

Armenia

Status Index		5.7	Management Index		5.1
(Democracy: 2.6 / Market economy: 3.1)					
System of government	Presidential democracy		Population	3.3 mill.	
Voter turnout	51,5 %		GDP p. c. (\$, PPP)	2,650	
Women in Parliament	3.1 %		Unemployment rate	20 %	
Population growth^a	0.3 %		HDI	0.749	
Largest ethnic minority	2.6 %		UN Education Index	0.91	
			Gini Index	59.3	
Data for 2001 – if not indicated otherwise. ^a Annual growth between 1975 and 2001. Source: UN Human Development Report 2003.					

1. Introduction

The economic and political challenges facing the former Soviet states continue to present difficult obstacles in these countries' transition to market economies and pluralistic democracies. For Armenia, the transition is particularly daunting. Subjected to a long standing economic and transport blockade by Azerbaijan and Turkey, its neighbors to the east and west respectively, small landlocked Armenia is struggling to maintain its reform program while engaged in an important effort to institutionalize and consolidate democracy in a conflict-prone region.

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

This political reality has also impeded the course of reform and is likely to further influence important national policies such as poverty-reduction programs, anti-

corruption legislation, criminal justice reform, and the next stage of the Armenian privatization program. Overall, the last five years have seen several wasted opportunities for advancing the still vulnerable transition process for the sake of short-term political exploitation. Such a flawed transition process will also continue unless there are significant improvements in terms of strengthening the state, through policies to ensure greater accountability and “good government,” and more forceful measures to combat corruption.

Although the Armenian economy continued to post positive growth through this period, the country’s widening economic inequality and income disparity also continued to expand. Officially, the percentage of Armenians judged to be living at or below the official poverty line has expanded to nearly 50 % of the population, with some estimates placing the percentage even higher. There is also serious concern over the Armenian government’s handling of its privatization program, with a lack of transparency only fostering greater public mistrust. Thus, the combination of a lack of a resilient institutionalized democracy and the weakened rule of law undermine much of the course of Armenian economic reform.

The challenges facing Armenia are indeed daunting. A key external factor, geography, as with most nations, is one obvious determinant in the course of development and nation building. For small, landlocked Armenia, geography has dealt a severe limitation. But in this era of globalization and the lessening dominance of territory and borders in the path toward national political and economic strength, the real tests for Armenia’s transition lies in the internal obstacles and pitfalls facing this infant nation.

2. History and characteristics of transformation

As with all states of the former Soviet Union, Armenia suffered a profound and abrupt decline in output following independence in 1991. Armenia’s real GDP fell by more than 50 % in the initial period of 1991-1993. Once this early phase of economic shock stabilized, the Armenian economy began to slowly recover, posting positive growth in 1994 and continuing this upward trend in resumed growth, averaging a healthy 5.5 % from 1994 to 2002. Although this is a notably positive trend, it must be recognized that GDP still remains seriously below pre-transition levels, however, and is still recovering from the cumulative 60 % fall in Armenia’s real GDP from 1991-1993.

The transformation to a market economy was initiated in the early 1990s, with Armenia quickly emerging as one of the strongest reformers of the former Soviet states. Structural reforms were introduced, starting with a comprehensive

privatization program and the establishment of a transparent legal framework for the development of an emerging private sector, with an early focus on opening the banking and energy sectors. During this early phase of transition, the well-educated Armenian workforce, many with specialized technical skills, played an important role and provided an important impetus for accelerating the reform program.

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

Given the limitations of its geography and an absent natural resource base, the economic development of small, landlocked Armenia depends to a large degree on the normalization and restoration of regional trade and transport links that have been disrupted for over a decade by an East-West blockade of the country (imposed by neighboring Turkey and Azerbaijan). Two key factors have helped to compensate for this limitation - the promotion of an open and liberal trade regime and the utilization of Armenia's most significant long term potential in human capital. This second factor, leveraging the human (and financial) capital of its large Diaspora, has resulted in a significant inflow of private remittances and official aid. These transfers have accounted for roughly 11 % of Armenian GDP for 1995-2000, with more than 50 % of this coming from private remittances from the Diaspora alone.

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

3. Examination of criteria for democracy and market economy

3.1 Democracy

Democratic reform in Armenia is generally steady, although there are several warning signs indicating a troubling trend for the medium term. Specifically, there is a marked trend toward authoritarianism in Armenia. Despite a much stronger record of pluralistic democratic elections and a significantly more open political system than its neighbors, there is a pronounced level of public apathy and distrust.

This trend is also worsened by a perceived lack of viable alternatives. The government is increasingly seen as arrogant- ruling without adequate accountability or responsiveness to the electorate, while the opposition is united only by a shared disdain for the government in general and a dislike of the president personally. Most political actors, including both opposition and the ruling elite alike, offer voters an appeal limited to personality rather than public policy or political platform.

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

3.1.1 Political organization

(1) *Stateness*: In terms of stateness, or national identity, Armenia holds a distinct advantage over its neighbors. This advantage is the fact that Armenia is the most homogeneous state of all former Soviet countries undergoing similar transition, a factor that has tended to reinforce an already strong national identity, though this identity cannot necessarily be described as overwhelmingly positive. The negative implications of this homogeneity can most readily be seen in the occasional display of virulent nationalism, which is also a result of the ethnic-driven conflict that has plagued the region as a whole. Such displays of overt and often aggressive nationalism are not reflected in state policy, however, and seem more constrained to the margins of society.

The state holds a strong, well-established and unchallenged monopoly on violence throughout the country. This entrenched state monopoly is also reflected in the smooth and peaceful state of civil-military relations in Armenia. Unlike neighboring Georgia, for example, the enforcement of law and order is complete and there are no areas of Armenian territory without effective policing. Another key difference is that the Armenian armed forces are completely subordinate to civilian state control and oversight.

Over the medium term, however, the state will face a potential problem stemming from the rise of a new wealthy political elite, so-called “oligarchs” or well-connected insiders, who are beginning to leverage their commercial clout with a foray into the political realm. This challenge may very well arise with new confrontation in the near future, as a significant number of deputies elected to the new parliament in May 2003 may try to more directly influence public policy.

With such a pronounced homogeneity, there is an overall consensus on the issue of citizenship, with the only exceptions limited to small numbers of refugees from Nagorno-Karabagh and for Armenians from the Diaspora seeking to acquire citizenship. There is also an obvious absence of ethnic division, with the non-Armenian minority communities (Kurds, Russians and some Jews) having never faced any significant ethnic-based discrimination. Technically, all citizens possess the same civic rights and the Armenian government defends equal access to education, the courts and public welfare. The government does not restrict internal or international travel. Although freedom of the press and speech are guaranteed, the government maintains its monopoly over television and radio broadcasting. National identity is greatly strengthened and solidified by the fact that over 96 % of the population uses the Armenian language in everyday life.

The state also easily maintains a clear separation of church and state, with no overt religious influence in the political sphere. The Armenian Apostolic Church, which accounts for roughly 94 % of the population’s religious affiliations, has long played an important and often vital role in maintaining Armenian cultural identity. This cultural role has also traditionally avoided partisan politics, a fact that tends to enhance its absence from political discourse in today’s Armenia.

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

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

The country's administrative system remains highly bureaucratic and, as a result, often functions with extreme inefficiency. The administrative infrastructure is fairly extensive and well-developed, however, and has been able to exercise unquestioned authority. There is a reasonable administration of justice, although there are many incidents where justice is contingent on political or financial interference. This directly coincides with a fairly weak rule of law, matched by a flawed system of law enforcement and a sometimes checkered record of justice, primarily in the less developed regions of the countryside, but not excluding incidents in the major cities.

(2) *Political participation*: The development of democracy in Armenia has followed a steady course through the past decade of independence and has survived sporadic challenges and obstacles. To better trace the development of democracy, it is important to begin at its infancy. After an overwhelming 99 % of the population voted for independence in a September 1991 national referendum at the end of the Soviet system, democratic, multi-candidate presidential elections were held the next month.

These early democratic elections came in the wake of the emergence of a new non-Communist alternative in the form of a truly populist and nationalist political grouping, the liberal Armenian National Movement (ANM). Initially more of an umbrella grouping of various disparate fledgling political movements and proto-parties, the ANM soon evolved into more of a traditional political party under the leadership of nationalist Levon Ter Petrosian, who was elected as president in October 1991 with 83 % of the vote.

The first term of the Ter Petrosian Administration was marked by a pro-Western shift and a priority focus on survival in the face of conflict with neighboring Azerbaijan over control of the Armenian-populated Nagorno-Karabakh region in Azerbaijan. The Armenian economy was also faced with blockade by both Azerbaijan and Turkey. State corruption was rampant during this period and, increasingly in the second term, a pattern of political violence and extralegal, arbitrary rule threatened both domestic stability and democratic reform. Rampant violations of human rights and a pattern of police brutality reached its height by 1995 and the Ter Petrosian government initiated a widespread crackdown on the opposition and moved against the independent media.

After a dubious reelection in September 1996 sparked mass protest demonstrations, the president reacted by deploying troops in the capital and arresting much of the opposition. The crisis mounted until public demonstrations against the Ter Petrosian Administration's policies on the Nagorno-Karabakh conflict culminated in President Ter Petrosian's forced resignation in February 1998.

He was then replaced by Prime Minister Robert Kocharian, the former leader of Nagorno-Karabakh, who was subsequently elected president himself in multi-candidate elections in March 1998. The presidential and parliamentary elections of March 1998 and May 1999, respectively, were seriously tainted by incidents of ballot stuffing, voter intimidation and a general environment of voting irregularity. Elections since 1998 have represented an improvement in terms of both fairness and efficiency, although they have still failed to fully meet international standards.

Shortcomings in Armenian democracy were most recently demonstrated by the two-round presidential election held in February and March 2003, as well as the May 2003 parliamentary elections, all of which were harshly criticized by the Organization for Security and Cooperation in Europe (OSCE) and other international observers. Leading politicians were accused of ballot-stuffing and violating campaign finance laws, among other irregularities. Another problem concerning the democratic nature of the recent elections was the parliamentary adoption of a new electoral code in July 2002 which precisely reversed the body's structure of representation, resulting in 75 seats now being filled by a "party list" system and 56 seats by a one-round majoritarian vote. Though implemented in a somewhat opaque manner, this manipulation of the electoral system significantly expanded the representation of political parties (based on "party lists") to the detriment of individual candidates more directly elected by the general population.

This also coincided with the issue of effective power among democratically elected officials. Due to significant levels of corruption in the last two administrations and the prevalence of questionable political favors and influence, which have both significantly infected the Armenian business world, effective governance by qualified and honest civil servants has tended to be stifled. This is explained by the fact that those who have attempted to resolutely combat corruption or impose "good government" ethics have been removed from office, and in most instances, have been dismissed, threatened, or even harmed.

Though not all officials are corrupt, the informal network of control and abuse that has developed over the last few years between certain prominent members of the government and the powerbrokers or "oligarchs" of the business world, has forced many politicians who entered office with good intentions to accept a subdued background role. This increasingly clan-based rule leads to less transparency, greater

public distrust, discouragement and apathy towards politics (i.e., only a 51.5 % voter turn-out rate in the most recent parliamentary election), and most distressing of all, has greatly widened the economic gap between the small, but powerful Armenian elite and the far greater disenfranchised segment of the population living in poverty.

There is universal suffrage for all Armenian citizens over the age of 18. General and local elections are held regularly and are fairly secure as the only avenue to power and leadership. Political groups and parties enjoy the right to assemble freely, but there are occasional risks, with periodic clashes with police during times of political crisis. There is no record of violent attempts to gain power or overthrow the democratically elected government.

The one aberration was the 1999 attack on the parliament by five gunmen and their subsequent killing of several senior government leaders, including the parliament speaker and premier. This was never a challenge to state authority, however, nor was it an attempt to seize power. Moreover, with sound civil-military relations, the military has strictly refrained from any negative role or interference in the political process.

In terms of Armenia's developing civic society, the number and work of civic and non-governmental organizations (NGOs) has significantly expanded in recent years. As of 2003, there were nearly 3500 NGOs officially registered, dealing with a wide range of issues including human rights and women's rights, healthcare, peace and conflict resolution, and the environment. It should be noted, however, that only a handful of these operate with any consistency. Furthermore, there is a definite need for Armenian NGOs to receive more support on the local level and from the Armenian government.

At present, there is more than enough foreign support, which has brought with it goals that are often different from local needs and methods that are not always applicable to those who are being targeted. Greater involvement in NGOs by local people could also result in a more influential force in the fight against corruption, but at this point there has already been a dangerous decline in public satisfaction with democracy and confidence in the democratic institutions in Armenia.

There has been a noticeable decline in some basic civil freedoms in recent years, with a troubling and more frequent pattern of state control and intimidation of the Armenian media. The main strategy of state influence over the media has been to adopt the Russian model, with tactics of economic pressure and an outright exercise of arbitrary control of state licenses for media outlets. By 2003, there were several incidents of outright censorship and physical attacks on journalists, which was aided by the combination of a weak and underdeveloped civil society and the increasingly

absent rule of law in Armenia. This more brazen pattern of intimidation encouraged a return to the Soviet-style practice of self-censorship and further hindered the effective development of Armenia's infant civic society.

The overall state of Armenia's media remains marked by a dominant state-run broadcast and print media set against a financially vulnerable and harassed opposition or independent media. This problem has become even more serious since the closure of the country's largest independent, privately owned television station, A1+, in April 2002. This was followed by numerous protests, which were basically ignored by the government, as well as the December 2002 murder of Public TV and Radio head Tigran Naghdalian. In fact, the murder of Naghdalian is the latest in a series of high-profile professional and anonymous assassinations, coming in the wake of a failed attack on the life of independent journalist Mark Grigorian in October 2002 and preceded by the still unsolved assassinations of Prosecutor-General Henrik Khachtrian in 1998 and Prime Ministerial aide Gagik Poghosian in 2001. As of July 2003, thirteen suspects had been arrested on suspicion of involvement in the contract killing, including Armen Sarkisian, the brother of former prime minister and opposition party leader Aram Sarkisian.

Further complicating the dilemma surrounding the media in Armenia, the Armenian State Commission on Television and Radio recently rejected a bid by the country's sole independent media outlet in a state-run auction for an official broadcast frequency. This independent media outlet, A+1, enjoyed a popularity rare in the country's still evolving media and often founds its critical coverage of state policies at odds with the most important and influential members of the Armenian political elite. The Armenian government effectively silenced the outlet by subjecting its broadcast frequency to a bidding auction, currently being used by "Armenia TV," which is owned by a Diaspora businessman who strongly supported President Kocharian in the 2003 election.

In a separate but related situation, Roy Reeve, the head of the Yerevan office for the Organization for Security and Cooperation in Europe (OSCE), recently released a statement criticizing articles of the Armenian Criminal Code, enacted in April 2003, which impose a three-year prison sentence for journalists convicted of libel. The government was forced into an earlier retreat from its initial draft media legislation in April 2002 after strong criticism by the Council of Europe. The initial draft law went as far as demanding that all state officials be paid for media interviews and official information. It also proposed a new oversight body empowered to regulate the media by enforcing a new annual state-licensing requirement for all media outlets.

This trend of media intimidation was also encouraged by several disturbing policies implemented by the Armenian government in recent years. The most blatantly

repressive policy centered on the punitive legal measures concerning “insulting the dignity and honor” of elected officials, a legal framework providing strict parameters that effectively curtails media coverage and analysis of the local and central government.

In one case revealing the raw sensitivity of the authorities to the 1999 attack on parliament, a poet was arrested and tried for authoring a crude poem that implicated President Robert Kocharian in the attack. The September 2002 case held some resemblance to the Stalinist period when police excitedly arrested the poet’s neighbor for having typed the poem for him on her typewriter. Another brazen incident came in October 2002, when the entire print run of an opposition newspaper vanished the day it published an investigative article exposing corruption among a small circle of associates liked to the prime minister. It was later revealed that an aide to the premier purchased all copies of the issue as it left the publishing house prior to distribution.

These policies restricting press freedoms and the cases of outright intimidation have combined to further inhibit an Armenian media already weakened by severe declines in circulation and purchasing power of the average consumer. A poll conducted in the summer of 2002 revealed that less than 15 % of the population read newspapers on a daily basis and reported that 48 % did not read newspapers at all. Ironically, it was the wounded journalist Mark Grigorian who reported the results of a September 2002 survey that found a mere 1.5 % of the Armenian population trust the country’s print media, compared with 80 % five-six years ago.

The fundamental fragility of the media on the whole has also encouraged the rise of the now dominant private outlets owned by the new wealthy elite closely associated with the ruling political elite. And this lack of alternative or dissenting media has significantly stilted political reforms and efforts at democratization, a crucial shortcoming for a state in transition. These obstacles and dangers facing the Armenian media have also minimized the effectiveness of the media playing an important role in the fight against corruption.

Given the current state of the Armenian media, it seems overly optimistic to suggest that the recent attacks on journalists can galvanize the support necessary for the media to regain its powerful potential to strengthen freedoms and combat corruption so vital for the development of Armenian democracy. And although Armenia still holds an advantage over its more authoritarian neighbors of Azerbaijan and Georgia, unless this trend of media vulnerability is properly addressed, that distinction will soon be lost to a muzzled and compliant press.

(3) *Rule of law*: Transformation deficiencies exist in the sense that there is little balance between the branches of government in Armenia. Consequently, the system

of checks and balances is ineffective and without adequate support. The executive branch is unquestionably the strongest and most dominant branch, while the judiciary branch can best be described as overly compliant to the demands of the executive, and the parliament as generally ineffective. Officially, an independent judiciary branch does exist in Armenia. In reality, however, the Armenian judiciary is hostage to the will of the executive branch and is directly affected by widespread corruption.

A leading example of the weakness of the judicial branch is its inability, or even unwillingness, to confront corruption. One can see this demonstrated in the fact that no official of the regime of former President Levon Ter Petrosian was ever adequately investigated and prosecuted for the blatantly illegal acts of political murder and political corruption that ultimately led to the downfall and steep decline in popular support for that regime.

There is also a serious lack of accountability in governance, commonly stemming from a general lack of political penalties for public officials who abuse their positions, an essential deterrent in the fight against corruption. Instead, the lack of prosecution for abuses of power has helped to create a more permissive environment allowing for the spread of institutional corruption.

Civil liberties and human rights are not seen as primary issues of concern in Armenia, although there have been isolated incidents that have attracted international attention. There have been cases of torture and mistreatment by state officials, albeit isolated cases without any evidence of a systemic pattern or practice, as well as the imprisonment of conscientious objectors to compulsory military service.

3.1.2 Political patterns of behavior and attitudes

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

The current system of government reflects the 1995 Constitution that established the relationship between the president and the parliament, with the balance of power in favor of the directly elected President. In reality, the strong executive also clearly dominates the other two branches of government. This is due in large part to an over-concentration of powers in the presidency, but can also be traced to the

ineffectiveness of the legislature and the rather subordinate and submissive judiciary. The newly appointed government is required to submit its program to parliament and the latter has a right to reject the program within 48 hours. As for the judiciary, it is formally independent of the executive and the legislative branches. The President appoints 4 out of 9 judges of the Constitutional Court and presides over the Council of Justice (which in turn makes recommendations on judges' appointments).

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

There are numerous registered political parties and political platforms are still developing. The media is also slowly developing a role as a check on the government and good investigative journalism is at a nascent stage. In addition, the NGO community and civil society organizations have yet to make their mark on society, and public participation in consultation and decision-making processes is minimal. The public service system in Armenia is slowly evolving from the earlier command-and-control administrative system, toward a more service-oriented public sector. The parliament adopted several laws in 2001 and the government has developed a strategy in 2000 on civil service reform.

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

The noted institutional stability in Armenia has survived a substantial challenge, however, suggesting a deeper resiliency capable of overcoming the trend toward authoritarianism. This institutional stability is most clearly demonstrated by the system's ability to manage the crisis of the October 1999 attack on the Armenian parliament by armed gunmen that resulted in the killings of several senior government officials. Fortunately, this proved to be nothing more than a violent aberration in the generally steady course of Armenian democratic development. There is also an element of "institutional friction" in the governance process but this is fairly well contained within the parameters of healthy debate over public policy.

(2) *Political and social integration*: The relevant social actors such as political parties, the military and even most civic associations all share an acceptance of and more or less support Armenia's democratic institutions, although political and legal integration with society is somewhat constricted by the stifling effects of the socioeconomic and political divide in the country. There is a stable party system with a number of parties representing a fairly broad spectrum of political ideologies and social issues. All share a respect for the democratic process and have followed a civil course of debate and dialogue with n incidents of violence or aggression. A notable example is the prominent role of such parties as the Armenian "Green Party, which advocates an environmental agenda with issues of social justice. There are also fairly new networks of interest groups, such as human rights and media "watchdog" groups contributing to a deepening of civil society.

The current Armenian Constitution was adopted by national referendum in July 1995, and its framework is secure. On the whole, the people of Armenia seem to be accepting of democratic ways, and have the will to make Armenia's institutions as democratic as possible. This sentiment, however, has in recent years been stifled and suppressed by the widening of the gap between the political elite and the average population, about 50% of which has remained below the poverty line since 1990 and sees the hope for upward mobility as increasingly dim.

With no party structure or organization, Armenian President Kocharian has ruled from a powerful, yet narrow, power base comprised of oligarchs and influential power brokers. This reliance on a powerful elite, has led to an increasingly authoritarian, clan-based rule that has done little to strengthen democratic institutions or the rule of law. The great divide in the Armenian polity is now defined not by the government and the opposition, but by a small group of powerful elite against a much larger but powerless and less economically secure segment of civil society. This chasm solidified the apathy and discontent of the general population that threatens to fuel a much more dangerous and volatile period of potential instability.

3.2 Market economy

The Armenian economy continued its record of positive growth through 2002 and posted a 12.9 % growth in real Gross Domestic Product (GDP). This bolstered a 2001 growth of 9.6 % in GDP. Much to the government's relief, this GDP growth was matched by other notable achievements: a 12-month inflation rate remaining at a manageable 2 %, a much improved set of measures in tax collection resulting in a significantly higher level of revenue for the last half of 2002, and a still comfortable level of foreign exchange reserves. The improved revenue collection effort resulted in \$181 million in tax collection and \$160 million in customs duties for 2002.

The government also posted a 48 % rise in net exports, reaching \$507 million in 2002 and reducing the trade deficit to \$483.8 million. The highlight of this export growth was the diamond industry, a sector of anticipated growth in the coming years as well. By the end of 2002, Armenia was also welcomed as a full member in the World Trade Organization (WTO), raising hopes for greater investment and integration into the world economy, and promising to offer the small Armenian economy the benefits of globalization.

3.2.1 Level of socioeconomic development

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

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

The imperative for the Armenian government over the medium term is to tackle the fundamental social exclusion related to socioeconomic disparities that have polarized Armenian society into two camps: a small, powerful wealthy elite and a larger impoverished underclass. Although variations in gender-based employment and educational opportunities are much less significant factors in Armenian socioeconomic development, the lack of an effective poverty reduction program, coupled with rising corruption and weakened rule of law, pose the most basic challenges to Armenia's development.

3.2.2 Market structures and competition

The foundations of a competition-based economic system based with a functioning market economy are steadily consolidating in Armenia. Armenia is endowed with the most open economy in the region, the most open to trade and investment policies of all former Soviet states, and presents no restrictions on capital. Over the longer term, the Armenian economy is poised to reap some of the benefits from globalization and

integration in the world economy. These structural characteristics are important milestones in the course of economic reform and bolster the marketization policies necessary to overcome the country's external blockade and the disruption of regional trade links.

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

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

A fundamental flaw in this regard is the trend of mortgaging the country's strategic national assets in return for mere debt cancellations. Specifically, one of the most recent cases constituting this trend is an "asset-for-debts" agreement, whereby Russia forgives some \$98 million in Armenian debt in exchange for control of at least four of Armenia's relatively few strategic enterprises. This deal targets the Hrazdan thermal-power station, the "Mars" electronics company and two Yerevan research institutes for transfer to Russian ownership.

There is a second shortcoming facing Armenia. Ironically, the fairly impressive legislative framework establishing the foundation for an open, market-friendly economy obscures the threatening presence of corruption. Armenia's notable achievement in advancing toward a market economy was recently cited by the U.S. "Heritage Foundation" report that ranked Armenia as one of the top ten countries posting the most progress in "economic freedom" for 2001. Although such a record of progress in "economic freedom" is seen as the ideal for Western marketization, it almost always tends to do nothing to address social inequality. Moreover, it tends to foster policies aimed at securing the highest economic growth possible at the expenses of public investment, and usually views anti-corruption efforts as a sign of excessive government involvement that hinders overall economic activity.

Trade and regional cooperation: After the collapse of the Soviet Union, trade links between Armenia and the former Soviet republics were disrupted and trade decreased

dramatically. Armenia adapted by forging new trade links, particularly with the European Union (EU), the Middle East, and the United States. Its major exports are diamonds, machinery and equipment, copper ore, brandy and other products of agriprocessing. Major export trading partners are currently Belgium (25.2 %), Russia (15.0 %), the U.S. (12.7 %), and Iran (9.3 %). Major imports are natural gas, petroleum, tobacco products, foodstuffs, diamonds, and major import trading partners include Russia (14.9 %), the U.S. (11.6 %), Belgium (9.5 %), and Iran (9.4 %).

Foreign trade in goods reached 53 % of GDP in 2001, with exports and imports constituting 17 and 36 % respectively. The negative trade deficit was about 19 % of GDP in 2001, and is expected to reach 17 % in 2002. Notably, and for the first time in the Armenian case, the strong 11 % economic growth reached in 2001-2002 was export-driven, with a 50 % expansion in manufacturing exports.

The Armenian government maintains a liberal trade regime with about one-third of imports subject to a single tariff of 10 % and the remaining goods imported duty-free. The country has a rating of 1 (i.e., most liberal) on the IMF's trade restrictiveness index and there are no taxes on exports or quantitative restrictions. Armenia's WTO accession process that started in 1993 was completed in 2002. The country currently has preferential trade agreements with a number of trading partners, including free trade agreements with Georgia, Kyrgyzstan, Moldova, the Russian Federation, Tajikistan, Turkmenistan and Ukraine.

Banking system: Armenia's banking system is by far the largest and most important component of the financial system. In spite of this, the banking sector remains very small compared to the size of the overall economy; total loans comprised 7 % and total deposits comprised approximately 9 % of GDP in 2001, respectively. Contractual savings (i.e., insurance companies and pension funds) and capital market-related financial institutions are underdeveloped. The network of micro-finance and rural credit institutions is not extensive enough to satisfy the demand for credit generated by the small and medium enterprises (SME) and farms in rural areas. In sum, compared to other countries in transition, the overall financial system remains shallow and under-developed.

Despite the fact that the Armenian banking sector benefits from a relatively stable macroeconomic environment, weaknesses and vulnerabilities remain. Aggregate monetary and financial data point to a highly dollarized financial sector. Even though aggregate figures suggest improvement over time, the level of private savings remains low, leading to a weak supply of deposits.

Within the past 18 months, the Armenian Central Bank (CBA) has moved against eight of thirty banks under temporary administration. The licenses of three of these

eight banks were withdrawn, and petitions were filed with the Economic Court to declare them bankrupt. The authorities intend to liquidate the remaining five banks under interim administration. A bank resolution department was also recently established to oversee the management of interim administrators dealing with problem banks.

The minimum capital requirements for existing banks currently stands at \$1.65 million (for existing banks), and will be raised to \$2 million, with a subsequent increase to \$5 million by mid-2005. To boost confidence in the banking sector, the Central Bank recently announced plans to introduce a deposit insurance scheme, which will start to collect premiums in 2003 and become operational in 2005. Recently, three new banks (with U.S., Swiss, and Russian capital) have applied for operating licenses, with each required to have \$5 million in capitalization (i.e., the existing minimum requirement for the new banks).

However, the population in general has little contact with the banking system either by means of depositing their savings or by means of borrowing. With virtually no cash-flow-based lending taking place, loans are heavily collateralized. Margins of lending also remain significant, suggesting high administrative costs and inefficiencies. A gradual reduction of the volume of Treasury Bills offered on the market, has led to a reduction of (risk-free) interest earnings and a worsening of profitability indicators.

3.2.2 Stability of currency and prices

While macroeconomic policies aim at ambitious growth targets, the government has also pursued fiscal consolidation and prudent monetary policy to ensure that macroeconomic stability is maintained. The flexible exchange rate regime has been important to mitigate the adverse impact of external shocks. However, these policies have not been implemented without slippage and difficulty.

Fiscal consolidation was followed by an accumulation of domestic expenditure arrears, which reached 2 % of GDP per annum in 1999-2000. Since then, the government has tried to address this issue by gradually eliminating the old and non-accumulating new arrears. If the 2003 budget law is fully implemented, there will be no outstanding domestic expenditure arrears by the end of 2003. Monetary policy has been complicated by higher real interest rates due to macroeconomic imbalances and by underdeveloped financial markets and instruments. Hopefully, long standing price stability will contribute to the current declining trend in interest rates (from 45-50 % in 1998 to 15-20 % in 2002).

Spurred by generally sound policies and structural reforms, the external balance has also improved substantially. The current account balance (export less imports plus net transfers and factor income) declined to a single digit level of about 9 % in 2002 from a peak of 30-35 % in the stages of transition. This was largely due to large external flows and deterioration in domestic savings immediately after the transition. However, the current account continues to be largely financed by non-autonomous sources, such as large official inflows and, in some years, by one-time privatization receipts. The volume of foreign direct investment remains small, although there are indications that it increased in 2002 relative to 2001. As a consequence of these developments, the Central Bank has managed to accumulate a substantial amount of official gross foreign reserves of more than 4 months of imports (approximately \$360 million) from an almost zero level after the introduction of its own currency.

Despite these macroeconomic improvements, per capita GDP remains low. Initial estimates of the supply side effects of macroeconomic and structural reforms were overoptimistic and job creation continues to be a major challenge. Preliminary data from the most recent 2001 household survey indicate that half the population was living below the poverty threshold, with 15 % facing extreme poverty. On the positive side, these figures represent reductions from 55 and 23, respectively in prior years. The government has prepared a comprehensive poverty reduction strategy and is currently working on its anticorruption strategy.

3.2.4 Private property

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

The Armenian government has made some progress in the easing of state interference in business formation and with a strengthening of property rights. According to recent enterprise surveys cited by the World Bank, the average time and cost to establish a new business and complete the official registration process was reduced from 27 days and \$109.00 in 2000, to 21 days and \$92.00 in 2001, respectively.

Other surveys conducted by the World Bank and the European Bank for Reconstruction and Development (EBRD) in 2002 have also noted an improvement in perceptions of governance by the Armenian private sector, with a reported drop in both the frequency of corruption and the average time spent by company management on dealing with public officials.

Over a decade of transitional reform in Armenia has resulted in decisive and sustained reform policies that succeeded in creating new institutions to support marketization and forged economic recovery. One aspect that must be accelerated, however, is the need to invest in people, or “human capital,” as the key to growth. Additionally, there must be improved social policies to protect the most vulnerable of the population, seeking to “lift all boats” through sustained economic growth that can be more fairly and effectively distributed.

“Lessons learned”: The key to achieving sustainability of Armenia’s economic transformation rests with recognizing the “lessons learned” from the transition process, maintaining the course of reform with increasingly viable mechanisms and resilient institutions, while simultaneously meeting the challenges of poverty reduction and social welfare. Although no easy task, the leveraging of Armenia’s unique advantages and assets, combined with its integration into the global economy, offers significant promise and opportunity for a graduation from transition.

Concerning “lessons learned” from the transition process, two factors must be recognized. First, the role of the entry and expansion of new firms, and small- and medium-sized enterprises in particular, in generating growth and creating employment must be acknowledged.

The growth of such firms depends in part on policies aimed at encouraging their entry and these policies must be accompanied by a strategy of discipline. By discipline, the introduction of hard budget constraints must replace the soft budget constraints of the traditional state subsidies and resource preference. Armenian success in privatization, the creation of an open market economy, and its prudent fiscal policies, have each greatly enhanced this effort.

The second “lesson learned” relates to the imperative to strengthen Armenia’s legal and regulatory institutions to oversee corporate governance. There must be adequate rules to enforce shareholder rights, protect consumers, and prevent “insider deals” and conflicts of interest. This need for corporate conduct mirrors the need for good governance in the political arena, although for Armenia, much needs to be done in both areas. This lesson also demonstrates that institutions matter, and must be strengthened to match the growth of the market.

3.2.5 Welfare regime

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

This statistical performance is also seriously undermined by the lack of any matching reduction in poverty or real improvement in the overall standard of living. Although the share of the population living in poverty has officially declined, the improvement was slight: from an all-time high of 55 % in 1998-1999 to 48 % in 2001. Thus, this has only reinforced Armenia's "economic paradox," whereby much of the economic gains has largely benefited the wealthy and exacerbated an already serious income inequality, while doing nothing to reduce widespread poverty.

For Armenia, the basic outlines of a social safety net to compensate for poverty and other such risks are in place and there has been considerable efforts to expand this safety net to meet the needs of the nearly 50 % of the population living below the poverty line. As a low-income country, social assistance is generally comprised of limited cash benefits (based on a system of targeting along regional, community and indicator lines), and a limited and gradually phasing-out state subsidies for energy ("lifeline" utility tariffs). Social insurance (unemployment and pensions) are both flat rate benefits.

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

Armenia has continually strived to maintain its system of universal basic education, although public expenditures on education have been consistently in decline. Secondary school enrollment remains high, however, with a ratio equally that of the Baltic States, and literacy is still at a level exceeding 99% of the population.

3.2.6 Strength of the economy

Following independence in 1991, Armenia suffered one of the most severe contractions of all transition countries. The economic crisis of the early 1990s resulted in a period of hyperinflation, rising unemployment and inequality and consequently increased poverty. Per-capita income fell by over 50 % in 1992, and decreased from \$1,800 to \$560 per annum between 1991 and 1993. The introduction of its own currency, the *dram*, in late-1993 in the after-math of the collapse of the ruble zone, combined with deteriorating fiscal and external balances, brought forth serious policy challenges.

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

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

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

The economy responded positively to the reform program. Growth rates averaged approximately 7 % a year between 1995 and 2002, a remarkably resilient performance in the face of the Russian financial crisis of 1998, political instability in 1999, and the continuation of blockades by neighboring Azerbaijan and Turkey. The economy's performance has become more robust in recent years led by significant expansion of exports. Real GDP grew by 9.6 % and 12.9 % in 2001 and 2002, respectively, making Armenia the fastest growing CIS economy. Investment grew in line with real GDP growth. National savings turned positive in 1999; consumption is lower than GDP for the first time in a decade. This growth performance has also been accompanied by a substantial expansion of the private sector, which currently accounts for 75 % of GDP and total employment.

3.2.7 Sustainability

The Armenian government seeks to incorporate environmental considerations into its reform program. It established a Ministry of Nature Protection several years ago and finalized a national environmental action plan in 1998 that targets the excess exploitation of natural resources, including the depletion of water resources, erosion of soil and degradation of biodiversity. Other specific concerns are the deterioration of the water table of Lake Sevan and the decreasing forest coverage. The Armenian government has also been working to harmonize its environmental legislation with the Council of Europe and has introduced a pollution-fee system by which taxes are levied on air and water emissions and solid waste disposal, with the resulting revenues used for environmental protection activities.

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

Through the decades of the Soviet period, Armenia held a leading role in education and science. The main challenge to maintaining and leveraging this national asset has been an inability to sustain adequate investment and state spending, a decline in the modernization of facilities, and the severe effects of the country's "brain drain," or sizable loss of human capital during the early- to mid-1990s. The decline in investment in education has led to a compromise in the overall quality of Armenian education. At its lowest level, state spending on education was a mere 2 % (or less) of Armenian GDP.

The end result was immediately evident in shortages of teaching materials, books and a delay in even the most basic upkeep of school facilities and has resulted in a decline in the student-teacher ratio in basic education, from 11.7 % in 1990 to 8.7 % in 1997. In the longer term, this is especially harmful for the preparation of a new generation of young entrants to the workforce and means that an entire group of school age children are already under-prepared for the emerging market economy.

4. Trend

(1) *Democracy*: The pattern of recent democratic elections notwithstanding, there is not yet a firm guarantee of a resolute advance in Armenian democracy, particularly in light of the structural shortcomings in the institutions of governance. A much more

dynamic and balanced system of government needs to be allowed to develop further. The very nature of the Armenian presidential republic, by virtue of the concentration of powers in the executive branch of government, demands a balanced counterweight from a strengthened and responsible legislature and a more independent judiciary. Just as important as a balanced system of government is the need for greater accountability and transparency. Accountability is vital for the creation of an effective deterrent to the temptation of political corruption and bribery, and transparency, and informed public debate, is also in short supply in governmental decisions and legislative actions.

(2) *A market economy*: The Armenian economy posted impressive growth in GDP for this period although an under-reported national unemployment rate tended to obscure the underlying failures of poverty reduction and an ineffective social safety net for the most vulnerable of the population. Income disparity, as reflected in the Gini index, is severe and continues expand. Although GDP per capita has risen for this period, it is still far below an acceptable level. The institutional framework for a market economy has been firmly consolidated in the past five years, but there are still glaring deficiencies in the regulation and oversight of economic activity. The pace of reform has continued during the period and, in terms of macroeconomic data, economic development has gained momentum, although is still far from a full recovery from the shocks of the early 1990s.

The high Gini index of income for Armenia (59.3 in 2001) reveals the widening social divide and demonstrates the severity of income disparity in the country. Specifically, the Gini coefficient in Armenia soared from a Soviet-era level of 0.27 (1987-1990) to the transition level of 59 (1996-1999). Although there is demonstrated tendency for income to be distributed “less fairly” during the transition to a market economy, there is a pronounced tendency for greater and more pronounced income inequality in cases of hesitant or fragmented structural reforms and/or in cases of widespread corruption. This may also lead to entrenched poverty that can easily lead to serious social and political unrest.

Table: Development of socioeconomic indicators of modernization

	HDI	GDI	GDP index	UN Education index	Political representation of women ^a	GDP per capita (\$, PPP)
1998	0.736	0.732	0.518	0.92 (1999)	3.1	2,229
2000	0.730	0.715	0.540	0.91 (2001)	3.1	2,545

^a Percentage of women deputies in parliament elected in May 2003.

Sources: UNDP, Human Development Report 2003, New York/Oxford 2003;

[<http://undp.org/hdr2003>, accessed July 2003], Ten Years of Independence and Transition in Armenia, UNDP, 2001.

Table: Development of macroeconomic fundamentals (1998–2002)

	1998	1999	2000	2001	2002 (2/4)
Real GDP Growth (annual % change)	7.3	3.3	6.0	9.6	12.9
Export growth (%)	8.9	6.5	16.6	20.8	29.4
Import growth (%)	5.0	-8.1	5.1	1.2	46.0
Inflation in % (CPI)	-1.3	2.0	0.4	2.5	2.0
Unemployment ^A (%)	9.4	11.2	11.7	20.0	17.5
Budget deficit (% of GDP)	21.2	16.6	14.6	9.5	6.2
Current account (\$ million)	-402.9	-306.9	-278.4	-302	-196.3

Sources: International Monetary Fund, Republic of Armenia Country Report, No. 03/93, April 2003; World Bank Armenia Country Profile [<http://devdata.worldbank.org>, accessed July 2003]; Republic of Armenia National Statistical Service; Armenian Development Agency, Economic Indicators [http://www.ossada.org/economic_indicators.htm, accessed July 2003], EBRD Transition Report Update 2001; World Development Report 2000/2001; *Armenia. 2002 Country Report*. The Economist Intelligence Unit, London, May 2002..

5. Transformation management

5.1 Level of difficulty

For this period, Armenia continued to face two main challenges, one external and one internal in nature. Specifically, the blockade of small, landlocked Armenia denied the country its natural strategic trade, transport and energy links and reinforced a mounting over-dependence on its Georgian neighbor to the north for crucial access to Russia. The blockade also continues to distort natural trade and economic development

Internally, the major challenge is the malignant presence of corruption and its distortion of economic activity. Following the model of each of the former Soviet states in transition, corruption in Armenia denies the state a substantial amount of tax revenue, fundamentally weakens the rule of law and important democratic reform, and poses a deeper fundamental challenge to state legitimacy and authority.

5.2 Reliable pursuit of goals

The Armenian government's strategy for economic reform clearly reflects prudent strategic priorities: continued economic recovery and a further expansion of democracy. Having recognized the two essential shortcomings (in poverty reduction and against corruption), there is a promising outlook for the government's commitment to meeting these challenges. With another election having secured a stable government, the focus will return to these priorities. The new parliament and the recently reelected president will be able to move away from the short term partisan politics of the past year and, once it tackles the potential threats posed by the "oligarchs," the government has the resolve and resources to advance Armenian development.

5.3 Effective use of resources

The Armenian government has effectively built up its resource base and has a new "toolbox" of measures at its disposal. There is added optimism in the recent civil service reform effort, enabling a more efficient utilization of a new generation of dedicated and qualified personnel ready and willing to serve the Armenian state. The real test for the use of these resources is the fight against corruption, however.

In nearly all cases of endemic corruption, there must be a significant weakness already present in the rule of law in the host country. For this reason, most post-

Soviet countries in transition are victim to corruption, as the breakdown of the rule of law and the pattern of “weak states” created an environment most conducive to an expanding shadow economy. The post-Soviet states also have a historical legacy of illegal economic activity, or black market, which also encouraged this trend. Another shared trait among most of the post-Soviet states is the lack of good governance. As the Soviet Union imploded, these states were abruptly faced with the new, rather unexpected demands of overnight independence with very little preparation and no recent tradition or experience of democratic governance. To be fair, such a serious challenge was daunting for these states in the early 1990s. But some states met this challenge better than others and Armenia sadly failed on this score.

Looking back at the record of the first post-independence government of President Levon Ter Petrosian, the rapid growth in state corruption and the pattern of authoritarian misrule in this early period reveals how corruption has evolved into one of the country's most serious threats. The extent of the state corruption was later revealed in the investigation of the energy sector during this period, culminating in the comprehensive report by parliamentarian David Lokian in July 2000 that uncovered more than \$200 million in losses attributed to state corruption and embezzlement. Additional evidence also came to light during the investigation into the series of political crimes and even murders conducted by the Ter Petrosian regime's interior minister, Vano Siradeghian, a fugitive who fled Armenia in April 2000 to escape prosecution for the crimes.

Even recent developments have confirmed the relationship between the Ter Petrosian era and corruption in Armenia. The country's energy sector was again the focus of a new investigation in December 2001, initially finding that a former senior official of the Ter Petrosian period, Sebouh Tashjian, abused his powers to incur "particularly large financial abuses" during negotiations in 1995. The main obstacle to determining the scope of the Ter Petrosian period of corruption in the early 1990s is the lack of any serious attempt by the present Armenian government to conduct a thorough and complete investigation. The result of this reluctance has been to encourage continued corruption, as the obvious lack of any accountability for such crimes removes the most obvious deterrent. The failure to lodge criminal charges against suspected politicians mentioned in the final report of the parliamentary investigation of the energy sector, and, moreover, the shameful flight of Vano Siradeghian are clear indicators of the vicious corruption/weak state circle.

5.4 Governance capability

With generally consistent policies of economic and political reform, the organizational capacity of the Armenian state seems assured. But the real test to the

state's organizational capability is the need to strengthen the state through enhancing "good governance" and establishing a civil society.

There are some important measures that the Kocharian government may implement to help in accelerating the campaign to combat corruption. In order to achieve some realistic impact on corruption, such measures must be formulated within an overall package designed to strengthen the state and ensure the rule of law. A careful combination of enhancements of key elements of the state structures is needed, starting with a focus on creating and strengthening regulatory agencies and bodies. In contrast to blanket measures granting the executive branch of government more powers, the fight against corruption must be carried out by bodies to supervise privatization, the emerging securities markets and to police the economy for monopolies, cartels or trusts. Such bodies should be independent from, but accountable, to the government and need to be empowered by supporting legislation. The related introduction of new mechanisms of transparency and oversight are also crucial to bolstering these regulatory bodies.

A primary element in such government measures is the need for "good governance." The prerequisites of transparency, ethics, accountability and competent administration are essential for good governance in Armenia. These prerequisites are notably lacking, especially in the current system of a strong executive that dominates a weaker judicial branch and has marginalized a rather ineffective legislature. There needs to be a determined effort to strengthen judicial independence and restore meritocracy over favoritism in governance.

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

5.5 Consensus-building

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

The role of the Diaspora brought optimism and hope for a stable recovery, sound development and integration into the world economy. The Diaspora was viewed as the important “push factor” in terms of economic reforms and democratic change. Since the devastating earthquake of 1988, the Diaspora has provided massive humanitarian aid to Armenia. To this date, however, the character of Diaspora’s assistance and the Armenia-Diaspora link remains largely humanitarian and cultural. With an exception of a few scattered attempts of large-scale business ventures, the economic and business agendas of the Diaspora remain underdeveloped. Much more work needs to be done to enable Armenia to capitalize on the intellectual and financial capital of the Diaspora.

5.6 International cooperation

Armenia is somewhat hindered by a continued reliance on foreign assistance. Faced with a limited outlook for attracting foreign direct investment, Armenia most recently received a \$20 million World Bank loan in December 2002, with another \$40 million set to be distributed later in 2003. A necessary condition for this aid, however, is the privatization of the country’s power utilities, only suggesting a further dependency and loss of strategic assets. There is also concern over the reliance on such external “conditionality” as a necessary prerequisite for obtaining further assistance.

6. Overall evaluation and outlook

The starting point for Armenia’s transformation has been rated as difficult, but positive overall. Prior to the observation period, the country was endowed with infant, yet functioning market economy structures. Given the legacy of the Soviet-era lack of traditions favoring the rule of law, civil society and democracy, close contact and integration with the West, a priority on education, and a progressive national identity have all helped to consolidate reform.

In the short term, there is a danger of a new period of tension and discord in Armenia, however, as the political aftermath of the presidential and parliamentary elections have exacerbated a divisive divide between the newly reelected president and the recalcitrant opposition. This divide has been looming for some time, with a pattern of confrontation emerging over the past few years. As much a reflection of a political schism, there is a much deeper and more fundamental element to this divide. The core divide is not simply a political contest, however, but again, is more a natural manifestation of serious social and economic disparity. And although the superficial contest is political - being waged between the government and the opposition, the more serious confrontation lies in a socioeconomic clash.

It is in fact the socioeconomic factors that have endowed the political arena with a significance and importance only recently seen in Armenia. With a degree of political apathy and public surrender in recent years, the only factors potent enough to garner widespread mobilization are those with socioeconomic roots. The real challenge for both the government and the opposition is to see who can leverage these factors into real political power most effectively.

There is also a regional dynamic to the Armenian situation, as the recent Armenian elections were only an opening round in a series of presidential and parliamentary elections set for the coming two years in both neighboring Azerbaijan and Georgia. And with Armenia's traditional comparative advantage over the more autocratic Georgian system and the one-man, one-party rule in Azerbaijan, the state of Armenian democracy is crucial to fostering greater regional reform. Perhaps even more importantly, the Western response to the Armenian case sets an important precedent, and possible deterrence, for its Georgian and Azerbaijani neighbors.

The past dozen years of transition in the region have demonstrated the substantial difficulty in effectively implementing the political and economic reforms essential to overcoming the legacy of the Soviet system. The sheer scope of the fundamental changes for these fragile states has also been often underestimated in the West. This has also led to some frustration by regional leaders, at times reacting with disdain for an imposition of economic reforms and by occasionally lashing out at Western standards of democracy and transparent governance.

Such reaction may help to explain, but cannot justify, the Armenian government's heated rejection of international criticism of its democratic shortcomings. This rejection has gone well beyond the acceptable, and has raised serious questions over the course of Armenian democracy. Although the political test for Armenia is the need to meet international standards of democracy, the real challenge is internal and involves the daunting need to address the unmet social discontent that threatens to pose a significant obstacle to the full development of the Republic of Armenia.