

# Armenia's Economic and Geopolitical Challenges in Regional Integration

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## Abstract

Due to the Nagorno-Karabakh territorial dispute, land-locked Armenia's exports and foreign direct investment (FDI) suffer from the economic embargo maintained by Azerbaijan and Turkey. Armenia can benefit from more active trade with its neighbors, the European Union (EU), and Russia, while maintaining ties with Iran. Armenia's economic performance depends heavily on Russia's economic conditions through trade, FDI, and remittances. It is important to observe how Armenia can benefit from its participation in the Eurasian Economic Union (EAEU). For Armenia it makes sense to diversify its external partners in order to reduce risks as it has been experiencing in connection with Russia's recession.

**Key words** : Armenia, FDI, international relations, remittances, trade

## 1 Introduction

Armenia is located east of Turkey and shares borders with Georgia to the north, Azerbaijan to the east and southwest, and Iran to the south. It is a mostly mountainous country landlocked in the Lesser Caucasus Mountains. The country's scarce natural resources include some deposits of gold, copper, molybdenum, zinc, and alumina. As such, the growth in industry is contributed significantly by raw material production and metal. Armenia had enjoyed uninterrupted and remarkably high economic growth (around 11% on average during 2000-2008) before the global financial crisis in 2009.<sup>2</sup>

Armenia declared independence from the collapsing Soviet Union in September 1991 and was

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<sup>2</sup> See Hayakawa (2015).

admitted to the United Nations in March 1992. Since then it has become a major recipient of international assistance. Multilateral donors have been active in a number of key development areas, as well as bilateral donors such as the US, Germany, Russia, and Japan.

Armenia is a member of the Commonwealth of Independent States (CIS), along with Azerbaijan, Belarus, Georgia (withdrew in 2008), Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan (unofficial), Ukraine (unofficial)<sup>3</sup>, and Uzbekistan. Armenia also joined Black Sea Economic Cooperation (BSEC) in 1992, together with eleven other countries including Azerbaijan, Georgia, Moldova, Russia, Turkey, and Ukraine. Armenia applied to the World Trade Organization (WTO) in November 1993 and acceded to the WTO in 2003.

Having received a more attractive economic integration proposal from Russia than the EU could offer<sup>4</sup>, in September 2013, Armenia declared its intention to join the Customs Union (established in January 2010) and the Common Economic Space (initiated in January 2012) of Belarus, Kazakhstan and Russia. In May 2014 these three countries signed a treaty on the Establishment of the Eurasian Economic Union (EAEU). In October 2014, a treaty to expand the EAEU to Armenia was signed. The Kyrgyz Republic also signed a treaty in December 2014 to be a full member of the EAEU in May 2015. The EAEU with four full member states started functioning in January 2015. The Kyrgyz Republic became a member of the EAEU in August 2015.

The purpose of this paper is to review Armenia's various challenges in its regional integration with a main focus on the performance of Armenia's external sector. Section 2 will provide an overview on Armenia's international relations. In Section 3, Armenia's challenges within the South Caucasus are highlighted. Section 4 will analyze Armenia's external sector in terms of trade, foreign direct investment (FDI), and remittances. Section 5 will present concluding remarks.

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<sup>3</sup> Turkmenistan and Ukraine have not ratified the CIS charter.

<sup>4</sup> See Jovanovic and Damjanovic (2014).

## **2 Armenia's international relations**

### **2.1 European Union (EU)**

Instability in the South Caucasus is considered a threat to the EU members, since they view the region as a far corner of Europe.<sup>5</sup> Armenia is a member of the Council of Europe, maintaining close relations with the EU, especially with France (an important origin of FDI) and Greece. In this context, the EU's European Neighborhood Policy (ENP) has great potential to achieve successful promotion of regional cooperation in economic issues.<sup>6</sup>

Until 2013 the EU had been seeking an increasingly close relationship with Armenia, including gradual economic integration and political cooperation. Armenia is a priority partner country within the ENP. A joint EU-Armenia Action Plan was discussed by the European Commission and the Armenian government and adopted in November 2006. The Eastern Partnership instrument put forth in May 2008 aims at approximation of six post Soviet republics (Ukraine, Moldova, Armenia, Azerbaijan, Georgia and Belarus) with the EU. The initiative appears as a platform for visa and trade agreements but does not guarantee EU membership.

Decisions made by neighboring Turkey and influential Russia regarding foreign relations toward the South Caucasus do not always match the principles promoted by the EU. The future of regional stability in the South Caucasus, considered important by the EU, depends on the delicate balance of interests and perceptions among different levels of interaction. For example, Armenia maintains much better relationships with Iran than the EU does.

### **2.2 Iran**

Armenia has been Iran's economic and geopolitical partner. Iran is a Caspian littoral state, a major oil producer in the Organization for Petroleum Exporting Countries (OPEC) also endowed

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<sup>5</sup> Nuriyev (2007).

<sup>6</sup> Babayan (2010).

with large gas reserves. Iran has preserved a neutral position with respect to the Nagorno-Karabakh conflict and has not abandoned trade with Armenia and Georgia.

Cooperation between Armenia and Iran has been taking place in the technical and economic areas including joint energy projects. In 1995 Armenia signed a 20-year agreement on purchases of natural gas and electricity from Iran. The agreement was signed in 2004 toward the Iran-Armenia gas pipeline, which started operations in 2006 and was officially inaugurated in March 2007. There are discussions to build a second pipeline from Iran to Armenia. As such, the cooperation is likely to raise bilateral trade in the near future.

### **2.3 Russia**

Russia considers Armenia as its strategic partner. Armenia, maintaining pro-Russian foreign policy since independence, needs extensive Russian support for both economic and geopolitical reasons due to Armenia's complicated position with Azerbaijan and Turkey. This partly explains why Armenia decided to join the EAEU, even though the EU also had been actively seeking a closer tie with Armenia.

### **2.4 US**

The positive relationship between Armenia and the US has been developing, partly due to the presence of 1.4 million<sup>7</sup> relatively young Armenian Diaspora living in the US. Similar to the EU, the US has economic and geopolitical interests in the South Caucasus. The necessity of oil and gas transit arteries across the terrain of Armenia and Georgia may have urged the US and the EU to call for cooperation among the three countries (Armenia, Azerbaijan, and Georgia) in the South Caucasus. The US approaches the regional cooperation in the South Caucasus also in the context of seeking balance against the influences from Russia and Iran.<sup>8</sup>

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<sup>7</sup> ArmeniaDiaspora.com

<sup>8</sup> The US has been critical of the political regime of Iran. As a result of improved dialogue between Iran and the international community, the political tension between the US and Iran is easing gradually.

## 2.5 Armenian Diaspora

3.29 million people lived in Armenia in 2014 according to the Asian Development Bank (2015). Overall, the population of Armenians world-wide is estimated to be a little more than 10 million, many comprising Diaspora communities in Australia (50,000), Canada (40,615), Russia (2,250,000), the US (1,400,000), Europe especially France (450,000), and the Middle East including Lebanon (234,000)<sup>9</sup>. Armenians are one of the world's most dispersed peoples.

There is a long history behind Armenian emigration. Important events include the mass killing of Armenians by Ottoman Turks during the World War I, a devastating earthquake in Spitak in 1988, and the military conflict with Azerbaijan disputing over the Nagorno-Karabakh from 1988 to 1994.

While possible brain drain can be a concern in terms of weakening domestic human capital, the role of Armenian Diaspora can become important for Armenia's economic growth. Since 1998, Armenia had experienced one of the fastest growth rates in the world partly attributable to Diaspora infrastructure rebuilding grants, remittances, and the Diaspora-connected FDI inflows adding to investment in Armenia.<sup>10</sup>

## 3 Armenia's challenges in regional integration

### 3.1 Armenia in the South Caucasus

The three South Caucasus states (Armenia, Azerbaijan, and Georgia) have been regarded as a single regional group.<sup>11</sup> However, the South Caucasus region has been the most unstable in the former Soviet Union.<sup>12</sup> As a result, the South Caucasus is not a united but a fragmented area in reality.<sup>13</sup> The region's current geopolitical affairs are rather complicated.

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<sup>9</sup> ArmeniaDiaspora.com.

<sup>10</sup> Hergnyan and Makaryan (2006).

<sup>11</sup> Raquel and Simao (2008).

<sup>12</sup> Nichol (2007).

<sup>13</sup> Wittich and Maas (2009).

Armenia has tried to combine its orientations towards the EU and the US in the west, while pursuing close ties with Russia in the north and Iran in the south.<sup>14</sup> Georgia also provides landlocked Armenia with an important outlet.

### **3.2 Armenia and Turkey**

After Armenia was conquered by the Ottoman Turks, Christians became a minority, and many were subjected to trials and persecutions. The mass killing of Armenians by Ottoman Turks during the World War I remains a sensitive and controversial issue, binding the Armenian Diaspora together. Turkey has disagreed to recognizing the 1915-1916 killings as genocide,<sup>15</sup> although some countries including Russia have formally recognized genocide against the Armenians.

After decades of hostility, an apparent breakthrough in Armenian-Turkish relations occurred in October 2009, when the two countries signed protocols aimed at reopening their common border and re-establishing diplomatic ties. Turkey had closed the border in 1993 in support of Azerbaijan's position in its conflict with Armenia over Nagorno-Karabakh. However, in April 2010, the protocol ratification process in parliament was suspended. No further progress towards a breakthrough has been made since, as Armenia's conflict with Azerbaijan over Nagorno-Karabakh has been an obstacle as a deeply complicated factor.

### **3.3 Armenia and Azerbaijan: Nagorno-Karabakh conflict**

The territorial ownership of the small enclave of Nagorno-Karabakh in southwestern Azerbaijan is still heavily contested between Armenian and Azerbaijan. This conflict is rooted in the events following the World War I, including the collapse of the Russian Empire. Tensions were high between Armenians and Azerbaijanis in the final years of the Soviet Union. An armed conflict took place from February 1988 to May 1994 in Nagorno-Karabakh, while both countries became independent. Although the hostilities ended after a Russia-brokered cease-fire in 1994, the countries

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<sup>14</sup> Vasilyan (2006).

<sup>15</sup> "The Armenian massacres: Was it genocide?" *The Economist*, April 18th-24th 2015, 49.

have failed to reach a peace agreement.

Armenia's territorial dispute with Azerbaijan, an important Turkish ally, remains unresolved. This dispute has been an obstacle for attempts by Armenia and Turkey to restore diplomatic ties and reopen the land border. The clash of interests between Armenia and Azerbaijan has led to deadlock. Tensions between Armenia and Azerbaijan are to remain high, especially in the border.

The US, Russia, and France chair the Organization for Security and Cooperation in Europe's so-called Minsk Group, which mediates on the dispute. Negotiations on the Nagorno-Karabakh conflict within the Minsk Group in 2011 demonstrated the need for further efforts by the concerned parties to make substantial progress.<sup>16</sup> In a joint statement from the Group of 20 meeting in Mexico held in June 2012, the US, Russian, and French presidents urged Armenia and Azerbaijan to find a peaceful solution to their conflict over the Nagorno-Karabakh region.

## **4 Trade, investment, and remittances**

### **4.1 Trade**

As a WTO member country, Armenia maintains a highly liberal trade regime. Armenia also has Free Trade Agreements (FTAs) with most CIS countries such as Russia, Ukraine, Belarus, Kazakhstan, the Kyrgyz Republic, Moldova, and Tajikistan.<sup>17</sup> However, the export has so far failed to be a constant major driver of economic growth. Between 1999 and 2003 exports grew robustly on the back of the diamond-processing sector. This sector, however, has slumped since, and instead exports of base metals increased due to new investment into the mining sector.

In terms of exports, the EU was Armenia's main destination led by Bulgaria (10.3% of total exports), Belgium (8.9%), Germany (5.8%), and the Netherlands (4.5%) in 2013.<sup>18</sup> Armenia benefits from preferences offered by the EU under the special incentive arrangement for sustainable

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<sup>16</sup> European Commission (2012).

<sup>17</sup> Schmidt (2011).

<sup>18</sup> Central Intelligence Agency (2015).

development and good governance.<sup>19</sup> As a country, Russia (22.6% of total exports) was the most important export destination. Neighboring Iran (6.5%) and Georgia (5.8%) are also important export markets for Armenia. Armenia's exports to Russia declined in 2014 as the Russian economy fell in recession due to lower oil prices and sanctions. This caused economic growth to slow down in Armenia.

In view of imports, the EU was also the main origin led by Germany (6.3% of total imports) in 2013. As single countries, Russia (24.8%) and China (8.6%) constituted main origins in 2013, followed by Ukraine (5.1%), Turkey (4.7%), and Iran (4.4%).<sup>20</sup>

Given the existence of a large number of Armenians residing outside of the country, mainly in Europe, Russia, the US, and the Middle East, the number of arriving tourists has been on a steady increase, thereby expanding the tourism sector. This trend can help increase the transportation services. As pointed out by Gevorkyan (2014), Armenia's IT and communications services exports have recently been showing strong performance.

Potential benefits from achieving peace with Azerbaijan and Turkey are considered high for Armenia. First, according to Polyakov (2000), Armenia could more than double its total exports if the Turkish and Azerbaijani markets were opened. This would reduce Armenia's persistently high trade deficit substantially and would lead to a 30% GDP increase. Armenia would also generate a strong demand for imports, offering trade opportunities for regional partners. Second, significant savings would result from straightening transport routes and switching to closer supply sources.

## 4.2 Foreign Direct Investment (FDI)

As in Table 1, since 1998, Armenia had experienced remarkable economic growth partly due to the Diaspora-connected FDI inflows. For instance, there has recently been a Diaspora-originated foreign investment from Argentina<sup>21</sup> in managing the construction of a new terminal of Yerevan's

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<sup>19</sup> European Commission (2012).

<sup>20</sup> Central Intelligence Agency (2015).

<sup>21</sup> ArmeniaDiaspora.com estimates that 130,000 Armenian Diaspora live in Argentina.

Zvartnots international airport. In fact, other areas that are main sources of FDI, such as Russia, the EU particularly France, and the US, all host large Armenian immigrant populations.

**Table 1**

Real GDP Growth (Percent)									
1997	1998	1999	2000	2001	2002	2003	2004	2005	
3.4	6.3	3.2	5.9	9.5	14.8	14.1	10.5	14.1	
2006	2007	2008	2009	2010	2011	2012	2013	2014	
13.2	13.7	6.9	-14.2	2.2	4.7	7.1	3.5	3.4	

Source: International Monetary Fund, World Economic Outlook Database, April 2015

Russia (mainly in mining, telecommunications, and energy), France (communications), the Netherlands (energy), and Argentina (air transportation) have been among the important sources of foreign investments. They did not stop investing during 2009 despite the economic crisis in Armenia, according to Ministry of Economy of Armenia (2010).

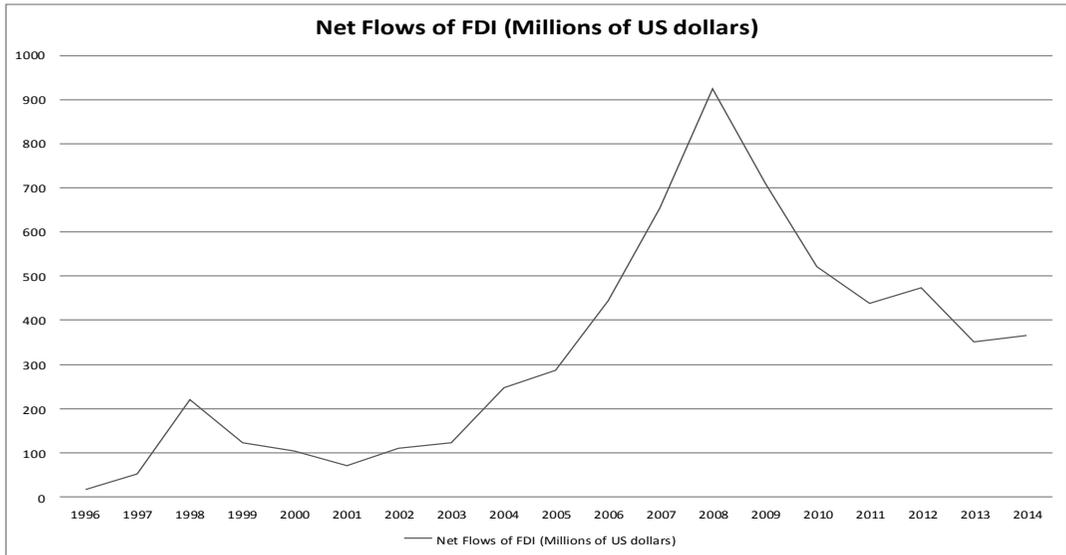
In 2011, net FDI into Armenia declined by 20% to an estimated \$447 million, from \$562 million in 2010 (Figure 1, Figure2).<sup>22</sup> Russia accounted for nearly half all investment. In general, the performance of Armenia in terms of attracting FDI has been rather irregular and lags behind its most comparator countries.<sup>23</sup> Other comparable countries such as Georgia and Kazakhstan show a higher FDI stock.<sup>24</sup> Currently, Russia remains a predominant provider of FDI. Thus, Russia's economic conditions affecting its FDI behavior can then influence the economy of Armenia.

<sup>22</sup> Balance of Payments statistics, National Statistical Service.

<sup>23</sup> Economy and Values Research Center (2010).

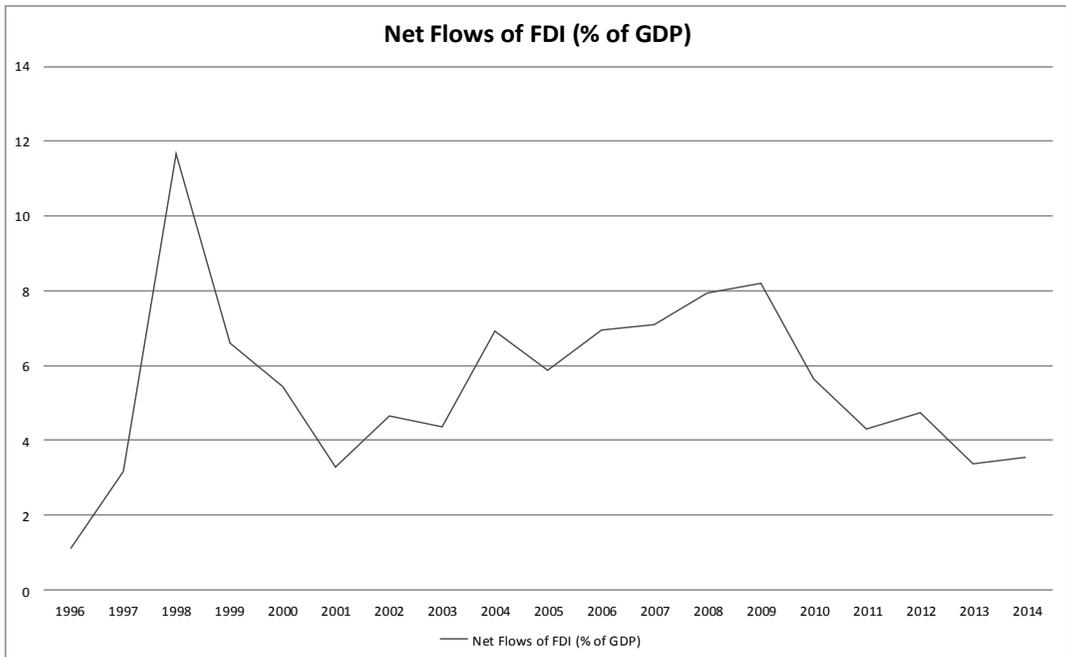
<sup>24</sup> Schmidt (2011).

**Figure 1**



Source: Asian Development Bank

**Figure 2**



Source: Asian Development Bank; International Monetary Fund

### 4.3 Remittances

While the amount of net FDI has declined after peaking in 2008, large remittances sent to Armenia, mainly from Russia and through the banking system in US dollars, have been sustaining growth recently (Figure 3, Figure 4). Remittances to Armenia, however, have been found relatively more volatile compared with remittances to other countries, determined by the evolution of the Russian economy.<sup>25</sup> According to the Asian Development Bank (2014), 80% to 90% of the remittances inflows into Armenia comes from Russia.

In 2014, remittances sent by Armenian workers abroad reached \$2.026 billion<sup>26</sup>, equivalent of 20% of GDP, and most remittances came from Russia. 80% of Armenian migrant workers go to Russia, where 85% work in the construction sector, making remittances to Armenia relatively more unstable compared with those to other countries.<sup>27</sup> Indeed, Armenia is heavily dependent on remittances from Russia, which fell down in 2014 and 2015 due to Russia's recession caused by lower oil prices and sanctions. Similar to the case of declined exports to Russia, this then leads to Armenia's slower growth.

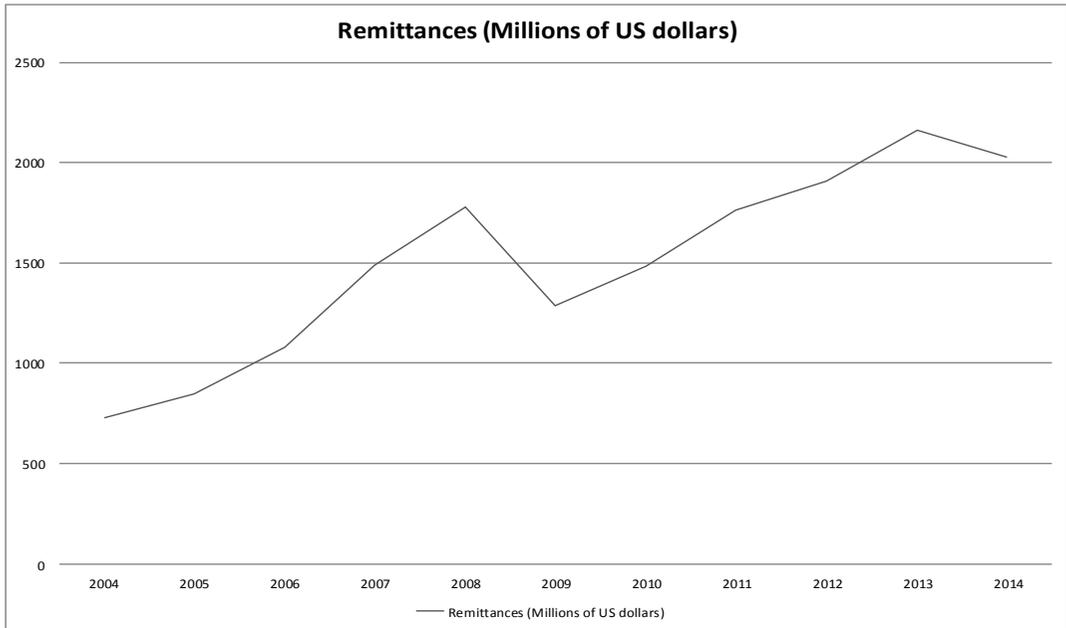
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<sup>25</sup> Ghazaryan and Tolosa (2012).

<sup>26</sup> Central Bank of Armenia.

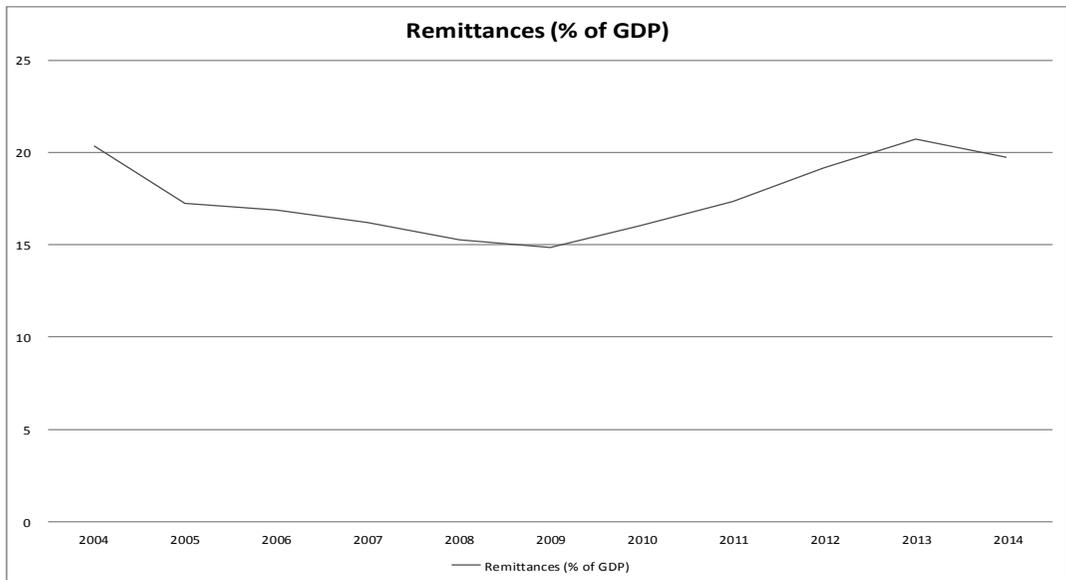
<sup>27</sup> Ghazaryan and Tolosa (2012).

**Figure 3**



Source: Central Bank of Armenia

**Figure 4**



Source: Central Bank of Armenia; International Monetary Fund

## 5 Concluding remarks

Armenia is a small landlocked country with high transportation costs. Enhanced regional integration hence is expected to greatly benefit the Armenian economy in principle, if at the same time the efforts to improve investment climate is continued. Connecting Europe and Asia, Armenia can function as an important land transport gateway.<sup>28</sup> However, Armenia lost chances to be a regional transit hub when regional infrastructure projects were being designed during the 1990s.<sup>29</sup> It is unfortunate that Armenia is not engaged in active trade with neighboring Azerbaijan and Turkey, due to the Nagorno-Karabakh conflict. Unlike Azerbaijan, Armenia is not a member of the Central Asia Regional Economic Cooperation (CAREC). Armenia's exports and FDI suffer from the economic embargo maintained by Turkey and Azerbaijan, in addition to the land-locked location. Transit costs through Georgia are high, due to extra travel distance. Trade with Iran is not large enough.

A political breakthrough would be necessary to strengthen further Armenia's external sector. First, progress needs to be made in the unresolved territorial dispute with Azerbaijan, which turns out to be a real bottleneck for Armenia's regional cooperation and integration going forward. It will probably take time, but in the future Armenia may benefit from joining the regional cooperation efforts between Azerbaijan, Georgia, and Turkey.<sup>30</sup> Turkey has signed FTAs with many countries, yet among the three countries in the South Caucasus, Georgia is the only country that established an FTA with Turkey.<sup>31</sup>

Armenia generally maintains good relations with most countries, is a WTO member country, and is making steady progress in various reforms to improve investment climate in general. As such, solving the long-standing conflict with its immediate neighbors would certainly lead to boosting Armenia's economic perspective by achieving higher levels of trade, investment, and tourism. Armenia can benefit from active trade with its neighbors, the EU, and Russia, among others, while

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<sup>28</sup> Schmidt (2011).

<sup>29</sup> Asian Development Bank (2014).

<sup>30</sup> Guney and Ozdemir (2011).

<sup>31</sup> Görgülü et al (2011).

maintaining business ties with Iran, whose global prospect has been improving. Armenia has a potential in attracting more FDI, which can play a more active role in stimulating and sustaining economic growth, as some other small open economies have done.

Armenia's economic performance depends heavily on the economic conditions of Russia, through the link on trade, FDI, and remittances. It is important to observe carefully how Armenia can benefit from its participation in the EAEU going forward. For Armenia it makes sense to diversify its partners in the external sector in order to reduce risks as it has been experiencing in connection with Russia's recession.

Since the risks from external factors are substantial in Armenia, there are huge gains from working on the challenges originated in regional issues. As the trade and FDI inflows expand, Armenia can start to recover its robust growth pattern observed prior to Armenia's economic crisis in 2009, by realizing its potential supported by otherwise favorable investment climate in general.

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