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on EU-10 and CIS



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The ICEG European Center issues its monthly publication, which includes 2-4 brief analyses on macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Commonwealth of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet *New Member States of the European Union – EU-10* (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

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About us

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ARMENIA'S PATH-DEPENDENCY TO BE CONSIDERED

Olivér Kovács

Since 2009, the nascent innovation policy of Armenia has put more emphasis on cluster-building than ever before. The present article addresses the question whether the Armenian cluster policy misses the importance of path-dependency. We argue that policymakers by no means should artificially urge the development of clusters, however, they should not mitigate their spontaneous development.

A brief overview – The role of cluster policy

While the prevailing view of economics stresses that innovation bears the torch of human well-being and economic development, ignoring the national characteristics, e.g. the fact that regional disparities are much bigger in developing countries relative to the developed countries (Williamson, 1965; Milanovic, 2005)¹, during the preparation and implementation of national innovation policy is impermissible. There are more and more voices advocating the importance of (innovation) clusters in Armenia in the phase of transition from industrial to knowledge society. However, we argue that the socialist path of Armenia is able to vigorously influence the success of innovation policy, and especially that of cluster policy.

Policymakers often envisage cluster policy as a top-down applicable opportunity which will assumingly promote the densification of companies by bringing them together and helping the knowledge transfer among the cluster members. This approach implies that clusters *per se* are able to support the better utilisation of innovation capacity and the transition to R&D&I driven knowledge-based economy. This kind of approach can easily be a *non sequitor*, because the expected benevolent effect of this cluster policy is based on an imperfect cluster definition. Without being exhaustive, the gist of the clusters can be summarized as follows: clusters are spatial densifications of already existing interconnected businesses and associated institutions in a particular field by voluntarily cooperating with each other within a registered cluster organisation. Subsequently, cluster policy has nothing to do with the idea to install high-tech and innovation-driven sectors where the traditional less innovative sectors dominate due to the path-dependency.²

Having a crisis, having a better look at economic activities of Armenia

During 2009 Armenia was undisputedly hit by the global financial meltdown and its spillover effects *via* the global demand shock. The economy was not able to fend off the recession owing to its poor economic diversification and its high external demand dependency (the economy contracted by 15 per cent in 2009). Instead of being comprehensive, we call the attention to the (i) falling oil and metal prices, (ii) decreasing remittances and (iii) moderating FDI inflow as major circumstances whereby Armenia is particularly vulnerable to any external demand shock.

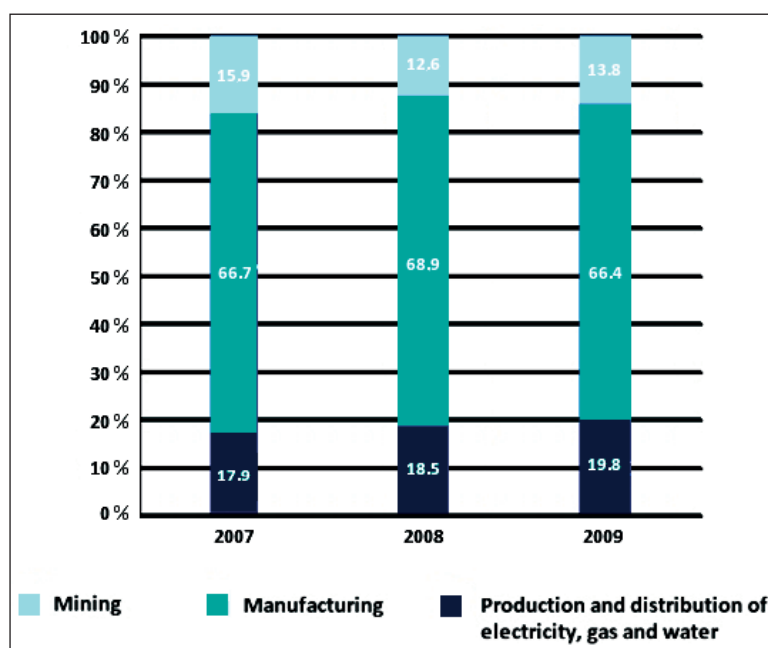
¹It goes without saying that the global poverty rate is rising, on the contrary, according to Pinkovskiy and Sala-i-Martin (2009) it is decreasing over time. That article argues that the poverty ratio (whose daily income merely amounts to \$ 1) has been declining since 1970s by approximately 80%.

²The reason behind this is the necessity of relatively intensive competition between already existing firms in particular fields of industry. The competition can flash the idea for firms to cooperate and reinforce efforts so that they will be able to maintain or boost their competitiveness.

Armenia's economy mostly relies on its export sector, remittances and foreign direct investments. Despite the fact that Armenia has been making lots of big strides in order to become a much more diversified economy through reforms, privatisation. The economic activity is still predominantly concentrated in the traditional sectors. In terms of employment agriculture and forestry represent 46.2%, industry and construction 15.6%, and services 38.2%.

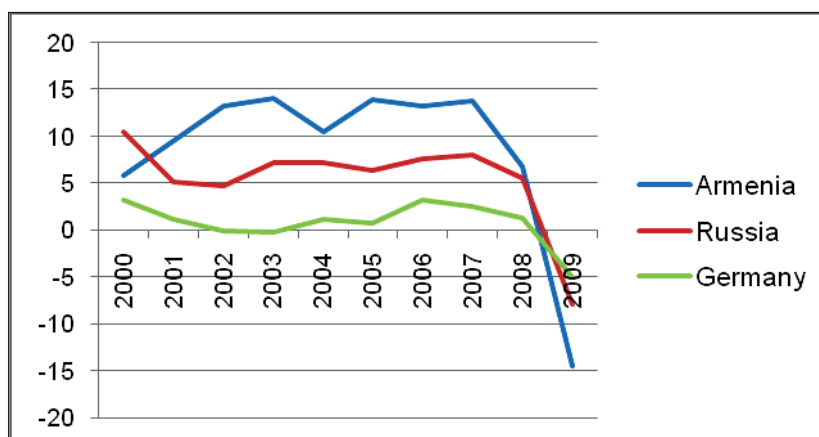
Regarding the export structure, Armenia has a much centralised one; the major share of its exports comprises the following traditional Armenian commodities: copper, metals and energy. This *per se* in a certain extent confirms our belief that the traditional economic activities (such as mining, manufacturing, construction, production and distribution of electricity, gas and water) are dominating the economy (*Chart 1*), which informs us about an inertia which should be incorporated by cluster policy.

CHART 1. DISTRIBUTION OF TRADITIONAL SECTORS IN ARMENIA



Source: National Statistical Service of RA (NSSRA, 2010)

Let us add immediately that the main partner countries of the resource-intensive exports are: Germany (16.47%) and Russia (15.45%). In hindsight, it is more than obvious that hardly the export partner's economic conditions had negatively affected by the crisis, erupted in the third quarter of 2007 and culminated in the first quarter of 2009, when Armenia's economic growth started to decline as well (*Chart 2*).

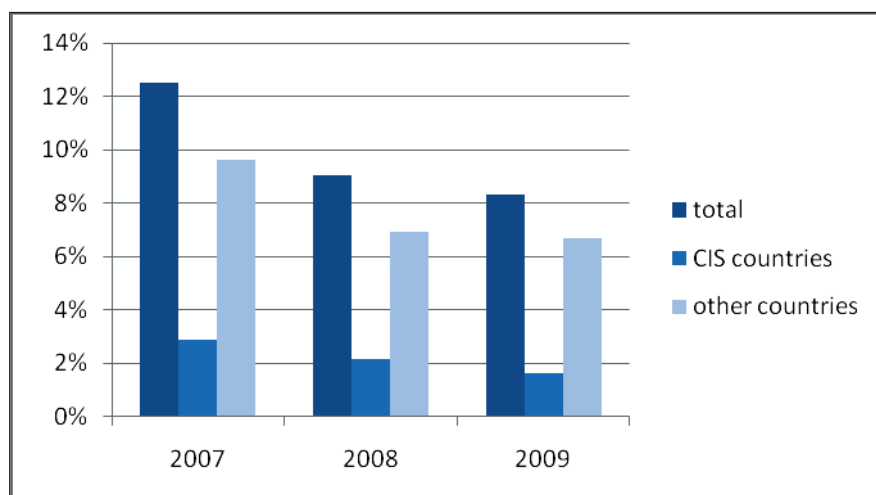
CHART 2. REAL ECONOMIC GROWTH IN THE MAJOR EXPORT COUNTRIES

Source: IMF (2010)

The survival of the previously mentioned traditional sectors can be partly rooted in a governmental decision. After the collapse of the Soviet Union, lots of traditional and already existed activities were placed under the authority of the Ministry of Industry. This contributed to the emergence of the vulnerability of the Armenian economy implying that the majority of the still existing sectors are less innovative (construction, basic chemicals, mining, etc.). As the global demand worsened, the exports, remittances and FDI started to decline. As a corollary of the deteriorating demand, oil and metal prices were depressed significantly (oil prices fell from the height of \$150/bbl to around \$35/bbl by February 2009) (Chart 3).

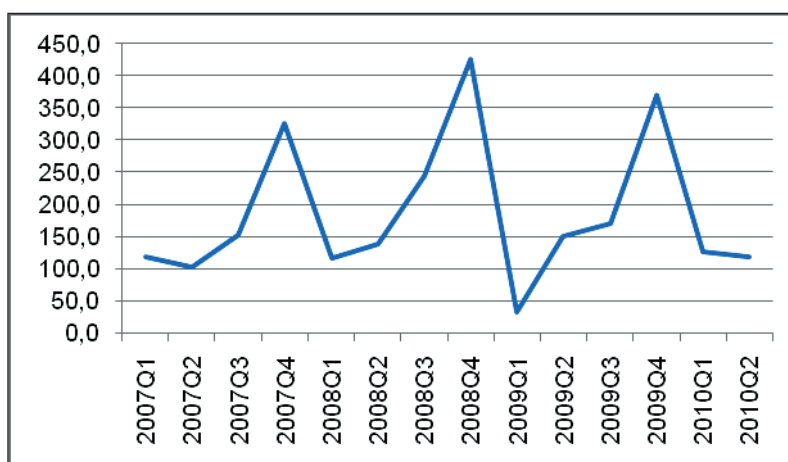
CHART 3. DEVELOPMENT OF COPPER PRICES (US\$/TONNE)

Source: London Metal Exchange (LME Copper)

CHART 4. DEVELOPMENT OF THE EXPORT (% OF GDP)

Source: Data source is the National Statistical Service of RA (NSSRA, 2010).

As it is discernible on Chart 4, exports experienced a shrinkage in the proportion of GDP as a result of the decline in global demand. Additionally, the dynamics of remittances and FDI also underwent a huge shrivelling. As for remittances, we can claim with reasonable certainty that while the country and its households are in a certain way beneficiaries of this type of inflow, including compensation of employees and migrants transfers, the dependency from remittances³ could have a detrimental effect on the economy especially in time of crisis as it was observable in the case of Armenia.⁴ Non-commercial money transfers declined by more than 40% by 2009 compared to the previous year (CBA, 2010).

CHART 5. DEVELOPMENT OF FDI IN ARMENIA (MILLIONS OF DOLLARS)

Source: Data source is the National Statistical Service of RA (NSSRA, 2010).

³Non-commercial money transfers include non-repayable transfers of individuals which are used for current needs as well as salary sent to and received from abroad.

⁴According to Rosstat (2010), the Russian economy showed a slow, but significant growth rate after the first quarter of 2010. In parallel, Armenia's economic growth was revived and grew by 2.4% in January-October 2010 (NSSRA, 2010). Importantly, the trajectory of FDI and remittances also illustrated a relative improvement conveying us the message that the Armenian economy is more or less moving together with the main export partners, like Russia.

CONCLUSION

All in all, these processes are able to bring caveats into the heady optimism impregnating the cluster policy. Consequently, assuming that cluster policy will enable the evolvement of the aimed knowledge- and innovation based economy would be *naïveté*. The survival of traditional resource-based and less innovative sectors calls the attention to the importance of appropriate interpretation of cluster policy. Without this kind of reconsideration, cluster policy is more likely to neglect the path-dependency of Armenian activities.

Therefore, we can claim with reasonable diligence that there will be uncertainty over the effectiveness of such cluster policy which would concentrate on new economic fields rather than provide better framework for already existing businesses and associated institutions.

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RECOVERING FROM THE FINANCIAL CRISIS: ACHIEVEMENTS AND CHALLENGES FOR GEORGIA

Liliya Levandovska

Georgia, a small Caucasus country emerged as an independent state after the dissolution of the Soviet Union in 1991. Like many other post-Soviet states over the following decade, Georgia faced political crisis, economic breakdown, corruption growth, severe civil and even military conflicts. However, at the beginning of the 21st century the country managed to implement rather successful reforms which may serve as an example for the young states in the region, regardless the current existence of frozen conflicts on its territory.

On the way to wider European community

The landmark change took place after the Rose revolution in 2003 when the new government declared its aspiration to follow the new way to wider European community. Some economic reforms and changes of geopolitical strategy applied in Georgia were criticised by opposition and even by some of its neighbours; nevertheless, by 2010 international experts have noted positive changes, while the citizens confirm the improvement of living standards.

It should be mentioned that, as in the case with all developing democracies, a lot of reformist steps in the economic sphere were taken in close connection with political reasoning; that is why current opposition blames the government for pursuing populist policy. At the same time the overall analysis of the implemented reforms shows that the country is on the right track. Due to the fundamental changes in the sphere of police, judiciary, public administration, privatization of state property (on the basis of transparent tenders with the aim to benefit to the better management of strategic enterprises), customs services and tax administration the country managed to decrease the level of corruption and red tape and attract foreign investors as a result.

The outdated patterns for local administration, customs and tax reporting, corrupt and inefficient procedures of obtaining certificates for starting a business, registering real estate, land share and vehicles were reduced to modern systems of registration (it is noteworthy that almost all CIS countries still apply lengthy and complicated procedures).

As a result Georgia currently occupies 12th position out of 183 countries in the Doing Business 2011 ranking compiled by the World Bank⁵ and 26th position out of 179 countries in the Index of Economic Freedom world ranking for 2010 provided by the World Heritage Foundation and the Wall Street Journal⁶. Apart from being labelled as “mostly free” economy for the first time, Georgian investment campaigns turn attention to the evaluations by international experts emphasising the improvement of trade, fiscal and labour freedom, property rights protection and most notably, combating corruption.

Georgia is member of the United Nations, the Council of Europe, the World Trade Organisation, the Organisation of the Black Sea Economic Cooperation, the Organisation for Security and Cooperation in Europe, the Community of Democratic Choice, the GUAM Organisation for Democracy and Economic Development (it emerged as a rather successful alternative response

⁵ <http://www.doingbusiness.org/Rankings>

⁶ <http://www.heritage.org/index/Ranking.aspx>

to CIS, though due to changes of geopolitical directions of some of the participating states the organisation has not been active lately), and the Asian Development Bank. Since 2003 the country continuously declares its aspirations to join the EU and NATO and is an active participant of EU Eastern Partnership initiative aimed at bringing participating countries closer to the European standards of democracy, market economy and freedom.

The declaration of European aspirations by Tbilisi and the sound national promotion campaign aimed at raising awareness about the country abroad attracted more tourists and investors, as well as greater eagerness of Western institutions (World Bank and IMF) to help the country by granting credits. “Impressive progress toward greater economic freedom” is noticed by the Economic Freedom Score analysis⁷ which is attested by increased trade with Western partners, in particular imports of famous Georgian wine and mineral water, greater FDI and labour flows. As of 2009-2010 the share of investments made by EU Member States into Georgia equalled to about 50% (UK, the Netherlands and the Czech Republic being the major investors); USA, Japan, Turkey and Egypt are actively participating in investment projects in Georgia.

The most important recent progress was made on November 20th 2010 when the European Commission officially invited Georgia to apply for membership in the European Energy Community. Cooperation on such level should advance negotiations on association and free trade zone between Georgia and EU.

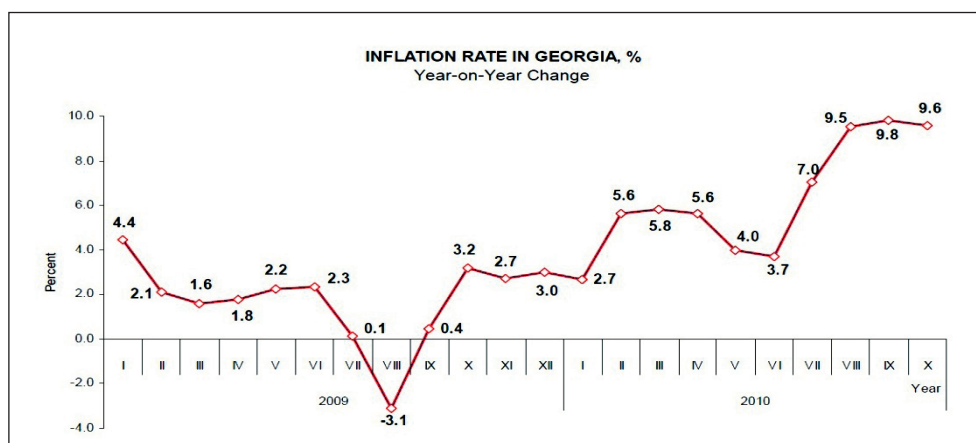
The decision of NATO Lisbon Summit on November 21st 2010 promising NATO membership for Georgia will also serve as a sign of the country's stability and potential for future investments projects.

Current macroeconomic indicators

After the dissolution of the USSR this small country had to look for new ways of economic growth. Georgia is a mountainous country with the advantage of having access to the sea, consequently, major activities contributing to the economic growth traditionally were agriculture, trade and tourism, with the latter increasing its share in state economic structure over recent years, promoting the growth of services sector as well. It is important to mention that due to its strategic location Georgia makes efficient use of oil and gas transit routes as well as international trade.

Analysing changes in the trade structure in Georgia we can say that trade turnover increased by 14.7% during the first quarter of 2010 with the negative proportion for Georgian exports. The main trade partners during the first half of 2010 were Ukraine, Turkey and Azerbaijan. It is worth mentioning that the share of famous Georgian alcoholic drinks in exports equals to 3.7% in 2010 comparing to 6.2% in 2009, thus experts admit that Georgia is not making effective use of its export potential. As of 2010 agriculture still plays one of the most important roles in Georgian economy equalling to 13% of GDP structure even though state financing for agriculture was decreased by 2.5 times. The leading industries in Georgia are the following: product manufacturing (wines, alcoholic drinks, mineral water, dairy, sugar, tea, etc.), metallurgy, chemistry production, machine construction as well as recycling industry.

⁷ <http://www.heritage.org/index/Country/Georgia>

CHART 1. YEAR-ON-YEAR CHANGE IN INFLATION RATE IN GEORGIA (%)

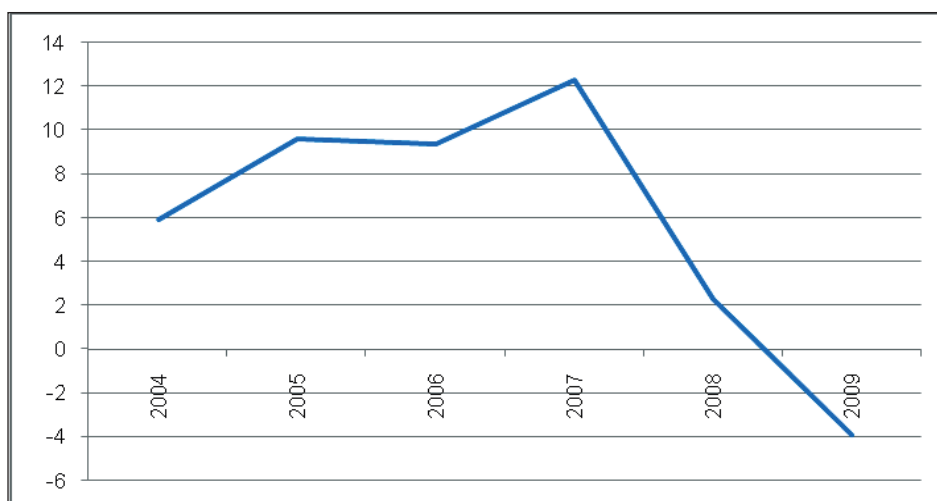
Source: Georgian National Office of Statistics.

TABLE 1. EMPLOYMENT AND UNEMPLOYMENT

	2004	2005	2006	2007	2008	2009
Active population (labour force) thousand persons	2041	2023.9	2021.8	1965.3	1917.8	1991.8
Employed, thousand persons	1783.3	1744.6	1747.3	1704.3	1601.9	1651.1
Unemployed, thousand persons	257.6	279.3	274.5	261	315.8	335.6
Unemployment rate, percentage	12.6	13.8	13.6	13.3	16.5	16.9

Source: Georgian National Office of Statistics.

The major criticism from the opposition relates to the fact that inflation and the level of unemployment are rather high (up to 10% (Chart 1) and 16.9 % respectively (Table 1)), GDP growth is still slow (though it reached 4.5% in 2010) (Table 2). The decrease of wages by 10,3% at the beginning of 2010 is one of the biggest economic concerns in Georgia.

TABLE 2. DEVELOPMENT OF GROSS DOMESTIC PRODUCT

Note: The 2010 real GDP growth rate were 4.5% and 8.4% in the Q1 and Q2, respectively.

Source: Georgian National Office of Statistics.

In summer 2010 a considerable price increase in terms of groceries was noticed in Georgia. Georgian officials explained it as the outcome of Russian ban on wheat exports. As 60-80% of Georgian wheat market was supplied from Russia, bread prices rapidly went up by 20% in Georgia and the country had to diversify its sources of wheat supply. Thus Ukraine became the major wheat supplier for Georgia, though the wheat was sold at the market prices which were 50% higher than Georgian estimates.

Economic successes and failures

2003 marked a new political and economic era for Georgia. The country declared its course towards NATO and EU integration which considerably worsened its relations with its neighbour and former major economic partner – the Russian Federation.

Aggressive economic sanctions on behalf of Russia taken together with the military conflict of 2008 showed that Georgia has to reconsider its trade structure and geopolitical strategy. The complicated relations with Russia contributed to the decision taken by the Georgian government to withdraw from the Commonwealth of Independent States in 2006 and to official withdrawal in 2009, though the country still participates in 75 bilateral agreements which are of direct economic benefit for the country. New legislation adopted in Georgia gives way to long-term economic reforms, as well.

The construction of gas and oil pipelines (South Caucasus and BTC pipelines) which will not include Russia means the most significant projects for the Georgian economy that will reduce its dependence on overpriced gas and oil supplies from Russia. More recently, state energy companies of Georgia, Azerbaijan and Romania started intercontinental project AGRI aimed at transporting gas from Azerbaijan via the pipeline towards a Georgian port from where it will be transported in tankers to Romania via the Black Sea and further will flow to the European market through the pipelines of Romania into Hungary (the latter also expressed its interest in the project).

Nevertheless, Georgia still has many issues to tackle. The majority of existing economic problems is directly intervened with complications in terms of bilateral relations with the Russian Federation. Even if we keep political factors aside (recognition of Georgian autonomous regions, Abkhazia and South Ossetia as independent countries by Russian officials, military conflict in 2008, visa regime for Georgian citizens), ambiguous economic disputes will still be left: the 2006 ban on imports of Georgian wine, unjustified increase of gas prices on behalf of Russia as well as recent Russian refusal to export wheat to Georgia significantly affected the Georgian economy. That is why recent refusals of Georgian officials to support Russian membership in WTO can be seen as a response in terms of long-term disputes between the countries.

The world financial crisis as well as the military conflict with Russia had negative effects on Georgian economy (important investment projects were postponed, namely in the sphere of transportation and construction; tourism and the banking system suffered great losses) but already in 2010 positive dynamics has been noticed as Georgian economy managed to preserve stability. USD 4.5 billion foreign help (out of which 2 billion were given as grant), the stability of national currency as well as the lessening of the impact of the National Bank on the banking and financial system contributed to the general incentives of the state to preserve economic growth and reform the instruments of fiscal control and management.

These incentives resulted in the state programmes “Georgia without poverty” aimed at the creation of additional working places and raising investment attractiveness of the country.

Nonetheless, Georgian labour is currently considered to be cheap, even though recent decrees on introducing English as the second language instead of Russian within the Georgian educational system are aimed at increasing the competitiveness of Georgian labour abroad. It should be mentioned that according to recent news reports many Georgian labour migrants who were staying in Greece are considering return to their homeland due to economic hardships there. Such development may increase the number of unemployed, as unofficial statistics speak about 150 thousand Georgian migrants who might return.

Georgian reforms as a model to follow?

Tbilisi was determined in implementing reforms which for most CIS countries may seem premature. The new taxation law may serve as one of the most disputed examples. On the one hand, the “flat income tax” introduced by the Saakashvili administration in 2004 as well as the elimination of numerous tariffs in customs control significantly improved conditions for entrepreneurship and trade; on the other hand, recent initiatives to introduce new taxes faced strong protests on behalf of various institutions. For instance, a new taxation scheme is planned to be introduced in 2011 for private universities, sport schools and musical schools. As it will increase the price for education for many citizens of Georgia, the government considers cancelling the proposed tax option. A possible tax on import for medical equipment is also largely criticised. Initiatives to tax cellular phone calls are discussed in the Ministry of Finance, as such a taxation principle may raise fees for cellular connection. The draft taxation law also introduces higher taxes for medium enterprises, owners of real estate and alcohol beverages producers (excluding wine makers). Some of these provisions do not reflect promises previously made by President Saakashvili to decrease the tax burden for entrepreneurs and that is why the public debate concerning new taxation is still ongoing.

On the other hand, reforms in the sphere of customs control, tax declaration and liberalised tax sanctions⁸ improved the economic climate in the country. Due to the successful implementation of the reforms initiated in 2006 (comprehensible tariffs and taxes, possibility of electronic registration, decrease in the number of administrative authorities) corruption was minimised. These changes serve as a model for other post-Soviet states, even though the President was criticised for appointing inexperienced young staff (for example, the 28-year old minister of economy) for high level state positions. Nevertheless, the presidential pattern of restructuring public authorities with the help of young managers free from the Soviet way of thinking and bearing innovative ideas served the purpose of breaking the tradition of Soviet style administration and fighting long-established corruption schemes.

⁸ When diligent tax payers will not have to pay huge fines, if once they “forget” to report their taxes in time, tax controllers would be able to give them more time to prepare tax report; besides, tax fines were decreased.