Along with its geopolitical importance, the Second Karabakh War, which ended the Armenia–Azerbaijan conflict, also has serious economic implications for the region’s countries, including Armenia. Hence, the main goal of this article is to elucidate the economic implications of the Second Karabakh War for Armenia. For this purpose, the article analyses the scale of the economic damage that the war inflicted on Armenia by describing the country’s military losses and loss of access to the energy and agricultural resources of the [formerly occupied] Karabakh region of Azerbaijan. The article also examines the impact of the war on the financial sector and the macroeconomic environment of Armenia. Moreover, in addition to the negative economic implications of the war, the article explains the newly created economic development and cooperation opportunities for the country. The article concludes that the Second Karabakh War has substantially affected the economy of Armenia, especially in the military, energy, and agricultural sectors, and also created new cooperation and development opportunities.

**Keywords:** Second Karabakh War, Armenian economy, economic and military losses of Armenia

*Orkhan Baghirov* is a Leading Advisor in the Center of Analysis of International Relations based in Baku, Azerbaijan.
Introduction

The Second Karabakh War ended the three-decade-old Armenia–Azerbaijan conflict, which has had a great impact on the formation of a new geopolitical and geo-economic situation in the South Caucasus. This conflict started in the early 1990s with the illegal territorial claims of Armenia against Azerbaijan that eventually led to the First Karabakh War (1988–94). As a result of that war, Armenia occupied about 20% of the internationally recognized territories of Azerbaijan, thereby creating a substantial humanitarian and social crisis. Along with political and social problems, the occupation had significant economic implications for the region’s countries, including for Armenia. Following the occupation, Azerbaijan and Turkey closed their borders and suspended economic ties with Armenia. As a result, Armenia lost its chance to get access to Turkey’s large market and the energy resources of Azerbaijan. Therefore, by occupying the territories of Azerbaijan, Armenia fell into an economic blockade, depriving it of the benefits of sustainable trade relations with its neighbours and preventing the country from joining regional energy and transportation projects. Because of the negative economic implications of the occupation, Armenia faced severe migration and poverty problems: about 30% of its population emigrated to other countries, and it became one of the poorest countries in the world.

Despite the serious economic implications of the occupation, Armenia was not inclined to give up its policy of occupation and prolonged that occupation by feigning peace negotiations. This attitude of the Armenian side, as well as the provocations of the Armenian army on the [former] line of contact, compelled Azerbaijan to end the occupation through military means, starting with a counteroffensive operation on 27 September 2020 and becoming known as the Second Karabakh War, which resulted in the restoration of the territorial integrity of Azerbaijan. During the war, the Armenian army experienced heavy losses of its military equipment and combat potential. Meanwhile, Armenia was also deprived from agricultural and energy resources in the Karabakh region, which it had illegally exploited during the period of occupation to meet the food and electricity demands.
of its population. These losses put significant pressure on the economy and the financial sector of Armenia.

However, as the Second Karabakh War ended the Armenia–Azerbaijan conflict, it also created development opportunities for Armenia in the form of ending its economic blockade and developing economic and transport relations with its neighbours. The trilateral statement signed on 10 November 2020 between the Presidents of Azerbaijan and the Russian Federation, and the Prime Minister of Armenia envisaged not only the cessation of military operations, but also the restoration of communication links and economic relations in the region and establishment of the Zangazur Corridor through Armenia to Azerbaijan’s exclave of Nakhchivan. By using the Zangazur Corridor, Armenia will be able to get direct land access to its main economic partners, including Russia.

All these factors show that the Second Karabakh War has significant economic implications for Armenia that will play an important role in the formation of its economic policy in the coming years. Therefore, the main goal of this article is to determine the level of economic damage of the war for the military, agricultural, and energy sectors of Armenia, and quantify the new cooperation opportunities. For this purpose, the first section of the article analyses the economic losses of Armenia in Second Karabakh War, including the military losses and lost resources in the agricultural and energy sectors. The second part of the article describes the impact of the war on the Armenian economy, particularly its financial sector and macroeconomic environment. The last section of the article analyses the newly formed economic opportunities in the post-war period.

**Economic losses of Armenia in the Second Karabakh War**

Because of the heavy defeat in the Second Karabakh War, Armenia’s army faced significant military losses. According to a minimal scenario assessment, the value of Armenia’s military equipment that was destroyed or taken as trophies by the armed forces of Azerbaijan
during the war amounts to $3.8 billion.\(^1\) That equipment includes 5 Su-25 aircraft, 366 tanks, 97 Grad installations, 50 anti-aircraft missile systems, 22 unmanned aerial vehicles, 352 guns of various calibres, 4 Smerch installations, 2 Uragan installations, 1 TOS flamethrower, and 1 each of MLRS and Tochka-U ballistic missiles, and an Elbrus missile complex. The most expensive equipment that Armenia’s army lost was the S-300 air-defence missile system. During the war, Armenia lost about 10 S-300 installations and their various tactical combat vehicles, after which the Azerbaijan army destroyed radar stations, weapons depots, and other equipment that played a major role in the provision of Armenia’s defence capabilities.

In order to see the scale of the devastation that Armenia’s army faced during the war, it is necessary to compare its losses to Armenian military expenditure in recent years. If we look at the annual military expenditure in the last decade, we can see that it had an increasing trend, reaching $635 million in 2020.\(^2\) The most significant increase in annual military expenditure was experienced after 2017. The annual increase in military expenditures was about $92 million between 2012 and 2017, but approximately $171 million between 2017 and 2020. For a small country such as Armenia with limited financial resources, such military expenditure is a significant financial burden. The annual military expenditure of Armenia constitutes about 4% of its Gross Domestic Product (GDP) (2019), which is higher than the ratios of countries such as the USA and Russia.\(^3\)

If we look at the last ten years, the total annual military expenditure of Armenia was about $5.16 billion.\(^4\) Taking into account the value of Armenia’s military equipment that was destroyed or taken as trophies in the war, about $3.8 billion, the value of that equipment constitutes more than 73% of the total military spending in the most recent ten years. This shows that, during

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4. Ibid.
the Second Karabakh War, Armenia was deprived of the major part of its military capabilities formed over a period of ten years. Along with military equipment, Armenia lost more than 3,600 military personnel\textsuperscript{5} in the war. These losses show how calamitous the war was for Armenia. Therefore, it will take many years and huge financial resources to restore the army. This, in turn, will put pressure on the economy of Armenia, worsening the socio-economic situation in the country.

All these losses indicate that the war will have serious economic implications for Armenia in the near future. In order to recover the combat potential of its army, it needs to allocate a significant part of its financial resources for military purposes. Even before the war Armenia was spending a large amount of national funds on its army. Now, it needs to continue a high level of financing of the army in order to restore it. We could expect that, after the recovery of its military capability, Armenia could decrease its military expenditure. However, as the army experienced a devastating defeat, it will take many years to restore it.

As a result of the war, Armenia also lost significant agricultural resources in the territories of Azerbaijan. These lands are fertile and suitable for the cultivation of fruits, vegetables, grain crops, and other agricultural products. During the occupation, Armenia illegally exploited these resources, notably grain products, for meeting the food requirements of its population. When Azerbaijan liberated the [formerly] occupied territories, Armenia lost access to those resources, which created a deficiency of agricultural products.

In the Second Karabakh War, Azerbaijan liberated more than 90,000 hectares of arable land, which were mostly used for grain production and constituted about 90\% of the arable land that was under the control of Armenia in the Karabakh region.\textsuperscript{6} There, 150,000 tonnes of various grain crops were produced annually and 100,000 tonnes (66\%) of those crops were exported to Armenia. As the total demand for grain products in Armenia is approximately 450,000 tonnes, the grain products that

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were imported from the [formerly occupied] Karabakh region provided about 22% of Armenia’s total demand. This shows that the Second Karabakh War significantly affected the agricultural sector and food security of Armenia and, in order to meet the internal demand for grain products, Armenia has to increase the volume of imports of those products. Increasing imports means that the price of products made from grain crops will increase, thereby negatively affecting the social situation in Armenia.

During the occupation, Armenia also intensively exploited the energy resources in the Karabakh region. Huge water resources enabled Armenia to build many hydroelectric power stations in the Karabakh region to meet the energy demands of Armenians living in the [formerly] occupied territories and for export to Armenia. In recent years, the electricity exported from the [formerly] occupied territories to Armenia constituted about 7% of Armenia’s electricity supply. However, after the war, Azerbaijan regained control of more than 30 hydroelectric power stations [out of 36] in the Karabakh region that were used by Armenia. As a result, Armenia lost about 60% of the electricity production capacity in the previously occupied territories of Azerbaijan.

Hydroelectric power stations in the Karabakh region had a special importance for Armenia as they provided a renewable energy source that was not dependent on gas prices.

Now, in order to compensate for the electricity shortage, the Armenian government has had to increase the share of thermal power plants, from which the production of electricity is more expensive. Alternatively, electricity can be imported from other countries. In either case, the more expensive source of electricity will lead to increases in electricity prices for households. High electricity prices will, in turn, increase the social problems in the country. It is no coincidence that electricity prices for households in Armenia have already changed. Starting from 1 February 2021, daytime electricity tariffs increased by 6.2% and night-time tariffs by about 7.9%. We could expect further electricity price increases in Armenia in the coming years.

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8 Ibid.
The impact of the war on the Armenian economy

The Second Karabakh War also had a significant impact on the financial sector and macroeconomic environment of Armenia, which will shape the economic policy of Armenia in the future. Because of the heavy losses during the war, in October 2020, Armenia had to make amendments to the Law on the 2020 State Budget. According to those amendments the budget expenditures increased by about $80 million. This was the second such amendment to the state budget as, in April of 2020 and because of the negative economic implications of the COVID-19 pandemic, the Armenian government had introduced an earlier amendment. After these changes, the budget expenditures of Armenia reached $3.4 billion, which was about 27% of GDP. Owing to economic problems, the Armenian government was increasing the budget, but, at the same time, tax revenues were reduced because of the low economic activity during the pandemic and the war. This process led to about a three-times increase in the budget deficit compared with initial budget projections. After the first amendments, the budget deficit increased two times, reaching the $663 million, or 5% of GDP. After the second amendments, up to the end of 2020, the budget deficit in Armenia reached $960 million, or 7.4% of GDP. The sizable increase of the budget deficit brings into question the financial security of the country.

It is clear that, compared with the military losses of Armenia in the war, the increased value of budget expenditures is too low. However, Armenia did not have the additional financial capabilities to substantially increase budget expenditures and its sources of revenue generation are limited. As the dependence of the Armenian economy on foreign debt is high, it could not allow the budget deficit to increase too much. Otherwise, it would need to attract additional foreign debt for financing the budget deficit which was already at a high level and had been swiftly increasing in recent years. Even the small increases in the state budget have significantly affected the level of public debt of Armenia. According to information from Armenia’s Finance Ministry, total public debt increased by about $647 million in 2020 and reached almost $8 billion. This means that, compared with the previous year,

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the public debt of Armenia increased about 12% in 2020. About 94% of that total public debt was owed by the government. The Armenian government’s external debt at the end of 2020 was about $5.6 billion, but increased about $300 million during the year. This shows that even small changes in budget expenditures necessitate the Armenian government to noticeably increase its public debt.

High public debt, in turn, caused the financial situation in Armenia to deteriorate, thus threatening the economic security of the country. Because of the high level of public debt, the debt-to-GDP ratio, one of the main indicators reflecting the level of financial security of any country, reached a dangerous level. According to a recent report by the Fitch Ratings Agency on the economy of Armenia, by the end of 2020, Armenia’s ratio of public debt to GDP had reached 67.3% as a result of the pandemic and war.\(^\text{11}\) The report further indicated that the debt-to-GDP ratio will increase to 67.6% by the end of 2021. After that, it will gradually decrease to 63.5% by the end of 2025, and, as a result of the implementation of the planned strict fiscal policy for the medium term, it will be possible to reduce this figure to 60% in 2026. However, it will not be easy to implement the strict financial policy and reduce the public debt any faster, as the economic shocks that Armenia faced in 2020 will require the allocation of budgetary funds to support the economy in the coming years. Moreover, the fact that 77% of public debt is foreign debt increases the risk of depreciation of the national currency, thus putting more pressure on the financial sector.

The war also had a significant impact on the exchange rate of the national currency and the inflation level in Armenia. The depreciation of Armenia’s national currency, the dram, started in early 2020 because of the pandemic-related economic situation. During the war, as of September, the depreciation of the dram began to accelerate and continued to do so after the war. Between September 2020 and April 2021, the Armenian dram depreciated by about 9% against the US dollar.\(^\text{12}\) Depreciation of the national currency, in turn, increased the prices of imported goods, negatively affecting the purchasing power

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Armenian citizens and creating an inflationary environment.

Along with currency depreciation, other economic problems have also affected the level of inflation in Armenia. Especially after the war, when the real economic impact of the conflict began to be felt, the inflation level began to increase. Despite fact that the annual inflation level in 2020 was low (about 1.2%), it increased more than 5 times and reached 6.2% in the first four months of 2021, which is greater than the 4% maximum target of the Central Bank. The highest inflation rate recorded was in food products. Between January and April of 2021, the average increase in the prices of food products was about 8.3%. Drastic increases were recorded in the prices of predominantly imported staple foodstuffs such as cooking oil and sugar. Their prices were up by more than 40% in April 2021 compared with the same month in 2020. In the same period, the prices of bread, vegetables, and fruits rose by more than 8%. In order to curb the further depreciation of the currency and the increasing rate of inflation, the Central Bank of Armenia increased the refinancing rate from 5.5 to 6%. This is the third rate hike since September 2020, when it stood at 4.25%. It was raised by about 1% and set at 5.25% in December 2020 and was increased to 5.5% in February 2021. Despite the efforts of the Central Bank, changes in the refinancing rate were unable to substantially prevent price hikes of products in Armenia.

**New economic opportunities in the post-war period**

Despite the economic losses, as a result of war Armenia will also gain opportunities to join regional cooperation frameworks and solve some of its deeply rooted economic problems. The trilateral statement signed between the Presidents of Azerbaijan and the Russian Federation, and the Prime Minister of Armenia on 10 November not only acted to end military operations, but

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also proposed the restoration of economic and transportation links between the region’s countries. According to the Provision 9 of the statement, all economic and transport links in the region shall be restored, and the Republic of Armenia guarantees the safety of transport links between the western regions of the Republic of Azerbaijan and the Nakhchivan Autonomous Republic (Azerbaijan) in order to facilitate unhindered movement of citizens, vehicles, and goods in both directions. This provision of the statement creates great opportunities for all regional countries, including Armenia. Despite the previous development of economic relations among the countries of the South Caucasus region and the implementation of several important energy and transport projects, there were some unexploited cooperation opportunities. Now, these opportunities will be realized, to the benefit of the region’s countries.

The restoration of economic and transportation links in the region will bring several important economic benefits for Armenia. As about 80% of Armenia’s international borders were closed because of its occupation policy during the last three decades, the country was subject to an economic blockade. Now, with the restoration of regional communications, Armenia will be able to free itself from that blockade and join regional projects. The creation of the Zangazur Corridor, which will connect the main territories of Azerbaijan with Nakhchivan, will play a special role in the in easing Armenia’s economic isolation. During the Soviet era, a railway existed in the territory of Zangazur and connected Armenia with Azerbaijan. Based on the implementation of the declaration, this railroad will be restored.

Using the Zangazur Corridor, Armenia will obtain direct land access to Russia, its main economic partner. Despite the fact that there is both a highway and a railway passing through Georgia to connect Armenia with Russia, Armenia was unable to use them efficiently. Owing to

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political problems between Russia and Georgia, the railroad was closed and the highway on Georgian territory is subject to frequent closures due to the severe winter climate. Therefore, the Zangazur Corridor offers a sustainable alternative to those routes. By using the new corridor, Armenian cargos can reach Baku, the capital of Azerbaijan, and then be directed on to Russia.

The economic blockade of Armenia also created problems in reaching Eurasian Economic Union (EEU) markets. Despite the fact that Armenia has been a member of the EEU since January 2015, it had no direct land link to other member states such as the Central Asian countries or Russia. After the establishment of the Zangazur corridor, by using the highways and railways of Azerbaijan along with those of Russia, Armenia could send its products to the Central Asian states. After the restoration of all communications in the region, Armenia will get access not only via the Zangazur Corridor, but also through other traditional routes that pass through Azerbaijan and that formerly played an important role in the foreign economic relations of Armenia. To obtain all the benefits of the restoration of these economic links, Armenia has to abandon its aggressive policy against its neighbours and join regional cooperation initiatives.

The other benefit of the opening up of transport connections in the region for Armenia is the opportunity to upgrade its traditional railway connection with Iran. After the occupation of Azerbaijani territories, Armenia had also deprived itself from using the railway connection with Iran that used to pass through Nakhchivan. Instead, during the occupation, it used highways through the mountainous areas that were not suitable for transportation of cargos in all seasons. Also, the condition of those highways meant that the transportation of those cargos was not comfortable. In an attempt to establish a sustainable railway connection with Iran during the occupation, Armenia tried to build a new rail route through the southern Meghri region. However, owing to high construction costs (about $3.5 billion) and inability to attract foreign investors to this inefficient project, Armenia was unable to carry out its plan.

to implement it. With the opening of the Zangazur Corridor, Armenia can restore the railway connection with Iran and develop its bilateral economic relations.

**Conclusion**

Because of the heavy losses, the Second Karabakh War has substantially affected the economy of Armenia and also created new cooperation and development opportunities. During the war, the Armenian army experienced a devastating defeat and lost its combat potential and a major part of its military equipment. The military potential of Armenia that was built over the past decade by spending significant amount of the country’s financial resources almost disappeared in the 44 days of the war. For restoring the army, Armenia needs many years and a large quantity of financial resources. Thus, the restoration of the army will put pressure on the economy of Armenia and will negatively affect the financing capacity of other economic sectors. Along with military losses, Armenia lost its access to the natural resources in the previously occupied territories, resources that it had been illegally exploiting during the occupation. Thus, Armenia will need to spend additional financial resources to substitute the energy and agricultural resources from which it has been deprived. Taking into account that those resources played an important role in the provision of food and energy security, Armenia has no choice other than to replace them. In doing so, Armenia will spend more funds, and prices for food products and electricity will increase. Therefore, the economic losses of Armenia will also impact the socioeconomic situation of the population in the coming years.

In order to meet the increasing financial expenses during the war, the Armenian government increased budget expenditures, which led to a substantial increase of the budget deficit. The high budget deficit, in turn, necessitated the attraction of foreign debt and increased the dependence of the Armenian economy on foreign financing, which has been one of the country’s main structural economic problems. As a result, the public debt of Armenia reached dangerous levels, thus undermining the financial security of the country. Based on the

economic situation in Armenia, we could expect that pressure on the financial system and macroeconomy of Armenia will continue in the coming years as, in the post-war period, Armenia will have to use a substantial part of its budget revenues for the restoration of the army and for replacing financial income that will be foregone owing to the lost resources in the previously occupied territories. Armenia will need more financial resources for maintaining food and energy security in the country. More importantly, economic and financial problems in the post-war period will keep the level of public debt high, thus undermining the financial security of the country. Moreover, as the pressure on the prices of products and the value of the national currency will continue, that will substantially affect the financial situation of the population and increase poverty. In order to prevent the increase of social discontent, the Armenian government will have to continue to provide support measures, as it did during the pandemic-related lockdowns. All these factors demonstrate that the Second Karabakh War will significantly affect the economic policy of Armenia in the near future. For the purposes of preventing the country from falling into a deep economic crisis, the Armenian government has to implement a strict financial policy, as far as is possible, and has to enact a socially oriented economic policy.

Despite all the mentioned negative effects of the war on Armenia, the end of the conflict has also created great opportunities for Armenia as the trilateral statement signed on 10 November 2020 envisions the restoration of all economic and transport ties in the region. Implementation of this statement presents a chance for Armenia to solve some of its main economic problems and to free itself from the economic blockade. The creation of the Zangazur Corridor will enable Armenia to use a sustainable land connection through the territory of Azerbaijan to reach its main economic partner, Russia, and other members of EEU. The new corridor will also enable Armenia to restore its traditional railway connection with Iran that was closed because of Armenia’s occupation policy. Armenia could benefit from all the opportunities described if it opts for regional cooperation over its previous, aggressive policy. The period of occupation demonstrated that an aggressive policy against Armenia’s neighbours did not bring it any prosperity. Therefore, participating in regional cooperation and using the benefits of the restoration of regional transport links, along
with the establishment of the Zangazur Corridor, are the only ways for the economic survival of Armenia in the future. The full use of the cooperation opportunities in the region and development of economic relations will also positively contribute to the establishment of a durable peace in the region.