EXECUTIVE SUMMARY

Competitiveness is a major challenge facing Armenia's decision makers in both the private and public sectors.

Armenia's economic growth rate has been exceptionally high during the last decade. However, it has been largely dependent on external factors (e.g. remittances, assistance from international financial and donor organizations). Attaining higher levels of competitiveness will determine whether Armenia can achieve sustainable and harmonious economic growth beyond that bolstered by remittances, foreign assistance and resource exploitation.

Armenia's current economic situation can be characterized as a "growth-competitiveness paradox".

Armenia records high rates of growth on most macro-economic metrics, but low and lagging competitiveness. In the Global Competitiveness Report 2007-2008, produced by the World Economic Forum, Armenia ranked 93rd out of 131 countries in the Global Competitiveness Index (GCI) and 108th out of 127 countries in Business Competitiveness Index (BCI).

Compared with other economies competing primarily on basic factors, Armenia demonstrated relatively solid performance in the areas of health, primary education, and macro-economic stability; procedures for starting a business; establishment of a flexible labor market; and ensuring security for businesses. However, it trails many peer countries in critical areas such as infrastructure, higher education, financial markets efficiency, technological readiness, level of business sophistication, and innovation factors.

Economic achievements of Armenia relative to comparator countries in CIS, Central and Eastern Europe (CEE) and Eurasian Crossroad regions are moderate.

In this report Armenia's economic performance is measured in comparison with regional peers and comparator countries. The traditional list of countries (CIS and CEE) is complemented by a select list of Middle Eastern and Mediterranean countries we refer to as Eurasian crossroad countries. Beyond historical and cultural connotations this choice is based on the country positioning options proposed in ACR. Ireland has been chosen as a benchmark country.

Prosperity: With CAGR of GDP per capita over 12% in 2000-2006, Armenia outpaced comparator countries except for Azerbaijan (over 16%). However, Armenia trails on other indicators of prosperity measured in absolute terms. Wage levels reached only around 40% of their level in 1990 and real unemployment (over 30%) and poverty (around 26% in 2006) still remain quite high.

Internationalization: Since 2000 Armenia's share of world exports has more than doubled, although in absolute terms it remains very small and is behind most of the CEE, CIS and Eurasian Crossroad countries. It is less than Armenia's GDP share of world GDP, suggesting that Armenia's growth has not been export-driven. Armenia's exports are largely resource intensive. The share of resource intensive exports in Armenia's total merchandise exports was about 64% in 2005 and increased to 69.5% in 2006.

Armenia has demonstrated moderate investment performance during the last decade and competed quite successfully in attracting FDI in infrastructure and resource-intensive industries. In 2003-2007, the CAGR of inward FDI to Armenia was 52.9%, which, however, was driven mainly by reinvestments.

Knowledge creation: R&D and innovation performance of Armenia has been rather disappointing. The link between S&T potential and other sectors of economy and the society has been disrupted, and S&T has not been viewed and/or integrated as an important factor for economic and social development. Public spending on R&D has been negligible.

Productivity: Armenia has a low labor force participation rate (59%) lagging behind most of the comparator countries. This reflects the effects of massive emigration since early 1990s. Labor productivity per employee is significantly lower than that of countries in EE region, but higher than that of Georgia and

Azerbaijan. According to official data the construction is the most productive sector (followed by mining and quarrying), while agriculture is the least one.

Armenia's key disadvantages lie in the microeconomic business environment.

While Armenia's overall macroeconomic environment is stable and relatively advanced, there are serious issues such as inequitable distribution of wealth and income as well as growing disparity between Yerevan and regions.

Since 2001 the Government of Armenia initiated a number of reforms including the consolidation and reduction of business inspections, simplification of administrative procedures, reduction of time for business registration, and streamlining of the licensing regime. This was reflected in comparatively high rankings of Armenia in such reports as Doing Business (39th place) of the World Bank and the Heritage Foundation's Index of Economic Freedom (28th place). However, these efforts proved to be insufficient for improving making the business environment globally competitive, as reflected in the low rankings of the quality of the national business environment in the GCR at 106th place, down by 17 places relative to the previous year.

Some of the bottlenecks in physical infrastructure are low level of telecommunication infrastructure and Internet penetration, while in administrative infrastructure these include poor implementation of laws (104th place in GCR), lack of judicial independence (120th in GCR). Other areas of concern are overall quality of education and S&T infrastructure.

The financial sector plays only a marginal role in financing Armenia's economy. The quality of financial intermediation in Armenia is one of the lowest when compared with comparator countries. The underlying reasons include the structure of GDP skewed toward the informal sector, unofficial tax privileges, uneven distribution of income, low trust towards financial institutions, micro-management of the sector, etc. Interest rate spreads and collateral requirements are the highest among the transition countries.

The quality of the business environment is also negatively affected by the overall unsophisticated demand of the Armenian consumers and lack of strong clusters. Lax corporate governance practices and non-transparent public institutions do not motivate Armenian companies to be more competitive. There are serious distortions in local markets that do not promote fair competition.

Armenian companies lag behind in management of strategy and most functional areas. Unwillingness to delegate authority, employment of mostly non-sophisticated operational processes and technologies, lack of control of international distribution chains, insufficient investments in skills upgrade and HR development are among the key disadvantages of the Armenian companies.

We believe that Armenia has yet to adopt a development-driven policy context.

We describe the evolution of Armenia's public policies as a transition from "survival context" in early 90s to "redistribution context" in late 90s and finally to "social or poverty reduction" context starting from early 2000s up until now. The first phase was characterized by a short-sighted view of policy and a general lack of policy coordination and of an overall strategy toward policy development. The government grew accustomed to governing in "crisis mode", forced to find quick solutions to urgent, short-term problems. The policy then shifted towards more redistributive functions, when one of the main areas of reform was privatization and massive asset reallocation throughout the country. This period is notable for economic stabilization, recovery of energy supply and revival of the economy. The beginning of the millennium was marked by a more comprehensive policy approach, primarily focused on poverty reduction supported by high rates of economic growth. The Poverty Reduction Strategy (PRSP) became an overarching document based upon which the Government developed its policies and programs. It introduced elements of longer-term planning, better coordination of policies and operations, and improved institutional capacities.

In the next stage an economic development-focused strategy should address such issues as Armenia's global value proposition, key drivers of competitiveness, sectoral preferences, etc.

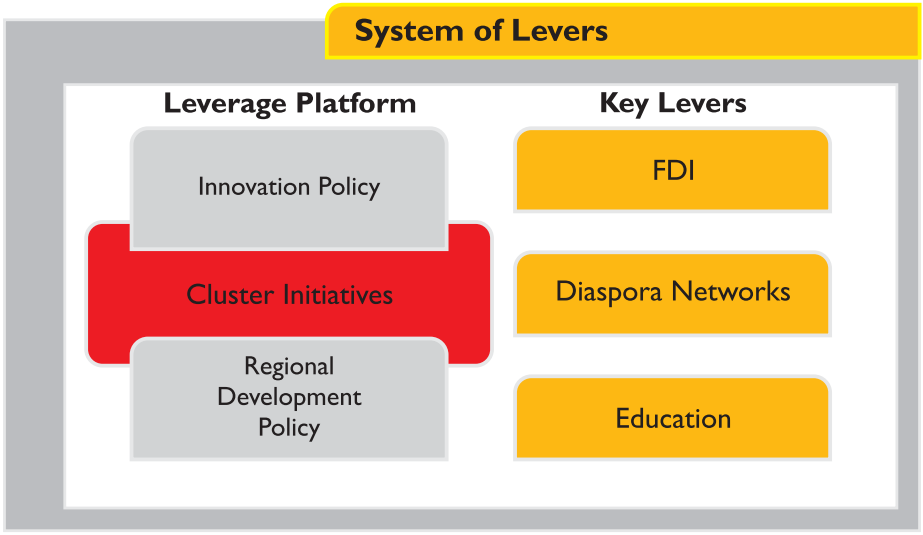
ACR proposes an approach which distinguishes two layers of action, namely "Strategic Breakthrough" and "Quick Wins".

The Quick Wins are targets that are achievable in a short time period, while actions in the Strategic Breakthrough sections define factors that may move Armenia to the next level of competitive position vis-à-vis other countries and direct competitors.

Strategic Breakthrough:

Strategic positioning suggests definition of country's ***value proposition*** that incorporates the specific role the country plays in the world or regional economy. Among many alternatives the ACR suggests the possibility of becoming a regional R&D hub capitalizing on the nurturing of unique human resources. Such positioning will require re-definition of a notion of region as Armenia's perceived positioning arena. Re-defining "competitors" should become a core theme for the country's branding and image building. We introduce the concept of the Eurasian Crossroad, including the South Caucasus, Middle Eastern, and Mediterranean countries, as another attractive platform. The strategic positioning based on the concept of a crossroad will also help overcome the perception of Armenia as a country in a landlocked location without significant natural resources. The region defined in this way provides opportunities for Armenia to capture leading roles in a few selected areas that demand highly developed human capital, access to global networks and a tradition of science and technology.

A system of levers is proposed as an approach to attain strategic breakthrough and create several internationally competitive industries. The system will consists of a leverage platform and key levers as described below:



Cluster-based policies will play a central role in shaping the leverage platform. This will be called the *policy nexus*. The cluster initiatives in potentially internationally competitive clusters will be enhanced by supportive innovation and regional development policies which can be called *policy add-ins*. The combined and integrated application of this platform is intended to create an efficient and conducive context for applying the levers.

Within this policy context three key factors are identified as levers that can be deployed to bring a true breakthrough:

(1) Technological FDI – top priority should be given to attracting selected elements of global value chains of medium and high technology multinationals;

(2) Diaspora networks - an effective partnership arranged as a "hub-and-spoke" model;

(3) Superior education – high standards for basic education and specialization in higher education linked to cluster priorities.

Quick Wins:

A special analytical tool (the "Prioritization Filter") has been developed and applied to identify the following short-term priorities and select the quick wins:

Energizing Financial Sector	1. Easing access to loans and expanding credit activity by banks 2. Reduction of interest rate spread
Improving Selected Elements of Business Environment	3. Raising effectiveness of antitrust policy 4. Improving the effect of taxation (tax incentives, total tax rate, burden of customs procedures, non-wage labor costs) 5. Introducing incentives for FDI in prioritized areas
Promoting Technology Usage	6. Spreading the use of cellular telephones 7. Encouraging use of personal computers 8. Encouraging use of Internet 9. Regulatory framework; encouraging use of ICT 10. Government procurement of technology products

Armenia still has a long way to go to create a highly competitive economy. The next stage requires more focused efforts, greater skills, higher aspirations and visionary leadership.