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I am delighted to be here at this second international conference of the Armenian International Policy Research Group. Within a short one-year period, AIPRG has grown considerably; it has organized two conferences and has published its first journal successfully, for which I wish to congratulate the Group. I trust AIPRG will continue to evolve to become an independent world class institution for research and technical analysis of Armenian public policy issues. I also wish to thank the organizers and sponsors of this conference for their efforts and dedication in promoting and hosting today's discussion on the challenges of sustainable development confronting Armenia.

I have been invited to speak about the political economy of the reforms in Armenia. I will thus review, first, the political foundations of the Armenian reforms, and the strategic directions of the transition; and then I will relate some of our achievements to date and the challenges that lie ahead.

In 1990, shortly after the collapse of the Berlin Wall, and about two years before the collapse of the Soviet Union, when the so called "velvet revolution" was unfolding, I recall passionate debates concerning our vision for the future of Armenia and the design of the foundation from which the reforms will flow and carry us forward. After some deep soul searching about the roots of our socio-economic problems, so as to identify the fundamental causes of the distortions in our society, we gradually, but surely, came to the conclusion that the fundamental cause of our problems for nearly twenty five centuries had been the despotic political culture that dominated the entire Region.

By despotic political culture, I mean concentration of power and arbitrary use of it. Regardless of the ruling despot of the time, the Shahs and Shahenshahs, the Khans and Sultans, the Czars and the Soviet dictators, (and of course we had some of our own home-grown despots), all had one thing in common: concentration of power and arbitrary use of that concentrated power. Despots deprived our people arbitrarily from their property, liber-

ty, and even, of their lives. People were always vulnerable and insecure and, therefore, over the centuries designed survival techniques and instruments, such as appeasement, treachery, and many forms of corruption so as to survive. Despotism of the national or imperial rulers often infected officials at lower ranks such as governors, mayors, village and party chiefs, all the way down to school principals and teachers. As such, they instilled fear and insecurity in our people, and, thus, stifled individual initiative in creating, innovating, enterprising and producing. Despots managed our society with top down social engineering of one form or another. This was the picture, more or less, until 1990.

From this fundamental diagnosis we began to design the foundation of our reforms. We clearly recognized that if the cause of the despotic political culture was concentration of power, then extrication from it must be through orderly diffusion of power. In practical terms, this meant two parallel tracks of transition (a) to liberal democracy and (b) to open, mostly private, market based liberal economy. Clearly, the principal prerequisite for our transition, particularly in the context of our long authoritarian past, is transition to liberal democracy, i.e. democracy and the rule of law for individual rights, together. Democracy alone is not enough for us because it only guarantees the power and status of the majority and often it upholds the old power structures that resist change and shirk adjustment and, thus, some are simply left out. That carries the risks of relapse to our old autocratic habits, if it does not guarantee liberty and rule of law for everyone. In liberal democracy, on the other hand, we would not only elect our own government, but we also would have our individual rights protected by due process of law that applies to everyone living or enterprising in Armenia.

We recognized that we can not have a fully functional market economy without liberal democracy, because a market economy requires checks and balances, a legal framework and administrative transparency that is essential for fair competition in an open market, where citizens can enterprise freely, regardless of whether they are a member of the majority or minority, foreign or domestic, rich or poor, a man or a woman, from the ruling authority or from the opposition. And private property is the institution that would limit the power of the state and enable democratic institutions to evolve and thrive in modern Armenia. We adopted the institution of private property in Armenia not only because private ownership sharply increases productivity of land, labor, and capital, but also because private ownership sharply promotes the cause of freedom. And it was mainly for this purpose that we privatized land in January of 1991, through a comprehensive land reform program, exactly one year before the collapse of the Soviet Union.

Twelve years ago, when we attained our Independence, we declared our commitment to liberty, democracy and social justice as I have just described for you. Subsequently, we expressed these commitments contractually in our Constitution, and the transition proceeded.

Diffusion of the political power in modern Armenia is being achieved through a lively parliament where all political parties above a 5 percent electoral threshold and independents are represented. The deputies debate freely, forge coalitions, and legislate through compromise and not the rubber stamps of yesteryears. Though we have had some problems in the electoral process, the trend has improved over time as witnessed by independent international observers.

The judicial power is being diffused through a program of judicial sector reform so as to forge an independent judiciary that can guarantee due process of law, enabling citizens to confidently go to the courts to claim their rights and settle their disputes, rather than fearfully submit to greedy judges in contests of graft. Whilst comprehensive institutional reforms have been made in this direction and some progress realized, admittedly behavioral modification by both judges and citizens is slow and it may take a generation for us to see substantial progress.

The knowledge power is being diffused through a free and mainly private mass-media to ensure public access to all news and provide a feedback mechanism for the authorities. Raising professional and ethical standards for a free mass-media through self-regulation is the next logical phase in this sphere so as to encourage the media to report news and not make news, and the authorities to guarantee freedom of the media in all its forms and manifestations.

Diffusion of executive or administrative power is being achieved through a comprehensive civil service reform, which aims to establish objective criteria and practices in recruiting, appointing and promoting competent and credible civil servants. It provides checks and balances so as to uproot arbitrariness of state officials and substantially reduce corruption of civil servants, and instead promote competent and efficient civil service and, thus, help to improve governance throughout Armenia.

Economic power is being diffused through a program of privatization to enhance a competitive, private sector driven production, enabling citizens free choice of enterprise and employment. Progress here is significant as private sector share of employment has increased to around 80 percent and private sector share of GDP is now also around 80 percent and rising. Our concern now is no longer monopoly of the state, but rather measures to prevent formation of monopolies and oligarchies in the private sector that may concentrate economic power again, this time in few private hands. We plan to deal with this through anti-monopoly legislation and executive regulatory framework to enhance competitive economic environment. Let us remember that private institutions, like corporations, can be just as tyrannical as governments, and whilst governments in democracies are

constrained by the constitution and the voters, corporations in the absence of effective regulation could become unlimited authoritarian institutions.

I do not claim today that we have a fully fledged liberal democracy in Armenia. I do claim, however, that we are in transition towards liberal democracy and in the twelve years since our independence we have achieved plenty as compared to our past, and as compared to our neighbors. Our principal comparator and destination, however, is the Western style liberal democracy, and to achieve this whilst we must work very hard now, a generation change may be required because old habits die hard and behavioral modification is more readily accepted by the young.

And now allow me to turn to our economic achievements and challenges that lie ahead. Ever since independence in 1991, the Republic of Armenia has embarked on an intensive program of structural reforms for transition from a centrally planned to an open, mostly private, market economy; through democratic processes along the lines of the principles that I outlined earlier. The main objective has been to create strong macroeconomic prerequisites for private sector driven economic growth. In the first phase of the reforms:

- All producer and consumer prices, and trade, is liberalized. Today Armenia is the most open economy in the region with minimal import tariffs (0 & 10 percent), no export tariffs, and no quantitative restrictions (no quotas, at all).
- Agricultural land and housing is privatized, and privatization of state enterprises is now nearly complete. All small enterprises, and nearly 1800 medium and large enterprises, have been privatized. Privatizations convey all property rights, including security of ownership and the rights to sell, to rent, to pledge as collateral; in line with liberal economic concepts of private property.
- The essential infrastructures have been substantially rehabilitated and are ready to support the growing production.
- A favorable and progressive taxation regime has been established and it is working as an important instrument of fiscal policy. The incidence of taxation is one of the lowest amongst the transition economies.
- The Central Bank has been established, the national currency introduced, and a small, but evolving private banking system is working, as important instruments of monetary policy. There are no exchange controls and funds can be transferred freely into and out of Armenia by residents and visitors alike.

- Social assistance has been rationalized from general subsidies to targeted assistance, and directed primarily to the vulnerable groups. The subsidies are transparent and budgeted, so as to ensure effective control and affordability.
- The basic legal framework for the new economic system is in place, and is developing along the lines of liberal economic concepts of private property, freedom and sanctity of contract.
- A Civil Service Commission has been set-up, as indicated earlier, and the entire government machinery is being overhauled so as to forge a professional civil service with checks and balances in place.
- The economy has been stabilized, as the annual inflation rate since 1998 has been around low single digits, and the national currency, Dram, has been the most stable currency in the region for several years. The economy has been growing steadily since 1994 around 5.5 percent annually; in 2001 the economy grew at 9.6 percent, and in 2002 the growth rate was 12.9 percent. In 2003 the economy grew at 14 percent and the growth rate for the industrial production was 15 percent, trade 14.5 percent, services 9 percent and for construction 41 percent.
- External trade has been diversified toward increasing trade with Europe, the Middle East and the New World, and the exports are now growing around 34 percent annually. Both trade and current account deficits, although high, are declining steadily. Moreover, Armenia has succeeded in her accession to the World Trade Organization without any outstanding conditions.
- And all these have been achieved despite the adverse influences of some serious external shocks and domestic tragedies.

Nevertheless, there have been imbalances in the pattern of economic growth and distribution because poverty (around 45 percent), unemployment (around 25 percent) and income inequality remain disturbingly high. Consequently, the level of Gini coefficient is unacceptable in Armenia. The income based Gini coefficient was around 0.27 prior to transition and it is currently estimated at around 0.5 (down from all time high of 0.65 in 1996). Here I must add that the expenditure based Gini coefficient in Armenia is significantly lower at around 0.3. This difference is mostly attributed to the shadow economy and large private family remittances from abroad.

Industrial development has been narrowly based on a few sectors and the industrial potential has not been widely utilized, yet. Clearly, economic growth must have a much stronger

ability for countrywide job creation in the private sector, and widening of the sector and enterprise bases of growth is essential and critical for achieving a significant job creation momentum. Expansion of employment and creation of a large prosperous middle class is essential to underpin the economy, sustain growth and enhance the sense of ownership for the Country by the general public.

Greed, vanity and incompetence have sometimes induced deviations from economic policy causing waste and misallocation of scarce resources. Simply said, abuse of both power and freedom has at times obstructed implementation of otherwise sound economic policies. If unchecked, such deviations may undermine economic performance and create both economic and social problems in the future.

The Kocharyan Administration, therefore, has refocused the economic reform program, the principal direction of which is private investment as the backbone of development strategy to increase production, increase productivity, and to enhance export driven economic growth and employment creation. The strategic focus for implementation of this policy is completion of privatization of the remaining medium and large state enterprises, and rapid mobilization of domestic and foreign capital to support productive investments in the growing private sector, and new essential infrastructure, in order to achieve and sustain high economic growth and employment. Concurrently, effective social investment would help to ensure sustainability of high economic growth through replenishment of healthy and highly trained manpower, and mobilization of public support to enhance confidence for the reforms during transition.

For efficient mobilization and allocation of public resources, the strategy now calls overhaul of the government machinery to substantially reduce waste and corruption, to reform administration of taxes and customs, and through continues civil service reform to improve governance. Implementation of a comprehensive anticorruption action plan, addressing abuses of authority and rent seeking behavior in all branches of the Government, is an important component of the Administration's strategy to improve governance. For mobilization of private resources, the strategy calls for a comprehensive and coordinated set of actions to simplify procedures and remove obstacles to trade and investment so as to improve the enabling environment to enterprise for both foreign and domestic investors.

New institutional interventions to assist investors, to eliminate administrative obstacles, and to enhance the enabling environment, are creation of the Business Support Council, strengthening of the Armenian Development Agency, and creation of the Information Technology Council, all reporting directly to the President of the Republic and composed of key cabinet level officials, and foreign and local businessmen, appointed by the President, the latter group on a rotational basis. The Prime Minister is designated as chair-

man, and the President's Chief Economic Adviser as vice chairman, for all three of these bodies, so as to enhance linkage of policy design and implementation. These institutional interventions are functioning as mechanisms for public-private policy dialogue and demand driven reforms of policy and administration for improving the business environment and removing administrative barriers to trade and investment.

As a result the business environment has dramatically improved. According to the 2003 Index of Economic Freedom published by the Heritage Foundation and the Wall Street Journal, Armenia is the "most open" of the Newly Independent States. It has improved from the 115th place in 1996 to the 44th place in 2003, well above its immediate neighbors. According to the same index Azerbaijan occupies the 104th place together with Turkey, and Georgia occupies the 91st place. In terms of trade, the Heritage-Wall Street Index ranks Armenia, together with Hong Kong, Singapore and Estonia, amongst the most open economies in the World.

Whilst in the past investors were understandably reluctant to invest in state enterprises, today, as I indicated earlier, around 80 percent of the economy is private, and growing, both in terms of GDP and employment, and it is wide open for investment. The new private enterprises are now modernizing and restarting the old and idle state factories (most of them now privatized), and starting new factories, this time in line with Armenia's comparative advantage (technology intensive, high precision, and high value added production and services), based on the highly skilled labor force in Armenia. Around 70.000 new jobs were created in the private sector during the last two years and this trend continues.

Thus, the strategic focus is on poverty reduction through employment creation driven by private sector growth, and investment in social infrastructure (health, education, civil society), with parallel and complementary efforts of the governmental authorities and the private sector. Replenishment of the highly skilled labor force during this rapidly changing high-tech world economy, and retraining of the population in the skills of the new economic order during transition, and provision of equitable access to basic education and health care services, are the fundamental elements of our poverty reduction strategy, i.e. investment, production, productivity, export driven growth, and thus improved quality of life through more employment and higher earnings.

Equity in distribution is to be achieved through improved employment opportunities in a more competitive and robust private sector, particularly expansion of small and medium enterprises and improved administration of the public sector, so as to arrest financial hemorrhages from weak fiscal and quasi-fiscal management, and to reallocate the recovered resources to priority social development purposes. Let us remember, that we must first have

sufficient and competitive production so as to be able to distribute the yields justly with social sensitivity.

This evolving program of the reforms has been, and continues to be, fundamental and far-reaching. Clearly, it requires a great deal of personal sacrifice and behavioral modification by all of us during transition, and benefits of the reforms are not immediately available to all segments of the population at this stage. We are determined, however, to continue to implement the reforms through democratic processes of open debate, mutual compromise, checks and balances, and due process of law. We believe reforms implemented through democratic institutions are far more stable and sustainable, and enhance better investment confidence. By improving the business and investment climate and with additional foreign and domestic private investment, we expect to maintain our high economic growth rates for this decade and with progressive distribution of the yields of that growth, the benefits of the reforms will be appreciably felt by the entire population through gradual improvement in quality of life.