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**The transmission mechanism in Moldova.  
Reasons for its weakness and  
recommendations for its strengthening**

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## **The transmission mechanism in Moldova. Reasons for its weakness and recommendations for its strengthening**

### **Executive Summary**

The National Bank of Moldova (NBM) has established an inflation targeting framework in 2009/2010, which replaced the problematic targeting of the exchange rate practised before. The transmission mechanism (TM) is of key importance in the new framework: The stronger the TM, the easier it is for the NBM to successfully target the rate of inflation.

Our research shows that the TM has clearly improved since 2009: The short-term effect of changes in the policy rate (“basic rate”) of the NBM on changes of banks’ lending rates has increased from just 9% in the period 2000-2008 to 42% in 2009-2015. However, despite this success, there is still much room for strengthening the TM.

One major reason for the current weakness is the underdeveloped money market (i.e. the interbank market). While the NBM can effectively influence the money market rate in the short-term (high effect of 63% in the period 2009-2015), there is no effect of changes in the money market rate on the bank lending rate. In order to develop the money market, it is necessary for banks to increase mutual trust in each other. A more effective banking supervision would be instrumental for this and crucial for strengthening the TM.

A further reason relates to the high levels of liquidity held by commercial banks, which reduces the dependency of banks from the NBM. In order to reduce liquidity it is necessary to increase competition in the banking sector. Furthermore, a better liquidity coordination between NBM and the Ministry of Finance could help to reduce the banks’ high liquidity.

Finally, lending to the economy - and thus the effect of monetary policy - is restricted by the strong dominance of lending using real estate as collateral. In order to increase secured lending, we recommend to introduce registers for movable assets, as successfully implemented in other transition economies. Furthermore, non-secured lending should be promoted by improving information about borrowers in the context of credit bureaus.

To sum up, a strengthening of the TM does not necessarily require a review of monetary policy instruments of the NBM. The key issues are banking supervision and the financial infrastructure of the country.

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**Contents**

- 1 Introduction .....2
- 2 The transmission mechanism in Moldova.....2
- 3 Reasons for weakness of the transmission mechanism and reform proposals .....6
  - 3.1 The small size of the interbank market.....6
  - 3.2 The high liquidity on the banks’ balance sheets.....7
  - 3.3 Obstacles related to collateralised and uncollateralised lending to firms and households.....8
- Annex .....11
- References.....12

## 1 Introduction

The transmission mechanism (TM) describes how actions taken by a central bank influence the economy. The National Bank of Moldova's (NBM) objective is to stabilise the annual inflation rate at 5% (+/- 1.5 percentage points) and it uses several instruments to achieve this. By raising interest rates, for example, it aims to reduce demand for goods in the economy, thereby lowering inflationary pressures. The exact channels through which this is achieved is the transmission mechanism.

It is often claimed that the TM doesn't work well in the Republic of Moldova, thus posing a challenge for the NBM to achieve its objective with its inflation targeting mandate. In section 2 we provide a short description of the transmission channels that are of most relevance for Moldova and discuss whether these channels are working properly. We then identify potential reasons for the weakness in the TM and conclude with recommendations on how to strengthen the TM in section 3.

## 2 The transmission mechanism in Moldova

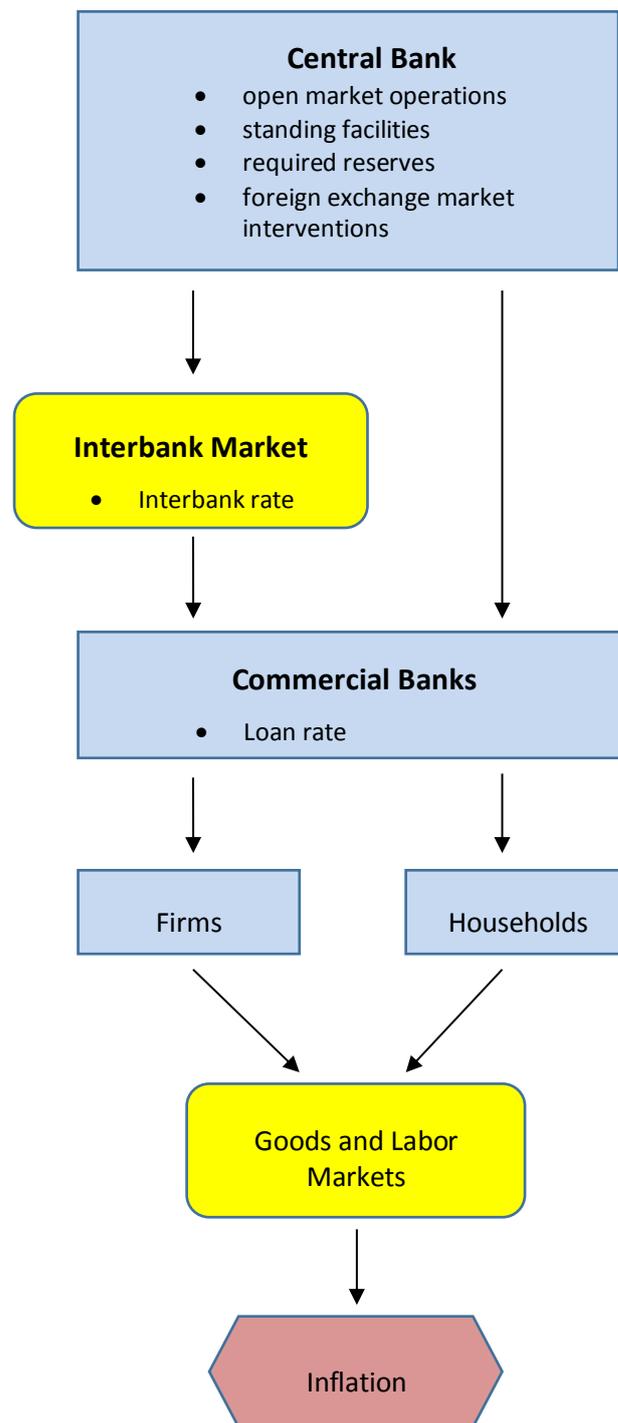
A number of transmission channels have been shown to play a role for various economies. In Moldova the most relevant one appears to be the bank lending channel.<sup>1</sup> The bank lending channel works through the effects of monetary policy actions on commercial banks' lending decisions to the real economy. A graphical sketch of the various actors, instruments and markets is presented below.

The NBM has several instruments for implementing its monetary policy: open market operations, standing facilities, the setting of the required reserves ratio and of the reserves' remuneration rate, and, lastly, foreign exchange market interventions. If policy becomes more expansionary (as indicated by a reduction in the main policy rate), this tends to increase the liquidity held by banks and the liquidity available on the interbank market. This incurs a reduction of the re-financing costs of banks, which, in turn, affects the banks' lending and other investment decisions. They can increase their supply of loans to firms and households at lower lending rates or offer the liquidity on the interbank market at a lower interbank rate to other banks with better investment opportunities or liquidity shortages. If loan demand is elastic and lending increases, this will boost aggregate demand for goods, investment and exert inflationary pressure. Thereby an inflation targeting central bank can achieve its objective.

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<sup>1</sup> Other transmission channels, that have been shown to be relevant in other countries, work through the effects of monetary policy action on long-term interest rates and the exchange rate. As the market for long-term financial assets is undeveloped in Moldova, this channel cannot play a role here. The exchange rate channel is also unlikely to influence output a lot for the following reason: Changes in quarterly export revenues and import expenditures are highly correlated. The contemporaneous correlation coefficient between those two time series has been 0.86 in the sample since 1995 and 0.92 since 2010 when the inflation targeting regime was introduced. This implies that net exports are unlikely to increase much after a depreciation induced by an expansionary monetary policy.

**Figure 1**  
The transmission mechanism



*Source: Own illustration*

We thus expect that the banks' lending rate charged on loans to firms and households and the interbank rate should change in response to monetary policy action. In order to see to what extent this is the case in Moldova, we first shed light on the effects of changes in the basic rate on the bank lending rate in Table 1. Thereby we try to assess implicitly how monetary policy action affects the supply of loans. We employed monthly data from the IMF's International Financial Statistics database starting in January 2000. We split the entire samples into two subperiods: 2000-2008 and 2009-2015, the regression equations employed are shown in the annex.

**Table 1**

Effects of changes of the basic rate on changes of commercial banks' lending rate

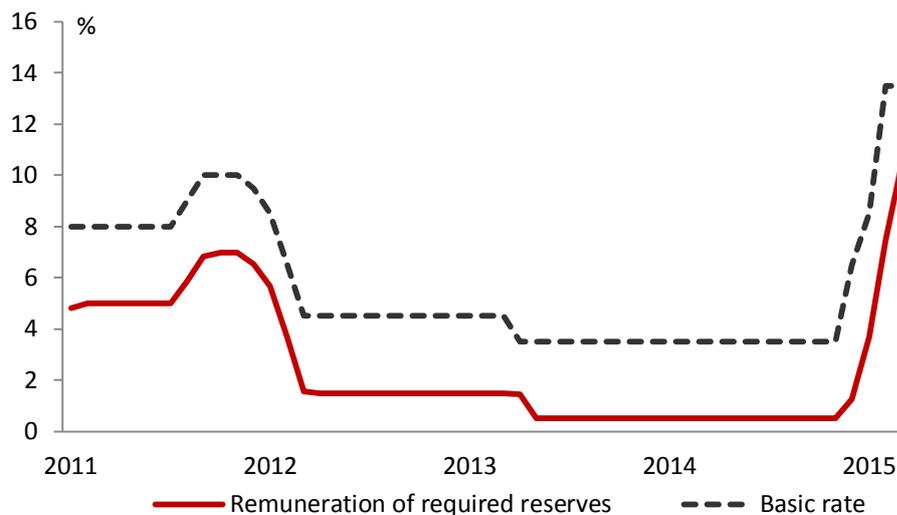
	Short-term effect
<b>2000-2015</b>	<b>0.16</b>
2000-2008	0.09
2009-2015	0.42

Source: Own calculations

Table 1 reveals that the NBM has significantly increased its short-term influence on the banks' lending rate. Within the same month, the lending rate increased by 42 basis points after a 100 basis point increase in the basic rate since 2009, while this effect was only 9 basis points before 2009.<sup>2</sup> This is not a huge but a sizable effect, and it is highly statistically significant.<sup>3</sup> A reason for the increased effectiveness could be that only since the introduction of the inflation targeting regime in 2009/10 has the basic rate been used as a main policy instrument. Furthermore, the basic rate has been almost perfectly correlated with the remuneration on required reserves in recent years (see Figure 2). This implies that both instruments have been employed jointly and thereby jointly influenced the lending rate (see also Lupusor, Babin and Popa (2012) on the role of NBM reserves policies).

**Figure 2**

The co-movement of the monetary policy rate and the remuneration of required reserves



Source: National Bank of Moldova

<sup>2</sup> However, the long-run effect, which captures the total cumulative impact of a change of the basic rate on the bank lending rate over time, has declined in the later period (not shown in the table). But here a high value cannot be expected anyway because in the long-run the market for loans is determined by the *real* loan rate rather than the *nominal* rate. The nominal rate set by the central bank is unlikely to influence the real rate for loans in the long-run where prices can be expected to be fully flexible.

<sup>3</sup> This value may well be upward or downward biased. First, it is quite likely that the basic rate is positively correlated with GDP which, in turn, might be positively correlated with loan demand. The latter could be positively related to the level of the lending rate causing an upward bias if GDP is not included in the regression as is the case in our estimation. Unfortunately, GDP data is not available at a monthly or even quarterly basis so we cannot control for this. Second, as lending is to a large extent collateralized and collateral valuations should go up with GDP, this could well dampen the positive effect of GDP on the lending rate causing a downward bias. We also cannot control for this. The two effects obviously work in opposite directions. However, the fact that the coefficient is statistically significant at the 1%-level is a good indication that the basic rate has a significant and independent short-term effect on the lending rate.

**Conclusion 1:** Monetary policy action has a measurable but limited effect on the the lending rate. We can thus expect lending to be affected too.

In a second step we try to grasp to what extent this channel works through the interbank market, i.e. whether the change of the basic rate affects banks' refinancing conditions on the interbank market and how this, in turn, affects the supply of loan to firms and households. We do this by estimating the effect of changes of the basic rate on changes of the interbank rate, results for this are shown in Table 2. In Table 3 we show results of estimates of the effect of changes in the interbank rate on changes of the lending rate.

Table 2 sheds light on the effects of changes in the basic rate on the money market rate (i.e. the interbank market rate). The results show a much stronger influence of monetary policy actions on the money market after 2008. The short-term effect has increased remarkably from 0.36 to 0.63 implying that a 100 basis point monetary policy rate hike incurs an increase of the money market rate of 63 basis points in the latter sample period. The long-term effect, which takes account of the fact that a change in the basic rate can incur changes in the money market rate for several periods, has been large already before the global financial crisis but has further increased to 0.91 thereafter. Interestingly, the long-term effect is comparable to that observed in advanced economies and much higher than in emerging economies based on a regression like this one for a sample of 24 and 26 economies respectively. In contrast, the short-term effect estimated for Moldova is even below that of emerging markets (see Mishra, Montiel and Spilimbergo, 2010).

**Table 2**

Effect of changes of the monetary policy rate on changes of the money market rate

	Short-term effect	Long-term effect
<b>2000-2015</b>	<b>0.39</b>	<b>0.86</b>
<i>2000-2008</i>	<i>0.36</i>	<i>0.88</i>
<i>2009-2015</i>	<i>0.63</i>	<i>0.91</i>

Source: Own calculations

**Conclusion 2:** Monetary policy action has a measurable but not too strong effect on the money market short-run effect and a very strong effect in the long-run.

The next step, presented in Table 3, is to check to what extent the money market influences bank lending conditions in the economy.

**Table 3**

The effects of changes of the money market rate on changes of the lending rate

	Short-term effect	Long-term effect
<b>2000-2015</b>	<b>0.00</b>	<b>0.12</b>
<i>2009-2015</i>	<i>0.05</i>	<i>0.23</i>
<i>2000-2008</i>	<i>-0.08</i>	<i>0.05</i>

Source: Own calculations

It is striking that changes of the money market rate hardly affect lending rates in the short-run and little in the long-run. The short-term effect since 2009 has been 5% although it risen when the sample is restricted to the last two years only, but it has remained statistically insignificant.

**Conclusion 3:** It seems impossible for the NBM to affect bank lending through its influence on the money market. Because also other factors affecting the money market rate had no significant effect on the lending rate, it seems the money market is detached from banks' refinancing decisions.

**Conclusion 4:** The TM seems to work through a small effect from the basic rate on the bank lending rate. The interbank market does not play any role here.

### 3 Reasons for weakness of the transmission mechanism and reform proposals

Why banks do not display a stronger lending reaction to changes in re-financing conditions induced by the NBM could be related to

1. the small size of the interbank market,
2. the high liquidity on the banks' balance sheets, and
3. obstacles related to collateralised and uncollateralised lending to firms and households.

#### 3.1 The small size of the interbank market

In 2012, turnover on the interbank market was just MDL 3 bn, but even the increase of the annual turnover to MDL 37 bn in 2013 implied a monthly transaction volume of just 4% of total bank assets. This constitutes a market that is far too small to matter for banks' refinancing considerations, hence it is of no surprise that monetary policy action doesn't affect bank lending through the interbank market. However, this fact is surprising in light of the high liquidity held by banks and the large difference of this liquidity across banks. One would expect this market to equalize this liquidity across banks as it does not bear any interest when held on the balance sheet.

**The most plausible explanation for the underdeveloped interbank market is a lack of trust among banks.** The purpose of the interbank market is to ease changing liquidity needs. If one bank is temporarily short in liquidity and another one has excess liquidity there exists a mutually beneficial lending opportunity between these banks. However, if the borrowing bank is not deemed trustworthy there will be no such transaction. If this is prevalent in the entire banking sector and the interbank market is small for that reason, banks will hold higher liquidity buffers on average in order to ease their changing liquidity needs. This constitutes an efficiency loss in the financial system and the economy as a whole because a smaller fraction of banks' assets is available for financing productive investment. And it inhibits the transmission mechanism.

**In order to overcome this lack of trust, banking supervision and regulation need to be improved and strengthened.** With better financial reporting and disclosure of ownership structures, supervisors and regulators will be better informed about fraudulent business activities enabling them to intervene early on. Furthermore, it will be easier for supervisors to assess the solvency of individual institutions. With such an improved supervisory and regulatory system in place, the informational asymmetries among banks will be mitigated and mutual trust restored because supervisors act like guarantors of trustworthiness in individual institutions and the financial system in general.

**With trust restored, the interbank market can grow considerably and the inefficiency of the financial system overcome.** A bigger interbank market will imply that it will play a bigger role for banks' re-financing, and the lending rate and loan supply can be expected to react more to monetary policy actions.

**Conclusion 5:** The small interbank market is related to a lack of mutual trust among banks. An improvement of bank supervision and regulation is thus necessary.

### 3.2 The high liquidity on the banks' balance sheets

Another reason for the lack of a strong response of bank lending to changes in monetary policy actions is the huge share of liquidity on banks' balance sheets. Liquidity ratios were 29% for the entire banking system in October 2014.<sup>4</sup> If banks hold a lot of liquidity, this insulates them from changes in market liquidity induced by the NBM and they will have little incentives to react by changing their loan supply. The IMF (2014) notes that this could be related to a lack of collateral (which we discuss below) and the shallow interbank market (discussed above) so that banks' changing liquidity needs have to be met with cash from their own balance sheets.

**Another potential reason for the high liquidity could be the high remittance payments** for which banks simply do not find enough lending opportunities in the domestic economy. **But this is quite unlikely** for two reasons: First, in Moldova with its sizeable current account deficit most foreign exchange earnings are used for imports so that little of the remittances actually stay in the country. The correlation coefficient of changes of quarterly export earnings and remittances on the one hand and export expenditures on the other hand is 0.9. Second, in an economy with an open capital account, excess liquidity could well have been invested profitably abroad.

**A more plausible explanation for the high liquidity is a lack of competition between banks.** A direct assessment of the market structure of Moldova's banking system is difficult, as it would require information with regard to the beneficial ownership structure of banks. Unfortunately, governance problems are ubiquitous and the true beneficial ownership structure of banks has been concealed for several banks (see IMF 2014). An improvement in the banks' governance and an improvement of bank regulation is thus essential for a reasonable assessment of the issue. An indirect way to assess the degree of competition in the banking sector is to look at the banks' net interest margins. These are very high in Moldova (see Figure 3) based on data from the Financial Development and Structure Dataset (see Beck, Demirgüç-Kunt and Levine, 2000), hinting at huge profits due to strong market power.<sup>5</sup>

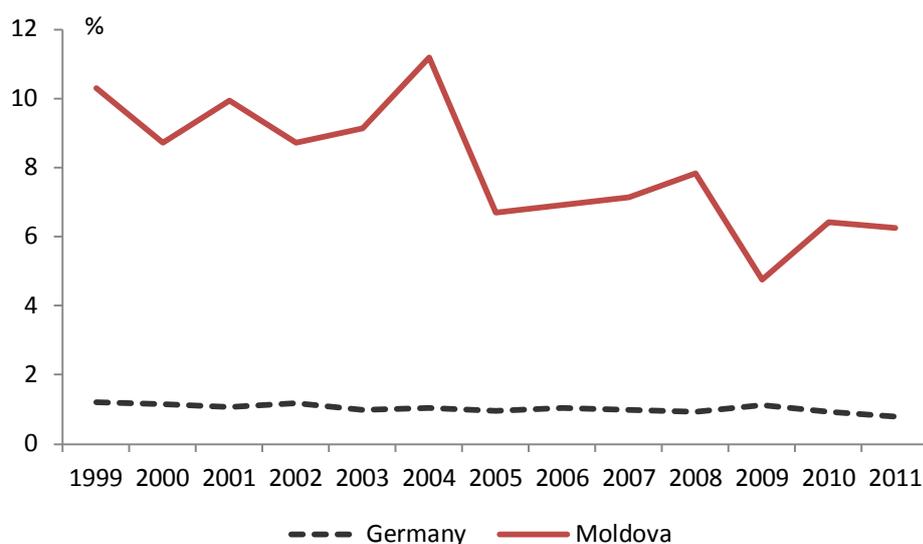
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<sup>4</sup> The IMF (2014) notes that some of the reported liquidity could well be encumbered so that actual liquidity could be below the reported figure. This implies that it is hard to interpret these reported values. An improvement in the quality of the reported balance sheets is thus essential for a thorough analysis. Furthermore, if one excludes the three banks involved in the fraudulent lending activities that became public last year, the liquidity ratio drops to still high but much lower 20% so that the excessive liquidity may well be a problem of major concern only in these three banks.

<sup>5</sup> One could argue that the high margins in comparison with banks in more mature economies are related to a higher risk of the loan portfolio. However, the high degree of loan collateralization in Moldova doesn't make this argument plausible.

**Figure 3**

Banks' net interest margin



Source: World Bank

A strong market power implies that banks do not heavily compete for customers and offer higher loan rates than under stronger competition where banks are induced to produce profits by increasing scale (i.e. lend more and to more customers) instead. Higher loan rates incur less lending to firms and households and a higher liquidity share given the size of the banks' balance sheets if no alternative investments are available. Furthermore, with a lot of liquidity and high margins, banks don't adjust their loan supply as strongly to changes in market liquidity induced by the central bank as under stronger competition. Hence, the transmission mechanism is impeded.

**The degree of competition in the banking sector thus needs to be increased.** Establishing a level playing field for foreign and new banks is essential in this regard.

**A last reason for the high liquidity could be related to an insufficient coordination between the Ministry of Finance and the NBM in their liquidity operations.** With shallow financial markets this is likely to cause a higher volatility of market liquidity and banks will react by building bigger liquidity buffers to insulate themselves from this volatility.

**Conclusion 6:** The large stock of reported liquidity is an indication of a lack of competition in the banking sector and an insufficient coordination between the Finance Ministry and the NBM and constitutes a major obstacle for the effectiveness of the transmission mechanism. The degree of competition thus needs to be increased and the coordination between the Finance Ministry and the NBM improved.

### 3.3 Obstacles related to collateralised and uncollateralised lending to firms and households

Another reason why banks' lending doesn't react more to better re-financing conditions induced by the central bank could be the prevalence of informational asymmetries between banks and potential borrowers. If banks don't know their customers they do not lend to them, no matter what the re-

financing conditions are. To overcome these obstacles, specific institutions and instruments are required. The existence and use of such institutions and instruments across the world is laid out in the “Getting Credit” ranking of the World Bank’s Doing Business Report 2015. Table 4 shows the results of this ranking for Moldova and a selected number of other countries from the region.

**Table 4**  
Getting Credit Ranking from Doing Business Report 2015

	<b>Strength of legal rights index (0-12)</b>	<b>Depth of credit information index (0-8)</b>	<b>Credit bureau coverage (% of adults)</b>	<b>Credit registry coverage (% of adults)</b>	<b>Overall Rank for Getting Credit</b>
<b>Georgia</b>	9	8	57	0	7
<b>Romania</b>	4	7	65	0	7
<b>Ukraine</b>	8	7	48	0	17
<b>Moldova</b>	8	6	9	0	23
<b>Russia</b>	4	7	65	0	61
<b>Belarus</b>	2	6	0	65	104

*Source: Doing Business 2015 Report*

Table 4 shows that Moldova is ranked 23 among the 189 countries covered, which appears quite good at first sight. However, in two crucial areas improvements are necessary:

Increasing credit bureau coverage: Table 4 suggests that Moldova could improve access to credit by increasing credit bureau coverage which is currently only 9% of the adult population compared to 57% in Georgia and 48% in Ukraine. Credit bureaus help overcome informational asymmetries and increase firms’ and households’ access to loans. They are available in Moldova, but they are not employed enough.

Increased credit bureau coverage would also help to expand unsecured lending. Banks in many countries have gained a lot of experience with unsecured lending, in particular to micro, small and medium sized enterprises. For a portfolio of unsecured loans to be profitable for a bank, in particular if these loans are small, special credit analysis and risk management techniques are required (see World Bank 2006). This requires training of bank staff in assessing the ability to repay a loan from business plans and cash flows, good financial reporting standards by firms and measures to keep the fraction of non-performing loans small. Needless to say, knowledge of a borrower’s credit history which credit bureaus provide is extremely valuable for such lending practices.

Introduction of a collateral registry system for movable assets: The features of the strength of the “Legal rights index” and the “Depth of credit information index” from the Doing Business Report which are not fulfilled in Moldova can be read from the World Bank’s Doing Business website (<http://www.doingbusiness.org/data/exploreconomies/moldova/getting-credit/>). The most notable missing institutional element is a collateral registry system for movable assets. If such a system was set up with all features laid out in the Doing Business report, Moldova would achieve the maximum of 12 points in the Strength of legal rights index. Registry systems for movable assets make a huge difference economically as research by Love, Martínez Pería and Singh (2013) for the Worldbank shows. The authors found that such a system has a strong impact on firms’ access to finance, that it reduces the interest rates charged on loans by three percentage points (!) and that it increases the average maturity of loans by six months. Furthermore, we can expect access to lending to improve too.

**Conclusion 7:** Moldova needs to improve firms' access to credit by a reduction of informational asymmetries that inhibit bank lending. This could be achieved by an increased credit bureau coverage and the introduction of a collateral registry system for movable assets. This would both improve the country's growth prospects and the lending reaction by banks monetary policy measures.

## Annex

Results presented in Table 1 were obtained from the following regression:

$$\Delta i_t^L = \alpha \Delta i_{t-1}^L + \beta \Delta i_{t-2}^L + \gamma \Delta i_t^{CB} + \delta \Delta i_{t-1}^{CB} + \varepsilon \Delta i_{t-2}^{CB} + \eta_t$$

where  $\Delta i_t^L$  is the change in the lending rate in period t,  $\Delta i_t^{CB}$  is the basic rate and  $\eta_t$  is an error term. From the estimation results we inferred the short-run effect of a policy change on the lending rate by the estimated parameter  $\hat{\gamma}$ . For Tables 2 and 3 we employed the regressions

$$\Delta i_t^M = \alpha \Delta i_{t-1}^M + \beta \Delta i_{t-2}^M + \gamma \Delta i_t^{CB} + \delta \Delta i_{t-1}^{CB} + \varepsilon \Delta i_{t-2}^{CB} + \eta_t$$

and

$$\Delta i_t^L = \alpha \Delta i_{t-1}^L + \beta \Delta i_{t-2}^L + \gamma \Delta i_t^M + \delta \Delta i_{t-1}^M + \varepsilon \Delta i_{t-2}^M + \eta_t$$

respectively where  $\Delta i_t^M$  and is the monthly change of the money market rate in period t. The short-run effect is again captured by the respective estimated parameter  $\hat{\gamma}$  while the long-run effect is  $\frac{\hat{\gamma} + \hat{\delta} + \hat{\varepsilon}}{1 - \hat{\alpha} - \hat{\beta}}$ .

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