



FPC Briefing: Armenia's Economy since Independence¹

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Foreword

A common analysis of Armenia's economic performance since independence typically focuses on the limitations imposed by geography and geopolitics and mostly ignores, or at best glosses over, the failures of governance and policy to deliver on what could have reasonably been expected. Proponents of such views fail to provide conclusive evidence of trade-imposed barriers to growth and progress in Armenia, or explain why other countries with similar governance characteristics but unhindered external trade remain poor. While I recognize the limitations imposed by the geopolitics and security considerations on the economic and social outcomes in general and in the Armenian context in particular, I am of the view that policymakers in Yerevan since 1991 have imposed additional constraints that became significantly more binding than geography and security and adversely influenced economic and social outcomes. The remainder of this briefing builds on this premise and highlights the specific policy failures that, in my view, are to be blamed for the current state of economic and social affairs in Armenia.

Armenia's Economic Performance

Armenia's path since independence from the Soviet Union in 1991 can be broken down into three rather distinct periods as follows: (i) 1991-99 (ii) 2000-07, and (iii) 2008 to present day. I highlight the specific features of these periods in Armenia's independent history in detail below.

Post-Transition Progress (1991-99)

Armenia's return to growth in 1994—the first among the former Soviet republics still recovering after the collapse of the USSR—was nothing short of remarkable and was achieved while the economy was recovering from the impact of a devastating earthquake and a full-blown war with the neighboring Azerbaijan.

Growth was underpinned by speedy and largely successful small- and medium-size state-owned enterprise and land privatizations. Yet the failure to create conditions for proper functioning of the markets and the lack of a meaningful role for the state became key constraints for progress thereafter. Ongoing conflict in Nagorno Karabakh and the legacy of a highly industrialized but by now mostly obsolete economic structure did not help.

¹ Based on remarks delivered at the conference on "The South Caucasus: 20 Years On", organized by the Carnegie Endowment for International Peace on November 28-29, 2011, in Washington, D.C. The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management.

Here is a short list of factors that proved critical and have influenced much of what had happened next:

- First signs of the *nouveau riche* concentrating sizable wealth and getting close to economic decision-making have emerged.
- The seeds of authoritarian governance were effectively sown. Generals, returning from the front lines, were getting increasingly powerful and had a major role to play in the hotly contested and violent 1996 election.²
- The promise to get the Diaspora involved meaningfully in rebuilding Armenia was effectively reversed.³

The assassination of then Prime Minister Vazgen Sargsyan—a controversial figure, who nevertheless is widely seen as perhaps the only hope Armenia had for building a strong statehood—and six others on October 27, 1999 in the parliament ended this period. The very high levels of public buy-in and social cohesion, which were present during the early 1990s but almost disappeared during the post-war reconstruction period, surfaced during V. Sargsyan’s short tenure in office, to never re-appear again.

Qualitative Stagnation (2000-2007)

The period coincides with the rule of Robert Kocharyan, whose particular political skills allowed him to consolidate power after the October 1999 assassinations and played a dominant role in this handling of both political and economic affairs in the country. This period witnessed double digit growth of GDP and macro-financial stability, but was marred by much of the same lack of regard for good governance and properly functioning markets.

The construction sector, which was the main engine of growth during this period, absorbed sizable amounts of credit and labor resources, driving interest rates, exchange rate, and wages up throughout the rest of the economy. Under these conditions and without effective policy intervention, the economy failed to diversify despite very strong signs of promise shown by some sectors (most notably, IT and agro-processing), effectively preparing the ground for the dramatic decline of GDP in 2009 (see below). Remittances and other transfers from abroad, which fueled this construction boom, complicated the macroeconomic management and created adverse dependence at the microeconomic/household level.

On the budgetary side, the period is characterized by a highly pro-cyclical fiscal policy, with budget being in deficit even during years of double digit growth. Despite this, Armenia’s spending on health, education, and public investment was among the lowest in the world measured as percent of GDP. Much of this was underpinned by poor tax revenue collection, itself a function of the presence of powerful oligarchs that were outside of the reach of the tax authorities. These oligarchs have functioned under the direct patronage of country’s political leadership and grew more influential in public life and

² While no demonstrators were killed, Amnesty International (1996) describes the use of force and repressions against civilians in the aftermath of the election, where the incumbent received 51.75 percent of the vote, barely sufficient to avoid the second round. PFA (2008a) puts those developments in the context of the prevailing political culture of the time.

³ See PFA (2010) for an extensive discussion on this issue.

economic decision making. The resulting monopolies in production and import of key commodities curtailed competition, limited growth, and resulted in higher prices.

“In the doldrums” (2008-present)

This period is characterized by political upheaval of 2008 and the impact of the global crisis. The poor crisis preparedness and inadequate policy mix during 2008-09 (with disproportionate reliance on externally financed fiscal stimulus compared to exchange rate and structural policies) resulted in a 14.2 percent decline in GDP in 2009, one of the worst performances in the world since the beginning of the current crisis.⁴ After 4 years, real GDP is still below its 2007 level and is projected to grow only modestly in the medium term, with sizable headwinds from Europe likely to undermine this outlook.

While some attempts were made to raise the level of tax-to-GDP, these efforts faced resistance from the oligarchs and the decline in economic activity. This put most of the burden of the stimulus on foreign borrowing. Public debt, while still largely on concessional terms, has reached alarming levels and composition (in excess of 40 percent of GDP by end-2011 from 16 percent as of end-2008, with close to 90 percent of it denominated in foreign currencies), with a sizable chunk of repayments scheduled for 2012-14.

Here are some highlights that should help get a better sense of the governance and policy landscape in the country at present:

- State capture, the control of the economy by special interest groups, has gotten worse. Economy remains highly concentrated in the hands of people directly/indirectly involved in politics.
- Migration, by now of the middle class, has intensified;⁵ inequality and poverty are rising.
- Developmental agenda is lacking and any future plans to vitalize the economy will face an overvalued exchange rate, corruption, uneven playing field, and weak property rights.

Overall, it is unclear as to where the potential growth could be coming from going forward, assuming the same quality of governance, ongoing political polarization and social discontent following the March 1-2, 2008 killing of demonstrators, and continued disengagement of the Diaspora (that may have acted as a catalyst for foreign investment and a champion for better governance). In the meantime, much of the same policies are being pursued and population is growing frustrated by the day with the regime’s handling of economic and social affairs and the brave face it puts while explaining its failure to deliver on promises.

In conclusion

⁴ For a discussion of alternative policies available to the government in the sake of the crisis, see PFA (2008b).

⁵ While still largely anecdotal, some evidence of this began surfacing following the release of the US diplomatic cables from the Embassy in Yerevan describing the phenomenon and providing specific examples.

Despite the mounting challenges on almost every important front, there remain grounds for optimism. Clearly, the experience of early 1990s, with progress made under the most severe of conditions, as well as the still sizable human capital and strong commitment to “making it work” among local population and the Diaspora, provide hope for the economy’s future, given better governance. Also, experience of neighboring Georgia, with swift improvement in governance and the elimination of retail corruption, is very encouraging. All in all, with a clean and democratic political leadership that can unite all constructive forces and help attract investments and talent from the Diaspora; a technocratic government that understands how the modern world functions and offers a meaningful way forward; and a strong public buy-in to underpin the reform efforts, there is practically no limit to what the country can achieve despite the constraints that are imposed by geography and security.

But we are not there yet and time is running out quickly given the scale and the scope of challenges posed by the pervasive nature of whole-sale corruption, adverse demographic developments, and challenging geopolitics. The main directions of the effort should be aimed at de-politicizing economic decision-making and building a vision as well as development-intensive policy capacity. The alternative to following this path is worrisome, if not outright scary.

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