



ARMENIA IN 2010

A YEAR OF UNCERTAINTY

A Report by
The Civitas Foundation
Yerevan, Armenia



ARMENIA IN 2010. A YEAR OF UNCERTAINTY

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The Civilitas Foundation
One Northern Avenue, Suite 30
Yerevan, Armenia
info@civilitasfoundation.org

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CONTENTS

PREFACE.....	4
ARMENIA: A YEAR OF UNCERTAINTY	5
A REGION IN STALEMATE.....	6
UNSTEADY STABILITY.....	27
THE CRISIS AFTER THE CRISIS	37
THE REGION IN FIGURES.....	49

PREFACE

This Report was launched three years ago to fill a gap – the missing Armenian perspective to the body of analysis about Armenia and the region offered by the international community.

These end-of-year reflections are intended to help grasp past policies and events, and serve as tools to shape the future.

2010 marked the culmination of nearly two decades of Armenia's independence. Perhaps for that reason, given independent Armenia's level of social, economic and political development, the reactions and assessments in this report are more severe.

The year 2011 will mark the beginning of the third decade of independent statehood. This will compel us to examine the causes for what most indexes and ratings consider inadequate external economic and political competitiveness and insufficient internal social and democratic transformation.

Successive governments have offered neither credible big-picture visions nor genuine short-term implementable solutions in response to citizens' visible and understandable dissatisfaction. Nor have the drivers of civil society – media and non-governmental organizations -- demonstrated the readiness, judgment and wisdom to ask and debate the profound questions.

These are some of the urgent questions to be asked:

- What are Armenia's necessary security requirements?
- How to revamp Armenia's domestic political system to make it healthy and inclusive?
- What should the educational system offer in order to nurture identity and also transform a small nation into a competitive global participant?
- What is the acceptable tradeoff between individual liberties and the collective good?
- How far is Armenian society willing to go to protect the most vulnerable?
- How to wisely and genuinely disentangle politics from business interests?
- How to introduce liberal, open, government supports for deep, sustainable, broad-reaching economic growth?
- What price is Armenia willing to pay to protect the environment, for healthy, ecological and economic benefit?
- How to enable true publicly accessible quality health care?
- How to instill trust and hope in the justice system?
- How to secure the integrity of soldiers as individuals and the armed forces as an institution?
- How to achieve essential Armenia-Diaspora cooperation?

In each of the significant areas of people's daily lives, what should be the policy objectives? The answer should be the affirmation found in the Armenian Constitution: to turn Armenia into a sovereign, democratic, social state governed by rule of law.

Anniversaries offer the benefit of hindsight and at the same time, inevitably intensify expectations. Armenia's 20th year to come will be no exception.

ARMENIA: A YEAR OF UNCERTAINTY

This publication is intended to be an annual overview of the political and economic situation in Armenia, as well as those global and regional developments that affect this country and the region.

We had described 2009 as the year of promise and reality. It was a year that promised far more than it delivered as borne out by regional, domestic and political realities.

In Armenia in 2010, glaring catastrophes or evident achievements were absent even as the economic and political troubles continued to take a real toll. That this sort of standstill was itself an obstacle to economic and political progress became obvious given the steps that were not taken.

In 2010, the region's internal uncertainties were compounded by global uncertainties vis-à-vis the region. Whether as a result of the US-Russia resetting of the previous year, or a series of choices forcibly or voluntarily made, the inclusion of the Caucasus in the Russian sphere of influence became more pronounced.

There was no improvement in Armenia's relations with its eastern and western neighbors. When Armenia-Turkey protocols were frozen, so were official Ankara-Yerevan relations. This ended up disappointing the optimists, baffling the mediators and vindicating the critics.

As for the Karabakh negotiation process, in 2010, it entered a phase of uncertainty, unpredictability and danger.

Internally, Armenian society saw a growing tension between personal freedoms taken for granted, and an expectation of greater civic freedoms. The result was a growing number of home-grown citizen initiatives in an otherwise politically unremarkable year. The middle class searched for prosperity and well-being in an economically and politically unpredictable and non-transparent environment. As a result, instead of middle class contentment nurturing a country of optimists, middle class discontent fed a growing legion of pessimists.

This was further aggravated by a recognition that institutions both in the economic and public sphere – from schools to police to tax collectors – appeared to be structurally unchanging, and therefore perhaps unchangeable. Both the international community and the country's own citizens began to view this not as a very long wave of uncertainty, but a permanent state of capitulation.

Economically, the government utilized all available fiscal and monetary options to dig its way out of the economic crisis. It succeeded to the extent that it prevented financial circumstances from deteriorating further. But in 2010, the government could not or would not tackle politically sensitive reforms. As a consequence, the lack of diversity and competitiveness, as well as interdependence of businessmen and government officials remained the fundamental impediments to economic growth.

Indeed, in 2010, there were fundamental structural impediments to growth all around – politically, economically and socially. So, the year ended as it began – with personal and national uncertainty.



A REGION IN STALEMATE

Neither the ‘reset’ in the US-Russia relationship nor the policy of Zero Problems with Neighbors in Turkey transformed the environment for Armenia or the South Caucasus. Abkhazia and South Ossetia remained a source of tension between Georgia and Russia, the Nagorno Karabakh resolution process did not move even a small step forward, and the Turkey-Armenia border remained closed.

For **Russia**, 2010 meant a consolidation of its position in the entire former Soviet space, not just the South Caucasus.

With the victory of the acceptable-to-Russia Viktor Yanukovich in the presidential elections in Ukraine, the forced resignation of Kyrgyzstan’s Kurmanbek Bakiyev from the presidency and his departure from the country, and its contemptuous posture toward Georgia’s Mikheil Saakashvili, Russia demonstrated that the Color Revolutions favored by the West had failed.

In the South Caucasus, too, Russia took on a more confident and assertive presence. With Tbilisi, Russia simply took a wait-and-see approach until the next Georgian elections. But it was different with Armenia and Azerbaijan.

In Armenia, the Russian presence was accentuated by the Kremlin extending the presence of a Russian military base in Gyumri from 25 to 49 years. Russia had also signed 49-year basing agreements with Abkhazia in February and South Ossetia in April. In addition, the Russian role in Armenia’s economic and regional agenda was expanded. The two presidents met nine times during the year – an unprecedented frequency and one that left its mark, both practically – in the domestic sphere as well – and symbolically.

Azerbaijan, too, tilted ever-more northward. There was a dramatic increase in the volume of gas sales by Azerbaijan to Russia, and prospects for the construction of the European Union-favored Nabucco pipeline appeared less hopeful.

Turkey-Russia relations improved. When Russian President Dmitry Medvedev visited Ankara in May, numerous agreements were signed, including the elimination of the visa regime between the two

A REGION IN STALEMATE

countries. Russia and Turkey have also drafted an intergovernmental agreement for the projected oil pipeline that is to cross from the northern Turkish city of Samsun, near the Black Sea, to the southern port of Çeyhan. This structure will enable Moscow to supply the oil pipeline with 25 million tons of crude oil per year, and up to three times that amount in the future.

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For **Turkey**, 2010 was a year that saw its increased engagement in the region and beyond, in accordance with its aspiration to the role of regional power. Turkey's return to the Near and Middle East, which many have described as Neo-Ottomanism, recalling Turkey's multicultural and imperial past, was heralded as an attempt to fix old mistakes in the region. On the one hand, Turkey was able to achieve a qualitatively new level of relations with immediate neighbors and former adversaries Greece, Syria, Iraq, and Iran; on the other hand, Turkey did not manage to straighten out the three main political challenges facing it – in Cyprus, in its own eastern and southeastern regions with the Kurdish population, and with Armenia.

The absence of success in these three critical areas undermined its policy of “Zero Problems with Neighbors.” Moreover, although Turkey is perceived most favorably in the Arab world, due to its very vocal and public condemnation of Israel's treatment of Palestinians, Ankara's role in the resolution of the most entrenched problem of the Middle East, the Palestinian-Israeli conflict, decreased significantly.

Even as Turkey removed Armenia, Iran and Syria from its official list of countries viewed as threats, it added Israel to the list, thus further fueling the year's question – Was Turkey tilting from West to East?

Despite its new assertiveness in the Middle East, Turkey's pronouncements indicated that it remains committed to its decades-old goal of achieving full European Union membership. In fact, it rejected proposals made earlier this year by France and Germany for a Privileged Partnership with the EU, something less than full membership. Nevertheless, by year's end, the repeated delays in the process had hit a new low. For the first time, no new negotiating chapters had been opened during an entire six month EU presidency period due to lack of progress on other matters.

Apprehensive and resentful at the prospect of being sacrificed on the “reset” altar, **Georgia** sought to further strengthen its established cooperation with Turkey, and to take its relations with Iran to a new level.

The acute tensions in Georgian-Russian relations resulting from the August 2008 war, the subsequent formal recognition by Moscow of Abkhazia and South Ossetia as independent sovereign states, and Georgia's severing of diplomatic relations in retaliation persisted in 2010. Georgia continued to block Russia's application for membership of the World Trade Organization; repeatedly reaffirmed its determination to join NATO and the European Union, and its right to re-arm (despite US reluctance to supply the desired weaponry.)

Further, it embarked on a new strategy of seeking to drive a wedge between Moscow and the population of the North Caucasus. The Georgian authorities began Internet television broadcasting in Russian to

A REGION IN STALEMATE

the North Caucasus with the stated aim of providing an alternative source of news about developments in the region. Georgia hosted academic conferences in Tbilisi on the killings and expulsions of the Circassians from their homeland by Tsarist Russian forces in 1864. Tbilisi further antagonized Moscow by unilaterally exempting residents of the North Caucasus republics from the need to acquire entry visas for visits to Georgia of up to 90 days. In the wake of that decision, Chechen Republic head Ramzan Kadyrov joined the chorus of Russian officials accusing Georgia of providing covert support for the North Caucasus Islamic insurgency.

In late November, the Georgian parliament began preparing for an international media campaign arguing that Russia does not have the “moral right” to host the 2014 Winter Olympics so near the site of killings in Abkhazia – even though in 2007 President Saakashvili hailed the Olympic Committee’s choice of Sochi as the venue for the 2014 winter games.

Saakashvili himself, as well as senior Georgian officials, repeatedly professed their readiness to embark at any time on talks without preconditions on those issues that constitute the fundamentals of bilateral relations, namely the withdrawal of Russian forces from Abkhazia and South Ossetia and the restoration of Georgia’s territorial integrity. The Kremlin ruled out any relations with Tbilisi so long as Mikheil Saakashvili is in power in Georgia. Prime Minister Vladimir Putin has, on several occasions, received members of the Georgian opposition in Moscow.

After remaining closed for several years because of “renovations,” the Georgian-Russian border checkpoint at Kazbegi-Upper Lars was opened mid-year – not without mediation by Armenians, who after all, are as dependent on that access to Russia, as are the Georgians. The crossing is for freight traffic

only. Earlier in the year, the first direct flight since the August 2008 War between Moscow and Tbilisi was reinstated.

Turkey did not manage to straighten out the three main political challenges facing it – in Cyprus, in its own eastern and southeastern regions with the Kurdish population, and with Armenia

Meanwhile, tensions have arisen in Russia’s relations with Abkhazia and South Ossetia. The Abkhaz leadership is under pressure from Moscow to agree to restore property belonging to persons who fled Abkhazia during the 1992-1993 war and subsequently acquired Russian citizenship; the Abkhaz opposition is resisting such concessions. In South Ossetia, Moscow is seeking to put a stop to the ongoing embezzlement of billions of rubles Russia allocated for post-conflict reconstruction.

Georgia’s relations with Azerbaijan and Turkey (its biggest trade partner, with bilateral annual trade totaling around \$1 billion) are ruled by economic pragmatism, as reflected in the resumption in May of construction work on the Baku-Tbilisi-Kars rail link (suspended in December 2009) and the trilateral agreements signed between Georgia, Azerbaijan and Romania in April and September on the transport of Azerbaijani natural gas to Europe. Turkish economic presence in the Adjarian region of Georgia continues to grow.

Georgia also launched an overture to Iran in May, just weeks after President Saakashvili felt the US snubbed him by not scheduling a one-on-one meeting between him and President Barack Obama on the sidelines

A REGION IN STALEMATE

of the nuclear security summit in Washington. From the outset, Georgian officials argued that the desire for closer ties with Tehran should not be construed as detracting from, or directed against, Georgia's strategic alliance with Washington, given that the primary focus is economic cooperation and trade. A bilateral agreement was signed in November on visa-free travel, the opening of an Iranian consulate in Batumi, and the start of direct flights between Tbilisi and Tehran.

Azerbaijan, encouraged by the freezing of the Turkish rapprochement process with Armenia, appeared increasingly to prioritize cooperation with Turkey and Iran over its strained relations with Washington.

Apprehensive and resentful at the prospect of being sacrificed on the “reset” altar, Georgia sought to further strengthen its established cooperation with Turkey, and to take its relations with Iran to a new level

Within days of the suspension of the protocol process, the Turkish prime minister and foreign minister publicly reaffirmed Turkey's obligations under the 1921 Treaty of Kars to protect Azerbaijan's Nakhichevan Autonomous Republic from “threats” posed by Armenia.

Turkey and Azerbaijan finally signed a long-awaited agreement paving the way for negotiations on the export via Turkey to Europe of gas from the second stage (provisionally scheduled for 2016-2017) of exploitation of Azerbaijan's Shah Deniz field.

During a visit to Baku in mid-August, Turkish President Abdullah Gül and Azerbaijani President Ilham Aliyev signed a declaration on strategic

partnership and mutual assistance. One month later, Aliyev visited Ankara where he and Turkish Prime Minister Recep Tayyip Erdogan agreed on the formation of a Council for Strategic Partnership. In November, the Azerbaijani government signed an agreement with a Turkish company on the joint production of 107mm and 122mm rockets.

However, Azerbaijan has not reciprocated the unilateral abolition by Ankara last year of the visa requirement for Azerbaijanis wishing to visit Turkey nor Iran's lifting of the visa requirement for Azerbaijanis visiting Iran for up to two weeks.

Azerbaijan does not technically have a strategic alliance with Russia, such as the one that exists between Russia and Armenia, nevertheless Azerbaijani-Russian relations continued to maximize the existing potential for mutually beneficial cooperation. Russian President Medvedev visited Baku in September, signing an agreement on the formal delimitation of the border between the two countries that some analysts claim is detrimental to their republic's interests. Also signed during Medvedev's visit was a further agreement – the third in one year – on purchases by Russia's Gazprom of Azerbaijani natural gas. The volume of sales thus rose from 500 million cubic meters annually in 2009 to one billion cubic meters in 2010 and two billion in 2011, with no ceiling set for further purchases. In addition, there have been recurring rumors, not denied by either side, about the sale to Azerbaijan of the Russian S-300 air-defense system.

The course of Azerbaijani-Iranian relations reflects Washington's dwindling influence on Baku on the one hand, and the potential advantages for Azerbaijan of capitalizing on increasingly close Turkish-Iranian ties, on the other. While Azerbaijan is bound by the UN General Assembly's Resolution 1929, it is apparently reluctant to compromise

A REGION IN STALEMATE

commercial ties with Iran by complying with the additional sanctions on Iran imposed by the US and the European Union.

Azerbaijani officials blamed Iran for flooding caused by problems with a dam at their border. Iran reacted to several incidents involving the destruction or near-destruction of mosques in Azerbaijan. One was torn down following a ruling issued by a Baku Economic Court. In the case of another, the State Oil Company of Azerbaijan said the destruction was necessary for technical reasons. But in May, Iran's religious leadership threatened to issue an appropriate fatwa if the destruction did not end.

Iran continued to remain involved in regional processes, despite the international policy of economically isolating the Islamic Republic. In late November, plans were announced for a summit of the Iranian, Turkish and Azerbaijani foreign ministers in Tehran, to discuss trilateral cooperation, including the possible creation of an economic zone on the borders of Turkey, Iran and Nakhichevan. Iranian President Mahmoud Ahmadinejad had earlier held a trilateral meeting with Turkey's Prime Minister and Brazil's President Lula da Silva in Tehran.

Tehran has also been able to maintain good relations with its immediate neighbors, Afghanistan and Iraq, and has influenced internal developments there.

As for Iranian-Russian relations, it appears that Washington has succeeded in securing a more neutral Russian position towards Iran, perhaps in return for an acceptance of the enhanced Russian role in the Caucasus. Moscow went along with the new international sanctions and constraints against Iran in the summer of 2010, and at the same time reversed its previous decision to sell Iran several S-300 missile systems. But it did not do a complete

U-turn. It did stay and complete the construction of Iran's Bushehr nuclear plant.

ARMENIA – IRAN

Armenia and Iran enjoy healthy political relations. Although within international organizations Iran votes favoring Azerbaijan's position on the Karabakh conflict, in the bilateral and regional context, Iran has succeeded in remaining balanced and neutral regarding both Armenia and Azerbaijan. In turn, despite international political and economic pressures, Armenia has resisted steps which Iran would perceive as going counter to its national interest. Such reciprocal consideration, in what is otherwise an uncertain environment, has placed the bilateral political agenda on firm ground and made prospects for maintaining and growing economic relations possible.

The course of Azerbaijani-Iranian relations reflects Washington's dwindling influence on Baku on the one hand, and the potential advantages for Azerbaijan of capitalizing on increasingly close Turkish-Iranian ties, on the other

In recent years, Iran and Armenia completed two significant energy projects together as part of a gas-for-electricity deal: the Iran-Armenia gas pipeline was completed in 2007, and 220 kW high voltage electricity lines were constructed. This year, the energy ministers of the two countries met at the Hrazdan Thermal Power Station, about 50 km (31 miles) north of Yerevan, where they participated in the official groundbreaking for a third high voltage

A REGION IN STALEMATE

line, this one with a 400 kW capacity, to extend 275 km (170 miles) from the power station south towards the Iran-Armenia border, to deliver electricity generated from Iranian gas.

During the same meeting, the two ministers signed a document on another project, long anticipated – construction of two hydropower stations on the Arax River. The agreement stipulates that the \$323 million project will be fundamentally financed and operated by Iran, 793 million kWh of energy transported to Iran annually, and the stations transferred to Armenia's ownership 15 years later. Construction is expected to commence in 2011 and take five years to complete.

In recent years, Iran and Armenia completed two significant energy projects together as part of a gas-for-electricity deal: the Iran-Armenia gas pipeline was completed in 2007, and 220 kW high voltage electricity lines were constructed

Other projects on the drawing board are continuously delayed. Chief among them is an Armenia-Iran rail line, expected to stretch 313 km (200 miles) across several mountain ranges, and could cost as much as \$4 billion. The dilemma with the construction of such infrastructure is that neither Iran-Armenia nor Iran-Armenia-Georgia freight transport would offer sufficient economic incentives to justify such expenditure. For that reason, no international entity has been willing to make this level of investment. The rail line would make economic sense if the Azerbaijan and Turkey blockade of Armenia were to be lifted, but in that case, the urgency would disappear, since the

Yerevan-Nakhichevan-Julfa-Tabriz line would be usable.

Plans to build an oil refinery on the border have been shelved, again for economic reasons, according to high-level government officials on both sides. The other project for which there are no concrete plans is the oft-mentioned Iran-Armenia pipeline and storage terminal for refined oil, despite an announcement by Armenia's Prime Minister Tigran Sargsyan, during a fall trip to Tehran, that construction would begin soon.

Clearly, the momentum that initially existed in Iranian-Armenian economic relations has not been sustained. The reasons include post-election instability in both countries, the disinterest of international organizations in a north-south energy or transportation corridor, and sanctions and limitations imposed on Iran. As a result, some programs have simply remained at the level of good intentions.

This is evidenced in the low volume of bilateral trade – \$200 million, annually – which is approximately equal to the trade between Armenia and Turkey, which takes place without open borders, across Georgian territory. The one significant positive change is a noticeable increase in the number of Iranian tourists visiting Armenia – estimates are 80,000 this year.

There are occasional problems in Armenian-Iranian relations, such as the Iranian denunciation of the visit to Armenia by Nobel Prize winner, attorney and human rights activist Shireen Ebadi, within the framework of the International Federation for Human Rights conference in Yerevan in April. The Armenian authorities, who did nothing to obstruct her visit, were themselves dissatisfied when she vocally and visibly supported the demands of the Armenian opposition.

A REGION IN STALEMATE

This resulted in the postponement of a few high-level Iran-Armenia visits. Nevertheless, during the year, Armenia's prime minister, as well as the defense and foreign ministers, visited Tehran. Conversely, Iran's foreign and energy ministers visited Armenia, as did the president of Iran's Parliament.

ARMENIA-GEORGIA

Armenia and Georgia have very different, often conflicting, foreign policy priorities, and these seriously weaken bilateral relations between them. These differences are not always articulated nor addressed at high-level meetings, yet often they do determine the nature, depth and scope of Armenian-Georgian dealings. As evidence, the two countries do not focus on transforming their relations to a strategic one, or liberalizing their customs regime, or simplifying border crossing procedures, or undertaking any one of a myriad other possibilities to benefit from what would appear to be a natural alliance.

The areas of divergence that prevent such a strategic association are Georgia's active pursuit of NATO membership, Armenia's alliance with Russia with whom Georgia has no diplomatic relations, and Georgia's economic and political ties with Azerbaijan and Turkey with whom Armenia has no relations. In addition, Armenia and Georgia are at opposite ends of the spectrum on the right of self-determination: Georgia has two secessionist regions and is therefore not a supporter of the principle of self-determination. Armenia supports the right of Nagorno Karabakh to self-determination. Finally, Georgia's policies regarding its Armenian minority are troublesome for Armenia. Yet, Armenia is disproportionately dependent on Georgia and therefore must take into account these differences, even as it searches for a peaceful, stable relationship.

Following the hot war with Russia, Georgia had few foreign policy direction options. The Russian threat, or Georgia's perception of it, moved it towards the West. Until 2005, Russia was Georgia's largest trading partner. Today, Turkey occupies that place with Azerbaijan coming in second at \$486 million.

Armenia and Georgia have very different, often conflicting, foreign policy priorities, and these seriously weaken bilateral relations between them

Such economic linkages, and especially in the energy sector, explain Georgia's pro-Azerbaijani leanings in international organizations. Add to that the fact that Armenia votes against Georgian proposed resolutions on Abkhazia and South Ossetia. In September, at the UN General Assembly, Armenia along with 16 other countries, including Russia, voted against the right of displaced persons to return to their homes in Abkhazia and South Ossetia. The Georgian Ministry of Foreign Affairs expressed disappointment with the vote, but added that this should not cause a break in relations between Tbilisi and Yerevan.

Another potential stumbling block in Armenia-Georgia relations is the continuing process of border delimitation. It is not a cause of bilateral problems, but a symptom of the non-urgency of the relationship.

Perhaps the greatest point of tension on the strictly bilateral agenda is the situation of Georgia's Armenian minority and their perceived treatment. More than 90,000 Armenians live in Tbilisi, yet the number of Armenian schools is steadily decreasing.

A REGION IN STALEMATE

Armenians claim this is an overt attempt to weaken ethnic identity and belonging. Georgians respond that Armenians increasingly send their children to Russian or Georgian schools, and therefore enrollment in Armenian schools is dropping. The government says the purpose is integration, the Armenian minority accuses the government of open efforts at forced assimilation.

Georgia has two secessionist regions and is therefore not a supporter of the principle of self-determination.

Armenia supports the right of Nagorno Karabakh to self-determination

The other expression of these same tensions is the status of the Armenian Church in Georgia. In contrast to Armenia, where there are over 60 legally recognized and registered religious organizations, the only religious organization that enjoys legal recognition and the right to be registered in Georgia is the Georgian Orthodox Church. The Armenian Church in Georgia, which has existed and continuously functioned there for centuries, may only be registered as a non-governmental organization, which is also true of other Christian churches, denominations, as well as the Jewish and Muslim communities. Religious minorities in Georgia find this unacceptable for a number of reasons, among them the limited rights accorded to non-governmental organizations, the difference in status and standing before Georgian civil and judicial authorities, the vast differences in tax legislation and charitable regulations, and the basic desire to be treated equally and without discrimination.

In both cases, the source of the conflict is in the very different perceptions of history and identity. Georgia's leadership is increasingly articulating its vision for a unitary Georgia, a nation-state, made up of Georgians. Armenians, who have lived in Tbilisi and Javakheti for centuries, believe they belong there, and therein lies the source of the strain. In addition, the Georgian government's loud proclamations of Western orientation and values make it easy for the Armenian minority to expect Western treatment.

The frequent visits of high-level officials help ameliorate the situation. More and more, these visits – such as Armenian President Serzh Sargsyan's in early 2010 – are not just to Tbilisi, but also to Batumi, on the Adjarian coast. An ever-increasing number of Armenian tourists also visit Batumi each summer – numbers exceed 100,000 – and the value of social and economic interaction of this magnitude is not lost on the Georgian establishment. And despite Armenia's taking a second place to the Turkey-Azerbaijan tandem for Georgia, Armenia's rather neutral role in the Georgia-Russia imbroglio has also not gone unnoticed.

ARMENIA - TURKEY

Although Turkey-Armenia trade amounted to approximately \$200 million last year, this figure is not expected to increase significantly so long as the land border between the two countries remains closed. In 2010, it was confirmed that Turkey will keep the border closed for the foreseeable future after the Turkey-Armenia normalization process which was made very public in 2008, when Armenia's president invited his Turkish counterpart to Yerevan to watch football together, collapsed. This ended up disappointing the optimists, baffling the mediators and vindicating the critics.

A REGION IN STALEMATE

The speed and optimism with which the two sides initially moved forward were based on two fundamental miscalculations. The Armenian side believed that Turkey, which had closed the border with Armenia to demonstrate solidarity with Azerbaijan in 1993, when it had lost territories in the military conflict over Nagorno Karabakh, could somehow in fact re-open the border without the progress that Azerbaijan wanted to see on the Karabakh issue. The Turkish side, too, had made its own assumptions. They perhaps thought they could in fact push Azerbaijan to become more flexible, and see the benefit of open borders for the security environment in the region. Moreover, the Turkish leadership estimated that the Karabakh process would be moving along sufficiently quickly and positively so that by the time Turkey and Armenia had agreed on protocols, there would be some tangible progress on Karabakh, acceptable to Azerbaijan, thus freeing Turkey to open the border.

The calculations were off. The protocols were suspended and the two sides are engaged in accusation and counteraccusation. The very public recriminations and retorts are wildly different, surprisingly undiplomatic, and their messages uncertain.

The process came to a standstill on April 22, 2010, not coincidentally precisely one year after the announcement of a Road Map for the normalization of relations. The significance of these April dates were obvious to most and later confirmed by WikiLeaks cables – Turkey had aggressively used the Turkey-Armenia protocols, particularly the prospect of their ratification, to pressure American leaders against US recognition of the Armenian Genocide, and in favor of a pro-Azerbaijani settlement of the Nagorno Karabakh conflict.

In other words, in 2009, Yerevan and Ankara announced an outline of a plan for the normalization of relations just two days before the annual commemoration of the Armenian Genocide precisely in order to offer US President Obama a reason to stand down from his campaign pledge to use the term ‘genocide’ in his remarks about that day.

The speed and optimism with which the two sides initially moved forward were based on two fundamental miscalculations

Almost immediately after the Road Map announcement, Turkey’s Prime Minister Erdogan publicly conditioned, for the first time, the Turkey-Armenia process to progress on Karabakh. By October 10, 2009, when the protocols were signed in Zurich by the two foreign ministers, under the watchful eyes of the top diplomats of the US, EU, Russia, France, the Karabakh linkage was an open secret – repeatedly mentioned by Turkey and rejected by Armenia. In fact, the problem was so contentious that the Zurich signing ceremony was almost derailed, and there was no agreement on any of the participants making public statements after the signing, given the diametrically different position each was likely to take.

Following the signing, the Armenian government submitted the protocols to the Constitutional Court. The timing was criticized – too late to influence the signing and too early to take into consideration any legislative amendments – but the Court ruled, nonetheless. The Constitutional Court, in taking into consideration the concerns and resistance made public, attempted to minimize the grounds for objections. In early 2010, the Court ruled that none

A REGION IN STALEMATE

of the provisions of the protocols can in any way relate to either the historical veracity of the Genocide or the Karabakh conflict and its resolution.

By October 2009, when the protocols were signed in Zurich by the two foreign ministers, under the watchful eyes of the top diplomats of the US, EU, Russia, France, the Karabakh linkage was an open secret

Subsequently, President Sargsyan introduced the protocols to the National Assembly and assured the world that the Armenian parliament would ratify them. The Turkish foreign minister announced that the protocols could be ratified within three days by his country's parliament but that it had not done so because of the unresolved Karabakh question.

Turkey, which had for the last half year, at the highest levels, insisted that the protocols did in fact have bearing over those two issues, cited the Court's statement and accused Armenia of sabotage. The Armenian side realized that the Turks would not or could not open the border, and subsequently suspended the process in April.

The decree came after President Sargsyan's meetings with US President Obama and Turkish Prime Minister Erdogan in Washington, then with Russian President Medvedev in Moscow. The Armenian authorities were finally compelled to accept that it was no longer possible to continue presenting the desirable as reality.

Those who had served as godfathers of the protocols process – the US, Switzerland and other European states – were pleased that Armenia suspended the process rather than end it. The Turkish side

quickly claimed that the cessation of the process was Armenia's unilateral decision and attempted to shape international public opinion.

Furthermore, the Turkish side announced at various levels that there is ongoing, albeit quiet, diplomacy between Armenia and Turkey. The intent, as evidenced by the publication of special instructions issued by Ankara to its diplomatic representations, was to convince public opinion internationally that the bilateral process is not dead, and thus to put the brakes on the Armenian Genocide recognition process, yet again. As a result, in the last months of 2010, Armenia was forced to frequently repeat that there is no quiet diplomacy, no Zurich Round Two, nor any other new process.

Needless to say, the optimists were disappointed. Some had hoped that Turkey would be bold enough to disregard Azerbaijan's real or perceived threats, confident that an open region would in the end benefit Azerbaijan by enabling a peace-minded, non-zero-sum agreement. Further, the optimists also clearly counted on the fact that by not including the terms "genocide" or "Karabakh" in the documents, and by merely vaguely referring to them, such circumvention of very divisive and difficult issues would somehow be possible.

Neither worked. There was disappointment all around. Turkey confirmed Armenians' worst fears when they later dismissed the deliberate vagueness that had been adopted and openly articulated their conditions.

The mediators were baffled. They had gotten as far as Zurich, they witnessed a signing, meetings at the levels of presidents, and yet, the nuances they did not understand or wished to ignore came back to haunt and derail the entire process. They were further bewildered by the new bitterness that is visible at the highest levels.

A REGION IN STALEMATE

But the critics were not. Those who had raised the alarm that the process was unfeasible and the documents inadequate were vindicated. Fears that a sloppy process would lead to failure were proven true. But worse, predictions that bilateral relations would be even more adversely affected also came to pass. Those who insisted that trying was better than not trying, or that trying couldn't hurt, are now faced with a pendulum that has shifted from groundless elation in 2008 to unnecessary hostility in 2010. The sides have much to explain to their own publics and the international community, yet the messages are unclear. As a result, the present discourse is limited to blame and distrust.

Finally, by suspending the protocols rather than completely dismissing them, the Armenian side has created a situation where there is no longer even slight pressure on Turkey to open the border. Instead, Turkey has now taken on the right to become an active negotiator in the Karabakh process, aggressively pushing for a resolution, in various forums, while clearly remaining a protector of Azerbaijani interests.

In the meanwhile, Turkey continues to expend political and financial capital on denying the Armenian Genocide and officially challenging or worse, punishing those who recognize it. In the spring, the Foreign Affairs Committee of the US House of Representatives and soon after, the Swedish parliament, both adopted resolutions recognizing the Armenian Genocide. Ankara retaliated. US Secretary of State Hilary Clinton personally appealed to the Congress not to vote on House Resolution 252. Sweden's prime minister telephoned his Turkish colleague and publicly apologized.

On the other hand, within Turkey, there were several first-ever occurrences in 2010. April 24 was commemorated in a central Istanbul square,

where scores of Armenians and Turks gathered and listened to both Armenian and Turkish speakers remember the genocide of 1915.

Armenia's Constitutional Court, in taking into consideration the concerns and resistance made public, attempted to minimize the grounds for concern

Months later, in September, the Turkish government finally relented and allowed the re-consecration of the historic tenth century Holy Cross Armenian Church on Akhtamar Island in the eastern Turkish city of Van. What had heretofore been beautifully restored as a 'museum,' could now serve as a house of worship for a special annual religious service. A liturgy was planned, but at the last minute, ostensibly because this was in the run-up to local elections and the ruling party did not want to antagonize conservative voters, permission was denied to put a cross on the dome. The situation simply confirmed for many that the process was a public relations campaign by the Turkish government, and not a true expression of tolerance. An equal number protested the easy dismissal of what is nevertheless a useful, positive step toward acknowledgement of the historic Armenian presence in Turkey.

NAGORNO KARABAKH CONFLICT

If the Karabakh negotiation process in 2010 could be described in one sentence, it would be that it entered a phase of **uncertainty, unpredictability and danger**.

A REGION IN STALEMATE

The **uncertainty** is due to a situation where, for the first time in more than half a decade, there's no single document which all parties recognize as the text that serves as basis for negotiations.

If the Karabakh negotiation process in 2010 could be described in one sentence, it would be that it entered a phase of uncertainty, unpredictability and danger

The Madrid Document had evolved over the several years of the Prague Process and had been deposited with the OSCE Secretariat in 2008, following its presentation by the top diplomats of the Minsk Group co-chair countries at the OSCE Ministerial Council in Madrid in 2007. The sides recognized the document as a basis for further negotiations, albeit each with its own concerns and reservations.

This document remained the negotiating document after Armenia's new administration came into office in April 2008. It was the subject of talks throughout 2009, when the presidents of Armenia and Azerbaijan met six times under the aegis of the OSCE Minsk Group co-chairs.

The presidents' first meeting of 2010 was in Sochi, Russia, in January, and like the two meetings that followed during the year, was held with the mediation of the Russian President.

For this meeting, the Minsk Group co-chairs, in accordance with their custom, presented yet another revision of the former document, modified per prior discussions. This document, which they called Madrid Revised, had apparently been so one-sidedly altered that now it was acceptable to Azerbaijan. It quickly became evident from public comments

that Armenia would not accept Madrid Revised, insisting that it was simply a working draft and that the only legitimate negotiating document remained the one submitted in Madrid, in 2007.

In June, at the second meeting of the presidents in 2010, again with President Medvedev as mediator, this time in Saint Petersburg, the document must have changed so much that it was reported that Azerbaijan's president publicly abandoned Russia's northern capital, in dissatisfaction. Azerbaijan stated that the new document was not legitimate, since it had been presented by the Russian side alone, without the presence and consent of the other co-chairs. Hours later, as a result of one of the largest military provocations since the May 1994 ceasefire, four Armenian soldiers were killed when an Azerbaijani unit succeeded in penetrating Karabakh's defensive positions.

By the third meeting of the presidents, in Astrakhan in October, the air was full of publicly traded accusations and threats. On the ground, the tension was reflected in the unprecedented level of ceasefire violations and sniper fire along the line of contact.

If in earlier periods there had been public arguments about specific aspects of the negotiating document, now the debate was not over the content of the document, but about which document should serve as a basis for future negotiations.

In Astrakhan, the presidents did not answer this question but signed yet another declaration, reaffirming the provisions of the November 2008 Meindorf Declaration. In addition, they put on paper something they had been doing for years: to exchange prisoners of war and return the bodies of the deceased, with the assistance of the co-chairs of the Minsk Group and the International Committee of the Red Cross. There was no mention of Karabakh in the Astrakhan document.

A REGION IN STALEMATE

That uncertainty inevitably compounded political **unpredictability**. In the months prior to the OSCE Summit in Astana in early December, expectations were high that the presidents of the Minsk Group co-chair countries would meet with the presidents of Armenia and Azerbaijan. Not only did such a meeting not materialize, but neither did a standard meeting of the two presidents. The fact that two presidents were in the same city, for the same summit, and chose not to use the opportunity to meet to make some, albeit minor, progress, is an indicator of the great amount of unpredictability that has become a part of this process. This is evidenced by the general absence of respect and diplomatic decorum in the tone and content of public statements uttered throughout the year by the leadership or by their spokesmen.

Finally, this uncertain and unpredictable phase in the history of the conflict has also become a **dangerous** one. The quantity and intensity of incidents along the line of contact are cause for serious alarm. According to official statistics, there are over 30 violations of the ceasefire daily.

In addition, Azerbaijan has significantly increased its military budget. The allocations for military expenditures in 2011 will exceed \$3 billion, and comprise nearly 20 percent of the state budget, surpassing the combined total state budgets of Armenia and Nagorno Karabakh. That trend will deepen in the coming years, Azerbaijani oil will not peak for another four or five years, and it is oil revenues that are fueling Azerbaijan's budget, and perceptions of power.

Turkey's continued involvement internationally is also fueling Azerbaijan's perception of hidden advantage. Turkey explains its involvement in pursuing a resolution of the Karabakh conflict,

because it has said overtly that only such a resolution will make it possible to open the border.

The pressure is on in all quarters, including the UN, where Azerbaijan this year again introduced a resolution on "The Situation in the Occupied Territories." Later, they withdrew the resolution in exchange for a new fact-finding mission to the territories surrounding Karabakh, as a follow-up to the one conducted five years ago.

The Madrid Document had evolved over the several years of the Prague Process. This document remained the negotiating document after Armenia's new administration came into office in April 2008

Yet despite such pressure and continuing expectations, nothing concrete came of the most important forum of the year, the OSCE Summit in Astana. The Political Declaration of the OSCE's highest annual meeting usually includes a paragraph, agreed on by the sides and the Minsk Group co-chairs, that reflects the year's progress. This year, there was no such language. Instead, there was a statement by the heads of delegations of the three co-chair countries, and the presidents of Armenia and Azerbaijan.

In support of the Minsk Process, there was a presidential statement made at the G20 Summit in Canada in June as well, which essentially reaffirmed the declaration a year earlier by the G8, at L'Aquila, Italy. In all three statements, France, the United States, and Russia reaffirmed the return of territories surrounding Karabakh, the granting of interim

A REGION IN STALEMATE

status to Karabakh, a final determination of the status of Nagorno Karabakh via a legally binding expression of will by its population, the return of displaced persons and refugees.

If in earlier periods there had been public arguments about specific aspects of the negotiating document, now the debate was not over the content of the document, but about which document should serve as a basis for future negotiations

While these discussions continued, the International Criminal Court in The Hague issued a verdict on Kosovo's legal status, which immediately triggered contradictory responses. Azerbaijan repeated the international community's line that the Kosovo situation is unique and does not apply to Karabakh. Armenians, on the other hand, stated that the Kosovo independence process proves that self-determination is the dominant norm in international relations.

Karabakh held its fifth parliamentary elections this year, reinforcing its de-facto sovereignty and electing 33 parliamentarians from three parties. Meanwhile, the world observed Azerbaijan's parliamentary elections as well, where the president's party again captured the majority of the seats.

Although visits between Armenian and Azerbaijani high-level officials are nearly non-existent, 2010 saw an unusual visit. In April, Karekin II, the Catholicos of All Armenians, visited Baku for 12 hours, at the invitation of Sheikh ul-Islam Allahshukur Pashazadeh, the spiritual leader of the Muslims of the Caucasus. Although the two had met previously

a number of times in Moscow and other world capitals through the mediation of the Patriarch of the Russian Orthodox Church, this was the first time one of them hosted the other. The Catholicos and the Grand Mufti once again confirmed the non-religious nature of the conflict, the necessity for the Nagorno Karabakh conflict to be solved only through peaceful means, rejected the use of force, and encouraged the continuation of dialogue between the parties. During his short stay in Baku, the Catholicos had a lengthy meeting with President Aliyev.

BEYOND THE REGION

Armenia's engagement with three power centers – Russia, Europe and the United States – was again characterized by varied degrees of intensity. Russia retained a greater role than the other two powers. The year was also marked by high-level US and European contacts with Armenian and regional leaders, as well as a promise of a new level of integration with the European Union.

Greater assertiveness and activity by Russia resulted in many high-level meetings, and in some greater dependency on the part of Armenia on Russia. The same cannot be said of Armenia's relations with the other two power centers. The public face of Armenian-American relations revolved not around bilateral issues, but rather on the US interest in pursuing improved Armenia-Turkey relations. Privately, those relations continued as they have for nearly two decades in a delicate dance between support for development and expectations of improved democratic governance. Armenian-European relations, far less defined, were less than satisfying for both sides, with neither side certain of what the other expects.

In perhaps the year's most positive development for the region, Russia and Georgia – after protracted

A REGION IN STALEMATE

talks mediated in part by Armenia – agreed to re-open the Lars border crossing that after a four-year closure again provides an overland connection for freight traffic between **Armenia and Russia**.

There seemed to be positive impact on Armenia-Russia trade. Bilateral trade turnover stood at more than \$700 million for the first nine months of 2010 – on track to rebound to \$1 billion mark first reached in 2008 prior to the global economic slowdown.

Throughout the year, high-level Russian-Armenian dialogue remained intense with Armenia's president traveling to Russia eight times and Yerevan hosting the Russian president in August, in conjunction with the annual meeting of the Collective Security Treaty Organization.

It was during this visit that an agreement was signed to extend the Russian-Armenian military treaty. Responding to Russia's request, Armenia agreed to extend Russian military deployment in Armenia until 2044.

The move appeared to be part of Russia's efforts to define its long-term military posture in the former Soviet south. In prior months, Russia achieved a similar extension for naval presence in Ukraine and it formalized its military presence in Abkhazia and South Ossetia.

While there is believed to be public and political support in Armenia for Russian military presence – comprising some 3000 personnel and, more importantly, combat aircraft and modern surface-to-air missile batteries – extension of the 1995 treaty was not without controversy.

Concerns focused on two areas. Whereas in the case of Ukraine, Abkhazia and South Ossetia, Russia offered financial incentives such as reduced price for natural

gas and economic aid, no such incentives were evident in Armenia's deal, which seemed to have been rushed by the Russian president's travel schedule, leaving little time for domestic discussions in Armenia.

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Treaty language was altered to suggest that Russian forces were now to protect Armenia's interests (rather than Russia's alone) and there were renewed expectations of transfer of advanced military technology from Russia to Armenia. But questions remained about the pace and exact nature of such transfers as well as the actual role Russian forces would play should Armenia be the target of aggression.

Critics further noted Russia's plans to step up military cooperation with Azerbaijan – the most likely source of aggression against Armenia – including reported plans to sell surface-to-air missile batteries that are more advanced than the ones deployed in Armenia, and that in combination with Azerbaijan's greater aircraft holdings, would provide it with significant military advantage over Armenia in the air. This mid-range anti-air system has fundamentally a defensive significance and can significantly affect the balance of forces.

A REGION IN STALEMATE

Russia had previously confirmed selling tanks and armored vehicles to Azerbaijan in recent years and Moscow may have also facilitated delivery of other weapons systems that Azerbaijan purchased from Belarus and Ukraine. These policies seem to run counter to Russia's alliance commitments to Armenia and stated concerns over regional stability.

President Sargsyan's visit to Washington was a consolation prize of sorts, recognizing both Sargsyan's politically controversial outreach to Turkey in a US-mediated process and failure of that process to produce promised results for Armenia

Russia's President Medvedev continued to play a leading role in bringing Armenian and Azerbaijani presidents together three times during the year – within the Minsk Group framework.

Since assuming the presidency, President Sargsyan held his first meeting with Russia's Prime Minister Putin in Moscow since June 2008.

In September, cease-fire violations on the Line of Contact were of sufficient concern as to be the subject of talks between the US defense secretary and the visiting Russian defense minister. Probably as a result, the following week at the United Nations in New York, in his first meeting with Azerbaijan's President Aliyev, President Obama publicly called on Azerbaijan abide by the cease-fire.

In a year when **Armenia and the United States** shared important foreign policy goals and Armenia complied readily with America's direction and encouragement in urging forward the Armenia-Turkey normalization

process, Armenian-American relations should have been at an all-time high. Instead, they appeared to lack real confidence or certainty.

In April, President Sargsyan met with President Obama, when the Armenian leader was invited to a summit on nuclear safety in Washington. Remarkably, this conference was the reason for the first visit by an Armenian president to the American capital in nine years.

President Sargsyan's visit to Washington was a consolation prize of sorts, recognizing both Sargsyan's politically controversial outreach to Turkey in a US-mediated process and failure of that process to produce promised results for Armenia.

Following that visit, President Sargsyan responded to US requests not to abandon the protocols that Armenia signed with Turkey in 2009 and declared the process of normalization suspended until Turkey renews its interest.

In the meantime, President Obama adjusted his annual statement on the Armenian Genocide away from his pre-election promise for the second year in a row. And the Administration effectively opposed a congressional Genocide resolution, although it was passed by the House of Representatives Foreign Affairs Committee.

In October, US Vice President Joe Biden said in videotaped off-the-cuff remarks, that President Sargsyan was ready to trade genocide recognition for relations with Turkey and was in effect to blame for President Obama's position rather than Obama himself. That claim was quickly denied by President Sargsyan as well as the US Embassy in Armenia. With that US position, the little immediate impetus that Turkey had to pay heed to the process with Armenia appears to have dissipated, with no bilateral meetings reported since April.

A REGION IN STALEMATE

In July, Armenia was one of five countries that Secretary of State Clinton toured in as many days. The 24-hour visit was largely symbolic with Clinton visiting the Genocide memorial in what was announced to be a “private capacity.” It was also the first visit by an American secretary of state to Armenia since 1992. Following a meeting with President Sargsyan, she said she raised the issue of press freedoms, and welcomed the work done by civil society in all areas, including fair, free elections, better access to health care, greater flow of information, and trying to heal the wounds of history.

The Armenian community of the United States, often taking foundational credit for the bilateral relationship, appeared resigned to yet another US Administration failing to recognize the Genocide even when US relations with Turkey were at the lowest point in decades. Armenian activists did win a congressional allocation expanding US aid to Karabakh to \$10 million a year. Overall, US programs in Karabakh amounted to more than \$35 million since 1998, but an additional \$25 million in congressionally-allocated funds were left unspent. This approach reflects both Congress’s desire to satisfy its Armenian constituency by allocating funds for Karabakh and State Department’s efforts not to antagonize their Azerbaijani supporters by not spending the funds.

Politically, with the Republican victory in the House of Representatives, Armenians lost some key champions in the Congressional leadership. But there was also lingering hope that the new majority, traditionally gung-ho on foreign policy and ready to ignore concerns of the White House, might become more assertive on Armenian Genocide vis-à-vis Turkey, as a way of threatening it for its policies on Iran and Israel.

On another Genocide “front,” Armenian Americans launched what promises to be a protracted and

difficult legal battle with Turkish commercial interests in the United States – as heirs to fortunes confiscated from Ottoman Armenians – with a lawsuit filed in Los Angeles in July. In November, a Federal Court ruling reversed a 2009 ruling that Genocide-era insurance claims in California courts are unconstitutional, paving the way for additional claims.

The public face of Armenian-American relations revolved not around bilateral issues, but rather on the US interest in pursuing improved Armenia-Turkey relations

In Washington, the Armenian lobby showcased its muscle by blocking Matthew J. Bryza as nominee for US Ambassador to Azerbaijan. Bryza was criticized for his performance as envoy for Karabakh talks and his perceived close ties with the Azerbaijani leadership were questioned.

Armenian lobbyists also renewed efforts to promote a US-Armenia free trade agreement. From January-September, bilateral trade measured approximately \$150 million, on track for about a 30 percent increase over 2009. In both years, an increase in Armenia’s exports to the US was due to shipments of aluminum foil.

While in 2010, the volume of US assistance to Armenia remained near 2009 levels, longer-term decline continued. The original Millennium Challenge Account commitment for \$235 million had been reduced to about \$175 million due to Armenia’s poor governance record. Thus, the MCC would not complete road construction. Instead, the irrigated agriculture project was headed for completion with apparently no prospects for extension beyond 2011.

A REGION IN STALEMATE

With curtailment of MCC funding, the European Union may thus replace the US as Armenia's chief source of foreign aid for the first time since independence. From 2011 to 2013, the European Union is expected to advance at least €157.3 million (\$208 million) in aid to Armenia.

Brussels, arguably the least imposing of the three power centers, continues to advance **European engagement with Armenia**. In addition to continuing assistance programs, the European Union formally launched talks on Association Agreements with the three Caucasus states in July. Armenia says it continues to make its engagement with Euro-Atlantic organizations a priority, yet it appears hesitant in identifying what it is it wants from the EU, and especially the new Eastern Partnership.

Politically, with the Republican victory in the House of Representatives, Armenians lost some key champions in the Democratic leadership

The Association mechanism promises greater economic cooperation – via free trade agreements and visa facilitation – and closer political association short of membership. Armenia expects to benefit from the trade allowances while Europe continues to insist on standardization, certification, intellectual property rights and public procurement procedures, as well as pressing for economic monopolies to be dismantled in order to allow maximal benefit from new opportunities. It is uncertain how far the Armenian authorities are prepared to go to meet these expectations.

Starting in April 2009, Armenia has hosted the EU Advisory Group, which has been described as a unique engagement with European advisors

involved in various facets of the Armenian government's decision-making.

The European Parliament passed Resolution 2216 in May, within which the Parliament called for “the withdrawal of Armenian forces from all occupied territories of Azerbaijan, accompanied by deployment of international forces to be organized with respect of the UN Charter in order to provide the necessary security guarantees in a period of transition, which will ensure the security of the population of Nagorno Karabakh and allow displaced persons to return to their homes.” Immediate responses by Armenia's top leadership, including the president of the National Assembly and the foreign minister, noted that the resolution's language contradicts the European Parliament's own resolutions passed since 1998, as well as the positions of the OSCE and the EU.

In late December, the European Union's Armenia Parliamentary Cooperation Committee concluded its meeting with a document that calls on Armenia's leadership to take practical steps to separate business from politics, and to work towards bringing police arrest and interrogation practices in line with European standards.

Trade ties continued to solidify and expand. Bulgaria emerged as the largest importer of Armenian goods – \$107 million between January-September 2010. As in years past, Germany, the Netherlands and Belgium remained Armenia's key trade partners.

In February, Armenia deployed a peace-keeping unit to serve with German forces in Afghanistan. Armenia also continued to participate in NATO's Kosovo mission.

2010 also saw Armenian presidential visits to four main European capitals, with trips to London in February, Paris in March, Brussels in May when he met with the European Council President, and Berlin in June.

A REGION IN STALEMATE

In his meeting with the NATO Secretary General in May, President Sargsyan called on the alliance to align its public position on the Karabakh conflict with that of the OSCE and stop highlighting territorial integrity without reference to the right to self-determination.

But in November, when it became clear that a NATO summit communiqué would remain unchanged, President Sargsyan, rather than taking advantage of the opportunity presented by a summit, took the unprecedented step of canceling his participation. The ruling party described this as an “understandable boycott.” But it was unclear how a boycott would bring Armenians any closer to promoting understanding by the international community of Armenia’s position.

OUTLOOK

In 2011, the uncertainty will continue in East-West relations. The US-Russia resetting will not lead to significant changes in the Caucasus. The West and Russia will continue to differ on the European security architecture, on South Ossetia and Abkhazia. Russia will continue to deepen its presence and influence in the Caucasus.

The Russia-Georgia relationship will remain tense. Georgia will insist on the removal of Russian forces from Abkhazia and South Osetia on the one hand, while repeating its readiness to negotiate with Russia on the other. Moscow will continue to refuse to negotiate as long as Saakashvili is still president.

Russia-Azerbaijan cooperation will preserve the momentum of previous years especially in the energy sector. Moscow will attempt to conduct an equidistant relationship with Armenia and with Azerbaijan, although in its public pronouncements Armenia will still be called the strategic partner.

In Russia-Turkey relations, the warming will continue, especially in the energy sector. The Moscow-Ankara political ties will be reinforced if Turkey manages to keep a certain distance from the US and the EU, and is able to perform as a bold regional player.

Turkey will continue to pursue its Zero Problems with Neighbors Policy, however, the credibility and effectiveness of the policy will diminish so long as Ankara retains an uncompromising position regarding Cyprus and Armenia, and towards the Kurdish issue. New approaches to domestic and foreign policy are possible only after Turkey holds parliamentary elections in June, and if the AK Party retains its single party majority.

Progress in Armenia-Turkey relations is unlikely, for many reasons, including the upcoming Turkish elections. Turkey will continue to insist on linkage between the normalization of relations and progress in the Karabakh negotiations, at the same time as it tries to sustain the impression that the Armenia-Turkey process is still alive, in order to impede the already diminished drive for international genocide recognition.

The Karabakh settlement process will remain uncertain. The sides will continue to argue not on the contents of a document, but on which document is on the negotiating table. Azerbaijan, in its bilateral and multilateral relations, will continue to offer rhetoric on a military “settlement” of the Karabakh conflict.

POLICY OPTIONS

Armenia must maintain its policy of positive neutrality regarding the Russia-Georgia and Iran and the West tensions.

Armenia must attempt to do away with the uncertainties surrounding foreign policy in general, and the Karabakh and Armenia-Turkey issues in

A REGION IN STALEMATE

particular. In the case of the Karabakh settlement process, the uncertainty pertains to the negotiating document. This is a serious threat for Armenians, and persisting disagreement over the document can endanger the existence of the concept of self-determination in the negotiations and in any new negotiating document.

Armenia must not respond to Azerbaijan's military threats with a reciprocal "threat" of its de jure recognition of Nagorno Karabakh. The de-jure recognition of Nagorno Karabakh by Armenia must not be a counter step, rather a conceptual anchor and outcome.

As Baku relentlessly preaches its version of Karabakh's right to self-determination, that is, within Azerbaijan's borders, Armenia must make clear Karabakh's self-determination attributes for the international community.

Notwithstanding the Azerbaijani president's admonition to his country's non-governmental organizations to not visit Armenia or Karabakh, Armenia should encourage contact between journalists, NGOs, artists and other professionals from Karabakh, Armenia and Azerbaijan.

Uncertainty must be removed from Armenia-Turkey relations. This "frozen" status, with the border closed, gives Armenia nothing, while it allows Turkey to exploit the situation unilaterally both on the Karabakh conflict and on Genocide recognition.

Given little chance that Turkey will remove the blockade of Armenia or that Azerbaijan-Armenia transportation routes will be opened, Armenia must deepen bilateral ties with its two other neighbors – Georgia and Iran. Taking into consideration the recent closeness between the two, Armenia must endeavor to become the land link connecting the northern and southern neighbors.

Euro-integration is one of the few unifying foreign policy directions for Armenia and Georgia. As cooperation intensifies with the European Union, Armenia and Georgia must work together. Armenia and Georgia, with their similar rankings in democratization, economic liberalization and value systems, are more attractive together as a market, for Europe.

China and India's presence is increasingly felt in the South Caucasus. Armenia must expend special effort to reach new levels of bilateral cooperation with China, the world's second largest economy.

UNSTEADY STABILITY

The political year 2010 ended as it began – by reinforcing the status quo in domestic life, and substantially diminishing expectations of change in society. No substantial steps were taken to tackle the causes and consequences of the deep public political crisis exacerbated by the 2008 presidential election. Nor were there efforts to lessen the effects of the crisis by introducing genuine liberalizing reforms. Thus the past remained murky, the present and future uncertain.

The already growing gap between the elites and the population grew a bit wider – not simply economically but politically. The majority of the public, disconnected from political processes, observed the workings of the state services and concluded that the ruling party's hold on the various institutions of society – education, taxation, police, media – had become even more unyielding.

The political and economic elites or those closest to power and most affected by them, became increasingly disheartened and pessimistic about the ability of the ruling party and leaders to maintain order, give direction and ensure some predictability and certainty in economic and political processes.

Internal processes were affected by regional developments and the continuing economic crisis. Domestic political forces were reconfigured

sufficiently to raise the specter of a new sort of uncertainty.

The Armenian Revolutionary Federation, which had formally left the coalition the previous year because of the president's insistence on pushing forward the Armenia-Turkey protocols, did not transform their agenda or activities in any significant way. Their political ambitions remained unclear.

The other coalition party, Prosperous Armenia, also took steps to signal its readiness to compete with the ruling Republican Party.

Finally, the Armenian National Congress (ANC), carrying the banner of the opposition, itself prevaricated in its statements and activities in ways that rendered vague its own positions and potential.

Thus, both the political and economic GINI coefficients grew even as political and economic processes progressed in unpredictable and uncertain ways. The first notable political event of the year was the special election held in the electoral district whose representative in Parliament, one of independent Armenia's first major businessmen and one of the first to enter politics, Khachatur Sukiasyan, laid down his mandate and left the country. He did so after spending some time in hiding following charges brought against him in the aftermath of the 2008 election, in the context of his close affiliation with former president and unsuccessful presidential candidate Levon Ter Petrossian. His parliamentary seat was sought by another opposition leader, Nikol Pashinyan, editor of the daily newspaper Haykakan Zhamanak, who was himself being held in detention on charges of organizing mass disorder.

In the midst of formal and informal charges of impropriety by the Armenian National Congress,

UNSTEADY STABILITY

the Armenian Revolutionary Federation, and others, the winner was a heretofore little-known member of the National Unity Party. Also remarkable was the fact that voter turnout did not exceed 20 percent, in a district whose residents are considered knowledgeable and politically savvy. Thus, this low figure, even in the Center District of Yerevan where voters had a chance to elect an arrested member of the opposition to the National Assembly, either was simply typical for a special election, or reflected the population's deep disenchantment.

The already growing gap between the elites and the population grew a bit wider – not simply economically but politically

Nine days after the election, Pashinyan's guilty verdict was issued and he was sentenced to serve seven years. This was subsequently cut in half. He remained in prison, but continued to be a significant political player with his editorials, which appeared daily until the end of the year, savaging the authorities and sanctifying the Ter-Petrosian-led opposition.

There were other changes, too, in Parliament. No longer did the Parliament's Council of Europe delegation include the vocal member of the opposition Heritage Party, Zaruhi Postanjyan, who consistently raised Armenia's domestic challenges in Strasbourg. Officials explained that the coalition's Rule of Law Party representative replaced the former coalition member ARF. The ARF, in turn, with more parliamentarians than the Heritage Party, and now a non-coalition member, became the "opposition" in the delegation.

But the Council of Europe's engagement was not as profound as in past years. In March, the monitors requested that the government provide them with a timetable for reforms. The opposition Armenian National Congress responded before the government did. This received no rejoinder from either the authorities or the Europeans. There was no public debate, nor was there one later, when the ANC presented a 100-Step Economy program, presented to the European ambassadors, as well as the public. The ANC did not pursue discussions on the specifics of either its economic or political proposals.

The Armenian National Congress was consistent and successful in using the presence in Yerevan of European policy and opinion makers to publicly express its dissatisfaction and its demands. One such event, in October, was the Future of Democracy Forum of the Council of Europe, this year held in Yerevan. Prior to that, in early April, an ANC demonstration was made to coincide with the annual conference of the respected International Federation for Human Rights, held in Yerevan. Conference participants, including well-known human rights defenders from various countries, actually joined the demonstrators who were calling for the release of imprisoned political activists.

The conference was held in the Philharmonic Hall, in Opera Square, although the square itself, the site of the post-election sit-in in February 2008, remained unavailable for public meetings. The opposition staged its protest at the Matenadaran while the area around the opera continued to be used for various entertainment purposes.

The year 2010 was one of uncertainty and internal challenges for the ANC, which at its irregular public demonstrations announced time-outs coupled with an expectancy for transformative

UNSTEADY STABILITY

events. In the absence of a role in the National Assembly, and without the opportunity for substantial input in domestic politics, the ANC began to experience internal problems, natural to such a situation. The history-making Armenian National Movement (ANM) which led the Karabakh and environmental movements in the late 1980s and subsequently was independent Armenia's home-grown political force, is the party at the core of the ANC. But in 2010, the president and vice-president of the ANM resigned, amid charges by internal opponents, that the two officers were in collusion with the authorities.

The ensuing elections for a new president were followed by charges of election manipulation. The accusation was made by Karapet Rubinyan, a prominent ANM member and former Deputy Speaker of the National Assembly. He resigned after explaining that the ANC has been transformed into a locomotive for one man, its leader, former President Ter Petrossian, and that there was no longer room for a plurality of opinions. Subsequently, another prominent ANM member and former foreign minister Alexander Arzoumanian also voiced concerns about the absence of liberalism in the party and in the country generally.

Although these discussions went no further and had no public consequence, the public's perception of a solid opposition was weakened.

The coalition's status, too, appeared vague, following some moves by the Prosperous Armenia Party. In the fall, the party held on to its portfolios in the cabinet but made new appointments. The deputy speaker of the National Assembly was removed and another installed, within the party's mandate. Neither the coalition nor the government bothered to interpret such moves. Everyone assumed the changes were internal party matters.

The pro-government Rule of Law party made similar changes. But it was the Prosperous Armenia Party's changes, both cosmetic and substantial, that transformed the perception of the group and its leader, businessman-parliamentarian Gagik Tsarukian, and their relationship with their partner, the ruling Republican Party.

The Prosperous Party took on the veneer of a real player, with frequent press appearances in the company of visiting foreign dignitaries as well as a variety of local constituencies.

Domestic political forces were reconfigured sufficiently to raise the specter of a new sort of uncertainty

As the Prosperous Armenia Party worked to reinforce its independent image publicly, the party's leader and others freely exchanged words with the Republican Party, including a charge by Tsarukian of the incompetence of the Minister of Economy. Although the minister was removed from his post at the end of the year, the Republicans rejected Tsarukian's criticism.

When a similar critical comment was made by former President Robert Kocharian, whose public political pronouncements were rare, rumors flew wild about a possible tandem between the two enabling Kocharian's return to politics.

ARF members echoed these economic critiques, but their focus was on the Turkey-Armenia protocols. In the period of debate over the desirability of the Turkey-Armenia protocols, a dozen different organizations formed a citizen initiative with the ARF, under the NO banner. When the protocols were frozen in April, the public NO campaign died.

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The borders remained closed, the prospects for improved relations remained foggy, and the anti-protocol forces found no other theme around which to rally their resources. Thus the hope of some, that the government's foreign policy failure would be transformed to a domestic issue, died. Ironically, the country's leadership, the same proponents of the protocols who a year earlier were predicting imminent improvement of Armenia-Turkey relations and open borders, now, in 2010, created their own official version of a NO Campaign, by mounting an anti-Turkey crusade.

Thus, both the political and economic GINI coefficients grew even as political and economic processes progressed in unpredictable and uncertain ways

Despite lack of success in foreign policy and in certain economic sectors, at year's end, the ruling Republican Party of Armenia initiated certain unexpected reshuffling and consolidating of positions and image.

The rearranging began when the President accepted the resignation of Yerevan's mayor Gagik Beglaryan over a violent incident between the mayor's entourage and one of the president's protocol team. Initially, this seemed like a personal settling of accounts coupled with an effort by the president to establish a better public image, and perhaps rein in the excesses of the political and economic elite. Karen Karapetyan, president of ArmRusGasard, one of the largest Armenian companies and the single gas distributor, was elected mayor by the City Council. In the meanwhile, Gevorg Danielyan, minister of justice, was removed for not having

complied with a directive of the prime minister and replaced by Hrair Tovmasyan, a young attorney, former member of the Armenian Democratic Party and experienced with international organizations.

There were resignations and new appointments throughout the economic team. The Minister of Economy, Nerses Yeritsyan who had only recently become a card-carrying Republican, and was considered a favorite of the international community but not of local businessmen, was replaced. Minister of Finance Tigran Davtyan, once deputy minister of economy, was appointed minister. The finance ministry's top post went to Vatche Gabrielyan, who like Yeritsyan came out of the Central Bank. All three are seen as being part of Prime Minister Tigran Sargsyan's team. These tactical steps are seen as moves by the president to positively impact public opinion.

Armenia's international ratings in 2010 were not encouraging. Freedom House, the international human rights and advocacy organization, judged Armenia to be 'somewhat free' for the second year in a row. Armenia received a six, which is only one place away from the 'not free' category. Transparency International, the anti-corruption organization, indicated that Armenia rates 120 out of 180 countries in perceptions of corruption. The Economist Intelligence Unit gave Armenia four points more than last year, which still places it at 109 among 167 countries, when neighbor Azerbaijan is at 137 and Georgia at 104.

In 2010, the phenomenon of practical and effective citizen initiatives was significant. Although they remained at the level of public calls for action, rather than strategized plans of action, they succeeded in rallying support from a variety of geographic and demographic constituencies. There were several in particular that gained popularity.

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“We Are the City” aimed to raise awareness of the need to protect the city’s parks from further development. The other campaign, “We Oppose Foreign Language Schools” attempted to preempt the government attempt to amend the law on language, and pass new legislation allowing public school instruction to take place exclusively in a foreign language. By year’s end the Law on Language was indeed changed opening the way for the controversial changes in the education law.

Another movement embraced the open-air amphitheater adjacent to the Moscow Theater and called for preventing its destruction. That appeared to have been successful.

Throughout the year, environmentalists were active in calling attention to the need to protect the Teghut Forest in the northern Lori region. In addition a new campaign took off when it became clear that there will be renewed uranium mining in Syunik.

In the fall, there was a huge outcry against a revision of the law on maternity leave, which cut the maternity payment allowances to levels lower than most professional working women’s salaries. Nevertheless, after the law was passed the government said it would ask the National Assembly for a review.

Cases of abuse and violence against women and children also drew public attention, both in and outside Armenia. The death of a young mother at the hands of family members raised concern about the weakness of domestic violence legislation. The abuse of children at a residential special education facility raised voices about the inefficient implementation of legislation.

The struggle between the community of non-governmental organizations and the Armenian

government had its ups and downs. Various meetings and protests by the organizations resulted in preventing the passage of legislation in the National Assembly. On the other hand, the Justice Ministry used the power of the administrative decision, mid-year, to unilaterally create an oversight body to monitor the fiscal and administrative activities and fiscal reporting in the sector. The agency has not actually conducted any work.

The Armenian National Congress was consistent and successful in using the presence in Yerevan of European policy and opinion makers to publicly express its dissatisfaction and its demands

The situation in the **Police Department** remained worrisome. In April, a young man died while under police custody in the city of Charentsavan. The immediate official explanation was suicide, although it’s been heavily tested in court with evidence of violence. The proceedings are continuing and all suspicions lie with those in law enforcement.

In the absence of political access and responsiveness, there was some hope that citizen initiatives might become the instruments by which citizens can express their opinions. For this to succeed, the Armenian **media** must be transformed. Yet, in 2010, they remained hamstrung by a lack of political freedom, financial independence and objectivity that translates into inadequate news reporting and analysis.

Armenia continues to fare rather poorly in global press freedom rankings. In 2010, Reporters Sans Frontières, an international media watchdog, ranked Armenia 101st out of 178 countries that

UNSTEADY STABILITY

were surveyed in the latest Press Freedom Index published. Still, that was an improvement over the Paris-based group's 2009 index that put Armenia in 111th place. Decreased violence against journalists appears to have been instrumental in the country's improved rating.

The March 2010 passage by the National Assembly of amendments to a number of media-related laws included the decriminalization of libel offenses. But others toughened financial sanctions for defamation of character. Media watchdogs expressed concern that this could make it easier for authorities to muzzle independent or pro-opposition outlets.

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The Armenian government faced strong domestic and international criticism as it pushed through the National Assembly in May a set of amendments to a law on television and radio that were meant to regulate local broadcasters' mandatory transition to digital broadcasting by July 2013. Armenia's leading media associations believe that the real purpose of these changes is to enable the authorities to retain their strong influence on the broadcast media's news coverage by decreasing the number of outlets.

These concerns were echoed by the Organization for Security and Cooperation in Europe and its Representative on Media Freedom in particular. They submitted to the Armenian authorities specific recommendations which would eliminate "undue

limitations on freedom of the media" envisaged by the government bill. The government claimed to have accepted most of these recommendations before having the parliament pass the bill in June. The OSCE Media Representative insisted, however, that the proposals "of crucial importance" were ignored.

The OSCE, as well as the European Union and the United States, urged the authorities to make further changes in the bill. President Serzh Sargsyan reportedly pledged to do so during his July 4 meeting with the visiting US Secretary of State. Sargsyan subsequently tasked Armenia's Human Rights Defender to form a working group of state officials and media experts to draft such changes.

Nevertheless, the tender announced and implemented by the National Commission on Television and Radio was held in late December. Only two frequencies had more than one bidder. In one of them, A1+, Armenia's independent broadcaster controversially taken off the air in 2002, was vying for a broadcasting frequency currently held by the ArmNews TV channel. A1+ lost again, as did the populist, unpredictable ALM channel.

The amended law on broadcasting also called into question the continued existence of GALA TV, another, functioning independent station based in Gyumri. It stipulates that there can be no more than one TV channel in each of Armenia's ten provinces outside Yerevan after 2015. There are presently four such channels operating in Gyumri and the surrounding Shirak province. All of them except GALA are loyal to the government. GALA indeed lost the tender and is scheduled to lose its license in 2015.

While retaining their tight grip on the airwaves, the authorities have remained largely tolerant of print and online media not controlled by them.

UNSTEADY STABILITY

Major Armenian newspapers continue to be highly critical of the government, dismissing nearly all government statements or initiatives. The country's two best-selling dailies, are aligned with the radical opposition. In total, their distribution is 10,000. Just how profitable or self-sufficient these publications are remains unclear.

The press is facing growing competition from a multitude of internet publications providing faster and less opinionated news coverage. There are presently more than two dozen online news agencies and other publications reporting from Armenia on a daily basis. At least three of them were launched in 2010. The most popular of the sites receive more hits per day than the most widely read newspapers.

While advertisements in printed publications has seen a significant decrease in the last two years, the amount of advertisements appearing on internet news sites appears to have grown, some say as much as 20 percent this year.

Some of the internet news outlets have this year added video content, making them potential rivals of TV stations where programming continues to be dominated by entertainment programs, local and foreign soap operas and foreign films. Television news programming remains mostly pro-government or innocuous.

In 2010, a government-approved national **education** plan for 2011-2015, as well as several institutional changes aimed at making the education system more responsive, had at their basis the same two rights and expectations: equal opportunity and access to education, improving the quality of education and efficient management.

This plan that, according to the law, is the expression of Armenian government policy on

education, contains no policy on foreign language instruction. Yet, that was the most hotly-contested topic of the year.

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A poorly conceived and even more poorly presented law whose purpose seemed to be to modify the legislation in order to allow instruction in a language other than Armenian first seized the public's attention in March when it entered the National Assembly. This led to months of bitter protest and extreme discussions about identity and education. The draft was pulled in favor of another where changes were made in the education legislation, not on the Law on Language. In December, despite protests, the Law on Language was amended, without addressing the following issues:

- Does Armenia have a national policy on foreign languages in public education? What derailed the 2007 draft legislation which had been prepared by the Ministry of Education and Science, did not pass and has been generally forgotten?
- What do other small countries with unique languages do in similar situations?
- Can the issue be discussed as two separate questions – how to teach and strengthen

UNSTEADY STABILITY

a nation's mother tongue and a people's identity, and how to teach and foster the learning of foreign languages in order to ensure global integration and competitiveness?

In 2010, structural changes continued at three different educational levels.

Re-introducing broadly accessible pre-school education and ensuring its accessibility to all is still a serious educational concern. Of the country's nearly 1000 villages and communities, more than 400 don't have pre-schools. And the rate of attendance of pre-schools is 29.8 nationwide, according to 2008 figures.

Rights and expectations: Equal opportunity and access to education, improving the quality of education and efficient management

Towards that end, in two marzes – Ararat and Aragatsotn, both agriculturally productive regions, adjacent to Yerevan, 41 pre-school centers were opened this year, each capable of offering services lasting one month to one year. A particular focus of these centers is to increase access for the children of economically disadvantaged families.

In 2010, 91 senior high schools opened in Armenia, 31 of them in Yerevan. This, in order to correspond to international standards, by adding 11th and 12th grades to the student's school years. The goal is to have 300 good quality senior high schools throughout the country. Therefore renovation, refurbishing, curriculum and textbook issues must be resolved. The same questions of accessibility affect senior high schools as well.

At the higher education level, questions about the quality and relevance of education from a private institution of higher learning resulted in seven such private colleges losing their licenses completely, and six others, only for certain departments. This was done at least in part to assure competitiveness.

Besides the institutional challenges, corruption in the education system remained a serious problem. There were more than four dozen incidents of selling diplomas and grades. A very few were punished.

But the struggle against corruption was also of the moral kind. Much of the year, the 'odyssey' surrounding the child abuse charges levelled against a teacher in a Special Education school grabbed the public's attention. After some efforts to blame the whistle-blowers for creating or exaggerating the problem, judicial proceedings were brought against the teacher and he was sentenced to two, then three years, in response to a public outcry. The principal was fired, but no charges were levelled against him.

In the **army** this year, although the number of violent incidents and deaths was lower than in years past, the public debate about the army and the treatment of soldiers was possibly the top news and discussion topic of the year.

In June, four soldiers died as a result of Azerbaijani incursion into Karabakh's defensive positions.

Just one month later, a soldier opened fire, killed five of his fellow soldiers and then himself. Two months later, four more soldiers died. During the year, there was both official and non-official information about other such incidents. In November, four soldiers died and four were wounded on the Line of Contact.

UNSTEADY STABILITY

The amount of information about corruption, violence and deaths, as well as information about incidents of brutality – among soldiers, and between commanders and soldiers – overtook the media and social media. The response of the Defense Ministry was surprising. The Minister and several top officers met with the families of victims, and publicly chastised and removed from command several responsible officers.

The general public consensus seemed to be that the near 50 incidents are significant not because this number is higher than in years passed, but because the public is now more informed about such tragedies.

These incidents raised a multitude of questions: What are the fundamental causes of these violent incidents?

What is the social, educational and command structure in the armed forces that allows for such tragedies to take place without preventive measure built in the system?

To what extent are these problems the result of the conditions of the army, and to what extent are they an extension of social and moral problems within society?

Are conditions in the armed forces egalitarian?
Are all layers of society represented in the army?
Or is there a distinction between the elite (the commanders and officers) and the unprotected layers of society (the soldiers)?

The absence of trust regarding army life remains a serious problem. Evidence was offered by a recent Caucasus Research and Resource Center poll that demonstrated that a mere 20 percent of the Armenian public trusts that there is no corruption in the Armenian army. Another 42 percent believes there is corruption, of some kind, in the army.

These questions were asked in the media, and answers were provided by the Defense ministry as well as their newly established Public Council, manned by a former soldier. The Defense Ministry's new spokesperson presented a more open communication system.

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Given the increased urgency created by regular Azerbaijani encroachments, and the limited educational, social and economic services and protections offered soldiers, the situation promises to remain tense.

Finally, structural reforms mean that the army will consist of not just draftees and career officers, but also professional soldiers, although there is no way the last two will suffice and replace the need for a draft, especially so long as the Karabakh conflict remains unresolved.

In addition to the internal issues of Armenia's armed forces, the army continued to undergo a process of increasing civilian control, per Armenia's IPAP with NATO. Armenia's Kosovo and Afghanistan contingents continued to serve with allied forces.

Arms production in Armenia has increased. There are 2000 different types of arms being locally produced – from uniforms to radio and optical instruments, munitions and other supplies.

UNSTEADY STABILITY

OUTLOOK

2011 will be considered a pre-election year, even though the May 2012 parliamentary elections are 18 months off. This expectant environment will exacerbate tensions between the government and the opposition. All parties, in and out of the coalition, will begin to position themselves for the elections. On the one hand, this will compound the uncertainty; on the other, if some political forces take bold and creative steps to create more acceptable and sensible political unions, then there may be new hope for a responsive system.

The two major parties – the Republican Party and the Prosperous Armenia party – will compete against each other. Such competition is also possible within the Republican Party itself for top positions on the party slate.

The opposition too will experience internal clashes. Although the ANC continues to claim that it is the only credible and leading opposition, neither the ARF nor the Heritage Party will sit idly by. The authorities will attempt to revive the marginal opposition.

In the absence of any significant reconfigurations, the reigning apathy will persist and together with the effects of the economic crisis, can aggravate the wave of emigration already on the increase.

Those television stations which have licenses for digital broadcast will on the one hand feel more secure; on the other hand, the government, given the pre-election worries, will continue to leverage its authority to manage content.

Although domestic reconfigurations will be the center of attention during the year, nevertheless foreign policy developments, as well as incidents on the Karabakh-Azerbaijan Line of Contact will seriously affect domestic developments.

Questions and debates on the safety, predictability and desirability of army service will persist, yet the Defense Ministry's open engagement will quicken structural changes.

POLICY OPTIONS

The leadership of the existing political forces must recognize that the political field requires such reconfiguration as to make possible the removal of the extant political monopolies and the creation of a healthier balanced political environment that offers choice.

Citizen initiatives can become useful instruments of reform if public institutions recognize the need for public involvement and the citizenry can conceptualize and define their demands specifically and practically.

The government will need the support of the public to meet external challenges. For that purpose the role of society must be strengthened and respected.

The policy of the government regarding education must be aimed at improving the quality of education in all its aspects, by benefitting from the totality of the European integration processes. At all levels, a transparent qualifications network is required for all private educational institutions.

Without financial and political independence, it will be difficult for either television or newspapers to reflect objectively on the country's problems. Nevertheless, in a pre-election environment, the press must become more comprehensive – providing space for problem topics as well as those holding differing opinions. Otherwise party politics and personalized issues will dominate the traditional outlets and further reduce the public's interest and trust.

THE CRISIS AFTER THE CRISIS

If in 2009, the international economic flurry focused, on the one hand, on rescuing the global economy and recovering from the crisis, and on the other hand, determining a judicious strategy and timing for an exit from dependencies on new growth drivers, then 2010 was the year that saw a winding down of stimulus packages, quantitative easing and tax credits.

In their wake, these interventions left behind enormous debt and deficit. The imperative for austerity measures followed. Major western economies, such as Germany and the UK, and Greece and Ireland, some grudgingly, some forcibly, adopted severe, strict budgets. The debate then spread to the wisdom of the timing of these measures, given the enduring fragility of the world economy.

Those countries that still feel the need to stimulate their economies have resorted to monetary policy. The initial fiscal stimuli which were heavily used during the height of the crisis were intended to slow the decline and mitigate its consequences. Later, governments injected money into their economies to continue to stimulate growth through quantitative easing, and particularly, purchasing of bonds.

Although this was the case for most, Armenia was among the exceptions. Armenia's stimulus did not yield the anticipated results. The Anti-Crisis Action Plan, intended to minimize decline and prepare the ground for post-crisis recovery, was not effective. In addition, long-term consequences of the short-term fixes are profound.

There are the reasons why Armenia's Anti-Crisis Action Plan did not have the intended effect in 2010:

- The government's program was not accompanied by structural reforms. The economy is not diversified, there is deep monopolization, close interdependencies persist between business and government, and a continuing absence of good governance.
- Competitiveness was neither mandated nor enabled. Armenia placed 98 out of 139 countries in 2010, in the World Economic Forum Global Competitiveness Report, outperforming only Tajikistan and the Kyrgyz Republic among the CIS and Eastern European countries. Although Armenia rates high in the ease of registering a business, but in doing business, Armenia is ranked 93 in protecting investors and 153 in ease of paying taxes, out of 183 countries.

THE CRISIS AFTER THE CRISIS

- The government program's tax component was not commensurate to the task of stimulating the economy. Despite a sizable VAT deferral program aimed at helping business, the government became both assertive and selective in tax collection, motivated as it was by high borrowing and high expenditures. The burden fell disproportionately on small and medium size enterprises, which particularly during a crisis period are expected to be the engines of economic growth.
- The value of the Armenian Dram (AMD) was artificially kept high during the height of the crisis. If the AMD had been allowed to depreciate to its market level, exports would have become more competitive and the purchasing power of those dependent on remittances from abroad would have increased. Instead, out of a fear of inflation and concern about alienating the powerful importers of oil, sugar, flour, cigarettes and beverages, the AMD was kept high.
- None of the big item ventures in the government program turned into actual projects. The construction of a nuclear power plant remained distant, as did the north-south highway. The rail line from Iran was not even a topic of conversation, and the Armenian Development Bank was remembered at year's end, with the appointment of a chairman.
- The cost of borrowing for local investors remained exuberantly high (above 20 percent) and dampened interest in possible investments. Armenia's hastily-devised stimulus effort not only did not

minimize the effect and local impact of the global economic crisis but created a whole new macroeconomic reality making future growth much more challenging. During the year, Armenia faced and continues to be daunted by these serious structural and fundamental challenges:

- Low diversity, low competitiveness, and high monopolization
- Limited external borrowing capacity
- Unsustainable budget deficit
- High inflation
- Crippling external trade deficit.

Therefore in 2010, the government's main policy direction was to address these post crisis challenges. The government modified its economic program to focus on the following vulnerabilities through what it called public-private partnerships:

- growth and poverty reduction
- fiscal and debt sustainability
- large external imbalance
- financial stability
- competitiveness and good governance.

During the year, the government was faced with the dilemma of balancing between the government's big item infrastructure expenditures and social programs on the one hand, and its commitment to fiscal and financial responsibility on the other.

On the fiscal front, the government pursued the following:

- Reducing the budget deficit from the high 7.5 percent of GDP to 4.8 percent

THE CRISIS AFTER THE CRISIS

- Increasing tax revenues to GDP ratio by ½ percent through improved tax collection
- Reintroducing the mid-term expenditure framework to reduced public debt and shift spending towards social programs and investments
- Keeping the public (and publicly guaranteed) debt at 50 percent of GDP in 2011.

On the monetary front,

- Price stability was the main objective of the government's inflation targeting framework. During the early months of 2010, concerns emerged about possible inflationary pressure and the government gradually tightened the interest rate policy through five successive rate increases. After May, with the slowing of growth, the rate remained unchanged.
- Government's intervention in the foreign exchange market was mainly aimed at smoothing large exchange rate movements, not resisting fundamental trends.
- The government continued to strengthen the monetary transmission mechanism, such as the link between government's policy rate and retail rate of banks, through encouragement of a developing market for Dram instruments. The law on third party liability insurance passed in June 2010, and the law on private investment funds – passed in December – are expected to promote market development.

- To reduce dollarization in bank deposits, in September, the government raised from one quarter to one half the proportion of required reserves on foreign currency deposits to be maintained in Drams.

These were the 2010 across-the-board fiscal and monetary policies – some timely, others too late to be effective. However, it was the real economic sector that called out for and did not receive fundamental, profound, real resettings.

THE ECONOMIC PICTURE

Armenia's economy is clearly not out of the woods. After a whopping 14.4 percent decline in 2009, the economy appeared to be modestly recovering in the first two quarters of 2010, registering 5.4 and 7.6 percent real GDP growth on a year-on-year basis. The January to September cumulative GDP growth, however, was a mere 2.8 percent, meaning that during the third quarter, the economy experienced negative growth. In October, the decline continued bringing cumulative GDP growth for the year to date to 2.4 percent.

Despite promises and tacit attempts to institute structural reforms, and diversify the economy, little was achieved in 2010. The main macro deficiencies of the Armenian economy, namely unsustainable growth drivers, a narrow and resource dominated export base, and overdependence on private transfers were still prevalent.

That **the Gross Domestic Product** went up by 2.8 percent in the period January to September 2010 compared to the same period in 2009, on the face of it, seems to indicate that the worst of the crisis may be over. Yet, there was a significant

THE CRISIS AFTER THE CRISIS

third quarter decline, mostly caused by a negative trend in agriculture. The projected annual growth rate, between 2.5 percent and 2.9 percent is far from the double-digit growth rates recorded in the pre-crisis era. Official unemployment figures have fallen slightly from 7.3 percent to 7.1 percent in the January to September period.

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The volume of gross **agricultural output** drastically decreased from January to September of this year compared to the same period in the previous year. The huge 17.9 percent decline can be explained by bad weather – violent rain and hail delayed planting of staples such as potatoes and tomatoes and decreased the yield of high-end crops such as apricots and cherries. Even though the start of the year was promising, with a slight increase in the first quarter of 3.2 percent compared to the same period in the previous year, 2010 went into decline in the summer. The drop in output was 13.1 percent by mid-year. It dropped further by September, following the disastrous harvest for most products, except grapes, where production increased by 10-15,000 tons to 215,000 metric tons. Meat production too fell in January-August 2010 by 11.5 percent or 3,500 tons compared to the same period in 2009.

Although bad weather is generally a part of Armenia's agricultural picture, the huge drop this year can be explained by two additional factors. First, the government stimulus largely ignored this sector which comprises on average 25 percent of Armenia's GDP. Second, the continuing effects of

decreased subsidies, per WTO requirements are visible in the output figures.

The only area which demonstrated solid growth was the wine and spirits industry thanks to several new investments both in production facilities and new vineyards. Attempts were also made at consolidation by forming consortia and cooperatives to protect and promote names and standards. Further development of this sector will hinge on the export readiness of Armenian producers and increased local and international demand, especially in Russia.

Industrial output was relatively positive throughout 2010. Overall, Armenia is second in the CIS industrial growth rankings with year-on-year average achievement of 10.9 percent in the period January to September 2010, due largely to the mining sector where higher global demand for commodities led to higher prices.

Construction figures fluctuated throughout the year. A 5.2 percent year-on-year decrease for the January to September period is an indication of the unsustainability of a sector based on an elite market, with few products for the median or low budgets. This decrease comes despite the fact that an important component of the government stimulus package was support to this sector to finish incomplete projects.

Retail trade turnover has largely been unaltered compared to the previous year. The monopolies extant throughout the retail sector have made the sector non-responsive to the crisis and resulted in near zero growth. The crisis aftermath has started to shift the structure in the retail sector in favor of food products.

Unlike retail products, the volume of **services** has increased as much as 7.4 percent from January to

THE CRISIS AFTER THE CRISIS

September, over the same period last year. The **tourism sector** saw the completion of the Tatev Revival Project in Armenia's southern Syunik region. That revolved around the restoration and conservation of the Tatev 14th century monastery complex which is a UNESCO World Heritage Candidate site. The project included the construction of what turned out to be the longest aerial tramway in the world at its centerpiece. It is too early to tell whether and how this project, financed by an individual investor, will affect the region's overall tourism capacity.

In the tourism sector generally, a weak support service base combined with high price margins added to the adverse consequences of the global economic crisis. Still, overall, inbound tourism over the period January to September 2010 increased by 15.6 percent compared to same period last year.

The external trade turnover improved in 2010. The three first quarters registered positive change compared to the previous year. However, the third quarter increase was lower. Armenia's foreign trade with European Union member states in January-September 2010 surged by 29.1 percent year-on-year to over one billion dollars, indicating deeper trade integration. Overall, EU countries accounted for 32.1 percent of Armenia's foreign trade. Germany is Armenia's largest trading partner among EU member states, due largely to mining exports and accounting for 7.2 percent of trade. Armenian exports to EU countries have skyrocketed by 65.9 percent, making up more than half of all 2010 January to September exports. Imports from EU countries increased by 17.1 percent, constituting 22.5 percent of all imports.

For overall **exports**, there was a 43.9 percent increase in the January to September period, over

the same period last year. Indeed, the total value of exports in January to September was nearly the same as the total for all of 2009. The main three export destinations were Bulgaria with 15.2 percent of total exports, followed by Germany with 14.2 percent and Russia with 13.9 percent. With raw minerals being sent to Bulgaria and Germany, it is clear that in 2010, Armenia's exports remained resource-dependent, largely because the non-resource-intensive sectors were significantly less competitive. Armenia has not succeeded in increasing and diversifying exports beyond raw materials thus leaving room for a greater vulnerability to external shocks.

The economic crisis has had less impact on **imports** because the sector is more diversified than exports. In the first nine months of 2010, imports grew about 19 percent, just about equal to the decline of the same sector in 2009.

The government stimulus largely ignored agricultural sector which comprises on average 25 percent of Armenia's GDP

Net private transfers, which decreased in 2009, saw a continuous increase during the first six months of 2010. Since private transfers from the Diaspora tend to be mostly injected into consumption of imports and not in high value-added sectors, the transfers have not resulted in sizeable increases in productivity.

The AMD/USD **exchange rate** depreciated by 6.1 percent in the first three quarters of 2010 compared to the same period in 2009, before it began to

THE CRISIS AFTER THE CRISIS

show the expected end-of-the-year appreciation. In a comparison between the January to October periods of 2010 and 2009, depreciation stands at 4.7 percent.

State budget revenue – incomes and official transfers – increased 19.2 percent in the first nine months of 2010, compared to 2009. Expenditures increased at a slower rate than revenues – 4.6 percent in the January to September period. Overall, a total of 580.8 billion AMD were collected in taxes and customs duties – 37.8 billion more than projected. This represents a 15.5 percent jump over 2009. In addition, there was a 9.5 percent increase in the collection rate of mandatory social security payments.

The decrease in construction comes despite the fact that an important component of the government stimulus package was support to this sector to finish incomplete projects

Total taxes paid by Armenia's largest corporate taxpayers grew by 18 percent. However, the increase was more a result of indirect tax revenues (VAT and excise taxes) which increased by 29 percent because there was greater economic activity and less of it stayed in the shadows. On the other hand, direct taxes fell by 5.5 percent, indicating a drop in corporate profitability. Compared to January to September 2009, the share of direct taxes paid by the largest taxpayers decreased from 26 percent to 21 percent. Nevertheless, reliance on big business essentially means that monopolistic prices are frequently set for many goods.

With regard to external **national debt**, Armenia was removed from the World Bank list of low-debt

countries. By the end of 2010, Armenia's external debt is projected to form about 42 percent of GDP, and 50 percent in 2012. This already large number becomes even more overwhelming when compared to 2008, when the public external debt consisted of just 13.5 percent of GDP.

Inflation has seen a significant increase in the first nine months of 2010 and has therefore been the object of tight monetary regulation. It is among the highest in the CIS (January-September 2010 compared to 2009) – 7.8 percent compared to 5.2 percent in Azerbaijan, for example. The rise is due largely to

- high food and commodity prices on world markets
- the prolonged impact of fiscal and monetary expansionary policies adopted in 2009 as a response to the crisis
- overall negative expectations caused by the 2009 Dram devaluation.

The Consumer Price Index too bounced between seven and 8.5 percent higher in the January to September period, over the same time last year. Throughout 2010, consecutive monthly increases in CPI fluctuated around 2.5 percent. The increase in retail agricultural prices was 17.7 percent for the first half of the year, then soared to 26 percent for the January to September period, after a miserable harvest.

The **banking sector** remained stable and banks earned around \$55 million in 2010. In the first three quarters of 2010, the banking system's assets grew seven percent year-on-year, while liabilities grew eight percent and total capital increased by 10 percent.

Deposits in foreign currency increased an average of 26.4 percent in the first three quarters of 2010,

THE CRISIS AFTER THE CRISIS

compared to the same period last year, whereas time deposits in AMD increased only 10 percent. This means that in contrast to the Dramization trend evident between 2003 and 2007, there is now a movement toward dollarization.

Interest rates are still higher than in the pre-crisis period. This is a consequence of the crisis highlighting existing economic and financial risks. It's also due to inflationary pressures. Interest on deposits increased from 8.3 percent in the second quarter this year to 9.3 percent in the third quarter whereas interest rates on loans recorded a slight decrease from 19.5 percent to 18.8 percent. Before the crisis, in the third quarter of 2008 for example, interest on loans was 16.7 percent.

Loans have not been easily available for those living in remote and border areas, although financial constraints resulting from the economic crisis have resulted in an acute need for additional loans, especially in major sectors of the economy such as agriculture, construction and industry. Still, the loan portfolio of commercial banks was 724 million AMD as of September 2009 and 848 million as of September 2010. This last number is nearly 30 percent higher than the amount in circulation in the same period in 2008. This expansion of the loan portfolio is driven by private sector need while lending to households decreased. Most banks froze granting of mortgages and consumer credits.

INSTITUTIONAL MATTERS

The urgent need for institutional reform has not diminished. Even as a second generation of structural reforms is officially proceeding, very little progress is noticeable. The country is still unable to move to a higher level of free market values and risks consolidating further the already entrenched

informal ties and practices. The danger for Armenia is that if things continue as they are, the country may fall into an institutional trap: the informal rules of the game may become formalized and transparent, predictable rules and an even playing field may be out of reach.

The best example of that danger is the widespread co-mingling of politics and business. This results in the creation of business groups and conglomerates that dominate various branches of the economy and goods markets, all the while enjoying tax advantages because of their political status or connections.

As in previous years, so too this year, according to the results of the World Economic Forum Global Competitiveness Report, the lowest scores for Armenia were for its competitive environment: All three scores are in the lowest tier among the 139 countries studied. Moreover, Armenia is next to last in the effectiveness of its anti-monopoly policy.

Germany is Armenia's largest trading partner among EU member states, due largely to mining exports and accounting for 7.2 percent of trade

Those scores are evidence of the lack of essential change in the status of markets in Armenia, despite pronouncements at the highest levels of government on the importance of free competition.

Parallel to all that, the government is nevertheless taking steps to strengthen the institutional capabilities of the economic competitiveness

THE CRISIS AFTER THE CRISIS

protection sub-commission. The evidence of that is the new package of legislative reforms proposed for this year, which includes (a) strengthening the sub-commission's powers to prevent anti-competitiveness and (b) resolving the matter of the sub-commission's financial independence. A three-year strategic plan has been adopted and if implemented, the sub-commission would assume an entirely different institutional form.

Those efforts are condemned to failure so long as one of the most important factors distorting the competitive playing field has not been resolved: the shadow economy. The struggle against it is outside the purview of the sub-commission. Moreover, the informal rules of the game as they exist directly prohibit the sub-commission from functioning productively. Evidence of that is the sub-commission's campaign against anti-competitive agreements in the drug market, which resulted in first-time-ever penalties against seven large firms that import drugs. However, that 2010 decision was overturned by the sub-commission's new leadership.

As in previous years, so too this year, according to the results of the Global Competitiveness Report, the lowest scores for Armenia were for its competitive environment

The **tax and customs sectors** remain among the fundamental obstacles to a favorable business environment and free competition. Understanding this reality, major donor organizations offer special attention and serious financial support to both agencies, in the form of financing, technical support, introduction of e-signatures and e-governance and other programs.

Despite such backing, business circles don't notice real change in the approach of the revenue services. So long as agencies are still saddled with plans, or quotas for the collection of revenues, agency heads will naturally deploy the resources available to them to collect those amounts. When the privileged status of many large companies is factored into the mix, it's clear why big business is not taxed in proportion to its capacity and output, and why the disproportionate burden falls on small and medium size businesses. This is confirmed by a report by finance ministry experts, based on the officially published list of the 1,000 largest taxpayers. This multifaceted study finds that big business's capabilities remain undisclosed. Thus, the logical path to resolving the revenue challenge is to ease the burden of tax and customs payments from small and medium size businesses and ensure fair implementation.

In 2010, the government attempted to implement the provisions of the amended 2008-2011 strategic plan for tax collection, to which temporary corrections had been made because of the global economic crisis. The main emphasis is on easing the tax obligation of taxpayers and the reduction of corruption by essentially reducing the transactional expenses of paying taxes by centralizing and making tax reporting and filing processes more uniform, as well as introducing electronic tax-filing.

To achieve more efficient tax collection,

- The government intends to work toward risk-based assessments for selection of taxpayers for audits
- The government will also use risk-based assessments to facilitate VAT refunds for a majority of (non-risk) exporters.
- The work of tax collection bodies will be made more transparent by increasing the

THE CRISIS AFTER THE CRISIS

knowledge base of businesses, especially small and medium. The tax agencies of Arabkir and Vanadzor will open service centers for this purpose.

- Rules for operating small businesses are being simplified and those with annual incomes of up to six million AMD will be exempted from the graduated tax system.

To achieve more effective customs collection, and to ease the burden on exporters and importers as well as transactional expenses,

- the State Revenue Service website will publish the complete list of documents required, by type of product, for foreign trade, as well as documents regarding post-clearance audit procedures
- an automated customs system will be installed
- risk management in the realm of post-clearance monitoring will be more efficiently utilized.

The programs above as well as other efforts by the government to **reform the business environment** in Armenia are apparently insufficient, as evidenced by the results of the 2011 Doing Business Report issued of the World Bank. This is not for lack of trying, but for focusing on the less critical and less serious problems and resisting tackling the large entrenched obstacles, most of which are “profit centers” for low, mid and high-level officials. In eight of the nine topic areas comprising the “overall ease of doing business,” Armenia ranked lower in 2011 than in 2010. The one area in which Armenia registered progress was “Trading Across Borders,” which went up 21 points, occupying a still-too-low 82nd place. That growth is the result of the simplification of customs procedures, the

implementation of an electronic declaration system, and other institutional reforms.

Just as in the tax and customs sectors, reforms are being introduced in this sector, too, aimed at eliminating bureaucratic obstacles to starting a business and entering a market—both to save business people time and money and to strengthen competition in certain goods markets. That’s the intent, in particular, behind the efforts to implement the “one-stop window” for starting a corporation and their electronic registration, to noticeably decrease the number of activities that require licensing, and to overhaul construction-permit procedures. This remains a good idea, even if it is now being introduced yet again. This idea, after all, was the one of the reasons for the creation of the Armenian Development Agency – one institution that’s not a part of any strategy plans.

The tax and customs sectors remain among the fundamental obstacles to a favorable business environment and free competition

The Corporate Governance Rulebook being developed by the Ministry of Economy is viewed as important to the process of corporate governance formation in Armenia. It’s intended to regulate the activities of not only private corporations but also government-owned enterprises to assure more efficient management of government assets.

Although the **financial sector** in Armenia is stable, it is still insufficient to promote the country’s economic competitiveness. Evidence of that is the Global Competitiveness Report, according to which Armenia’s financial market numbers 110 in terms of development, out of 139 countries

THE CRISIS AFTER THE CRISIS

studied; the third most important obstacle for launching a business, according to the report, is the unavailability of financial resources. The large spread between interest rates for savings and for credit, as well as the small size of the total loan portfolios in proportion to the GDP are evidence that the financial system cannot adequately influence the real sector of the economy.

Two new programs introduced this year – compulsory motor vehicle liability insurance and a restructuring of the state pension system – will help market development for Dram instruments.

Compulsory motor-vehicle liability insurance will serve two purposes. The first is to introduce rules and predictability in the institutional realm dealing with motor-vehicle accidents. The second reason, and the one more consequential for the economy, is to develop the insurance sector.

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There is no unanimity among experts regarding the timing of the compulsory regulation, nevertheless, the nearly 450,000 automobiles registered in Armenia must, as of January 2011, be insured.

Parallel with the quick growth of the insurance market, the sector consolidated and the number of insurance companies has reduced by three, and now

totals nine. Future legislation will probably tackle compulsory health insurance as well as policies to cover construction-related issues.

The other new introduction, pension reform is among the most complex, and socially most significant, undertaking in Armenia as elsewhere. Its proper, farsighted and ethical formulation and implementation will mean economic and social stability for the state. Pension reform in Armenia is essential given that the official worker to pensioner ratio is an alarmingly low one to one, and given the consequences of the country's low birth rate in the early 1990s.

Starting in 2011, Armenia will have a new multi-tiered pension system. The funds must be invested in stable, income generating deposits, with the fundamental mission of "securing tomorrow's old age today."

However, numerous issues and concerns regarding implementation are already being raised having to do with (a) the lack of maturity of Armenia's institutions, particularly the financial system; (b) the capacity to return the invested sums in the future; (c) the additional tax burden on the public and the employers; (d) the proper execution of obligations assumed by the government; (e) the high levels of corruption in the country.

Of course, because these systems are both new to Armenia, they will have shortcomings which will become apparent as they are implemented. However, arguably the most critical and economically consequential question is where and how these funds will be invested. This concern is most relevant to the pension system simply because of the scale of that program. Would those sums flow out of the country for the purpose of reinsurance or investment in other funds, or would they remain in-country? Of course, from the country's point of

THE CRISIS AFTER THE CRISIS

view, keeping the funds in Armenia is preferable. The fundamental question, however, is whether the real sector of the economy is sufficiently developed to absorb the accumulated resources. If not, those funds, which will have accumulated at the expense of current consumption, will most likely flow out of the country and help finance other governments and corporations.

Thus, the institutions are faced with a double dilemma: the success of financial sector reforms is immediately dependent on fundamental transformations in the real sector so as to facilitate the ability of the economy to absorb and use the additional funds. On the other hand, the real sector requires additional funding and mediation in order to grow.

OUTLOOK

In 2011, the global economy will grow moderately but geographically unevenly. China and India will grow around six to eight percent, raising inflation fears, which will trigger some growth dampening measures. Europe and the US will grow one to three percent. The dominant global economic challenge will be debt and deficit reduction. Europe will continue to be challenged by sovereign debt issues in the periphery countries. How all this plays out will impact other countries, including Armenia.

Russia, Armenia's main trade and economic partner, will be affected by these developments. Despite high oil prices, the Russian economy will grow moderately, thus generating commensurate foreign direct investments and remittances for Armenia.

Armenia's economic growth will remain anemic. Despite moderate global growth, there will still be lagging effects on Armenia's economy. Additionally, as a result of the global crisis, Armenia will be burdened with new limitations on growth, such as

limited borrowing capability, high debt and a high budget deficit.

Demand is likely to remain weak, domestically as a result of increased unemployment and poverty and a decrease in purchasing power, and externally, Armenia will remain vulnerable to Russia's and Europe's moderate growth and Euro depreciation.

Armenia's budget deficits and external debt will remain high despite attempts to bring them down. Despite the government's effort to exercise fiscal discipline, 2011 is a pre-election year and for political expediency, expenditures will become more dominant.

Promises and serious efforts notwithstanding, the government will remain incapable of implementing crucial second-generation reforms, in order not to challenge politically powerful businessmen, especially in a pre-election year.

Discriminatory tax collection policy combined with huge concentration in certain sectors will continue to drive out small and medium business owners, further shrinking the field and limiting competition.

POLICY OPTIONS

The government has exhausted and utilized all fiscal and monetary options. Therefore, in 2011, to create new fiscal space, the government has no choice but to tackle politically sensitive reforms with clear economic implications.

The government should shift gears away from macroeconomic policy to reform policy. The fundamental impediments to economic growth are the lack of diversity and competitiveness, as well as interdependence of businessmen and government

THE CRISIS AFTER THE CRISIS

officials. Reform in these areas ought to be the government's focus.

The various economic indexes published by international agencies must be taken seriously. They are useful not just for their general ratings, but for the detailed explanations of indicators and categories. To improve competitiveness, government focus should be on strengthening institutions, education, labor, goods and markets efficiency, and technological readiness.

The European Union Association Agreement offers a tremendous opportunity for real reforms, changes, growth in very specific areas that would hugely support economic competitiveness. The Agreement allows Armenia to take away as much as it wants in the way of new measures, regulations, standards. Armenia should take hold of the chance to revisit and revise practices regarding standardization and intellectual property rights in order to foster innovation and competitiveness, not just in the European markets.

The leadership must leave behind the reactive emergency mode thinking of the last two years and re-focus on overall growth. The government's main policy document – the Sustainable Development Program – requires serious revision, given the new economic conditions created as a result of the economic decline of the past two years.

A second import substitution strategy is needed, to take the earlier (2000-2005) attempt to a higher level, to address various sectors, from food products to high-tech instruments and hardware. This is essential to ameliorate the external balance.

Despite government pronouncements that interference in the exchange rate is only to smooth the variations, there is still resistance to fundamental

trends. The Dram ought to be left to itself, to depreciate sufficiently to create a monetary situation beneficial to exports and increase the purchasing power of the population, especially those dependent on outside remittances.



THE REGION IN FIGURES

ARMENIA

GDP
Growth:
2.9 percent

Inflation:
8 percent

GDP:
\$8.8 bn

GDP per capita:
\$2676
(PPP \$5178)

Population:
3.2 m

Outlook: Armenia's economy will benefit from growing remittances, especially from Russia as commodity prices continue to rebound. Growth is expected to hover around three percent in 2011, with inflation returning to the four to five percent range. The current account balance may also improve by a couple of percentage points down from the current -14.5%, while gross government debt will continue to rise to 50% of GDP.

Politically, 2011 will be considered a pre-election year, although the May 2012 elections are 18 months off. This environment will exacerbate tensions between government and opposition. The various parties in and out of the coalition will start to position themselves for the elections. On the one hand, this will compound the uncertainty; on the other, if some political forces take bold and creative steps to create more acceptable and sensible political unions, there may be hope for a responsive system.

In foreign policy, All issues will revolve around the Karabakh conflict, including relations with Turkey, which this year will be a more subdued theme due mainly to Turkish elections in 2011.

AZERBAIJAN

GDP
Growth:
4.3 percent

Inflation:
6 percent

GDP:
\$52 bn

GDP per capita:
\$5764
(PPP \$9953)

Population:
9 m

Outlook: Azerbaijan's economy is expected to grow further due to improving conditions in global commodity markets. Although dependence on commodities may have shielded the country from the effects of the global crisis, the country still sustains serious structural weaknesses including its heavy dependence on the oil and gas sector. Still, Azerbaijan's economy will grow around five percent. The main challenges facing the country are to radically improve the business climate, promote strategic sectors and investments and reform the financial sector.

Politically, having concluded parliamentary elections in 2010, no new political events are on the horizon. The domestic scene, though not free, is stable, with President Aliyev and his party and supporters dominating the political and economic fields. Increased revenues and a more visible role in world energy trade will continue to feed Azerbaijan's more assertive stances on regional and international issues, including Karabakh. Azerbaijan's military rhetoric vis-à-vis Karabakh will escalate in inverse proportion to progress in the Karabakh talks.

GEORGIA

GDP
Growth:
5.5 percent

Inflation:
10 percent

GDP:
\$11.2 bn

GDP per capita:
\$2559
(PPP \$5057)

Population:
4.4m

Outlook: Georgia's economy is expected to slow down slightly in 2011 due to limited FDI inflows and continuing need for further structural reforms and strengthening of the financial system. Domestic demand will continue to be encouraged by expansionary policies and lending programs.

Current account deficit will persist at around 12 percent while public debt will increase to 48 percent of GDP. Public debt and inflation control will remain two of the key challenges along with enforcing the rule of law and improving the investment environment.

Politically, the opposition will try to consolidate and will continue to challenge the administration in the run up to parliamentary elections in 2012. Nevertheless, President Saakashvili will retain power and stability. Georgia will also continue to develop closer relations and deeper integration with the EU. On foreign policy, relations with Russia will remain frozen, and Georgia will continue to deepen relations with Turkey and Azerbaijan.

THE REGION IN FIGURES

RUSSIA

GDP

Growth:
4 percent

Inflation:
8 percent

GDP:
\$1476 bn

GDP per capita:
\$10521
(PPP
\$15806)

Population:
140.3 m

Outlook: Russia's recovery from the crisis has been conditioned by a large fiscal intervention, stronger commodity prices as well as market demand. In 2011, the economy is expected to grow only marginally by half or one point as structural and other weaknesses persist despite the government's strive for modernization of industry and diversification of the economy, with a focus on the banking and high technology sectors. Deregulation and reforms, as well as careful fiscal consolidation, will be important for achieving sustainable growth.

The Medvedev- Putin tandem will dominate the political scene, displaying real or perceptions of competition. Until the fall, it won't be clear who will be the one candidate for the next presidential race. In the Caucasus, Russia will continue to reinforce and consolidate its influence. In global policy, Russia will continue to challenge US supremacy and may try to work with other emerging powers to create a second pole to counterbalance to US.

TURKEY

GDP

Growth:
7.8 percent

Inflation:
8.2 percent

GDP:
\$729 bn

GDP per capita:
\$10206
(PPP
\$13392)

Population:
71.5 m

Outlook: The Turkish economy's resilience during this financial crisis can be attributed not only to improving external conditions and demand but also to fiscal prudence, privatizations and ongoing reforms. Political reforms and a strong government also seem to have restored confidence. In 2011, growth will decrease closer to the averages of developed countries, and inflation will be lower.

Politically, this is a critical year for Turkey. Their 2011 parliamentary elections will result with the ruling AK Party in the lead, albeit with probably a reduced majority. Depending on the strength of that majority, their policies regarding EU integration, regional expansion, Cyprus, Armenia and the Kurds will all be affected.

IRAN

GDP

Growth:
1.5 percent

Inflation:
8 percent

GDP:
\$338 bn

GDP per capita:
\$4484
(PPP
\$11024)

Population:
75.3 m

Outlook: Stability in international commodity markets has maintained the status quo in Iran's economy, with slight improvements in GDP. The economy is expected to expand at about three percent in spite of renewed international pressures and sanctions over its nuclear program. Stronger demand on the other hand will create new inflationary pressures in 2011.

Domestically, despite post-election instability, the government is more confident. Still, within power structures, tension between the presidency and the religious leadership will become more evident and can lead to further government reshuffling and efforts for both side's influence.

In foreign relations, Iran will continue to be intransigent on the nuclear issue, and with the nuclear negotiator being named foreign minister, that matter will remain Iran's number one foreign policy goal. Nevertheless, the West will attempt to increase the pressure on Iran, which will result in increased worries in the region.

*All indicators represent estimates for 2010.

Sources: The World Bank, IMF World Economic Outlook, EBRD, the Economist, E & V Research Center,

