace will become possible only if and when there is definite agreement regarding the status of Nagorno Karabakh, the need for a geographic link between Nagorno Karabakh and Armenia, and the return to Azerbaijan of the territories surrounding Nagorno Karabakh

There is near absolute unity of opinion in Azerbaijan that at the very least those territories must all be returned to Azerbaijani jurisdiction. But in Armenia, there is no consensus about the future of those territories. Yet, the solution hinges on an agreement among the parties on the number, sequence and timing of the territories to be returned and on the nature of the status of the corridor that will link Armenia to Nagorno Karabakh.

On the corridor issue, the Azerbaijani position is that the corridor can be given to Armenians for use under international jurisdiction. Armenians insist that the corridor's status should be the same as Nagorno Karabakh's, now and later. On the return of territories, there is a wide divergence of opinion. Some Armenians argue that no territories should be returned, others that only some should

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be returned, and that the return should be linked to the finalization of Nagorno Karabakh's status, while a third group believes that all should be immediately returned but the overland corridor maintained. This variety of opinions is explained by different degrees of security concerns.

While all these issues remain unresolved, the Russia-Georgia clash in August changed the entire environment. It attracted international interest to the region as a whole, and therefore to this seemingly quiet and intractable conflict, too. The sides felt new pressure to make some movement forward.

Russia realized that after its military incursion into Georgia, it needed to show that it could also engage peacefully in the Caucasus. In addition, to offset its recognition of South Ossetia and Abkhazia as independent states, it needed to demonstrate an understanding that not all conflicts can or should be resolved in the same way.

Azerbaijan has spent some \$4.5 billion on upgrading its military from 2006 to 2008, including the acquisition of tactical missiles, rocket systems armed with cluster munitions, and modern aircraft

The international community's loud anger over Russia's and Georgia's use of force served to mute Azerbaijan's military rhetoric, at least temporarily. The warming trend in Turkish-Armenian relations, driven in part by the Russian interest in securing access to Armenia via Turkey and to Turkish markets from Armenia, similarly induced Azerbaijan to take stock of its stand-off with Armenians in Armenia and Nagorno Karabakh.

In early November, the presidents of Armenia and Azerbaijan met near Moscow at the invitation of Russian President Dmitrii Medvedev. This was the two presidents' second meeting since Sargsyan's election in February, and the first after Ilham Aliyev's reelection in mid-October for a second term.

The Moscow Declaration that the three presidents signed was notable in several ways.

- It was the first signed document since the cease-fire agreement of 1994
- However, unlike that document, it did not include the participation or signature of a representative of Nagorno Karabakh
- The declaration reaffirmed the central role of the Minsk Group co-chairs in the conflict resolution process
- In the aftermath of the military confrontation in Georgia, and given Russian mediation, observers looked for the explicit inclusion of the term 'non-use of force' that would have given the agreement considerable weight and significance. Instead, the document reiterates the traditional terminology committing the sides to a 'peaceful settlement'
- Finally, while international norms were cited, there was also reference to international decisions.

Some expressed concern that Azerbaijan would use this Declaration and these provisions to divert attention from the negotiating track and the principles agreed to there and would instead try to focus on UN resolutions which reflect their one-sided, unilateral aspirations.

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Indeed, by late November, President Aliyev explicitly cited the Moscow Declaration to support the Azerbaijani position. He also declined to rule out the use of force. After all, Azerbaijan has spent some \$4.5 billion on upgrading its military from 2006 to 2008, including the acquisition of tactical missiles, rocket systems armed with cluster munitions, and modern aircraft – all decidedly offensive weapon systems that present a very real threat to Nagorno Karabakh and Armenia. This year, tensions along the Line of Contact rose palpably and Azerbaijan was openly testing Armenian positions in what was widely perceived as a preview to war.

If there were differing interpretations of the Moscow Declaration, its intent and consequences, at the OSCE Ministerial Council, in Helsinki, at the beginning of December, Azerbaijan demonstrated that it is still quite far from a readiness to compromise and that they want to retreat from the Madrid principles. For the first time in the history of the conflict, at the key annual meeting of the organization charged with mediating the Nagorno Karabakh resolution process, the negotiating principles were nowhere to be seen, and instead, Azerbaijan distributed a one-sided document that stubbornly repeats the elements that represent their preferences.

Thus, the year comes to a close, with the sides far from agreement, and Azerbaijan trying to derail a document which has at its core the principle of self-determination for Nagorno Karabakh.

Armenia and Georgia

The Georgia-Russia clash had an immediate and significant economic impact on Armenia. Armenia's access to the sea is through Georgia,

Armenians use the Georgian ports of Poti and Batumi, as well as the Georgian railroad. Some 70 percent of Armenia's trade goes through Georgia.

When the Georgia-South Ossetia clash in August escalated into a full-fledged Russian-Georgian military conflict, Russia entered the Georgian city of Gori and the main east-west Georgian railroad was struck. As a result, Armenia had no rail connection to the outside world for several days.

Despite cordial, friendly, high-level reciprocal relations, there is an undercurrent of unease in the relationship, which manifests itself in insufficient and unequal attention from both sides. This is at least partly because the differences between the two countries are many and of great consequence. Those deep-rooted contradictions have become even more sensitive and crucial in the wake of the Russian-Georgian clash.

- Georgia is actively seeking NATO membership while Armenia, despite its multi-faceted and high level cooperation with NATO, is not
- Georgia has two secessionist regions and is therefore not a supporter of the principle of self-determination. Armenia supports the right of Nagorno Karabakh to self-determination
- Russia is Armenia's strategic ally. Georgia and Russia have no diplomatic relations
- Georgia depends greatly on Azerbaijan and Turkey in various economic relationships. Not only does Armenia not have official relations with either of those countries, they actively work to isolate Armenia economically

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- Georgia's policy on minorities is restrictive and discriminatory, and the Armenian community there is often at odds with the Tbilisi government. The Georgian Orthodox Church has primacy among other churches, including the Armenian Church, which has had a presence in Georgia for centuries, but is still not registered as a religious institution. Churches, monuments and other signs of Georgia's vast Armenian heritage are not sufficiently protected. This is a source of tension with Armenia.
- At the same time, for Armenia, its relations with Georgia are irreplaceable and unique. Armenia needs Georgia far more than Georgia needs Armenia. Finally, if Armenia-Georgia relations are damaged, this will create new and untenable dividing lines in the region.

Despite cordial, friendly, high-level reciprocal relations, there is an undercurrent of unease in the relationship, which manifests itself in insufficient and unequal attention from both sides

That is why Armenia was very careful during and after the August war. Although Russia recognized the independence of South Ossetia and Abkhazia, Armenia has not done so, nor is it likely to, for several reasons. Although the parallels with the Nagorno Karabakh situation are obvious, Armenia continues to insist that Nagorno Karabakh's status be determined through

negotiations and not unilaterally. That is why Armenia itself has not recognized Nagorno Karabakh's independence. In that context, as President Sargsyan said in September, recognizing the independence of Abkhazia or South Ossetia is not likely. Third, Armenian-Georgian relations must be handled with care, not just for Armenia's sake, but also because of the huge (300,000+) Armenian minority within Georgia.

President Sargsyan visited Tbilisi in the fall and agreed to create a consortium to implement an idea that has been floated for more than a year – the joint construction of a Yerevan-Batumi highway. This would reduce the distance from Armenia to the Black Sea to five hours. In addition to the obvious value of this highway for Armenia, it would facilitate economic and social improvements in the underdeveloped areas of Georgia through which it would pass. The Georgian government's agreement to such a consortium is a good sign, and contradicts fears that previous efforts at such projects failed precisely because those underdeveloped areas are highly populated by Georgia's Armenian minority. Indeed, such a road would serve as a natural bridge to link the two countries and alleviate the economic and social hardships that were created when the Russian military base left this region.

Armenia and Iran

The importance of Iran to Armenia was highlighted in August 2008 when the Georgia-Russia confrontation drove Armenia to rely almost exclusively on Iran as an outlet to the world. This was a situation both countries remembered well from the early 1990s when domestic instability in Georgia had shut off Armenia's northern access.



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The August war lent new urgency to plans to construct an Armenia-Iran railroad, and President Sargsyan announced in his October address to parliament that work on it would begin in years to come. A pipeline to bring Iranian natural gas to Armenia has been completed and can be utilized as soon as necessary, and several high-voltage power stations are also being built. Discussions are continuing on building two hydro-electric power stations on the Araks River which marks the border between the countries, and also an oil refinery in Armenia's southernmost Meghri region near the border with Iran.

A pipeline to bring Iranian natural gas to Armenia has been completed and can be utilized as soon as necessary, and several high-voltage power stations are also being built

In 2008, there was also continuity in political relations. Iran continued to maintain its balanced position on the Nagorno Karabakh conflict. Despite religious and ethnic similarities with Azerbaijan, and in the face of Azerbaijani pressure and insistence, Iran has succeeded in maintaining an unbiased and even-handed relationship with both Armenia and Azerbaijan. That ability to balance has characterized Iran's foreign policy throughout the ages. In this case, that balanced policy is in Iran's own interests.

The presence of a very large Azeri minority in Iran serves a dual role – it helps sustain warm relations with Armenia, and with Azerbaijan. It is both a carrot and a stick in Iran's relations with both countries. Tehran's strict even-handedness in relations with Armenia and Azerbaijan could easily tilt toward

Armenia if Azerbaijan were to unnecessarily provoke the Azeris of Iran. On the other hand, the presence of its Azeri minority limits Iran's ability to overtly support Armenians. This web of complicated interconnectedness in an already interconnected region preserves the status quo.

Still, the factor that most impacts Armenian-Iranian relations is Iran's relations with the West. Sanctions on Iran have thus far not significantly affected Armenian businesses or trade. The West, usually rather understanding about Armenia's geographic and political predicament, is aware of Armenia's limitations. A recent US State Department Anti-Terrorism report noted visits to Armenia by Iran's leaders, and observed that these visits reinforced transport and energy cooperation between the two, as a result of which Armenia hesitates to adopt positions critical of Iran in international votes. On the other hand, Iran recognizes, too, that its good relationship with Armenia, a Christian neighbor, works to its advantage in the face of Western assumptions and belligerence.

In the face of Azerbaijani pressure and insistence, Iran has succeeded in maintaining an unbiased and even-handed relationship with both Armenia and Azerbaijan

... AND BEYOND

All aspects of Armenia's bilateral relations are impacted by its relations with the three power centers – Washington, Brussels and Moscow – and their relations with the other countries of the Caucasus. During 2008, these relations too were

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largely predicated by the domestic, regional and global crises.

The controversial presidential election in Armenia in February and its violent aftermath figured on the agenda of all discussions with the three important capitals, as did the steadily deteriorating relations between Georgia and Russia, even prior to the August war. This impending crisis shaped and drove the European, American and especially Russian agendas in the Caucasus.

Finally, the global financial crisis and its economic fallout impacted relations both within the region and between the region and the three power centers.

These three events formed the basis of the interactions between Yerevan and the US, Russia and the European Union in 2008.

With Russia, four issues persisted to dominate the bilateral agenda: continued deepening of economic ties amid worsening transportation challenges; Russia's resurgence as regional power; its leading role as mediator in the Karabakh standoff and as facilitator of Armenia-Turkey normalization.

*Russia needs even-handed relations
with Armenians and Azerbaijanis to
allay distrust about its intentions*

Of course, Armenia's domestic issues were also on Moscow's agenda. It unequivocally made clear in early 2008 its support for then Prime Minister Serzh Sargsyan's campaign for the presidency, rather than that of his main challenger, former President Levon Ter-Petrossian. Senior Russian officials – including the Duma speaker and the prime minister – visited Yerevan in a show of

support for Sargsyan, who traveled to Moscow just weeks after the election's violent aftermath. Russia congratulated Sargsyan promptly on his election victory and, unlike the US, did not publicly criticize the Armenian government over its handling of the election and protests that followed.

Russia is Armenia's largest individual trade partner and supplier of strategic commodities like nuclear fuel and natural gas, and the largest and closest market for Armenia-made goods.

Booming Russia has emerged as the largest foreign investor in Armenia. In 2007, Russian-Armenian trade amounted to some \$750 million, or about 16 percent of Armenia's total foreign trade turnover. That year, Russian companies also became the largest foreign investors in Armenia, with their share totaling more than \$200 million, or about one-fourth of all foreign investments.

Russian companies bought the two Armenian mobile phone service providers, while Russian Railways acquired the Armenian rail network. Major Russian financial and insurance organizations opened and expanded their presence in Armenia.

Russia has also offered funding and expertise to build a new nuclear power plant, a multi-billion dollar undertaking prioritized by the Armenian government, which has also been seeking European and US participation in the project.

The Russian-Georgian conflict that escalated into a full-blown war in August presented Armenia with a particularly acute dilemma. The war pitted its historically friendly neighbor that also serves as a key conduit for trade with the world, against its strategic ally, and Armenia could not and would not take sides.



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Armenia and Russia are allies because of a set of reciprocal strategic interests. For Russia, the Caucasus has strategic, historic and economic importance. Yet over the last several years, Russia has felt undermined in the Caucasus because of Georgia's overtly pro-Western orientation. Russia's relations with Azerbaijan have been on-again, off-again. But with Armenia, the relationship is stable and reliable, based on reciprocal security, economic and political interests.

Yet Russia is a global power with interests more and more often at odds with those of the US and the EU. On a whole range of issues, Russia has so many needs and opportunities to trade-off positions and policies, that it may ignore Armenia and Armenia's interests, as it has done in the past. In the web of new positions and relations being defined in the aftermath of the Georgia crisis, with the new deepening of relations between Georgia and Azerbaijan, given each country's huge interests in the politics of energy, Armenia's and Nagorno Karabakh's interests can easily be trampled.

On the other hand, although the Georgia-Russia war increased Russia's leverage in the region, it also underscored the West's perception of an aggressive, unyielding, intransigent Russian policy toward the Caucasus. In that context, Russia needs even-handed relations with Armenians and Azerbaijanis to allay distrust about its intentions. The challenge for Russia is to counter those suspicions while strengthening its position in the region.

Following the Russian-Georgian conflict, **the European Union** was compelled to look for ways to forge closer relations with all three Caucasus countries, especially in light of severely disrupted transport links in the Caucasus and new and serious security challenges. Seen solely from Europe's perspective, they must safeguard energy supplies, protect transport links to Central Asia,

and prevent massive migration that is inevitable from areas with no stability or prosperity.

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This new focus required new and serious discussions in Brussels to enhance existing instruments and develop new ones to engage the three Caucasus states. In some circles, it is hoped that this might somehow distract Georgia from its desire to become a NATO member at the earliest possible opportunity, a matter on which EU member states remain divided. Partially in response to the Georgian sense of urgency, and also in response to Europe's own search for more predictable relations, the EU has unveiled the Eastern European Partnership. This enhanced instrument promises to be more than the European Neighborhood Policy by offering stronger integrational elements, even a possible free trade agreement and visa facilitation. In Armenia where there is often a feeling that Georgia receives more acclaim and attention, this is exactly the kind of even-handed treatment that is desirable.

Opinion polls testify that a large majority of Armenians support EU membership, although most believe that Armenia will not be ready to join the EU until after 2015 at the earliest. For now, EU-Armenia engagement is formalized through the Partnership and Cooperation Agreement and the European Neighborhood

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Policy. As part of the policy, Armenia and the EU have developed an Action Plan that outlines steps they are already taking to enhance cooperation and achieve a “significant degree of integration.”

As part of the European Neighborhood Policy, the European-Armenian dialogue continues to focus on democracy, human rights, economic and administrative reforms, a peaceful settlement of the Karabakh conflict, and facilitation of regional integration efforts.

The European-Armenian partnership has also been driven by practical economic considerations such as the size, proximity and affluence of European markets for Armenian products and the level of demand for European consumer goods in Armenia.

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As a result, Armenia’s trade ties with European countries have grown steadily since the 1990s. For over a decade now, trade with EU member states accounted for the largest share – more than one-third – of Armenia’s entire foreign trade turnover. Germany, the Netherlands and Belgium are Armenia’s largest European trade partners.

One of the recurring differences in EU-Armenia relations is EU’s insistence that the Soviet-era Metsamor Nuclear Power Plant be closed as early

as possible. Armenia explains that it cannot do so until alternative energy sources are assured. Thus, Armenia has reached out to various countries, including a major European nuclear energy company to build a new nuclear power plant. Although no investment commitments have been announced, Armenian leaders are hopeful that a joint project with European, Russian and US involvement will prove possible.

Also this year, Europe’s second largest communications company Orange (France Telecom) won the tender to establish the third cellular phone operator in Armenia, paying 51 million Euros for the license. The service is due to be launched in 2009.

The conduct, and especially the violent aftermath of the February presidential election continues to cause considerable stress in Armenian-European relations.

Both European Union and Council of Europe officials continue to express concern over the shortcomings of the Armenian political process.

The same is true of **Armenia – United States** relations. The critical US reaction to the Armenian government’s handling of the presidential elections and subsequent opposition protests in February and March put a strain on relations for much of 2008. While the opposition’s tactics were also controversial, US officials effectively blamed the government.

The deep US concerns are largely conditioned by the nature of US interest in the Caucasus, and particularly in Armenia. While the US has country-specific interests in the Caucasus – in the case of Azerbaijan, that interest is centered on oil; in the case of Georgia, the US is interested in the country’s geopolitical significance and appreciates



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Georgia's willingness to give the US a foothold in the Caucasus – in the case of Armenia, its bilateral interest remains in the realm of its general regional interest. In the Caucasus, the US seeks to support peace and stability including resolving conflicts, minimize Russian influence, and promote democratization and the establishment of rule of law. Thus, the US attention to Armenia is focused on democratic and economic development. Therefore, any serious reversals in those areas result in acute responses and reactions.

US and Armenian officials have described their bilateral relationship as one of “partnership” and “friendship,” with some “allied” characteristics added in recent years as small Armenian contingents deployed with US-led peace-keeping forces in Kosovo and Iraq. Since 2001, the US and Armenia have worked to develop a bilateral security relationship. Armenia has become more actively engaged in NATO's Partnership for Peace program, and has risen to the level of Individual Partnership Action Plan, a stage just short of the membership plan, and at a par with the nature of NATO relations with Georgia and Azerbaijan.

On assuming office in April 2008, President Sargsyan articulated a strong interest in strengthening US-Armenia relations. Just as he had done first as defense minister and then prime minister, Sargsyan seeks to cultivate a better image for himself and for Armenia in Washington.

The two countries entered 2008 with a long-standing agenda. As before, US expectations were focused on settlement of the Karabakh conflict and the establishment of democratic processes and institutions, with a particular eye to improved electoral conduct in Armenia and support for US foreign policy priorities, first and foremost the “war on terror” and the isolation of Iran.

Armenia, in turn, anticipated continued US economic, technical and democratic assistance, as well as support in efforts to improve relations with Turkey.

Of the few joint projects underway, US funding for a technical feasibility study for a new Armenian nuclear power plant – with the prospect for US participation in the plant's actual construction – and the \$235 million Millennium Challenge Corporation program for rural infrastructure offered most promise. Of course, the United States was a key source of assistance and expertise in economic and democratic assistance even before MCC.

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The political activism of the Armenian-American community has undoubtedly contributed significantly to Armenia's stature in Washington. Annual appropriations of US assistance to Armenia and America's relative neutrality in the Karabakh stand-off with Azerbaijan are born as well of US domestic political considerations, even though they do of course also complement US foreign policy goals.

The realization by the US in the wake of the Russia-Georgia clash of the vulnerability of the Caucasus may translate into more equal treatment in the future. For the present however, the Bush Administration has showed minimal interest in Armenia. Although senior Bush Administration

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officials, including the Vice President and the Secretary of State, have traveled to the Caucasus in recent months, neither visited Armenia.

Members of the US Congress have traditionally demonstrated more interest on Armenian issues than has the executive branch. Unable to effect a revision of the Bush Administration's policy on the Armenian Genocide, Congressmen continued to speak out on the US failure to bring about a change in Turkey's policy towards Armenia, and to condemn Azerbaijan's threats of war over Karabakh. An amendment to cut US military aid to Azerbaijan failed narrowly in July.

Following the announcements of a \$1 billion post-war US aid package to Georgia in September, members of the Congressional Armenia Caucus pointed to losses suffered by Armenia as a result of the war and argued for a share of funds to go to Armenia, as well as to Armenian-populated areas of Georgia. While no specific carve-outs were won, US legislation on aiding Georgia that was passed by Congress included a "regional dimension", and the Bush Administration pledged to study Armenia's needs in the aftermath of the Georgia war.

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In 2008, no new efforts to conclude trade or economic treaties between US and Armenia were

made public. From 2004 to 2007, US-Armenia trade ties have remained relatively steady, with an average annual trade turnover of about \$125 million. US exports to Armenia accounted for most of the volume, with Armenia's exports to US declining from \$46 million in 2004 to \$33 million in 2007.

By June, the United States had effectively suspended the MCC program, conditioning its continuation on the government's satisfying the bulk of the demands put forward by European institutions. By fall, a shift in the US focus towards regional security issues and President Sargsyan's statements about steps to investigate post-election violence had seemed to improve chances for the MCC program to resume.

Although the Russian-Georgian war temporarily revived US interest in Armenia and other regional countries, the political transition now underway in Washington means a more productive phase in US-Armenia relations will have to wait until President-elect Barack Obama takes office.

OUTLOOK

- In the wake of the August war, both the EU and the US now tend to view the South Caucasus primarily through the prism of Russia-Georgia relations. That focus risks failing to notice regional problems that appear to be of only secondary importance, or require action that might undermine efforts to repair relations with Russia.
- At the same time, barring a resurgence of hostilities involving either Georgia or Nagorno-Karabakh, the South Caucasus is still unlikely to figure among



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the most urgent foreign policy priorities of the EU, of which the Czech Republic takes over the presidency on January 1, 2009. President Vaclav Klaus and Prime Minister Miroslav Topolánek are at loggerheads over the Lisbon Treaty, so Prague is likely to focus primarily on EU trade and economic issues. Czech-Russian relations will continue to be overshadowed by Moscow's hostility to the planned US anti-missile shield.

- The new US administration, too, will be focused on its own economic meltdown, and on other explosive regions of the world. Policymakers dealing with Caucasus issues will remain oil-centric. The Obama Administration will be more attentive to European concerns, will engage Russia on a variety of issues, and will address serious security concerns with new approaches and openness.
- Georgia-Russia tensions will continue without any conciliation, given Russia's firm refusal to talk with President Saakashvili. Talks on S. Ossetia and Abkhazia will produce few results.
- Russia will continue its active involvement in the Caucasus, unless the deepening crisis limits its capacity.
- Turkey's initiative on a Caucasus Security platform, despite initial reservations by potential participants, will remain under discussion, giving Turkey its own platform for a presence in the Caucasus. There are no expectations that the Security Platform will materialize

because it still lacks concrete mechanisms and potential participants continue to disagree on basic principles.

- Turkey will continue to engage Armenia at the highest levels, without clarity about its genuine intent. High-level visible processes will be complemented by negotiations to try to achieve Armenia's purpose of normalization, while Turkey continues to attempt to improve its image and standing on this matter, without taking serious political chances.
- In the Nagorno Karabakh conflict, there will be neither a political resolution nor a resumption of war. Politically, although the OSCE Minsk Group mediation will continue, Azerbaijan will chip away at the Madrid principles, particularly the idea of self-determination. Its energy and focus will be on diverting and delaying, on producing new documents at the United Nations and the Council of Europe, reaffirming their own approaches. Military activity is unlikely because Armenians will not initiate them, and Azerbaijan, with the Russia-Georgia conflict fresh in mind, will not risk a third military loss and endangering oil investments.

POLICY OPTIONS

- New international crises should not be allowed to eclipse the need for sustained focus on Georgia in particular and the region in general. In particular, the use of the \$4.5 billion in post-

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conflict aid promised to Georgia at the October donors' conference should be scrupulously monitored and shared with neighbor Armenia (which lacks other resources to offset economic losses).

- Since the existing post-Cold War security institutions are unable to override old security frontiers, or prevent the exercise of prerogatives to prevent clashes, the Summit proposed by the presidents of Russia and France to review European security structures is urgently needed.
- The idea of creating a nonaligned Caucasus, free of security memberships and adversarial alliances may be possible in today's environment, where the possibility of a new Security Pact is on the table. Such a pact, that marginalizes no one, and stresses a comprehensive, strong security component is needed by everyone in and around the Caucasus.
- Security in South Ossetia and southern Abkhazia remains a pressing problem given that those regions remain off-limits to the EU observers deployed to the region in October. In addition, the mandate of the UN Observer Mission in Georgia, due to expire in February 2009, must be renewed especially as some Abkhaz officials have admitted that they are nervous at the prospect of the international peacekeepers' departure.
- Politics in Georgia, a multi-ethnic country, is the purview of Georgians. Tbilisi should be encouraged to take more seriously the concerns and grievances of its sizeable Azerbaijani and Armenian minorities. A broad public discussion of the merits and drawbacks of transforming Georgia into a federal state would help counter the perception shared by those minorities that they are regarded, and often treated, as second-class citizens.
- The ambiguity surrounding the status of Abkhazia and South Ossetia requires innovative thinking. Saakashvili's inability to comprehend that the travesty of autonomy that was imposed on Abkhazia and South Ossetia during the latter decades of the Soviet era devalued that concept irrevocably was a contributing factor to the rejection by the leaders of both regions of his successive peace proposals. If the international community continues to affirm its support for Georgia's territorial integrity despite the de facto permanent severance of Abkhazia and South Ossetia, it should persuade the Georgian leadership to craft alternatively worded innovative proposals for reincorporating the two regions on terms acceptable to the titular nationality.
- Outstanding border demarcation issues between Armenia and Georgia can be quickly resolved and serve as a measure to build confidence and obviate territorial concerns.
- Although the new Armenian administration doesn't use the term complementarity, in reality that policy is being implemented and should be further emphasized and enhanced, especially in light of ongoing tensions in



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the region and the remaining uncertainties in relations between Russia and the US.

- The consortium, high-level dialogue, the Yerevan-Batumi Highway are all urgently needed and mutually beneficial for promoting further integration of Armenia with Georgia.
- Projects of regional strategic value in the fields of energy and transport must remain priority areas of practical cooperation with Iran.
- If Turkey adheres to its previous course and continues to link bilateral relations with a resolution of Nagorno Karabakh, thus focusing on high-visibility interactions without political breakthroughs. Armenia can either sustain this high-level or reduce the level, but it cannot completely withdraw from the process. In this case, however, the border will not open.
- If Turkey has truly had a change of policy, and is willing to delink Nagorno Karabakh from the establishment of Turkey-Armenia bilateral ties, then the remaining obstacle will be the concept of the commission. Armenia cannot accept the Turkish formulation of a Historical Commission. Armenia must search for the right kind of diplomatic packaging to arrive at a definition of a commission that may address the events of 1915, not with a view to study the facts, but with the purpose of finding ways to transcend it. Furthermore, the establishment of this commission cannot be a pre-condition to opening

the border, but a parallel move. Then, the border may open in 2009.

- In Nagorno Karabakh, Armenians are waiting for the recognition of their right to self-determination and their having successfully resisted the military onslaught unleashed by Azerbaijan. Azerbaijan, roused by petrodollars, is waiting for a new outcome – political or military. An emphasis on public and diplomatic efforts to explain the essence of the Nagorno Karabakh conflict, and the expectations of the sides, is essential for a comprehensive, lasting and just resolution, based on the Madrid principles. Thus, clarity on the status of Nagorno Karabakh must be at the core of a just resolution and a way to provide them the political security that they require.
- In the face of Azerbaijan's attempts to chip away at the Madrid document and transfer the negotiation process away from the OSCE, Armenia's challenge must be to retain the Minsk Group process, and keep the Madrid principles on the negotiating agenda. Armenia can point to the aftermath of the Russia-Georgia conflict and Russia's subsequent recognition of S. Ossetia and Abkhazia to explain that it will keep its options open regarding recognition of Nagorno Karabakh's independence, but has not done so thus far only because the principle of self-determination is part of the negotiating package.

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SITUATION AT HOME

In Armenia, 2008 was presidential election year. The election on February 19 was initially assessed as “mostly in line with OSCE and Council of Europe commitments and standards” despite irregularities in the voting and vote count. Distrust in the electoral process, cynicism regarding the authorities’ lack of respect for civil rights, and desperation at the seeming impossibility of effecting peaceful political change led large segments of the public to peacefully protest the election outcome. On March 1, clashes between police and demonstrators led to 10 deaths.

The events of March 1 can be considered Armenia’s greatest tragedy, after the October 27, 1999 assassinations in the National Assembly. March 1 not only plunged the country into its worst political crisis in nearly a decade but also dealt a serious blow to its steady albeit patchy democratic thrust forward. Never before has an Armenian electoral battle claimed human life.

Never before have Armenian politics and Armenian society been so polarized. While Armenia’s leadership has managed to hold off the tough challenge to its power and stability from its political opponents led by first President Levon Ter-Petrossian, it has so far done little to heal the wounds inflicted on the nation.

It is ironic that the most peaceful and dignified change in administration took place in early 1998, when Ter-Petrossian, himself under severe pressure, resigned. Robert Kocharian, then prime minister, became president and Ter-Petrossian, whose resignation remained controversial, was even present at the inauguration ceremony – the first time such a calm transfer of power had taken place in the CIS.

Ter-Petrossian returned to the political stage in the fall of 2007, angry about the state of the country,

and ready to rally all those feeling disaffected and disenfranchised. The presidential camp, where Prime Minister Serzh Sargsyan was tapped to succeed Kocharian, misread and dismissed the depth of popular frustration and resentment, and caught on late to the implications of the surprising level of support Ter-Petrossian garnered.

Sargsyan’s campaign speeches were full of conciliatory, visionary, liberal and inclusive messages about the future of the country and society. At the same time, the Sargsyan camp entered the elections with a great deal of administrative resources and a resultant sense of entitlement.

The events of March 1 can be considered Armenia’s greatest tragedy, after the October 27, 1999 assassinations in the National Assembly

The election became a confrontation, a zero-sum game, all but precluding the possibility of a post-election scenario where compromise solutions would give the two significant, albeit opposing candidates a stake in the existing political order.

The seeds of that order, however, were sown during Ter-Petrossian’s time in office, from 1991 to 1998. His administration set the precedent for less-than-democratic and heavily contested elections in 1996, when the opposition stormed parliament: court rulings ordered by the executive branch; the monopoly on lucrative sectors and businesses enjoyed by senior government officials; crackdown on the opposition; and the closure of

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media outlets critical of the government. Thus, Armenians came to view non-transparent elections as the norm, and post-election calls for fair remedies as inevitable.

Successive administrations have resorted to similar practices to hold on to power. Each believed an electoral defeat would mean conceding power to those whose approach to fundamental political issues it considered at the very least to be wrong. Each was afraid that the other side would 'sell out' on Nagorno Karabakh, change the balance in relations with Russia and the US, appease Turkey, and even jeopardize economic growth. Each believed that the others are not just diametrically different, but even dangerous.

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In addition, in a new country, the institution and tradition of former president or other high-level member of government does not yet exist. Upon leaving office, that official no longer has a legitimate public role. Thus an electoral loss would mean, at the very least, the end of a political career. It also would mean the loss of political power, which in turn serves as the key to individual power and wealth. Finally, in some election, since 1995 including the one of 2008, both sides also threatened the freedom and personal security of their opponents. Hence each candidate's obvious desire to win at any cost. In Armenia, as in many other former Soviet republics, an election is not just a political contest but a race to protect one's future.

Thus, disputed elections and the resulting lack of confidence in the democratic mechanisms for rotation of power among key political actors has been the principal source of political instability in Armenia ever since independence.

The 2008 political crisis began with the extreme and personal accusations and promises made during the election campaign. The official election results gave 53 percent of the vote to Prime Minister Sargsyan and 22 percent to Ter-Petrosian. Former Parliament speaker Artur Baghdasarian placed third with 17 percent of the vote, and the Armenian Revolutionary Federation - Dashnaktsutyun's candidate, Vahan Hovannisian, fourth with 6 percent.

All three losing candidates questioned the accuracy of the official returns. Within a week of the election, and following the first post-election report issued by the OSCE's Office of Democratic Institutions and Human Rights, the Ter-Petrosian camp staged a demonstration which turned into a 24-hour sit-in, in Opera (or Freedom) Square, demanding a new election. The numbers dwindled over time and the authorities periodically accused the protesters of violating laws on public assembly and public order. Finally, on March 1, law enforcement authorities entered the square, according to official explanations, to conduct searches based on information about the presence of weapons among the demonstrators, but demonstrators insist that it was to violently disrupt the quiet assembly. By the evening of March 1, after the authorities had somehow dispersed the demonstrators, a large crowd had gathered near the Embassy of France. What began as an angry demonstration turned into a noisy, violent confrontation.

Near midnight on March 1, President Kocharian declared a state of emergency, and on the

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morning of March 2, Armenians heard that there were at least eight deaths (two more died in hospital) with more than 100 wounded the previous night. These numbers included police and civilians. Amateur videos soon circulated showing policemen aiming rifles and chasing civilians. The authorities, witnesses and experts have said that that they were shooting rubber bullets or tracer rounds. But this did not placate anyone. Those opposed to the authorities continued to believe that real bullets were used, or that in any case, rubber bullets fired at such close range had the same effect. Others insist that regardless of the nature of the confrontation, the police have no right to fire on their own citizens. Eight months later, both sides continue to reject categorically the other's version of what actually happened.

More than 100 opposition activists and supporters were arrested in the days and weeks immediately following March 1.

The Armenian authorities maintain that the street protests were part of the Ter-Petrosian-led opposition's conspiracy to use the election to stage a coup d'état. The opposition insisted that this accusation was contrived in order to persecute the opposition.

The European Union and the United States were quick to express serious concern about the post-election unrest, urging the Armenian authorities to lift the state of emergency in Yerevan, release all political prisoners and allow an independent investigation. None of those demands were met, except the one asking that the state of emergency be lifted. It expired in 20 days and was not renewed.

The Council of Europe subsequently became involved when its Parliamentary Assembly (PACE) expressed the same concerns in April. In June, they also demanded an immediate end to

the practice of local courts passing convictions solely on the basis of incriminating testimony by police officers. Over 70 detainees remain incarcerated despite strong pressure exerted on the authorities by the United States and international bodies like the Council of Europe. The latter believe that at least some of these detainees are political prisoners.

Thus, disputed elections and the resulting lack of confidence in the democratic mechanisms for rotation of power among key political actors has been the principal source of political instability in Armenia ever since independence

Most of the detainees have already been tried and sentenced on charges stemming from the March 1 clashes. The most common accusations were resistance to the police and participation in 'mass disturbances'. However, the verdicts were based solely on the testimony of police officers. Ter-Petrosian himself has not been prosecuted. Nor have law enforcement authorities arrested or charged anyone in connection with the deaths of the eight civilians and two interior troops servicemen in the clashes. They say the precise circumstances of those killings have not been clarified yet.

Nine months after the events, the political situation remains one of mutual distrust, disdain and disinformation. The Council of Europe expectations remain unmet. Three parliament deputies and four other opposition leaders are now set to go on trial on charges of organizing

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the March 1 violence and attempting to ‘usurp’ power. More than 30 have been given suspended prison sentences or conditional release.

A major factor that prolongs the discord and mutual distrust is the absence of fair, credible, objective information on what actually transpires in the hotly contested political arena

A major factor that prolongs the discord and mutual distrust is the absence of fair, credible, objective information on what actually transpires in the hotly contested political arena. In the case of the March 1 events, there are extreme discrepancies and contradictions in what is believed – from the provocative aggression on the part of the demonstrators to the excessive and untrained aggression of the various law enforcement units. The majority believe that it is the authorities who are finally responsible. The public information field consists of eyewitness reports, second and third hand testimonies and rumors that have evolved into deeply-held beliefs. PACE and other international bodies have cast doubt on the official version of events, calling for the launch of an independent inquiry.

In June, the authorities formed an ad hoc parliamentary commission tasked with investigating the violence. Heritage, the only opposition party represented in the parliament, and Ter-Petrossian’s opposition alliance, the Armenian National Congress, were asked to name their representatives to the commission. Both rejected the offer on the grounds that the body would be dominated by pro-government lawmakers.

In July, the Council of Europe Commissioner for Human Rights proposed a new format – a fact-finding body in which the government and opposition would have equal representation. The parliamentary commission would make a political assessment of that body’s findings.

The Armenian authorities accepted the proposal. In October, President Sargsyan signed an executive order on the formation of the Fact-Finding Group of Experts. The group is to have five members, two of them appointed by Ter-Petrossian’s Armenian National Congress and Heritage, two by the four-party governing coalition, and the fifth by Armenia’s human rights ombudsman. The latter promptly named his representative to the group, welcoming the presidential order. But the two opposition forces set a number of conditions for their participation in the new inquiry. The most important of those conditions is the inclusion of foreign experts in the fact-finding group.

In October, Ter-Petrossian called a halt to the periodic street protests that had resumed in June in reduced numbers. Ter-Petrossian explained that he wanted to avoid weakening Armenia’s leadership at a crucial stage in the Nagorno-Karabakh peace process. He further accused Sargsyan of being ready to make more concessions to Azerbaijan in an effort to ensure continued Western support for his rule, and said that he, Ter-Petrossian, does not want to be blamed for such concessions.

The stand-off continues. It will be difficult for the authorities to accommodate calls for reform, including those the president himself had made, for fear of appearing to be caving in, or of losing their hold on power. The disaffected view all government policies and actions – domestic and international – with suspicion.

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INSTITUTIONAL CRISIS

The presidential elections of 2008, as well as the political and societal instability that came before and after, were evidence that Armenia's civil society, just like its political and social institutions, have not matured. The civil society organizations allowed themselves to become financed tools and mouthpieces of partisan interests, rather than arenas for open, public, tolerant debate. Although active in the past as well, this political season, they were clearly polarized and the space for constructive dialogue which in many countries is preserved and facilitated by civil society did not exist in Armenia in the spring and summer of 2008.

The continuing instability and the prevailing unease and distrust is also because institutions are still more form than content, not predictable and stable; in a word, not reliable. Indeed, it is possible to explain the shock of the opposition's outburst, its violent climax and the still-unresolved and unexplained events exactly because these institutions are ineffective.

The public institutions with an important role to play in governance and in providing access and recourse in public life did not adequately or appropriately manage these processes; rather, the opposite happened. The processes drove the institutions, pushing them to irrational, reactionary actions, the result of which is even greater distrust – of the government by the public and of the public by their government. The **National Assembly**, the **political parties** as institutions, the **media**, the **judicial system** and **law enforcement** agencies did not provide effective and reliable outlets for disagreement and dissatisfaction, or dialogue and cooperation.

The government's proposal for a new institution – a public chamber – whose purpose is

to strengthen ties between the authorities and the public, and to channel the public's concerns to government, is evidence that existing institutions are insufficient. This one, too, may not work. The opposition, whose participation is key to the chamber's success, clearly distrustful, has already rejected any meaningful participation.

The continuing instability and the prevailing unease and distrust is also because institutions are still more form than content, not predictable and stable; in a word, not reliable

The ineffectiveness of the **National Assembly** has great consequences. It is a branch of power and, by definition and structure, it is representational. In Armenia, although the 2007 parliamentary elections resulted in five parties passing the minimum threshold and entering parliament, following the president's inauguration, four of those five parties formed a new coalition and only one party remained in opposition – the Heritage Party, with seven votes out of 131. Thus, during the one year between the two elections, the National Assembly became, if anything, less representational.

Despite platforms which were strongly critical of the Sargsyan candidacy, the two other presidential candidates and their parties (the Dashnaktsutyun and the Rule of Law Party) announced that remaining in the opposition would amount to supporting Ter-Petrosian's radical approach, and thus explained their joining the coalition. Thus, the National Assembly has come to behave as an extension of the executive branch of government, not as an institution which provides balance. This

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was sealed in the fall, when the National Assembly overwhelmingly elected Hovik Abrahamian, the former chief of the presidential administration and deputy prime minister, as its new speaker. The previous speaker, Tigran Torosian, stepped down earlier in September under strong pressure from President Sargsyan's ruling Republican Party.

As a result, there is no legitimate political platform for the nearly 50 percent who, according to the official vote count, chose someone other than the sitting president. The Armenian National Congress and the Heritage Party contested some of the local elections held across the country from August through October. The ruling Republican Party won most of those votes.

The outcome of all these contests – from the presidential to the parliamentary to local elections – demonstrate that a further important political institution – the viable **political party** – has not yet developed. Political parties do not function as a healthy opposition, grounded in ideology. Instead, with the possible exception of the Armenian Revolutionary Federation–Dashnaktsutyun, they are created to be and remain platforms for individuals. In turn, instead of nurturing, or at least allowing, a healthy flow of ideas and resources, those in political power at every level, from national to local, and at every election except the first, in September 1991, have sought to limit and control the three levers of popular influence: ideology, money, and media. The personalized political parties, unsophisticated and lacking a solid ideological base and human and financial resources, have not been able to resist this kind of control.

In covering Armenian political life in 2008, the **media** demonstrated its own extreme polarization. The printed press was divided in

two. The broadcast companies exercised great self-restraint (or self-censorship) and were careful not to upset the authorities, and in many cases, their own pro-government owners. As a result, there was an absence of diversity on the airwaves. Worse, there was no confidence in their reliability. The street, again, became the preferred source of news, information and even analysis.

Media companies known for their opposition positions were visited by the tax authorities. Gyumri-based Gala TV mounted a fundraising campaign and with public support raised and paid the unpaid taxes they were assessed. Tax inspectors also visited four daily newspapers.

The government presented a draft law to the parliament postponing by two years the next opportunity to bid for airwaves, from 2009 to 2011. The law on television and radio was changed to mandate the transformation of the broadcast system from analog to digital by 2012. The media community and experts were highly critical of this move, not only because it delayed the possibility to secure airwaves, but because the transformation to a digital system will be very expensive, therefore it will be difficult for all broadcast companies to comply, thus potentially further limiting access. Similar expensive processes in other countries are subsidized by the government.

Interestingly, this decision came on the heels of a European Court of Human Rights Verdict upholding the claim of A1+ television that when, in 2002, it was denied broadcast rights, its right to freedom of speech had been abrogated. The Armenian government was fined 30,000 euros, and received a strong recommendation that A1+ be offered the opportunity to acquire a national broadcast channel.

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The government decided in early November to create a public media and information center which will conduct studies, seek transparency in state institutions, gather and disseminate information, study the media market, implement project observations and conclusions. The governance of this center will be the responsibility of the president's office. The fear in the media community is that this agency will rein in those media outlets considered undesirable in an effort to 'bring order to the media market and fight against yellow journalism' as the prime minister extols the media professionals to themselves do.

Opinion about the polarized press is itself polarized. The content of the press, on either side of the political spectrum, ranges from the contradictory to the insulting. There is no clear distinction between news and commentary. The press as a whole, and individual journalists, have grown accustomed to functioning as tools or weapons in an intense political battle. As a result, some journalists have become the victims of verbal and even physical abuse.

To arbitrate the efficacy, legality and appropriateness of the actions, inactions and decisions of the media, of public organizations, and of the other two branches of power, the **judicial system** must function as a transparent, predictable institution.

There was precious little confidence in the court system prior to this year, and this year made things, if anything, worse. Several dozen trials of opposition members have taken place, often with convictions based solely on the testimony of police officers, thus validating the charge that the courts are simply doing the government's bidding. Concern about this procedure has been voiced by Armenian parliamentarians, as well as by PACE.

Members of Armenia's Parliament also voiced concern, saying that there is room for the Appeals Court to review this procedure and determine when it is appropriate for police testimony to provide cause.

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Perhaps those corrections will come from the European Court, where Armenians can take cases which have already gone all the way up the Armenian judicial ladder.

The opposition promises to send the cases associated with the March 1 events to the European Court, too. According to the Ombudsman, Armenia will again be handed unpleasant verdicts. However, the cases must first be heard within the Armenian courts. Indeed, the one case which bundles seven top names of the opposition movement, including the head of Ter-Petrosian's campaign, a former foreign minister, Alexander Arzoumanian, will be watched nationally and internationally.

Still, the effectiveness of the justice system depends on a competent and honest partner in the **law enforcement** agencies. In this case, the Prosecutor General and the various police forces are seen as extensions of the government. Especially following the events of March 1, the public sees the police as having used disproportionate force, with no legal justification, and the prosecutor's office as persecuting

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opposition leaders and activists, by presenting them with artificial accusations, detaining them, and not expeditiously following through with a judicial process that offers them recourse.

Still, the effectiveness of the justice system depends on a competent and honest partner in the law enforcement agencies

Pursuing corruption charges is one of the major challenges facing all law enforcement. There were certain instances this year when mid or low level government officials were identified and prosecuted. The head of the police services was also replaced, and with that came several significant changes in other important agencies, including the still-not-very-responsive Administration Department for Passports and Visas, whose services affect every citizen and non-citizen.

There were also very public attempts to carry out reform efforts in the tax and customs administrations. The President has repeatedly described government corruption as “the number one problem” facing Armenia and said the fight against it must start from a crackdown on widespread tax evasion and arbitrary tax collection. His cabinet approved in late June a wide-ranging program aimed at improving the country’s overall business environment which many believe hampers faster economic development.

The government is due to unveil a new anti-corruption strategy by the end of 2008. Meeting with the leadership of Armenia’s National Security Service on July 3, President Sargsyan

acknowledged that the government’s previous anti-graft plan launched in 2003 did not have the desired effects because of its heavy emphasis on legislative changes. He indicated that the situation will not improve markedly as long as only a few corrupt government officials are prosecuted, dismissed or sanctioned otherwise. He pledged to take “drastic steps” against corruption in his October speech in the parliament. There are tangible results within the customs service where there is reportedly a significant reduction in bribery, favoritism and other such practices.

Finally, the other institutions which must develop more quickly and evenly are those in the spheres of education, social services, culture and health. The 2009 budget acknowledges the need to more generously invest in these areas, and funding for each sector is up an average of 15 percent from last year’s level.

Missing in the budget are clear strategies for how to more efficiently use the additional funding to affect real change and improvement. Also missing is a collaboration between government and civil society in determining how to use limited resources and what strategies to adopt in each critical area. Although there is an increase in funding each year, those in need of the services do not sense a commensurate improvement in the sector. Either the public is impatient, expecting progress in areas where much needs to be done, or there truly is no coordinated, strategic plan for a way forward.

OUTLOOK

- The mood of distrust and frustration will be compounded by the economic uncertainties. The disgruntlement that

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had turned into apathy will at best persist or at worst, be rekindled, if no new avenues for dialogue and engagement are created.

- The government will continue to act defensively to control sources and expressions of dissatisfaction. Those opposed to the government will continue to oppose and protest the government's domestic and international initiatives, not for their content, but as an extension of their opposition to the authorities.
- The reverberations of the events of March 1 will continue, culminating with its one year anniversary. The continuing lack of clarity about what happened and how, as well as the absence of an even-handed approach to those whose actions caused these events will continue to prevent a healing. The findings of the commission(s) studying the events of March 1 may further aggravate and deepen hostilities.
- The Ter-Petrossian opposition has suspended its formal, mass gatherings for now. They will resume in 2009. They may be able to maintain the level and depth of association. But they risk the further disappointment and disaffection of some portion of their own followers.
- Social dissatisfaction will deepen if reactions to the economic crisis do not include efforts to repair the fundamentals of the economy.
- No new elections are likely, but the political and professional elite will

remain excluded (some by force, others by choice) from decision-making processes.

- International organizations will review the situation and will continue to assess it negatively, given the absence of clarity on the detention of the main opposition leaders, on media and assembly restrictions.
- PACE will review the political situation in January, present the government with more forceful and demanding language and may indeed suspend Armenia's voting rights as threatened.
- The process and the resolution of the case against seven top opposition leaders, including the head of Ter-Petrossian's campaign, a former foreign minister, Alexander Arzumanyan, will be source of continuing tension. The process and the aftermath will be watched closely by international organizations. In the absence of transparency and presentation of convincing evidence by the prosecution, international watchdogs will label them as political prisoners.

POLICY OPTIONS

- By allowing the media to operate openly, without the influence or intervention of authorities, the information field will become more credible, the exaggerated and distorted differences and distances among people and groups and ideas will begin to diminish.

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- Obstructing the natural development of alternative political forces will leave the field open to only the most extreme, desperate, maximalist groups.
- Acknowledging that although the National Assembly does not represent Armenia's political spectrum, yet recognizing that new elections would create new political shocks and instability, there is much work that can be done with political parties to ensure that in the next elections there is maximal participation, that parties receive equal access to resources, modification in election law, and public supervision mechanisms. At the same time, working with civil society organizations and educational institutions can inculcate the inalienable right to a vote.
- By beginning the difficult work of consciously, publicly, confronting the Soviet legacy of distrust in political systems and authorities and the lack of a tradition of self-government, Armenia's authorities and society can begin on the long path to creating a polity. That work to create a healthy political arena is already late in starting.
- This effort can succeed if it is accompanied by a strategy to strengthen, not coopt, civil society and its institutions. A strong civil society is able to absorb the shocks of a rocky, painful transition and can voluntarily participate in collective public life outside of government, where groups of citizens gather around ideas, objectives, values, and take responsibility for the difficult decisions authorities must make with these limited economic and political options.
- Policy makers and opinion makers have an opportunity to reap social dividends by promoting the investment of public funds, not just in construction, but in the upgrading of public institutions as a response to the severe and deepening economic crisis.
- Investing in education, health care and culture would serve the dual purpose of stimulating the economy and alleviating poverty, and at the same time repairing the social fabric and fostering spiritual and physical health.
- Efforts to transform the interaction of authorities and citizens – from determinations on the national budget, to adopting legislation and regulation – from one of donor and supplicant, lord and subject, to a team that together explores, argues, discusses, debates, and advocates policy, will make it easier for the government to implement and execute decisions.

THE GLOBAL CRISIS AND THE ARMENIAN ECONOMY

The global financial crisis finally hit home at summer's end. As the major economies and international financial institutions search for cures and ways out, there are financial and fiscal lessons to be learned. Given the already palpable effects on Armenia and other transition countries, this crisis is prime evidence, if we needed it, of the great institutionalization and inter-dependence of the global economic system.

In most transition countries, development has been marked in recent years by unprecedented economic growth, averaging 7 percent per year, and with it a period of relative prosperity, lower unemployment and poverty. In countries like Armenia, higher volumes of remittances have offset the effects of initially weak foreign direct investment flows, thus fueling and sustaining strong domestic demand. Over time, fiscal discipline and banking sector restructuring and reforms allowed for increased lending activity and improved customer confidence in financial institutions.

The global crisis will cool transition economies, including Armenia's, and will hit hardest those that, like Armenia, rely heavily on external sources of funding. This crisis will demonstrate whether the past period of relative prosperity has been sufficiently utilized to implement the necessary reforms and raise productivity and competitiveness.

The crisis does, however, also offer the opportunity to review agendas, reaffirm commitments to free market fundamentals and market values, and accelerate meaningful reforms.

While the Armenian government originally downplayed the effects of the crisis, now it is clearly trying to assess and minimize its implications for Armenia.

Indeed, a number of key risk factors render Armenia seriously vulnerable in the mid-and long term.

- reliance on significant remittances and other transfers from Russia and the US, where the crisis has already claimed many casualties among financial institutions, housing markets, exports, manufacturing and especially, construction
- particular reliance on Russian investment in the construction, real estate, industrial, banking and services sectors
- great weight of the predominantly foreign-financed construction sector, which accounts for about 28 percent of GDP
- the unusual strength of the Armenian Dram (AMD)
- the export sector's heavy concentration on base metals and ores, which over-performed throughout the decade as commodity prices soared, thus attracting investments and creating jobs that are at great risk as prices fall
- persistence of double deficit conditions in the economy: budgetary and balance of payment
- shallowness of financial intermediaries, less liquidity and therefore less stimulation, investment and spending
- weak ratio of deposits to GDP (around 13 percent compared with about 25 percent in transition countries, and at least 50 percent in developed economies)

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- weak conditions for fair competition, persistent bureaucratic obstacles, and lagging taxation reforms
- lack of a proactive, clear and consistent approach to engaging Diaspora resources

Recent reports and indicators demonstrate how the global crisis has already begun to impact Armenia's economy, even as businesses and government attempt to stay the course in the hope that a swift global upswing will minimize the negative toll that the crisis is having on developing countries. These recent negative developments include:

- an 8.3 percent contraction in economic growth in October over September
- a temporary halt of some mining operations and subsequent labor actions following the sudden decline of international commodity prices, especially copper
- a decrease in remittances and transfers, resulting in a visible cutback in domestic demand
- a sharp decrease in real estate transactions and, reportedly, a 10-20 percent fall in property values
- a decrease of 41 percent in construction sector growth in October over September
- overall caution in the banking sector, as manifested in interest hikes on credits and toughened conditions for obtaining business and individual loans
- as a result of the support to Armenian Dram AMD, fast dwindling net international reserves
- early return for migrant workers who face uncertain employment prospects for 2009

ARMENIA'S ECONOMIC PICTURE

Armenia's vulnerability to the global crisis – and the ensuing opportunities – must be understood in the context of its economic growth over the past 15 years.

Armenia's economy imploded following the collapse of the Soviet Union in December 1991, hitting rock bottom in 1993 before a slow recovery got underway. The double-digit economic growth of the past decade has been built on three pillars: sound and consistent macroeconomic policy; a steady pursuit of first generation structural reforms, including free price formation, convertibility of domestic currency, liberal trade and investment, promoting large scale privatization; and finally, reliance on high foreign assistance, investment and remittances.

In 2008, the new president and the new government promised to maintain macroeconomic stability – low inflation and a low deficit – and to move towards more difficult second generation reforms. These would include the areas of good governance, competition policy, anti-corruption efforts, development of banking and capital markets, and laying the basis for innovation and knowledge-based development. This level of reform would also require steps toward deeper international integration of Armenia's economy.

But the global financial crisis has presented the Armenian government with several unexpected dilemmas. While the pillars of recent growth – macroeconomic stability, and steady pursuit of reforms – were essential in normal conditions, in

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this crisis environment, adhering to a low budget deficit and a stable currency for the sake of low inflation can instead be impediments to growth. The need to stimulate the economy means exacting low taxes and encouraging spending, which goes against the golden rules of the last 10 and more years. Further, to stimulate production and export, a depreciated Armenian Dram is more important than currency stability.

The second dilemma is the issue of second generation reforms. These are recommended for all transition countries, and they differ depending on local circumstances. Each country has its own specific challenges, and its own bottlenecks. For reforms to be effective, first the country-specific bottleneck must be removed. In Armenia's case, this bottleneck is caused by corruption and lack of competition. These would be difficult to tackle even under normal conditions, because of the deeply-entrenched power-business interdependence. But in the midst of a crisis, this bottleneck needs to be opened in order to allow reforms to secure a fair business environment, an investor-friendly climate and less government interference. Yet such accelerated and radical moves will, at least in the short term, inevitably alienate big business, and cause complications and slowdowns at a time when what is needed is more economic activity, not less.

Thus, the government is forced to deal with the causes of economic dissatisfaction, in the midst of a crisis, without the ability to do away with restrictive factors. These are low employment and slow job generation, uneven development, unequal growth in the regions, weak governance, deeply-rooted corruption, income disparity, and an under-funded, non-responsive public sector.

During the first nine months of 2008, Armenia's economic performance neared the high growth

rate of the last several years. The effects of the international financial crisis were not reflected in the key macroeconomic indicators until October, when preliminary signs began to show. The effects will be measurable by the beginning of 2009, when reduced private transfers and declining export opportunities will have begun to take a toll.

The global financial crisis has presented the Armenian government with several unexpected dilemmas

Real GDP growth from January to September was 10.4 percent – about 3 percent less than in the same period of 2007, when it was 13.5 percent. The major drivers of growth remained construction and services – retail trade, hotels and restaurants, telecommunication, activities related to real estate and financial intermediation. High growth rates have also been registered in mining, retail, food processing, information and communication technologies, and in financial intermediation. But it is the construction sector which remained the most significant in the Armenian economy, accounting for 28.4 percent of GDP, exceeding industry and agriculture.

Under pressure of external factors, **price stability** faltered beginning in 2007 and prices continued to rise in 2008. Price stability has been a major tenet of the monetary policy pursued by the Central Bank of Armenia, which, in the past, has succeeded in offsetting external inflationary pressures, thus contributing to the appreciation of the national currency. The strong movement of the Armenian Dram vis-à-vis the US\$ and the Euro leveled off during 2008 and the exchange rate didn't register any significant moves all year.

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The **inflation** surge observed throughout 2008 (9.7 percent) was explained by external factors, such as a rise in commodity prices, and therefore was expected to drop when international commodity, food and fuel prices fell. But monopolies in certain of Armenia's commodity markets, especially imports, limit competition, hence thinning the price flexibility and significantly diminishing the effects of a price drop in international markets. Therefore, inflation is expected to stabilize near 7 to 8 percent by the end of 2008.

The restructuring of the tax and customs agencies (which were joined to form the Armenian Revenue Agency) and the introduction of certain reforms are expected to improve their operations and yield strong revenue performance. Budget revenues accounted for 21.1 percent of GDP and 100.2 percent of the projected tax revenues for the first nine months of the year. Coupled with decreased government spending — 90.2 percent of the planned level — the result was a budget surplus of 0.4 percent of GDP. A large share of budget revenues (41 percent) was generated from value-added taxes. However, the share of direct taxes, such as corporate tax, increased notably and reached 12 percent during the first nine months of 2008.

The moderate increase in **foreign debt** didn't affect Armenia's status as a low indebted country. The debt totaled US\$ 3.1 billion as of July 2008, an increase of 7 percent compared to 2007. The share of government and monetary authorities accounted for only half of the total (US\$ 1.36 billion and US\$ 196 million respectively), while the rest was generated by the banking and private sectors. The Government's debt is comprised of mostly long-term "soft" loans from multinational financial institutions safeguarding the country from a significant liquidity risk. The net debt

accounted for only US\$ 1.1 billion. The foreign assets of the Central Bank comprise US\$ 1.5 billion. The government and the private sector own the remaining US\$ 0.5 billion.

Foreign trade continued to expand, with imports overtaking exports by a large margin, thereby widening the trade deficit. During the first nine months, the foreign trade deficit doubled compared to the same period of 2007, reaching the record level of US\$ 2.3 billion. After a slight increase in the first quarter, exports showed only 0.4 percent growth, while imports grew significantly by 43 percent. This trend was the consequence of increased disposable income, capital expenditures in production facility upgrades, and a strong Dram. Export performance is expected to deteriorate further in the short-run due to the sharp fall in international commodity prices, especially for base metals. As Armenia's export continues to be heavily resource-based, this poses significant risks for its export performance. The biggest product group — non-precious metals comprising 35 percent of total exports — grew significantly in 2007 (by about 40 percent) but only negligibly (+1.1 percent) in the first nine months of 2008, while the export of precious metals and precious stones, the second largest product group, continued to decline significantly (-13 percent). But the agriculture and food processing industry recorded a high performance in terms of export growth, at over 30 percent.

Seventy percent of Armenia's foreign trade is with Europe, Asia and the Americas. Armenia's biggest individual trading partner is Russia with a 19 percent share, mostly in energy resources. Russia also leads as an export destination, being the major market for the Armenian food and beverage industry.

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Private transfers from abroad, one of the major drivers of economic growth, increased in the first nine months of the year. However, the trend is expected to reverse due to the impact of the global disorder. According to Central Bank data, the actual amount of private transfers exceeds significantly the recorded amounts that are channeled through banks. Still, each year, the difference between real and official figures diminishes. This year, the total again registered a significant increase of 33 percent to reach US\$ 1.205 billion owing to the growth of transfers from Russia, which accounts for 83 percent of the total. The January-September data already indicate a slight reduction in US-based funds compared to the same period of 2007.

High foreign investment figures are largely supported by implementation of ongoing projects especially by investors from Russia. Foreign investments in the real sector of Armenia (excluding investments in public and banking sectors) registered a notable increase, growing by 65 percent to US\$ 515 million. Foreign direct investment (FDI) which comprised about 70 percent of total foreign investment (including portfolio investments and inter-firm credits) followed the same pattern. The largest share – over 40 percent – went, as previously, into infrastructure, namely energy generation and distribution, including natural gas.

Telecommunications attracted the next significant share of investment, accounting for about 27 percent. The remainder was distributed among mining and metal processing, food processing, aviation, real estate, information technologies and tourism.

As a result of recent major acquisitions in infrastructure and telecommunications, Russia has become the clear leader in foreign investment in the Armenian economy. In the first half of 2008, 75 percent of all foreign investment originated in

Russia, a 3.2-fold increase over the first half of 2007. Other countries with significant investment shares are France, Germany, the US, Lebanon and Argentina. The largest foreign investment decision in 2008 was the granting of a license to France Telecom to operate the third mobile connection service in Armenia.

As Armenia's economic figures rose consistently year after year, experts knew that it would become progressively harder to maintain that level of growth. Starting as it did from an extremely low point, the initial growth is impressive. Sustaining double-digit growth, however, would have been a challenge even without a global crisis. In the second part of the year, most sectors were already feeling the impact of the crisis.

The agricultural sector performed moderately, registering 4.3 percent growth during the first nine months of 2008. Good weather conditions helped. However, excessively small farms and outdated technologies limit the potential for growth in productivity. The output in animal husbandry grew relatively slower at only 2.9 percent, partly due to the sharp decline in pig breeding as a result of an outbreak of hog cholera in 2007. Poultry and egg production are the most advanced subsectors thanks to serious investments in technology.

Beginning in 2009, in line with Armenia's World Trade Organization obligations, VAT will be levied on agricultural products. These have thus far been VAT-exempt. Many in agribusiness expect that this will significantly complicate development prospects. The government is considering introducing supporting instruments, such as subsidies or a reduced tax rate.

Structural changes in Armenia's economy have significantly lowered the role of **industry**, whose share of GDP has decreased steadily to only 13.8

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percent as of September 2008. Industrial output is highly concentrated in a few industries: mining and quarrying, energy generation and distribution, food and beverages, manufacturing of metallic and non-metallic products. Despite reportedly large-scale investments, the mining industry became stagnant by fall as a result of the drop in international base metal prices. The major manufacturing subsectors (food and beverages, manufacture of metallic and non-metallic mineral products), together account for almost 80 percent of total industrial output and registered only a very modest 1.5 percent increase. The robust growth of the construction materials industry to meet demand from Armenia's booming construction sector is going to slow down considerably.

There was a further significant decline in diamond processing and jewelry production, by 15.8 percent. This is expected to fall further due to the financial crisis. The output of the textiles, chemical, leather and wood processing and machinery subsectors shrunk as well.

Industry will face a further major challenge next year when Russia abolishes the subsidized price it charged for natural gas. Starting on April 1, 2009, Armenia will purchase gas at US\$ 154 per 1000 cu meters instead of the current US\$ 110, with a further increase in 2010 of up to US \$200.

Construction, the major force driving economic growth, is close to a standstill. Financing for residential construction projects is drying up. Real estate developers face financing problems for their ongoing projects, while the number of new residential projects in recent months is near zero. Real estate agencies report that demand for new residential spaces is down after the post-election crackdown and the emerging international

economic downturn. Diaspora Armenians, who were also fueling the real estate market, are less ready or able to spend significant sums to purchase second homes.

What was a consistent path to more infrastructure upgrades and renovations throughout the country will also be negatively affected. Kirk Kerkorian's Lincy Foundation has contributed nearly US\$300 million over the last 10 years but the future of that program is now uncertain as no new initiatives have been announced. The only major infrastructure projects are likely to be those supported by the Asian Development Bank and the Millennium Challenge Corporation, which has conducted in-depth planning over the past few years but has not yet embarked on any significant construction.

Finally, **the service sector**, one of the fastest growing, has also slowed down. Its growth in the first nine months of 2008 was 14.5 percent, compared to 17 percent the previous year. The considerable expansion of commercial bank lending to private households (36 percent within the first nine months of 2008) has mostly taken the form of mortgage and consumer loans which comprise more than half of banks loan portfolios.

The average monthly salary reached US\$ 300 in September 2008, but there are significant variations among sectors, with the financial services offering the highest and agriculture offering the lowest salaries.

The increase in net disposable income (by 21 percent) and the expansion in consumer credits contributed to further growth in retail trade turnover. However, as a consequence of the international credit crunch, Armenian banks quickly increased interest rates and put on hold

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large loan applications, not because of a liquidity crunch, but due to extreme caution.

Government initiatives to develop tourism as a priority sector of the economy have led to an expansion in the hotel and restaurant businesses. More than 200,000 foreign tourists visited Armenia during the first half of 2008, 13 percent more than in the first half of 2007. Ongoing projects in Dilijan, Tsaghkadzor and Jermuk will further expand the range of touristic offerings and upgrade available facilities, hence strengthening Armenia's position as a tourist destination. The effective public-private partnerships that led to what is considered a success in the development of Tsaghkadzor (a ski resort in the winter, a forest environment in the summer) will be duplicated in Jermuk, which the Ministry of Economy is preparing to promote as a spa resort. The government's own commitments for the Jermuk region are near US\$100 million.

ECONOMIC POLICY

The newly adopted revised Poverty Reduction Strategic Program (PRSP) with the new title of Sustainable Development Program (SDP) is expected to become the backbone of Armenia's economic policy. It is considered an overarching strategic document that sets a comprehensive framework for various government policies and programs, including medium term budgetary expenditures. The previous version of PRSP (2003) was believed to focus primarily on policy goals, rather than concrete mechanisms for attaining those goals. It also did not address fundamental issues such as the sustainable drivers of growth, key competitive advantages, weaknesses, and other contextual issues.

The government has highlighted tourism, health care, education, business environment and the financial sector as focus areas for national programs

The government believes the new title reflects an important paradigm shift. Until recently, economic policy goals have had a predominantly social and infrastructure focus. High rates of economic growth and an improved budgetary situation, accompanied with substantial donor assistance, allowed the government to invest in physical and social infrastructure. While this has resulted in notable improvements, the economic impact has been limited. By refocusing its main strategic document, the government is attempting to shift the context of its policies to economic development.

The new SDP identifies economic development as the first pillar of future policies and includes a special section on Economic Development Strategy. The SDP sets out the following three main priorities:

- Ensuring sustainable and high economic growth
- Implementing active social policies targeted at vulnerable segments of the population
- Modernizing governance institutions

As prescribed in the SDP, the strategic directions of Armenia's economic development policy will be

- implementation of targeted regional policies aimed at the reduction, or at least alleviation, of regional disparities

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- intensification and acceleration of second generation reforms, with particular focus on institutional development and modernization and, specifically, legislative and institutional approximation to EU standards
- improvement of the business environment, in particular by ensuring free economic competition and limitation of monopolies, which in turn will create equal opportunities for economic activity
- promotion of exports and greater involvement in the global economic system, including intensification of integration processes with the European Union, within the framework of European Neighborhood policy
- increasing the productivity and international competitiveness of Armenian businesses, and creation and development of elements and institutions for a knowledge-based economy.

The creation of the Pan-Armenian Bank, an idea born prior to the urgency of the current situation, is yet another ambitious initiative

The SDP aims at a gradual reduction of the poverty level in Armenia from 26 percent in 2006 to 6.8 percent in 2021, with extreme poverty to be eliminated in 2015.

Recognizing the need to revise strategies and policy tools, the Government of Armenia is

actively exploring specific policy initiatives and intervention mechanisms. The government has highlighted tourism, health care, education, business environment and the financial sector as focus areas for national programs. However, specific mechanisms, as well as resource commitments for these projects are still largely unclear.

Various government ministries and agencies have drafted concept papers and strategies with the aim of pinpointing and securing support for the most viable projects. These range from the rationale and ways to develop the IT sector, tourism, and crafts to transforming Gyumri into a techno-city, and creation of a financial center in Dilijan. Reactions have been mixed, especially with regard to the latter.

The creation of the Pan-Armenian Bank, an idea born prior to the urgency of the current situation, is yet another ambitious initiative. It is to be launched in late 2008 or early 2009 with an authorized capital of US\$ 100 million. It is planned in the form of an open joint stock company, co-funded by the government and the world's leading financial institutions and private investors. Its mission will be to utilize the advantages of the Armenia-Diaspora connections and the transnational Armenian network, and create resources to fund knowledge-intensive and innovative projects in cooperation with the National Competitiveness Council of Armenia, which has been created to increase economic competitiveness through public-private joint efforts. This Council is a promising attempt to establish a sound forum for public-private partnership, initiate strategic projects and secure appropriate funding. Thus far, the activities of the Council have been limited and the underrepresentation of local business community has been a key concern.

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INSTITUTIONAL REFORMS

Armenia's economic development hinges on the formation of a predictable, level field for new and old, large and small entrepreneurs. This is the government's challenge, now as never before, especially in this time of crisis. The President and the Prime Minister have both addressed subject. But it will require bold, consistent reforms of a new kind – second generation reforms – to restructure the institutions and adjust the business traditions which underpin Armenia's economy.

The most serious threat to the effective implementation of reforms is likely to be insufficient political will and decisiveness, inadequate human resources (both quantity and quality), as well as resistance from those who stand to be affected by such changes. The institutions most in need of reform are taxation, customs, banking and securities. These institutions, reformed, will open the field to normal competition, fair taxation and collection, dependable capital and credit.

According to many international reports, **tax and customs** issues remain the most problematic. Flawed tax and customs administrations have seriously distorted Armenia's business environment and created unequal competitive conditions. The government declared reforms in these two areas to be of crucial significance for the improvement of the economy. There was ample reason for the government to tackle these areas first.

International best practice, especially the European Union experience was benchmarked for tax administration reforms. A detailed diagnosis of administrative and institutional capacities, along with the recommendations of the IMF and

World Bank, were used to develop the 2008-2011 Program for Tax Administration Strategy. The political strategy of this new document is a significant shift, and professes to address the needs of the taxpayer, in order to more efficiently increase tax revenue while not hampering entrepreneurship.

As a result, a package of taxation laws was adopted in August. Amendments have been made to the laws "On Value Added Taxes," "On taxes," "On profit tax," "On income tax" and "On obligatory social insurance payments". As an immediate step, the law on the controversial "Simplified tax" will be abolished in January 2009. The problem was not in the idea of a simplified tax structure, but in the way it was implemented, allowing very large enterprises to be classified in this category. In general, small and medium sized businesses supported the changes, hoping that this would alleviate some of their tax burden. Where annual turnover in the SME sector is lower than 100 million AMD, it will be exempt from monthly VAT payments and will be eligible for the simplified profit (income) taxation mechanism.

In addition, a simple mechanism of "privileged payments" is planned for the self-employed with an annual turnover of less than 5 million AMD.

The system of VAT refunds is also being reviewed, in order to relieve exporters from the cumbersome and prohibitive process. There is also the possibility that by 2010 the state will pay a penalty for delaying refunds of excess VAT payments (collected at the beginning of the process, as goods enter the country.) For the state to take on such responsibility is a radical and new approach and will have a definite and positive impact on the country's business climate if implemented in the spirit of the law.

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The most serious threat to the effective implementation of reforms is likely to be insufficient political will and decisiveness, inadequate human resources (both quantity and quality), as well as resistance from those who stand to be affected by such changes

There are other measures which seek to infuse confidence into a skeptical business environment.

Since July 2008, a new complaint system has been in effect, thus significantly improving procedures and transparency in the tax service. There are doubts, nonetheless, about the impartiality of this new system.

There is also a simplified procedure for submission of reports in order to minimize the necessity of regular interpersonal contact, considered a potential opportunity for corrupt practices.

A pilot system for selecting those taxpayers subject to a tax audit is now in place. With audit selection based on risk assessment instead of a tax officer's discretion, it is expected that this mechanism will reduce the arbitrariness in the selection process which has allowed the process to become a tool for "punishing" a business or businessman.

Similar wide scale reforms aimed at strengthening the overall institutional capacity of the customs administration are also in place. These reforms aim to improve customs valuation rules, to use risk-based, rather than discretionary, customs and post clearance controls, and to enhance the

operational capacities of the customs administration through the use of new technologies and improved professional skills. The adoption of a Customs Ethics Policy is also part of the plan.

Although some of these new methods have already been introduced, the effect on businesses is unclear.

The absence of a **fair and competitive environment** in the most lucrative sectors of the economy, such as the import of key commodities, including sugar, wheat, fuel, is widely regarded as one of the most fundamental challenges to Armenia's economy. The dominance of this sector by specific business groups is attributed to their close personal ties to senior government officials.

The government's efforts to ensure a fair competitive environment include strengthening the institutional capacity of the State Commission for the Protection of Economic Competition.

The Commission investigated anti-competitive developments in the liquid natural gas market when gas prices increased as a result of elimination of subsidies in May 2008. The Commission also dealt with possible anti-competitive agreement cases in the financial sector related to the activities of banks and insurance companies in the consumer credit market. This was the first case of effective cooperation between the Commission and the Central Bank of Armenia.

The Commission expressed its concern at the situation in the flour and bread market, where vertically integrated entities with dominant market positions operate. The Commission also revealed abuse of dominant market position in

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telecommunication market, as a result of which ArmenTel CJSC has been accused of violating competition rules in dealing with internet service providers.

The Commission's effectiveness is, however, limited by serious impediments to enforcing its decisions, and a lack of appropriate capacity in the judicial process without the professional capacity to address competition issues.

The presence of a large shadow economy seriously misrepresents the market and creates favorable conditions for selected businesses. Some state entities can essentially distort competition by their decisions and proposed legislation. In countries with widely spread informal institutions, including Armenia, the authorities tasked with ensuring free competition are often too weak to function effectively.

The **banking sector** remains institutionally sound but plays too small a role in financing the economy. Currently 22 commercial banks with 364 branches operate in Armenia.

Still, the banking sector lags behind comparable countries. Capital to assets ratio in 2007 was at the level of 22.5 percent, which illustrates the inadequate level of deposit and other credit recourses (i.e. loans from international banks) secured by local banks. Domestic loan to GDP ratio, equal to about 13.5 percent in 2007, is one of the lowest among European and Central Asian countries, despite the fast growth in lending volumes in recent years. This is evidence that the role of the banking sector in financing the real sector is extremely low. Interest spread was 10.8 percent, pointing to the ineffectiveness of banking operations, the lack of competition among banks, the strict regulatory normative basis (as a result of inflation-targeted policy) and the unnecessarily high

levels of perceived risks. Moreover, the banking sector is still rather "small-scale," as evidenced by the low banking assets to GDP ratio (24.3 percent). Although such strong regulations do not feed economic growth, they do appear to have attracted considerable foreign interest and even allowed the sector to avoid the impact of the first wave of the global financial crisis.

The Commission's effectiveness is limited by serious impediments to enforcing its decisions, and a lack of appropriate capacity in the judicial process without the professional capacity to address competition issues

The entry of several important foreign financial institutions is expected to trigger fast growth. The French Credit Agricole, German ProCredit, the Russian Troyka Dialog, VTB and Gazprom banks have all entered the Armenian banking sector. This will definitely intensify competition within the banking system and potentially lead to a decline in the interest rate spread in the long-term. In the short-term, however, interest rates have already begun to rise due to the impact of the financial crisis. Moreover, the entry of such reputable banks is expected to provide transfer of knowledge and expertise, and help introduce new financial products in the market.

This year also brought new institutional developments to the banking and financial sectors. Early in the year, the banking supervision system was introduced. The Law on Covered Mortgage Loans introduced new instruments in the mortgage market, which may serve to boost mortgage lending in Armenia.

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The Law on Asset Securitization and Asset Backed Securities may help develop long-term financing for the business sector, once the global asset-backed securities markets recover.

Several pieces of legislation strengthen consumer protection and the development of the securities market. The Law on Attracting Bank Deposits sets the rules regulating the opening of deposit accounts. The Law on Consumer Credits regulates the bank-customer relationship in credit agreements. Within the same pool, the Law on the Financial Ombudsman is envisaged as a quick response tool for protection of consumer rights. The recently adopted Laws on the Securities Market and on Insurance and Insurance Activities are based on European standards and have opened new opportunities in those sectors of the economy. The NASDAQ-OMX group has become the owner of the Armenian Stock Exchange and Central Depository, and the largest Russian insurance company, RosGosStrakh, has entered the Armenian market. Nevertheless, the new regulations are insufficient to put the securities market on a fast growth track, since this is a new institution in Armenia, and will require a change in traditional thinking, business environment and corporate perceptions.

OUTLOOK

- The global economic crisis will continue to worsen. Therefore, the impact on transition countries, including Armenia, will continue to be substantial.
- There will be a considerable decrease both in Armenia's rate of economic growth and in consumer demand, both conditioned by external factors, such as a decrease in inflow of funds, especially remittances, and by internal factors, such as the government's restrictive fiscal policies.
- The current policy of pegging the exchange rate exacerbates external imbalances and will be difficult to sustain in 2009. Maintaining the strong national currency will continue to cause an increase in the level of imports and hurt exports, thus increasing the trade deficit. Export growth decline will also be aggravated by the fall of metal prices and weak external demand.
- The Central Bank has already lost US\$ 200 million or 12 percent of gross reserves since the beginning of the year because of heavy intervention to protect the AMD. There is also a high likelihood, especially if the current balance of payments trend continues to worsen, that the Central Bank's net international reserves will also fall below the IMF benchmark.
- Inflation has declined to 9 percent from the August high of 12 percent. This will no longer be a major policy issue, in light of a slow economy and the international drop in commodity prices. In 2009, inflation will not exceed 6 percent, and may even meet the budget target of 4 percent.
- Perhaps most significantly, the risks to the 2009 budget are substantial. The macro assumptions (particularly 9.2 percent economic growth) behind the 2009 budget, approved by the National Assembly in November, are largely unrealistic in today's situation. By mid-

THE GLOBAL CRISIS AND THE ARMENIAN ECONOMY

year, the government may be forced to seek serious amendments to the budget, but that may be late for a business community exhausted by tax pressures.

- Intensifying tax collection efforts can lead to expatriation of capital, further deterioration of the business environment, as well as higher prices.
- The Government's plan, as announced in November by the Prime Minister, includes some proposals in the short-term, to ensure stability, meet growth targets by offering new incentives, support overall industry, boost exports, and improve the balance of payments.
- The government intends to offer support to new enterprises by issuing state guarantees and subsidies and offering equity participation. The mechanisms remain unclear.
- The situation in the mining industry can only improve if the government takes forceful and significant action. Of course that would be difficult given budget restraints.

POLICY OPTIONS

To avoid the dangers threatening the Armenian economy, to allow the right preconditions for development, and to create qualitatively new economic relations, the following types of micro and macro measures will be essential.

- A coherent stimulus package, introduced early in 2009, with a focus on public works, to boost economic activity and generate employment
- A more flexible Central Bank exchange rate policy reflecting market demand and supply conditions to help exports and increase the purchasing power of those who will be constrained by a decrease in remittances
- Further enhance deposit insurance for AMD accounts. This is doable since the total deposits are below 15 percent of GDP and the banks are solvent. This will alleviate any concerns about a run on banks in the case of a depreciated Dram
- Properly working mechanisms to protect property rights and exclude the possibility of illegal acquisition and distribution of property
- A tax amnesty coupled with the introduction of a liberal and progressive taxation system
- Differentiated tax policy to serve not just a fiscal function, but based on economic strategies, to offer stimuli to certain sectors of the economy
- Securing the necessary registration and availability of documents and fight against the shadow economy beginning with big business and not SMEs, for whom a fixed tax rate should apply, and not graduated profit tax
- Given the limitations in the availability of capital for certain segments of the economy, introduce legislation to change the way VAT is collected at the border, thus not depriving businesses of liquidity even before goods are consumed

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- Continuing with customs reform, quickly moving to collection based on invoices as presented by importers, and ceasing to assess high customs fees which result in price increases and consumption decrease
- Passing anti-trust legislation together with the creation of a genuinely independent anti-trust agency
- Assuring open competition and free price formation
- Calling for a donor conference to present Armenia's disadvantaged position following the Russian-Georgian military flare-up may alleviate some of the adverse effects of that albeit short-lived conflict on Armenia's trade with Europe and Russia.

WHERE ARMENIA RANKS IN THE WORLD

Armenians are not happy. In fact, according to the University of Michigan Institute for Social Research “happiness index,”¹ Armenians are practically the saddest people in the world. Of the 97 countries included in the index, only Zimbabweans, with a happiness score of -1.92, are more depressed than Armenians who frown in at -1.80, just below Moldova’s -1.74. What do the three unhappiest countries in the world, Zimbabwe, Armenia and Moldova, have in common that makes their people so miserable? The fact that all three are landlocked does not explain it. Landlocked Switzerland makes the happiest top 10 with a score of +3.96 and even Kyrgyzstan smiles in at +1.59.

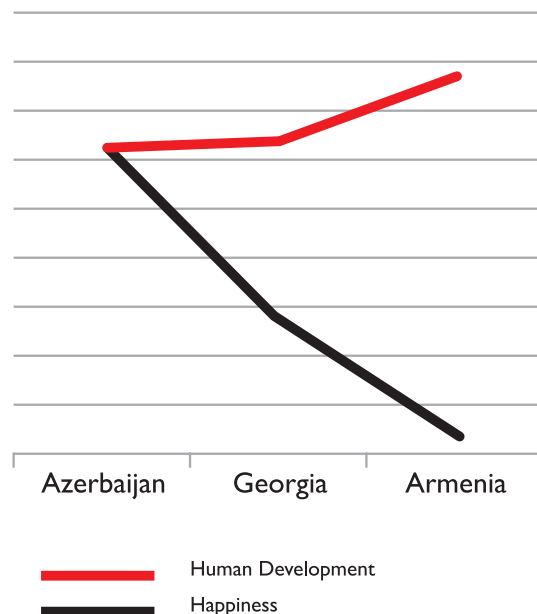
Could the unhappy trio’s despondency be a direct result of how poor and underdeveloped they are? Again, not likely. Granted, Zimbabwe and Moldova have low GDPs per capita: around \$200 for Zimbabwe and \$2,000 for Moldova. But the same is true for happy Kyrgyzstan, which, like Zimbabwe and Moldova, can be found in the lower, triple-digit section of the UNDP’s Human Development Index rankings². Armenia’s per-capita GDP, on the other hand, is more than twice as high, at over \$5,000, and its performance on the Human Development Index puts it in the double-digit club: 83rd among 177 countries ranked in 2008.

THE OTHER CAUCASIANS

Also in the double-digit Human Development Index ranks are Armenia’s South Caucasus neighbors, Georgia and Azerbaijan (ranked 96th and 98th, and with per-capita GDPs of around \$5,000 and \$9,000 respectively). How does Armenia compare with them in terms of

happiness? Georgians are only a little less unhappy than Armenians. Interestingly their happiness index score is identical to the Russians’ -1.01. Azeris, on the other hand are noticeably happier and, in fact, break through the doldrums with a score of +0.13.

South Caucasians unhappy with development



Judging from the Azeris’ relatively high spirits, freedom, democracy and rule of law are not drivers of happiness either, at least not in the South Caucasus.

¹ http://umich.edu/news/happy_08/HappyChart.pdf

² http://hdr.undp.org/en/media/HDR_20072008_Tables.pdf

WHERE ARMENIA RANKS IN THE WORLD

LIBERTIES, FREEDOMS AND GOOD GOVERNANCE

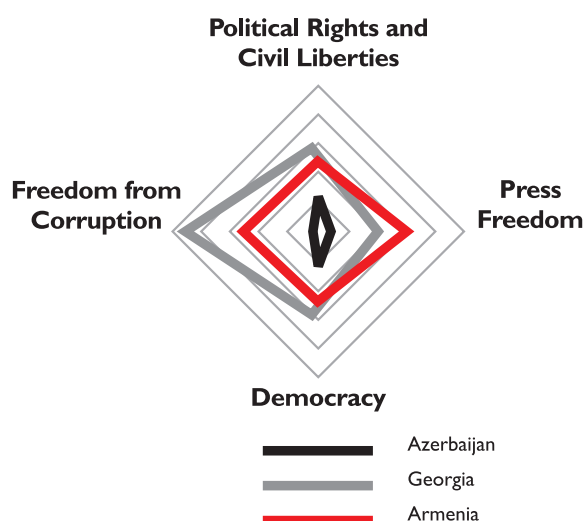
Freedom House's Freedom in the World Report is an authoritative indicator of political rights and civil liberties in the world but has a lag built into how it reflects progress or backsliding, factoring in latent trends mainly when they manifest themselves as noteworthy events. As such, it is best looked at several years at a time, rather than tracked from one year to the next. The 2008 Report³ characterizes Armenia and Georgia as "Partly Free" and Azerbaijan as "Not Free," assessments which have held steady for several years now, with Georgia in the lead as the freest (but regressing) and Azerbaijan bringing up the rear.

The more specialized World Press Freedom Index published by Reporters Without Borders is consistent with Freedom House's assessment in that it gives the South Caucasus a low freedom grade, in this case for freedom of the press. The 2008 rankings⁴ place the three countries in the southern hemisphere of the Index, and show that all three have clearly been heading further south compared to the year before. But in this case, out of a total of 173 countries in the index, Armenia's rank of 102 places it in a relatively better position than Georgia's 120 and Azerbaijan's 150.

The Economist Intelligence Unit also has a ranking in this general category, this one for democracy, as defined by a combination of electoral process, pluralism, functional government, political participation, political culture and civil liberties. Switzerland, one of the top ten happiest countries is also in the top ten of this Index of Democracy for 2008⁵ in a category

labeled "full democracies," which is followed by a lower category called "flawed democracies." Of the South Caucasus countries, Georgia and Armenia are placed in the even lower category of "Hybrid regimes" along with other regional neighbors like Turkey and Russia. Azerbaijan is firmly in the lowest category of the index, "authoritarian regimes," which it shares with regional neighbor Iran. As in the Freedom House rankings, Georgia, at 104th place out of 149 countries, comes ahead of Armenia (113th) and Azerbaijan (135th).

Freedom and democracy in the South Caucasus, a lopsided neighborhood



And finally corruption, as reflected by Transparency International's 2008 Corruption Perception Index⁶. Here Georgia has broken away from its South Caucasus neighbors according to this index, securing the 67th place out of 180 countries ranked, while Armenia holds the

³ <http://www.freedomhouse.org/uploads/fiw08launch/FIW08Tables.pdf>

⁴ http://www.rsf.org/IMG/pdf/cl_en_2008.pdf

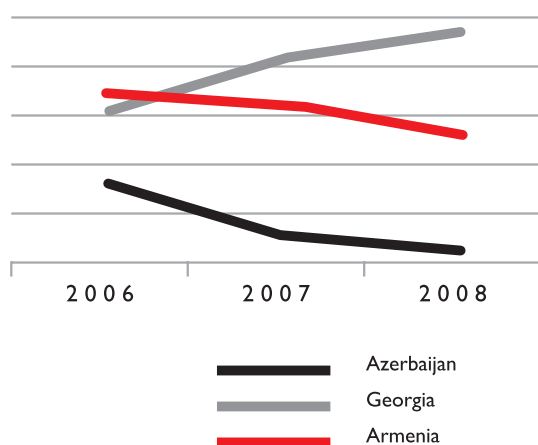
⁵ <http://a330.g.akamai.net/7/330/25828/20081021185552/graphics.eiu.com/PDF/Democracy%20Index%202008.pdf>

⁶ http://www.transparency.org/news_room/in_focus/2008/cpi2008/cpi_2008_table

WHERE ARMENIA RANKS IN THE WORLD

109th position (with the same ranking as its unhappiness neighbor Moldova) and Azerbaijan is ranked 158th. Georgia's progress in eliminating corruption has been impressive and all the more remarkable against the backdrop of Armenia's and Azerbaijan's retrograde tendencies. While Armenia and Azerbaijan slid around 20 percent each in their respective rankings between 2006 and 2008, Georgia shot up by more than 20 percent.

Transparency International's Corruption Perception Index: Georgia breaks free



THE FREEDOM TO MAKE MONEY

Over the course of the last year, prominent ads in the Economist magazine have told us that Georgia is better than blue-chip countries like Germany and Japan in this or that aspect of doing business. This is based on the World Bank Group's Doing Business Report⁷ which "provides objective measures of business regulations and their enforcement across 181

economies." The 2008 report identified Georgia as one of the world's top reformers across a number of indices, witnessing its rapid rise in the Doing Business rankings. In the three years leading up to mid 2008, Georgia went from 37th to 15th place, while Armenia slid from 34th to 44th place. The spot vacated by Armenia in the rankings was filled by its other neighbor, Azerbaijan which shot up from 99th to 33rd place in the same period. Such significant fluctuations can be hard to interpret, especially for business people working in each of the South Caucasus countries who might wonder why they are not noticing huge changes in the ease of doing their particular business.

Georgia's progress in eliminating corruption has been impressive and all the more remarkable against the backdrop of Armenia's and Azerbaijan's retrograde tendencies

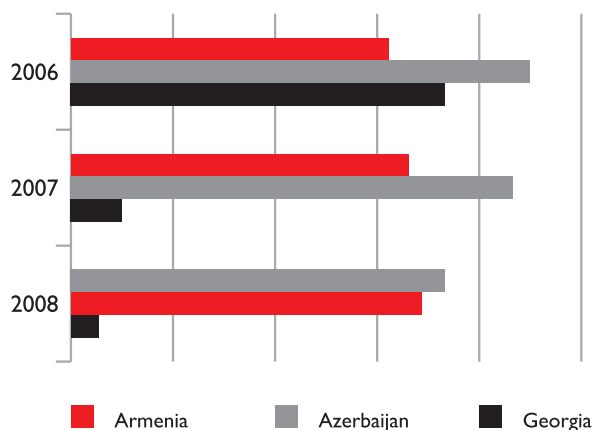
The picture becomes more confusing if we compare what the Doing Business index is telling us to the conclusions of another index focused on economic policies in over 150 countries, the Heritage Foundation/Wall Street Journal Index of Economic Freedom⁸. Here Armenia is the star at 28th place in 2008, although a bit of a falling star, having lost the 14th place spot it occupied in 2006. Still, Armenia falls in the "Mostly Free" category along with countries like Denmark (incidentally, the happiest place on earth, according to the happiness index) while Georgia is "Moderately Free" at 34th place and Azerbaijan is "Mostly Unfree" at 107th.

⁷ <http://www.doingbusiness.org/EconomyRankings/>

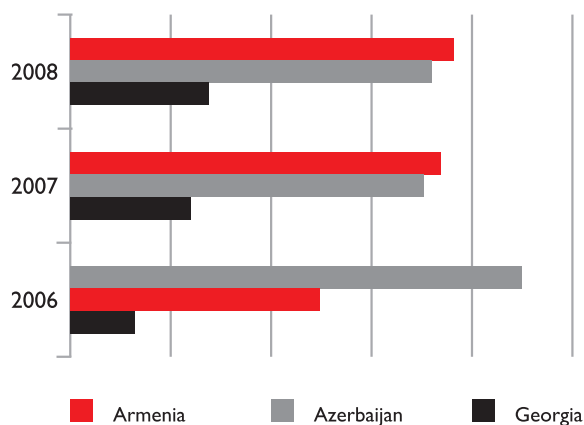
⁸ <http://www.heritage.org/research/features/index/countries.cfm>

WHERE ARMENIA RANKS IN THE WORLD

Ease of Doing Business...



... versus Economic Freedom?



THE COMPETITIVENESS COMPETITION

In a 1994 article in *Foreign Affairs* titled *Competitiveness: A Dangerous Obsession*, the Nobel laureate economist Paul Krugman took a stand against the notion that countries compete against each other economically the way private sector companies compete in the market. He argued that national competitiveness is at best “a poetic way of saying productivity.” And in fact, most competitiveness gurus now define the term competitiveness to mean, basically, economic productivity. But ironically, one way that countries do seem to be competing like companies might is in terms of their rankings on the World Trade Organization’s Competitiveness Index. Where Armenia falls in this ranking of 134 countries and how it does compared to its neighbors and other comparator countries is a topic that touches the competitive nerve of many policy makers and analysts.

It turns out that Armenia does very badly in this particular competition. The 2008-2009 edition of the World Competitiveness Report⁹ puts Armenia in the 97th position among 134 countries ranked. Georgia, ranked 90th, does only a little better while Azerbaijan is noticeable stronger at 69th. But the more interesting insights come from looking at some of the over 100 individual factors that are aggregated to produce the ranking.

Armenia does well in some areas such as the flexibility of its labor code when it comes to hiring and firing, the flexibility of wage determination, school and university enrollment rates, female participation in the workforce, and low terrorism and crime rates.

⁹ <http://www.weforum.org/documents/GCR0809/index.html>

WHERE ARMENIA RANKS IN THE WORLD

But predictably, the structure of Armenia's economy is a problem for the country when it comes to a cluster of factors that reflect the effects of the local business elite. Armenia is practically the worst place in the world in terms of the "Extent of Market Domination": 133rd place out of 134 countries – only Mauritania is worse. On both "Intensity of Local Competition" and "Effectiveness of Antimonopoly Policy" it ranks 132nd, barely ahead of countries like Chad or Bosnia.

CREDIT-RATING-WORTHY

In 2006, Armenia was considered, for the first time, worthy of getting a sovereign credit rating. Given its high level of dollarization at the time, combined with underdeveloped financial services, and the frozen but unresolved Nagorno-Karabakh conflict, Armenia received Fitch's initial "Non-Investment Grade" long-term credit rating of BB-. By 2008, this was upgraded to a BB with a "stable outlook," still lower than Azerbaijan's BB+, but higher than Georgia's B+ which is now tagged with a "negative outlook."

The three Southern Caucasus countries are also rated by Moody's. The Moody's ratings are consistent with Fitch's: Azerbaijan gets a "Speculative Grade" Ba1 with a stable outlook, Armenia is rated Ba2 with a stable outlook, while Georgia is also a Ba2 but its outlook is not considered stable.

For the non-specialist, one aspect of these sovereign ratings stands out: Despite the three neighbors' good standing in the Doing Business and Economic Freedom indexes and their impressive economic growth of the past several years, the South Caucasus is still, essentially, not investment grade – it is high risk, high returns territory.

BACK TO REALITY

Armenia's relatively risky credit ratings make intuitive sense to most people. But can the same be said about the other rankings? Certainly Armenia has a critical problem with its de facto monopolies, but is market dominance in Armenia really worse than in 99 percent of the world's other countries as the Competitiveness Index indicates? On the other hand, does it sound right that working in Armenia is significantly easier than in Spain, Italy and Poland as the Doing Business Report claims? Most observers would agree that Armenia's democratic institutions are far from perfect or even flawed, but would they be comfortable taking at face value the Economist Intelligence Unit's claim that Armenia does not even rise to the level of a "flawed democracy?" And even though few would characterize Armenians as cheery, the idea that they are among the unhappiest people in the world seems to have a somewhat tenuous link with reality.

But the fact that rankings can be counterintuitive does not mean that they are not useful. In fact, leaving specific comparisons with other countries aside, what they are objectively and quantifiably telling us about the hard work that lies ahead for Armenia is quite accurate. Armenia will have to tame its monopolists, send its corruption into remission, liberate its media, improve its productivity, build up a critical mass of functional democratic institutions, and create the conditions for safe and profitable investment.

And do Armenians need to cheer up? Maybe not quite yet. They are probably unhappy because their reality does not match their expectations. This perpetual state of dissatisfaction may be a potential source of energy to fuel the country's progress.

THE REGION IN FIGURES

ARMENIA

GDP Growth: 7.5 percent
Outlook: The economy is sure to slow down in 2009, at a rate that will depend largely on developments in Russia and the US. The base line scenario could put growth in the plus territory. In the worst case, there may be negative growth, which would aggravate social dissatisfaction and fuel political discord. The political consequences of March 1, particularly the trial of the top names, will continue to be a source of tension. The government will continue to feel cornered and unable to act for fear of losing power. An opening in relations with Turkey would offer a positive balance to the domestic economic and political crisis. The government is also seriously addressing the Nagorno Karabakh conflict, but there, much depends on the Azerbaijani willingness to compromise.

AZERBAIJAN

GDP Growth: 18.6 percent
Outlook: Declining oil prices and the global financial crisis will hugely affect Azerbaijan's economy. Domestically, it will remain stable, since, compared to the other Caucasus republics, the clampdown on the opposition is near complete. Azerbaijan will follow closely developments between Armenia and Turkey, and will attempt to ensure that the thaw does not lead to opening the Turkish-Armenian border. Russia - Azerbaijan relations will become more important. On the Nagorno Karabakh issue, Azerbaijan will remain engaged in talks, but will continue to chip away at the compromise package on the table, instead looking for easier, more political venues, such as the UN.

GEORGIA

GDP Growth: 2 percent
Outlook: The economic slowdown has affected Georgia, as well, but the massive post-conflict bailout packages, if delivered, will compensate somewhat for the economic losses. They will not compensate for the ongoing tension between Russia and Georgia, sure to continue. Serious bickering about the extension of international observation and monitoring missions in Georgia will dilute the international presence there. Domestic pressures on Saakashvili to explain the August events will increase, as will calls for his resignation. In the process, new political forces will emerge, attempting to consolidate the disaffected, and offering an alternative, second pole.

RUSSIA

GDP Growth: 7.3 percent

Inflation: 14.5 percent

GDP: \$1,297.5bn

GDP per Head: \$9,131 (PPP \$14,400)

Population: 142.2m

Outlook: Russia's spectacular rebound, economic as well as political, was hit badly by the global financial and economic crisis. The Russo-Georgian conflict exacerbated the economic situation and caused further damage to an already tricky investment environment. The outlook remains grim since falling global demand is expected to keep oil prices down. Russia still wants domination over energy transit routes from East to West even as it tries to repair its ties with Europe. It will maintain the Georgia stand-off, and at the same time re-insert itself into the Caucasus processes, especially in mediating the Nagorno Karabakh conflict.

TURKEY

GDP Growth: 4 percent

Inflation: 10.3 percent

GDP: \$657.1bn

GDP per Head: \$9,309 (PPP \$12,350)

Population: 72.6m

Outlook: Slower global and regional demand, as well as weaker FDI inflows, will decelerate the economy in 2009. However, Turkey's main concerns will continue to be internal strife between the AKP vision and programs and the ideology of the traditional nationalist establishment. Turkey will try to define a new role for itself in the region in this year which will also be important for its EU accession process. How it deals with the Russian-Georgian conflict, the border which remains closed with Armenia, its supportive role of Azerbaijan in the Nagorno Karabakh negotiations process will determine how serious a regional player it becomes. Turkey will continue to use the idea of a Caucasus Security and Cooperation Platform to remain engaged in the region.

IRAN

GDP Growth: 5.5 percent

Inflation: 18.5 percent

GDP: \$270bn

GDP per Head: \$3,939 (PPP \$9,852)

Population: 72.9m

Outlook: Iran's solitary economy will be severely affected by the current crisis and ensuing drop in oil and commodity prices. Hefty government expenditures will suffer as well. Despite international pressures Iran is likely to pursue its nuclear ambitions, hence also risking economic sanctions. This will affect its neighbors, particularly Armenia. To fend off deeper isolation, it will attempt to become more engaged in regional processes while keeping a balanced policy on conflicts, including Nagorno Karabakh.

GDP Growth and Consumer Price Inflation indicators represent estimates for 2008. GDP and GDP per Head figures are for 2007.

Sources: The Statistical Service of the Republic of Armenia, the Economy and Values Research Center, the Central Bank of Armenia, the Economist, Fitch's Ratings, the International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development, Societe Generale.



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