German Economic Team Moldova

in cooperation with

Expert-Grup

Policy Paper Series [PP/03/2013]

Moldova’s trade policy: Strategy, DCFTA and Customs Union

Jörg Radeke, Ricardo Giucci, Adrian Lupusor

Berlin/Chişinău, June 2013

About the German Economic Team Moldova

The German Economic Team Moldova (GET Moldova) advises the Moldovan government and other Moldovan state authorities such as the National Bank on a wide range of economic policy issues. Our analytical work is presented and discussed during regular meetings with high-level decision makers. GET Moldova is financed by the German Federal Ministry of Economics and Technology under the TRANSFORM programme and its successor. Our publications are publicly available at our website (www.get-moldova.de).

German Economic Team Moldova

c/o Berlin Economics

Schillerstr. 59

D-10627 Berlin

Tel: +49 30 / 20 61 34 64 0

Fax: +49 30 / 20 61 34 64 9

E-Mail: info@get-moldova.de

http:www.get-moldova.de

© 2013 German Economic Team Moldova

All rights reserved.

Moldova's trade policy: Strategy, DCFTA and Customs Union

Executive Summary

Moldova is a very open economy, with combined exports and imports accounting for almost 100% of GDP. As such, trade policy is a crucial element of economic policy and a key determinant for the wellbeing of the population. Consequently, the country needs to define clear trade policy goals and a strategy to achieve such goals.

The main goal should be to increase foreign trade, while maintaining a regionally diversified trade structure. As of today, the EU and the CIS countries are the main trading partners, each of them accounting for more than 40% on both the export and the import side. This regional diversification is very positive and should not be put at risk.

This brings us to the topic of how to achieve this goal. Moldova's trade strategy should be to ensure a trade-supportive framework by concluding a series of bilateral free trade agreements (FTAs) with its trading partners. The instrument FTA is very convenient for two reasons. First, it reduces bilateral trade tariffs and thus contributes to more foreign trade. Second, it deals purely with bilateral issues and has thus no effect on trade relations with third parties. This is the key difference to a customs union, which feature common external tariffs and thus regulate not just bilateral, but all trade flows of a country: Moldova can conclude 20 or 30 FTAs, but can join just one customs union.

Let us now look at the concrete trade policy decisions for Moldova. One important decision concerns the DCFTA with the EU. The DCFTA is in essence a FTA, and as such suits perfectly in the proposed strategy. It would significantly reduce trade barriers leading to a GDP increase of 6.4%. Thus, Moldova should go ahead with the DCFTA with the EU, but at the same time pursue other FTAs, including a FTA with the newly built customs union between Russia, Belarus and Kazakhstan.

A further decision concerns the Russian offer to join the Customs Union. In our view, Moldova should reject this offer for two main reasons. First, the level of common external tariffs of this Customs Union is rather high. By joining this rather protectionist club Moldova would reduce its overall foreign trade, with negative impact on the wellbeing of the population. Second, joining the customs union would jeopardise the healthy regional trade structure of Moldova and hinder it from keeping existing and concluding new FTAs, such as the DCFTA with the EU. This is likely to lead to a decline in GDP of 9.7%, even if the effect of discounted gas is factored in.

As far as Moldova's trade policy objectives are concerned, the DCFTA with the EU is a good idea, but the customs union with Russia would not be in the economic interest of the country. Moldova should not enter any customs union, but focus instead on FTAs. The problem of the Russian offer is not Russia, but the proposed instrument. Russia should remain a key trading partner, but trade relations with Russia should be regulated by a FTA, not a customs union.

Authors

Jörg Radeke	radeke@berlin-economics.com	+49 30 20 61 34 64 7
Dr. Ricardo Giucci	giucci@berlin-economics.com	+49 30 20 61 34 64 0
Adrian Lupusor	adrian@expert-grup.org	+373 22 211 599

Contents

1 Introduction

Motivation

Moldova has two strategic trade offers and has to decide which offer to take. On the one hand there the offer to join the Customs Union between Russia, Belarus, and Kazakhstan, and on the other the offer to enter into a Deep and Comprehensive Free Trade Agreement with the European Union.

While a number of good quantitative assessments of the economic consequences of both offers exist, there is little understanding on how they would affect Moldova's economic policy goals.

Objective of this report

As such, the objective of this report is to assess how these offers would help Moldova to achieve its strategic trade policy goals and its main economic policy goals.

Structure

Following this introduction we first look at the structure of Moldova's trade to understand the importance of trade for its economy and its main trading partners. In chapter 3 we outline Moldova's strategic trade objective and which instruments should be used to achieve it. We then assess how the two strategic trade integration offers – Russia-led Customs Union and the DCFTA – contribute to achieving Moldova's trade policy objective.

However, both options are not only trade-related but offer a certain degree of economic policy integration. Therefore, in chapter 4, we assess how the two offers contribute to achieving Moldova's overall economic policy goals.

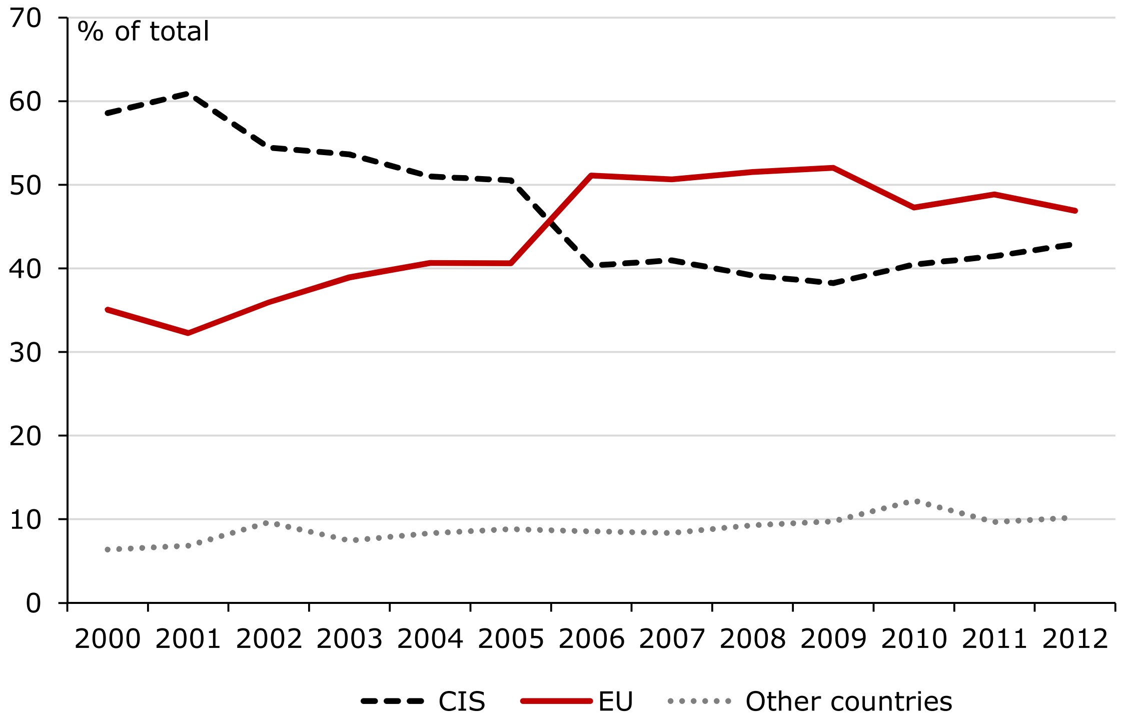
We conclude and provide an outlook in chapter 5.

2 Status quo of trade with Moldova's main trading partners

2.1 Foreign trade between Moldova and the EU

Exports. In 2012 Moldova exported goods worth USD 2,161.8 m, which is equal to 29.8% of GDP. Exports to the European Union were USD 1,013.4 m accounting for 46.8% of Moldova's exports. This share has declined from 52.0% in 2009 against the backdrop of challenging economic conditions in the European Union. The EU is, however, still the most important export destination (Figure 1).

Figure 1: Export share of main trading blocks



Source: NBS National Bureau of Statistics of the Republic of Moldova (2013)

This is the result of continuous liberalisation of trade between Moldova and the EU. Specifically, the EU has granted a number of unilateral trade preferences, notably the general scheme of preferences (GSP) and GSP which opened up the duty-free access of Moldovan industrial products to the European market. Moreover, the Autonomous Trade Preferences granted to Moldova in 2008 brought an additional boost to its exports to EU. Furthermore, Moldova benefitted from Romania's intensifying trade relations with the EU following the enlargement in 2007. Additionally, the Russian wine embargo also increased the share of exports to the EU – although this was likely rather through a decline of export to Russia as only a small share of producers were able to reorient their export market to the EU.

Looking closer at the products exported to the EU, the most important item were electrics wires, cables and other insulated electric conductors, which in 2012 accounted for 16.3% of total Moldovan exports to EU. This relatively new industrial sector became rapidly a leading one after the set-up of car part supplier "Draexlmaier" in Bălți and "Leoni" in Chișinău and Ungheni in 2008. Around 97% of this production is exported to Romania. Otherwise, exports to the EU are dominated by agricultural commodities such as sunflower seeds (7.7% in total exports to EU) and fresh or dried nuts (6.4%) exported to Italy and Greece. Finally there is the textile industry with clothing articles accounting for 6.5% and car seat covers accounting for another 5.3% of exports to the EU.

Table 1: Foreign trade structure between Moldova and EU 2012*

Exports			**Imports**		
Item	***% in total exports to EU***	***Main trading partners***	***Item***	***% in total imports to EU***	***Main trading partners***
Insulated wire, cable and other insulated electric conductors	16.3	Romania	Oils petroleum, bituminous, distillates	16.0	Romania
Sunflower-seed, safflower or cotton-seed oil and fractions thereof	7.7	Italy, Romania	Medicaments	5.4	Italy, Germany
Nuts, fresh or dried	6.4	Italy, Greece	Insulated wire and cable, optical fibre cable	4.1	Austria
Seats and parts thereof	5.3	Hungary, Poland	Motor vehicles for transport of persons	2.9	Germany
Women's or girls' suits, ensembles, jackets and other clothing items	3.6	Italy, Germany	Hair preparations	1.6	Romania
Men's or boys' suits, ensembles, jackets and other clothing items	2.9	Poland, Italy	Insecticides, fungicides, herbicides	1.6	Germany, France
Fruit juices and vegetable juices	2.9	Poland, Austria	Made up articles nes, including dress patterns	1.4	Poland, Hungary
Cane or beet sugar and chemically pure sucrose	2.5	Romania	Parts and accessories for motor vehicles	1.4	Romania, Germany
Sunflower seeds	2.1	Romania	Tractors (other than works, warehouse equipment)	1.3	Germany, Netherlands
Wine of fresh grapes	2.0	Czech Republic, Poland, Romania	Other furniture and parts thereof.	1.2	Romania, Italy

*Source: UN Comtrade, *4-digit level of disaggregation (HS-2007)*

Imports. Moldova imported USD 5,213.1 m in 2012 of which USD 2,318.7 m were imported from the EU. As such, with 44.5% the EU is also the region accounting for the largest share of total imports. With imports higher than exports Moldova has a trade deficit with the EU, which reached USD 1,305.3 m in 2012 the equivalent of 18% of gross domestic product in 2012 (Figure 2).

Figure 2: Exports, imports and trade balance between Moldova and EU

Source: NBS National Bureau of Statistics of the Republic of Moldova (2013)

Among Moldova's imports from the EU petroleum products accounted with 16% for the largest share of total imports from EU and were mostly supplied by Romania. The remainder of Moldova's imports is rather diversified. It often reflects the business model of some of the large exporters, which import car parts such as cables to assemble them into wire harnesses or other car parts for re-export to Romania.

2.2 Trade between Moldova and the CIS countries

Exports: Exports of goods to the CIS countries amounted to USD 928 m in 2012 accounting for a substantial 42.9% share of total exports and thus making exports to the region similar important as exports to the EU. The strong trade ties reflect first of all close historic ties especially the strong economic integration and specialisation of all Soviet republics. Furthermore, trade is supported by the close geographic proximity low or non-existing language barriers. Also one could argue that non-trade barriers are lower as quality standards are similar and less demanding as opposed to those required by the EU. However, the CIS export share has been declining since reaching 50.5% in 2005, reflecting a number of factors such as the larger role of trade with the EU as well as an increased trade volume with other countries such as Turkey and China.

The most important trading partner among the CIS countries is the Russian Federation, which attracts more than two thirds of Moldovan exports to the CIS. Hence, the evolution of the bilateral trade with this country has largely influenced the overall trade with the CIS. For example, the Russian embargo from 2006 on imports of wines from Moldova significantly reduced exports in that year.

Figure 3: Exports, imports and trade balance between Moldova and CIS

Source: NBS National Bureau of Statistics of the Republic of Moldova (2013)

Indeed, grape wines form the most important exported item with 11.5% of total exports to CIS, the main customers being Russia and Belarus. It is followed by medicaments (9.6%) and "cognacs" (5.4%), both being primarily exported to Russia and Ukraine. Fresh fruits form another important category of Moldovan exports to CIS, with a share of about 7.4%.

Imports. Moldovan imports from the CIS were USD 1,623.8 m in 2012. This means Moldova also has a trade deficit with the CIS countries, which reached 9.6% of GDP in 2012. However, this compares favourably to the deficit 18.4% seen in 2008 (Figure 3).

The imports' structure is clearly dominated by various types of energy products such as gas, petroleum and coal mainly supplied by Russia, Belarus, Ukraine and Kazakhstan. Indeed, in 2012 gas imported from Russia represented 30.1% of total Moldova's imports from CIS.

Table 2: Foreign trade structure between Moldova and other CIS countries*

Exports			Imports		
Item	***% in total exports to CIS***	***Main trading partners***	***Item***	***% in total imports to CIS***	***Main trading partners***
Grape wines	11.5	Russia, Belarus	Gas and gas products	30.1	Russia
Medicaments	9.6	Ukraine, Russia	Petroleum oils and oils obtained from bituminous minerals, other than crude;	10.8	Russia, Belarus
Liqueur, spirits and undenatured ethyl	5.4	Ukraine, Russia	Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.	3.8	Ukraine
Apples, pears and quinces, fresh	4.3	Russia	Petroleum gases and other gaseous hydrocarbons.	3.6	Russia, Kazahstan
Stone fruit, fresh (apricot, cherry, plum, peach)	3.1	Russia	Coal; briquettes, ovoids and similar solid fuels manufactured from coal.	1.5	Ukraine, Russia
Hair preparations	2.9	Russia	Mineral or chemical fertilisers.	1.4	Russia
Carpets, woven, not tufted, flocked	2.8	Russia	Wheat or meslin flour.	1.3	Ukraine
Parts and accessories for motor vehicles	2.8	Russia	Bars and rods of iron or non-alloy steel	1.2	Ukraine
Other furniture and parts thereof	2.2	Russia	Bread, pastry, cakes, biscuits and other bakers' wares.	1.1	Ukraine
Sunflower seeds	2.1	Ukraine	Chocolate and other food preparations containing cocoa.	1.1	Ukraine

*Source: UN Comtrade, * 4-digit level of disaggregation (HS-2007)*

Conclusions

Moldova's foreign trade is almost equally split between the EU and CIS countries. This reflects the countries strategic location between those two regional blocks. Furthermore, Moldova also has close historical ties and almost no language barriers with Romania and Russia the two most important trading partner of each respective regional block. However, there are many differences in trading patterns with the EU and CIS. The European Union market is important especially for Moldovan industrial sector (e.g. wires and cables, car parts, clothing) and also for the capital goods required for the modernization of the economy. At the same time, the CIS remains a strategic partner at least due to two major reasons. Firstly, it is the main foreign outlet for the domestic agri-food sector (e.g. wines, fresh fruits). Secondly, the CIS countries and particularly Russia, Ukraine, Belarus and Kazakhstan serve as the main energy suppliers to Moldova. Thus, Moldova is at the doorstep of two major trading blocks, both being important for the country’s economic development.

3 Moldova trade objectives and regional integration options

3.1 Strategic objectives of Moldova's trade policy

Trade leads to higher economic growth as it allows countries to exchange their goods and services against the best goods and services produced internationally. For consumers this means more variety of goods at lower prices while producers benefit from access to export markets as well as access to new technologies. Trade agreements can also substantially reduce the cost of doing business and trading internationally.

To maximise the benefits of trade, Moldova's overall strategic trade policy objective should be to maximise trade with all trading partners.

This poses the question of how trade with all potential trading partners can be maximised; in other words, which policy instruments should be used to achieve this strategic goal of trading as much as possible with everyone. The standard instruments for liberalising trade between two nations or economic blocks are bilateral free trade agreements (FTA). Thus, in order to achieve its strategic policy objective Moldova should negotiate FTAs with as many trading partners as possible. A good example here is Chile, which has intensively used this instrument to liberalise trade with many different trading partners. So in an ideal world Moldova negotiates or extends free trade agreements with the European Union, with the Customs Union formed by the Russian Federation, Belarus and Kazakhstan, as well as with other CIS countries, Turkey, South Korea and all its other relevant trading partners. Used in this way, FTAs are Moldova's first best policy option for achieving its strategic trade policy goal.

It is important to highlight in this context that the intended EU-Moldova Deep and Comprehensive Free Trade Agreement (DCFTA) is, after all, only a free trade agreement. As such it would not exclude any other FTAs with other countries and, thus, is very much in line with Moldova's strategic trade policy goal.

However, at the moment the Russian-led Customs Union does not offer Moldova a free trade agreement; instead it expects Moldova to join the Custom Union consisting of Russia, Kazakhstan and Belarus. However, it is not possible to be member of the Customs Union and to have the DCFTA at the same time. Consequently, the first best option of using a multiple free trade agreements to maximise trade is not available. Thus, instead of entering into free trade agreements with all its main trading partners, the country may be forced to decide between the DCFTA with the EU and the Russia-led Customs Union.

Such a decision should be fact-based and assessed according to how either offers – Custom Union or DCFTA – helps Moldova to best achieve its strategic trade policy objectives of maximising trade with all trading partners. Below we describe and assess the two main trade integration offers for Moldova.

3.2 Customs Union with Russia, Belarus and Kazakhstan[1]

Unlike bilateral trade agreements, customs unions are free trade areas with a common external tariff. That is, the members of customs union give up their national autonomy over setting tariffs and non-tariffs barriers to a central body that represents the entire customs union. The European Union is currently the largest customs union.

The establishment of the Customs Union consisting of Russia, Belarus and Kazakhstan (CU) occurred within the Eurasian Economic Community integration process. The Eurasian Economic Community (EEC) agreement signed in Astana in October 2000 was designed to function as a regional international organisation recognised by the United Nations. Although a free trade zone has been implemented in the Eurasian Economic Community, it operates with exemptions and not to the fullest possible extent.[2]

Since 2008 the EEC top priority has become the establishment of a Customs Union – first in the framework of Russia, Belarus and Kazakhstan. A supranational body of the customs union – the EEC Customs Union Commission – was established in December 2008. The Customs Union members (Kazakhstan, Belarus and Russia) reached an agreement on a unified customs tariff in June 2009 and endorsed a schedule for creating a unified customs territory. The formation of the CU started on January 1, 2010 with the implementation of this common tariff scheme. Finally, in mid-2011, a common border control in the Customs Union has been established.

Apart from common tariff policy, the CU has envisaged unification of non-tariff measures in commodity trade, including development of common technical regulations, sanitary and phyto-sanitary standards, extension of anti-dumping and safeguard measures applied by any country-member of the CU to the entire CU, unification of customs procedures and customs valuation, statistics etc.

It should be emphasised that the Customs Union is focused on trade in goods primarily, leaving aside trade in services. Further harmonisation of regulatory issues has been envisaged at the next stage of regional integration of Russia, Belarus and Kazakhstan in 2012, when the countries forming the Customs Union declared their intention to establish the Single Economic Space. This additional level of integration is expected to encompass common policies in such spheres as macroeconomic policy, competition policy, state aid, protection of intellectual property rights, exchange rate policy, migration policy, etc.

To sum up, for Moldova joining the Russia-led Customs Union would indeed mean a very close integration with that regional block. Although ample exemption exists, this would mean little of no tariff barriers for industrial goods and many agricultural products.

[1] This sub-chapter is largely based on a similar chapter from policy paper PP/05/2011 by the German Advisory Group in Ukraine

[2] Shynkaruk K. (2010) Overview of the Customs Union of Russia, Belarus and Kazakhstan // IER (2010) Ukraine's trade policy choice: pros and cons of different scenarios. Report commissioned by the World Bank

Furthermore, it also aims at reducing the cost of non-tariff barriers by aligning standards. Finally, with the intended creation of a single economic space CU members would also align many other trade-related and other economic policies. However, it is important to note that the original CU is rather intended on trade in goods and largely excludes the services sectors.

As a customs union, it also would require Moldova to give up its sovereignty in trade policy. The question for the Moldovan government is, whether the additional benefits compared with the existing FTAs it has with the countries justify these costs.

Following this description of the CU as one of the offers for regional integration, we now assess how it would contribute to achieving Moldova's objective of maximising trade with all trading partners. In this context the two criteria should be (i) the reduction in bilateral trade barriers offered and (ii) access to existing markets:

(i) Reduction in bilateral trade barriers

Clearly, one of the main objectives of joining the CU should be a reduction in the trade barriers between Moldova and the CU members Russia, Kazakhstan and Belarus. As outlined above this reduction of trade barriers offered through the Customs Union could be significant as tariffs for industrial goods will be abolished and for agricultural goods reduced. Furthermore non-tariff barriers in bilateral trade will also be reduced as the Customs Union seeks to align technical, sanitary and phyto-sanitary standards and many other trade-related issues. Indeed, given their common past traditionally technical and other standards have been very similar; however, following the break-up of the Soviet Union the CIS countries have been diverging somewhat in those areas.

(ii) Maintaining extending existing trade relations

Following Moldova's accession to the CU most formerly national trade policy decisions will be decided by the CU at supra-national level. Importantly, this includes also trade policy with third countries that are not part of the CU. Thus, as part of the Customs Union the Moldovan trade regime with other countries especially tariffs and important non-tariff measures would not be taken at national level anymore.

This means, when Moldova joins the Russian-dominated customs union, it would not be able to sign any new free trade agreement (FTA); in particular no DCFTA with the EU, no FTA with Turkey (which is currently under negotiation) and no FTA with the USA, Canada and Brazil.

Furthermore, Moldova would have to discontinue existing FTAs, such as the Central European Free Trade Agreement with Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Kosovo. Finally, Moldova would have to re-negotiate its membership with the WTO. Thus, joining the customs union with

Russia implies the end of Moldova's independence regarding trade policy. Given the dominance of Russia in the Customs Union, it is likely that it also dominates the terms of Moldova's trade policy as a CU member. To illustrate this point, consider when Russia joined the WTO, Belarus and Kazakhstan had to adopt Russia's tariffs automatically.

Additionally, the common external import tariff that is applied by the Customs Union is also much more protectionist. For example, as a result of implementing the common external tariff of the customs union with exceptions, the tariffs of Kazakhstan have increased from an average of 6.7% to 11.1% on an unweighted basis (and 5.3% to 9.5% on a trade-weighted basis) (World Bank 2012). Currently, Moldova has an average external tariff of 4.6% (WTO 2013).

Assessment: While the Custom Union offers favourable potential for improved access to the CU market, it would undermine Moldova's access to other foreign markets. As such, the additional benefits gained there would be bought at the very high cost of losing an independent trade policy, having to abolish the DCFTA with the EU, and not being able to continue or entering in a number of regional or overseas trade agreements. On balance we expect a negative impact on achieving the policy objective of improved access to the foreign markets. Quantitative assessments suggest that this could lead to a decline of Moldova's GDP of around 9.7% (Prohnitchi 2012).

3.3 DCFTA with the European Union

Moldova and the European Union negotiate a free trade agreement since February 2012. The DCFTA is the trade part of a wider Association Agreement and has one distinctive feature as compared to the FTA agreements in the framework of the CIS, namely its strong regulatory and institutional character. While existing free trade agreements – for example the one conducted with the CIS in 2008 – would cause only very limited regulatory adjustments in the country, the DCFTA with the EU results in significant harmonisation of Moldova's regulatory practices to European rules and norms in trade-related spheres.

According to available information, major clauses of the DCFTA envisage the following trade regime between the EU and Moldova:

- Duty free exports to the EU for industrial products starting the date when the agreement comes into force
- Significant quotas on duty-free exports of selected agricultural products, including dairy products, grain and cereals, and sugar, to the EU
- Duty free imports of majority of EU agricultural products to Moldova
- Further service trade liberalisation

In addition, the DCFTA envisages significant adjustment of Moldova's regulations in such spheres as competition policy, state aid, public procurement, sanitary and phyto-sanitary measures, technical regulation, protection of intellectual property rights, sustainable development (ecological issues, labour and social issues) etc. At the same time, the EU committed to provide substantial technical assistance to ensure the implementation of the necessary changes.

Consequently, the EU-Moldova DCFTA goes much further than most free trade agreements in intending a wide-spread approximation of regulations and even institution to the EU legal frame as well as covering the services sector. It is important to note though, that – despite the deep and comprehensive character of the agreement – it remains only a bilateral free trade agreement. As such, it is does not influence Moldova's trade policy with other nations and is fully compatible with the country's existing and future free trade agreements.

When assessing whether the DCFTA is likely to help Moldova to achieve it trade policy objective one needs to look at two aspects: (i) The reduction in trade barriers offered and how the trade agreement affects the (ii) access to existing markets.

(i) Reduction in trade barriers

The reduction in trade barriers offered through the DCFTA is substantial. Firstly, all FTAs with the EU intend a <u>full abolition of import tariffs</u> for all industrial goods as well as a <u>significant liberalisation of trade in agricultural and food products</u>. However, with tariff barriers already substantially reduced on both sides even more important is the intended <u>reduction in non-tariff barriers</u>. Here the DCFTA offers a 'deep and comprehensive' component which would see an alignment of Moldova's institutions and regulation in the areas of technical standards, hygiene and phyto-sanitary standards. Furthermore, there will be an alignment of customs procedures. It is expected that those will significantly reduce the cost of trading between Moldova and the EU and consequently provide a much improved market access.

Finally, unlike many other free trade agreements the DCFTA also covers trade in services allowing Moldovan companies to offer services on the EU market while opening up Moldova's services markets such as telecommunication, aviation, and transport services for EU companies. Consequently, as already suggested by its name, the DCFTA offers access to its market that is so far unprecedented by non-EU members.

(ii) Maintaining extending existing trade relations

A new trade agreement should not sacrifice existing trade arrangement, indeed in the best of worlds it helps to extend trade with other trading partners. In this regard it is worth reiterating that the DCFTA is after all only a bilateral free trade agreement. Thus, if Moldova signs a DCFTA with the EU, <u>the country would maintain its independency regarding trade policy and Moldova could sign new</u>

FTAs with any other trading partners. So technically Moldova could even sign a free trade agreement (but not join) the customs union formed by Russia, Belarus and Kazakhstan.

Assessment: As far as Moldova's strategic policy objective of maximising trade is concerned the DCFTA offers privileged access to the largest single market in the world. The agreement negotiated would offer a substantial reduction in non-tariff barriers. At the same time it would not preclude Moldova from pursuing other FTAs with other trading partners. Finally, with the EU standards being widely accepted international standards, it is likely to also improve access to other international markets. A quantitative assessment of the resulting economic impact carried out by Expert Grup suggests a 6.4% increase in Moldova's GDP (Prohnitchi 2012).

4 Comparison DCFTA and CU regarding their impact on Moldova's wider economic policy objectives

Making free trade agreements with other countries is not a goal in itself; it should be part of Moldova's wider economic policy and should help Moldova to achieve its economic policy objectives. Indeed, it could be argued that both offers, the Customs Union and the DCFTA, will not only affect Moldova's trade objective but also how it achieves other important economic policy objectives.

The overall objective of Moldova's economic policy is and should be economic prosperity.

There are three main channels how this policy objective can be achieved.

- Maximise trade with all trading partners (strategic goal of trade policy) which we discussed in the previous section.
- Improved business climate and investment attraction
- Increased energy security and affordability

In this section we compare how both of Moldova's two strategic regional integration options contribute to fulfilling the two other economic policy objectives: improved business climate and investment attraction as well as energy security and affordability.

4.1 Assessment of the DCFTA with the EU

Improved business climate and investment attraction

In addition to good access to foreign markets an equally important economic policy objective is the continuous improvement of the business climate and, connected to that, the attraction of foreign investment to Moldova. Thus, any trade integration option should be assessed as to how it affects this objective.

Given the nature of the DCFTA, it is likely to have a substantial effect on the business climate. Indeed, since it is designed as a policy instrument that helps align Moldova legislation with the legal framework in the EU, it requires a substantial adjustment of legislation and institutions. By approximating to the EU, Moldova will gradually implement a legal and institutional framework that reflects best international practice. Indeed, according to the World Bank doing business indicator the average ranking of the EU was 40 in 2012, this compares to an average ranking of 85 of CIS countries and 112 of Russia (World Bank 2013). Key factors of the DCFTA that are likely to contribute to an improved investment and business environment include:

- Technical regulation and SPS systems aligned with international practices
- Efficient competition policy
- A more transparent and competitive public procurement policy
- Improved protection of intellectual property rights

To sum up, the DCFTA already does and will continue to stimulate domestic regulatory reform in line with international practices resulting in a better investment climate in the country. Consequently, it is very well suited to contributing to Moldova's economic policy objective of an improved business climate and the attraction of foreign direct investment.

Energy security and affordability

Many former Soviet Union member states have inherited an energy infrastructure that makes them depended on energy imports from other CIS countries. Given the importance of energy as inputs for businesses and for household consumption, it is fair to state energy security and affordability as a third main objective of Moldova's energy security and affordability. Consequently, each of the two regional integration options should be assessed against this objective.

As far as affordability is concerned the DCFTA cannot offer cheap energy; so there would be no benefits in this regard from signing and implementing the DCFTA. However, neither would there be additional cost or reduced energy affordability resulting from the DCFTA.

However, the European Union is a world leader in energy efficiency improvements. With 0.12 koe/USD[3], the average energy intensity of the EU – the amount of energy used for each dollar of output produced – is one of the lowest in the world. This compares to an average energy intensity of 0.36 koe/USD in the CIS countries (OECD/IEA 2012). The DCFTA can help to improve the investment climate which would also benefit investments in energy efficiency improvements. Additionally - although not directly related to the DCFTA – the European Union already supports energy efficiency improvements in Moldova through technical and financial assistance programmes. Such investments offer a lasting long-term approach to reduced energy consumption which will improve affordability and energy security.

4.2 Assessment of the Customs Union with Russia, Belarus and Kazakhstan

Having explored how both regional integration offers affect Moldova's strategic trade policy objective, in this section we explore how joining the Customs Union would affect Moldova's other economic policy objectives. Specifically we look at the objectives of improved business climate and investment attraction as well as energy security and affordability.

Improved business climate and investment attraction

The impact of Moldova joining the Customs Union on the business climate and investment attraction is ambiguous. On the one hand the CU aims at reducing non-tariff

[3] Measured in kilogram oil equivalent per USD GDP purchasing power weighted

barriers by aligning technical standards, sanitary and phyto-sanitary requirements, customs procedures and many more. This would lead to a reduction in the cost of trading between members of the CU and in turn improve the ease of doing business. However, this is only relevant for the members of the CU. For the majority of Moldova's trading partners who are not part of the Customs Union the non-tariff barriers (and also tariffs) would actually increase.

Furthermore, with the objective of turning the Customs Union into a single economic space with a common foreign exchange rate policy, macroeconomic and other policies, the Customs Union would affect the overall business climate. With Russia only achieving rank 112 in the 2013 World Bank Doing Business assessment it is unlikely that this would lead to any improvements in Moldova's overall business climate.

Indeed, the increase in tariff and non-tariff barriers is actually likely to deter investments from investors outside the Customs Union which is unlikely to be compensated by additional investment from investors based in the Customs Union.

Assessment: There is little reason to believe that joining the Customs Union would improve the business climate; indeed, increased tariff and non-tariff barriers with trading partners outside the CU may actually worsen the business climate and reduce the attractiveness of Moldova as a location for doing business.

Energy security and affordability

Energy security and affordability remains a priority of Moldova's economic and energy policy. In this context the offered discount on the natural gas import price would indeed go a long way in reducing energy costs.

Indeed, currently the Republic of Moldova receives natural gas almost exclusively from Gazprom, which can use its market power to demand prices over USD 400 per tcm[4]. In comparison Belarus is currently only charged USD 286 per tcm in return for joining the CU.

Lower energy prices will strengthen the competitiveness of the domestic and foreign markets and reduce cost of living for the population which, combined, should be positive for the economy.

However, while the gas discount will be undoubtedly positive for the economy, this may not be enough to compensate the negative economic effects arising from joining the CU, in particular higher tariff and non-tariff barriers for the majority of Moldova's trade partners. Economic assessments point to contraction of gross domestic product of 9.7%, even if Russia would offer a 10% gas discount (Prohnitchi 2012). In comparison, the DCFTA with the EU is expected to increase the gross domestic product by 6.4%. Thus, the price Moldova may have to pay for the cheap gas may be actually a very high one.

[4] thousand cubic metres

Finally, there is the question of how sustainable any gas price discount offered will be, since once Moldova joins the Customs Union and thus gives up its European ambitions, there will be little incentives for Russia to continue subsidising Moldova on energy.

A sustainable approach would be investment in energy efficiency and lower energy consumption combined with a diversification of Moldova’s energy sources to reduce the market power of any dominant provider.

5 Conclusions and outlook

The Republic of Moldova is a small and open economy that essentially relies on well-functioning trade relations for its economic development. Additionally, intensive trade is not only necessity but also a great chance for Moldova's economic development. Indeed, the country already reaps the benefits of its strategic location between the two economic blocks, the CIS countries and the European Union and maximising trade with all trading partners should be a priority of its economic policy.

Moldova should conclude a series of bilateral free trade agreements to achieve this goal. The offer from the Russian-led Customs Union does not entail a free trade agreement, but membership. Since this offer is not compatible with the intended Deep and Comprehensive Free Trade Agreement with the EU, Moldova is forced to decide which of the two strategic integration offers would better help it to achieve its strategic trade policy goal of maximising trade.

Table 3: Overview of assessment of policy objectives

<table>
<tr><th>Policy objectives</th><th>DCFTA</th><th>CU</th></tr>
<tr><td>1) Better access to foreign markets for MD businesses</td><td>Positive</td><td>Negative</td></tr>
<tr><td>2) Improved business climate and investment attraction</td><td>Positive</td><td>Neutral</td></tr>
<tr><td rowspan="2">3) Increased energy security and affordability</td><td>Neutral</td><td>Positive</td></tr>
<tr><td>Positive</td><td>Negative</td></tr>
</table>

Source: Own display

There is strong indication that joining the Customs Union would actually worsen Moldova's trade with the countries outside the Customs Union. It would mean favourable conditions with a small group of Customs Union members at the price of hurting existing trade with a much larger trading block.

The problem here is the instrument offered, not the trading partner. Instead of a Customs Union Moldova should attempt to extend its existing FTAs with the CIS countries and negotiate new FTAs with the Customs Union. As such it would maintain and extend trade with all trading partners and hence achieve its trade and economic policy objectives.

References

NBS National Bureau of Statistics of the Republic of Moldova (2013). Trade statistics. National Bureau of Statistics of the Republic of Moldova. http://www.statistica.md/category.php?l=en&idc=127&.

OECD/IEA. (2012). IEA Energy Statistics - Energy Indicators for Moldova, Republic of. Retrieved 10 February 2012, 2012, from http://www.iea.org/stats/indicators.asp?COUNTRY_CODE=MD.

Prohnitchi, V. (2012). Strategic Comparions of Moldova's Integration Options: Deep and Comprehensive Economic Integration with the EU vs. the Accession to the Russia-Belarus-Kazakhstand Customs Union. Economic Analysis and Forecast Paper. E. Grup. NR. 3/2012.

World Bank. (2013). Doing business - measuring business regulations. from http://www.doingbusiness.org/.

World Bank. (2012). Kazakhstan in the Customs Union: Losses or Gains? Retrieved 29/05/2013, from http://www.worldbank.org/en/news/feature/2012/04/18/kazakhstan-in-the-customs-union-losses-or-gains#2.

WTO. (2013). World Trade Organisation Trade Profiles Retrieved 15/04/2013, from http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=E27

List of recent Policy Papers

- Liberal Professions in Moldova – Neglected Economic Potential, by Alexander Knuth and Marcel Chistruga, Policy Paper 02, June 2013
- Current Account Sustainability in Moldova: Policy Implications, by Ricardo Giucci and Robert Kirchner, Policy Paper 01, April 2013
- The DCFTA between Moldova and the EU – A Risk Assessment, by Jörg Radeke, Policy Paper 03, September 2012
- FDI Attraction to Moldova: Facts, Potential and Recommendations, by Ricardo Giucci and Jörg Radeke, Policy Paper 02, April 2012
- Emission Trading as a Catalyst for Energy Efficiency Improvements: Options and Potential for Moldova, by Jörg Radeke and Georg Zachmann, Policy Paper 01, February 2012
- Credit Growth in Moldova: Empirical Analysis and Policy Recommendations, by Enzo Weber and Robert Kirchner, Policy Paper 03, July 2011
- Options for a Deep and Comprehensive Free Trade Agreement between Moldova and the EU, by Matthias Luecke, Alex Oprunenco and Valeriu Prohnitchi, Policy Paper 02, May 2011
- Proposals for Reducing the Administrative Burden of Tax Regulations in Moldova, by Ricardo Giucci, Alexander Knuth, Natalia Cotruta and Ana Popa, Policy Paper 01, March 2011

List of recent Policy Briefings

- Economic impact of the Eurozone crisis on Moldova: Identification and quantitative assessment of transmission channels, by Robert Kirchner, Ricardo Giucci and Adrian Lupusor, April 2013
- Eurozone crisis and its impact on Moldova, by Ricardo Giucci, Policy Briefing 03, November 2012
- The inflation targeting regime 2013-2017: Analysis and Recommendations, by Ricardo Giucci and Cyrus de la Rubia, Policy Briefing 02, September 2012
- The Third Energy Package and Electricity Market Reform, by Jörg Radeke and Georg Zachmann, Policy Briefing 01, June 2012
- Moldovan Carbon Credits beyond 2012, by Georg Zachmann, Policy Briefing 09, December 2011
- Comments on the Draft Law on Small and Medium Enterprises as of October 2011, by Alexander Knuth, Policy Briefing 08, October 2011
- Reform Proposals for Primary Documentation in Moldova, by Alexander Knuth and Natalia Cotruta, Policy Briefing 07, October 2011