

ARMENIA: ECONOMIC CHALLENGES DURING THE CHANGE OF GUARD

Haroutiun KHACHATRIAN

*Economic and political analyst, Noyan Tapan Information Center
(Erevan, Armenia)*

The next parliamentary elections in Armenia are to take place in May 2007, followed by presidential elections in March 2008. In other words, the country is to go through a radical “change of guard:” Robert Kocharian is to leave the post of president because in accordance with the Armenian Constitution he cannot be nominated for a third term of office. This highlights the importance of the 2007 parliamentary elections, considering that the name of the future occupant of the presidential palace for a term of four years will in large part depend on the results of these elections. Amendments to the Basic Law made in November 2005 enhance the role of parliament and government by transferring to them some of

the president’s powers, and this complicates the picture still further.

Another point to note about the coming change of power is that Robert Kocharian’s ten-year presidency and Andranik Margaryan’s seven-year tenure as prime minister (2001-2007) have undoubtedly proved to be quite successful for the country’s economy. This means that the coming change of power is also a test for the economy of this small (in size) republic or, more precisely, a test for its stability and policy continuity. In addition, on the threshold of this decisive change of guard the country faces (or may face) a number of economic challenges, whose successful resolution is also part of the test.

Main Economic Results of the Kocharian Era

Although Robert Kocharian is to remain at the helm of state for almost a year, an attempt to sum up the preliminary results of his rule (economic results above all) is perfectly justified, especially since

one can say that the main events of his term of office have already taken place, while his further moves are predictable.

The general situation in the economy is as follows.

—The country was among the first seven FSU republics to restore the 1989 level of GDP by 2005.¹ In this case, Armenia differed from the six post-Soviet states with higher rankings in that, among other things, it had no natural resources (in contrast to Azerbaijan and Kazakhstan). Moreover, the crisis through which it passed in the early 1990s was one of the deepest among the crises experienced by all FSU republics (GDP fell to 42% of the 1989 level). There were also the economic consequences of tense relations with Azerbaijan and Turkey in view of the Nagorno-Karabakh conflict.

Economic growth (for six years running, from 2001 to 2006, this growth was expressed in double-digit figures) entailed a substantial reduction in poverty: the share of the population living below the poverty line was down from 56% in 1999 to 29% in 2005. In other words, in six years a quarter of the population (about 800 thousand) ceased to be poor.

—Now that the republic has restored its pre-crisis GDP level, its new economy has proved to be more competitive than it was right after the breakup of the U.S.S.R. In the first place, this is expressed in lower resource intensity: with the same GDP, the country now consumes 2.5 times less electricity and almost three times less gas than in the Soviet period. The material intensity of GDP has declined as well, with a sharp reduction in the republic's dependence on the foreign market: the foreign trade turnover has decreased almost sixfold compared to the Soviet period.² Such a reorientation toward the domestic market is in itself a sign of the economy's growing competitiveness and stability.

—The main factor that has produced this result is the state's highly liberal economic policy, as evidenced, for example, by the Heritage Foundation/Wall Street Journal Index of Economic Freedom. In terms of this index, Armenia has for several years now ranked above all the other CIS republics, and in 2005 it was among the top 30 countries in the world (out of more than 150), outranking even a number of EU states. The republic also ranks quite high on the Ease of Doing Business Index, calculated by the World Bank. At year-end 2005, it was 46th among 155 countries, far ahead of all the other CIS republics.³ This has been achieved, in the first place, due to Armenia's liberal tax and trade regime, whose foundation was laid under Robert Kocharian's predecessor, the country's first president Levon Ter-Petrosian. And the Kocharian-Margaryan tandem continued to pursue the course adopted at that time (improving the situation in some respects and worsening it in others).

—Today the Armenian economy is fairly balanced (its dependence on growth in some particular sector or subsector is insignificant). A distinguishing feature of the six years of "double-digit growth" mentioned above was that in different years this growth was driven by different "locomotives," with industry, agriculture and construction replacing each other in this capacity. Similar processes were underway within these sectors: in industry, for example, food production took the lead alternately with diamond cutting and mining.

¹ See: *EBRD Transition Report 2005*. According to forecasts for that year, only six countries were expected to reach that level: Uzbekistan, Estonia, Turkmenistan, Belarus, Kazakhstan and Armenia. But then it turned out that in 2005 the Soviet-period GDP level was also reached by Azerbaijan, whose record GDP growth (26%) at that time was due to a sharp increase in oil production and world oil prices.

² See: H. Khachatryan, "Economic Situation in the South Caucasus Countries in the 15th Year of Independence. A Comparative Analysis," *Armenian Trends*, 2006, Q4.

³ According to an updated technique applied a year later, Armenia's ranking was even higher: 37th place (see: [www.doingbusiness.org/ExploreEconomies/Default.aspx?economyid=10]).

- Armenia is not a model of democracy, but the fairly long period of stability⁴ has enabled its authoritarian leaders to take steps conducive to economic development and growth. Internal political processes ran along lines that helped, as far as possible, to separate economics from politics. Two major developments were of particular importance in this respect. First, the introduction of a system of civil service (one of Kocharian's key reforms) has made most of the state apparatus independent of political processes: from now on, ministers can be replaced as often as once a month, but none of the new ministers have the right, as they had only six years ago, to dismiss their subordinates (at the appropriate level) as they see fit. Another characteristic development of this kind is that over the past two years the function of the main reforming agency has passed from the government to the Central Bank, which is much less dependent on the current political situation. The Central Bank is now engaged in creating a securities market, which implies the need not only to develop an appropriate legislative framework and infrastructure, but also to carry out fundamental reforms in the area of corporate governance in Armenia, especially when it comes to companies owned by big businessmen (oligarchs). And the fact that the Central Bank is not susceptible to political change and, in particular, that its present chairman, Tigran Sarkisian, can retain his position for another five years is good reason to hope for success in this matter.
- Armenia is undoubtedly a unique state as regards its geopolitical position. What I mean is that it is probably the only country in the world which, while being a military-political partner of Russia, at the same time declares its pro-Western orientation, actively implementing market reforms and getting Western assistance for their implementation. In particular, throughout most of the 1990s the republic was the world's third largest recipient of U.S. government aid (per capita), ranking behind Israel and Egypt. This ensured, among other things, a constant inflow of money and technical assistance from international financial organizations: the International Monetary Fund and the World Bank. At the same time, the existence of such an ally as Russia provides tangible support in ensuring the security of the country's borders. In recent years, cooperation with Russia has also led to an increase in investment (it should be noted that Russia—Armenia's "strategic ally"—has never provided it with any free assistance, in contrast to the United States, Russia's rival in the region). In 2006, Armenia's allied relations with Russia probably for the first time produced real economic results. Thus, Russia's Gazprom agreed to keep the price of gas supplied to the republic down to the level of \$110 per 1,000 cubic meters, which is half the price paid by most other CIS countries, in exchange for the unfinished fifth power generating unit of the Razdan Heat and Power Plant (Armenia could not find an investor for this unit for over 10 years). The resultant "gas respite" is a welcome development for Armenia, whose industrial growth has slowed in recent years.

The Challenges of the Near Future

The economic challenges facing the country today and those it may confront in the coming years are mostly due to the factors listed above. They can be divided into two groups. First, there are challenges of

⁴ In effect, stability has lasted for almost seven years, since the appointment of Andranik Margaryan as prime minister in May 2000. The Kocharian-Margaryan tandem was able, without much difficulty, to keep the reins of power during the 2003 presidential and parliamentary elections. True, these elections took place with obvious violations in favor of the ruling elite, but the weak and fragmented opposition failed not only to undermine the existing regime (to realize their dream about a "color revolution" of their own), but even to create a tangible threat to its stability. One of the main reasons for the weakness of the opposition was evidently the weakness of the protest electorate, which could not be strong in the conditions of rapid economic growth accompanied by poverty reduction in the country.

an objective kind caused by the fact that the republic's development has reached a certain watershed, a point from which it has to move forward so as not to lag behind and lose the advantages gained in competitive struggle. The second group includes factors external to the economy, which, for their part, can be divided into two subgroups: factors partly determined by the domestic political situation (primarily the coming elections) and purely external challenges. Finally, all these three sets of challenges are closely interrelated, and the fact that they have come together at this time only complicates their analysis.

A) Risks Associated with Elections

1. Risk of Destabilization During and/or After the Election Campaigns

The record of the past few years shows that there is little likelihood of political destabilization in the republic and that when such risks did appear (as during the 1996 presidential election and both elections in 2003) the ruling regime was able to neutralize them with considerable ease. But the coming election campaigns are unique in the sense that for the first time (at least since 1995) there is to be a contest not between the ruling party and the opposition, but between different factions of one and the same ruling regime. Political reality and legislation are such that these factions will not take a common stand against some kind of opposition, but will compete with each other both for parliamentary seats and for the presidency. This situation will be complicated by two circumstances. First, by the ambitions of Robert Kocharian, who will have to step down as president, but who declares that he has no intention of leaving the political scene.⁵ The role that he wants to play after March 2008 and that the ruling elite is prepared to entrust to him (let us recall that officially Robert Kocharian is not a member of any political party) remains a matter for conjecture. And second, by the emergence of a new and potentially powerful political organization, the Bargavach Hayastan (Prosperous Armenia) party. Analysts are at a loss about its ambitions and its possible place in the country's political spectrum.⁶ But all of them agree that this party is destined to make a significant contribution to the implementation of Robert Kocharian's personal plans after his departure from the position of head of state.

All of the above suggests that the change of guard will probably be accompanied by some kind of upheavals. And it is taken for granted that such upheavals will have a negative or even catastrophic effect on the economy. In my opinion, however, there is little likelihood of such a turn of events; the ruling elite will manage to reach an agreement and go through this new and unprecedented period in the country's history without upheavals, which are ultimately not in the interests of any group of the national elite.

2. Risk of International Sanctions for Improperly Held Elections

This is a more mild version of political upheaval which may follow in the wake of elections if they do not meet the standards of democracy, as has been the case virtually throughout the past ten years. Western donors have repeatedly shut their eyes to the violations of electoral laws and procedures used by the ruling party to consolidate its power in the struggle against the opposition. In the period preceding the current election cycle, the Armenian authorities got more warnings than usual that in case of detection of such violations foreign donors would apply certain "sticks." There are two of these. First, the

⁵ Here is what he said in an interview on 15 December, 2006: "I have no intention of becoming the youngest pensioner in Armenia" (see: [<http://news.president.am/rus/separate.php?sub=press&id=96&year=2006>]).

⁶ Today one can say the following about this party. First, it was set up and is financed by Gagik Tsarukian, one of the country's wealthiest businessmen. Second, the party engages in charity on a large scale, winning widespread popularity. And third, it has no prominent professional politicians among its members.

threat of suspension of the U.S. Millennium Challenge program (\$236 million for the rehabilitation of roads and other infrastructure facilities in rural areas). And second, the possibility of a review (or suspension) of the joint Action Plan under the European Neighborhood Policy program (whose implementation begins in 2007), a possibility which is not ruled out by the European Commission.

As I see it, this risk is not very significant either. And the point is not only that the Armenian ruling elite is afraid of these “sticks” (although they are not large in money terms, their use would mean a break with the leading Western partners and donors, even while there is no alternative to the “Western” path of development for the country’s economy). There is yet another and possibly more important factor, a consequence of the above-mentioned political situation, in which the main struggle is to take place between different factions of the ruling elite, i.e., between forces in possession of virtually equal resources both for election rigging and for counteracting such attempts. It is precisely due to this circumstance, paradoxical as it may seem, that they will probably have no choice but to determine the composition of the future parliament in the course of a relatively fair fight (the outcome of the presidential election is a more complicated and distant problem). It cannot be ruled out that National Assembly Chairman Tigran Torosian, who has recently stated on many occasions that fair elections are in the interests of all political forces in the republic, will prove to be right.

B) Risks Associated with the Country’s Economic Development

As noted above, Armenia has carried out sufficiently rapid and effective market reforms and has reached a point where these reforms have already produced their results, whereas further active economic growth requires qualitatively different reforms. Consequently, the risks included in this group would have appeared even without an election campaign, but the realities of the latter complicate these problems still further. In my opinion, there are two main risks of this kind:

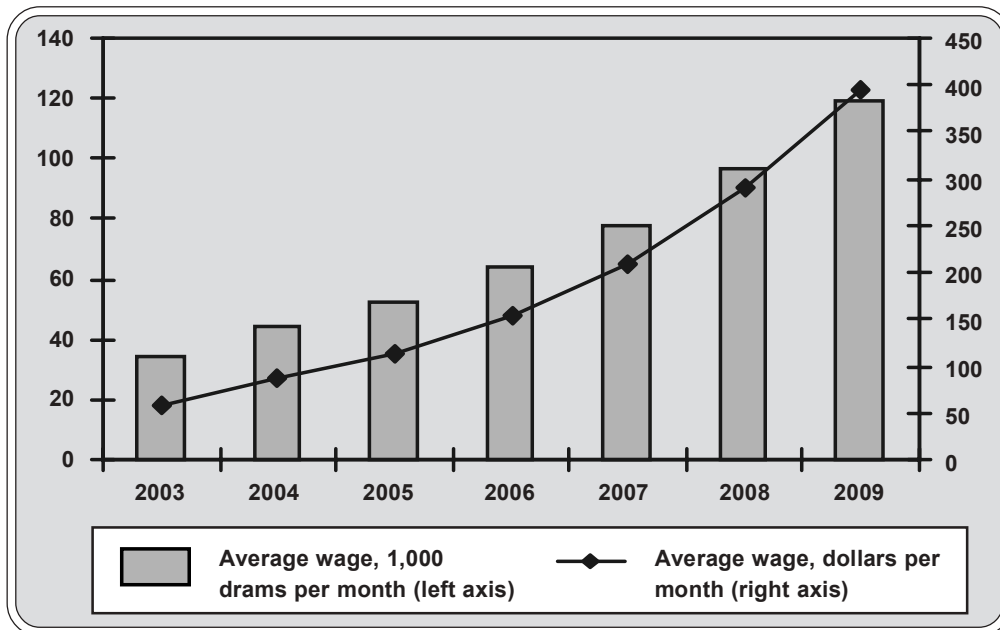
1. The possibility of a departure from liberal economic principles or a suspension of the reforms. The beginning of 2007 was marked by an event which causes some concern. In terms of the Index of Economic Freedom for this year, Armenia has dropped from 27th to 32nd place. Although it has retained the “title” of the freest economy in the CIS (and according to the authors of the Heritage Foundation report, this drop, at least in part, is due to changes in the calculation technique), it is worrying that a number of problems cannot find their solution for several years. These include corruption, dependence of the judicial system on the executive authorities, unequal law enforcement in relation to different subjects, etc. All of this can create the risk of Armenia’s losing its investment attractiveness, which is not too great as it is in view of geopolitical factors. According to experts of international financial organizations, in order to achieve further stable economic growth Armenia should set itself more ambitious tasks than at the first stage of economic reforms. Now that the basic tasks of economic transition along these lines have in the main been accomplished (creation of a private sector with a subsequent increase in its role in the economy, development of appropriate state regulation of the “rules of the game”), it is necessary to radically increase the role of financial institutions. This task has been undertaken by the Central Bank, which in 2005 and 2006 was vested with such functions as the development of mechanisms for the creation of a securities market and an insurance market (even including the development of a framework for transition to a funded pension system). As noted above, this is a step in the right direction if only because the Central Bank is relatively independent of political factors (incidentally, this very independence is among sovereign Armenia’s undeniable achievements). However, it is also obvious that without support from the government the Central Bank will be unable to cope with these tasks (take, for example, the question of introducing modern corporate governance principles in business companies, without which

it is impossible to create a securities market). Hence the danger that the government and parliament, preoccupied with their pre- and post-election concerns, will not pay proper attention to these problems. Robert Kocharian appears to be aware of this, because he has time and again spoken of his intention to prevent electoral processes from having a significant effect on the economy.

- Continued strengthening of the Armenian dram. This process began in 2003 (the dram was at its lowest point in relation to the dollar in March 2003: 587 drams per dollar). Since then the dram has risen against all currencies at an annual rate of about 10%, causing discontent among a significant part of the population (say, employees of foreign organizations paid in foreign currency). This discontent is most pronounced in the large segment of the population (according to Central Bank estimates, about one-third of the country's households) that receives monetary support from relatives abroad. According to the Central Bank, these remittances are actually the main cause of the rise in the value of the national currency, because in recent years their amount has increased at an annual rate of at least 15% (other contributing factors are a reduction in the trade deficit and an increase in investment inflows). However that may be, this discontent does not go beyond faint murmurs, because the people's purchasing power has been rising anyway, both due to these remittances and as a result of rising income levels in the country. Another and much more serious consequence of this phenomenon could be excessively rapid growth of the dollar equivalent of Armenian wages, which could have a negative effect on the competitiveness of domestic goods. According to government assurances, the strengthening of the dram has so far had no such effect, while the slowdown in the growth of exports over the past two years is caused by other factors. The chart shows the movement of the average wage in the country—in drams and in dollars—from 2003 to 2006 (real) and its projections until 2009, given a continued increase in the dram wage (at 23% per year) and a rise of the dram against the dollar (at an average annual rate of 10%).

Chart

Real and Projected Average Wages in Armenia



If the current trend continues, in 2008 the average dollar wage will already exceed \$300 per month, and in 2009 it will be close to \$400. And this is already comparable to the figures for East European countries, i.e., the republic will lose such an important (in some respects) advantage as relatively low wages, which will deal a severe blow to the competitiveness of domestic goods.

For the time being, the strengthening of the Armenian dram is to some extent even beneficial to local producers, because the weakening U.S. dollar reduces investment costs, e.g., the costs of purchasing new equipment abroad. Over the past two years, according to the Ministry of Trade and Economic Development, imports of such goods have been growing faster than other imports, and this, in the Ministry's opinion, opens up prospects for enhancing the competitiveness of Armenian goods.

C) Risks Associated with External Factors

The most serious external risks to the Armenian economy are undoubtedly outbreaks of violence in territories adjacent to the republic. Such risks can come from each of the four neighboring countries: in the form of a resumption of hostilities in the zone of the Karabakh conflict, a U.S. armed attack against Iran, destabilization in Georgia or even in Turkey. However, the likelihood of all these adverse scenarios being set in motion in the foreseeable future is very insignificant. The following risks appear to be more real:

1. A simultaneous return home of large numbers of labor migrants from Russia as a result of the Russian government's new policy. This can not only reduce the inflow of remittances, but also cause a surge in unemployment and related problems.⁷ The government of Armenia, in contrast to the authorities of Azerbaijan, is not particularly concerned about the possible inflow of compatriots, who are now prohibited, by decision of the Kremlin, from working in public retail markets. According to fragmentary data, there are not too many Armenians in Russian markets. But even if one in ten Armenian citizens living in Russia are obliged to return home (and this is about 60-70 thousand people), the country will be faced with a serious problem: it will take at least several years to integrate the returnees into the economy.
2. Shocks caused by changes in world grain and energy prices. Armenia has partly insured itself against such shocks by its deal with Gazprom, signed in April 2006. However, the possibility of its violation by the Russian company cannot be entirely ruled out; on the other hand, by 2009 the price of gas in Armenia is to double anyway, and the country should make the most of this "gas respite." Although the rise in the value of the dram (according to Central Bank forecasts, it is to continue for at least another year) will to some extent cushion this blow, Armenia will in any case eventually have to deal with a significant rise in the price of its basic fuel: from the current \$110 to about \$235 (if not more) per 1,000 cubic meters. For the present, the republic's authorities are in no hurry to reduce electricity rates, which is quite possible given the current price of gas and the continued weakening of the dollar (this could be a preventive measure in the face of the future increase in gas prices).
3. Geopolitical risks associated with a possible change of economic orientation driven by political and not economic factors. A meeting between Robert Kocharian and Vladimir Putin held in Sochi on 24 January, 2007, produced a sensational result: Russia declared its intention to invest in Armenia over the next few years roughly as much as it had invested in the previous decade. One

⁷ Of course, a great deal will depend on the occupations of people returning in the first place. The country has recently experienced a growing shortage of skilled labor, primarily in construction. But skilled construction workers are unlikely to return, because Russia itself is in the midst of a building boom.

of the options here is even a project for the construction of such a facility untypical for Armenia as a refinery for processing Iranian oil.⁸ On the one hand, an inflow of investment can only be welcomed but, on the other, such plans will mean Erevan's close ties to the Moscow-Tehran axis, which will probably have a negative effect on the prospects of Armenia's contacts with the West. Another consequence of this expansion could be a "politicization" of investment activity. For example, attention is already drawn to the fact that Russia has stated its intention to engage in uranium production in Armenia, even though a short time ago the republic's authorities rejected a similar proposal made by the American company Global Gold.

4. Shocks associated with the possible unblocking of transportation routes. At present, the republic suffers from the closure of the Abkhaz Railway, the most convenient route connecting Armenia and Russia, and also from the closure of the Armenian-Turkish and Armenian-Azerbaijani borders. My own analysis carried out three years ago showed that the chances of these communication lines being unblocked decreased precisely in the above-listed order, i.e., that the unblocking of the Abkhaz Railway was most likely, while the opening of the Armenian-Azerbaijani border was least likely.⁹ Given the recent complications in relations between Moscow and Tbilisi, and also certain progress in the talks on Nagorno-Karabakh, this order no longer appears so indisputable. An "easing" of Armenian-Azerbaijani relations as such can hardly be expected to have an immediate beneficial effect on the economy, but it could pave the way for the opening of the Armenian-Turkish border, closed by Ankara in April 1993 as a token of solidarity with Baku over the Karabakh conflict. Although the probability of this is fairly low, Erevan should be prepared for such a turn of events because, according to experts, the opening of the border with Turkey could result in a doubling of GDP growth in Armenia,¹⁰ i.e., the republic could be faced not only with very rapid GDP growth (known as "overheating of the economy" and believed to be a rather dangerous phenomenon), but also with a mass of other problems (the need to restart communications, the inflow of freight and people, etc.), for which Armenia has to prepare as well.

⁸ For more detail, see: "Svet v kontse truby," *Kommersant*, 26 January, 2007.

⁹ See: H. Khachatrian, op. cit.

¹⁰ The results of a recent conference are available on the website of the U.S. Embassy in Armenia: [www.yerevan.usembassy.gov/news/2007/january/news011307.pdf].