THE IMPACT OF THE SECOND KARABAKH WAR ON THE ARMENIAN ECONOMY AND FINANCIAL MARKETS IN THE FRAMEWORK OF ARMENIA'S FOREIGN RELATIONS

(ERMENİSTAN'IN DIŞ İLİŞKİLERİ ÇERÇEVESİNDE İKİNCİ KARABAĞ SAVAŞININ ERMENİ EKONOMİSİ VE FİNANS PİYASALARINA ETKİSİ)

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Abstract: *Thirty years after the First Karabakh War, the events that developed with Armenia's attack on the city of Tovuz in Azerbaijan started the Second Karabakh War in September 2020. While the first war was an ethnic-based conflict that emerged in the Soviet geography after the collapse of the Soviet Union, the second war was an ethnic conflict and a proxy war based on political economy, apart from the issues of reclaiming the lands that Azerbaijan had lost military control. After Turkey's geopolitical problems with Russia, it has sought to diversify its energy imports and replace Russian gas with Azerbaijani gas to reduce its dependence on Russia. The Tovuz attack, an essential point in delivering Armenian-Azerbaijani gas to Turkey, occurred in this ongoing process. In this primary layer, the Second Karabakh War was a proxy war based on*

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the economy and politics between Russia and Turkey. With the war, Iran supported Armenia, and Israel supported Azerbaijan. In the secondary layer, it was a geopolitically based proxy war between Israel and Iran at a weaker level. Since the founding element of the war was the economic-political plane, this study examines the economic-political dimension of the war for Armenia. In this context, this study aims to analyze the effects of the Second Karabakh War on the Armenian economy and financial markets within the framework of Armenia's relations with Russia and the Western world. According to the results, during the process that turned into a war, the Armenian economy contracted with the increasing public expenditures during the war, and economic and financial fragilities increased. After the armistice, Turkey's internal economic-political and growing confidence in solving the problem provided capital inflows from Russia and the West, supporting economic growth and financial markets. However, the Armenian economy has been susceptible to the geopolitical and military tensions that have risen during the post-war period. On the other hand, Western and Russian capital are energizing the Armenian economy in alternative ways according to the changing geopolitical and alliance system conditions. Russia's relative influence in this dynamic is more significant. At a higher level of analysis, the main reason for this is Armenia's varying relations with Russia and the Western alliance. As Russia's positive impact on the Armenian economy decreased in the post-war period, this effect was replaced with the positive impact of Western capital on the Armenian economy.

Keywords: *Armenia, Second Karabakh War, War-Politics Relationship, Economy, Financial Markets*

Öz: *Birinci Karabağ Savaşı'ndan otuz yıl sonra Ermenistan'ın Azerbaycan'da Tovuz şehrine saldırmasıyla gelişen olaylar Eylül 2020'de İkinci Karabağ Savaşı'nı başlatmıştır. Birinci savaş, Sovyetler Birliği'nin dağılmasından sonra Sovyet coğrafyasında ortaya çıkan etnik temelli bir çatışma iken, ikinci savaş Azerbaycan'ın askeri kontrolünü kaybettiği toprakların geri alınması meseleleri dışında etnik bir çatışma ve politik ekonomiye dayalı bir vekalet savaşı olmuştur. Türkiye, Rusya ile jeopolitik sorunlarının ardından Rusya'ya bağımlılığını azaltmak için enerji ithalatını çeşitlendirmeye ve Rus gazını Azerbaycan gazıyla ikâme etmeye çalışmıştır. Ermenistan'ın Azerbaycan gazının Türkiye'ye ulaştırılmasında önemli bir nokta olan Tovuza saldırısı, devam eden süreçte gerçekleşmiştir. Birincil katmanda İkinci Karabağ Savaşı, Rusya ile Türkiye arasındaki ekonomi ve siyasete dayalı bir vekalet savaşıdır. Savaşla birlikte İran Ermenistan'ı, İsrail Azerbaycan'ı desteklemiştir. İkinci savaş ikincil katmanda, İsrail ile İran arasında daha zayıf düzeyde jeopolitik temelli bir vekalet savaşı olmuştur. Savaşın kurucu unsuru ekonomik-politik düzlem olduğundan, bu çalışma*

Ermenistan için savaşın ekonomik-politik boyutunu incelemektedir. Bu bağlamda bu çalışma, Ermenistan'ın Rusya ve Batı dünyası ile ilişkileri çerçevesinde İkinci Karabağ Savaşı'nın Ermenistan ekonomisi ve finans piyasaları üzerindeki etkilerini analiz etmeyi amaçlamaktadır. Elde edilen sonuçlara göre savaşa dönüşen süreçte ve savaş sırasında artan kamu harcamaları ile Ermeni ekonomisi daralmış, ekonomik ve mali kırılganlıklar artmıştır. Ateşkes sonrası Türkiye'nin de sorunun çözümüne ekonomi-politik olarak dâhil ile artan güven ortamının Rusya ve batı kaynaklı sağladığı sermaye girişleri iktisadi büyümeyi ve finansal piyasaları desteklemiştir. Ancak Ermeni ekonomisi, savaş sonrası dönemde yükselen jeopolitik ve askeri gerilimlere karşı duyarlı olmuştur. Öte yandan Batı ve Rus sermayesi, değişen jeopolitik ve ittifak sistemi koşullarına göre alternatif yollarla Ermeni ekonomisini desteklemektedir. Rusya'nın bu süreçteki göreceli etkisi daha önemlidir. Daha yüksek bir analiz düzeyinde, bunun temel nedeni Ermenistan'ın Rusya ve Batı ittifakı ile değişen ilişkileridir. Savaş sonrası dönemde Rusya'nın Ermeni ekonomisi üzerindeki olumlu etkisi azaldıkça, bu etkinin yerini alan Batı sermayesinin Ermeni ekonomisi üzerindeki olumlu etkisi artmıştır.

Anahtar Kelimeler: *Ermenistan, İkinci Karabağ Savaşı, Savaş-Siyaset İlişkisi, Ekonomi, Finans Piyasaları*

Introduction

Almost 30 years after the First Karabakh war, upon the background of the military attack on Tovuz (which is on the energy lines on the territory of Azerbaijan) by Armenia in July 2020, the Second Nagorno-Karabakh war started on 27 September with the operation that Azerbaijan initiated to regain the lands lost during the first war. A ceasefire was established with diplomatic efforts after Azerbaijan managed to recover most of its lost lands at the end of 44 days, leading to the war also being called the "44 Days War". In this context, it is necessary to analyze the process from the first war to the present to understand the process leading to the second war in the economic-political plane, which is the main subject of this study, as well as in the geopolitical plane.

In line with this requirement, first of all, the ethnic-based conflict dynamics caused by the disintegration of the Union of Soviet Socialist Republics (USSR - Soviet Union) should be examined. With the dissolution of the USSR, ethnic conflicts between Armenia and Azerbaijan sparked over the Karabakh issue. In this context, the Russian Federation replaced the USSR in the international order. Since Russia is a hegemonic power over both countries in the Caucasus region, it has approached the dynamic of conflict between Azerbaijan and Armenia with the concept of "neither war, nor peace". It did not want this conflict to have a clear winner or loser to maintain its current hegemony dynamic in both countries.[1] In this context, Russia deliberately tried to prevent the initiatives of the Organization for Security and Co-operation in Europe (OSCE) Minsk Group, which had a diplomatic mission aimed at securing lasting peace between Armenia and Azerbaijan that continued until the second war.[2]

In this context, the process that causes war is supported by a two-dimensional structure, strategic and military. Accordingly, border and territorial disputes constitute the strategic dimension of the war for both countries that are directly involved in the war; and security policies and military capabilities constitute the military dimension of this war. Although technically only temporary ceasefires were established after the tactics and strategies developed by Russia regarding the war based on its hegemonic role in the Caucasus region, they were short-lived and could not provide permanent peace.[3] After the armistice signed at the end of the Second Karabakh War on 9 November, Russia did not

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1   Shamkhal Abilov and Ismayil Isayev, "The Consequences of the Nagorno–Karabakh War for Azerbaijan and the Undeniable Reality of Khojaly Massacre: A View from Azerbaijan", *Polish Political Science Yearbook*, 45 (2016): 291-303. 10.15804/ppsy2016022.

2   Abilov and Isayev, "The Consequences of the Nagorno–Karabakh War…"

3   Andrius Bivainis, "Multi-dimensional assessment of the Second Nagorno-Karabakh War", *Security and Defence Quarterly* 38, no.2 (2022): 51-61. doi: 10.35467/sdq/146180.

directly intervene in the processes that created the intermediary path of non-permanent non-conflict, which froze a part of the problem for now. This caused a conflict dynamic that has occasionally flared up after armistice, which could lay the groundwork for a new war in the future.[4]

Since the study's primary goal is to evaluate the war as a strategic dimension on the economic-political plane, let us first look at the conflict's military aspect to identify its mediating and regulating impacts:

The use of "UAVs and UCAVs", which are unmanned aerial vehicles that had been imported by Azerbaijan from Turkey prior to the second war, for the first time in a comprehensive conventional warfare, has been a milestone in the transition from traditional warfare to the modern electronic warfare process. Moreover, the Second Karabakh War has shown that modern technological warfare is costly and destructive. War is expensive, especially since the financial burden of current technical wars has increased significantly compared to the past. To have modern military and remote-controlled combat equipment based on the highest technology, the state's economic power must be high, and its defense budget must be sufficient.

If we need to examine the military resources used during the Karabakh war, let us point out that the military resources used by Armenia are imported goods. With a majority of their weaponry coming from Russia or left over from the Soviet era, Armenia has roughly 45,000 active soldiers. In 2019, its military expenditures totaled $673 million USD. Armenia's economy is hampered, in contrast to Azerbaijan, by its landlocked location between two hostile neighbors and a dearth of oil and gas earnings. Iran to the south and Georgia to the north are its sole open trading borders. Due to the tight ties between Turkey and Azerbaijan, as well as historical considerations, Armenia views Turkey as a possible foe as well.[5]

Most of the military resources used by Azerbaijan are imported as well, but a small part is derived from domestic resources. Such domestic resources are produced in factories affiliated with Azerbaijan's Ministry of Defense Industry.[6]

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4   Ana Jović-Lazić, "The Second Armed Conflict in Nagorno-Karabakh – Causes and Implications," in *Convergence and Confrontation: The Balkans and the Middle East in the 21st Century*, ed. Slobodan Janković. ISBN 978-86-7067-293-2 (Belgrade: Institute of International Politics and Economics, 2021), 211.

5   Andrew Philip, "Lessons from the Nagorno-Karabakh 2020 Conflict", *Center for Army Lessons Learned*, August 2021, accessed 12.06.2023, https://api.army.mil/e2/c/downloads/2023/01/31/693ac148/21-655-nagorno-karabakh-2020-conflict-catalog-aug-21-public.pdf

6   Gubad Ibadoghlu, "The Political Economy of the Second Karabakh War", *SSRN*, October 8, 2021, accessed 23.02.2023, https://ssrn.com/abstract=3939263

In this direction, the lessons to be learned from the second war in terms of military technology can be sorted as follows:[7]

1. Conventional ground forces lacking adequate sensors are very vulnerable against electronic warfare-based drone weapons.

2. Ground-based integrated fire support and unmanned aerial vehicles are crucial in modern warfare.

3. The deterrent effect of wars has increased.

4. Drones and small and medium-range missiles also play an essential role in detecting and destroying defense systems.

5. Despite advancements in technology, traditional tactics and weapons have retained their importance.

6. Despite the drone era, military geostrategic concepts are still important.

7. The success of the Azerbaijani military in the war, despite the seemingly impossible conditions, went down in the history of wars as an important event.

To express the strategic dimension of the war, first of all, the driving factors that dragged Armenia and Azerbaijan to war should be determined for both countries. Accordingly, the driving factors that led Armenia to the Karabakh war can be listed as "security problem", "enemy image", "participation of other countries with interests in the region", and most importantly, "Armenia's internal politics and historical memories". We can briefly explain these factors in the following manner:

Based on Armenia's security problem, Armenia is geographically located between two Turkish states, Turkey and Azerbaijan. In addition, it has historically fought with these two Turkish states for different reasons and defines them as enemies. On the other hand, the geopolitical purpose of the Armenian state's construction process by Russia has been to create a buffer zone between "Turkish Turkishness" and "Russian Turkishness". As a result, the elites ruling Armenia think that the Turkish world will eventually liquidate Armenia, which the Turkish world allegedly (from the perspective of Armenia) sees as an artificial state in the integration process.

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7   Can Kasapoglu, "ANALYSIS – Five key military takeaways from Azerbaijani-Armenian war", *Anadolu Agency*, October 30, 2020, https://www.aa.com.tr/en/analysis/analysis-five-key-military-takeaways-from-azerbaijani-armenian-war/2024430 ; Khayal Iskandarov and Piotr Gawliczek, "The second Karabakh war as a war of new generation", *Journal of Scientific Papers "Social Development and Security"*, Vol. 11, No. 2 (2021). ISSN 2522-9842.

The image of the enemy can be examined in two dimensions. The first of these is the historical memory of Russia's past wars with the Ottoman Empire during the disintegration of the Ottoman Empire. The other is that, after the collapse of the Soviets and because of the fighting against Azerbaijan, Turkey and Azerbaijan are perceived as enemy countries by the Armenian political elites. In addition, the "Greater Armenia" is an aspiration for the Armenian political elite. This image of the enemy intertwined with this aspiration is perpetually maintained, as it includes some of the lands of Turkey and Azerbaijan.

The reason for the involvement of other countries in the issue in this region is that Russia, the USA, and France, which are members of the Minsk Group, are already active in the region. Russia sees the region as a post-Soviet territory, as in, Russia's historical backyard. As a natural consequence, Russia considers the Caucasus to be under its sphere of influence. The USA wants to increase its influence in the region with its Black Sea and Caspian policies. On the other hand, France sees itself as the protector of Armenia under the influence of the Armenian Diaspora. In addition, as a part of the anti-Turkey foreign policy process that has increased in French foreign policy in recent years, France wants to prevent Turkey from gaining strength in the Caucasus. On the other hand, Iran sees the Armenians as a brotherly people, while it sees the Azerbaijani lands as its historical lands. In addition, it considers the presence and strengthening of Azerbaijan in the region as a threat to its national security due to the lands of Southern Azerbaijan in Iran. Turkey's interest is related to seeing Azerbaijan as a strong, successful Turkish state that will assure Turkish presence in the Caucasus.

Concerning Armenia's internal politics and historical memory; the military and political elites who waged the First Karabakh War constitute a significant place in the internal politics of Armenia. Therefore, all developments in Karabakh directly affect the internal politics of Armenia. The historical memory of Armenia has been shaped by the tragic results of the failed dream of establishing a Greater Armenia with the support of the West and Russia at the beginning of the 20th century.

For Azerbaijan, it was retaliation against Armenia for its attack on previously uncontested regions such as Tovuz (as in, regions apart from the areas that Armenia took control of in the first war), taking back lands lost in the first war, and the national identity of Azerbaijan. Concerning the national identity; Azerbaijani people did not want war with Armenia simply for the sake of war, but they demanded the regaining of the Azerbaijani lands that had been under the occupation of Armenian forces for decades.

On the other hand, to better understand the strategic dimension of the war, the position of the strategic players and factions involved in the war and armistice should be accurately described. Although the Armenian lobby in the Diaspora openly declared its support in favor of Armenia during the Second Karabakh War, the effect of this support on the war process did not materialize as expected.[8] One of the most important reasons for this situation was the widespread perception that Russia, rather than the Western alliance, carried out a proxy war in Armenia during the second war. This is because Russia's geopolitical and military influence on Armenia has been traditionally much greater than that of the Western world. On the other hand, the second war is also expressed as the third conflict phase of the proxy war between Russia and Turkey after Syria and Libya.[9] However, concerning proxy wars, while Russia and the Western alliance continue their proxy war from time to time through Armenia, it cannot be said that Azerbaijan is continuing Turkey's proxy war. This is so because in the first war, Azerbaijan lost control of its official lands based on an ethnic-based conflict. In the second war, Azerbaijan joined the war simply to regain the lands it had lost.

On the other hand, as an ally of Azerbaijan, Israel's role during the war dramatically impacted the war. In this context, it is stated that due to the dynamic of conflict and tension between Iran and Israel and the fact that Iran, which has Southern Azerbaijan within its borders, supports Armenia in the Karabakh issue, Israel has formed a dialectical alliance with Azerbaijan, which can be considered surprising. The Azerbaijan-Israel partnership is interesting because of Israel's diplomatic issues with Turkey (Azerbaijan's most significant ally), which began with the "One Minute" incident in 2009 and worsened with the "Blue Marmara" incident in 2010. However, Israel's historical issues with Iran and Armenia are based on Azerbaijan's relationship with that country. Attention is drawn to the increasing role of Israel, especially in establishing Azerbaijan's air defense system, in the post-armistice period.[10] On the other hand, it was emphasized that Israel uses its approach to the Armenian-Azerbaijani conflict and the Karabakh conflict as a soft power element against Iran in the context of its disputes with Iran.[11] In this context,

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8   "The Outcome of the Second Karabakh War: Confrontation Between the Diaspora and the Armenian Government", *Center of Analysis of International Relations (Air Center)*, 2021, accessed 23.02.2023, https://aircenter.az/en/single/the-outcome-of-the-second-karabakh-war-confrontation-between-the-diaspora-and-the-armenian-government-697

9   M. Hakan Yavuz and Vasif Huseynov, "The Second Karabakh War: Russia vs. Turkey?", *Middle East Policy*, 27 (2020): 103-118.

10 Avinoam Idan and Brenda Shaffer, "Israel's Role in the Second Armenia-Azerbaijan War", *Foundation for Defense of Democracies*, 2021, accessed 23.02.2023, https://www.fdd.org/wp-content/uploads/2021/12/The-Karabakh-Gambit_IsraelRole-1.pdf

11 Brenda Shaffer, "Israel's Role in the Second Armenia-Azerbaijan War and Its Implications for the Future", *The Central Asia Analyst*, September 9, 2022, accessed 23.02.2023, https://www.cacianalyst.org/resources/pdf/220912Shaffer.pdf

because Israel used its role in the Second Karabakh War as a soft power element against Iran, Iran did not allow the celebrations of Azerbaijani citizens in the South Azerbaijan region, which is located within the borders of Iran, for the area that was regained by Azerbaijan with the armistice.[12]

The most crucial element of the strategic dimension of the war is the economic-political plane. In this context, economic-political parts have a founding dialectic during the outbreak of war. After the soldiers that Turkey lost in Syria, especially in February 2020, and after Turkey's apparent victory during its operation called "2019 Spring Shield" that was made possible by the unmanned aerial vehicles against Syria (which enjoys the protection of Russia), an agreement was signed by the Turkish and Russian delegations in Moscow, determining the terms of the ceasefire between Syria and Turkey. Turkey's conflict in Syria's regions, especially in Idlib, the conflicts over the Tel-Rifat territory, the deployment of Russia to the American field military bases vacated in the PYD regions in the "Peace Spring" military operation, and the different axes of the parties regarding Libya, both military and political, are all important factors. This economic-political effect is most pronounced for Turkey, which is highly dependent on Russia's energy resources, and explains why it turned to Azerbaijan gas as a substitute for Russian natural gas. After Turkey's diversification in energy imports with Azerbaijan gas, it was significant that Armenia attacked Tovuz, a critical point in the transport of Azerbaijani gas to Turkey. TANAP has occupied an important position for Turkey for a long time (not just because of the gas it supplies). TANAP was also an important and expensive investment for the Middle Corridor. It was for this reason that Turkey wanted to protect it. At the outbreak of the second war, the conflict in the economic-political plane, in a way, in the war between Armenia and Azerbaijan, changed the parameters of the war-politics relationship and caused the second war to be based on both ethnic and political economy, rather than the first war that was based purely on ethnic conflict. The effects of the war on the economy are critical for Armenia, which suffered heavy losses militarily, politically, strategically, and economically after the second war process and the armistice. Therefore, this study aims to determine the effects of the war on Armenia in terms of economy and finance. In addition to the adverse effects caused by the war, Turkey's indirect diplomatic and economic-political involvement in the armistice process after the war is essential in the economic gains that the armistice will provide for Armenia.

In this direction, Turkey's efforts to revive trade and economy in the South Caucasus by using diplomatic missions as an intermediary for the

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12 Farrokhpour Aida, "The Impacts of the Second War of Nagorno-Karabakh Conflict (2020) on the Identity Consciousness of Iranian Azerbaijanis", Master of Science (M.S.), *Middle East Technical University*, 2022.

normalization of relations with Armenia and by opening the Zangezur Corridor and the borders with Armenia; added an economic-political dimension to the armistice dynamic after conflicts and conflicts between Armenia and Azerbaijan.[13] Similarly, political and economic factors were influential in the process that turned into war. In this context, although it is not a primary factor in the outbreak of the war, the conflict zone is located on alternative trade routes of China's Belt and Road Initiative (BRI); this has enabled it to emerge as one of the primary motivations for the parties in the economic-political process, which is the dominant phenomenon in the spirit of the post-war peace and dialogue process.[14]

In addition, the settlement of the peace process in the region on an economic-political basis, together with the potential economic contributions that the normalization of Turkey-Armenia relations will provide to both countries, has enabled the cooperation and alliance between Turkey and Azerbaijan to evolve into an economic-political and geopolitical integration dynamic.[15]

Political circles in Armenia attach importance to relations with the Western alliance; they expected the government of Nikol Pashinyan, who came to power again in the elections held in 2021 after the war, to continue the dialogue process with Baku and Ankara, and by taking into account the initiatives of the Minsk Group, to solve the problem on an international platform that takes into account the mutual interests of both sides and to bring the economic-political dimension of the peace process to the fore.[16]

On the other hand, this multilateral dialectical process in the Karabakh issue is one of the most critical obstacles to the permanent emergence of a regional peace system dynamic with political and economic outputs for both countries. The financial inability of both countries, low trade volume and low employment problems based on the Karabakh issue, which has been going on for nearly 30 years, make the economic-political dimension of the armistice and peace process even more critical.[17]

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13 "Turkey's role in the Nagorno Karabakh war: a potential resource for peace", *Caucasus Edition: Journal of Conflict Transformation*, July 15, 2013, accessed 23.02.2023, https://caucasusedition.net/turkeys-role-in-the-nagorno-karabakh-war-a-potential-resource-for-peace/

14 Damjan Krnjevic Miskovic, "Geopolitics and the Second Karabakh War", *Caucasus Strategic Perspectives* 1, Issue 2 (Winter 2020): 35, https://cspjournal.az/uploads/files/Vol_1_Is_2_Winter2020/(3)%20Damjan%20Krnjevic%20Miskovic.pdf

15 Güçlü Köse and Keisuke Wakizaka, "The Historical Dynamics of the Second Karabakh War and the Shift in Turkey's Policy: The Effects of the Syrian Civil War", *Karadeniz Araştırmaları* XIX, 74 (2022): 311.

16 Robert Aydabirian, Jirair Libaridian, and Taline Papazian, "The Karabakh War of 2020 and Armenia's Future Foreign and Security Policies", *Armenia Peace Initiative (API)*, July 2021, accessed 23.02.2023, p. 6, https://armeniapeace.org/wp-content/uploads/2021/09/Armenia_Foreign_and_Security_Policies.pdf

17 Nika Chitadze, "Economic Factors of the Nagorno-Karabakh Conflict", *Review of Armenian Studies*, Issue 33 (2016): 95.

On the other hand, the asymmetrical process in question for both sides has also manifested itself in economic-political terms. After the first war, the necessary investment climate was created in Armenia for its companies in Karabakh to make profitable investments and engage in economic activities with countries such as Russia, the USA, India, Sweden, Lebanon, England, Germany, and France. In this direction, the mining sector has been the main area where Western origin enterprises operate. There are more than 160 different precious metal deposits, five gold deposits, seven mercury, two copper deposits, one lead and zinc deposit, one coal deposit, six alabaster, four vermiculite, one soda production deposit, 12 colored regional soils, decorative stone beds, 21 facing stone beds etc. in Karabakh. These areas, which are of great importance in terms of the economic potential of Azerbaijan, had been processed by these enterprises for about 30 years to the benefit of Armenia. After the first war, Azerbaijan was deprived of the opportunity to use Karabakh's rich mineral resources. Exploiting natural resources in Karabakh during the occupation posed severe environmental and economic risks. In this direction, during the years of work, the mining industry formed highly polluted waste pools that require special cleaning. According to the report published in 2016, millions of tons of heavy metals and other dangerous substances were pouring into the ponds in Karabakh at that time.[18]

However, despite the investments and earnings of Western-based enterprises in the Karabakh region, the Armenian economy could benefit at a different rate. In addition to the economic and financial problems left over from the first war, the Second Karabakh War significantly impacted the Armenian economy. After the war, the need for foreign financing, which is one of the main economic problems of the Armenian economy, increased. After the first war, the most challenging issue for Armenia was that Azerbaijan and Turkey closed their borders to Armenia, which triggered economic problems for Armenia and increased its foreign dependency. On the other hand, declining macroeconomic rebalancing with dwindling financial resources and worsening macroeconomic indicators hindered the realization of Armenia's economic development perspectives.[19] Therefore, the war's economic devastation will have serious economic consequences for Armenia in the long run, undermining its financial security. All these problems, the concept of non-peaceful foreign policy towards neighbors and the use of hard power also show that it has never led to development for Armenia and that the only way for Armenia's rapid economic recovery is to participate in regional cooperation. This naturally necessitates Armenia to improve its relations with both Azerbaijan and Turkey.

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18 Aynur Nesirova, "Economic Results of The Karabakh War: Plundering in The Territories of Azerbaijan During the Occupation Period", *Uluslararası Yönetim Akademisi Dergisi* 5, 2 (2022), DOI: 10.33712/mana.1094314: 257.

19 "Inflation Reports 2020", *Central Bank of Armenia*, 2020, accessed 12.06.2023, https://www.cba.am/en/SitePages/mp2020_report.aspx

In addition to the defeat in the war that meant the Armenian side's military losses, and demographic and economic aspects were adversely affected by the war as well. The financial cost of the war to Armenia is almost equal to the total military expenditure of Armenia in the last ten years. It will take many years for Armenia to rebuild its army both in personnel and equipment.[20]

On the other hand, Armenia has also lost access to many natural resources in the occupied Azerbaijani territories, which Armenia and multinational companies had used for nearly thirty years and which played a vital role in ensuring food and energy security in Armenia. For this reason, the Armenian economy must increase its imports of energy and food products to replace the resources it lost in the war.

In addition, the war significantly negatively impacted Armenia's financial sector and increased its financial risk. On the other hand, the Armenian economy may have been affected more by Russia's pressure on the Armenian economy after Pashinyan came to power and the disruption of supply chains due to the Covid-19 pandemic. So the problems related to balancing the Armenian economy are based on the restrictions caused by the COVID-pandemic and the breakdown of supply chains, apart from the 2020 war. Due to the increasing military and social costs during the war, Armenia had to change its budget. Increasing budget expenditures made it necessary to attract foreign capital to the country. This issue will be especially examined in the statistical analyses below. As a result, Armenia's Debt to GDP ratio has reached a dangerous level and is expected to increase in the coming years. Due to these financial problems, Armenia must realize its approved state budget estimates for 2021. Along with the financial sector, economic problems also pressure Armenia's national currency. Currency depreciation has accelerated since the war, prompting the Armenian government to use its foreign exchange reserves to stabilize the dram.

In this context, the liberation of Azerbaijan's occupied territories creates a great potential for sustainable economic development and lasting peace in the region.[21] This is so because after Azerbaijan has taken back control of its occupied territories, the diplomatic deconfliction process between Armenia and Turkey-Azerbaijan may support economic activities in the region. Until now, the Armenian economy has been negatively affected by the closure of its borders with Turkey. At the same time, the closure of the Nakhchivan

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20 Okhan Bagirov, "Economic Implications of Second Karabakh War for Armenia – OpEd", *Eurasia Review*, April 18, 2021, accessed 09.03.2023, https://www.eurasiareview.com/18042021-economic-implications-of-second-karabakh-war-for-armenia-oped

21 Mirza İbrahimov, "The Military and Economic Consequences of the Second Karabakh War for Armenia", *Center of Analysis of International Relations (Air Center)*, 2021, accessed 20.03.2023, p. 14-15, https://aircenter.az/uploads/files/military%20and%20economic%20consequences.pdf

corridor negatively affects the economic integration of the Turkic world. In addition, the diplomatic and military conflict environment has hindered the economic potential of the region, which is one of the possible routes of China's modern silk road project.

On this plane, the conflict over Karabakh is one of the most severe and complex ethno-regional asymmetric conflicts in the post-Soviet region, because the parties to the war have different legal statuses, goals, and implementation strategies. While Azerbaijan uses tactics of psychological pressure, and threats to renew military operations, thus intimidating the enemy, stalling forces under the auspices of Russia in Karabakh and its ally Armenia from carrying their actions, which can be defined as deterrence of the enemy. As a result of the divergence of objectives, this conflict is a zero-sum conflict and is unlikely to reach a solution that satisfies the demands of both sides. The course of the battle, the current "neither war, nor peace" situation and the uncertain perspectives of the future can be interpreted in the categories of asymmetry, mainly within the scope of resources belonging to the parties to the conflict. While it is expected that regular clashes will resume between the parties in the short and medium term, the psychological pressure will likely increase further, and the actions in the diplomatic field will intensify. In the ongoing process, the asymmetrical dimension of this war is likely to deepen even more.[22]

1. Design of The Research and Data Set

This study aims to determine the economic-political and economic effects of the conflict dynamic that started in 2016 after the first Karabakh war between Azerbaijan and Armenia (the 4 Day War) and turned into the Second Karabakh War in September 2020 and to investigate the effects of the results on the multilateral relationship dynamic in the Armenia-Western World-Russia triangle.

First, dummy variables to represent the exogenous effects of the 2020 war were investigated. In this context, a dummy variable modelling the Karabakh War has been developed in line with the chronology of the war.[23] The chronology part of the war, which was developed in the time series of this

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22 Rafał Czachor, "The Nagorno-Karabakh Conflict as a Specific Example of Asymmetric Conflict", *Journal of Science of the Gen. Tadeusz Kosciuszko Military Academy of Land Forces*, 185 (2017), 10.5604/01.3001.0010.5119: 17-31.

23 0 = ceasefire, 0.5 = occasional clashes in the case of ceasefire, 1 = no conflict, 1.5 = increased tension that may evolve into conflict, 2 = conflict, 2.5 = starting of ceasefire negotiations while the war was continuing, 3 = state of war, 3.5 = partial involvement of the Russian Federation in the war. Chronology of the war developed using: https://www.crisisgroup.org/content/nagorno-karabakh-conflict-visual-explainer, accessed 20.03.2023.

variable, was used. The observation interval of the time series is monthly between January 2016 and December 2022. Other external dummy variables created are the Russia-Ukraine war, the Covid-19 pandemic, credit ratings, and US dollar/Ruble parity.

In the second step, the variables that will represent the Armenian economy and financial world were investigated for the study. All information about internal and external variables has been compiled in this context. MSCI_Armenia data was created by the authors from these data. MSCI (Morgan Stanley Capital International) measures stock price and performance. This data needs to be calculated for Armenia. On the other hand, MSCI_Armenia data was created by the authors due to the discrete data on the Armenian stock market. For this, shocks related to Armenia's benchmark interest rate on the MSCI_World time series were applied using impulse-response analysis. It was formed as MSCI_Armenia time series with the reactive values obtained. In a way, the mediating effect of share price performances in global markets on stock returns in Armenia has been included in the research. Information for calculating this variable is given in the appendices (See Appendices).

VARIABLE	TYPE	SOURCE
Economic_Growth %	Intrinsic (Dependent Variable	https://www.theglobaleconomy.com/
Net_Foreign_Reserves	Internal	https://www.theglobaleconomy.com/
Usd_Amd	Internal	https://www.investing.com/currencies/usd-amd
Rub_Amd Parity	Internal	https://en.investing.com/currencies/rub-amd
Industrial_Manufacturing	Internal	https://www.theglobaleconomy.com/
Inflation (CPI)	Internal	https://www.theglobaleconomy.com/
Net_Invest_Position	Internal	https://www.cba.am/en/SitePages/statexternalsector.aspx
Benchmark_Interest	Internal	https://www.cba.am/en/SitePages/statmonetaryfinancial.aspx
MSCI_Armenia	Internal-Agent	Created by authors using https://www.investing.com/indices/msci-world
Unemployment	Internal	https://www.theglobaleconomy.com/
Financial_Balance	Internal	https://www.theglobaleconomy.com/
Karabakh_War	Extrinsic	Developed using https://www.crisisgroup.org/content/nagorno-karabakh-conflict-visual-explainer.
Rating Notes	Extrinsic	https://www.theglobaleconomy.com/
Covid	Extrinsic	Created by the authors.
Usd_Rub Parity	Extrinsic	https://www.investing.com/currencies/usd-rub

Table 1: *Information of Variable Set*

The methodology followed in the research design is first to determine the static effects of the independent variables on the growth rate of the Armenian economy and then to determine the dynamic effects by taking these static effects into account. For this reason, three different methods were used in the

study. These are the "Augmented Dickey-Fuller" test,[24] which examines the stationarity of the variables, the "Robust Regression", which statically detects the effect of the variables on the dependent variable; and the "Historical Decomposition" method, which investigates the historical dynamic effects between the variables.

Robust regression is the static method used in the research. It is an alternative regression method used when the assumptions cannot be met in the classical least squares method. The robust regression method was chosen for the static analysis because of the multicollinearity problem encountered in the classical regression analyses.[25]

The other method used in the study is the historical decomposition method derived from the Vector Auto-Regressive (VAR) method. The VAR method is a method that detects bidirectional back-and-forth relations and interactions between variables.[26] The historical decomposition method derived from VAR is calculated retrospectively by determining the parametric and shock effects of the predictive variables on the target variables during the observation period and how the explanatory variables affect the target variable dynamically during the analysis period.[27]

Before proceeding to the methodological phase of the research, graphs of the variables were drawn. According to these graphs, interpretations were made on the series of variables during the estimation period (See Figure 1). Performing graphical analysis before econometric analysis contribute to a more meaningful analysis of experimental results.

Concerning the Armenian economy growth rate, it has been observed that it was negatively affected by the conflict dynamics that took place in Azerbaijan and Karabakh. In 2016, the economy contracted with the conflicts that preceded the Second Karabakh War. In 2020, an economic contraction dynamic started in the pre-war period. In this context, the shrinking Armenian

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24 David A. Dickey and Wayne A. Fuller, "Distribution of the estimators for autoregressive time series with a unit root", *Journal of the American Statistical Association* 74, 366a (1979): 427–431.

25 P.W. Holland and R.E. Welsch, "Robust Regression Using Iteratively Reweighted Least-Squares", *Communications in Statistics: Theory and Methods* 6, 9 (1977): 813-827 ; James O. Street, Raymond J. Carroll, and David Ruppert, "A Note on Computing Robust Regression Estimates via Iteratively Reweighted Least Squares", *The American Statistician* 42, 2 (1988): 152-154 ; William Du Mouchel and Fanny O'Brien, "Integrating a Robust Option Into a Multiple Regression Computing Environment", *Computer Science and Statistics: Proceedings of the 21st Symposium on the Interface* (1989), American Statistical Association.

26 Christopher Sims, "Macroeconomics and Reality", *Econometrica* 48, no. 1 (1980): 1-48.

27 John Burbidge and Alan Harrison, "An historical decomposition of the great depression to determine the role of Money", *Journal of Monetary Economics*, Issue 1 (1985): 45-54 ; Mehmet Balcilar, Zeynel Abidin Ozdemir, Huseyin Ozdemir, and Muhammad Shahbaz, "The renewable energy consumption and growth in the G-7 countries: Evidence from historical decomposition method", *Renewable Energy*, 126 (2018): 594-604.

economy entered a low-profit-low-investment cycle, and the political basis of the Second Karabakh War emerged.[28] In a sense, the 2020 war made indirect adverse impact to Armenia's economy. Additionally, with the start of the Ukrainian war in 2022, Russia's geopolitical focus has been on Ukraine. For this reason, Armenia has continued the proxy war of the Western alliance on the Karabakh issue after this date. At this point, it can be hypothesized that the process that turned into war in Karabakh slowed down the economic development of Armenia because of the increasing military expenditures.

The comments made for the economic growth rate are almost valid for the industrial production variable. With this, the industrial production variable is more sensitive to the conflict dynamics in the Karabakh region. This claim will be examined in more detail in the econometric analysis section.

Conflict dynamics negatively affect the budget balance/GDP or fiscal balance variable. It can be argued that the military expenditures made in Karabakh before and during the conflicts caused the Armenian economy to have a budget deficit.

With the increase in the net foreign reserves of Armenia in the period of increasing tension in 2016-2022, during the second war, the reserves decreased. In this case, it can be argued that Armenia was using its foreign resources to finance the ongoing war. However, after the war, there was an increase in foreign reserves again.

The international net investment position, meanwhile, had a continuous deficit. On the other hand, some recovery was observed in the balance of the net investment position with during the post-war period. Although Armenia has been integrated with Russia in the context of security policies, the Armenian lobbies, influential in the USA and France, strengthened the country's political economy and ties with the Western world and its periphery. In this context, the net investment position recovered after the war can be explained by the economic and political relations dynamics of Armenia with the Western world. When viewed on the same theoretical plane, it is observed that post-war Western-based credit rating agencies increased the credit rating outlook of Armenia.

According to the MSCI_Armenia indicator estimated by the authors, it is observed that share prices and performances decreased in Armenia with the war.

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28 Fatih Kocaoğlu, "Savaşın ekonomi politiği üzerine Sümer dünya sistemi örneği", Unpublished Master Thesis, *Gazi Üniversitesi*, Ankara, 2014.

When the unemployment indicator is examined, unemployment increased during the war period, and unemployment decreased with the armistice and partial dialogue process with Turkey.

With the war, the interest rate of the benchmark bond for Armenia started to increase. This indicates that the borrowing costs of Armenia increased after the war.

A period of high inflation started in the Armenian economy. The causes of this inflation have been, respectively, the COVID-19 pandemic, the Second Karabakh war and the ongoing Russia-Ukraine war.

The US Dollar/Armenian Dram parity rose during the war period. With this, after the war, a severe and notable decrease was observed in the parity with the capital inflows from the West.

Similarly, concerning Russian Ruble/Armenian Dram parity, although it rose during the war, it began to decline after the war. However, this downtrend is less intense than in the Dollar parity. The reason for this is that the capital flows to Armenia after the war may have come from the Western world rather than Russia.
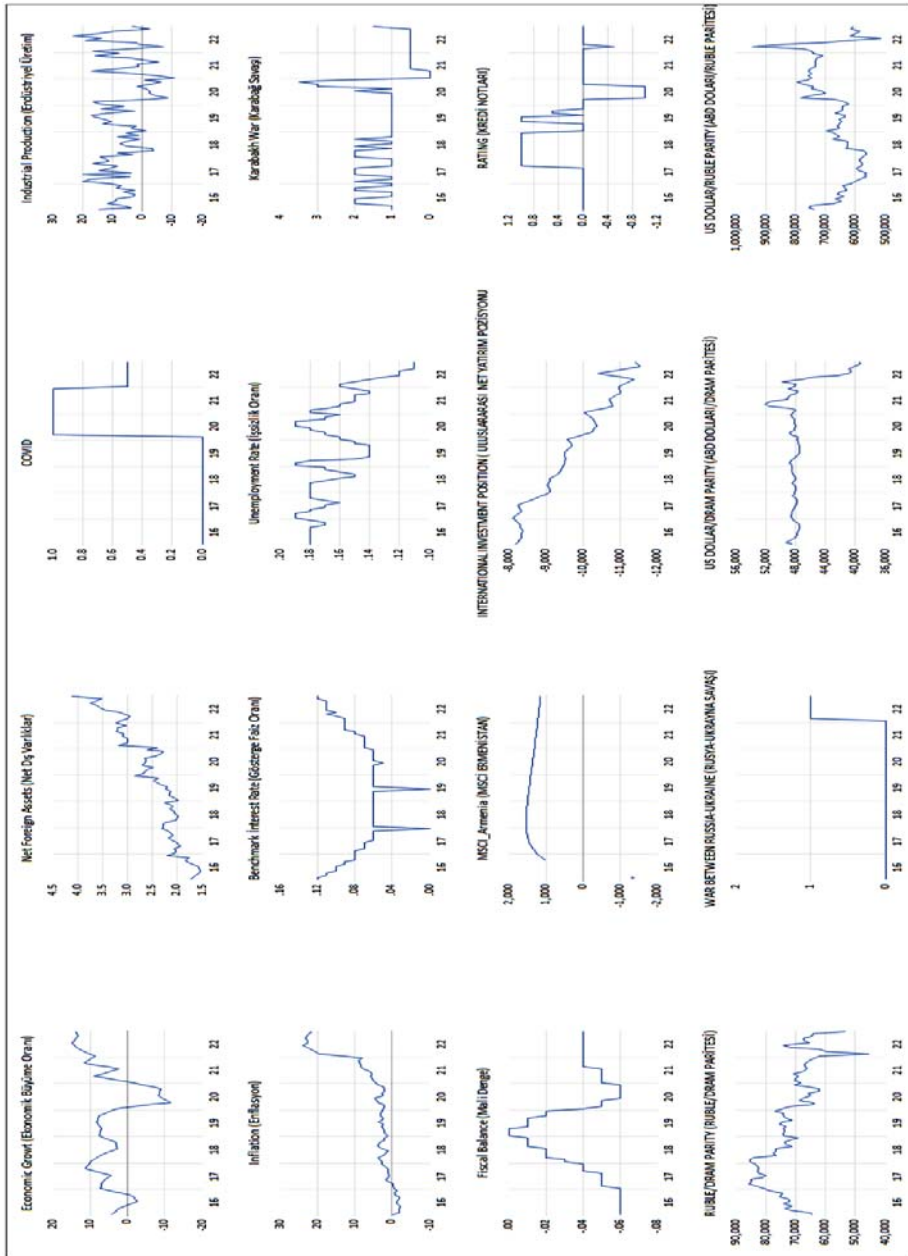
Figure 1: *Graphs of Variables*

2. Results of the Research

As the first step of the research, stationarity analysis was performed with the help of the Dickey-Fuller unit root test for the variables other than the dummy variables created by the authors. It has been determined that the variables are not stationary at the same level according to the model structures with the constant term, constant term with the trend, and model with constant term and no trend.

A unit root test is a statistical test that checks the presence or absence of a unit root in time series data. A unit root indicates that a time series has a stochastic trend, which leads to a spurious regression and makes it difficult to detect strong relationships between variables. Unit root tests are made to determine whether a time series is stationary or non-stationary. Stationary time series have a constant mean and variance over time, while non-stationary time series have a changing mean and/or variance over time. Dickey-Fuller Test is one of the methods that calculate these unit roots.

For this, probability values were examined. Variables with probability values less than 0.05 are stationary (See Table 2).

UNIT ROOT TEST RESULTS TABLE (ADF)	With Constant		With Constant & Trend		Without Constant & Trend	
At Level	t-Statistic	Prob.	t-Statistic	Prob.	t-Statistic	Prob.
ECONOMIC GROWTH	-24.614	0.1288	-24.937	0.3305	-15.493	0.1133
NET_FOREIGN RESERVES	0.4664	0.9846	-19.132	0.6387	21.510	0.9922
INDUSTRIAL_PRODUCTION	-53.065	0.0000	-53.549	0.0001	-39.466	0.0001
INFLATION	-0.0267	0.9528	-13.685	0.8630	0.8408	0.8905
BENCHMARK_INTEREST_RATE	-13.126	0.6203	-18.854	0.6530	-0.2806	0.5819
UNEMPLOYMENT	-0.7607	0.8244	-19.878	0.5988	-11.071	0.2415
FISCAL_BALANCE	-13.683	0.5940	-12.734	0.8875	-10.365	0.2681
MSCI_ARMENIA	-71.369	0.0000	-0.7205	0.9672	-82.603	0.0000
INT.NET INVESTMENT POSITION	-0.4084	0.9015	-43.426	0.0048	23.905	0.9957
RUB_AMD	-19.143	0.3243	-37.959	0.0216	-0.4919	0.5001
USD_AMD	-0.5215	0.8807	-0.9127	0.9491	-11.291	0.2336
USD_RUB	-25.729	0.1027	-28.649	0.1792	-0.6133	0.4488
	With Constant		With Constant & Trend		Without Constant & Trend	
At First Difference	t-Statistic	Prob.	t-Statistic	Prob.	t-Statistic	Prob.
D(ECONOMCI GROWTH)	-32.248	0.0222	-31.815	0.0956	-31.996	0.0017
D(NET_FOREIGN RESERVES)	-119.237	0.0001	-120.013	0.0000	-115.079	0.0000
D(INDUSTRIAL_PRODUCTION)	-128.006	0.0001	-127.224	0.0000	-128.819	0.0000
D(INFLATION)	-65.890	0.0000	-66.584	0.0000	-63.357	0.0000
D(BENCHMARK_INTEREST_RATE)	-97.624	0.0000	-105.207	0.0000	-98.254	0.0000
D(UNEMPLOYMENT)	-65.436	0.0000	-66.037	0.0000	-64.593	0.0000
D(FISCAL_BALANCE)	-79.096	0.0000	-79.408	0.0000	-79.373	0.0000
D(MSCI_ARMENIA)	-11.575	0.6878	-81.385	0.0000	-12.449	0.1939
D(INT.NET INVESTMENT POSITION)	-27.710	0.0675	-26.928	0.2427	-12.121	0.2048
D(RUB_AMD)	-96.277	0.0000	-97.601	0.0000	-96.811	0.0000
D(USD_AMD)	-67.653	0.0000	-68.835	0.0000	-66.658	0.0000
D(USD_RUB)	-85.584	0.0000	-85.066	0.0000	-85.965	0.0000

Table 2: *Unit Root Test Results*

In the second step, the effects of the independent variables on the growth rate of the Armenian economy at the time of the increasing conflict that started in 2016 and the subsequent war were analyzed with the help of a robust regression method.

According to the results, variables with a probability value less than 0.05 are significant at the 5% level. Accordingly, variables such as inflation, unemployment, fiscal balance, MSCI_Armenia, net investment position, Karabakh war, rating grades, and Russia-Ukraine war are insignificant at the 5% level. The Karabakh war dummy variable is significant at the 20% level. For the order of magnitude of the variables with positive coefficients, the benchmarks are the interest rate, financial balance, unemployment, foreign reserves, Russia-Ukraine war, rating grades, industrial production, inflation, Dollar/Dram parity, and Ruble/Dram parity. The order of magnitude of the variables with negative coefficients as absolute values are the constant term,

Dollar/Ruble parity, COVID, Karabakh war, MSCI_Armenia and its net investment position (See Table 3).

According to these results, the need to move the research from a static plane to a dynamic plane has emerged to calculate the effect of war on economic growth more precisely during the war period. According to the static results, the most striking result is the low significance level of the Karabakh war variable. From this point of view, it can be hypothesized that Armenia is strongly supported economically by both axes so that it does not collapse after the war, since Armenia receives geopolitical support from both the Western alliance and the Russian Federation. For this reason, it can be hypothesized that the increased foreign capital inflow in the post-war period reduced the significance level of the Karabakh war. In line with these hypotheses, the phase of determining the dynamic historical effects in the research was started.

Dependent Variable: ECONOMIC_GROWTH
Method: Robust Least Squares
Date: 04/02/23   Time: 21:22
Sample (adjusted): 2016M02 2022M12
Included observations: 76 after adjustments
Method: M-estimation
M settings: weight=Bisquare, tuning=4.685, scale=MAD (median centered)
Huber Type I Standard Errors & Covariance

Variable	Coefficient	Std. Error	z-Statistic	Prob.
NET_FOREIGN RESERVES	5.684322	2.416485	2.352310	0.0187
INDUSTRIAL PRODUCTION	0.145475	0.061784	2.354572	0.0185
INFLATION	0.101677	0.317388	0.320355	0.7487
BENCHMARK INTEREST	88.80904	30.29979	2.931012	0.0034
UNEMPLOYMENT	11.91049	31.11956	0.382733	0.7019
FISCAL_BALANCE	53.03980	41.55652	1.276329	0.2018
MSCI ARMENIA	-0.001057	0.001546	-0.683650	0.4942
NET_INVENTION_POSITION	-0.000716	0.001880	-0.381055	0.7032
RUB_AMD	0.000245	9.76E-05	2.504449	0.0123
USD_AMD	0.000961	0.000378	2.546059	0.0109
COVID	-5.362977	2.548906	-2.104031	0.0354
KARABAG_WAR	-0.904333	0.654182	-1.382386	0.1669
RATING	3.270960	0.953449	3.430661	0.0006
RUSSIA_UKRAINE_war	5.543316	4.942826	1.121487	0.2621
USD_RUB	-7.07E-06	1.21E-05	-0.582372	0.5603
C	-79.54187	23.12854	-3.439121	0.0006
Robust Statistics				
R-squared	0.655482	Adjusted R-squared		0.569352
Rw-squared	0.877382	Adjust Rw-squared		0.877382
Akaike info criterion	90.20548	Schwarz criterion		135.2673
Deviance	410.8204	Scale		2.495368
Rn-squared statistic	315.1764	Prob(Rn-squared stat.)		0.000000
Non-robust Statistics				
Mean dependent var	5.289342	S.D. dependent var		6.506815
S.E. of regression	2.834075	Sum squared resid		481.9190

Table 3: *Robust Regression Results*

With the obtained data, the VAR model was first established. The appropriate lag length for this model has been investigated. The based VAR model must be stable for the historical decomposition results derived from the VAR equations to be meaningful and interpretable.[29] For this reason, the appropriate lag length was investigated first. In this context, the 1st lag length was chosen for analysis. In the first leg, the inverse roots of AR characteristic polynomials are in the unit circle, and the modulus values are less than 1. The model is significant in interpreting the historical decomposition of the unit circle (See Figure 2).
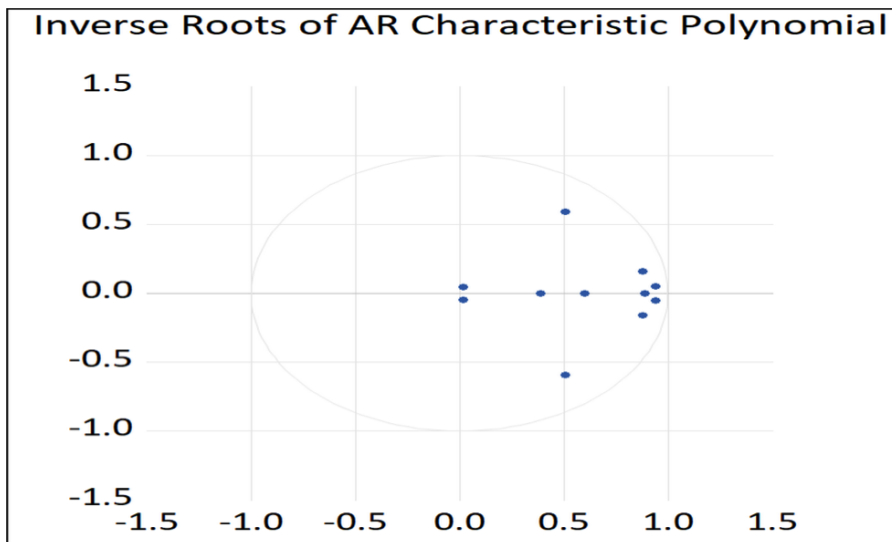

Figure 2: VAR Model Stability Test

The Historical decomposition method provides a dynamic and sensitive analysis of explanatory variables with structural shocks on the target variable and parameter values retrospectively during the observation period. The method is dynamic, as it has been chosen to take the traditional static regression equation analysis to a further dimension because it measures differential sensitivity responses at temporal observation points.

Accordingly, the economic growth rate for Armenia was chosen as the target variable. Explanatory variables are net foreign reserves, inflation, unemployment rate, MSCI_Armenia, Russian Ruble/Armenian Dram parity, US Dollar/Armenian Dram parity, industrial production level, benchmark interest rate, financial balance, and net investment position variables. The

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29 Balcilar et. al, "The renewable energy consumption…"

external regulatory variables are the Karabakh war, the Russia-Ukraine war, the COVID pandemic, and credit rating agency ratings are dummy variables. In the structure of VAR models, external variables can also be defined as dummy variables. In other words, from the point of view of the VAR model application, external variables and dummy variables have the same form.

Accordingly, let us explain the dynamic effects of the explanatory variables on the economic growth rate of Armenia in terms of the Second Karabakh War.

It has been observed that the growth dynamics have been disrupted due to the negative impact of the process that turned into a war for the Armenian economy in 2020 and the shocks caused by their own effects during the war. For this reason, the negativities in the rate of economic growth before the war attract attention.

Likewise, shocks in the growth rate during the military conflicts in 2016 negatively affected the economic growth dynamics. On the other hand, after the armistice was reached, improvements were observed in the economic growth rate dynamic in 2021. However, with the increasing tension in the region in 2022, the growth dynamic has become vulnerable to shocks again.

Concerning net foreign reserves, in the period leading up to the war in 2020, it had a negative impact on the Armenian economy; This effect turned positive in 2021 after the armistice. Again, as with the shocks in the economic growth rate, the conflict dynamics that started again increased the negative effect of net foreign reserves on the economic growth rate.

It is observed that inadequate industrial production negatively affected economic growth during the war period. Respectively, the negative effect of the war period, the positive impact after the armistice, and the increasing conflict dynamics again caused a negative effect.

The unemployment variable, with the armistice signed after the war in 2020, also negatively affected the economic growth of Armenia.

According to the results of the MSCI_Armenia intermediary variable, the stock market movements that took place for the recovery of the post-war Armenian economy supported economic growth in 2021 with the confidence provided by the armistice. On the other hand, the increasing conflict dynamics in 2022 have reset this effect by decreasing confidence.

The inflation rate, along with the war period, negatively affected the Armenian economy. This effect turned positive in 2022 with the re-balancing of the breaks in the supply chains.

It is observed that the effect of interest rates on the Armenian economy during and after the war was close to zero.

Fiscal balance negatively affected growth for Armenia in the process that turned into war. This situation was reversed into a positive outcome with post-war foreign aid and capital inflows. However, the situation was reversed again as the financial balance slowed economic growth with the increasing tension in the region in 2022.

The international net investment position hurt the Armenian economy like other essential variables leading up to the war. After this, the increased capital inflows with the post-war period enabled the net investment position to support growth.

The effects of exchange rates should be done comparatively within the framework of the US Dollar and the Russian Ruble. Which exchange rate affects the growth positively or negatively for Armenia in which periods? Is Armenia experiencing a trend towards the Western axis in the economic and political sense? Or is there the signal that Armenia is converging to the Russian axis? The US Dollar exchange rate had a negative impact on economic activity during the war period. This effect turned positive after the war. At the beginning of 2022, the result turned negative again. Later, with the visit of the USA House of Representatives Speaker Nancy Pelosi to Armenia and the USA's participation in the Karabakh issue in the direction of Armenia, the effect remained slightly positive.

The Russian Ruble, on the other hand, negatively affected growth during the war period, but supported growth after the armistice. The situation turned for the worse with the emergence of the possibility of a military operation by Russia against Ukraine in the spring of 2021 and the war that broke out in 2022, and so the Ruble severely impacted the growth of the Armenian economy. The Ruble, which recovered in global financial markets after it started to be used as a reserve currency in energy trade, began to energize the economic growth of Armenia again in the last quarter of 2022.
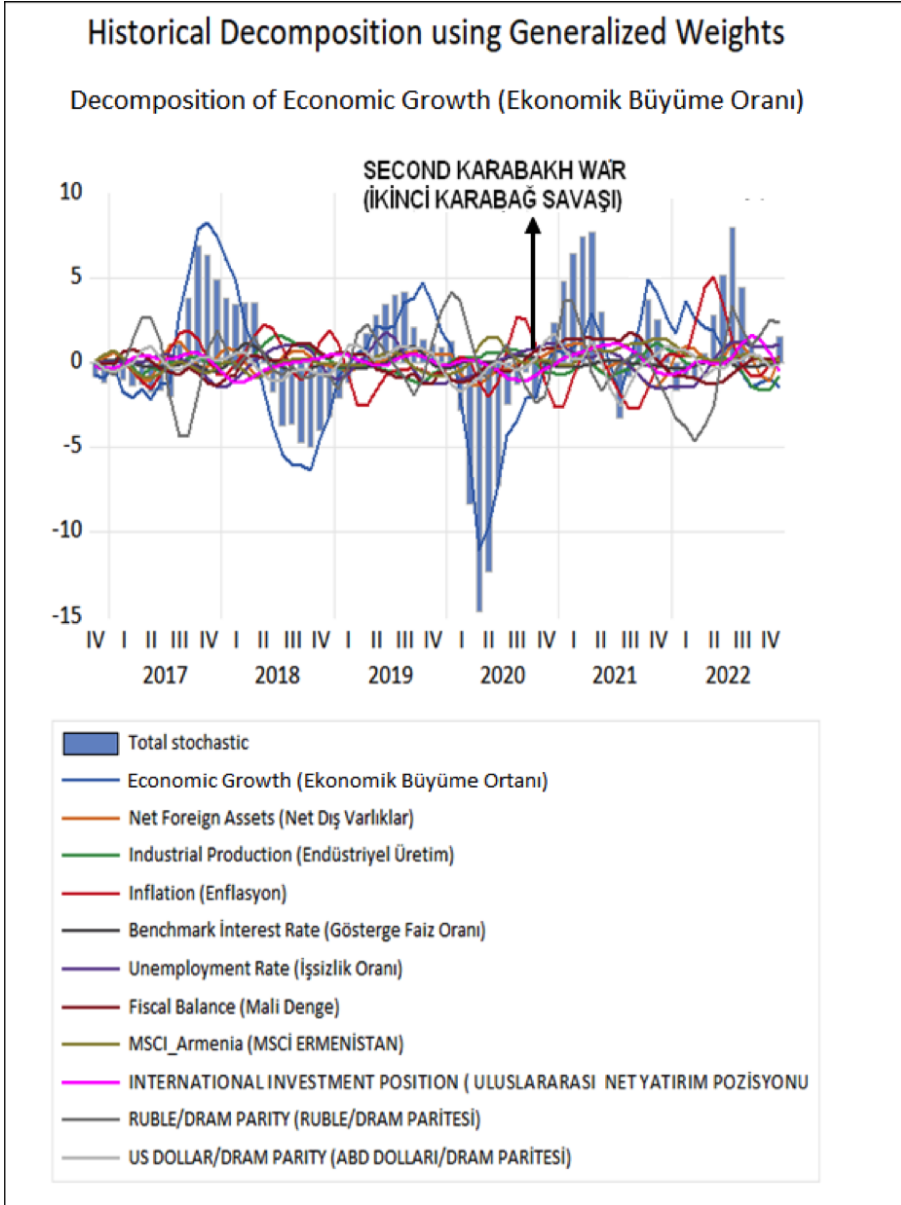
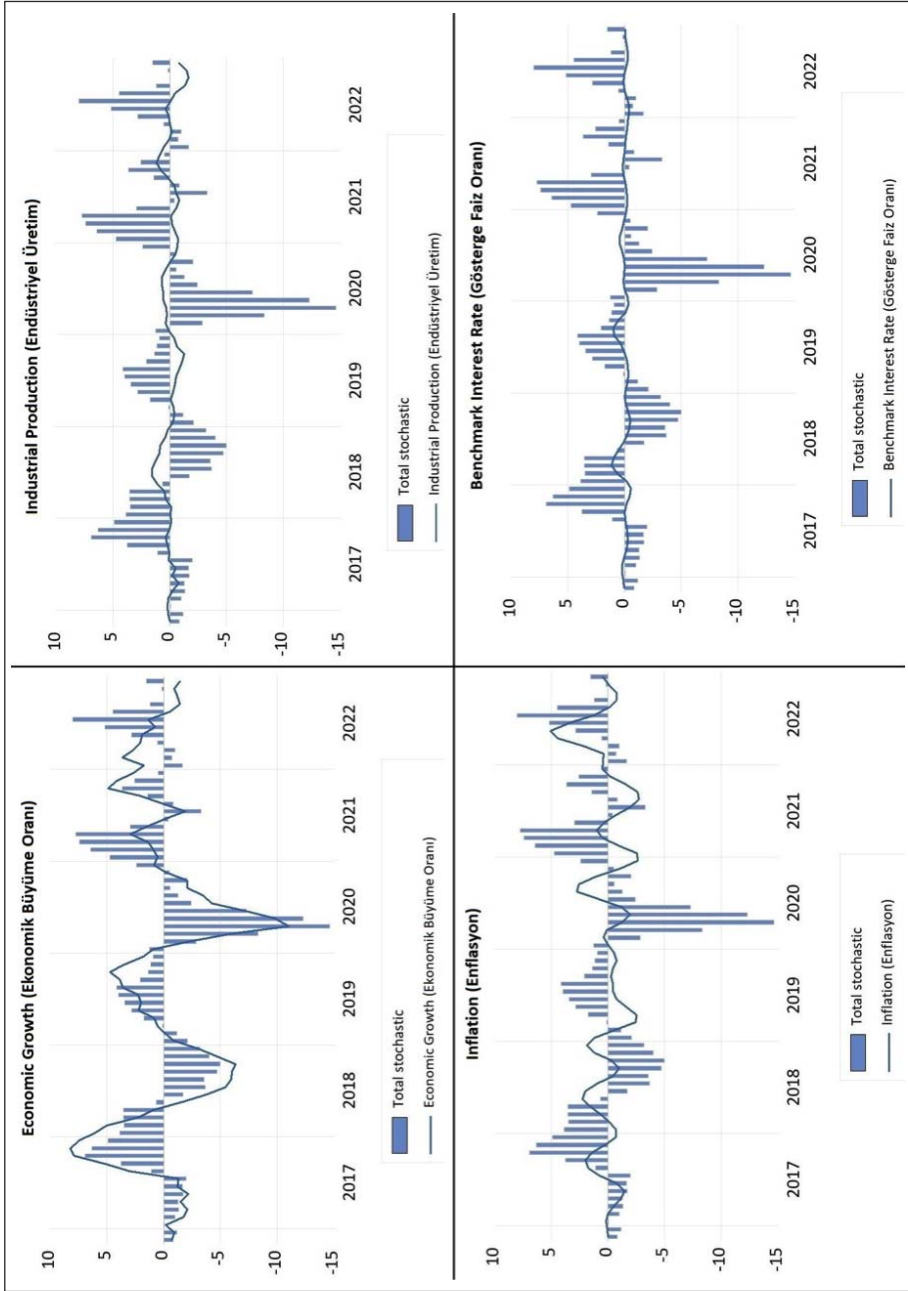***Figure 3:*** *Historical Decomposition Results, Single Graph*

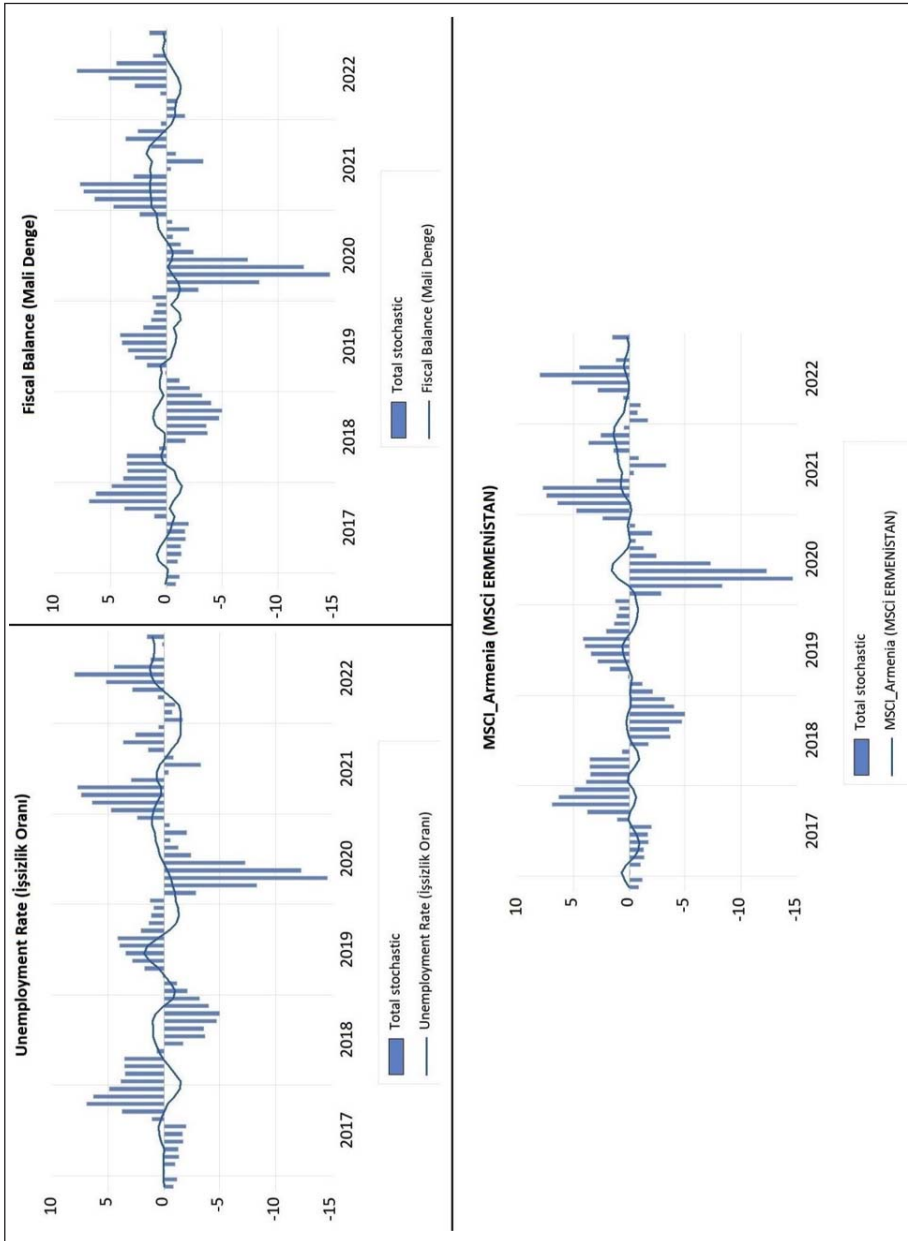***Figure 4:*** *Consolidated Graph of Historical Decomposition Results 1*

Figure 5: *Consolidated Graph of Historical Decomposition Results 2*
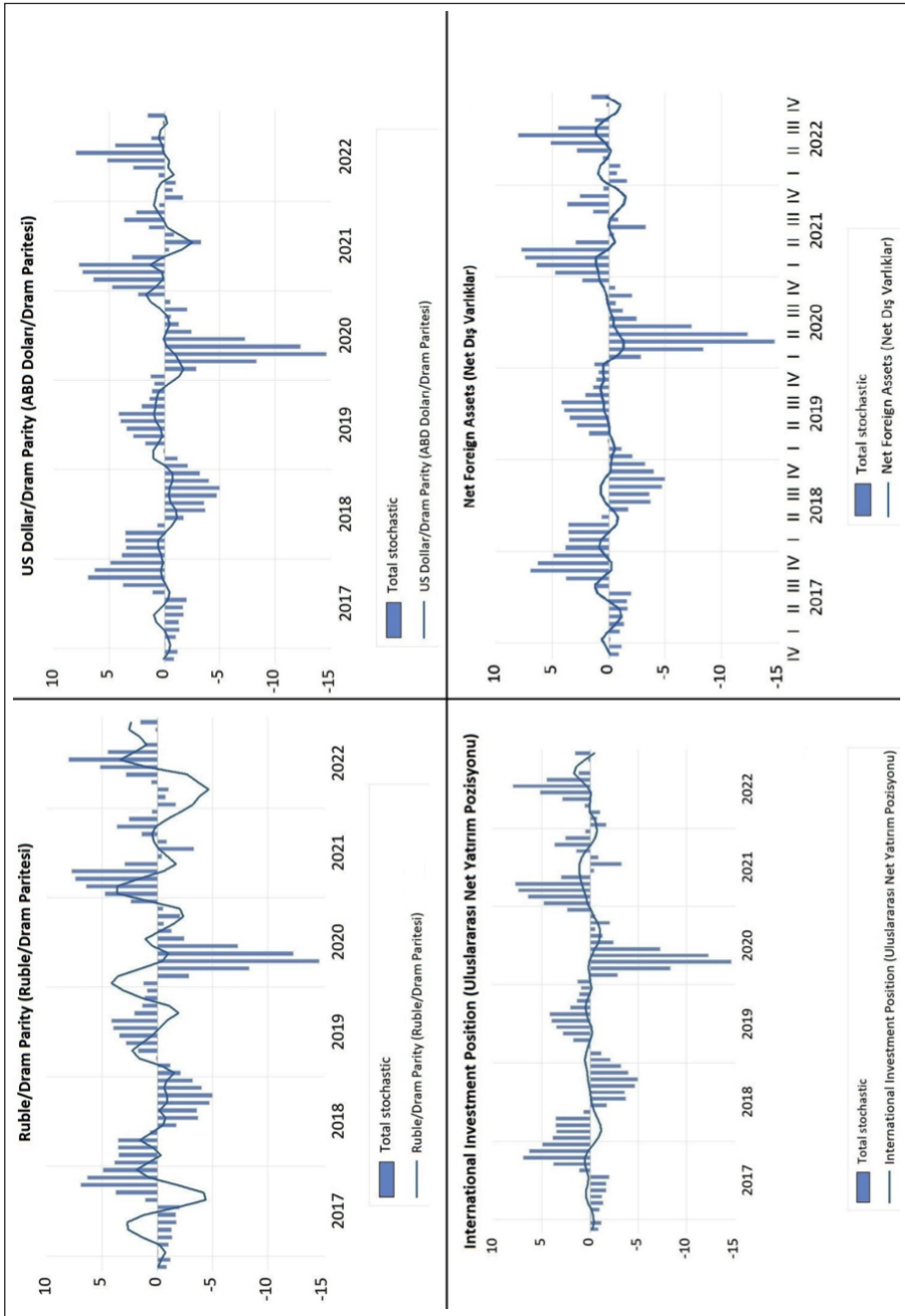
Figure 6: *Consolidated Graph of Historical Decomposition Results 3*

Conclusion

In the process that started after the end of the Cold War, risks of ethnic conflict emerged between the countries that emerged from the union in the USSR geography based on disputed regions. As a result of these risks, Armenia occupied the (Nagorno) Karabakh region within the territory of Azerbaijan, and the First Karabakh War began. After the battle, Azerbaijan lost military control of the region to Armenia. After the first war, tensions in the region rose from time to time, and conflicts continued. The most severe of these conflicts prior the Second Karabakh War took place in 2016.

It can be seen that the founding conceptual elements that led to the first and second wars differed. According to this, while the first war was an ethnic-based conflict that Armenia started by claiming the territory of Azerbaijan, the main constituent element of the second war was a proxy war that broke out as a result of the economic-political plane caused by the geopolitical rivalry between Turkey and Russia. For this reason, this element underlies the economic-political analysis, which is the primary motivation of this research.

There has been a geopolitical and military rivalry between Turkey and Russia in various regions, such as in Syria and Libya since 2018. Especially after the death of Turkish soldiers in Syria's Idlib in February 2020, there has been a strong perception that a comprehensive alliance system cannot be established permanently. In particular, this perception was primarily seen in Turkish public opinion. In the ongoing process of reducing its energy dependence on Russia, Turkey has sought to diversify its energy imports and relatively replace Russian natural gas with Azerbaijani gas. Later, Armenia carried out a military attack on the city of Tovuz in Azerbaijan, located on the lines transporting Azerbaijani gas to Turkey. After this attack, on 27 September 2020, Azerbaijan launched a comprehensive land and air operation in the Karabakh region to regain the lands lost in the first war.

With the start of the second war, in addition to the support of the Turkish staff, the unmanned aerial vehicles provided to Azerbaijan determined the direction of the war. On the other hand, Israel, as a soft power element due to the geopolitical problems it has with Iran, provided ammunition to the Azerbaijani military through the airspace of Turkey. Iran, meanwhile, supported Armenia along with Russia in this war. Accordingly, the second war is a Turkey-Russia proxy war in the primary semantic layer, in the secondary layer, it can also be expressed as a weaker Israel-Iran proxy war.

After the second war that lasted for 44 days, an armistice was signed under the mediation of Russia. With this agreement, Azerbaijan regained control of 70% of the lands it lost military power in the first war. The second war had

devastating economic-political consequences for Armenia, causing it to lose geopolitical status, and military personnel and equipment.

The study in this conceptual framework aimed to investigate the effects of the second war on the Armenian economy to determine the political and economic convergences between Armenia's Western alliance and Russia relations after the war based on the results obtained. For this reason, variables explaining the economic growth rate of the Armenian economy were chosen. In addition, exogenous variables representing the second war, the COVID pandemic, the country's financial risk situation, the Russia-Ukraine war, and the Dollar/Ruble parity were created.

A two-stage structure was adopted in the research method. Firstly, the parameter coefficients of the endogenous variables explaining the economic growth of Armenia between January 2016 and December 2022 were estimated using the robust regression method. According to the results, variables with a probability value less than 0.05 are significant at the 5% level. Accordingly, variables such as inflation, unemployment, fiscal balance, MSCI_Armenia, net investment position, Karabakh war, rating grades, and Russia-Ukraine war are insignificant at the 5% level. The Karabakh war dummy variable is significant at the 20% level. For the order of magnitude of the variables with positive coefficients, the benchmark are the interest rate, financial balance, unemployment, foreign reserves, Russia-Ukraine war, rating grades, industrial production, inflation, Dollar/Dram parity and Ruble/Dram parity. The order of magnitude of the variables with negative coefficients as absolute values are constant term, Dollar/Ruble parity, COVID, Karabakh war; MSCI_Armenia, and net investment position.

In the second stage, the dynamic or time-varying shock and parametric effects of endogenous variables on the growth rate of the Armenian economy were estimated during the analysis period. According to the dynamic analysis, it was observed that the growth dynamics in the Armenian economy deteriorated before the second war in Karabakh and during periods of increasing tension and conflict in the region. During the war, this negative effect got worse. However, it is observed that the economy is doing well in the post-war period. When the dynamic impacts of net investment position and net foreign reserves account for economic growth are followed, it can be stated that the Armenian economy, which was stuck in a bottleneck after the war, was re-vitalized by foreign capital inflows. This situation is observed when the effects of the US Dollar and Russian Ruble on the Armenian economy are examined.

In a way, since Armenia is a country under the patronage of both political axes (Russia and the Western world), the economic contractions caused by the dynamics of war and conflict in the Armenian economy (in particular

concerning Karabakh) are remedied with the US Dollar (as foreign capital) when Armenia gets closer to the West, and with the Russian Ruble (again, as a foreign capital) when Armenia gets closer to Russia. The stock market movements in Armenia during the periods of capital inflows partially compensated for the losses incurred during the war. Another great point is that the interest policy for Armenia is not a factor since its effect is at a level close to zero. According to the results obtained, if the effects of the financial balance (that is, the budget balance) on economic growth rate is examined, it becomes noteworthy that the expenditures that caused the budget deficit were the basis of the shrinking economy in the pre-war period. This trend is likely to continue as defense budget expenditures will be increased by Armenia in the post-war period.

To summarize, the process that turned into the Second Karabakh War in September 2020 and the increasing public expenditures in the Armenian economy during the war period negatively affected the economic activity in the Armenian economy and caused an economic contraction. During the post-war period, the Armenian economy and financial markets are recovering with the normalizing relations with Turkey, and especially with the West's and Russia's capital inflows. However, while the increasing military tensions in the region have not evolved into war, the Armenian economy is nevertheless very sensitive to these tensions in a negative sense despite the armistice. This is because Armenia maintains both the Western alliance axis and different levels of alliance and cooperation diplomacy with Russia. According to the changing geopolitical and economic conjuncture, it is striking that the Western and Russian capitals alternatively support the Armenian economy. Since Armenia's alliance system with Russia is robust, it should be noted that Russia's influence on the Armenian economy is more potent than that of the West. This is because the biggest trading partner of the Armenian economy is Russia and many Armenian citizens working in Russia transfer their income to Armenia, which explains the higher effect of capital inflows from Russia.

We may see economic consequences from the debate over Armenia's place in the Eurasian region (as envisioned by Russia) and the Collective Security Treaty Organization (CSTO). Questions over Armenia's continuing participation in the CSTO and the Eurasian Economic Union (EAEU), a significant economic partner for the country, might result in a decline in trade and investment. Concerns about the stability and security of Armenia might also deter international investment and have a detrimental effect on economic growth. The economic situation may worsen due to local investors losing trust due to the uncertainty surrounding Armenia's ties with the CSTO and the EAEU. Since economic development and stability are intimately related to political stability and security, Armenia's economy may ultimately suffer due to this issue.

Market volatility may result from uncertainty surrounding Armenia's connections with the CSTO and the EAEU. Investors may react adversely to the unpredictability and volatility, which might reduce interest in Armenian assets and cause the value of the national currency to fall. Sell-offs in the stock market might occur as investors try to transfer their money to safer places. Additionally, there may be a rise in borrowing prices and a decline in credit availability, which might even hurt economic activity. In conclusion, the adverse impacts of unpredictability and volatility can reduce the performance of the financial markets and thus damage the Armenian economy.

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Appendices

1.Calculation of MSCI_Armenia Mediator Variable

Estimation Proc:

===============================

**LS(NOCONST) 1 3 ARMENIA_INTERES_ MSCIWORLD @
RUS_UKR_WAR SAVAS COVID**

VAR Model:

===============================

**ARMENIA_INTERES_ = C(1,1)*ARMENIA_INTERES_(-1) +
C(1,2)*ARMENIA_INTERES_(-2) + C(1,3)*ARMENIA_INTERES_(-3)
+ C(1,4)*MSCIWORLD(-1) + C(1,5)*MSCIWORLD(-2) +
C(1,6)*MSCIWORLD(-3) + C(1,7)*RUS_UKR_WAR + C(1,8)*SAVAS +
C(1,9)*COVID**

**MSCIWORLD = C(2,1)*ARMENIA_INTERES_(-1) +
C(2,2)*ARMENIA_INTERES_(-2) + C(2,3)*ARMENIA_INTERES_(-3)
+ C(2,4)*MSCIWORLD(-1) + C(2,5)*MSCIWORLD(-2) +
C(2,6)*MSCIWORLD(-3) + C(2,7)*RUS_UKR_WAR + C(2,8)*SAVAS +
C(2,9)*COVID**

Response of MSCIWORLD:	MSCI WORLD calculations is used for mediator MSCI_Armenia	
Period	ARMENIA_INTERES_	MSCIWORLD
1	-4.068579	107.7921
2	-13.37175	80.17472
3	-1.718771	72.34194
4	1.800014	76.73850
5	0.968473	74.59420
6	4.628143	72.66136
7	6.403019	72.30786
8	7.416578	71.25839
9	8.974557	70.30973

10	10.04566	69.62330
11	10.90794	68.86833
12	11.74320	68.17552
13	12.40409	67.55065
14	12.95885	66.94181
15	13.43967	66.36828
16	13.83352	65.82551
17	14.16086	65.30353
18	14.43255	64.80337
19	14.65278	64.32202
20	14.83020	63.85637
21	14.97082	63.40516
22	15.07922	62.96661
23	15.16015	62.53917
24	15.21742	62.12172
25	15.25425	61.71314
26	15.27356	61.31251
27	15.27780	60.91904
28	15.26909	60.53202
29	15.24928	60.15085
30	15.21995	59.77502
31	15.18247	59.40408
32	15.13803	59.03763
33	15.08765	58.67533
34	15.03221	58.31689
35	14.97247	57.96205
36	14.90908	57.61059
37	14.84262	57.26232
38	14.77357	56.91706
39	14.70235	56.57466
40	14.62934	56.23501
41	14.55483	55.89798
42	14.47911	55.56348
43	14.40240	55.23142

44	14.32491	54.90172
45	14.24681	54.57432
46	14.16826	54.24914
47	14.08937	53.92615
48	14.01026	53.60530
49	13.93102	53.28653
50	13.85174	52.96982
51	13.77249	52.65512
52	13.69332	52.34241
53	13.61430	52.03166
54	13.53545	51.72284
55	13.45683	51.41593
56	13.37846	51.11090
57	13.30036	50.80774
58	13.22258	50.50643
59	13.14511	50.20695
60	13.06799	49.90928
61	12.99122	49.61340
62	12.91482	49.31931
63	12.83879	49.02698
64	12.76315	48.73640
65	12.68790	48.44757
66	12.61305	48.16046
67	12.53860	47.87506
68	12.46455	47.59137
69	12.39091	47.30937
70	12.31767	47.02905
71	12.24485	46.75039
72	12.17244	46.47340
73	12.10044	46.19805
74	12.02885	45.92433
75	11.95768	45.65225
76	11.88691	45.38177
77	11.81655	45.11291

78	11.74660	44.84563
79	11.67706	44.57995
80	11.60792	44.31584
81	11.53919	44.05330
82	11.47086	43.79231
83	11.40293	43.53287
84	11.33540	43.27497
85	11.26827	43.01860
86	11.20153	42.76374
87	11.13519	42.51040
88	11.06923	42.25856
89	11.00367	42.00821
90	10.93849	41.75935
Generalized Impulse		