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## Issues Related to Promoting a Competitive Business Environment in Armenia

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### Abstract

Despite the apparent growth performance of Armenian economy there is a widespread concern that the lack of competition within Armenia could threaten the long term sustainability of growth and that it has been a contributing factor to the existing wealth polarization in the society. The paper examines the scope for anti-competitive behavior, which sectors are the most affected, what relevant work has been done on these issues, what policy options are available to deal with the problems and what additional work is needed. The analysis points at the three main areas: (1) regulated sectors, where there are natural monopolies or where competition is inherently limited, such as utilities, telecommunications and transportation, (2) sectors of the economy that in Armenia are generally viewed as being controlled by a small number of incumbents, and (3) barriers to entry into economic activities. Ultimately, the paper suggests policy options for promoting a competitive business environment in Armenia.

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the Armenian International Policy Research Group. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

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## ***I. Introduction***

The Armenian economy has registered sustained rapid growth over the past decade, especially in the last few years. In 2003, GDP increased by 14 per cent in real terms, after having increased by 12.9 per cent in 2002. This growth performance is one of best in the world. The government has committed to economic reform and the economy is gradually being transformed. It has made private sector development the main pillar of its growth strategy and has been working to improve the business environment through a reduction in regulations, improving the bankruptcy law, improving customs administration, strengthening the banking system and reducing the capacity of officials to hamper businesses. In this process, it has received substantial support from donors. Nevertheless, per capita GDP remains low. Although extreme poverty has fallen, there are still large numbers of poor in Armenia, especially in the rural areas and urban centers outside the capital, Yerevan. Unemployment statistics still show large number of unemployed, although the informal sector, which currently accounts for the equivalent of 46% of GNI<sup>1</sup>, probably has absorbed a substantial number of those who are recorded as being out of work. The “trickle down” impact of the high growth rates on poverty alleviation has been disappointing and there has been slow progress in reducing the unequal distribution of income – Armenia’s Gini coefficient<sup>2</sup> is .45, which is the highest in the FSU although household survey data put the coefficient at a much more reasonable .27, possibly because of unrecorded informal sector and remittance income.

Although the growth performance of the economy has been strong, the government is anxious to ensure that it is sustainable. In this regard, there is concern that the lack of competition within Armenia could threaten the long term sustainability of growth and that it has been a contributing factor to the apparent failure of the recent economic expansion to benefit a larger proportion of the population.

The aim of this paper is to come to a preliminary judgment on the importance of this issue for the development of the Armenian economy. The paper examines the scope for anti-competitive behavior, which sectors are the most affected, what relevant work has been done on these issues, what policy options are available to deal with the problems and what additional work is needed. The paper touches on the political economy issues related to areas of the economy where competition is lacking and suggest policy options for the government.

The paper is organized as follows. We look at three main areas where competition issues are important in Armenia. In the first section, we discuss briefly those sectors that are traditionally regulated; where there are natural monopolies or where competition is inherently limited, such as utilities, telecommunications and transportation. Then, in the

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<sup>1</sup> Source: World Development Indicators 2003.

<sup>2</sup> The Gini index of income is a measure of the degree to which income among a population is unequally distributed. The Gini coefficient ranges from 0 to 1. If the income is perfectly even distributed, the Gini coefficient is 0. If the income is perfectly concentrated, the Gini coefficient is 1.

second section, we look at sectors of the economy that in Armenia are generally viewed as being controlled by a small number of incumbents who either singly or in cartels dominate distribution of particular products. These include gasoline, wheat, cut flowers and sugar. In this section we also discuss some of the methods that appear to be used to maintain market dominance and make some suggestions for dealing with it. In the third section, the paper looks at barriers to entry into economic activities more generally – the higher the entry barriers, the less likely is growth to trickle down to the population more generally and the greater the long run constraint on growth. The final section of the paper provides some conclusions and policy implications.

## ***II. Existing Analysis of Competition Issues in Armenia***

Several pieces of work on Armenia touch on issues raised in this paper, but to date there has been little specific analysis of the issues related to competition. Trade Diagnostic Study (World Bank 2002) examined constraints related to further integration of Armenia's foreign trade into the world trading system. It touched on some of issues related to promoting competition, particularly in the customs area as well as some of the constraints to private sector development in foreign trade. A recent USAID Report (2004) on competitiveness in the Armenian economy generally engages in a substantial amount of business school management jargon applied to countries, without pinpointing any of the real issues related to lack of competition that are holding back the economy. A study of financial markets in Armenia by Mu, *et al.* (2004) sets out issues related to financial market underdevelopment. A very recent report (Schiffman 2004) on bank corporate governance and creditors rights analyzes recent changes in laws related to collateral and finds that little has been done. An analysis is currently being done of Armenia's trade in services within the context of the General Agreement of Trade in Services. It will examine in greater depth some of the issues raised in this paper, particularly with respect to landing rights at Yerevan airport. Additional relevant work includes and analysis of competition law reform (McArdle 2001). None of these studies, however, address the issues related to promoting an effective environment for competition in Armenia.

## ***III. Competition Policy in Armenia***

This section looks briefly at some of the issues related to sectors that are traditionally regulated in most economies. These include telecoms, power, water, natural gas, transport and airports. In Armenia, telecom regulation is about to come under the jurisdiction of the Public Service Commission once a Telecom Act that is currently in Parliament is passed. The Commission also regulates power, water and natural gas.

Other sectors are regulated differently. The Civil Aviation Service regulates air traffic. Yerevan airport is operated under a concessional agreement by a foreign company, owned by an Argentinean-Armenian, which is an important step in creating favorable initial conditions for successful air transportation regulation. The Ministry of Transport regulates transportation. The railway company is still state owned and unfavorable practices have been reported in this sector. In addition, the Commission for the Protection of Economic

Competition (CPEC) also has jurisdiction to the extent that actions by companies in these sectors are deemed to harm the consumer. So far this authority has not been exercised, although the CPEC is adamant that it could do so in the future.

The Public Services Commission has been the recipient of substantial support from donors, both in the area of technical assistance to upgrade skills and in improving its operating infrastructure. As a result, the capacity of the Commission to regulate the industries under its jurisdiction has improved.

### **A. Telecommunications**

After independence, Armenia inherited a relatively extensive but low quality telecommunications network. However, the design of the network was not commercially driven, leading to misallocated lines and low call volumes. These elements combined with politically driven low local tariffs (subsidized by high international call rates) resulted in low revenues per line. The outcome was outdated equipment, poor network quality and a slow digitalization rate due to chronic under investment in the sector.

The government added substantially to the problems of the telecommunications sector by awarding a long term monopoly (granted until 2013) to ArmenTel, the local telecommunications company owned by the Hellenic Telecommunications Organization, a Greek company. The monopoly, which also encompasses cellular and “last mile” internet services, has allowed ArmenTel to provide low quality services at high prices, further hampering growth in telecommunications and related sectors. The process of privatization was poorly handled, was not transparent, and occurred without an adequate regulatory framework. Its costs are still being born by the private sector of the Armenian economy.

The impact of the high costs of telecommunications are especially severe given that Armenia is remote from Europe and the United States – the need for low cost communications is acute in small remote economies. One of the rapidly expanding areas of the economy is the IT sector, which relies on communicating easily with the outside world.

The result was very high telecommunications costs that severely exacerbated Armenia’s geographical disadvantages. One indicator of the inefficiencies arising because of the monopoly is that mobile phone cards, issued by ArmenTel itself sell at a high premium on a secondary market. ArmenTel does not issue sufficient quantities of calling cards to meet demand and the price is bid up to 3 or 4 times the face value of the cards.

In spite of this, the internet sector of the Armenian economy has thrived and there are a large number of internet service providers. However, they all have to go through ArmenTel to connect to the Internet, which results in unreliable connections and a limit on their ability to compete on price. Service is also limited to modem connections only – ArmenTel maintains a monopoly on high speed connections and charges prices that are 20 to 30 times more than those in countries where there is competition in the telecommunications sector. The government recently has taken ArmenTel to arbitration in a London arbitration tribunal

on the grounds that it has failed to fulfill its contractual obligations to invest in the telecommunications sector<sup>3</sup>. It has also announced that regardless of the outcome of the arbitration, it will open the cellular and data transfer portion of the sector to other providers. These steps should result in improved competition, lower prices and better service. The need for regulation, however, will not disappear with the forthcoming changes, and it is important that a coherent and competent regulatory structure be put in place. To ensure this, continued donor assistance to the Public Services Commission to enhance its capabilities to regulate the telecoms sector is warranted.

## **B. Utilities**

The electricity sector has been substantially restructured over the past few years. First, the distribution system has been privatized, an effort that appears to have been very successful. Whereas prior to privatization, inefficiencies and large arrears strained the system to the point where it was breaking down, arrears have now been eliminated, electricity bills are collected on time and the system is functioning reliably. This is one of the success stories of Armenian privatization.

The power generation sector consists of 5 large generators, one of which is nuclear, two of which are thermal and the other two are hydro-electric. One of the hydro generators and one of the thermal generators are run by Russia, who acquired the generators from the Armenian government in a debt-for-equity swap. Russians also run the nuclear station under a management contract. In addition to the large generators, there are a substantial number of small private hydro producers who supply the grid, which is compelled to purchase any power that they produce.

The Public Services Commission also regulates the natural gas distribution sector – many of the same issues appear to apply and there was no indication that it was being done ineffectively. The Russian-Armenian joint-stock company “ArmRusGasProd” has invested intensively in developing a gas-distribution network in the country.

The Commission regulates the producers<sup>4</sup> on a rate of return basis. While it is possible to quibble over the efficiency of rate of return regulation, a brief review indicated that it appears to be done competently, although a much more in-depth study would be needed to confirm this.

## **C. Transport**

There are several issues in the transport sector that appear to warrant further investigation. The Ministry of Transport regulates rail traffic. In the railway sector there were reports that

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<sup>3</sup> Although there is some concern that since ArmenTel also had a business in Armenia selling telecom infrastructure equipment, the ability to engage in transfer pricing makes the investment issues less clear cut than they otherwise would be.

<sup>4</sup> Except for the small ones, which can sell at a predetermined price until 2007.

price setting is non-transparent and opportunistic – there were ongoing negotiations with the Gold Mining Company regarding new rates that the Ministry was attempting to approve. Realizing that the Gold Mining company should connect its mining facilities (situated in the North-East part of the country) with its melting facilities (located in the South-West of the country) and the fact that using other means of transportation other than the only existing railway are economically inefficient the state – owned railway company made attempts to extract extra-high profits from its naturally dominant power in the sector by proposing high rates for transporting ore.

Further issues relating to air traffic also give grounds for concern. The national flag carrier, Armenian Airlines became bankrupt and was liquidated in 2003. A local company, Armavia bought the liquidated Armenian Airlines, and hence acquired bilateral landing rights in flights to and from Armenia. Armavia, and with it the landing rights, was in turn purchased by Air Siberia, a Russian airline company. There have been reports that whenever foreign airlines operating in Armenia, wanted to increase the number of their flights and applied for permission to the Civil Aviation Service, the CAS has in turn sought the agreement of Armavia which owns the bilateral rights. Effectively, access by foreign airlines to Yerevan is controlled indirectly by a private company that has no interest in seeing competition increase because it reduces the value of the landing rights that it holds.

This clearly substantially disadvantages Armenia. A small remote economy that implements policies that drive up the price of communications, whether they be telecoms policy or transportation policies is effectively exacerbating the costs of smallness and remoteness. The Armenian national interest requires that the government take as bold a policy towards air transport as it appears to be doing with the telecom monopoly. An open skies policy should be implemented without delay. Moreover, in this context the operating infrastructure of the Civil Aviation Service should undergo necessary changes to maintain open skies policy.

#### ***IV. Lack of Competition in Distribution***

Many private sector participants in Armenia operate in ways that would be unusual in the industrial countries. As is common in many countries with weak institutions, facilitation payments are frequently used as a means of ensuring that dealings with the public sector proceed without undue delay. However, unlike other countries, the system has so far not degenerated into one where massive corruption is pervasive, although undoubtedly there is corruption that extends to the highest levels. Rather it has evolved into one in which interlocking obligations arising from favors and interventions govern much of the interaction between the business community as well as between businesses and the legal system. A person who acts to intercede on behalf of another becomes a *roof*, and the benefactor incurs an obligation to return the favor in one form or another at some point in the future. In Armenia, there appear to be few rules which cannot be modified or adjusted through the intervention of a *roof* even within the judicial system. In sectors where a powerful roof exists, the incumbents appear to have the power to make life extremely difficult for new entrants.

It is also noteworthy that foreign investors often do not have the network which provide them with a *roof* and so are frequently more likely to have difficulty navigating their way through the various bureaucracies and judiciary, something which has been mentioned in all the surveys that have been done on foreign investment in Armenia. In addition, companies which are only exporters claim that they are singled out for unfavorable treatment, especially with respect to VAT refunds.

This phenomenon, however, can act as a substantial barrier to entry in the economy, both on the part of foreign investors as well as for new local businesses that attempt to compete with well established companies and individuals operating in the Armenian economy. Although there have been improvements recently, subtle methods are used to impose severe operating constraints on new competition, ranging from problems in clearing goods through customs, to inspections of various types by government officials, to outright sabotage of operations. Furthermore, such behavior is difficult to identify clearly because it is protected by all the members of a particular *roof*.

There are numerous and widespread anecdotes that the economy is dominated by a few powerful groups that maintain a tight control on certain activities, particularly imports of petroleum, sugar, flowers and wheat. It is, however, difficult to obtain hard evidence on the allegations and the deeper the investigation, the greater the contradictions. There do appear to be “roofs” operating in these sectors but on the face of it, there is some competition. On the other hand, there are also widespread allegations that companies in this area are anonymously owned by interlocking share holdings, so that effectively the sectors are controlled by a small number of people who are making large profits and who engage in extremely conspicuous consumption.

### **A. Petroleum Products**

Having no oil or natural gas resources, Armenia is totally dependent upon imports. Imports of fuel products constitute about 20% of total imports. This import group includes two major components in terms of volumes: petroleum products (which include gasoline and diesel) and natural gas imports.

[Insert Text Box 1 in here]

Statistics on imports of petroleum products appear to have been underreported. Firstly, all data largely exclude imports by the Defense Ministry, Internal Affairs and the Nuclear Power Station so it is not possible to determine the total imports of these products. Furthermore, in spite of very rapid growth, statistics on gasoline and diesel imports into Armenia show that in 2000 there was a sharp drop in the import volumes, and only very modest growth afterwards. This occurred in spite of a very sharp increase in automobile imports, which rough statistics indicate exceed 14000 vehicles per year, compared with 1200 per year in 1999. Although it is true that in 2000 oil prices rose, depressing demand that recently imported automobiles are more fuel efficient and that there has been conversion of motor vehicles from gasoline to natural gas, it does not seem likely that in the

face of such rapid growth, fuel consumption could go down. One explanation for the flat fuel imports is that there is smuggling of petroleum.

The structure of market concentration underwent changes in the 1999-2000 period. In 1999 there was only one gasoline importer in Armenia, so that market power was located inside the borders of the country. In 2000 and 2001 the number of importers into the country increased – looking only at the number of operators within Armenia, the market could not be defined as uncompetitive. However, analyzing the import chain reveals that there is only one supplier who provides the bulk (88 per cent) of imported gasoline to importers. While the concentration of direct importers has declined, the virtually single sourcing of supply for gasoline importers means that the supply chain remains highly concentrated. Even though it has been reported that one more company started to supply importers with gasoline in 2002, the share of the incumbent supplier firm remained dominant. It constituted about 70% of total supply to importers.

[Insert Chart 1 in here]

More interestingly, even though the large number of retail companies operating in Armenia, ensures retail competition, the retail mark-up price was substantially higher than the imported (wholesale) price (which we took to be customs clearing price). The gross profit mark-up, most of which probably occurs at the wholesale level, constituted more than half of the retail price in 2001 (Chart 1). These very rough calculations indicate that there appears to be large welfare losses arising from the concentration of the petroleum market that could amount to the equivalent of over 1 per cent of GDP. This loss figure could be even higher if we take into consideration that there is a further profit margin earned by the single source monopoly supplier of imports. This is not included in the calculations of the deadweight loss, which can occur as a result of monopoly power of the one supplier of importers and that the same situation dominates in similar markets (such as in the diesel market).

## **B. Sugar**

The vast majority of sugar imports are brought into Armenia by a single importer. Various rumors abound regarding business practices in sugar distribution, many of them dark, but all of them pointing to control by a single “oligarch”. The sugar importing company was investigated by the Commission on the Protection of Economic Competition, but before a judgment could be reached, the importing company was dissolved and a new one was opened, but with the same shareholders. As a result, the original case did not proceed – whether a new one will start is yet to be determined. Trade data indicate that imported sugar comes mainly from United Kingdom. For the considered period the import share of UK averaged around 70%. Other countries, which has notable share in the sugar import into Armenia are: Iran, Russia, Turkey, and Ukraine.

[Insert Chart 2 in here]



Monopoly power in the sugar market is reflected in the price and mark-up data. Chart 2 shows that the difference between the customs clearing price and the retail price of sugar is substantial – the retail margin is 47 per cent, very high by any standards. Like petroleum there is substantial competition at the retail level, so excess profits are unlikely to be earned at this stage.

[Insert Table 2 in here]

Table 2 reveals the patterns of the mark-up. Sugar has a very low demand price elasticity, which allows a high-profit seeking importer with dominant power to hinder potential entrants. The sugar market profit is estimated to average around \$14 million during the period under consideration.

Some in Armenia argue that there are not large welfare issues arising from the importation of sugar. They point out that the market is small and the main supplier can use his dominant position to purchase large quantities of sugar at a low price. Therefore, even if there are some monopoly rents being extracted, the welfare losses are offset by lower wholesale prices than would exist if there were several importers buying at higher prices in the exporting countries. The flaw in this argument is that if the current importer had concerns about new entrants, he would not exploit market dominance to the same degree and would extract lower rents. In addition, the large numbers of businesses that are opening in areas where there is no restriction of competition illustrate the potential dynamism of the economy. Companies in the IT area, restaurants, retail outlets and building are being created in large numbers. Clearly there is an entrepreneurial and dynamic element in the Armenian economy – restricting competition harms this element as well as consumers.

### **C. Wheat and Cut Flowers**

Gathering data in other markets proved to be more difficult and it was not possible to undertake analysis as detailed as that for petroleum and sugar. Approximately 50 per cent of Armenia's wheat is imported as is the majority of cut flowers. There are widespread reports of concentration of distribution in both these products, with potential competitors being harassed at the borders by customs who used many non-tariff restrictions – health standards, quality standards, and valuation prices - in order to delay imports to the point where costs arising from dealing with the delay eroded any potential profit. These issues are discussed at greater length in the section on the customs service.

### **D. How Monopolies are Maintained**

Corruption and rent sharing with state officials are a pervasive reality of doing business in Armenia. These practices affect the competitive environment in many ways. Market incumbents make illicit payments to or enter into collusion with governmental officials, agreeing to share rents, which are generated as a result of collusion. There are reports of state officials being given shares in incumbent companies, which distorts the incentives associated with increasing public welfare through greater competition. The incentive for

officials who are also shareholders in the incumbent companies is to maintain the status quo. As a result, the abuse of the state power is used as a tool for maintaining monopolies in the market. Although illicit and sometimes violent “private methods” have been used to maintain a dominant position in one specific market, the abuse of state power remains the most effective and widespread method for maintaining monopoly power.

### ***1. The Customs Office***

Armenia has made great strides in attaining compliance associated with WTO access. This has not prevented the Customs Office from remaining one of the predominant instruments for hampering or eliminating potential competitors, particularly in the distribution sector. Customs clearance and valuation procedures are far from being transparent and standardized, with substantial discretion being applied in the licensing of brokers, storage, freight transporters and the operation of the free trade zone. In addition, the continued widespread use of reference pricing in contravention of WTO commitments is another method of delaying imports. Since customs also has some responsibility for enforcing product standards, the number of potential administrative barriers are legion, particularly since some of these standards are also under the jurisdiction of the Ministry of Health. There are therefore numerous opportunities for delaying imports for a large number of reasons. Some of these issues are discussed in greater detail in the following sections.

### ***2. Limiting the Number of Customs Brokers and Associated Activities***

The Customs Office controls “unwanted” private enrolment in customs operation through widely reported unfair and discretionary licensing of customs brokers<sup>5</sup>. The Customs Office appears to limit strictly the number of brokers through customs examinations. Each year there are examinations for customs brokers – even incumbents must take annual exams<sup>6</sup>. A reliable source reported to the mission that in 2003 apparently 30 out of 36 applicants passed the examination but after internal review the Customs Committee declared that there were only 5 successful applicants. One of the unsuccessful applicants (an operating broker) apparently was able to get another Minister to call the Chairman of the Customs Committee on his behalf, so finally there were 6 successful applicants.

On the face of it, the procedure is entirely valid – a written examination subject to scrutiny and appeal. In practice, however, the results of the examination are subject to internal review and adjustment at the whim of the Customs Committee. This “informal review” procedure is not written down anywhere. Since there is such wide discretion, however, the Customs Committee can control very strictly the number of brokers and ensure that they are compliant through the annual examination.

### ***3. Clearing Procedures***

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<sup>5</sup> Customs brokers were only legalized 3 years ago.

<sup>6</sup> Licensing fees are \$500 per year, very high in a country where civil servants salaries rarely exceed \$100 per month.

Customs have introduced electronic clearing procedures to expedite the clearance of goods. Customs brokers, however, do not have access to the computer system and therefore have to deal with paper documentation that nullifies many of the advantages of computerized clearance and that also keeps them in the dark with respect to the status of the goods that they are attempting to clear. The result is uncertainties in the process and delays that can cost importers substantial amounts, especially since they are charged for storage of the goods that are held up.

Another issue frequently cited by importers is the continued use of reference pricing by customs unless extensive documentation accompanies shipments<sup>7</sup>. If any of the documents are missing, then customs apply reference prices to the shipment, a practice that is contrary to WTO rules. In other countries goods can be cleared with partial documentation under surety bonds that provide a guarantee in the event that the declaration was incorrect. However, the lack of financial system development in Armenia implies that surety bonds are difficult to obtain and even when they are, the cost is high. The problem of reference prices is further compounded by the relatively high VAT rate (20 per cent) and the extreme difficulty in obtaining drawbacks of VAT payments upon the export of any goods that use imports as inputs.

### **E. The Role of State Commission on the Protection of Economic Competition (CPEC)**

Should the Commission be one of the pillars of policy to promote competition in Armenia? There are understandable concerns that it could become yet another layer of bureaucracy that leads to “inspections” and the ability of businesses to function without undue interference of officialdom, which in turn can be used to harass entrepreneurs and to protect incumbency. Arguments in favor of the strengthening of the Commission are based on the recognition that it could by one of the ways in which the restrictions on competition that abound in several sectors of the economy could be resisted.

The view of this paper is that in its present form, the Commission is not a significant bulwark against anti-competitive behavior. It has neither the necessary skills, the staff, nor the facilities to operate effectively. Although it has been successful in a limited number of cases<sup>8</sup>, it is not a force in areas where competition is obviously restricted. Its report on the petroleum market is deficient in terms of depth as well as analysis<sup>9</sup>.

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<sup>7</sup> Importers are required to present original documents, including the invoice, the contract covering the import, the certificate of origin and an export declaration from the country of origin.

<sup>8</sup> The Commission has investigated a number of recent cases among which was the successful elimination of a monopoly granted by the airport operator to a taxi cab company. There have been also several hearings concerning the abuse of monopoly power by ArmneTel. The company had cut-off the telephone lines of some internet service providers without prior notification, suspecting them of providing Voice-Over IP service in Armenia. In almost all cases the Commission made decisions in favor of the ISPs and fined ArmenTel to cover the losses incurred by ISPs.

<sup>9</sup> A 4-page analysis concluded that there is competition in the distribution of petroleum because of the fact that there are several wholesalers/ importers within Armenia. The paper does point out that there is only one supplier/seller to the wholesalers but appeared not to view this as a problem.

Does this mean that attempts to assist the Commission should therefore be abandoned. No, over the longer term it could be one of the instruments for promoting competition in Armenia. Modest technical assistance is warranted and perhaps some help with improving its IT resources. It is unrealistic, however, to perceive it as useful in the shorter term. It needs several years to evolve into any sort of instrument against restrictions on competition. Nevertheless, its continued existence is assured and the interests of the private sector lie in it improving its technical competence.

## ***V. Barriers to Entry***

Formal barriers to entry have been reduced. For example, the cost of registering a business is now negligible and occurs with few delays. And the Armenian authorities are determined to eliminate delays altogether. However, reducing the costs of formalization does not address the many issues related to the benefits of being formal. As the next sections will point out, public goods related to the business sector are still inadequate. The main reasons for formality are access to finance and access to the system of formal contracting. In Armenia, financial markets function poorly and the system of contracting and dispute resolution is haphazard at best and under normal circumstances is not effective. It does not provide Armenian businesses with incentives to formalize, particularly since it also allows petty officialdom to target formal businesses with inspections that have as their aim payoffs.

There has been some progress in reducing these. For examples, tax official can only do one audit per year. However, they are still allowed to undertake “fact finding”, which is not classified as an audit. Nevertheless, businesses report that information obtained during fact finding, which can occur as often as requested, is used in annual audits. The protection of the restriction on auditing is therefore no more than limited.

### **A. Financial Markets**

Financial markets play a key role in intermediating between savers and investors. In addition, the financing of new projects enhances openness and competition by ensuring that profitable investment opportunities do not go untapped. The pressure of potential competition that well functioning financial markets bring ensures that monopoly profits are limited. Since financial markets in Armenia fail to play this role, the disincentive on incumbents not exploit their position is severely weakened.

#### ***1. Financial Underdevelopment***

Financial markets in Armenia are severely underdeveloped and finance effectively neither local production nor foreign trade.

[Insert Chart 3 and Chart 4 in here]

Charts 3 and Chart 4 show the level of financial market development in Armenia compared to that in other countries at various stages of development<sup>10</sup>. Even by the standards of low income countries – those with per capita incomes of less than \$1000 – the ratio of credit to the private sector is very low – only one fourth that of the average credit to GDP ratio in other low income countries. The lack of finance to business acts as a severe barrier to entry. Potential competitors cannot obtain finance for their businesses, either in the form of working capital or to finance foreign trade. The result is that incumbents' market dominance is rarely threatened by new entrants and that wealth remains concentrated among those with resources.

In spite of the low amount of credit to the private sector, there does not appear to be an excess demand for loans. On the contrary, at current rates of interest, there is an excess supply of loanable funds. For example, the largest bank in Armenia (HSBC) lends a much smaller proportion of its liabilities (10 per cent) to private business than it does in other countries in which it operates, where it lends 60 to 70 per cent of liabilities.

Although interest rate spreads between borrowing and lending rates have fallen, they remain higher than in other low income countries. Financial activity in the foreign trade sector is limited. Some importers do use the banking system of raise letters of credit but the practice is not widespread. There is little export financing. The practice of using irrevocable letters of credit as basis for providing funds to fulfill export orders appears to be non-existent. As a result, the financial system cannot be said to support the growth of trade that in turn is the key to promoting more competition in Armenia. Essential skills in raising letters of credit are confined to a small number of banks. Before exporting under letters of credit can occur, training in the minutiae of the procedures will be required for most banks in Armenia.

## ***2. Secured Transactions Framework***

In Armenia, movable property cannot be used effectively as collateral to secure loans. There are numerous problems with the secured transactions framework. Floating pledges are not allowed and there are no registries, which allows pledges to be perfected. Repossession is time consuming and costly. A particular problem with financing exports is that there is no provision which allows the use of future production as collateral so that financing against export orders is not feasible. A similar problem arises with imports because there is no provision for pledging goods that are not possession of the borrower – goods that are being imported even though they have been paid for by letter of credit cannot be seized in the event of default. The effect of the inadequacies of the collateral framework extend throughout the economy, with the result that banks correctly perceive lending as extremely

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<sup>10</sup> The data for Armenia appears as percentages superimposed on the charts. For the countries in the sample, the chart is based on the ratio of credit to the private sector from deposit money banks and other financial institutions. For Armenia it is the ratio of credit to the non-government sector. Sample of 47 countries. High income countries are defined as countries where GDP per capita in 1999 was higher than US\$10,000; Upper middle income countries are defined as countries where GDP per capita in 1999 was between US\$3,000 and US\$10,000; Lower middle income countries are defined as countries where GDP per capita in 1999 was between US\$1,000 and US\$3,000; Low income countries are defined as countries where GDP per capita in 1999 was lower than US\$1,000. Source: International Financial Statistics Database and World Development Indicators Database

risky<sup>11</sup>. To understand what is necessary for establishing a framework for secured transactions, it is essential to understand the four economically important stages of any system. They are:

- *Creation*. The process by which the creditor establishes a security interest in a specific property (the collateral.)
- *Priority*. The process by which the lender establishes the priority of the security interest.
- *Publicity*. The process that makes public the priority of the security interest.
- *Enforcement*. The process by which, upon the debtor's default, the creditor will seize and sell the collateral to satisfy his claim.

Each of these stages must function effectively for collateral based lending to occur. Currently, in Armenia, none of them work well.

There is an ongoing USAID project to assist in the reform of the Collateral framework. The implementers of the project reported that a law had been drafted by a prominent Canadian expert but that the Ministry of Justice had redrafted the law and that it now has many undesirable features. There is also World Bank assistance in this area through further review of the law. In the view of this paper, neither approach will be successful. Comprehensive collateral reform requires that the whole process for the pledging of property be reviewed and changed. While rewriting the laws governing the ability of property to serve effectively as collateral is an integral part of this process, it is a long way from being all that is needed. Without a thorough revision of the whole system, collateral reform will remain elusive.

There have been many attempts at such reform in other countries, most of them unsuccessful. Legal analysis without corresponding analysis by economists of suggestions for reform have failed in most countries in which they have been tried. Internationally known legal practice may not represent best economic practice. In many places, model laws have provided the foundation for attempts to reform the collateral framework. However, fiddling with model laws is often much less desirable than rewriting laws from scratch.

A good project requires close coordination between the economists, international expert lawyers, local lawyers, and technical experts. Local lawyers perform crucial functions both at the first stage, in research, and in the second stage, explaining the work to other local people. Failing to integrate the local lawyers and the international experts can only produce poor results. The international experts cannot make sensible recommendations without considerable input from the local lawyers, so it is futile to depend on the international experts to rescue the work at the end. Furthermore, leaving legal drafting only to lawyers is

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<sup>11</sup> Some advocate “relationship lending” in terms of which banks make loans on the basis of analysis of business plans and the borrower’s history as an entrepreneur. This is unlikely to happen. First, most lending to businesses in the United States is secured by collateral. Second, the skills available for drawing up business plans is scarce. Third, those who have run businesses successfully are often the entrenched interests in Armenia, so that loans go to those who have tight control of the business sector.

a common donor practice but it is almost always a mistake. Economists and technical experts should be involved from the outset of the project, collaborating with lawyers in a diagnosis of the issues and elaborating drafting options.

Examples of successful reform do exist and serve as a model of what could be done in Armenia. A recent reform of the secured transactions framework in Romania has transformed Romania's lending environment by facilitating the use of collateral as security for lending, not only from the banking system, but also from equipment suppliers, wholesalers, and agricultural suppliers. There were many similarities between the Romanian financial sector before this reform and that in Armenia – severe financial underdevelopment, inability of a large sector of the economy to access credit, and a distrust of banks. Furthermore, Romania is also a civil code country. Use of this model could have significant potential for the development of the Armenian financial system that could substantially reduce barriers to entry.

The secured transactions reform in Romania tightly integrated diagnosis, drafting, regulations and is one of the main reasons for its success. This methodology has rarely been followed in reform efforts elsewhere. Even in the United States, reforms of the collateral framework have proved to be much more expensive than they needed to be<sup>12</sup>.

### ***3. Credit Bureau***

There is a new initiative in Armenia to establish a credit bureau. The progress of the entrepreneur, is an interesting illustration of the difficulties of doing business in the country and why there is still a much less than competitive environment there. Initial contacts indicated substantial enthusiasm for obtaining credit information on potential borrowers. There was support from the banks, microfinance institutions, as well as utilities, all of whom promised to supply information.

However, the Central Bank proved to be less than enthusiastic, apparently because the credit bureau would compete with information that it sells. Commercial Banks supply full details to the Central Banks on all the loans that they make that exceed \$3000. This is sold to commercial banks that ask for information on potential borrowers that have applied for loans. The Central Bank has taken the position that it intends at some point to privatize this information and is therefore unwilling to make it available to the credit bureau. In addition, the lack of support by the Central Bank has, in turn, led to a waning of enthusiasm by the commercial banks for the new credit bureau and only one has signed up for its services. In other countries where credit bureaus have been established successfully, it has usually been necessary for the Central Bank to insist that the commercial banks share information on their customers. The fact that in Armenia the Central Bank is almost a competitor not only does not bode well for the new credit bureau, but also sends an ambiguous message to

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<sup>12</sup> The State of Maryland reformed its secured transactions law, but left in the unnecessary condition that original documents had to be filed. This necessitated the development of a very expensive scanning system in order for the system to be accessible on-line. The final cost was over \$10 million, compared with substantially less than \$1 million for the Romania reform.

potential entrants in this area. In the view of this paper, the Central Bank should be cooperating to encourage the entrance of credit information systems rather than hindering them.

## **B. Commercial Law and Contracting**

The law governing commercial transactions is inadequate, with the result that contracts tend to be informal and take place between people who know each other well. The effect is a barrier to entry – arms length contracting is a requirement of a well functioning economic system. It also has the effect of increasing incentives for informal behavior, which is widely observed in Armenia. Problems include:

- Decisions on issues related to commercial transactions are based on an agglomeration of civil code laws making the applicability of contract provisions uncertain.
- Contractual agreements are based on “unless otherwise governed by law” rather than “unless otherwise stated in the contract” provisions. Since many commercial transactions are subject to a wide range of laws, rather than a more unified commercial code, this provision requires a full knowledge of all the laws and implementing regulations that may apply to an agreement which compounds the problem of unavailability of translations.
- Not only does precedent not play a role in court decisions but there is no record of cases being kept, although this is partly being addressed by a World Bank legal reform project.
- On top of the uncertainty arising from the commercial code, judges are widely viewed as incompetent and corrupt. As a result, businesses have little recourse if they are the victims of anti-competitive behavior.

### ***1. Notaries and Formal Contracts***

The role of the notaries adds to barriers to entry and the incentives for informal behavior. Notaries are government employees and are required to validate most contractual documents. Procedures are antiquated and slow. Notaries also act as judges and determine the validity of documents (and in many cases insist on preparing the documents). Notary fees and stamp fees are high and are based on the value of the transactions covered by the contract being notarized. The result is that many contracts remain informal because of the high cost of notarization. This also favors incumbents who have experience with working with one another.

## **C. Bureaucracy**

A further problem for businesses in Armenia is the failure of the government to issue VAT refunds to those companies that are primarily or solely engaged in exporting. For example, a company that exports smelted copper is owed large refund amounts, that stretch over more than 12 months. While this is not an issue that can be said to impinge directly on competition in Armenia, it is another illustration of the failure of the state to protect



property rights and the rights of businesses, and it is a further example of the limited benefits of being formal. Similar problems are reported by one of the major hotels in Yerevan that is having difficulty getting VAT refunds on the cost of building.

A recent FIAS Report (2004) also highlights the role of the tax authorities in raising transactions costs. Over 80 per cent of respondents indicated dissatisfaction with their dealings on tax issues. Within the tax and tax administration the most problematic ones are “extra-legal requirement for advance payment of taxes”, “frequency of changes in rules and rates” and “availability of information regarding the laws and regulations”. While these data must be interpreted cautiously – Armenian businesses are not known for their compliance with the tax codes – the widespread dissatisfaction with the lack of transparency of the process is indicative of the extent to which taxation can be used as an instrument for harassing entrants into areas that are dominated by incumbents.

## ***VI. Conclusions and Policy Implications***

There is little doubt that there is a serious lack of competition in some sectors of the Armenian economy. The preceding analysis indicates that in several sectors, particularly those related to imports and distribution, monopoly profits are being earned by a small group who are profiting greatly and imposing welfare losses. This paper concludes that concerns regarding lack of competition are warranted. It identifies three separate areas of the economy where competition, or its lack, is an issue. These are:

- the traditional sectors that are regulated – utilities and natural monopolies;
- areas where competition is widely perceived to be restricted, especially petroleum, sugar, wheat and flowers;
- and barriers to entry that maintain the position of market incumbents.

Nevertheless, it is important to recall that Armenia has been among the fastest growing economies in the world for several years. The rapid growth is all the more noteworthy because has taken place against a backdrop of closed borders and the threat of renewed hostilities with Azerbaijan over the Nagorno-Karabakh problems. Some things are clearly going well.

Lack of competition, however, has long run efficiency implications as well as the danger that the apparent concentration of wealth could reduce political support for reform and limit the benefits of rapid growth. There is ample evidence of poverty in Armenia, even in Yerevan – outside the capital it is far worse. Poverty reduction requires that the benefits of growth “trickle down” to a substantial number of people, because even at current growth rates, it will be some time before Armenia can afford adequate social safety nets. The more competition is restricted and activities reserved for incumbents, the less likely it is that the benefits of growth will be widespread.

There are additional unfortunate consequences of the dominance of the oligarchs in some sectors. The concentration of wealth provides substantial ability to grant “favors” to officialdom to subtly (and sometimes, not so subtly) hinder competitors entering the market.

The phenomenon of “roofs”, discussed in the section on business practices, is one manifestation of the way in which incumbents maintain their market power. In other cases, it appears that there are direct attempts to prevent competition. Widespread subversion of the “rules of the game” by the rich and powerful sends strong messages to those who are on the outside. It contributes to a general attitude that taxes should not be paid, officials should be bribed and goods smuggled. This does nothing to develop the foundation for a modern competitive economy.

### **A. Geography and Competition Policy**

The Armenian economy is small and remote. One of the aims of policy should therefore be directed at ensuring that nothing exacerbates these geographic facts of life. In particular, policy should ensure that communications and transport are as low cost as possible. In the past, this principle has not been adhered to and almost appears to have been designed to intensify the disadvantages of Armenia’s geographic limitations. The ill-conceived awarding of the telecom monopoly to ArmenTel has substantially raised the cost of communications. The policy regarding regulating flights into and out of Yerevan raises that cost of traveling to and from the country. There is no valid economic reason for these restrictions. The government has started to do something about the telecom issues. It should take similar measures with regard to air transport and declare an open skies policy, allowing any airline that wishes to fly to Armenia to land at Yerevan.

### **B. Regulated Sectors**

In the sectors that are traditionally the object of regulation, progress is being made. Actions are being taken to deal with the ArmenTel monopoly, and telecom regulation will come under the jurisdiction of the Public Service Commission once pending legislation is passed by Parliament. Regulation of power generation and distribution, as well as natural gas has advanced. Both these industries are also regulated by the Public Service Commission. The functioning of the Commission appears to have improved – for example they reversed price increase in the energy sector. Although it is possible to quibble about the methods used, as well as some of the details of regulation, there is no doubt that in this area significant progress has been made.

There are concerns regarding regulation in sectors that are still state dominated, especially the railways, a vitally important industry given Armenia’s transport problems. Currently railways are both administered and regulated by the Ministry of Transport. Transport intensive industries such as mining complain that attempts are being made to raise tariffs without any apparent justification. This is an issue that needs further investigation as well as the development of a system for setting tariffs. No options should be dismissed a priori, including privatization of the railways and bringing regulation under the purview of the Public Service Commission. Regulatory capabilities are scarce in Armenia and consolidation under one body, which can then be the recipient of intensive technical assistance could be the best policy option.

### **C. Areas Where Competition is Restricted**

The paper examines sectors of the economy that are widely regarded to suffer from lack of competition through monopoly and restriction of competition in the distribution chain. It concludes that there is evidence that prices are higher than they would be if there were more competition, and that welfare losses are significant. Most of the sectors discussed in the paper are involved with the distribution of imported products. In one sense, the problem would disappear immediately if there were the ability to import freely. However, the paper points out that customs have become an instrument for maintaining the monopoly position of incumbents. There are several things that can be done about this.

The first is to increase the transparency of the process. When light falls upon irregular practices, they tend to decline. Two steps are possible in the short run. First, make the computerized customs database available to brokers, including the clearance of all goods, so that restrictions on shipments must be explained. Second, make the customs exams more transparent by following the letter of the law in this regard. All examination papers and the marking of the papers should be available for inspection.

Whether this is feasible from a political economy perspective is another matter. Recommendations for the reform of customs have been made by donors almost from the time of the country's independence. Some progress has been made, particularly with respect to the procedures related to Armenia's WTO accession. Nevertheless, there is still a long way to go in this regard and the process is clearly the main way in which monopoly positions are maintained. Since the number of access points to Armenia is limited as a result of closed borders with Azerbaijan and Turkey, the effectiveness of restricting certain imports is enhanced. In addition, the use of reference pricing is still widespread, in contravention of WTO undertakings. Although customs and revenue officials claim that it is necessary to check invoices in order to ensure that there is no cheating on VAT payments, there are alternative procedures that allow goods to be cleared pending a check on prices that are used successfully in other countries. There is no reason why these methods could not also be used in Armenia.

One further issue hinders the customs process. By any standards, Armenia's VAT rate of 20 per cent is high and provides incentives for smuggling and for evading duties. It is understandable that the authorities and donors are reluctant to reduce the rate when the overall tax take is equivalent to only 13 per cent of GDP. Nevertheless, taking into account incentives faced by the private sector is a key to the successful long term development of the Armenian economy and the need for reform of the tax system is part of this.

Perhaps another avenue is open to the authorities to improve competition in the petroleum market. They could insist that at least 50 per cent of the petroleum imported into Armenia come from one of the large western petroleum companies and that the invoices supplied with the shipment be made available for public inspection.

## **D. CPEC**

In its present form, the Commission can do little to ensure competitive markets in Armenia. It lacks the resources and the skills to be effective, and it has no power to enforce its own judgments except through the court system, which itself is arbitrary and open to outside influences. The policy question is therefore whether devoting resources to strengthening it is warranted. Such assistance would take the form of upgrading the Commission's resources, particularly in the IT area, upgrading the skills of the Commission, and perhaps giving it the power to enforce its judgments. Currently a USAID project is underway which will achieve partly the first two objectives, although the extent to which it will do so will be set out in a report that is so far not finished.

Concerns regarding strengthening the Commission rest on the understandable desire to avoid that yet another layer of bureaucracy that could be used as an instrument to harass business. However, the Commission is not going to disappear – its existence is enshrined in law and it appears to have powers that have so far been untested. Upgrading its skills is necessary to prevent it from turning into the very institution that some fear it could become. The more professional the Commission, the less likely it is to turn into an instrument for restriction rather than promotion of competition.

## **E. The Long Term Promotion of Competition and Development**

In the long run, promoting competition in Armenia is inseparable from promoting private sector development in the country. The ability to restrict competition frequently arises because the institutions that underlie private sector activity are underdeveloped, providing strong incentives for informal behavior. In Armenia, the public goods that provide the foundation for private sector development are weak. The court system does not function effectively and arms length contracting is risky, so that transactions tend to take place between those who know and trust each other. This gives powerful advantages to incumbents. Similarly, the financial system remains extremely underdeveloped even by the standards of low income countries. Hence, those who have substantial financial resources are in an especially strong position in maintaining and strengthening their market dominance. The development of institutions supporting the private sector is the only long run solution to promoting a competitive market environment. Legal reform and the reform of the secured transactions framework are two measures that will greatly enhance private sector activity. In addition, the institutions of government must be upgraded. They need to be of positive assistance to the private sector, rather than the instruments for maintaining anti-competitive behavior that they now are. In particular, reform of the customs service is the key to promoting competition.

## **F. Shorter Term Measures**

Several of the suggestions in the preceding sections could be implemented with little delay. The announcement of an open skies policy would signal the government's commitment to establishing a more competitive business environment. An immediate change in the examinations for customs brokers would signal a commitment to transparency in customs

procedures as would giving access to brokers the computerized clearing system. Another measure that would promote competition would be the insistence that a certain percentage of imports of petroleum be purchased from one of the large international petroleum companies and that the documentation be made publicly available.

### **G. Suggestions for Further Work**

There are a number of areas where further work is needed in order to suggest more detailed reforms. The most important of these are:

- A thorough review of the commercial code is required in order to identify areas that are inimical to modern commercial practice and to suggest reforms. This review should not only be undertaken by lawyers but by a team of a lawyer and an economist in order to ensure that the incentives inherent in the code are identified from an economic as well as a legal perspective.
- A similar review of the consumer protection law is warranted in order to take stock of the system for consumer protection that underlies the role of the CPEC. Such a review will ensure that the commission does not become an instrument for the harassment of businesses and that the incentives in the law make sense from an economic perspective. This review could also look into the feasibility and desirability of establishing a small claims court where consumers and producers who have been harmed by anti-competitive behavior could sue the perpetrators.
- At this point, a stocktaking and review of the regulatory framework is also warranted to determine how well it is now functioning, where further strengthening is needed and how the Public Services Commission can be further supported in its work.
- A thorough review of the issues related to secured transactions reform, from an economic as well as a legal perspective. This should include the feasibility of using a similar approach to that taken in Romania.

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**TEXT BOX 1: WELFARE IMPACT OF NON-COMPETITIVE BEHAVIOUR IN THE GASOLINE MARKET**

To stress the negative impact of non-competitive behavior in gasoline market we made a very simple calculation of welfare losses (Table 1). (For the explanation of the terms used in the analysis below one is referred to Tirole (1988)). We assumed a linear market-specific demand curve and estimated its slope and intercept considering price-increase vs. demand-decrease scenarios during 1999-2000 (such a decrease in demand is mainly explained by price increase in the international oil prices in contrast to the observed non-price impact (such as increased imports of cars after 2000) on the demand during later years).

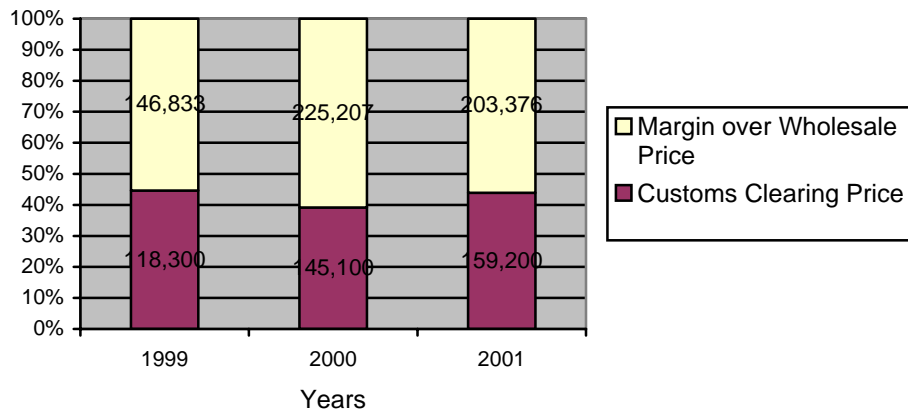
**Table 1: Welfare Calculations in the Petroleum Market**

Year	1999	2000	2001
Retail Price (AMD per Ton)	265,133.7	370,307.4	362,576.0
Customs Clearing Price (AMD/Ton)	118,300.0	145,100.0	159,200.0
Quantities Consumed (Tons)	258,100.0	181,400.0	187,500.0
Total Profit (AMD)	37,897,777,970.0	40,852,622,360.0	38,133,000,000.0
Estimated Slope of the Demand Curve	-1.4	-1.4	-1.4
Estimated Intercept of the Demand Curve	626,473.7	626,473.7	626,473.7
Quantities under Customs Clearing Price	362,981.2	343,838.4	333,766.9
Deadweight Loss (AMD)	7,700,048,377.0	18,291,160,036.2	14,873,591,432.6
Deadweight Loss (USD)	14,528,393.2	33,256,654.6	26,094,020.1
GDP (in mln. USD)	1,845.5	1,911.5	2,118.4
DWL as a percentage of GDP	0.8	1.8	1.3

It turns out that welfare loss, as a result of non-competitive behavior in the gasoline market alone, was averaged on 1.3% of GDP. This loss figure can be even higher if we consider that there is a double marginalization (we have not include in the calculations the deadweight loss, which can occur as a result of monopoly power of one supplier of importers) and that the same situation dominates in many other similar markets (such as in diesel market).

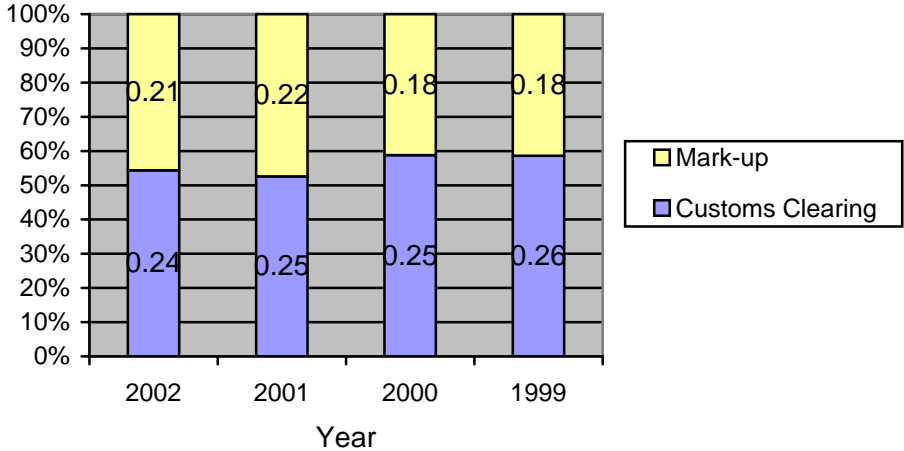
Moreover, the fact that concentrated rather high gasoline market profits (about 3.7% of GDP) have not contributed to reducing unequal distribution of income in the country accentuates the importance of liberalizing the petroleum oils market.

**Chart 1: Gasoline Price Structure for the Period 1999-2001; AMD per Ton**





**Chart 2: Sugar Price Decomposition  
(USD per Kilo)**



<b>Table 2: Sugar Market Data</b>				
<b>Year</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Mark-Up (USD/KG)	0.185	0.176	0.222	0.205
Percentage Annual Change of Mark-Up	-	-4.650	25.933	-7.349
Import of Sugar (Metric Tons)	69,836	69,422	73,485	68,400
Percentage Annual Change in volumes of imported Sugar	-	-0.592	5.853	-6.921

