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THE SECOND SYSTEMATIC COUNTRY DIAGNOSTIC

ARMENIA

BEYOND BOUNDARIES:

UNLOCKING POTENTIAL
FOR A SUSTAINABLE TOMORROW

Executive Summary



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Abbreviations and Acronyms

ALMMs	Active Labor Market Measures
AMD	Armenian Dram
ADB	Asian Development Bank
ArmStat	Statistical Committee of Armenia
BACI	Base pour l'Analyse du Commerce International (Database for International Trade Analysis)
BaTIS	Balanced Trade in Services
BOP/IIP	Balance of Payments and International Investment Position Statistics
BPM6	Balance of Payments and International Investment Position Manual, sixth edition
BRI	Belt and Road Initiative
CBA	Central Bank of Armenia
CIO	Chief Information Officer
COVID-19	Coronavirus Disease 2019
CO2	Carbon Dioxide
CPC	Corruption Prevention Commission
CPF	Country Partnership Framework
CSO	Civil Society Organization
EAEU	Eurasian Economic Union
ECA	Europe and Central Asia
EEA	European Environment Agency
ESG	Environmental, Social, and Governance
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GRID	Green, Resilient, and Inclusive Development
GSM	Global System of Mobiles
HCI	Human Capital Index
HLO	High-Level Outcome
ICT	Information and Communication Technology
ILCS	Integrated Living Conditions Survey
ILO	International Labour Organization

ILOSTAT	International Labour Organization Statistics
IMF	International Monetary Fund
ISMB	Information Systems Management Board
IT	Information Technology
LCU	Local Current Unit
LPI	Logistics Performance Index
IFC	International Finance Corporation
IRI	International Republican Institute
MHTI	Ministry of High-Tech Industry
MoLSA	Ministry of Labor and Social Affairs
MRV	Monitoring, Reporting, and Verification
MW	Megawatt
NCD	Noncommunicable Disease
NDC	Nationally Determined Contribution
NEET	Not in Education, Employment, or Training
OECD	Organisation for Economic Cooperation and Development
PHC	Primary Health Care
PPP	Purchasing Power Parity
PV	Photovoltaic
SCD	Systematic Country Diagnostic
SMEs	Small and Medium Enterprises
SOE	State Owned Enterprise
STEM	Science, Technology, Engineering, and Mathematics
TFA	Trade Facilitation Agreement
TFP	Total Factor Productivity
UMIC	Upper-Middle-Income Country
UNCTAD	United Nations Conference on Trade and Development
UNICEF	United Nations International Children's Emergency Fund
WEF	World Economic Forum
WDI	World Development Indicators
WHO	World Health Organization
WTO	World Trade Organization

Executive Summary

The **Systematic Country Diagnostic (SCD)** provides an assessment of the constraints Armenia should address and the opportunities it can embrace to accelerate progress toward the twin goals of ending extreme poverty and promoting shared prosperity. The first-generation SCD in Armenia, published in 2017, highlighted the need for a new growth model grounded in greater productivity, and it identified four main related challenges: (1) poor external sector performance, (2) low private sector productivity, (3) insufficient labor productivity, and (4) key macroeconomic, environmental, and microeconomic vulnerabilities. This second-generation SCD looks into the future by reflecting on the five years that have transpired since 2017. It finds that the challenges identified in SCD1 remain valid, while it highlights new challenges related to fragility, conflict, and violence. It also finds that governance, institutional capacity, and investment in data are cross-sectoral constraints.

A RAPIDLY CHANGING CONTEXT

Since 2017, Armenia has seen significant internal and external changes including the Velvet Revolution, an event that led to a dramatic transformation of political sentiments in Armenia. Armenian society's growing discontent with their government had been building for several years due to perceptions of systemic corruption and a lack of social and political reform. Mass citizen engagement led to a peaceful transition of power in April 2018 which boosted the democratic aspirations of the Armenian people and markedly changed the expectations of the population. The Velvet Revolution also ignited fresh momentum for renewed growth. The new government implemented a range of economic and governance reforms with a focus on bold anti-corruption and justice sector reforms. Pro-competition measures and gains in market liberalization led to gradual improvements in the business environment. Fiscal reforms included tax administration and tax policy reforms which led to an increase in revenues to 23.2 percent of GDP in 2022 and supported deficit containment.

Overall, Armenia has made important development gains since 2017, achieving upper-middle income status while demonstrating resilience to economic shocks that have had a relatively limited impact on poverty levels. Government mitigation measures helped contain larger shocks, and the increase in poverty due to the onset of COVID-19 and the military conflict with Azerbaijan in 2020—the twin shocks—was confined to 0.6 percentage points, from 26.4 percent in 2019 to 27.0 percent in 2020. Extreme poverty remained low between 1 percent to 1.5 percent during 2017-21. Inequality as measured by

the Gini index grew slightly from 25 percent in 2020 to 28 percent in 2021 (based on the international measurement) but remains lower than most countries in the region. These improvements were driven mainly by jobs followed by social protection transfers. Improvements were also observed in non-monetary dimensions such as life expectancy and survival rates as reflected in the Human Capital Index of 0.58, higher than comparator countries such as Tunisia, Kosovo, and Bosnia and Herzegovina in 2020.¹ Armenia also made significant progress in closing the gender gap as demonstrated by the improvement in the Gender Gap Index—moving up from 98th place in 2018 to 61st place in 2023 (WEF 2023).

The post-revolution euphoria came to a sudden halt in 2020 with the eruption of the military conflict with Azerbaijan in the midst of the COVID-19 pandemic, shifting public attention from the economic and governance issues that were the focus of the revolution to national security. Armenia faced the twin shocks in 2020 which resulted in one of the largest contractions in real gross domestic product (GDP) in the region. On the back of changing sentiment after the 2020 military conflict, a snap election was held in 2021, which the incumbent government won. In 2022, Russia’s invasion of Ukraine and new clashes with Azerbaijan, including in Armenian territory, added to the uncertainty. The unresolved border issues, and the proximity of forces close to the border settlements in Armenia, have weighed on economic activity.

The political events of the past five years translated into highly volatile growth performance, driven mostly by consumption growth (or contraction) and reflecting a limited contribution from physical capital. Growth averaged 5.2 percent during 2017–22, but this was a period of significant volatility, with growth contracting by 7.2 percent in 2020 due to the twin shocks then rebounding in 2021 and 2022 (12.6 percent), supported by post-COVID-19 recovery and by Russian migrants and money flows, respectively. On the demand side, growth was driven by private consumption followed by investment then government consumption, with a smaller contribution from net exports. However, limited capital expenditures, a declining trend in foreign direct investment (FDI) during 2008–20, and decreasing domestic private investment led to limited physical capital accumulation. On the supply side, structural transformation resumed as the economy continued to shift from agriculture into services. Workers moved from the lower-productivity agricultural sector into higher-productivity industry and services.

World Development Indicators database (World Bank) as of July 2023.

KEY CHALLENGES TO INCLUSIVE AND SUSTAINABLE GROWTH

For further poverty reduction in the coming years, job creation remains the biggest development challenge for Armenia. While the economy has been growing, it has not been creating enough quality jobs. This issue is critical, as jobs have been the main driver of poverty reduction in Armenia in the last few years. Improvements in governance and the competitive landscape since 2017 have spurred an increase in firm establishment and some, if limited, job creation. Despite these improvements, the number of good-quality jobs remains substantially lower than in other countries in the region, as indicated by a high level of informality. While 45 percent of the labor force in Europe overall had decent jobs working for 20 hours or more in a week with a contract, the rate was only 22 percent in Armenia in 2015. The challenge is also indicated by the large number of temporary emigrants seeking better employment opportunities and wages abroad. Furthermore, the share of youth not in education, employment, or training is among the highest in the region at 28 percent in 2021.² While unemployment has improved from the 18 percent it hovered around for much of 2008–20, it remains high at 13 percent in 2022.

Decent jobs are not only scarce but also distributed unevenly, with 47.5 percent of the poor lacking access to such jobs compared to 37 percent of the non-poor in 2021. Especially among the rural poor in the agricultural sector, lack of human capital in terms of education and health has resulted in low labor productivity, hindering their ability to secure decent jobs. This challenge is exacerbated by insufficient connectivity to markets, preventing workers in remote areas from accessing resources and opportunities. The limited mobility of the workforce into higher-productivity sectors is slowing progress in poverty reduction and economic growth. Addressing the structural impediments to job creation, both from the supply and demand sides, will be critical to achieving faster and inclusive growth. On the supply side, greater investments in the skills and health of the existing and potential workforce need to be prioritized. On the demand side, Armenia needs to strengthen the competition environment and investment climate further.

Exposure to shocks

Lack of economic diversification in terms of trade partners and export products has been a persistent source of growth volatility that will remain a challenge in the coming years. Despite growth averaging 6.2 percent over 2000–22, this period was punctuated by two large slowdowns in growth in 2009 and 2016, largely due to Armenia’s economic structure, its exposure to commodity price fluctuations, and its

2. ArmStat Labor Force Survey.

limited number of trading partners. More than two-thirds of Armenia’s exports are to Russia, the European Union, China, and Switzerland. Primary products from mining—namely copper, molybdenum, and gold—have grown to about 30 percent of exports, both limiting the complexity of Armenia’s exports and exposing Armenia to commodity price shocks. Armenia’s imports are also heavily concentrated. For example, energy supply from gas relies exclusively on imports from Russia, and the high dependence on basic food items poses a risk to food security.

The last five years have underscored an increased vulnerability to fragility and conflict. Armenia’s GDP shrank by 7.2 percent, and exports fell by 34.0 percent in 2020 due to the 2020 twin shocks. While Russia’s invasion of Ukraine in 2022 has affected domestic consumption and foreign trade positively, it has also placed upward pressure on fuel, housing and food prices, and affected future opportunities for inclusive growth. These factors, coupled with some volatility stemming from shocks, have led to declining private and public investment rates and FDI which have adversely affected the level of potential growth and economic efficiency. Moreover, as this SCD2 went to print, Armenia was experiencing the influx of more than 100,000 displaced ethnic Armenians from Nagorno-Karabakh³ as a result of a military operation by Azerbaijan. Integrating them into the Armenian society and economy poses a new challenge.

Climate change and environmental and natural disasters represent additional sources of risk to Armenia’s prospects for sustainable growth. Such events would not only affect overall growth but are also expected to have distributional impacts that could disproportionately hurt the poor. The average temperature in Armenia has risen more than the global average in recent years, with an increasing rate of acceleration. Sectors such as agriculture, mining, energy, water, and waste management are not sufficiently prepared to adapt to these risks. Moreover, despite some progress and efforts by the government, the disaster risk management system is not well prepared to safeguard the population from shocks such as floods, heat waves, droughts, and earthquakes, to which Armenia is especially prone.

Armenia has shown some resilience to shocks amid sound and improved macroeconomic management. Estimates indicate that fiscal policy has contributed to reduced poverty incidence and lower inequality, although it has not been as effective at stimulating short-run growth (World Bank 2023b). In 2020, for example, government mitigation measures helped contain the 2020 twin shocks, with measures to shield both households and firms. Assistance included direct cash transfers to households and workers,

3. With the reference to Nagorno-Karabakh in this document, the Bank does not intend to make any judgment on the legal or other status of concerned territories or to prejudice the final determination of the parties’ claims.

wage subsidies, utility subsidies, tax benefits for businesses, state-sponsored loans, and higher investment. Fiscal policy has been countercyclical and progressive, and the measures helped mitigate impoverishment and unemployment. As a result, the poverty rate increased by less than one percentage point in 2020. Real GDP growth rebounded to 5.7 percent in 2021.

Nevertheless, resilience to shocks from fragility and conflict, economic causes, and climate change needs to be strengthened to end extreme poverty and boost shared prosperity. The whole population is vulnerable to these shocks, especially people in rural areas, women and girls, the displaced population, and international migrants providing remittances. Increased resilience could be achieved through several actions. For example, to diversify the economy, Armenia can enhance efforts to build on its existing trade relationships and diversify trade products—for example, based on its comparative advantage in metal products, textiles and apparels, food and beverages, and other manufacturing—and trade partners as well as raise the competitiveness of export products and value chain development. To increase resilience to fragility and conflict, Armenia can strengthen emergency preparedness and service delivery for border areas and enhance the registry and delivery mechanisms for social protection. To mitigate exposure to climate change and environmental risks, Armenia will need to adapt to climate change and natural disasters by scaling up risk prevention systems and ramping up climate-smart energy, agriculture, and mining sectors. It will also need to reduce pressures on natural capital by scaling up investments in energy efficiency and renewable energy and by better managing air pollution and land and forests.

Structural bottlenecks to growth and inclusion

Access to markets within and outside of Armenia is constrained, both physically and digitally. Armenia is a landlocked country (with two borders closed for political reasons) in a region of difficult topography and geopolitical tensions, which constrains access to regional and international trade and integration. Armenia is only exporting a small share of its potential and stands to gain from increased trade from full effective implementation of the WTO Trade Facilitation Agreement. Currently, Armenia's integration in global value chains is limited to some participation in light manufacturing. While Armenia has scored large improvements in logistics service quality, tracking and tracing, and customs, poor infrastructure within the country constrains access to goods, services, and labor markets. This contributes to spatial disparities and hinders basic public service delivery, inputs for productive activities among firms, and the household accumulation of human capital. Although digital connectivity is high overall, digital adoption in rural areas is constrained by affordability, service quality, access to digital devices, and lack of digital skills and awareness.

The low quality of human capital in terms of education and health is an important development challenge in achieving sustainable and inclusive growth. A relatively high enrollment rate in schooling is not coupled with high learning outcomes, as demonstrated by the stagnation of international test scores. Achievements are also uneven, reflected in lower access and scores in rural areas and among the poor. Expected years of schooling have remained virtually constant since 2010. Moreover, returns to education have been declining, indicating that the education system has not been responsive to the rapidly changing demands in the labor market. Access to adequate healthcare is often inaccessible and unaffordable to the poor, in part due to the significant share of health expenditure paid out-of-pocket, which is among the highest in the world at almost 85 percent. Enhancing the inclusion of vulnerable groups such as women, youth, and displaced populations would improve the equity and productivity of the labor force.

The economy is not as competitive or as innovative as it could be. Some measures of the business climate have improved. For example, since 2016, the perception of competition policy for Armenia has notably improved. However, among the measures related to the organization of the market and competition, competition policy is the area where Armenia most lags its peers, followed by liberalization of foreign trade. In addition, investment, a crucial input, has been declining, the cost of credit is relatively high, and access to finance remains a major constraint to doing business for small and medium firms. Larger firms report being constrained by informality and political instability. Firms are also faced with increased power outages and a deteriorating quality of energy supply. The low quality of human capital and the skills mismatch are also key constraints for the private sector.

Governance and institutional constraints

A cross-cutting challenge in achieving inclusive and sustainable growth is governance bottlenecks, institutional quality, and a need to invest in data which underlies Armenia's development challenges. Since 2017, Armenia has made progress in strengthening the quality of its institutions, especially in the areas of anticorruption and transparency in the public sector. And despite the difficult security priorities for the country, the government has continued its commitment to reform. However, institutions remain fragile and vulnerable to shocks. Despite ambition toward an overarching development agenda captured in the government's 2021-26 program, the institutional framework for planning, monitoring, and evaluation is neither clear nor comprehensive, and strategic planning is weak. Government effectiveness - a bottleneck to inclusive service delivery and growth—is the lowest among peers and has regressed. Greater investment in data collection and management, a prerequisite for government functions, is needed to accelerate the pace of reforms based on evidence-based policy making.

LEVERAGING OPPORTUNITIES

Looking forward, Armenia faces high uncertainty in the context of a global megatrend of increasing geopolitical and economic fragmentation, as well as rapid changes in technology. While these megatrends present challenges, they also inspire new opportunities for growth (Box O.1).

In conclusion, Armenia needs to build on reform momentum and unlock its potential in the context of fragility and uncertainty. Since 2017, in the face of significant internal and external changes, the country has demonstrated resilience and strong economic recovery through sound macroeconomic management. Going forward, Armenia will need to address critical bottlenecks to create more jobs and higher-quality jobs and to ensure that its development path is sustainable and better prepared to handle shocks from fragility and conflict, economic shocks, and climate change. One key opportunity for Armenia is to go beyond its boundaries and strengthen its links with the world, such as through enhancing its trade partners and products, building on its acumen in ICT, and leveraging its diaspora as a network nation. The policy objectives and reforms identified in this SCD would support Armenia in unlocking its potential to generate higher-quality jobs, enhanced education and health outcomes, improved resilience to shocks, and ultimately, a sustainable tomorrow for all.



Box O.1. Capturing Megatrends—Challenges and Opportunities

It is critical for Armenia to consider the possible impacts of megatrends on the economy to seize opportunities and prepare for new threats. An understanding of relevant megatrends for Armenia - their pace, interconnectivity, and potential impacts - is a key element in designing policies to achieve inclusive and sustainable growth. It can facilitate the development of strategic action plans that respond to future scenarios, increase resilience to changes, and help capture the advantages and realize potential opportunities. Below are some of the megatrends that may have significant impacts for Armenia.

Geopolitical Shifts

Connectivity is a pressing issue in Armenia, complicated by the challenging terrain and geopolitical tensions in the region. At the same time, Armenia is vulnerable to economic shocks given that its economy is concentrated in terms of trade partners and products. Should the political climate be amenable, an opening of borders with neighboring countries would be expected to accelerate international trade and integration. This would provide more opportunities to diversify export products, partners, trade routes beyond existing ones with Georgia and Iran. For example, restoring the border with Türkiye could increase freight flows, and reopening the border with Azerbaijan could foster linking Armenia to the Middle Trade and Transit Corridor, a transport corridor connecting China and Europe. Gravity modeling analysis shows important potential export potential for Türkiye. At the same time, it should be noted that although opening of these borders would allow Armenia to improve its trade with current trading partners and diversify trade toward Europe and China, such openings are sensitive and pose significant geopolitical risks.

Technological Advancement and Enhanced Connectivity

Armenia could build on its dynamic information and communication technology (ICT) sector and better position itself to leverage global digital trends. Armenia aspires to be an ICT hub and has a recent track record of providing outsourcing services to global firms mostly in software programming. This is an important opportunity, as service exports help mitigate Armenia's physical constraints. ICT service exports as a share of total service exports more than doubled between 2017 and 2021 to 22 percent, and its service exports on a per capita basis outperform those of China and India. It can do more, however, to reach the level of global leaders. To do so, Armenian firms need to branch out to activities that are catalyzed by emerging technologies. The recent relocation of information technology (IT) firms and talent from Russia presents an additional opportunity for Armenia to seize.

Armenia is also a potential network nation, with an important role for its diaspora to boost human capital, investment, and connectivity. The size of the Armenian diaspora is currently estimated at 7 million people in more than 100 countries. Much of the diaspora retains strong links to Armenia. In 2021, around 14 percent of households reported that they received remittances, which can serve as an automatic stabilizer during crises. Diaspora connections and prominent Armenians in various ICT hubs around the world have played a pivotal role in the accelerated development of the ICT sector since the early 2000s by bringing in technological multinational companies to Armenia, setting up local research and development centers, investing in IT educational and infrastructure programs, generating leads for local IT companies, and linking with knowledge and funding sources. They can enhance connectivity by promoting trade and FDI, creating businesses, spurring entrepreneurship, and transferring new knowledge and skills. There is also vast untapped potential in the value the diaspora can bring to the science and research ecosystem in Armenia. The scientific community of the diaspora excels in quality and performance. Ways to engage the diaspora in higher value-added activities include stocktaking of strategic connections in priority sectors and building mechanisms for joint projects.

Green Transition

Armenia can also better seize opportunities from the green transition. Armenia is among the countries that are most vulnerable to risks from climate change, environmental and natural disasters. These risks are amplified by human pressures and a history of unsustainable resource management leading to heightened air, soil, and water pollution and land degradation today. However, moving toward greener growth could—in addition to reducing pressures on domestic natural capital - unlock competitiveness in the private sector through efficiency gains and reduced exposure to future carbon border taxation. Providing financial incentives to promote the green transition, for example, would support integration of the private sector into global value chains. Second, Armenia's proven reserves of copper and molybdenum and the significant potential for gold and other transition critical minerals that are in high global demand as the world decarbonizes could provide significant near-term revenues. Exploring these opportunities would, in addition to attracting significant investment, require a step-change in environmental, social, and governance-related regulation of the sector to ensure that best practices in minimizing damages are followed and that market prices reflect residual externalities.

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