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WEIGHTS AND MEASURES
Metric System

GOVERNMENT FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

ACP	African, Caribbean and Pacific countries
ACV	Agreement on Customs Values
AITA	International Association of Road Haulers
AMTAI	Moldovan Agency for International Road Transportation
ANRTI	National Agency for Regulation in Telecommunication and Information Sciences
BEEPS	Business Environment and Enterprise Performance Survey
CAP	Common Agricultural Policy
CEECs	Central and East European Countries
CEN	European Committee for Standardization
CENELEC	European Committee for Electrotechnical Standardization
CFM	Moldovan Railways
CIS	Commonwealth of Independent States
CM	Contract Manufacturing
CMEA	Council of Mutual Economic Assistance
CMR	Contract for the International Carriage of Goods by Road
CPTA	Cargo and Passenger Transport Authority
EBRD	European Bank for Reconstruction and Development
ECMT	European Conference of Ministers of Transport
EU	European Union
FDI	Foreign Direct Investment
FSU	Former Soviet Union
FTAs	Free Trade Agreements/Free Trade Areas
GAP	Good Agricultural Practice
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GOM	Government of Moldova
GOST	Standardization institute from the Soviet Union
GSM	Global System for Mobile Communications
GSP	Generalized System of Preferences
HACCP	Hazard and Critical Control Points
ICT	Information and Communication Technology/ Moldova's Telecommunication
IFI	International Financial Institution
IMF	International Monetary Fund
IRU	International Road Transport Union
ISO	International Organization for Standardization
LCs	Letters of Credits
MEPO	Moldovan Export Promotion Organization
MFN	Most Favored Nation
MRL	Minimum Residue Levels
MT	Metric Tonnes
MTC	Moldtelecom
NBM	National Bank of Moldova
OECD	Organization for Economic Cooperation and Development
PCA	Partnership and Cooperation Agreement
PPP	Purchasing Power Parity
PSI	Pre-Shipment Inspection system
SAD	Single Administrative Document
SEE	South East European
SPS	Sanitary and Phytosanitary
TACIS	Technical Assistance for Commonwealth of Independent States
TBT	Technical Barriers to Trade
TTFSE	Trade and Transport Facilitation in Southeast Europe Program
WTO	World Trade Organization
VoIP	Voice over Internet Protocol

Vice President	Shigeo Katsu (ECAVP)
Country Director	Paul Bermingham (ECC07)
Sector Director	Cheryl Gray (ECSPE)
Sector Manager	Asad Alam (ECSPE)
Task Team Leader	Lawrence Bouton (ECSPE)

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PART I: MAIN TEXT

PART II: CASE STUDIES

EXECUTIVE SUMMARY

INTRODUCTION

1. The Moldovan economy was hit hard by the disintegration of the Soviet Union. Not only did Moldova lose direct and indirect subsides from the all-Union funds, it experienced a severe terms of trade shock which was compounded by the de facto separation of the Transnistrian region, the breakdown of traditional trade links and distribution channels, a relative reduction in the demand for Moldovan products due to higher quality Western substitutes and reduced incomes of its main Commonwealth of the Independent States (CIS) trading partners. In the thirteen years since independence, Moldova has seen per capita income fall by more than 60 percent. Moldova is now the poorest country in Europe with an Atlas GNP per capita in 2003 of around US$550.

2. Starting in 2000, however, the economy has rebounded and Moldova has enjoyed cumulative growth of more than 20 percent. Growth has relied primarily on domestic consumption fueled by large inflows of workers' remittances and sizable increases in wages. Investment remains a relatively small share of GDP and has not contributed greatly to the recent growth performance. While exports have grown strongly, rebounding from the collapse experienced following the 1998 regional financial crisis, imports have grown even faster with the results that the contribution of net exports to growth is still very negative. It is unlikely that the factors that have led to the resurgence of the Moldovan economy will persist over the medium term. While workers' remittances will continue to play an important role in the Moldovan economy, it will be difficult to sustain the current growth rate of these flows. The growth impetus from past structural reform efforts has not been reinforced and future growth will be compromised by the poor business and investment climate. As a small open economy, closer integration into the world economy and a rapid growth in net exports must serve as the engine of growth in Moldova.

3. Across the transition economies, there appears to be a strong and positive association between export market growth and economic growth. Export market growth, for its part, has been closely linked to the larger order trade reorientation towards the European Union (EU). This reorientation, in turn, has been associated with product upgrading and investment, commonly undertaken by foreign investors. Given its proximity to the EU, the performance of Moldova's exports to the European Union (EU) has been disappointing. Moldova's exports are still concentrated in a few commodities and are still primarily destined for the CIS market. While macroeconomic stability has been largely achieved, formal and informal trade and investment barriers, including a high bribe tax, have limited much needed restructuring, domestic and foreign investment and quality upgrading. As this study suggests, the achievement of more sustainable export-led growth and poverty reduction will require policies that go beyond formal trade policies. Indeed, a more open trade regime must go hand-in-hand with a good business and investment climate.

Trade, Growth and Poverty

- *Trade can play an important role in alleviating poverty in Moldova by stimulating growth, increasing employment and reducing the price of consumed products;*
- *The full impact of trade on poverty will only be realized if the range of informal barriers to both imports and exports in Moldova, such as cumbersome and restrictive trade procedures, corruption, burdensome and inappropriate regulations and high transport costs, are significantly reduced.*

4. Trade will affect poverty through its impact on the rate of economic growth. Economic policies that promote trade and growth are therefore likely to have a substantial impact on poverty reduction. However, vulnerability to changes in external conditions, as shown by the impact of the Russia crisis on

poverty rates, suggests that factors constraining the diversification of trade in Moldova need to be alleviated.

5. Trade will also affect poverty through changes in prices, which affect consumption, and by affecting employment, wages and incomes. It is important to note that the trade-poverty links are influenced not only by formal trade policies, such as tariffs, but also by a range of informal barriers in Moldova. Cumbersome and restrictive customs procedures, corruption, burdensome and inappropriate regulations, such as those relating to product standards, and high transport costs all act to raise the prices of traded goods and have implications for poverty.

6. A number of simulations undertaken for this study show how policy initiatives which reduce the cost of importing and exporting in Moldova, and which make it easier to access overseas markets, could have substantial impacts on poverty – reducing poverty by more than 10 percentage points.

Trade Policy and Regional Free Trade Agreements

- *The tariff schedule is growing more complicated. A simpler, more uniform tariff structure should be adopted, allowing tariff revenues to be collected more efficiently;*
- *Severe constraints on transit through Ukraine and lack of effective dispute settlement to deal with this issue greatly undermines the value of the CIS free trade agreement for Moldova;*
- *The current export promotion strategy should be reworked to achieve a balance between offshore and onshore objectives, and to provide an effective mechanism of implementation. An increasing focus on quality should be at the forefront of export promotion activities in Moldova.*

7. While Moldova has drastically liberalized its trade regime in the decade since independence, and now has a very liberal statutory trade policy regime, the way trade and other policies are being implemented is creating substantial barriers to imports and exports. The current tariff schedule has become more complex, increasing the administrative burden in applying trade policy and collecting tariff revenue. A more uniform tariff structure with a small number of tariff bands that is subject to less frequent changes will reduce uncertainty and allow tariff revenues to be collected in a more efficient manner. A further reason for maintaining fairly uniform tariffs is to avoid an escalating tariff structure. While higher tariffs on finished products than on imported inputs provides higher levels of effective protection for producers of final goods, in Moldova it appears that in certain instances tariff differentiation has actually led to de-escalating tariffs with higher duties on raw materials and unprocessed products than on finished goods. This suggests that producers of some final products in Moldova will find it more difficult to compete with foreign producers in the domestic market since they will be paying more than the world price for their inputs.

8. Moldova has become increasingly dependent on the taxation of imports. Customs duties, however, play a rather minor role in import taxation. From the taxation viewpoint, the small collection of customs duties does not justify the administrative complexity of a highly detailed and variable import tariff schedule. Revenues from import duties would be collected more efficiently with a simpler and more uniform tariff structure.

9. Exporters in Moldova are confronted with the burdensome requirement to repatriate export earnings within a given time period. Late repatriation leads to the levying of heavy fines. This requirement, even if the timeframe is extended, is unnecessary and should be removed. The timely reimbursement of VAT paid on both domestic and imported inputs is also problematic. The Moldovan Export Promotion Organization (MEPO) asserts that no more than 45 percent of export VAT refund requests are being satisfied on a regular basis and these are typically in the form of offsets against other tax liabilities. The existing VAT refund mechanism, therefore, creates considerable hurdles for exporters, at least in terms of the high cost of delays, and should be reformed.

10. Moldova is a participant in a number of free trade areas: the plurilateral CIS free trade area, consisting of 12 former Soviet republics, the bilateral Romania-Moldova free trade area and free trade agreements (FTAs) with six stability pact countries of South Eastern Europe. The CIS free trade area is playing an extremely important role in Moldova's external trade, absorbing over half of the country's exports. The FTAs with CIS countries, however, have a number of important shortcomings: (i) the web of bilateral and multilateral agreements undermines transparency and hampers the efficiency of the free trade area; (ii) exclusions from the free trade regime can be imposed unilaterally; (iii) the agreements lack permanency; and (iv) in the absence of a plurilateral dispute resolution mechanism, all disputes have to be resolved politically at the bilateral level. These features are particularly disadvantageous for a small country such as Moldova.

11. Despite a free transit provision included in the FTAs, Moldova experiences serious problems with the transit of its trade through Ukraine. The transit environment remains chaotic and a regime of free transit has never been achieved. While Moldova sits on the Working Party for the accession of Ukraine to the World Trade Organization (WTO) and could potentially exert pressure on Ukraine by making requests on free transit issues, transit issues through Ukraine do not appear to be on the agenda of Ukrainian accession to the WTO. Hence, on this issue, Moldova could exploit the benefits of its membership of the WTO further.

12. Moldova adopted an export promotion strategy in early 2002. International experience suggests that a good export promotion strategy should strike a balance between offshore objectives (information gathering, market research, trade representation, and trade fairs) and onshore objectives (issues of competitiveness: quality standards, pricing, supportive services, domestic input supply, development of new business models and practices). The current strategy, while addressing some of the former issues, is weaker on the later. In this regard, it is unlikely that progress in provision of information will have a substantial export promoting impact without significant efforts to improve the domestic business environment.

Market Access to the European Union

- *Through lobbying of the EU on the extension of the Generalized System of Preferences (GSP) scheme, Moldova should seek to have a larger number of processed agricultural products classified as non-sensitive under the GSP, thereby making them eligible for zero duties, and to include as eligible for preferences for the first time products such as wine;*
- *Internally, strong efforts should be made to identify and alleviate constraints on the take-up of GSP preferences and to ensure that Moldovan producers are aware that new opportunities for exports may arise in the new member countries in central and eastern Europe;*
- *Addressing the domestic constraints on trade and investment would not only stimulate trade but also bring Moldovan institutions and policies on a path whereby a free trade agreement with the EU could become a reality.*

13. Given its economic size and proximity, economic analysis suggests that the principal trading partner of Moldova should be the EU. Instead, Moldovan trade is dominated by exchange with other CIS countries – principally Russia – and the share of the EU in Moldovan exports remains very low relative to what would be expected under "normal" trade relations. EU trade protection and agricultural subsidies can only explain a small part of the gap between the current share of the EU-15 in Moldova's exports (around 23 per cent in 2003) and the share that could be expected under "normal" trade relations (between 40 and 50 per cent). Indeed, Moldova is one of the most preferred partners of the EU under the GSP with significantly better market access than other CIS countries, the main competitors to Moldova. However, there is still room for further enhancement of these preferences, particularly with respect to Moldovan wine exports, which are currently excluded from preferences. Access to the EU market, particularly for agricultural goods, will be substantially altered by the recent enlargement, raising competitive challenges

for Moldovan producers but also providing new opportunities as duties on some of the key products exported by Moldova fall in the new EU members.

14. While reducing EU tariff barriers can contribute to reorientation of Moldovan exports to the EU, effective market access is determined by much more than tariffs in the overseas market. A number of policies applied in the home market can influence the ability of exporters to penetrate overseas markets. Having to contend with, for example, the costly and time consuming clearance of exports, the difficulties and costs of obtaining funds for working capital and for investment and the difficulties caused by the current system of product regulations and conformity assessment are equally important factors limiting the ability of Moldovan exporters to penetrate the EU market. Indeed, in many cases, removal of these domestic barriers will be a pre-requisite for the successful expansion of exports to the EU. If these barriers are, in effect, prohibitive, then there can be no impact from the reduction of EU tariffs until they are alleviated. For example, if Moldovan products cannot satisfy the minimum requirements necessary to be placed on the EU market, then changes in the EU tariff will have no immediate effect and will only be exploited in the longer-term if constraints on the ability of firms to invest to raise quality are removed. Addressing these barriers would also put Moldova on a path towards a free trade agreement with the EU and a clear track towards more comprehensive integration with the EU under the 'new neighbors' policy currently being developed.

Standards and Conformity Assessment

- ✍ *The government should aim to move rapidly to the so-called "voluntary" system of standards based on the adoption of international and, where relevant, EU standards. It should establish clear targets for this process;*
- ✍ *The government should consider drawing up a national quality plan, integral elements of which would be raising awareness of standards issues in the public institutions and private sector, a shift to a more modern and business oriented approach to conformity assessment, greater participation of the private sector in the standards process and enhancing the reputation of testing, inspection and accreditation bodies for independence and competence.*

15. Standards have come to be crucial elements facilitating transactions and trade both within countries and in international exchange between countries. The ability to comply with the standards in overseas markets is a major factor determining access to those markets and the capacity to export. In addition to the writing of standards, an essential element of the system of standardization is conformity assessment, the technical procedures such as testing, verification, inspection and certification, which confirm that products fulfill the requirements, laid down in regulations and standards.

16. As part of its accession to WTO, Moldova has a commitment to implement a system of voluntary standardization. Despite the ambitious program set up by the Government concerning the transition towards this system by 2005, there has been inadequate financial or technical support for this program. As a result, Moldova's institutional structure in the area of standardization, metrology, certification and accreditation still resembles many of the features of the former system of centralized control, which results in a high degree of government control and influence over the placing of products on the market.

17. The slow pace in adopting a modern standards system contributes to a negative business environment. The current system is overly complicated with no clear rules regarding application, which leaves too much room for discretion. Functions, relationships and responsibilities of different state bodies comprising the system are not clearly defined and very often are overlapping. Information is not readily available and the rationale behind some of the requirements is not made clear to those that have to apply them. In addition, the need to certify goods and production processes is daunting, both for exporters and importers, because of the high direct and indirect costs.

18. The slow adoption of international standards, and the excessive use of mandatory standards, is an important factor affecting the access of Moldovan exporters to the EU market. Moldova's current system of standards also acts to discourage foreign direct investment and constrains innovation and strategies towards product differentiation. Adequate and appropriate conformity assessment infrastructure and transparent, non-arbitrary regulations and procedures are key factors affecting the location decisions of multinational firms. Countries meeting world standards tend to attract more investors. This constraint on foreign direct investment (FDI) limits the transfer of technological knowledge to Moldova, especially of processes and procedures that would raise quality in Moldova.

19. A key issue for Moldova is to encourage and facilitate more companies to focus on, and take responsibility for, the quality of the goods or services they produce. Without this fundamental change of attitude, the prospects for generating higher value added activities and of long-run increases in competitiveness will be poor. An increasing focus on quality, therefore, should be at the forefront of export promotion activities in Moldova.

Customs Administration

- *Review all documentary requirements with the objective of increasing trade facilitation by streamlining Customs procedures. In particular, review the necessity for the confirmation procedure and ensure that the application of current procedures are consistent with the Kyoto Convention;*
- *Develop a proper valuation system by (i) reinforcing the valuation unit and developing a transaction price data base, (ii) establishing communications with industry and importers to assess realistic values for major commodities, and (iii) developing an initial valuation investigation process;*
- *Over the longer-term, Customs should aim to substantially reduce the number of physical examinations by introducing a basic form of risk management which could be supported in the earlier phases by random selection of declarations. Based on preliminary results, Customs should start preparing a more sophisticated risk management system.*

20. Reductions in tariff barriers around the globe and changes in supply chain management practices, such as a greater reliance on just-in-time deliveries, have resulted in a relative increase in the importance of border procedure-related trade transaction costs. Inefficient and costly border procedures exact significant cost on both the businesses that have to use them as well as the authorities that have to administer them. Similarly, inefficient border procedures are also likely to lead to poor export competitiveness, make a country less attractive to foreign investment and reduce the ability of domestic firms to participate in global production networks.

21. Moldova has achieved some success in improving the services of the Customs Administration and reducing the associated trade and transport impediments. Unfortunately, surveys of Moldovan businesses reveal that, despite recent improvements, customs regulations are still perceived as cumbersome and costly, acting as an impediment to foreign trade operations. These perceptions are the result of (i) complicated, non-transparent, and frequently changing Customs procedures, (ii) long delays for clearing goods or proceeding through the border, including frequent physical inspection of goods and, (iii) difficulties in applying modern Customs standards, such as the WTO Agreement on Customs Valuation.

22. Many of the control mechanisms imposed by Customs are designed to control fraud and increase revenue collection on existing transactions. While revenue collection has increased, the efficiency of Moldovan Customs lags behind other countries in Southeastern Europe. Further, the objective of Customs to control fraud is not being effectively achieved. The detection of irregularities is rare – only 2.3 percent of all import declarations, a figure usually encountered only in highly compliant countries. Instead,

complex procedures impose an unnecessary and costly burden on legitimate businesses. Risk analysis, which allows for some selectivity in checks, is still very limited and more attention needs to be paid to the negative impact of these controls on trade facilitation. The direct and indirect cost of these control mechanisms to society can be very high. Customs should review all current documentary requirements and procedures to ensure that they are consistent with the Kyoto Convention and the objective of improving trade facilitation. Among the benefits of simplified Customs procedures would be the increased competitiveness of local firms and the increased efficiency of Customs.

Transportation and Logistics

- *Improve road management and financing systems, including the establishment of a road maintenance fund and the development of performance-based road maintenance contracts;*

23. The cost and quality of transport and logistic services matter for trade competitiveness. Even if tariff and non-tariff barriers to trade are substantially liberalized, the penalty of high transportation costs has a negative impact on growth rates and income of countries with poor international transport links. Countries with higher transport costs are also less likely to attract FDI. Since FDI is often a key channel of international knowledge and technology diffusion, these higher costs may lead an economy to be further removed from the world technology frontier and impede its rate of productivity growth. Moldovan exporters, confronted with high freight and logistic costs, must pay lower wages to its workers, accept lower profits or increase productivity.

24. Moldova's existing transport infrastructure, albeit extensive, has been poorly maintained and no infrastructure has been added to address the needs associated with changing trade patterns. The generally poor condition of Moldovan roads imposes a substantial cost on the economy. Estimates suggest that reducing vehicle-operating costs by upgrading road quality would generate savings on the order of US$20 to 25 million annually. To achieve these savings, there is a need for better road management and financing systems with a particular emphasis on road maintenance. This requires: (i) the State Road Administration to strengthen its procedures for planning and budgeting road expenditures and assessing priorities for road maintenance; (ii) a transparent road fund, for both national and local networks, be established to provide a stable source of funds for road maintenance; and, (iii) development of multi-annual performance-based maintenance contracts.

25. Moldovan trucking firms have the lowest operational costs in Europe. The shift to higher standard vehicles in other countries, however, reduces this cost advantage. With its aging truck fleet, only a small number of multilateral transport permits are available to Moldovan trucking firms. Unless Moldova upgrades its trucking fleets, its ability to compete in the EU market will be hindered. Unfortunately, fleet renewal to meet higher EURO-standards has been modest because of the high cost of loans and the VAT tax bias against leasing arrangements.

26. It is estimated that over US$70 million could be saved annually through more business friendly government policies and more efficient logistics. If, for example, the Government brings trade documentation and administration to the level found in most EU accession countries, logistics costs of firms could be reduced by about US$35 million. A more predictable trade environment would lower inventory-carrying costs by over US$10 million, even when inventory-handling costs remain unchanged. Reducing average border crossing time would save at least US$20 million in waiting time costs alone. Finally, more efficient operations and increased competition in rail and road transport could lower the total transport costs by 20 percent, equivalent to US$25 million. Reduced logistics costs would dramatically improve the competitiveness of Moldovan firms and contribute to their ability to participate in global production networks.

Financial Services

- *The restrictions limiting foreign exchange lending to exporters should be removed;*
- *The fiscal agent responsibilities imposed on the banking sector, such as the monitoring of repatriations of export proceeds, should be lifted.*
- *To facilitate leasing, the VAT status of lessors should be adjusted to be the same as for banks. The 5 percent of each payment to the leasing company that the lessee is required to deduct as a tax advance should be eliminated.*

27. Financial services are essential for the functioning of a modern economy. Such services are especially important for the facilitation of international trade, where there is a need for various services and instruments to increase speed and certainty in payments across international borders and in different currencies. Insofar as these financial services have limited availability and are costly, they become important constraints for the development of international trade.

28. A highly dollarized banking sector dominates the financial sector. Capital markets, contractual savings and specialized financial institutions are non-existent, inactive or very small. Almost all business surveys carried out for Moldova show that access to finance is a considerable impediment to business development. The capacity of banks to appraise the creditworthiness of clients is still developing and, as a result, banks are generally credit risk adverse. The dearth of medium to long term credit is not only due to the high funding risk, but also because such credits effectively reduce the capacity of banks to restructure their balance sheets when circumstances change. A legal framework that clearly establishes the rights, responsibilities and liabilities of the parties to financial transactions and which provides a means to enforce legal obligations and claims efficiently is a key ingredient to a more stable and robust financial system.

29. The banking sector is fairly concentrated, with the sizable number of small and very small banks suggesting large inefficiencies and high costs. Encouraging the reduction in the number of smaller banks will be an important part of creating a banking sector that is healthier and more capable of providing efficient, better and cheaper financial services. The introduction of foreign banks into the Moldovan banking sector would be highly desirable as they would exert competitive pressure on local banks and bring new financial products to the market.

30. Several government and National Bank of Moldova (NBM) restrictions and regulations further affect the performance of the banking sector. With very limited exceptions, and contrary to the reality of lending risks, banks are authorized to lend in foreign currency only to importers. Exporters cannot borrow in foreign currency to finance local expenditures. Since local currency interest rates are considerably higher than foreign currency rates, this restriction makes credit much more expensive to exporters, reducing their international competitiveness.

31. Banks are also charged with a number of fiscal agent responsibilities that are incompatible with banking business. Among these are the controls over repatriation of export earnings. These regulations are a costly burden for the banks that are required to monitor all transactions and report in detail to the authorities. Eliminating these regulations will not only save exporters a lot of administrative hassle, it will save the commercial banks and NBM the significant cost of monitoring, recording and reporting the related data.

Table 1. Action Plan for Major Trade Issues

Constraint	Recommended Actions/Measures	Proposed Timeframe	Responsible Bodies	Monitoring Indicator
Trade Policy				
Complicated tariff structure;	Simpler, more uniform tariff structure;	2005-2006	MoE	Number of tariff bands reduced to no more than 4;
Problems with transit through Ukraine and lack of effective dispute settlement undermines FTAs;	Mobilize support in WTO for national treatment on transit in Ukraine; Mobilize support among other CIS-7 for formal legal dispute settlement mechanism;	2005-2006	MoE MoFA MoE MoFA	Reduced discrimination against Moldovan producers transiting Ukraine; More active defense of Moldovan interests in regional and global trade agreements.
Weak trade policy capacity.	Mobilize donor support for continued capacity development in core trade policy agencies.	2005-2008	MoE MoFA	
Market Access to European Union				
Key products excluded from EU GSP;	Lobby EU to broaden coverage of GSP and exploit opportunities available in new neighbor policy;	2005-2006	MoFA MoE	Inclusion of wine and other key products in GSP;
Restrictive rules of origin limit exploitation of GSP;	Lobby EU for more liberal rules on sufficient processing and inclusion in Pan-European cumulation;	2005-2007	MoFA MoE	Improvements in domestic environment for trade and investment
Inferior EU market access relative to SE and Central European competitors	Put Moldova on a path to a FTA with the EU.	2005-2007	MoFA MoE	
Customs Administration				
Excessive documentary requirements for imports and exports;	Streamline customs procedures and ensure consistency with Kyoto Convention;	2005-2006	MDC	Reduce delays at border crossings and cost of clearing customs
Weak valuation system	Reinforce valuation unit in Customs; Establish better communications with industry;	2005-2006	MDC	Establish a transaction price database; realistic valuation of major commodities supported by industry
Excessive physical inspections as a result of limited risk management.	Introduce more sophisticated risk management system.	2005-2008	MDC	Reduce number of physical inspections.

Table 1. Action Plan for Major Trade Issues (continued)				
Constraint	Recommended Actions/Measures	Proposed Timeframe	Responsible Bodies	Monitoring Indicator
Standards and Conformity Assessment				
Limited development of a transparent and voluntary system of standards;	Introduce transparent and voluntary system of standards consistent with WTO commitments and establish benchmarks for adoption of international and EU standards;	2005-2008	MoE MDS	Number of international and EU standards adopted and adequate budgetary funding for this modernization process;
Inability to meet international and EU standards constraining overseas market access;	Develop strategy, in collaboration with private sector, for raising quality standards in Moldova;	2005-2006	MoE MDS	Increased number of firms certified to ISO standards; increased participation in international bodies dealing with conformity assessment;
Lack of suitable conformity assessment services.	Review current conformity assessment structure and develop more business-oriented approach.	2005-2006	MoE MDS	Increased international recognition of Moldovan conformity assessment bodies.
Financial Sector				
Exporters access to foreign currency lending is restricted;	Remove restrictions on foreign currency lending;	2005-2006	NBM	Exporters have free access to foreign currency credit;
Costly and burdensome fiscal agent responsibilities raising cost of banking services;	Eliminate rules regarding repatriation of export earnings;	2005-2006	MoF NBM	Rules on export repatriation requirement eliminated;
Unequal VAT treatment of leasing constraining availability of this key financial instrument.	VAT status of lessors same as banks; eliminate advance payment requirement for lessee	2005-2006	MoF NBM	VAT status of lessors adjusted allowing for increased use of leasing.
Transportation and Logistics				
Poorly maintained transport infrastructure raises transport cost and reduces export competitiveness;	Establish road maintenance fund and develop performance based road maintenance contracts;	2005-2008	MoTC	Road maintenance fund in operation; introduction of multi-year performance based contracts;

INTRODUCTION

1. Rapid economic growth is a precondition for sustained poverty alleviation. Since 2000, when Moldova's economic recovery finally commenced, poverty rates have dropped significantly - from a high of 71 percent in 2000 to less than 40 percent in 2003. With the current economic recovery driven largely by consumption, there is concern that the current growth performance will not be sustained over the medium term. International evidence suggests that broad-based and sustained growth depends, in part, on an open and transparent trade regime. In Moldova, however, the efficient allocation of resources that openness brings is being undermined by poor governance and domestic policies that raise the cost of doing business. Improving the business environment and reducing the cost of doing business will not only promote more sustainable growth, it will also have a direct impact on the economic welfare of Moldova's population. Reform of policies that affect international trade, therefore, has an important role in poverty alleviation.

2. Confronted with higher costs of doing business, Moldovan producers must either accept lower profits, undertake investments to increase productivity or pay lower wages to its workers. The current investment climate, however, has discouraged the domestic investment needed to increase productivity and has made it difficult to attract foreign direct investment. Since foreign investment is often a key channel of international knowledge and technology diffusion, these higher costs have lead the Moldovan economy to be further removed from the world technology frontier and has diminished Moldovan future growth prospects. Apart from the obvious and direct impact on poverty, lower wages have been a key factor contributing to the massive international movement of labor out of Moldova. Reducing corruption and lowering the cost of doing business in Moldova are, therefore, key elements of any strategy to sustain economic growth and reduce poverty.

3. While a good business environment has many important dimensions, this study focuses on those areas that have direct implications for international trade. The key topics chosen for this study were identified by stakeholders in the private and public sectors as being major barriers to international trade. To set the stage for the study, Chapter 1 reviews the Macroeconomic setting. As is now well recognized, growth in Moldova has been driven primarily by final consumption with the contribution of net exports being negative. As a small open economy, sustained growth will require improved export and investment performance. The chapter notes that in order to stimulate exports and overcome the impact of remittances on the real exchange rates and the poor overall business environment, Moldova will need to address the major impediments to trade identified in this study. The key finding of this study, that measures to reduce trade-related impediments has a significant impact on poverty, is presented in Chapter 2. Drawing on the findings presented in the rest of the study, simulations undertaken for this chapter demonstrate the potentially large impact that the removal of these impediments can have on poverty.

4. Unlike many transition countries, Moldova has been slower in redirecting trade away from its CIS trading partners towards the EU. In addition, Moldova's exports continue to be focused on a narrow range of products. Moldova's recent trade and investment performance is described in Chapter 3. As the Chapter notes, the narrow country and product focus of Moldovan exports has potentially negative implications for future export growth performance and exposes Moldova to further regional external trade shocks. The inability of Moldova to attract much needed foreign investment is also reviewed in the chapter.

5. The extent to which trade performance has been influenced by Moldova's own formal trade policies and regional trade agreements is examined in Chapter 4. The value of the regional trade arrangements to Moldova is also explored. The chapter examines the way in which trade and other policies are implemented in Moldova and how they create a substantial barrier to imports and exports. Some commentators have expressed the view that Moldova faces crippling external trade restrictions,

such as those in the EU, that prevent them from exploiting their sources of comparative advantage. The trade barriers inhibiting Moldova's market access to the European Union are explored in Chapter 5.

6. While reducing EU tariff barriers can contribute to the reorientation of Moldova exports to the EU, the rest of the study highlights the important point that effective market access is determined by much more than tariffs in overseas markets. A number of policies applied in the home market can also influence the ability of Moldovan exporters to penetrate overseas markets. In Chapter 6, the difficulties caused by Moldova's current system of product regulations and conformity assessment is highlighted. The chapter notes that ability to comply with the standards in overseas markets is a major factor determining access to those markets and the capacity to export. Having to contend with the costly and time-consuming clearance of exports and imports also limits the ability of Moldovan exports to penetrate new markets. Chapter 7 examines Moldova's inefficient and costly border procedures and notes that these procedures exact a significant cost on both the businesses that have to comply with them as well as the border authorities that have to administer them.

7. In addition to border-related trade transaction costs, Chapter 8 analyzes the extent to which the cost and quality of Moldova's transportation and logistics services matter for trade competitiveness. The chapter also addresses the barriers that inhibit Moldova trucking firms from taking advantage of their low operating costs. Finally, Chapter 9 examines the difficulties and costs of obtaining funds for working capital and investment that confront Moldovan firms. Insofar as financial services have limited availability and are costly, they become important constraints for the further development of international trade. The extent to which government restrictions and regulations affect the performance of the banking sector, and hence trade competitiveness, is explored.

8. While Moldova's recent strong export growth performance is encouraging, exports have only just recovered to levels achieved before the advent of the regional financial crisis in 1998. The continuation of this growth performance is not a foregone conclusion. However, given its proximity to the large European market, Moldova has many opportunities that, if exploited, will sustain the growth in exports and, hence, economic growth and poverty reduction. To realize these opportunities, however, Moldova must address the barriers that impede Moldova's efforts to diversify exports, attract foreign investment and integrate into global production networks. The study presents an action plan that highlights the main constraints to trade and presents policy recommendations to overcome these barriers. The analysis in the study confirms that alleviating these barriers to trade would have a substantial impact on poverty.

CHAPTER 1. MACROECONOMIC SETTING: WEAK BUSINESS ENVIRONMENT UNDERMINES SUSTAINABLE GROWTH

INTRODUCTION

Trade can play a key role in reducing poverty, especially in small open economies such as Moldova, but trade can also bring new risks and lower welfare for some.

1.1 In the thirteen years since independence, Moldova has seen per capita income fall by more than 60 percent. Moldova is now the poorest country in Europe with an Atlas GNP per-capita in 2003 of around $550. There are several reasons for Moldova's difficult transition performance. In the Soviet system, Moldova's role was mainly to supply agricultural products while being entirely dependent on imported energy inputs. Consequently, Moldova was among the hardest hit by the collapse of the Soviet Union. Not only did Moldova lose direct and indirect subsides from the all-Union funds – subsidies that amounted to 25 percent of its GDP – it also experienced the worst terms of trade deterioration of all CIS countries, approximately 40-50 percent. This shock was compounded by the breakdown of traditional trade links and distribution channels, relative reduction in the demand for Moldovan products due to higher quality Western substitutes and the reduced incomes of its main Commonwealth of the Independent States (CIS) trading partners. Further, the civil war and de facto separation of the Transnistrian region eroded the industrial base of the republic since most industry was located primarily in the breakaway region.[1]

1.2 During the early 1990s, Moldova was considered a leading reformer among the CIS countries. A new currency was introduced in 1993 that, combined with a tightening of monetary and fiscal policy, contributed to early success at macroeconomic stabilization. These efforts were complemented by a series of first generation reforms, including trade and price liberalization, mass privatization and financial sector reforms. By the mid-1990s, however, macroeconomic stabilization and early liberalization efforts had proved insufficient to attract foreign investors or generate growth from internal sources. In part, the productive sector failed to sufficiently adjust to the post-independence energy price shock and household consumption did not fully adjust to the fall in real incomes. The absence of political consensus behind further economic reforms, frequent changes in government and weak institutional capacity combined to produce a stop-go pattern in the implementation of structural reforms.

Moldova was one of the CIS countries hardest hit by the regional financial crisis in 1998.

1.3 Moldova was one of the CIS countries hardest hit by the regional financial crisis in 1998. The depreciation of the leu against western currencies and its simultaneous appreciation against the Russian rubble resulted in Moldova's second dramatic terms of trade shock. Exports halved and real household incomes were reduced to less than 60 percent of the pre-crisis levels. Following the crisis, the sources of fiscal deficit financing diminished considerably as the T-bill market and foreign financing dried up. As a result, fiscal policy had to tighten considerably, both through increased revenue collection in cash and expenditure reduction. A number of important structural reforms also took place. Among the most important were: a) significant steps towards rationalization in the energy sector, including the privatization of three electricity distribution companies; b) imposition of hard budget constraints through energy sector reform and collection of budget revenues in cash; and, c) launching of pension reform and clearance of pension arrears. These reforms, combined with the economic recovery

[1] Transnistria accounted for more than a third of the total industrial output but only about 17 percent of the population before independence. Nearly all the cotton textiles, power transformers and electrical machines were produced there, as well as 90 percent of the electricity generation.

in neighboring countries and the sizable inflow of workers' remittance, contributed to Moldova's growth turnaround in 2000.

RECENT GROWTH PERFORMANCE

Since 2000, Moldova has enjoyed cumulative growth of more than 20 percent. The turnaround in Moldova's growth performance has been driven primarily by domestic consumption.

1.4 Since 2000, Moldova has enjoyed cumulative growth of more than 20 percent. In the last three years, growth has averaged more than 6.7 percent. As shown in Table 1.1, the turnaround in Moldova's growth performance has been driven primarily by domestic consumption. Private consumption has been fueled by large inflows of workers' remittances and sizable increases in wages and pensions. A large increase in tax revenues, principally taxes on imported goods, has contributed to an increase in public consumption. While investment has also grown steadily over the last three years, it still represents only a relatively small share of GDP and, hence, has not figured predominately as a contributing demand factor in current growth performance. Over the last three years, exports have rebound sharply from the steep drop experienced in the aftermath of the regional financial crisis. Export growth during this period has averaged nearly 19 percent annually. Imports, however, have grown even faster, averaging nearly 20 percent per annum over the same period. With the value of imports amounting to more than one and half times that of exports, the contribution of net exports to Moldova's growth has been negative.

Table 1.1. Moldova: Contributions to Real GDP growth, 2000-2003
(percent)

	2000	2001	2002	2003
Real GDP growth	2.1	6.1	7.8	6.3
Final Consumption	15.4	4.5	9.8	17.9
Gross Investment	1.4	1.9	0.4	1.9
Net Exports	-14.8	-0.3	-2.3	-13.5

Source: National Account Statistics and Staff Calculations

There is a strong and positive association between export market growth and economic growth. Export market growth has been closely linked to trade reorientation towards the European Union.

1.5 All the transition countries started with common ownership and control regimes, administered prices and trade organized on the basis of the requirements dictated by centralized planning. While trade patterns among these economies may have mimicked some view of comparative advantage, almost all trade was conducted intra-Council of Mutual Economic Assistance (CMEA). While, trade barriers in most of these countries have come tumbling down, albeit with different degrees across countries, growth performance has varied widely across countries. Empirically, there appears to be a strong and positive association between export market growth and economic growth.[2] Export market growth, for its part, has been closely linked to the larger order trade reorientation towards the European Union (EU). In turn, excluding trade in natural resources, export growth has been associated with product upgrading and investment, commonly undertaken by foreign investors. By contrast, formal and informal trade and investment barriers, including a high bribe tax, limit the much needed restructuring, domestic and foreign investment and quality upgrading. As a result, productivity improvements remain small or absent as do export opportunities. As the rest of this study suggests, any solution to this problem needs to embrace a great deal more than just formal trade policy. Indeed, a more open trade regime must go hand-in-hand with a good investment climate and other virtuous features and vice versa.

Formal and informal trade and investment barriers limit the much needed restructuring, domestic and foreign investment and quality upgrading.

1.6 *The "Non-observed" economy*. The non-observed economy in Moldova, which includes the informal sector, household production for own final use, and hidden activity of the formal sector, is estimated at 31.6 percent of GDP. Of this, 6.6 percent is the

[2] See, for example, Christofferson and Doyle (1998), "From Inflation to Growth: Eight Years of Transition", IMF Working Paper, WP98/100, Washington DC

hidden economy in the formal sector and 9.2 percent represents the informal sector and the rest is comprised of household production for own use. With regards to hidden activity in the formal sector, the major part is concentrated in industry and trade, those areas of the economy subject to a higher fiscal burden and, hence, with a greater incentive to evade taxes. Reforms that improve the business climate, including the removal of the various impediments to trade, would launch a virtuous cycle such that the activities of the informal and hidden economy are encouraged to migrate to the "observed" economy thereby reducing the need for the burdensome control mechanisms designed to detect these informal and hidden activities. This shift in economic activity would also have the associated benefit of broadening the tax base, allowing for a reduction in marginal tax rates while at the same time increasing overall tax revenues.

Box 1.1 – Workers' Remittances

Traditional trade theory, anchored on the assumed international immobility of factors of production, focuses on the exchange of goods across international borders as a result of the differences in technologies and factor endowments. According to this theory, unfettered international trade in goods will lead to the equalization of factor returns across countries. In practice, however, factors of production, including labor, are not immobile. Any constraints on trade in goods, therefore, may lead to the international movement of the factors of production to seek out higher returns abroad. That is, rather than exporting the services of domestic factors embodied in the form of goods, those services are provided directly to market overseas through physical movement of factors.

Temporary migration is a relatively new phenomenon for Moldova. It began in earnest after the 1998 regional financial crisis and has expanded significantly in the last three years. As a result, Moldova's single largest export has been its labor force and workers' remittances have become the single largest source of foreign exchange inflows. In 2003, recorded remittances amounted to $393 million (20 percent of GDP and 49 percent of merchandise exports). Although transactions are secure, associated costs are high. If the money is converted into Moldovan lei, bank fees for conversion and remitting funds can amount to up to 25 percent of the amount transferred. As a result, a large portion of remittances is sent home via unofficial channels (estimated at about 40 percent). Recorded remittances, therefore, substantially undervalued actual flows. It is quite likely that the total inflow of workers' remittances is more in the neighborhood of $650 million a year (33 percent of GDP or 80 percent of exports).

The absence of a recent population census makes it difficult to estimate the precise number of Moldova working abroad. Various studies put the number of migrants at between 200,000 and 700,000 Moldovans. (By comparison, employment in Moldova is 1.5 million and the population is 3.6 million). About half of Moldova's migrant population is working in CIS countries, primarily Russia. The rest are distributed mainly between Western Europe, Southeastern Europe and the Middle East. Those migrants in the CIS are predominately men working in seasonal jobs, tend to have lower education levels and earn less compared with migrant workers in Europe. Despite the relative small share of the total migrant population, nearly 60 percent of remittances come from workers living in Western Europe – predominately educated females working as caretakers or baby-sitters.

Insofar as Remittances augment the recipient individuals' incomes and increase the recipient country's foreign exchange reserves, the economic effects can be positive. If remittances are invested, they

Host Country	Number of Migrants
Russian Federation	240.000-270.000
Italy	150.000
Portugal	80,000
Greece	30.000
Czech Republic	40.000
Turkey	20.000-50.000
Spain, France, Israel	20,000

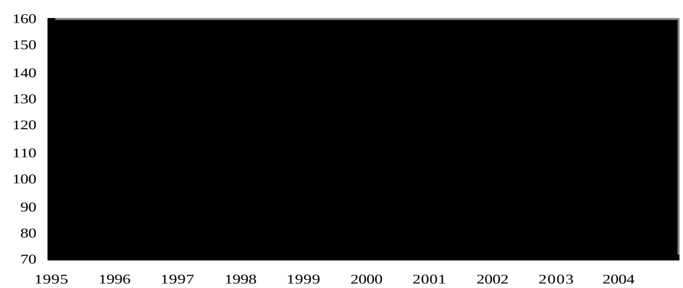
Source: IMF Article IV Staff Report, 2004 contribute to output growth, and if consumed, they can have positive multiplier effects, lifting some families out of poverty. While most remittances in Moldova appear to support increased consumption, some 16 percent of recipients use the funds to support some sort of business investment. Contrary to local concerns, Labor migration does not appear to have precipitated a brain drain. Indeed, the local labor force is more likely to have a university education than expatriates. One emerging area of concern, however, is the so-called “Dutch disease” effects that can take place as a result of the la rge inflows of remittances. The corresponding increase in foreign reserves can cause the real exchange rate to appreciate - an increase in the relative price of non-traded goods – resulting in the contraction of the manufacturing sector or de-industrialization.

INTERNATIONAL PRICE COMPETITIVENESS

The Government can contribute to improved competitiveness by addressing costly policy and “behind-the-border” barriers to trade.

1.7 *The Real Effective Exchange Rate.* The international price competitiveness of a country can be broadly measured by the evolution of its real effective exchange rate (REER).[3] Moldova introduced a new currency, the leu, in November 1993 to replace the Russian ruble. The currency was backed by foreign-exchange reserves and some US$250 million in International Monetary Fund (IMF) loans. Until November 1998, the leu was stable against major currencies, appreciating in real effective terms between 1994 and 1997. After the devaluation of the Russian ruble in August 1998, the leu’s relative stability came to an end in the face of intense speculative pressure and the outflow of capital. In November 1998, the central bank stopped supporting the currency and the leu depreciated rapidly throughout the remainder of 1998 and into 1999, losing almost 20 percent of its value in real effective terms. Since the beginning of 2001, the leu has experienced a gradual depreciatin g trend, reflecting largely the real depreciation against the Russian ruble. In mid-2003, the central bank tightened monetary policy, moderating its foreign exchange purchases, in order to slow the rapid growth in domestic credit and inflation. With the continued inflows of workers’ remittances, this change in policy will likely lead to the further appreciation of the nominal and real exchange rate. To offset the negative impact on overall macroeconomic competitiveness, domestic firms will need to reduce costs and undertake productivity-enhancing measures. The Government can contribute to improved competitiveness by addressing costly policy and “behind-the-border” barriers to trade.

Figure 1.1: Real and Nominal Effective Exchange Rate
(Index 2002 = 100)



Source: National Bank of Moldova and IMF data.

[3] The real exchange rate measures a country’s competitiveness position resulting from changes in the nominal exchange rate and domestic costs/prices relative to its trading partners. Generally, the comparison of relative prices can be based on consumer prices, producer prices, GDP deflators or unit labor costs. Many studies on competitiveness favor the use of unit labor costs because it reflects both changes in productivity and wages. Unfortunately, a consistent time-series of aggregate unit labor costs is unavailable in Moldova. As a substitute, the consumer price index is used since it allows for easy comparability with other countries.

Box 1.2. Transnistria

The economy of Transnistria has registered a spectacular decline since the early 1990s with living standards deteriorating even more than that experienced on the right bank of the Nistru river. The economic policies promoted in Transnistria have been very different from those in the rest of the country. While Moldova was pursuing economic liberalization, albeit in a somewhat stop and go fashion, the separatist regime in Transnistria has vigorously resisted economic reforms.

With its long porous border with Moldova, Transnistria has had a major impact on both foreign and domestic trade of the Republic of Moldova. It is the common perception that Transnistria has become a 'big trans-shipment camp' for cigarettes, oil products, liquor, and other smuggled products. This illegal trade is believed to not only benefit the Transnistria regime, but also businesses from Moldova and neighboring countries that use Transnistria as a means of avoiding Moldova's Customs and Tax authorities. Indeed, the existence of such trade, and the perceived loss to the Moldovan budget, has been an important element of the Moldovan authorities reluctance to ease administrative controls over trade.

Though it is difficult to give an exact estimation of the size of the smuggling phenomenon and its impact on the budget, its order of magnitude is suggested by Transnistria's trade indicators. Over the last three years the Transnistrian economy has been registering an extremely high degree of openness - 4 times higher than in Moldova. For some key products, Transnistrian imports vastly exceed internal needs.

Solutions adopted to prevent illegal activities through the boundary have relied on the cooperation of Moldova's neighbors. Up until 2001, Moldovan authorities allowed Transnistria to use Moldovan customs stamps and issue Moldovan certificates of origin for the Transnistria's exports. With Moldova's accession to the WTO in 2001, however, new customs stamps were introduced and, two years later, an agreement was reached with Ukraine, according to which goods from Transnistria could be only be imported if they used official Moldovan documents (which also implied the registration of Transnistrian exporters with the Moldovan Registration Chamber). This had a serious impact on Transnistria's external trade and resulted in significant economic loses for the region. In reaction, the separatist regime introduced a custom fee of 100 percent for all imports from the right bank.

Resolution of the Transnistria issue would eliminate a major source of policy distraction and permit greater investment and political stability. While the government of Moldova has placed the resolution of the Transnistria conflict at the top of its political agenda, the integration of the two economies remains a distant prospect. Economic reforms in Moldova that resulted in stronger economic growth and poverty reduction, however, would provide an impetus to further push the political process towards resolution.

Source: "Research Paper on Transnistria", Center for Strategic Studies and Reforms, November 2003.

Formal and informal impediments to business and trade make Moldova less attractive to foreign investment and reduces the ability of firms to take advantage of low wages and participate in global production networks.

1.8 *Average Wages*. The cost and productivity of labor also plays an important role in determining a country's competitive position, particular with respect to foreign investors interested in labor-intensive industries. Average wages for both skilled and unskilled labor have increased considerably since 1995, albeit from a very low base. In US dollar terms, the average monthly wage paid to skilled workers increased from $55 dollars in 1995, rising to $92 dollars in 1998. The impact of the large devaluation against the dollar drove down wages in dollar terms and by 2002 average wages had only risen back to $87. The trend in wages paid to unskilled workers follows a very similar pattern. Low wages, an educated population and proximately to Europe could make Moldova an attractive location for firms seeking to take advantage of these resources. Formal and informal impediments to business and trade, however, make a country less attractive to foreign investment and reduces the ability of firms to take advantage of Moldova's low wage rates in order to participate in global production networks.

Table 1.2 Real and Nominal Wages, 1995-2002

	1995	1996	1997	1998	1999	2000	2001	2002
Real Monthly Wages (Index)								
Skilled Workers	100.0	107.8	118.3	132.9	123.0	124.4	131.6	150.9
Unskilled and Semi-Skilled Workers	100.0	98.6	97.8	100.9	84.7	81.9	97.1	116.0
Nominal Monthly Wages (in US$)								
Skilled Workers	55	72	88	92	60	68	76	87
Unskilled and Semi-Skilled Workers	30	36	40	38	23	24	31	37

Source: Moldova Department of Statistics and author's calculations

MOLDOVA'S BUSINESS ENVIRONMENT[4]

Creating a good business environment is a key aspect of the transition to a market economy.

1.9 Creating a good business environment is a key aspect of the transition to a market economy. A good business environment encourages entrepreneurial activity, job creation, and economic growth with positive implications for poverty alleviation. Similarly, a good quality business environment fosters domestic investment and, all else equal, makes a country more attractive to foreign investors.

A good business environment has many dimensions.

1.10 A good business environment has many dimensions. It is linked to the quality of a country's public and private institutions, government policies and legal and regulatory frameworks that protect property rights, enforce contracts, and provide other public goods that are needed in a market economy. A sound business environment depends on the integrity of public and private agents and the control of crime and corruption. It requires political and economic stability, a level playing field among market participants and a tax system that is universally applied and not unduly distortionary. Effective infrastructure and a well functioning financial sector are also important considerations.

Moldova consistently ranks behind other countries on several critical aspects related to a conducive investment climate.

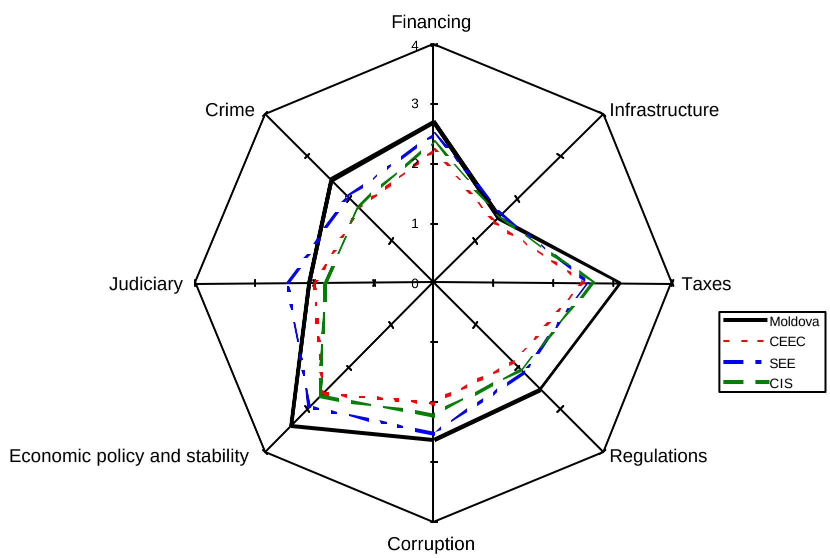
1.11 A number of surveys have been undertaken recently to assess the quality of the business environment. The Business Environment and Enterprise Performance Survey (BEEPS) asks enterprises to evaluate economic governance and state institutions and to assess how the functioning of the state, physical infrastructure and financial institutions affect their business operations. As the BEEPS survey indicates, shown in Figure 1.2, Moldova consistently ranks behind other countries in the CIS, and considerably behind the Central and Eastern Europe and Southeastern Europe, on several critical aspects related to a conducive investment climate. Policy uncertainty clearly leads the concerns of Moldovan enterprise managers. More than 80 percent of managers are concerned with macroeconomic and microeconomic (regulatory) policy uncertainty. Tax rates, tax administration and the access to and cost of financing also rank among major constraints. Nearly 60 percent of firms identified corruption as a major or moderate constraint and, related to this, 58 percent of managers identified business licensing and operating permits as an important constraint to doing business.

[4] Moldova's business environment is reviewed extensively in the Investment Climate Assessment for Moldova, World Bank, March 2004.

Much more remains to be done before Moldova can match the standards of the advanced transition countries – Moldova's competitors in the global production networks.

1.12 Looking at the perceptions of entrepreneurs in more detail, it becomes clear that administrative barriers are the number one constraint. While there have been recent improvements in this area, registering a new business is still cumbersome, and licensing remains one of the most restrictive among transition economies. Similarly, while the duration and cost of inspections have come down, the frequency of inspections has increased. While the BEEPs and complementary "Cost of Doing Business surveys suggest that the business environment has shown some recent improvements, much more remains to be done before Moldova can match the standards of the advanced transition countries – Moldova's competitors in the global production networks. The remainder of this study explores a number of trade specific areas – customs administration, standards and conformity assessment, financial services, transportation and logistics and telecommunications – and makes specific recommendations for changes in those areas that would positively improve the business environment.

Figure 1.2. Perceptions of the Business Climate



Source: Business Environment and Enterprise Performance Survey, 2002

CHAPTER 2. TRADE AND POVERTY: EFFECTIVE ACTIONS IN MOLDOVA CAN BRING LARGE REDUCTIONS

INTRODUCTION

Trade can play a key role in reducing poverty, especially in small open economies such as Moldova, but trade can also bring new risks and lower welfare for some.

2.1 The linkages between trade and poverty in developing countries have been extensively investigated and a consensus has emerged that trade can be beneficial for some individuals while at the same time being harmful for others. Whereas integration into world markets provides new opportunities for growth and higher welfare, trade liberalization may also bring about new risks and increased poverty for some. It is therefore important to identify the winners and losers from trade liberalization and to quantify these gains and losses. This is particularly relevant in Moldova, a small open economy vulnerable to changes in external conditions.

2.2 There are a number of channels through which trade can have an impact on poverty. Trade causes prices to change, thereby generating changes in the welfare (real income) of the household by affecting:

Trade affects households through changes in prices, which affect consumption expenditures, and by affecting wages and incomes.

- *Consumption expenditures.* Trade liberalization may bring down tariffs on products, such as food, causing prices and, consequently, poverty to decline. Trade liberalization typically leads to different price changes for different goods and varying impact for households who consume diverse bundles of goods and services. To study these effects, the chapter looks at the different consumption patterns of Moldovan households at different levels of income.
- *The value of goods and services produced within the household*. These own-production effects of trade refer to the changes in household income that are brought about by changes in producer prices. Higher trade-induced prices for some goods (for example, agricultural inputs) cause welfare gains for households that are net producers of these goods, and losses for households that are net consumers. To deal with these impacts, the present chapter examines the importance of own production as a source of income of Moldovan households and investigates how the value of own-production is affected by trade.
- *Incomes from employment outside of the home.* Trade liberalization causes some sectors to expand and others to contract. Expanding sectors will demand factors of production (skilled labor, unskilled labor, land) in different proportions from those used in the contracting sectors. Factor prices, particularly wages, will therefore adjust. As a result, the income of Moldovan households will change depending upon their different factor endowments. This study examines the impact of trade on labor income and on cash agricultural income.
- *Transfers either from government or from private sources*. Trade can affect both the capacity of the government to provide transfer within the economy and flows between private individuals, both within the country and from outside.

2.3 Trade liberalization will also affect households if it has an impact on the rate of economic growth. The expansion of those sectors benefiting from trade will require labor (and other factors) and, as a result, sectoral employment will increase. This provides new opportunities for substantial welfare gains. There is a substantial, although contested, body of work that suggests that trade plays a major role in economic growth. While this chapter highlights the importance of economic growth to poverty alleviation in Moldova, simulations of the impact of trade on poverty concentrate on the static effects on consumption and incomes.

Trade liberalization also has an effect on poverty by allowing for a higher rate of economic growth.

While formal trade policies in Moldova are fairly liberal, it is likely that the wide array of informal barriers to trade have important implications for poverty.

2.4 It is important to note that the trade-poverty links are influenced not only by formal trade policies, such as tariffs. While, as shown in Chapter 4, formal trade policies are fairly liberal, with relatively low tariffs and formal export barriers, trade is constrained by a range of informal barriers in Moldova. Cumbersome and restrictive customs procedures, corruption, burdensome and inappropriate regulations, such as those relating to product standards, and high transport costs all act to raise the prices of traded goods and have implications for poverty. This chapter seeks to assess how a reduction in these constraints upon trade may influence poverty in Moldova. Many of these factors constrain exports as well as imports. However, since exports are also affected by the policies implemented in overseas markets, it is necessary to consider how improvements in overseas market access will impact the poor in Moldova.

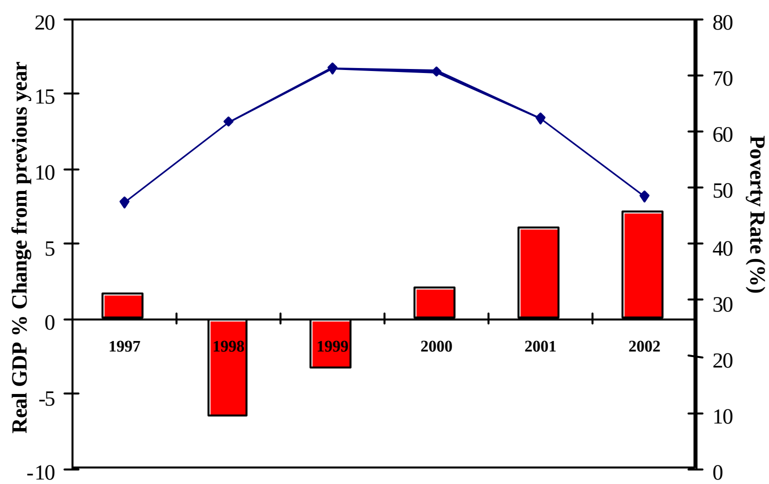
2.5 The analysis is based on simulation exercises which link estimated changes in prices, predicted expansion of particular sectors and other relevant changes, brought about by the integration of Moldova into world markets, with changes in consumption and income for households. The basic data input for this exercise was information obtained on the structure of consumption and the sources of income for different household groups in Moldova. Before discussing the poverty simulations, the main characteristics of this data on poverty in Moldova are briefly presented here.

POVERTY IN MOLDOVA[5]

Poverty in Moldova is widespread and deep. Despite a significant fall in the number of the poor since the peak during the Russian crisis almost half of Moldovans still live in poverty.

2.6 There are two distinctive features of poverty in Moldova: it is widespread, deep and closely related to growth in mean consumption. Figure 10.1 shows the trends in poverty and the rate of growth of per capita GDP from 1997 to 2002. From a poverty rate (head count ratio) of 47.4 percent in 1997, poverty reached a peak of 71.1 percent in 1999. This dramatic increase in poverty occurred at the same time as the Russian crisis and the severe recession that characterized the period. During 2001 and 2002, the economy in Moldova grew at 6.1 and 7.2 percent, respectively, with poverty declining to 62.3 percent in 2001 and 48.3 percent in 2002 as a result. This recent experience suggests that growth and poverty are closely linked in Moldova. Hence, economic policies that promote growth are likely to have a substantial impact on poverty reduction. On the other hand, being a small open economy also leads to a degree of vulnerability to changes in external

Figure 2.1 Poverty and GDP Trends 1997-2002



Source: Beegle (2004)

[5] The data comes from the Moldova Household Budget Survey (MHBS), conducted monthly since 1997, and is designed to be representative of the population of the country (excluding Transnistria). Using a slightly different methodology, the authorities estimate that the poverty rate has continued to fall in 2003 to about 37 percent of the population.

conditions, as shown by the impact of the Russian crisis on poverty rates from 1997 to 1999. This suggests that factors constraining the diversification of trade to a broader range of markets should be alleviated.

Poverty is highest in small towns and then areas and lowest in large cities. Subsistence agriculture is an important characteristic of rural households.

2.7 The geographical division of Moldova in the Household Survey comprises large cities, small other towns, and rural areas. During the whole period, poverty in large cities was much lower than in small towns and rural areas, with the highest poverty rate observed in small towns. In 2001, for example, the head count ratio was 80 percent in small towns, 64 percent in rural areas and 44 percent in large cities. In 2002, after strong growth, the head count ratio was 28.1 percent in large cities, 62.2 percent in small towns and 51.6 percent in rural areas. The lower poverty rate recorded in rural areas, relative to that in small towns, reflects the contribution of subsistence agriculture for food consumption and employment opportunities.

2.8 Poverty in all regions increased from 1997 to 1999. Although the poverty rate in large cities was the lowest, it increased faster than in any other region. In addition, even though the country grew by 2 percent in 2000, poverty in small towns, as opposed to poverty in large cities and rural areas, continued to increase during this year. 2001 and 2002 finally brought about substantial poverty declines in all regions.

2.9 A key aspect of the analysis of the impact of trade liberalization on poverty is the initial structure of household expenditures and sources of household incomes. Since different households have different consumption bundles, a change in relative prices will impact more on some households than others. Indeed, increases in prices of products that comprise a large proportion of consumption expenditure will tend to have a negative impact on household welfare, whereas households will benefit from declining prices of the main products in their consumption bundle.

Household expenditures in all regions are dominated by food and beverages.

Table 2.1 Consumption and Budget Shares in 2002

	Deciles Lowest	Middle	Highest
Large Cities			
1. Food & Beverages	72.6	63.4	38.6
Of which cash	65.7	55.7	32.7
2. Alc beverages, tobacco	2.6	2.1	2.3
3. Clothing and footwear	1	2.3	12.7
4. Housing	9.2	15.4	15.8
5. Transportation	5.2	4	6
6. Other goods and services	9.5	12.8	24.5
Other Towns			
1. Food & Beverages	78.4	69.7	47
Of which cash	60.3	48.7	38.8
2. Alc beverages, tobacco	3	3.9	2.2
3. Clothing and footwear	1.5	4.3	10.1
4. Health care	1.2	2.8	8.9
5. Transportation	0.2	0.8	3.3
6. Other goods and services	7.5	9.6	21.7
Rural Areas			
1. Food & Beverages	81.6	75.4	52.1
Of which cash	17.5	20.5	19.6
2. Alc beverages, tobacco	4.6	5.7	3.3
3. Clothing and footwear	1.4	3.7	10.1
4. Housing	6.4	6.9	17
5. Transportation	0.6	1.2	2.8
6. Other goods and services	5.4	7	14.6

Source: Household Budget Survey

2.10 Table 2.1 summarizes the information on the structure of household expenditures in 2002 according to large cities, other towns and rural areas. By far, the most important category of expenditure, in all regions and for all deciles, is food and beverages. Households in the lowest four deciles in large cities spend more than 65 percent of their budget on food. In small towns the averages are higher than 70 percent, and in rural areas, they are higher than 75 percent. Thus, trade will primarily affect household welfare in Moldova through its influence on consumption of food.

Trade will primarily affect household welfare in Moldova through its influence on consumption of food.

2.11 The table also shows the amount of total outlays on food and beverages that households report as being paid for in cash, with the difference referring to in-kind food expenditures. Most of the expenditure on food and beverages in urban areas (Large Cities and Small Towns) is in cash, but a significant fraction comprises in-kind expenses.

In contrast, most of the expenditure on food in rural areas is in kind, indicating that own-produced and bartered food items dominate consumption in these areas.

There are significant differences between cities, towns and rural areas in the main source of income.

The effects of international trade on poverty will be transmitted mostly through wages and the value of agricultural production.

2.12 In poor households, the only other important category of expenditure is housing, a non-traded good that includes utilities and energy. In the bottom of the distribution, average budget shares spent on housing range from 9 percent to roughly 15 percent in large cities. In small towns, these shares are smaller, ranging from 9 percent to 12 percent, while in rural areas the averages are more stable at around 6 to 7 percent. Expenditures on other categories, including alcoholic beverages and clothing and footwear, are a small fraction of total outlays.

2.13 Table 2.2 reports the average share of different sources of income of Moldovan households in 2002, again distinguishing large cities, small towns and rural areas. The table shows that there are substantial differences in the main source of income in different regions. In large cities, income from employment is the main source of income of the poor, while in rural areas the crucial source of income is agricultural production. In small towns, the poorest region, income from employment is the most important income source. In all regions, income from pensions and gifts are important. This implies that the effects of international trade on poverty will be transmitted mostly through wages and the value of agricultural production.

Table 2.2 Sources of Income in Moldova Households, 2002

	Deciles Lowest	 Middle	 Highest
Large Cities			
Non-agricultural production	0	2.6	2.2
Agricultural production	1.3	0.4	0.6
Income from employment	46.9	43.1	58.8
Pensions and retirement	31	32.7	7.7
Other social security income	1	0.7	1.1
Gifts	10.8	16.9	26
Other	9	3.7	3.7
Other Towns			
Non-agricultural production	0	2.2	1.9
Agricultural production	11.2	16	8.4
Of which: cash	1.9	2.9	2.6
Income from employment	46.4	42.6	48.5
Pensions and retirement	24.5	21.8	5.4
Other social security income	1.1	0.1	0.1
Gifts	13.1	14	26.5
Other	3.7	3.3	9.2
Rural Areas			
Non-agricultural production	0.1	0.4	0.8
Agricultural production	67.9	61.2	57.1
Of which cash	4.3	7.8	15.3
Income from employment	8.8	7.8	12.3
Pensions and retirement	14.5	22.4	9.6
Other social security income	1.1	0.4	0.8
Gifts	5.2	4.8	12.3
Other	2.4	3	7.1

Source: Household Budget Survey

2.14 Given the importance of income from employment as a source of income, it is also important to look at differences in wages across sectors of economic activity. If the adjustments following the liberalization of trade lead to a shift from higher-wage to lower-wage sectors then there will tend to be a negative impact on household incomes. On the other hand there will tend to be a positive effect if trade leads to an increase in the number of relatively highly paid jobs.

2.15 Exploiting the panel structure of the Household Budget Survey will reveal, in more detail, the reallocation of resources from contracting sectors to expanding sectors for the main features of the socioeconomic dynamics in Moldova. The survey is a rotating panel, which means that some households are interviewed for several years (some for two consecutive years, others for four consecutive years). The approach is to first look in more detail at those households that moved into poverty between 1997 and 1999 and then to look at the fraction that changed socioeconomic groups.

2.16 The main conclusion drawn from Table 2.3 is that there are only mild transitions across socioeconomic groups among those families that moved into poverty from 1997 to

1999. Perhaps the most important dynamics are observed among the farmers in 1997 that tended to become workers in the agriculture sector in 1999. There are also some wage-workers (in agriculture and non-agriculture) that became farmers, indicating movements towards subsistence agriculture.

Table 2.3 Dynamics of Movements into Poverty in Moldova 1997 – 1999

	Socioeconomic group in 1999					
Socioeconomic group in 1997	Farmers	Employed in Agriculture	Employed in Non-Agriculture	Self Employed	Pensioners	Others
Farmers	10	8	4	0	3	0
Employed in Agriculture	12	54	4	0	7	0
Employed in Non-Agriculture	8	2	72	1	5	1
Self Employed	0	0	6	2	1	0
Pensioners	2	5	5	0	90	0
Others	1	0	1	0	3	0

Source: Household Budget Surveys

2.17 The second, look is at the dynamics of those households that moved out of poverty from 1999 to 2002. Table 2.4 shows that again there are only minor movements of households from one socioeconomic group to others. Indeed, most families tended to remain in the same socioeconomic group in 1999 and in 2002. However, there are some important movements of those that were employed in agriculture in 1999 towards farming activities in 2002. It is also interesting to note that the net effect of movements towards employment in non-agriculture is positive, indicating that there was a tendency among those escaping poverty to move to employment activities not related to agriculture. The lack of significant changes in socio-economic groups as households both enter and leave poverty suggest that such movements may be very costly in Moldova and may take much longer than the short period which has been the focus here.

Table 2.4 Dynamics of Movements out of Poverty in Moldova 1999--2002

	Socioeconomic group in 2002					
Socioeconomic group in 1999	Farmers	Employed in Agriculture	Employed in Non-Agriculture	Self Employed	Pensioners	Others
Farmers	26	3	6	0	2	1
Employed in Agriculture	31	23	9	0	10	1
Employed in Non-Agriculture	6	7	73	1	6	3
Self Employed	0	0	3	0	0	0
Pensioners	5	2	7	0	112	1
Others	1	0	7	0	1	2

Source: Household Budget Surveys

THE POVERTY EFFECTS OF INTERNATIONAL TRADE

The lack of significant changes in socio-economic group as households both enter and leave poverty suggest that such movements maybe very costly in Moldova.

2.18 A number of policy exercises is now presented with the aim of assessing the role of trade as a poverty reducing mechanism in Moldova.[6] Since formal trade policies are fairly liberal, the exercises start by considering the elimination of informal barriers to trade in Moldova, such as, high transport costs, cumbersome customs practices, inappropriate regulations and corruption. What follows are estimates of the poverty effects of each of these factors, a look at the poverty impacts of improved custom

[6] A more detailed discussion of the modeling approach is provided in Porto, G (2004) "Informal Export Barriers and Poverty" forthcoming Working Paper, World Bank.

practices on the import side, and then, an analysis of the poverty effects of reducing such costs associated with exports.

2.19 *Imported Goods: Improved Customs Practice.* This section covers the investigation of the effects of improving custom practices on the prices of imported goods and on poverty. Import procedures in Moldova are cumbersome and complicated and they impose a cost on importing firms. As a result, prices are higher for imported goods and poverty may be affected. Moldovan imports comprise mostly chemicals, fertilizers, machinery, energy and manufactures. A simulation exercise was performed which investigated the consumption effects of improving customs practices on imports of consumer goods and energy.

2.20 For modeling purposes, all goods were aggregated into a single import commodity with price p_i. The domestic price of this aggregate commodity is given by

(1) $$p_i \; ? \; p_i^*(1 \; ? \; ?_i)(1 \; ? \; ?_i) \, ,$$

where p_i^* is the international price of the goods, $?_i$ is the import tariff levied on these goods and $?_i$ is a measure of the transaction cost associated with import procedures. Accordingly, it is assumed that a reduction in the cost of importing can be modelled as a reduction in the price of imports.

2.21 The first order effects on household welfare (real income) of improving import practices can be measured by the product of the budget shares spent on different importable goods and the induced change in their prices. It is assumed that the prices of the following goods are affected by the cumbersome custom practices: Clothing and footwear, energy, household operations and leisure related goods (entertainment goods such as TV's radio, etc.). Some food prices will also change andit is assumed that 10 percent (the food import share) of the total food expenditures is affected by import prices.

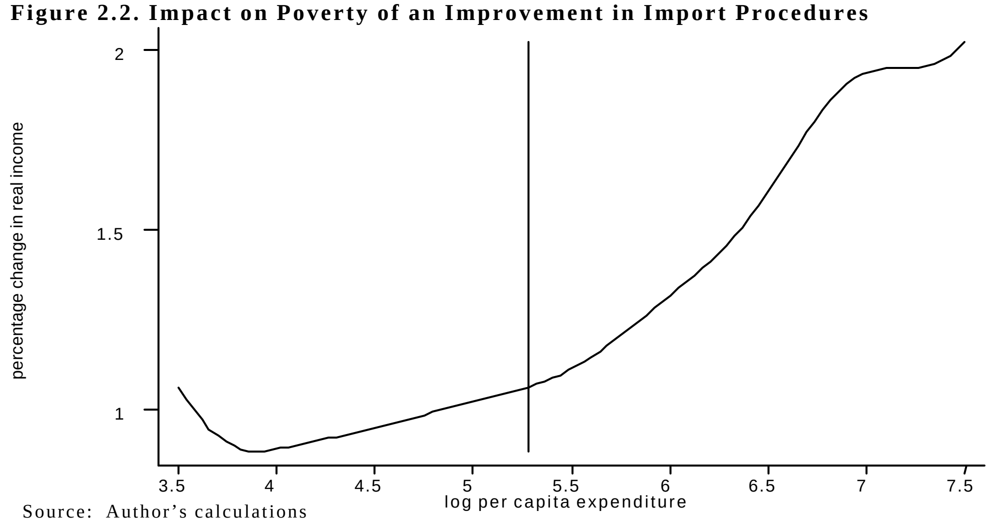
2.22 The Cost of Doing Business Surveys were used, supplemented by a recent survey of exporters and importers and importers to get an estimate of the cost of informal import barriers to trade in Moldova. This analysis suggests that the average transaction cost related to imports was equivalent to around 9 percent of the value of a shipment. This is a large number. The most costly regulations are related to customs procedures, standards verification, tax administration issues, and ecological controls. Of lesser importance are the costs associated with border troops, the road authority, the border police, and sanitary and veterinary controls.

2.23 For the purpose of the simulation, it is assumed that these costs are reduced in a way that the prices of imported goods decline, on average, by 4.5 percent. The poverty impacts of such a change in import prices are in Figures 2.2. The curve represents the average change in the real income of the household (measured as the product of budget shares and a price change of 4.5 percent) at different levels of per capita expenditure. Usually, averages by deciles are computed, as in Tables 2.1 and 2.2. Here the averages are computed for the full range of income levels. By doing this, the poverty effects can be visualized across the entire income distribution. The averages represent the changes in real expenditure, as a share of initial expenditure, so that a welfare effect of 1 means that household real income (expenditure) increases by an amount equal to 1 percent of its initial outlays. In Figure 2.2, the vertical line represents the poverty line, so that all households to the left are considered poor and all households to the right are considered rich (or not poor).

Improving customs and tax procedures, and other administrative factors that raise the price of imports in Moldova would benefit all households. There would be a decline in the poverty rate from 48.3 to 47.6 percent.

2.24 Figure 2.2 suggests that improving import procedures benefits all households across the income distribution. For poor families, the average gains are equivalent to less than 1 percent of initial household expenditures. The curve is upward sloping, especially after crossing the poverty line, indicating that these impacts are relatively pro-rich. Indeed, for the richest Moldovan households, the average gains amount to up to 2 percent of expenditure. This reflects that all families face the same price levels, but richer families spend a higher share of their expenditure on the consumer goods being considered here. There are some positive effects due to lower prices on imported food (which tend to benefit the poor more than the rich). However, imported food comprises a small fraction of total household food expenditures. Our estimates indicate that, from an initial poverty rate of 48.3 percent in 2002, poverty would decline to 47.6. This implies that 0.7 percent of the population, or slightly over 25,000 individuals, would leave poverty due to better import practices.

Figure 2.2. Impact on Poverty of an Improvement in Import Procedures



Source: Author's calculations

2.25 *The Impact on Poverty of Alleviating Export Constraints*. Corruption, inefficient customs procedures, high transport costs and inappropriate regulations, such as standards and requirements relating to repatriation of export proceeds, tend to raise the costs of exporting, which in turn may influence prices, employment and wages, with a consequent impact on poverty. The investigation of the impacts of barriers to exports on the income that households earn is presented here. Specifically, it is assumed that households supply inputs to exporting firms. Labor or raw agricultural goods used in the production process (such as grapes supplied to the wineries or apples supplied to the juice producers) are examples. It is assumed that trade barriers erode the net price received by exporters. In this sense, trade barriers are modeled as transaction costs with a formal treatment similar to an export tax.

2.26 For the modeling exercise, it is assumed that the government reduces these barriers to export. This works to increase the net price of export goods. As a result, the exporting sectors expand and the demand for the inputs used in the sector (grapes, apples, labor) increases. This, in turn, causes an increase in the price of the inputs, such as wages and the price of raw agricultural goods with an impact on household incomes.

2.27 The costs associated with export barriers are again derived from the Costs of Doing Business Survey and the exporter and importer survey carried out for this study. The average reported cost of the range of barriers to exports, as a share of the value of a shipment, was 12 percent. The most important components were associated with tax administration, customs officers, road authority, standards verification, and veterinary and sanitary controls. In addition, the exporter and importer survey revealed that the average transport cost reported by Moldovan exporters is around 12 percent of the value of the shipment. It is assumed that the costs associated with these export barriers are reduced so that the net price faced by exporters increases by 6 percent. Given a total cost associated with these export barriers of around 24 percent, the reduction of prices by 6 percent could be generated by a reduction of 25 percent in these costs.

Wages and agricultural incomes are sensitive to changes in export prices. Factors, such as inefficient customs procedures, which reduce the price received by exporters in Moldova will have significant impact or household incomes.

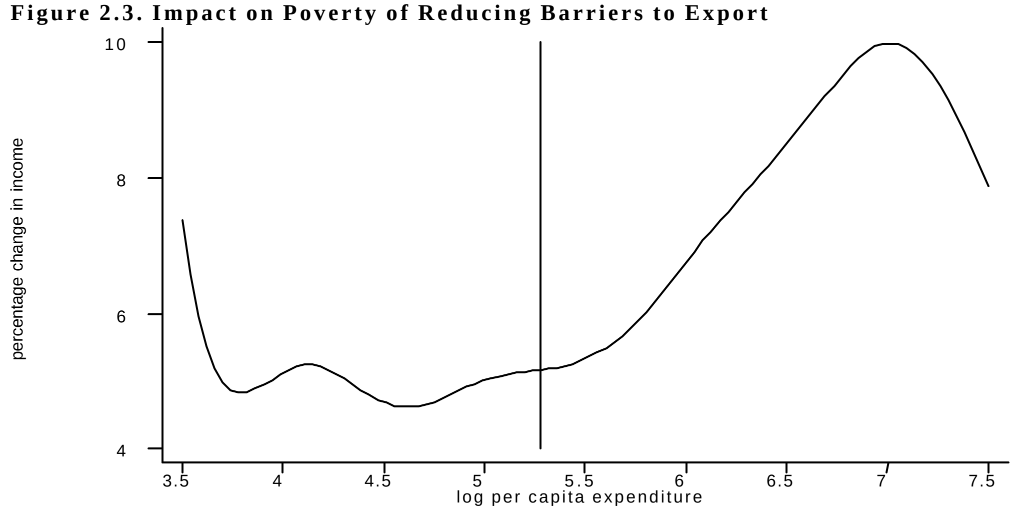
A 6 percent increase in prices received for exports generates average gains in the order of 5 percent of initial household expenditure. This would lead to a fall in poverty from 48.3 to 43.3 percent, equivalent to 200,000 Moldovans leaving poverty.

2.28 Initial results show that reducing the costs of exporting has a positive impact on the labor income of the household. When firms are able to realize higher prices for their product, they hire more workers, which tends to push up wages. The response of labor income in Moldova to changes in prices is found to be quite elastic (and statistically significant) – a 1 percent increase in the price of industrial goods causes wage income to increase by 3.2 percent.[7] It is estimated that agriculture income increases with export prices, too. The response is less elastic, around 2.5 percent, but still high. It is also statistically significant. The interpretation, as before, is that an increase in the price p_t causes firms to demand higher amounts on raw agriculture goods produced by the household (such as grapes) and this drives up the prices of agricultural inputs.

2.29 As noted above, a substantial proportion of agricultural income and expenditure in rural areas takes place in non-cash form. In this exercise, it is assumed that the impact of higher prices on in-kind income is exactly compensated by the effect on higher consumption expenditures, and, therefore, only focus on the share of income generated by cash activities. The impacts by income level are shown in Figure 2.3. It is clear that the effects of reducing export barriers on income are positive at all income levels. For households below the poverty line, a 6 percent increase in prices received for exports generates average gains in the order of 5 percent of initial household expenditure. These large effects are explained by, first, the substantial increase in prices and, second, the high elasticities of wages and agriculture income. Interestingly, the welfare effects increase with income as they cross the poverty line and move up the income distribution. This is because the share of labor income in total household income increases as households become richer. The implications for overall poverty are that the head count ratio falls by 5 percentage points from 48.3 percent to 43.3 percent, equivalent to almost 200,000 Moldovans leaving poverty. These are substantial impacts and point to the significant impact on poverty that could be achieved if barriers on exports in Moldova were to be reduced. It is also interesting to note that there are no losers in this experiment. This is an instance, then, in which all households are on the same side of the market in the sense that all of them are net suppliers of labor and raw agricultural inputs.

[7] These elasticities are derived using regression analysis and utilizing the monthly variation in the information on sources of income from the Moldova Household Budget Survey and the observed changes in prices.

Figure 2.3. Impact on Poverty of Reducing Barriers to Export



Source: Author's calculations

2.30 *Market Access in Developed Countries*. Finally, the poverty impacts are examined, at the household level, of an increase in the quantity of Moldovan exports as a result of an improvement in access to European and Russian Markets. This could follow from a reduction in formal trade barriers, although, as noted earlier, tariffs and quantitative restrictions on imports from Moldova are low in the EU and Russia. It could also be the result of a better standards infrastructure in Moldova that allows Moldovan produced products easier access to foreign markets. Improvements are modeled in market access as an increase in the labor income and agricultural income of Moldovan families. The linkage is that better access to world markets leads to higher demand for labor and agricultural inputs. As above, this leads to an increase in factor prices and household income. In the medium-run, there is an additional important effect of market access. This is related to the substitution in production. Farmers employed in subsistence agriculture and in other own-production activities may shift to wage-labor and cash crops. This may be the case because of higher demand for labor or because farmers decide to sell their land and elect to work for a bigger farm enterprise. Since these mechanisms take time to take place, these effects are modeled as representing medium-run and long run effects. As a consequence, it is assumed that the share of household income originating in cash-agricultural crops and in labor markets increases with higher market access.

Improvements in overseas market access, together with the reduction of barriers to import and exports in Moldova, would reduce poverty 37.4 percent, equivalent to 390,000 Moldovans leaving poverty.

2.31 This simulation shows that improvements in overseas market access could reduce the head count ratio by 4.5 percentage points from 48.3 to 43.8 percent. If this improvement in market access (with substitution possibilities in production) were to occur together with efforts to reduce constraints on imports and exports, as discussed above, there would be a large decline in poverty, from 48.3 percent in 2002 to 37.4 percent. This implies a reduction in the head count ratio of 10.2 percentage points, which is equivalent to over 390,000 individuals leaving poverty in Moldova.

CONCLUSIONS

2.32 Since Moldova is a small and open economy, factors that impinge on trade are likely to have a significant impact on poverty. The simulations undertaken in the chapter show how policy initiatives which reduce the cost of importing and exporting in Moldova and, which lead to easier access to overseas markets, could have substantial impacts on poverty, reducing those in poverty by about 10 percentage points.

CHAPTER 3. TRADE AND FOREIGN INVESTMENT PERFORMANCE AND STRUCTURE: LIMITED DIVERSIFICATION CONSTRAINS FUTURE PROSPECTS[8]

INTRODUCTION

Moldova was highly integrated into the Soviet Union, trading over 100 percent of its output.

3.1 Upon independence, almost all of Moldova's exports and 80 percent of its imports took place with other Former Soviet Union (FSU) countries. Trade represented a large share of domestic output with Moldova supplying agricultural and agroprocessed products, as well as consumer durables and high-tech defense systems, and importing almost all industrial inputs -- most notably primary energy resources -- and most consumer goods from the rest of the Union of Soviet Socialist Republics (USSR). As shown in Table 3.1, Moldova's pre-independence trade ratio was only exceeded by Armenia and Belarus.

Table 2.1 Trade in Goods and Services
(Percent of GDP)

	1988	2003
Moldova	**102**	**136**
Armenia	126	90
Azerbaijan	100	107
Belarus	118	154
Georgia	92	67 *
Kazakhstan	58	93
Kyrgyz Republic	78	81
Russia	47	53
Tajikistan	76	125
Turkmenistan	85	94 *
Ukraine	74	110
Uzbekistan	71	78

* 2002
Source: World Development Indicators and Belkindas and Sagers (1990).

The disintegration of the Soviet Union had a profound impact on the Moldovan economy and its external trade relations

3.2 The disintegration of the Soviet Union had a profound impact on the Moldovan economy and its external trade relations. Independence was accompanied by a severe dislocation in the trade and payments system, the establishment of a complex and uncertain legal and regulatory environment among the newly independent states and trade restrictions (especially on exports) that, among other things, led to a dramatic decline in trade in the 1992-1994 period. In addition, Moldova experienced a massive terms of trade shock - estimated to be at least 20 percent of GDP - as prices on previously subsidized imported energy and exported agricultural and agroprocessed products adjusted to world levels.[9] Since export and import prices in the Soviet Union were not market determined it is difficult to precisely estimate the extent of the trade collapse in the period immediately following independence. The order of magnitude of the decline in trade is probably similar to the decline in GDP, dropping by more than 50 percent between 1991 and 1994. Following this initial decline, however, trade has recovered and the trade to GDP ratio now stands at 136 percent (Table 3.1).

3.3 Numerous empirical studies have shown that the beneficial effects of trade and investment openness are quite large. These studies indicate that countries which are more fully integrated into the international economy achieved higher rates of economic growth. In part, this reflects the strong link between participation in international trade and the transfer of technology and know-how. In the case of Moldova, however, there is some

[8] The data used in this chapter reflect only officially recorded trade flows. The poor quality of trade and national accounts data complicates the analysis of trade policy and trade developments. Moldova has a large and flourishing "informal" sector meaning that some economic activity is not included in official statistics. This informal sector is quite large, with estimates of its size ranging from 30 to 50 percent of official GDP. It is also well known that CIS trade statistics have a number of flaws related to the under recording of trade flows. In the case of Moldova, these flaws are complicated by the exclusion of economic activity and trade emanating from Transnistria - a gateway for smuggling goods into and out of Moldova. For example in 2000 the outside world reported trade flows with Moldova that was 50 percent larger than those registered by the Moldovan Customs department.

[9] Estimated by considering only the increase in energy prices and assuming that other prices increased in line with inflation. See, Jonathan Walthers "Trade in Newly Independent States", World Bank, 1994.

concern that trade openness has not brought the expected results. In part, this reflects the fact that Moldova has yet to significantly diversify its trade patterns away from its Soviet past. As discussed below, Moldova's exports are still concentrated in a few commodities and are still largely destined for the CIS market. As the remainder of this study suggests, the concentrated direction and commodity composition of trade reflects, in part, a number of underlying informal trade barriers and impediments that have inhibited diversification. Despite the appearance of a liberal "formal" trade regime, Moldova's trade openness is not necessarily synonymous with liberal policy openness. Finally, utilizing market exchange rates to measure the ratio of trade to GDP may give a misleading picture of trade openness in transition economies.[10] If, instead, the trade is compared to GDP measured at Purchasing Power Parity (PPP) exchange rates, the Moldova economy is not a particular open one – in 2002, trade is less than 20 percent of GDP measured on PPP basis and it has been declining since independence.[11] It is still clear, however, for a small economy like Moldova, closer integration into the World economy and the rapid growth in exports must serve as the engine of sustainable growth.

OVERALL TRADE PERFORMANCE SINCE 1995

Following the initial shock of transition, external trade recovered with exports and imports growing strongly from 1995 to 1997.

In the period following the 1998 financial crisis, exports and imports dropped by half.

Starting in 1999, Moldovan trade experienced a second round of strong growth.

3.4 Following the tumultuous period after independence, by the mid-1990s, Moldovan trade started to gradually recover as relations with the original CIS markets were reestablished and as new trade relations were made with other countries. Over the 1994-1997 period, trade grew rapidly with exports increasing by 55 percent and imports increasing by more than 75 percent (in US dollar terms). Moldova's export recovery was fuelled primarily by the reestablishment of trade relations with Russia. While most other transition economies, particularly the Baltic Republics and the countries of Central and Eastern Europe, were redirecting their trade away from the FSU during this period, Moldova was increasing its dependence on the CIS and Russian markets. By 1997 the CIS, primarily Russia, was the destination for 70 percent of Moldovan exports. When the Russian financial crisis hit the region in 1998, Moldova experienced its second major trade shock. In the two year period following the crisis, Moldovan exports dropped by half, primarily the result of the 60 percent decline in exports to Russia. The significant depreciation of the leu (see Figure 2.1), combined with the decline in domestic demand, led to a similar sharp decline in Moldovan imports.

3.5 In the period following the Russian financial crisis, Moldovan trade has experienced a second round of strong growth driven, in part, by economic recovery in its main trading partners. Between 1999 and 2003, merchandise exports have grown, on average, by about 18 percent per annum while imports have increased even faster – averaging 29 percent per annum over the same period. Growth in both exports and imports has continued to be strong in 2004. This second wave of trade growth has one major difference from the earlier period -- it is geographically broader. Trade with non-CIS countries has grown more rapidly than trade with CIS countries. Barter transactions have also been practically eliminated – the share of barter in total merchandise trade declined from 22 percent in 1995 to slightly more than 1 percent in 2002. Despite the rapid growth in trade, however, the level of exports in 2004 have only just reached the peak levels obtained in 1997.

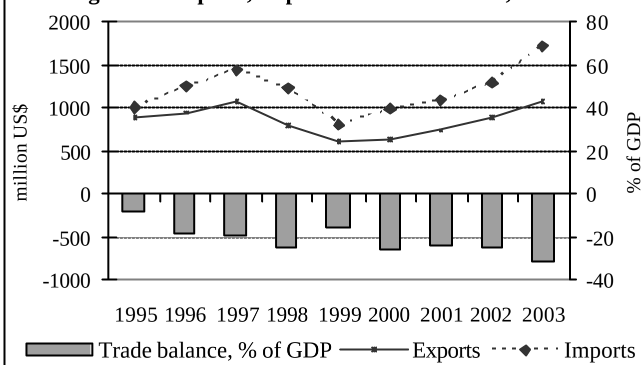
[10] See, for example, EBRD, Transition Report 2003.

[11] The choice of PPP rates for converting GDP into US dollars is important because Moldova is much richer when measured in PPP rather than current market exchange rates. Consequently, the ratio of trade to GDP is lower at PPP rates than at market rates because it eliminates the distortions in non-trade goods. One way to interpret these results is in terms of the long-term trade potential of Moldova compared with its current trade levels. In the long term, the difference between GDP in PPP and current US dollars is likely to narrow.

Moldova has consistently been running large trade deficits.

3.6 With the growth of imports exceeding exports, Moldova has consistently been running large trade deficits (Figure 3.1). Over the1995-2003 period, the trade deficit averaged about 21 percent of GDP and has been exhibiting a deteriorating trend. The pre and post 1998 trade deficits differ in one important way - their financing. In the early part of the 1990s, the trade deficit was financed primarily through accumulation of external debt. Loans from International Financial Institutions (IFIs), along with the accumulation of arrears on energy imports, allowed the country to finance its large trade deficit. In the later part of the 1990s, an increasing portion of the trade deficit has been offset by labor remittances and financed to a larger extent by concessional assistance and foreign direct investment. While large trade and current account deficits do pose macroeconomic risks, it is imminently sensible for Moldova to be importing intermediate and capital goods that upgrade its technological base and increase the productivity of domestic firms.

Figure 3.1 Exports, Imports & Trade Balance, 1995-2003



Source: IMF Balance of Payments.

DIRECTION OF TRADE

"Gravity" models predict that Moldovan trade flows should be redirected away from the CIS towards the EU.

3.7 Using so-called "gravity" models[12], a large number of studies have been undertaken that explore how the normalization of trade relations should alter the geographical composition of trade of the transition economies. Given the huge size and proximity of the European Union, it is not surprising that these models predict that, absent any policy impediments, the trade flows of transition economies should be redirected away from the Council of Mutual Economic Assistance (CMEA) towards the EU. Indeed, as shown in Table 3.2 most CIS countries have undergone a massive reorientation of trade. For most of these countries, this adjustment has taken place very rapidly and by now, many of

Table 3.2 Predicted and Realised Shares of Intra-CIS Exports

	Actual share of inter-republic exports, 1985	Predicted share of inter-republic exports,1985	Actual share of intra-CIS exports, 2003
Armenia	97	27	18
Azerbaijan	94	24	16
Belarus	90	32	55
Georgia	94	20	50
Kazakhstan	90	27	23
Kyrgyz Republic	98	37	35
Moldova	**95**	**26**	**54**
Russia	68	16	15
Tajikistan	86	26	18
Turkmenistan	91	22	42
Ukraine	84	33	25
Uzbekistan	84	26	44

Note: Inter-republic exports included the Baltic states, which are not the members of the CIS. However, the statistical discrepancy is rather small.
Source: Kaminski et al. (1996), IMF Directions of Trade Statistics.

[12] A gravity model relates the level of trade between two specific countries to the size of their respective economies and the cost of shipping goods to each other. This cost may have been influenced by geographical distance as well as the cost of transport and any policy-related obstacles that hinder trade.

these countries are trading primarily outside of the CMEA region. Moldova, however, along with Belarus, Turkmenistan and Uzbekistan, has redirected its trade - particularly exports - much less than predicted by these models. In the chapters that follow, the domestic and external reasons why this might be the case will be explored.

Moldova, however, has redirected its trade much less than predicted by these models

Exports remain highly dependent on the CIS markets

3.8 As can be seen from Table 3.3, Moldova's exports remain highly dependent on the CIS markets, particularly Russia. Although the share of exports going to these countries has been declining since 1997, when it reached it's post-independence peak of 70 percent, the CIS still remains the destination over 50 percent of Moldovan exports. The increase in non-CIS exports has been mainly the result of increased exports to the EU-15, with the share of exports to Romania and other countries exhibiting little overall change. The increased non-CIS share was driven, in the first instance, largely by the large drop in trade to Russia following the 1998 financial crisis. Since then, however, exports to the European Union (EU-15) have grown broadly in line with total exports, so that the share of EU exports in total exports has remained relatively constant at about 21-23 percent.

Table 3.3 Geographical Composition of Trade

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Avg.growth 1995-1997	Avg.growth 1999-2003
Exports, mill.US$	**746**	**653**	**874**	**601**	**428**	**456**	**550**	**623**	**776**	8%	16%
CIS	63%	69%	70%	70%	57%	59%	62%	56%	54%	14%	14%
o/w Russia	48%	56%	59%	55%	44%	46%	45%	38%	40%	19%	13%
Ukraine	8%	5%	6%	7%	7%	7%	10%	10%	7%	-10%	18%
Other	6%	8%	6%	7%	7%	7%	7%	8%	7%	1%	19%
non-CIS	37%	31%	30%	30%	43%	41%	38%	44%	46%	-3%	18%
o/w EU-15	12%	10%	9%	12%	21%	21%	21%	22%	23%	-2%	20%
Romania	14%	9%	6%	9%	8%	8%	7%	9%	11%	-26%	25%
Other	12%	12%	14%	9%	14%	12%	11%	14%	11%	19%	10%
Imports, mill.US$	**841**	**1072**	**1171**	**1023**	**587**	**777**	**892**	**1038**	**1399**	18%	24%
CIS	68%	61%	50%	43%	41%	34%	38%	39%	42%	2%	25%
o/w Russia	35%	30%	28%	25%	24%	15%	16%	15%	13%	8%	7%
Ukraine	27%	24%	18%	15%	13%	14%	17%	20%	22%	-5%	41%
Other	7%	6%	5%	5%	4%	5%	5%	5%	7%	-4%	43%
non-CIS	32%	39%	50%	57%	59%	66%	62%	61%	58%	47%	24%
o/w EU-15	14%	17%	19%	27%	27%	29%	28%	26%	28%	38%	26%
Romania	7%	6%	8%	11%	14%	15%	10%	9%	7%	32%	4%
Other	12%	16%	23%	19%	18%	22%	24%	25%	22%	63%	31%

Source: UN Comtrade database

The significant shift in the trade flows of other "late reformers" reflects both the improved policy environment of these countries and the steadfast pursuit of their EU aspirations. It suggests that similar policy changes in Moldova could have similar effects.

3.9 The shift of Moldova's exports towards the EU-15 has not reached levels comparable with other "late reformers" such as Bulgaria, Lithuania, Romania and Slovakia. As shown in Table 3.4, in the later half of the 1990s, these countries dramatically reoriented their exports and now send between one-half and two thirds of their exports to the EU-15 - twice as much as Moldova. The reorientation is noteworthy given that Moldova is located in the same geographical region and has a similar natural resource endowment.[13] The significant shift in the trade flows of these countries reflects both the improved policy environment of these countries and the steadfast pursuit of their EU aspirations. It suggests that similar policy changes in Moldova, combined with Moldova's reinvigorated EU aspirations, could have similar effects.

Table 3.4 Exports to EU

(percent of total exports)

	1995	2003
Bulgaria	39	57
Lithuania	36	42
Moldova	**12**	**23**
Romania	54	68
Slovakia	37	61
CIS, avg	19	25

Source: IMF Directions of Trade.

3.10 Moldova imports have undergone a much faster reorientation with the share of imports coming from non-CIS countries increasing rapidly since 1995. This pattern is similar to other transition countries. The share of imports from the EU grew very quickly in the early and mid 1990s and by 2003, over a quarter of Moldova's imports came from the EU. An equally important increase in non-CIS imports comes from the

[13] With the exception of Romania which has some oil reserves.

countries of Central and Eastern Europe. Within the CIS, the proportion of imports coming from Russia has declined dramatically while the share of imports coming from Ukraine has rebounded and now exceeds Russia.

COMPOSITION OF TRADE

Moldova has not yet been able to expand its participation in the global production chain to higher value assembly operations

3.11 Modern trade theory suggests that Moldova's comparative advantage lies in its skilled and inexpensive labor force and the quality of its agricultural lands. With the globalization of production, one would expect Moldova to increasingly participate in the production of products that employ labor intensive processes. Such production integration has already taken place in the Moldovan apparel industry.[14] European clothing producers supply materials and product specifications to the Moldova garment producers who, for their part, supply only manufacturing skills and low cost labor. Unlike many other Eastern European countries, Moldova has not yet been able to expand its participation in the global production chain to higher value assembly operations. This study suggests that a number of domestic impediments, such as excessive delays in transiting Moldova's international borders as a result of cumbersome and bureaucratic custom procedures, reduce the attractiveness of Moldova for these types of operations despite it's inexpensive and relatively skilled labor force.

Moldovan exports are also heavily concentrated in a few product categories and have become increasingly concentrated over time.

3.12 In addition to being geographically concentrated, Moldovan exports are also heavily concentrated in a few product categories and have become increasingly concentrated over time. As shown in Table 3.5, the share of the top three export products in total exports has increased from 39 to slightly over 53 percent between 1995-2003. Over the same period, the number of products that Moldova has exported has fallen, declining from 765 in 1995 to 597 in 2003.[15]

Table 3.5. Export concentration

	Nr. of commodities exported[1]		Export concentration index[2]		Share of the three largest products[3]	
	1995	2003	1995	2003	1995	2003
Bulgaria[4]	1114	1092	0.09	0.10	17.6	33.4
Lithuania	1080	1106	0.09	0.16	20.7	32.7
Moldova	***765***	***597***	***0.13***	***0.30***	***39.4***	***53.3***
Romania	982	1071	0.12	0.12	31.3	34.5
Slovakia	1002	1162	0.09	0.18	18.3	27.1

1/ Number of products at the four-digit level (HS, 1988/92); maximum 1300.
2/ Herfindahl-Hirschmann index was calculated according to the formula

$$H_i = \frac{\sqrt{\sum\left(\frac{x_i}{X}\right)^2} - \sqrt{\frac{1}{239}}}{1 - \sqrt{\frac{1}{239}}}$$

x_i = value of exports of product i
239 = number of products at the 3-digit SITC level
3/ Three-digit level. Apparel (group 84 in SITC Rev.2) was considered one product.
4/ 1996 year is presented instead of 1995.

Source: UN Comtrade database

3.13 Moldovan exports are dominated by wine, food products and apparel products. Wine is the single most important export item, comprising 28 percent of total exports in 2003. Food products make up about 27 percent of exports, with apparel contributing 15 percent of exports. Since wine and food products are mainly exported to Russia, these goods were particularly hard hit by the 1998 crisis. In the two-year period following the crisis, the value of these exports to Russia contracted by 56 percent. Even in 2003, after four years of robust growth, total exports of wine and food amounted to only 72 percent

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[14] See the Textile Case Study in Part II of this study.
[15] Defined as the number of non-zero 4-digit HS export categories.

of their pre-crisis level. Perhaps the most noticeable trend in exports, as noted above, has been the steady growth of apparel exports to EU. These exports have grown at average of 25 percent per year since 1998. As a result, the share of apparel in total exports has increased from 3 percent in 1995 to 15 percent in 2003.

While imports are dominated by energy, they are, in general, more diversified then exports.

3.14 While imports are dominated by energy, they are, in general, more diversified then exports. Energy has been the single biggest import item throughout the 1990s. The share of energy in total imports, however, has been constantly declining and by 2003 had fallen to 21 percent of total imports, significantly below the 46 percent share recorded in 1995. In value terms, energy imports declined from 1995 to 1998 but have remained relatively constant since then. On the other hand, the import of manufactures have been on the rise and replaced energy as the leading import group, reaching 30 percent of 2003 imports. Imports of food products and chemicals and fertilizers have also been increasing in both relative and absolute terms and accounted in 2003 for 14 and 12 percent of total imports.

There is a significant difference between Moldova's trade with the CIS countries and its trade with the EU.

3.15 The commodity composition of total trade disguises a significant difference between Moldova's trade with the CIS countries and its trade with the EU. In 2003 , for example, wine exports made up about 27 percent of Moldova's total exports. However, wine comprised only 0.9 percent of the exports going to the EU but nearly 50 percent of the exports going to the CIS. Similarly, while apparel exports comprised 15 percent of total exports, they made up only 0.2 percent of exports going to the CIS but over 47 percent of exports going to the EU. As these examples illustrate, Moldova exports a very different product mix to the EU than it does to the CIS. In 2003, less than 10 percent of the products being exported to the CIS are also exported to the EU.

FOREIGN DIRECT INVESTMENT

There is a need to increase both the quantity and quality of investment as well as acquire technology and design skills, production methods, plant management techniques and market expertise.

3.16 Moldova, like many transition economies, inherited a capital stock and production methods and practices that, by western standards, are largely obsolete. There is a need to increase both the quantity and quality of investment as well as acquire technology and design skills, production methods, plant management techniques and market expertise. Foreign direct investment (FDI) can play a crucial role in helping Moldova overcome the legacy of its soviet era capital stock. Not only does FDI increase the level of financing available for investment, it provides a means for the transfer of the most modern and efficient technologies and techniques from western firms. There is a growing body of evidence that suggests these more modern technologies and techniques "spill-over" into the domestic economy, thereby directly and indirectly contributing to economic growth. The positive link between FDI and firm level productivity suggests that the ability of Moldova to attract FDI in the future will be a key determinant of economic growth.

Table 3.6 Foreign Direct Investment
(average, 1995-2002)

	% of GDP	US$ per capita
Bulgaria	4.4	70
Lithuania	3.9	122
Moldova	***4.8***	***18***
Romania	2.7	46
Slovakia	3.7	233
Small CIS*	2.9	15
Central CIS**	2.9	39

* Armenia, Georgia, Kyrgyz Republic, Tajikistan and Uzbekistan.
**Belarus, Kazakhstan, Russia and Ukraine.
Source: World Development Indicators

3.17 Despite rising absolute FDI inflows, Moldova has consistently ranked in the bottom third of countries in Eastern Europe and Central Asia in terms of total cumulative direct investment inflows and FDI per capita. Over the period 1995-2002, FDI flows to Moldova had averaged only US$18 per capita. By comparison, neighboring Romania had managed to attract inflows on the order of US$46 per capita while Lithuania and Slovakia had experienced FDI flows 7 to 12 times as large.

Moldova has consistently ranked in the bottom third of countries in Eastern Europe and Central Asia in terms of total cumulative direct investment inflows and FDI per capita.

3.18 The source of FDI into Moldova is quite diverse and, to a large extent, reflects its trade patterns (Table 3.7). Russia is the single largest foreign investor, holding almost a quarter of the total stock FDI. The EU as a group accounts for a third of FDI, with Great Britain, Spain, France and Germany, each contributing about 5-6 percent of total FDI. The USA is the second largest source for FDI, with a 10 percent share of total FDI. The large share of FDI coming from off shore zones suggests that Moldovan investors might be seeking profit expatriation, fiscal benefits or additional legal protection of their investments that they would not receive as domestic investors.

Table 3.7 Geographical Composition of FDI
percent

Russia		22.9
EU		32.9
incl.	Great Britain	6.4
	Spain	6.2
	France	5.3
	Germany	4.5
USA		10.0
Off shore zones*		6.9
Romania		3.6
Other		23.6

* Liechtenstein, Cyprus, Malta, Cayman Island
Source: National Bank of Moldova

FDI is largely concentrated in the energy and water sectors.

3.19 As shown in Table 3.8, the largest share of FDI, slightly less than 44 percent, is concentrated in the energy and water sectors, with Russia and Spain being the major players. In fact only two transactions, the Gazprom (Russia) investment in Moldova gas and Union Fenosa privatization of the three central and southern electricity distribution companies, account for the biggest part of Moldova's FDI. Agro-processing has attracted about a quarter of all FDI while commerce and transport and communications are the only other sectors that have received any noticeable amounts of FDI.

Table 3.8 Sectoral Breakdown of FDI

	percent	Leading investors
Energy and water	43.9	Russia, Spain
Agro-processing	23.0	USA, Germany, Spain
Commerce	12.0	Netherlands, USA
Transport & communications	10.6	France, Netherlands
Building industry	2.6	Greece
Hotels & restaurants	2.6	USA, Canada
Other	5.3	

Source: Department of Statistics and Sociology, Moldova

The risks associated with foreign investment in Moldova are currently very high. The legal and institutional environment for foreign investment does not appear to be conducive to large inflows of foreign capital.

3.20 FDI may be motivated by a number of reasons. It may be "resource-seeking" in the sense that FDI is triggered by the availability of natural resources. It may also be "market-seeking", with the aim of establishing a foothold to serve a local market because of its size or growth rate or to overcome trade barriers. Since Moldova has little in the way of natural resources and lacks market size, its attractiveness to FDI is determined primarily by the ability of foreign investors to take advantage of local assets, such as skilled or inexpensive labor, to achieve efficiency gains.

If Moldova is to enjoy the economic benefits of FDI, it must provide a stable legal framework and ensure that regulations are applied in a transparent and predictable manner.

3.21 The risks associated with foreign investment in Moldova are perceived to be very high. The legal and institutional environment for foreign investment does not appear to be conducive to large inflows of foreign capital. There is little stability in the range of legislation affecting investment in Moldova and the implementation of rules and regulations often causes substantial problems for enterprises. The cost of operating in Moldova is also influenced by the local barriers that raise the cost of imported inputs, the high cost of capital, the lack of adequate infrastructure and services, and the high cost of the regulatory burden imposed by the government. The experience from the countries of Central and Eastern Europe and the Baltics suggests that the extent and breadth of the reform effort is a key factor to attracting foreign capital. If Moldova is to enjoy the economic benefits of FDI, it must provide a stable legal framework and ensure that regulations are applied in a transparent and predictable manner.

Box 3.1 Moldovan Market Share

Overall, since Moldova is a small country, its market shares in the main export markets is insignificant, ranging from a meager 0.006 percent of total EU imports to about 0.7 percent of Russia imports. With the exception of Romania, where Moldova presence has declined significantly, Moldova position in these markets changed little since 1996. While overall market share is expectedly low, some specific Moldovan products hold a sizeable share of the Russian, Ukrainian and Romanian markets. Moldovan wine, for example, has a significant and growing market share of both the Russian and the Ukrainian markets despite the significant contraction of this market following the Russian crisis – inexpensive Moldovan wines have survived better on the Russian and Ukrainian markets then their more expensive competitors. Moldova succeeded in building a significant presence on the neighboring Romanian markets in products that where barely traded in 1996, such as, sunflower oil. Unfortunately it could not hold its leading position in the fast growing market for glass containers. In Ukraine glass container exports performed much better and captured a significant part of a much-reduced market. The same is true for refined sugar. As can be seen from Table 3.9, Moldova's presence in EU imports is extremely small both overall and in the three largest export items: apparel, nuts and fruit juices. Moldova has succeeded in increasing its share in the apparel and nuts markets, but has lost grounds in the fruit juice market.

Table 3.9. Moldova Market Share on Major Export Markets

(Moldovan share of total imports)

	1996	2003
Russia	***1.4***	***0.7***
-wine (1121)	62.5	40.3
-spirits and liquors (1124)	22.9	8.8
-tobacco (12)	3.7	1.2
Ukraine [1]	***0.4***	***0.3***
-wine (1121)	14.8	63.3
-glass containers (6651)	0.5	34.5
- refined sugar (0612)	0.0	31.0
EU	..	..
-apparel (84)	..	0.1
-nuts (0577)	0.3	0.8
-juice (0585)	0.8	0.2
Romania	***0.7***	***0.3***
-sunflower oil (4236)	12.1	98.0
-glass containers (6651)	32.6	21.4

1/ 2002 data instead of 2003

Number in brackets denotes SITC classification

.. Zero or insignificant

Source: UN Comtrade database

CHAPTER 4. DOMESTIC TRADE POLICIES AND REGIONAL AGREEMENTS: FORMAL STRUCTURES UNDERMINED BY WEAK IMPLEMENTATION

INTRODUCTION

Moldova has a very liberal statutory trade policy regime. However, in practice, the way that trade and other policies are implemented in Moldova creates substantial barriers to imports and exports

4.1 During the decade since independence, Moldova has moved from a very restrictive to a liberal statutory trade regime. The 1993 Moldovan import tariff schedule included rates of up to 300 percent. These rates were doubled for the non-Most Favored Nation (MFN) countries. Exports and imports were also severely restricted by non-tariff measures, such as pervasive licensing, quotas, and state trading. In addition, there were wide-ranging price controls in the domestic market and foreign-exchange restrictions.

4.2 Moldova drastically liberalized its trade regime in the mid and late 1990s and joined the World Trade Organization (WTO) in July 2001. Moldova's current trade regime is ranked by the IMF as a "one" (the most liberal) on a ten point index of the restrictiveness of formal trade policies.[16] However, the way trade policies and other policies, which impact on trade flows, are being implemented, is creating substantial barriers to imports and exports.

4.3 The challenge for Moldova is to address the range factors that unnecessarily raise the cost of undertaking trade in Moldova and to create an environment for trade that is conducive to growth, economic development and poverty reduction. This needs to take place in conjunction with efforts to ensure consistent application of WTO requirements, especially those regarding the protection of intellectual property, customs valuation, sanitary, phytosanitary measures and technical barriers to trade. Further, Moldova would benefit from the more effective implementation of regional trade agreements, which are currently undermined by uncertainty and extremely weak formal dispute settlement mechanisms.

THE MOLDOVAN TRADE REGIME

The average import tariff in Moldova is relatively low. However, the import tariff has become more complex in recent years.

4.4 When Moldova joined the WTO, the maximum bound rate agreed to was 35 per cent. This level of binding is relatively low compared to other countries at a similar level of development but is high relative to more advanced developing countries and to developed countries. Negotiations on market access at the WTO, such as those that are taking place under the current Doha Development Round, typically concern reductions in the bound tariff rates.

4.5 As is typically the case, the tariffs that Moldova currently applies are much lower than these bound rates. The 2003 tariff schedule has 14 tariff rates in the range of zero to 25 per cent, with the majority of rates in the lower brackets, leading to a simple unweighted average tariff of 6.5 per cent – 10 percent for agricultural goods and 4 percent for industrial goods.[17] The weighted average tariff is 4.6 percent. Table 4.1 shows that the average applied tariff in Moldova is low compared to other countries in the region and is similar to that applied by advanced countries such as the Czech Republic and the EU.

[16] Only 27 of 183 countries have been assigned this rank.

[17] This is based on ad valorem rates only. According to the IMF Article IV staff report, the average duty, including specific duties (which are applied to products such as tobacco and alcoholic drinks), is 6 per cent.

The current tariff schedule is more complex than the one applied in the late 1990s and the wider range of tariff rates has increased the administrative burden in applying trade policy and collecting tariff revenue.

4.6 While the average tariff, and the low level of dispersion around that tariff, compares favorably with other countries in the region, the current tariff schedule is more complex than that previously applied in the late 1990s, which had only 4 rates of 0, 5, 10 and 15 per cent. Tariffs have been recenlty increased on a number of products, such as finished textile products, agricultural commodities and processed foods, up to rates of 35 per cent. These changes, however, have not affected the overall averge tariff rate. The current approach to tariffs has a number of disadvantages. First, the wider range of tariff rates increases the administrative burden in applying trade policy and collecting tariff revenue and is not effective in preventing smuggling and corruption.

Table 4.1: Comparison of Average Applied Tariff Rates

Country	Simple average tariff, percent
Moldova (2003)	**6.5**
Azerbaijan (2002)	14.1
Albania (2001)	8.6
Bulgaria (2001)	12.1
Czech and Slovak Customs Union (2001)	5.9
Estonia (1998)	0.0
Hungary (2001)	8.8
Poland (2002)	12.0
Romania (1999)	24.2
Slovenia (2002)	11.2
European Union (2001)	4.7

Source: UNCTAD –TRAINS database

A given amount of tariff revenue will be more efficiently collected through a small number of tariff bands

4.7 In general, for a small economy such as Moldova, a given amount of tariff revenue will be more efficiently collected through a small number of tariff bands. Second, economic analysis tends to favor simple uniform tariff structures.[18] Third, frequent changes to the structure of tariffs introduces a degree of uncertainty that may constrain trade. Similarly, while maintaining bound rates significantly above applied rates provides for a degree of flexibility, it also sustains uncertainty about future applied rates. Developed countries tend to have lower bound rates with little, if any, gap between those rates and the rate actually applied.

4.8 Nevertheless, the fact that current rates are substantially below bound rates implies that a conclusion to the Doha development round will have only a limited impact on the tariffs applied by Moldova. This is because the formulas that have been proposed for reducing tariffs (as contained in the drafts from the Cancun meeting) are non-linear and act to reduce high tariffs proportionately more than low tariffs such as those applied in Moldova.

4.9 A further reason for maintaining fairly uniform tariffs is to avoid an escalating tariff structure. Typically countries impose higher tariffs on finished products than on imported inputs to provide higher levels of effective protection for producers of final goods. For example, the EU applies zero duty to imports of cotton but relatively high duties to cotton fabrics and cotton clothing. The degree of protection offered to textile and clothing firms would be lower if they had to pay a duty on their imported input. This raises substantially the prices paid by consumers for these final products.

Tariff differentiation has actually led to de-escalating tariffs with higher duties on raw materials and unprocessed products than on finished goods.

4.10 In Moldova it appears that tariff differentiation has actually led to de-escalating tariffs with higher duties on raw materials and unprocessed products than on finished goods. The average tariff rate on primary products is around 11 per cent whilst that on semi-finished products is 3.4 per cent and the average duty on finished products is 5 percent. This suggests that producers of final products in Moldova will find it more difficult to compete with foreign producers in the domestic market since they will be

[18] David Tarr in *Development, Trade, and WTO: A Handbook,* The World Bank, 2002 (Chapter 52) concludes that "there is little economic justification and there are many dangers in providing differentiated tariff protection to various sectors of industry and agriculture."

paying more than the world price for their inputs. Further, in the absence of an effective duty drawback system, exporters who use imported inputs will be disadvantaged when competing in overseas markets. The reduction of the higher duties on primary products would lead to a more coherent structure of protection in Moldova.

The proposed change to the tariff structure could have strong negative implications for urban poverty.

4.11 Further, if some of the primary products that are subject to relatively high duties enter directly into consumption baskets, as would be the case with food, then this outcome of the tariff structure could have strong negative implications for urban poverty. The average tariffs on agricultural products are 12.3 percent for products of animal origin, 10.6 percent for products of vegetable origin, 8.2 percent for fats and oils, and 10.8 percent for prepared foodstuffs, significantly higher than the 6.5 percent overall average import tariff.

The current tariff structure locks in the existing geography of the sourcing of raw imports from the CIS.

4.12 However, in practice, many of these imported products will be coming from free trade partners and therefore not subject to duties In 2002, 73 percent of imported primary goods came to Moldova from the CIS (mainly Russia). However, it may be that without the duties these inputs could be purchased from lower cost and perhaps higher quality sources in other countries. In this way the current tariff structure locks in the existing geography of the sourcing of raw imports from the CIS.

4.13 There are three basic customs regimes for importation and exportation in Moldova: import for free circulation; temporary importation for inward processing; importation into a customs free zone or free warehouse. In principle, customs duties and VAT are only levied on goods imported for free circulation. However, these regimes have been subject to changes in regulations that have contributed further to uncertainty concerning the trade regime in Moldova.

Clarification and simplification of the customs and fiscal codes with regard to inward processing would provide a more stable environment for a broader range of processing activities in Moldova and would reduce the role of government discretion in deciding which firms and sectors are exempt from duties.

4.14 The customs code of 2000 stipulates that, under the inward processing regime, customs duties and taxes should be collected and then refunded upon exportation of the exported goods. This effectively undermines the processing scheme and replaces it with a scheme analogous to a duty drawback system. The fiscal code also states that VAT on imports for inward processing should be collected and then refunded upon exportation, with the exception of light industry (clothing). A list of firms exempt from paying VAT on imports is determined by government decision. Following the letter of these codes, the Government Decision and Customs Department instructions led to the establishment in early 2003 of a duty drawback system for imports under inward processing. Perhaps in recognition of the problems that exist in obtaining a full and prompt return of VAT, there was intense lobbying by inward processing companies and the system was amended. At present, an inward processing firm has to conclude an agreement with the Customs Department to obtain a waiver from paying duties and taxes. This system does not prevent the functioning of the inward processing scheme for clothing but the formulations in the Customs and Fiscal Codes should be amended in order to create a more stable regulatory environment to encourage processing in a broader range of industries.

4.15 *Free economic zones.* There are six free economic zones in Moldova today: Tvarditsa, Taraclia, Vulcaneshti, Otaci, Ungheni, and two zones located in Chisinau. The first two zones established were Expo-Business-Chisinau (in 1995; later subdivided into two subzones) and Tvarditsa (in 1996). The impetus for zone formation was to create business friendly enclaves in a hostile business climate. Early experience with the zones in Chisinau and Tvarditsa was negative: due to poor regulations, zones became a convenient means to evade taxes and duties. As a rule, new zones were anchored at bankrupt enterprises. The Government learnt from the early mistakes and the current Law on Free Economic Zones, developed in cooperation with the IMF, provides a more solid basis for zone development.

4.16 Free economic zones enjoy special customs regime (customs territory): Goods for final consumption in the zone and goods originated from free economic zones and exported either abroad or to the customs territory of Moldova are exempt from customs duties. Sales from the zone to the domestic market, however, are limited at 30 percent of output. They feature zero value-added and excise taxes, a 50 percent reduction of the profit tax, and a 10-year grandfathering provision for the firms operating in the zones on the change of laws and regulations.

A better strategy of export development would be to overhaul the national business environment rather then create tiny enclaves with better conditions than in the rest of the country.

4.17 Despite the increase of the number of free economic zones over the last eight years from one to six, the small size of these zones has limited their economic impact. Moldovan free economic zones are currently generating only about three percent of total Moldovan exports. The Government does not plan to increase the number of zones any time soon, viewing them as a vehicle of regional development and a demonstration tool for a better business environment.

4.18 A World Bank review of free trade zones concludes that they can play a role in economic development if "they are appropriately set-up, well-managed, WTO compatible in incentives, and used as an integrated part of a national liberalization and reform program".[19] Nevertheless, analysis of the impact of such zones suggests that, in a small country such as Moldova, a better strategy of export development would be to overhaul the national business environment rather then create tiny enclaves with better conditions than in the rest of the country.

IMPORTS AND TAX REVENUES

Moldova has become increasingly dependent on the taxation of imports.

4.19 Table 4.2 presents data on the taxation of imports from 1999-2002. A few observations are in order. First, Moldova has become increasingly dependent on the taxation of imports reflecting the weak capacity for taxation of domestic activities. In 2002, taxation of imports provided almost half of total tax revenues and this share was 50 percent higher than in 1999. This in part reflects the increase in imports over this period but is also due to weak capacity for taxation of domestic activities.

4.20 Second, taxation of imports is the primary vehicle for collecting VAT and excise tax. Excises account for over a quarter of taxes on imports and VAT for 60 percent. Eighty-four percent of excise tax and 55 percent of VAT was collected from imports. From 1999 to 2002, the share of VAT in import taxation increased while the share of excise tax in import taxation declined. However, as the share of excise tax collected on domestic production in total tax revenues also declined, the share of excises collected on imports in total excise collection increased. As a result, the importance of import taxation in total tax revenues increased.

From the taxation viewpoint, the small collection of customs duties does not justify the administrative complexity of a highly detailed and variable import tariff schedule.

4.21 Third, customs duties play a rather minor role in import taxation. In 2002, customs duties accounted for ten percent of total taxes on imports, although it increased over this period by two percentage points. The average effective import tariff rate (calculated as the ratio of customs duties over the value of dutiable imports) has been very low during the whole period, fluctuating between 1.3 and 3.5 percent. From the taxation viewpoint, the small collection of customs duties does not justify the administrative complexity of a highly detailed and variable import tariff schedule, which creates incentives for commodity misclassification at customs, fuelling the scope for corruption.

[19] Madani, D. "A Review of the Role and Impact of Export Processing Zones", World Bank, 1999.

These given revenues from import duties would be collected more efficiently with a more simple and uniform tariff.

Table 4.2: Moldova: taxation of imports, 1999 – 2002 (Million MDL)

	1999	2000	2001	2002
Total tax revenues (Mil.	2,423	3,086	3,437	4,284
As percent of total tax				
	18.3	21.3	19.8	15.4
VAT[1)]	40.2	44.8	44.8	48.5
Total taxes on	34.8	39.8	40.8	44.4
Composition of import taxes (as percent of total import				
Custom	8.1	7.2	8.8	10.4
Excise tax on	34.2	33.3	34.3	29.1
VAT on [1)]	57.7	59.5	56.9	60.5
Share of import taxes in total collection of the given tax				
Excise	65.0	62.1	70.7	84.0
VAT[1)]	49.9	52.8	51.8	55.3
Average effective import tariff rate, as dutiable [2)]	3.1	1.3	2.7	3.5

[1)] Net of VAT refunds.
[2)] Dutiable imports equals total imports minus imports from the CIS and Romania minus imports for inward processing (about 48 percent of total imports).
Source: World Bank staff estimates based on data provided by the Ministry of Finance of Moldova

Requirements for exports to repatriate export earnings within a given time period can be very burdensome.

EXPORT REGIME

4.22 Although there are no constraints on foreign exchange, there do exist requirements for exporters to repatriate export earnings within a given time period, which can be very burdensome. In the exporter survey carried out in the course of this diagnostic trade study, 30 percent of respondents said that they missed the deadline for the repatriation of export earnings at least once during 2002 as a result of difficulties getting payments from their customers. Late repatriation leads to the levying of fines for each day in excess of the deadline. In addition, as the chapter on the financial chapter indicates, there are costs of compliance with this requirement in terms of paperwork (imposed on domestic banks, not to mention the exporters themselves).

There are conflicting statements concerning refund to exporters of VAT paid on inputs.

4.23 VAT paid on both domestic and imported inputs is subject to reimbursement upon exportation of finished goods. However, it is difficult to verify how well this system works. The Ministry of Finance claims that there are no problems associated with VAT refunds. According to the Ministry, the ratio of non-refunded export VAT as a result of legal proceedings to actual refunds stood at 3 percent in 2000, spiked to 20 percent in 2001, and fell to 7 percent in 2002. However, Moldovan Export Promotion Organization (MEPO) asserts that no more than 45 percent of export VAT refund requests are being satisfied on a regular basis and the average time lag of reimbursement (typically, in the form of offsets against other tax liabilities) is about six months.

The Ministry of Finance suggests that slow refund is not a major problem, while a substantial number of exporters complain of late refunds. Uncertainty over refund of VAT is likely to constrain export activities.

4.24 The exporter survey showed that only 56 percent of exporters actually applied for a refund to which they were eligible. The responses suggest that the time between application and refund averages 94 days, which slightly exceeds the Ministry of Finance commitment to refund within 3 months. However, there is considerable variation with some exporters reporting a delay of up to a year. Hence, some firms are clearly being disadvantaged by delays in VAT refunds and again uncertainty will act to constrain economic activity. Two-thirds of firms received refunds in offsets rather than cash. Exporters incur sufficient costs of refund delays. According to the survey, the average reported cost of delays is equivalent to 9.5 percent of export earnings, which creates a considerable hurdle for exports. Therefore, the existing VAT refund mechanism creates considerable hurdles for exporters at least in terms of the high cost of delays.

REGIONAL FREE TRADE AGREEMENTS (FTAS)

4.25 Moldova is a participant in a number of free trade areas: the plurilateral CIS free trade area, consisting of the former Soviet republics (with Russia and Ukraine as the most important partners of Moldova), the bilateral Romania-Moldova free trade area., and, most recently, bilateral free trade arrangements with six Stability Pact countries of South Eastern Europe. The CIS free trade area is playing an extremely important role in Moldova's external trade absorbing over half of the country's exports.

The CIS free trade area

Free trade agreements with the CIS countries are weakened by arbitrary product exclusions and ad hoc use of safeguard measures.

4.26 The CIS free trade area was established in 1992 and the two umbrella plurilateral free trade agreements were signed in 1992 and 1994. These agreements have not been ratified by the Russian parliament and are not in effect and have been substituted with a number of bilateral free trade agreements among the CIS members. Moldova has concluded agreements with all CIS participants, except Tajikistan. The agreements provide for duty-free trade in goods with potential exemptions (not specified in the texts of the agreements) and free transit of goods through the signatories' territories. The agreements explicitly prohibit re-exports. There are provisions for contingency protection (safeguards and anti-dumping). Moldova is not currently subject to any anti-dumping measures from its CIS partners. However, Russia often introduces safeguard measures directed towards non-members of Eurasian Economic Community (EURASEC). Moldova, although not a member of this Community, is generally unaffected.

4.27 Exemptions from the free trade regime are introduced in the Protocols to the above FTAs, which are elaborated annually by respective bilateral trade commissions. These exemptions are non-symmetrical. To date, the following exemptions from free trade apply:

- in Moldova-Russia trade, Russia exempts sugar (a tariff quota is in effect), liqueurs and spirits, and tobacco and manufactured tobacco products including cigarettes/cigars, while Moldova does not have any exemptions;
- in Moldova-Ukrainian trade, Ukraine exempts sugar, sugar syrups, and molasses while Moldova exempts spirits; and,
- in Moldova-Belarus trade, Belarus exempts sugar while Moldova has no exemptions.
- There are no exemptions in trade between Moldova and the other 8 FTA participants

4.28 The FTAs with CIS countries have a number of shortcomings: (i) the web of bilateral and multilateral agreements undermines transparency and hampers the efficiency of the free trade area (ii) exclusions, including quantitative restrictions, from the free trade regime can be imposed unilaterally (iii) the agreements lack permanency; and, (iv) safeguards and antidumping measures are applied on an ad hoc manner with little regard to WTO agreements on this matter. Each bilateral agreement is subject to annual changes (in the case of the exclusion of goods from free trade), or even more frequent changes (in the case of safeguards). At present, the exclusions cover only a small percentage of intra-CIS trade but the agreements do not guarantee that this situation will persist. Hence, there is a considerable amount of uncertainty regarding these agreements.

Despite provisions for freedom of transit, there remain considerable restrictions on the transit of Moldovan goods through Ukraine.

4.29 Despite a free transit provision included in the FTAs, Moldova experiences serious problems with the transit of its trade through the territory of Ukraine. This transit route is of paramount importance for Moldova due to the importance of Russia as an export market. At different times, restrictions have included regional transit fees (for each oblast of Ukraine), long processing times at the border damaging perishable goods (a special regime for perishable goods was introduced later), and mandatory payments in local Ukrainian currency (and at an unrealistic exchange rate). As a result of numerous bilateral talks, some restrictions were repealed or relaxed, though new restrictions then arose. The transit environment remains chaotic and a regime of free transit has never been achieved.

By not effectively raising this issue in the accession negotiations of Ukraine, Moldova is not fully exploiting the benefits of its membership of the WTO.

4.30 Moldova sits on the Working Party for the accession of Ukraine to the WTO and could potentially exert more pressure on Ukraine by making requests on free transit issues, in accordance with General Agreement on Tariffs and Trade (GATT) Article V, which calls for freedom of transit and national treatment. However, transit issues through Ukraine do not appear to be on the agenda of Ukrainian accession to the WTO. On this issue, Moldova could exploit the benefits of its membership of the WTO further.

4.31 The rules of origin are common across all of the CIS FTAs and do not appear to be overly restrictive. The basic rules of origin require change of tariff heading at the 4-digit level of the CIS trade nomenclature (which is equivalent to the Harmonized System at this level of aggregation). However, the Annex to the Rules of Origin presents a list of goods that are subject to different rules, either rules which stipulate specific technological operations to be performed or an amount of value that must be added in the free trade area. The 50 percent value added rule is rather demanding. However, sensitive commodities, such as textiles and clothing, are subject to the simple change of tariff-heading rule. The Chamber of Commerce issues this certificate in Moldova.

4.32 The Rules of Origin allow for full cumulation of origin: all processing activities conducted in any of the CIS countries can be included in the calculation of sufficient domestic processing. This is an important incentive for trade integration among the CIS countries and avoids the adverse effects of a hub-and-spoke system where trade is centered on the dominant member(s) of the free trade arrangement (i.e., Russia) with little interaction between the spoke countries. Tax residents in the free trade area must conduct exports subject to the free trade treatment.

4.33 There is also a mutual recognition agreement between CIS countries that should facilitate intra-CIS trade. Since the standards of CIS countries are harmonized, members should honor each other's certificates of conformity and quality. This is an important trade advantage for the CIS members since their national standards, which are based on the GOST (standardization institute from the Soviet Union) system, are not recognized in the rest of the world. The harmonized standards are formulated by the Interstate Council on Standardization, Metrology, and Certification (Eurasian Standards Committee), established under the Agreement. The Council has been gradually introducing new standards, in line with International Organization for Standardization (ISO) standards, but more than half of the positions in the standards nomenclature are still based on GOST.

The mutual recognition agreement between CIS countries is undermined by the two-tiered system of standards.

4.34 The mutual recognition agreement, however, is undermined by the two-tiered system of standards. There is the CIS interstate set of harmonized standards as well as some differing standards at the national level. Further, the interstate system does not differentiate mandatory and voluntary standards (all of its standards are mandatory and the list of products subject to mandatory standards is excessive relative to western countries). Differences in standards are most pronounced for agricultural products, which particularly disadvantages Moldova. Agricultural exports from Moldova to Russia are being denied access to the Russian market without additional testing in Russia. The Council can potentially act as a vehicle for integration of the CIS into the world trading system if the evolving CIS standards system is built on the basis of international standards systems and in accordance with WTO guidelines. However, at present it is not fulfilling this role.

Another important deficiency of the CIS trade arrangements is the lack of plurilateral dispute resolution mechanism.

4.35 An important deficiency of the CIS trade arrangements is the lack of plurilateral dispute resolution mechanism. Although some barriers faced by Moldova in the CIS and, most importantly, transit issues in Ukraine, are in violation of the spirit and the letter of the CIS agreements, there is little Moldova can do in the framework of the CIS as all disputes have to be resolved politically at the bilateral level. CIS trade arrangements should be reformed in such a way to guarantee application of the rules of the agreement or at least conditions guaranteed by the WTO. This should include information sharing before trade measures are taken and a functioning plurilateral dispute resolution and remedy mechanism to protect small countries such as Moldova. In cooperation with other CIS members, Moldova should aggressively pursue measures aimed at strengthening the free trade area.

?? Exemptions from the free trade regimes should be eliminated.

?? A formal mechanism of contingency protection compatible with WTO agreements should be elaborated.

?? Harmonized standards should be comprised of a limited number of mandatory technical regulations based on international standards.

?? An effective plurilateral dispute resolution mechanism within the CIS should be established.

?? An aggressive program to eliminate the non-tariff and informal barriers to trade should be carried out.

ROMANIA-MOLDOVA FREE TRADE AGREEMENT

4.36 The Free Trade Agreement between Romania and the Republic of Moldova became effective on January 1, 1995, and covered all agricultural and industrial products. Overall trade turnover increased from the last pre-agreement year (1994) to 2002 by between 5 and 13 percent, according to different estimates. This observation masks, however, the very different export performance of the two countries: Moldovan exports to Romania halved while Romanian exports to Moldova doubled. The Romania-Moldova Free Trade Agreement has failed to expand aggregate mutual trade and to arrest the precipitous decline of Moldovan exports to Romania.

4.37 The key issues currently constraining the impact of the FTA appear to be:

?? Although there is a mutual recognition clause in the Agreement, in practice, the reconfirmation of Moldovan conformity assessments is frequent: for 80 percent of exports in the first half of 2002 (according to the Ministry of Economy). Making mutual recognition of conformity assessment will require dealing with a

If Moldova were to actively seek to bring its own trade regulations more into line with those of the EU and to effectively upgrade testing and conformity assessment procedures this would facilitate trade with Romania and be consistent with a strategy of European integration.

number of systemic issues relating to confidence and trust in the partners conformity assessment procedures and dealing with corruption relating to certificates of conformity.

?? Romania is in the process of acceding to the EU and is harmonizing its technical regulations and conformity assessment procedures with those of the EU. If Moldova were to actively seek to bring its own trade regulations more into line with those of the EU and to effectively upgrade testing and conformity assessment procedures this would facilitate trade with Romania and be consistent with a strategy of European integration.

?? The rules of origin (modeled on EU rules) can be restrictive, especially for sensitive products, such as textiles, clothing, and agriculture. There is no scope for cumulation of inputs from other countries. Trade with Romania and with the EU would be stimulated if Moldova were to be included in the Pan-Euro area of cumulation.

THE INSTITUTIONAL FRAMEWORK FOR TRADE POLICY FORMULATION

4.38 The primary agencies involved in trade policy making and implementation are the Ministry of Economy (coordinating agency), the Central Bank (exchange rates and currency repatriation), the Ministry of Finance (principles of trade taxation), the Customs Department, and line ministries. The Ministry of Economy includes two trade departments: the department of foreign and domestic trade and the department of foreign economic relations. The Ministry is charged with the task of the analysis and forecasting of trade and the formulation of trade policy. It also is responsible for the coordination of sectoral trade policies formulated by other agencies. However, the Ministry faces considerable problems in carrying out its responsibilities. As with many other ministries, it suffers from inability to attract and retain highly qualified staff, as it is unable to compete in remuneration and benefits with the private sector. It also lacks resources (financial, informational, technological, and human) for analytical work. As a result, its analytical capacity is weak. Training and technical assistance offered by international donors have been unsystematic and have not brought enduring increases in capacity.

4.39 The trade negotiation capacity of the Government is also rather limited. Since the overall negotiating power of small countries such as Moldova is not very strong, it is essential to form alliances in multi/plurilateral negotiations and to use opportunities offered by the multilateral trading system to the fullest. These strategies are difficult to implement and they require considerable trade capacity, which Moldova does not have at the present time. As a small developing economy, Moldova should use the WTO as a forum to defend its trade interest. However, Moldova's use of the advantages offered by the WTO is minimal, as illustrated by the above-mentioned example of transit disputes with Ukraine. Operational options of the use of advantages provided by the WTO membership for commercial diplomacy is one of the areas where future trade-related technical assistance will be very beneficial.

4.40 The efforts of international donors have brought some positive developments in trade capacity building. Examples include US Agency for International Development's (USAID's) trade component of the Private Enterprise Project and Technical Assistance for Commonwealth of Independent States (TACIS's) program of assistance to the implementation of Moldova-EU Partnership and Cooperation Agreement (PCA). Some useful organizations and NGOs have emerged as a result of international trade capacity building, such as MEPO, which works under the auspices of the Ministry of Economy and also receives funding from international donors and local businesses. However, the core government agencies, by and large, remain weak in trade policy capacity.

GOVERNMENT EXPORT PROMOTION STRATEGY

The proposed export promotion strategy has a number of important deficiencies.

4.41 In January 2002, the government of Moldova approved an Export Promotion Strategy for 2002-2005. This strategy features an analysis of major export markets and includes a list of measures to promote Moldovan exports. However, the program has a number of important deficiencies. First, certain proposed measures would violate WTO rules, for example, suggested tax subsidies and subsidized credit for exporters. These measures have not been implemented due to budget constraints, others, such as a free trade agreement with the EU, have not materialized due to institutional constraints and the slow pace of reform in Moldova. The strategy also envisioned alleviating the problems with VAT drawbacks for exporters by changing the collection point of VAT for imported inputs. However, the VAT collection system has remained unchanged and an additional hurdle has arisen following the newly introduced regulations on inward processing (discussed above).

4.42 Experience elsewhere suggests that a good export promotion strategy should strike a balance between offshore objectives (information gathering, market research, trade representation, and trade fairs) and onshore objectives (issues of competitiveness: quality standards, pricing, supportive services, domestic input supply, development of new business models and practices).[20] The current strategy, while addressing some of the former issues, is very weak on the later. It is unlikely that progress in information provision will have a substantial impact in the absence of significant efforts to improve the domestic business environment.

CONCLUSIONS

4.43 Although Moldova has a liberal statutory trade regime on paper, the current tariff schedule is overly complicated. Given the relatively small amount of customs duties collected on imports, tariff revenues would be collected more efficiently from a simple uniform tariff schedule.

4.44 The regulatory environment for the treatment of inputs under the inward processing regime is complicated and controversial. It should be clarified and simplified with all inputs under the inward processing regime being exempted from VAT and customs duties.

4.45 The repayment of VAT for exporters can occur with considerable delay and is paid mainly in the form of tax offsets rather than cash, causing extra costs for exporters.

4.46 The current free trade agreements with the CIS countries and Romania suffer from significant weaknesses that limit their value to Moldova. With regard to the CIS agreements, product exemptions should be eliminated, safeguard and anti-dumping provisions should be brought into line with WTO rules to provide for greater certainty and, to preclude ad hoc measures, and there is a need for standards reform at the plurilateral level and for an effective dispute resolution mechanism.

[20] See Wulf, Luc De. “Why have trade promotion organizations failed, and how can they be revitalized?” PREM Notes 56, World Bank, August 2001.

4.47 The Romania-Moldova FTA would be improved if there were regional cumulation of origin and effective mutual recognition of conformity assessment. The latter would be facilitated if Moldova were to make significant efforts to upgrade its standards infrastructure as part of a policy towards increasing integration with the EU.

4.48 There is a clear need to strengthen the analytical capacity of the government agencies in the area of trade policy formulation and negotiations. Efforts towards trade capacity building should be directed towards the core government agencies. The current Government Export Promotion Strategy should be reworked, dropping all WTO-inconsistent measures, achieving a balance between offshore and onshore objectives, and elaborating an effective mechanism of implementation.

CHAPTER 5. MARKET ACCESS TO THE EUROPEAN UNION: EU COULD DO MORE BUT DOMESTIC BARRIERS DOMINATE

INTRODUCTION

Moldovan exports considerably less to the EU than one would expect on the basis of "normal" trade relations. Is this due to EU trade barriers or constraints in Moldova?

5.1 Given its economic size and proximity, the European Union (EU) provides a major source of demand for Moldovan exports. While the share of the EU has increased substantially in recent years, economic analysis suggests that the principal trading partner of Moldova should be the EU. Instead, Moldovan trade is dominated by exchange with other CIS countries – principally Russia – and the share of the EU in Moldovan exports remains very low relative to what would be expected under "normal trade relations". This chapter explores why the reorientation of exports towards the EU has been so limited. In particular, it examines whether there are significant barriers in the EU that are constraining the market access of Moldovan exporters.[21]

Policies applied in the home market can also influence the ability of exporters to penetrate overseas markets.

5.2 It is important to stress that effective market access is determined by much more than tariffs in the overseas market. Technical regulations in overseas markets can have an important impact on the ability of firms to access that market. Subsidies granted to firms or farmers in overseas markets may also undermine the ability of firms from other countries to compete. As will be made clear in later chapters, a number of policies applied in the home market can influence the ability of exporters to penetrate overseas markets. Having to contend with, for example, the costly and time consuming clearance of customs on export, the high cost of finance, a domestic system of standards and technical regulations which is at odds with international practices and a range of other domestic "behind the border" barriers raise costs relative to those of other firms competing in overseas markets.

TARIFF BARRIERS IN THE EU – AN OVERVIEW OF GENERALIZED SYSTEM OF PREFERENCES (GSP) PREFERENCES

Moldova receives preferential access to the EU market under the GSP. However, the exclusion of wine from preferences is a major limitation.

5.3 Moldova is a beneficiary under the EU's GSP scheme. The GSP allows for lower duties than the MFN (Most Favored Nation) rates subject to the products meeting the requirements stipulated by the EU, such as the rules of origin (see Box 4.1).[22] Under the current GSP scheme there are two categories of products covered by the scheme: non-sensitive and sensitive.[23] For *non-sensitive* products the duties are suspended while for *sensitive* products there is a flat rate reduction of 3.5 percentage points from the MFN rate.[24] Thus, the GSP scheme entails high proportionate reductions for most industrial

[21] It is worth noting that the geographical reorientation of the trade of the Central and East European Countries (CEECs) towards the west and, in particular the EU, took place relatively quickly after transition commenced. By 1993 and 1994 it was not possible to distinguish the trade patterns of most of the CEECs from those of a market economy. In this sense, the transition with regard to trade was already completed before the Agreements between the CEECs and the EU came fully into effect, and during a time when those countries faced similar, or worse, market access conditions to those currently facing Moldova.

[22] Rules of origin define the degree or nature of processing that must be undertaken in the beneficiary country for the product to qualify for preferential access to the EU market.

[23] The current GSP scheme was revised in January 2002 and will run until the end of December 2004. The EU Commission, however, has recently proposed to extend the duration of the scheme until the end of 2005 since there is some uncertainty regarding the completion date of the Doha Development round of multilateral trade negotiations.

[24] If the percentage reduction under the previous GSP scheme leads to a lower rate than is maintained under the new GSP scheme. For goods where the duty is related to physical rather than monetary values (i.e. specific duties), the duty is reduced by 30 percent. When a duty is comprised of both an ad valorem and specific component, as is the case for a range of processed agricultural products of interest to Moldova (i.e., sugar confectionary), the specific duties are not reduced. When minimum duties are specified in the EU's Common Customs Code, for example, the EU duty on beans is 13.6 percent subject to a minimum duty of 1.6 euro per 100kg being paid, these minimum duties no longer apply for products

Moldova is one of the most preferred suppliers of the EU market following the additional preferences granted under the EU's labor clause.

products -- where the average EU MFN tariff is around 4 percent -- but relatively low proportionate reductions for many agricultural products --where the average MFN duty is much higher, around 20 percent. The GSP scheme also includes an additional 5 percentage point reduction in duties for countries implementing the International Labor Organization (ILO) codes on basic labor rights. So far Moldova is the only GSP beneficiary which has successfully applied for these additional preferences and, as such, it is one of the most preferred partners under the EU's GSP scheme.

Moldova market access to the EU relative to other countries depends on the products and sectors excluded from their agreements with EU

5.4 The market access position of Moldova relative to other countries will depend upon a number of factors. Least Developed Countries (LDCs) are eligible for duty free access for all products under the "Everything But Arms Agreement. African, Caribbean and Pacific countries (ACP) have access to the EU under the Cotonou Agreement under which almost all industrial products enjoy duty free access.[25] In practice, there is a range of country/sector exclusions from GSP preferences. Since many countries do not fully utilize their GSP preferences, a proportion of exports from GSP beneficiaries will, in fact, pay the MFN tariff. Moldova is also competing in the EU market with countries which have signed a free trade agreement or customs union with the EU -- Central and Eastern European countries, certain countries in the Mediterranean, Mexico, South Africa, Turkey, and European Free Trade Association (EFTA) countries -- as well as countries which effectively receive duty free access to the EU under association agreements -- such as countries in the Balkans. The market access position of Moldova relative to these countries will depend upon the products and sectors which are excluded from the agreement, typically certain agricultural products.

THE IMPACT OF GSP PREFERENCES ON MOLDOVA - TRADE COVERAGE AND UTILIZATION

Almost three-quarters of Moldova's current exports to the EU are eligible for preferences, but only 60 per cent of eligible exports actually request preferences.

5.5 There are two key elements to assessing the impact of GSP preferences on a country's total exports: the proportion of exports which is eligible for preferences and the extent to which exports eligible for preferences are actually granted preferential access. As shown in Table 5.1, almost 73 percent of total exports from Moldova to the EU are eligible for GSP preferences. Most of the remaining exports are subject to zero MFN duties and hence, by definition, there can be no tariff preference. Only a small amount of Moldovan exports, less than 1 percent, are excluded from preferences. Importantly, as discussed below, this includes wine, one of Moldova's major industries and key exports.

covered under the GSP. If the tariff reduction provisions provided for under the GSP scheme result in a preferential duty of 1 percent or less then the duty is suspended. Finally, a major exception to the scheme is made for textiles and clothing products where a reduction of 20 percent of the MFN rate is applied.

[25] The difference in market access for these industrial products is likely to be slight since for most products Moldovan exporters will only be subject to duties in the EU for products where the MFN duties exceeds 9.5 percent or where the product is excluded from the GSP.

Rules of origin are an important factor influencing the impact of trade preferences.

Being a member of the Pan-European area of cumulation would allow Moldova to overcome some of the restrictiveness of the EU rules.

Box 5.1 Rules of Origin

There are two elements to the constraining impact of rules of origin: the nature of the rules themselves and the cost of providing the necessary documentation to prove origin. If the cost involved in satisfying these requirements exceed the margin of preference, then the GSP is redundant. Available studies suggest that the cost of providing the appropriate documentation to prove origin can be around 3 percent of the value of the export shipment. The rules themselves can be very difficult to meet while remaining competitive on the EU market. For example, the EU rules of origin for clothing stipulate manufacture from yarn. This entails that clothing producers in Moldova cannot import fabric, except from the EU under the bilateral cumulation that exists under the GSP, and still receive preferential access to the EU. Moldovan producers cannot source fabrics from low cost locations such as China and India and receive preferences under the GSP.

For those firms involved in the processing of EU fabrics, conformity with the rules of origin is straightforward since all the materials used come from the EU. However, for other clothing companies, satisfying the rules of origin can be very difficult in the absence of suitably priced domestic or EU fabrics. This is another factor which may be constraining the ability of Moldovan firms to move into higher value-added production systems in the clothing sector, as highlighted in the case study on this sector (see Part II), in which firms produce clothing from their own designs and source fabrics themselves.

A provision which can reduce the restrictive effect of rules of origin is cumulation. This allows imported inputs from specific partners to be counted as if they originate in the country concerned. One possibility which is potentially available for Moldova is to join the so-called Pan-European Area of Cumulation regarding exports to the EU. This would allow Moldova to use inputs from Central and East European Countries (CEECs), Turkey and certain Mediterranean countries and count these as qualifying material, subject to those materials satisfying the relevant EU rules of origin.

Table 5.1: Moldova's Exports to the EU Under the GSP in 2002

Total Exports to EU (€ 000)	*227,828*
Total Exports to EU of Products with zero MFN duty (€ 000)	60,560
Exports Eligible for GSP (€ 000)	165,346
Exports excluded from GSP preferences (€ 000)	1,922
Share of exports where MFN duty is zero (per cent).	26.6
Share of GSP Exports in Total Exports to the EU (per cent)	72.6
Share of exports excluded from preferences (per cent)	0.8
Exports Requesting GSP (€ 000)	99,481
Share of Exports Requesting GSP in Exports Eligible for GSP (Per cent)	60.2

Source: World Bank Staff calculations based Eurostat data

5.6 As indicated in the final row of Table 5.1, in 2002 only 60 percent of Moldova's exports which are eligible for GSP preferences actually request entrance to the EU on a preferential basis. This implies that the remaining 40 percent of eligible exports paid the full MFN tariff. Thus, the potential impact of the GSP for Moldova is weakened by the under-utilization of the available preferences. The reasons for this low take-up of preferences are likely to include the difficulties in satisfying the rules of origin of the EU scheme, lack of knowledge of the scheme and, for certain products, the small margin of preference relative to the costs of satisfying and proving origin (see Box 4.1).

5.7 By comparison, in 1998 around 47 percent of eligible exports requested preferential access to the EU. The increase in utilization rates probably reflects the growing importance of processing EU fabrics into made-up clothing -- which is more straightforward in proving conformity with the rules of origin -- and increasing knowledge of the GSP scheme. The current utilization rate of Moldova slightly exceeds that of other CIS countries (in Ukraine 50 percent of preferences are utilized, while in Russia and Georgia around 54 percent of exports request preferences) and is similar to the overall utilization rate of the EU's GSP scheme.

The value of EU preferences granted to Moldova is equivalent to 1.6 percent of exports. With fuller utilization, this transfer would have amounted to 2.7 percent of exports.

GSP Preferences are unlikely to be a key factor determining decisions to locate processing activities in Moldova.

5.8 The preferences requested amount to an implicit transfer (the tariff revenue that would have been paid to the EU if these preferences had not been given) of €3.6 million to Moldova -- equivalent to about 1.6 percent of the total value of Moldovan exports to the EU, or about 0.2 percent of GDP. If preferences had been fully exploited then the estimated transfer would have amounted to 2.7 percent of exports to the EU and around 0.3 percent of GDP.[26]

Box 5.2 GSP Preferences and EU Outward Processing of Textile and Apparel

Clothing and Footwear account for over 50 percent of Moldovan exports to the EU and over 40 percent of products requesting preferences. As discussed in the Textile and Apparel case study (see Part II), this trade is dominated by the processing of temporarily exported fabrics and accessories in Moldova. Given the relatively low share of value added in Moldova it is unlikely that the preferences are a key factor determining the choice of Moldova as a location for these processing activities. The GSP, with the additional reductions for Moldova relating to labor rights, provides for a 40 percent reduction on duties on clothing products. Most clothing products are subject to a 12 percent tariff on importation into the EU. With the value added in Moldova estimated at 20 percent of the recorded exports from Moldova, the preferences reduce the price of a product processed in Moldova by less than 1 percent relative to the situation of the full tariff being applied to the value added in Moldova. It is likely that differences in labor cost and transport cost and the importance of proximity to the EU market will be more important in determining the location of these processing activities.

Nevertheless, as Moldova seeks to undertake more value added activities in these sectors. and therefore for Moldovan firms to source the materials themselves. then the EU preferences, and the rules of origin governing those preferences will become more important. The current tariff preferences for Moldova would reduce the price of a fully sourced product by as much as 4.3 percent. On the other hand, a successful outcome to the Doha round will substantially reduce EU tariffs on clothing products. For example, under the current chairman's proposal, the tariffs on clothing products imported into the EU will fall from 12 to between 3.2 and 5.1 percent. Expanding capacity on the basis of EU preferences is unlikely to be a successful long-term strategy.

TARIFF BARRIERS IN THE EU – MEASURES OF AVERAGE PROTECTION

The average duty levied on Moldovan exports to the EU is around 70 percent of the duty that would be levied if Moldova did not receive preferences.

5.9 The impact of the GSP can also be evaluated by identifying the impact of the preferences on the average tariff levied on Moldovan exports to the EU. As shown in Table 5.2, if Moldovan exporters did not receive any preferences, that is, they were to pay the MFN tariff on all products, the average trade weighted tariff that would apply to Moldovan exports would be 8 percent.[27] This average is high relative to the overall trade weighted average tariff on total

Table 5.2. Average Tariffs on Moldova Exports to the EU (percent)

Average MFN Tariff	7.9
Average GSP preference (assuming full utilization)	5.9
Average GSP preferences with additional labor preferences (assuming full utilization)	4.1
Average GSP preferences with additional labor preferences (with actual utilization).	5.6

Source: EU TARIC database

[26] These simple estimates are likely to overstate the actual transfer that occurred. This is because clothing and footwear products are a major element of Moldovan exports to the EU and such trade is dominated by the processing of temporarily exported EU fabrics in Moldova. For such processed exports to the EU, it is only the value-added that is subject to EU import duties and therefore to preferences. The calculations above are based on the total value of clothing and footwear imports from Moldova recorded by the EU rather than just the value-added. In 2001, clothing and footwear products accounted for over 50 percent of Moldovan exports to the EU and 40 percent of products requesting preferences. Some 67 percent of these clothing exports and 98 percent of footwear exports were recorded by the EU as having processed EU materials. Assuming crudely that the value added in Moldova is about 20 percent, then the estimated transfer from EU preferences falls to only 0.7 percent of exports to the EU and 0.08 percent of GDP.

[27] Averages are based on 2002 duties weighted by the 2001 trade structure. Non ad valorem duties have been converted to ad valorem equivalents.

EU imports -- less than 5 percent – reflecting the concentration of Moldovan exports to the EU of relatively high duty products.

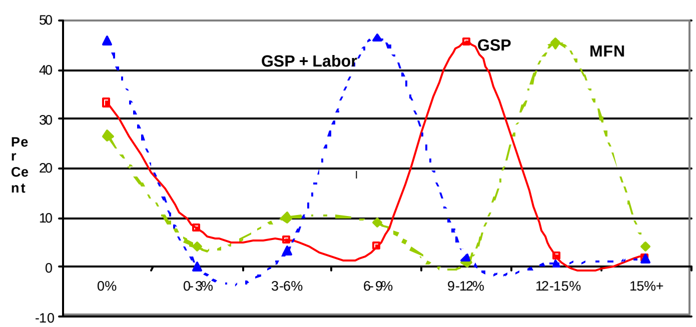
5.10 Under the standard GSP, assuming all such preferences were fully utilized, the trade-weighted tariff on Moldova's exports to the EU would be 5.9 percent. This is the average tariff that would apply if Moldova were treated in the same manner as other CIS countries and other GSP countries not covered by special schemes. Relative to the MFN tariff, therefore, the average margin of preference enjoyed by Moldova is 2 percentage points. With the additional preferences available to Moldova under the GSP labor clause, the average tariff on total Moldovan exports to the EU falls to 4.1 percent, almost 50 percent of the MFN tariff and about 70 percent of the tariff under the standard GSP.

5.11 Under Moldova's current take-up of GSP preferences, the trade weighted average tariff was 5.6 percent. This average takes into account the fact that, for certain products, only a proportion of the available preferences are actually requested and most closely reflects the actual duties that were levied on Moldovan exports. In 2002, therefore, the average tariff applied to Moldovan exports to the EU was 1.1 percentage points higher than if preferences had been fully utilized. Nevertheless, these tariff numbers show that the average duty levied on Moldovan exports to the EU was around 30 percent lower than if Moldova was not eligible for EU preferences. [28]

Under-utilization of preferences led to the average EU tariff applied to Moldovan products being 1.1 percentage points higher than would have occurred if all preferences were taken up.

5.12 The implications of these different regimes for the tariffs levied on Moldovan exports to the EU are highlighted in Figure 5.1. As can be seen, the distribution of exports under different bands of MFN tariffs is highly skewed with large proportions of exports entering either under zero duties or very high duties in the range of 12 to 15 percent. The GSP preferences act to increase the amount of exports able to enter duty free and to shift a large proportion of exports to a lower tariff band. Thus, the 45 percent of exports in the 12 to 15 percent band under MFN tariffs shifts to the 9 to 12 percent band under the GSP and the proportion of exports able to enter duty free rises from just over one quarter to around one third. The GSP with labor provisions further accentuates the peaks in the distribution with just over 40 percent of exports able to enter duty free and a similar proportion now subject to tariffs in the 6 to 9 percent band rather than the higher bands.

Figure 5.1: Distribution of Moldova's Exports to the EU According to Tariff Bands, with and Without Preferences



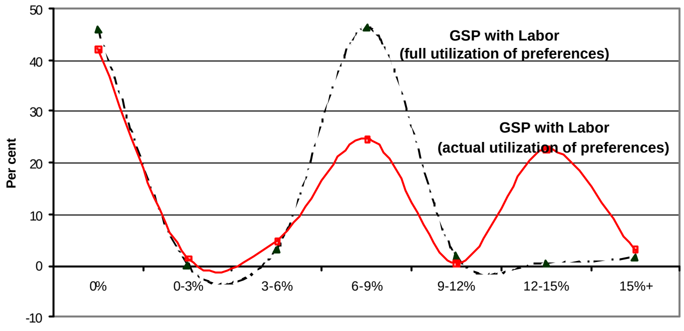
Source: EU TARIC

5.13 Figure 5.2 shows the impact of the lack of full utilization of preferences on the distribution of trade according to the selected tariff bands. Interestingly, it shows that under-utilization of preferences has little impact on the proportion of exports to the EU which receive duty free treatment. If preferences were fully utilized, then 46 percent of exports would enter the EU duty free, whereas with the actual utilization of preferences, just over 42 percent of exports enter the EU duty free. The under-utilization of

[28] Again, these calculated average tariffs will overstate the duties actually paid by giving undue weight to the relatively high duty clothing sector since much of the value imported into the EU is not taxed.

preferences primarily affects the proportion of exports in the higher tariff band peak. In fact, with the actual utilization of preferences, there are two peaks at the upper end of the distribution of exports. About 25 percent of exports enter the EU with tariffs in the range of 6 to 9 percent while a further 23 percent enter under the higher tariff band of 12 to 15 percent even though they are eligible for reduced duties.

Figure 5.2: Distribution of Moldova's Exports to the EU by Tariff Band With Full and Actual Utilization of Preferences



Source: EU TARIC database

THE IMPACT OF EU TARIFF PREFERENCES ON KEY SECTORS

For certain agriculture products, such as walnuts, EU preferences provide for zero duty access to the EU and a preference margin of 100 per cent. But for other important products, such as apple juice, preference margins are smaller and the duty paid by Moldovan exporters much higher.

5.14 EU protection against key products in Moldova's exports to the EU is presented in Table 5.3. As shown in the table, the value of agricultural exports to the EU is less than 20 percent of manufactured goods exports (which is primarily clothing). It is worth noting that some 67 percent of all clothing exports to the EU -- and nearly 100 percent of footwear exports -- enter the EU under the Outward Processing Trade (OPT) scheme. The clothing sector itself accounted for 83 percent of all of the processing of EU materials recorded under the OPT scheme of the EU.

5.15 The take-up of GSP preferences varies greatly across sectors. Overall, in agriculture, some 67 percent of Moldovan exports request preferences while in manufacturing, preferences where requested for about 60 percent of exports. Within agriculture, 84 percent of shelled walnuts exports requested preferences, but the request for preference by fruit juice exporters was only 22 percent. In manufacturing, the share of both cotton fabrics and footwear exports requesting preferences is relatively high, over 90 percent. For clothing, however, the share of exports requesting preferences was only 52 percent. The large variation in preference utilization suggests that an important element of the take-up of preferences is sector specific. In the case of the under-utilization of GSP preferences, a prime suspect is the sector and product specific rules of origin that the EU applies (see Box 5.1)

Table 5.3: Key Sectors in Moldovan Exports to the EU and Tariff Preferences

	Agriculture			Manufacturing			
	Total	Shelled Walnuts	Fruit Juices	Total	Cotton Fabrics	Clothing	Footwear
Total Exports to EU (€ 000)	36,611	16,673	6,109	190,987	6,403	105,535	12,101
Share Requesting Preferences (%)	66.5	84.2	21.7	59.1	97.6	51.6	93.3
Outward Processing Trade (%)	4.2	9.2	0	44.1	0	67.3	97.7
Average MFN Tariff (%)	7.6	5.1	22.2	7.9	8.4	12.3	8.6
Average GSP Tariff (%)	5.2	1.6	18.3	6.0	6.7	9.8	5.0
Average tariff with Labor (%)	3.5	0	13.7	4.3	5.0	7.3	0.5
Average tariff with labor with actual preference utilization (%)	5.1	0.4	20.4	5.7	5.1	9.7	1.0

Source: Eurostat, WTO and TARIC databases.

5.16 In terms of duty reductions, among Moldova's main agricultural exports to the EU, the absolute reduction in fruit juices tariffs is much larger (8.5 percentage points)

Margins of preference for clothing are smaller than those available for other manufactured products.

than that for shelled walnuts. This is, however, because walnuts have a much lower MFN rate to begin with (only 5.1 percentage points). Indeed, the tariff applied to fruit juices exports from Moldova is very high, almost 14 percent after taking into account the various GSP preferences. Given the low utilization of preferences, a large proportion of these exports to the EU pay the full MFN tariff of over 22 percent. Moldovan juice exporters have to compete in the EU market with products from Central and Eastern European countries, Turkey and a number of Balkan countries whose producers can export to the EU market free of tariff duties. The EU duty and low utilization of preferences entail a 20 percent disadvantage for Moldovan juice exporters to the EU relative to competitors in the region. For walnuts, the reduction in tariffs gives Moldovan producers a margin of preference of more than 5 percent over suppliers from countries that have to pay the MFN tariff.[29] Within the manufacturing sector, GSP preference with the labor provision provides for a 40 percent reduction in the tariff for textiles and clothing products and an 8.5 percentage point reduction in duties for other products, such as footwear, leads to an almost 100 percent reduction in tariffs.

5.17 Given that the average EU tariff is around 4 percent, the average duty of 5.6 percent confronting Moldovan exports to the EU cannot be deemed a major barrier to market access and increased exports to the EU. As this section notes, however, there are a number of products, such as fruit juices, where duty rates applied to exports of Moldova remain very high even after preferences are granted. For these particular products, the key issue is to identify the tariffs confronting Moldova's main competitors. Is Moldova competing with countries that pay the MFN tariff or countries which receive the same or better access to the EU market, such as the Central and Eastern European countries? This issue is partially addressed in the final section of this chapter on the impact of EU enlargement.

Extending and deepening EU preferences for agricultural products, for example, by including wine, would have very small direct impact under the current structure of trade. It is the treatment of clothing which is currently crucial.

THE IMPACT OF ENHANCED EU TRADE PREFERENCES

5.18 Given the current structure of exports, Table 5.4 summarizes the impact on the average EU tariffs confronting Moldova that would be achieved by broadening GSP preferences. If, for example, GSP preferences were extending to all Moldovan agricultural products (including wine) then the average tariff confronting Moldovan exporters would fall to 3.5 percent, if preferences were fully utilized, or 5.3 percent if the current level of preference utilization was maintained. If, however, the EU were to provide the same GSP preferences to textiles and clothing (currently a 40 percent reduction for Moldova) that are given to other products (a reduction of 8.5 percentage points), the impact would be more substantial, with the average tariff on total exports to the EU falling to 2.2 percent with full utilization of preferences and 4.5 percent under current utilization rates. Thus the impact of EU tariff protection on Moldovan exporters would decline most if current preferences were more fully utilized, particularly in the clothing sector, and if deeper preferences were offered to clothing products. Given the structure of current trade with the EU, extending and deepening preferences for agricultural products would have a much more limited impact.

[29] In practice, there is a range of country/sector exclusions from GSP preferences. In the case of nuts, for example, Chile, Mexico and Thailand are excluded from GSP preferences.

The exclusion of wine from EU preferences is a major limitation for Moldova. However, it is not possible to conclude that protection in the EU on products of interest to Moldova, while important, can be the only factor constraining the expansion of Moldovan exports to the EU.

5.19 It is, of course, likely that Moldova's current export structure gives a distorted view of the impact of EU protection since high EU tariffs may be suppressing trade in precisely those products in which Moldova has a comparative advantage. One way to address this potential issue is to evaluate EU protectionism assuming that Moldova's exports to the EU were similar in structure to its exports to Russia – a country with which Moldova has a free trade arrangement and hence where the majority of products confront no tariff restrictions. For this exercise, the key issue centers around wine exports. Wine dominates exports to Russia but comprises a small proportion of exports to the EU. Is EU protection the main reason behind this?[30]

Table 5.4. The Impact of Deeper GSP Preferences on Average EU Tariffs

	Average Tariff Rate	
Current GSP preferences	4.1	5.6
Extending GSP preferences to all Agricultural Products	3.5	5.3
Extending GSP preferences to Textiles and Clothing Products	2.2	4.5

Note: Trade weighted average tariffs
Source: EU TARIC database

5.20 As shown in Table 5.5, the predicted trade weighted average MFN tariff that would be applied on Moldova's exports to the EU if they had the same structure as Moldova's exports to Russia is 9.9 percent. This rate is 2 percentage points higher than the average EU tariff given Moldova's current exports to the EU. With GSP preferences and the additional labor benefits, the hypothetical average tariff would be 7.6 percent. This compares with an average tariff on current exports to the EU of 4.1 percent. Since wine dominates Moldova's exports to Russia, the impact on the hypothetical tariff if wine and related products were offered the same GSP preferences would be substantial -- leading to an average tariff of only 3.8 percent. The exclusion of wine from the EU's GSP preference scheme has a measurable impact on the average EU tariffs confronting Moldova.

5.21 It is not reasonable, however, to conclude that EU protectionism has been the only or major factor constraining substantial reorientation of Moldovan exports towards the EU. If, following the results indicated in Table 5.5, one assumes that EU tariffs on products of interest to Moldova are reduced such that the average

Table 5.5. Average EU tariffs as Applied to Moldovan Exports to Russia (assuming full utilization of GSP preferences)

	Hypothetical Export Structure	Current Export Structure
Average MFN Tariff	9.9	7.9
Average GSP Tariff with Labor Provision	7.6	4.1
Average GSP Tariff with Labor Provision & Extending GSP Preferences to Wine Exports	3.8	3.5

Source: EU TARIC database.

[30] Unfortunately, this exercise is not straightforward. First, the data on Moldovan exports to Russia are not available at the same level of detail as the EU tariff schedule. Moldovan exports data are at the 6-digit level while EU tariffs are defined at the 8-digit level. Hence average tariffs at the 6-digit level must be used. Second, a number of the duties in the EU on key products of interest to Moldova are non ad valorem duties - usually specific duties - such as the duty of 13.1 euros per hectoliter currently levied on bottles of white wine. To calculate averages, tariffs based on quantity need to be converted into ad valorem equivalents. This conversion, however, depends upon the value per unit of quantity. The protective impact of specific duties is particularly heavy on low-value, low-quality products and becomes less restrictive the higher the unit value of the product. The unit value provides a very rough indication of quality. Will Moldova be able to export to the EU products of the same unit value/quality as currently being exported to Russia? As shown in the case study on Wineries in Part II of this study, wine demand in the EU is dominated by the taste for dry wine that has a higher alcoholic content than the sweeter wine that currently dominates exports to Russia. Thus, it is unlikely that Moldova could simply undertake a large scale expansion of exports to the EU of the type of wine currently exported to Russia. If demand in the EU is such that wine exported to the EU must be of a higher quality and unit value to that exported to Russia, then the duties applied in this simulation will overstate the duties that would actually be applied.

tariff declines from 7.6 percent to 3.8 percent, then, even with some extremely heroic assumptions, Moldova's exports to the EU would increase by just under 18 percent.[31] Even with such an increase, Moldova's exports to the EU as a share of total exports would only increase from the current level of around 21 percent to 23.8 percent. As noted in Chapter 2, gravity models suggest that under "normal" trade conditions the share of Moldova's exports to the EU would be at least double the current level.

5.22 While reducing EU tariff barriers can contribute to reorientation of Moldovan exports towards the EU, it is clear from remaining chapters of this study that a range of factors in Moldova, such as the high costs of clearing customs, the difficulties and costs of obtaining funds for working capital and for investment and the difficulties caused by the current system of product regulations and conformity assessment are equally important factors limiting the ability of Moldovan exporters to penetrate the EU market. Indeed, in many cases, removal of these domestic barriers will be a pre-requisite for the successful expansion of exports to the EU. If these barriers are, in effect, prohibitive, then there can be no impact from the reduction of EU tariffs until they are alleviated. For example, if Moldovan products cannot satisfy the minimum requirements necessary to be placed on the EU market, then changes in the EU tariff will have no immediate effect and will only be exploited in the longer-term if constraints on the ability of firms to invest to raise quality are removed.

THE IMPACT OF EU SUBSIDIES ON MOLDOVAN AGRICULTURAL EXPORTS

EU subsidies cannot explain the gap between actual and potential exports to the EU

5.23 In addition to tariff protection, it is conceivable that Moldova's access to the EU market is being constrained by the impact of EU agricultural subsidies to domestic EU producers. Table 5.6 compares the sectoral structure of Moldovan agricultural exports to Russia – a benchmark for what Moldova's export structure to the EU might look like without EU tariffs or subsidies -- with the structure of EU domestic and export subsidies. Nearly 84 percent of EU domestic support goes to 4 commodity groups: meats, dairy products, fruit and nuts and sugar. These products, however, accounted for just 6.3 percent of Moldovan exports to Russia. Hence, the most heavily subsidized products in the EU are not a major element of the Moldovan export basket. The subsidies for the production of all beverages and alcohol, including wine, amounted to only about 5 percent of the total EU agricultural subsidies.

Products which are most heavily subsidized in the EU do not comprise a major proportion of current or potential Moldovan exports.

5.24 EU export subsidies, which affect Moldovan producers through their influence on competition in third markets and through their depressing impact on world prices, are concentrated in 3 sectors – meats, dairy products and cereals – that account for 84 percent of total EU payments. These 3 products, however, comprised only

Table 5.6. EU Agricultural Subsidies and Moldovan Exports

	Share in Moldovan Exports to Russia	Share in EU Domestic Support	Share in EU Export Subsidies
Beverages, Spirits	71.28	5.29	1.37
Preparations of Vegetables, Fruits, Nuts	9.49	2.25	0.68
Tobacco	8.63	2.74	0.57
Fruit and nuts	3.28	13.78	0.75
Meat and Edible Meat Offal	2.69	37.62	21.83
Cereals	0.52	0.00	33.74
Dairy, Eggs, Honey	0.27	16.02	27.94
Sugars	0.08	16.09	7.10

Source: Eurostat and EU TARIC database

[31] Such as a price elasticity of demand for 5 for Moldovan products – very high relative to standard estimates of such elasticities and assumes fully responsive supply in Moldova.

3.5 percent of Moldovan exports. Relative to other countries in the region, such as Ukraine and Russia, it does not appear that Moldova has a strong reveal comparative advantage in the meat, dairy and cereals sectors. While EU export subsidies for fruit and vegetables and beverages represent a relatively small share of total EU exports subsidies, one cannot ignore that sectors of importance to Moldova, especially wine and fruit and vegetables, are subsidized in the EU.

Box 5.3 EU Subsidies to the Fruit and Vegetables Sector.

The EU protects its domestic fruit and vegetables sector through the use of a complex system of minimum import prices (known as entry prices) as well as customs duties. Both customs duties and entry prices vary throughout the year, with particularly high barriers during the main EU growing and marketing period. There are, however, an array of preferential access arrangements: GSP, Cotonou, Euro-Med and agreements with the CEECs. These preferential arrangements include reduction of customs duties (frequently by 100%) and concessions on entry prices. These preferential arrangements are, however, often limited by tariff quotas or reference quantities.

Internal prices in the EU are maintained by interventions which remove excess supply – by compensating farmers to withdraw products from the domestic market, subsidizing exports or encouraging additional processing. The EU specifies a limit on the amount of particular products that can be withdrawn from the market. These, together with the withdrawal prices, have been declining following the reform of the Common Agricultural Policy (CAP) in the mid 1990s. For example, there is now a ceiling of 8.5 per cent of the production of apples and pears for which withdrawal compensation can be paid, down from 50 per cent in 1997/1998. The amount of compensation that can be received for apples has fallen from 10.69 euro per 100 kg in 1997/98 to 8.81 euro per 100 kg from 2002. The EU regime also comprises compensation to processors of fruits and vegetables who have to pay a minimum price to producers. This is backed up by a system of national quotas for processing of certain products – tomatoes, peaches and pears – with penalties, in terms of reductions in aid in subsequent years, for overruns.

The key fruit and vegetable products that Moldova currently exports to the EU, however, are not subject to extensive EU interventions. It has been estimated that a 50 percent cut in industrial countries domestic support for fruit and vegetables would lead to an increase in exports from developing countries as a whole of just over 1 per cent. Similar estimates show that a cut in industrial countries import tariffs of 50 per cent would lead to an increase of more than 12 per cent in developing country exports. Given these estimates, it is unlikely that the removal of EU subsidies for fruits and vegetables would result in a substantial increase in Moldova's exports of these products. While tariff cuts are much more important in raising developing country exports, for Moldova the impact could be smaller given the prevalence of GSP tariff preferences.

A further issue is whether current EU policies are constraining Moldovan diversification into a wider range of fruit and vegetable exports to the EU. It should be noted that, except for tomatoes, EU withdrawal compensation is only paid for products which satisfy a certain quality, class II or higher, of the marketing standards that are in force. This entails that EU policies will have only an indirect effect on products that do not meet these standards. It is also clear from the case study of this sector, that there is a range of very important barriers and constraints in Moldova that are affecting the ability of this sector to expand into overseas markets. It is important that these be addressed in order that Moldovan producers are able to exploit new opportunities that may arise in this sector.

THE IMPACT OF EU ENLARGEMENT

For industrial products, the impact of enlargement for Moldova will tend to be positive as the new members implement the common external tariff, which is lower than current tariffs for many countries.

5.25 In analyzing the impact of EU enlargement on Moldova, a key distinction must be made between manufactured and agricultural products. For manufactured products, the impact of trade policy changes following enlargement of the EU will tend to be positive for Moldova and other CIS countries. There will be no significant change in relative market access to the current EU market since all tariff and non-tariff barriers on imports from the accession countries have already been removed. Moldova's market access to the accession countries, on the other hand, will improve since tariffs in the largest markets, Poland and Hungary, will decline as these countries implement the common external tariff and adopt the EU's GSP preferences. For example, the Polish tariff on clothing products is currently 18 percent. This will fall to 12 percent upon accession and the tariff applicable to Moldova will decline to just over 7.2 percent once GSP preferences are applied. In the case of Hungary, duties on bars and rods of steel, the principal import from Moldova, will fall from 4.5 percent to zero when the EU common external tariff is applied. There may also be a shift in processing activity to lower cost CIS countries as labor costs in the accession countries increase. The adoption of EU outward processing regulations may also encourage clothing producers in the accession countries to outsource the assembly stage of the production process to low labor cost, but proximate locations, such as Moldova.

Box 5.4 EU Subsidies to the Wine Sector

EU policy towards the wine sector in the 1970s and '80s led to very large surpluses of low quality table wines. Subsequent policy has tried to encourage production of quality wines and limit the amount of low quality wines produced in the EU. The 1999 revision of EU wine policy has sought to regulate supply, through limits on replanting and payments for grubbing up vines, while providing guaranteed minimum prices for surpluses that are distilled into alcohol or fuel. Distillers are in turn eligible for aid to compensate for the higher price that they have to pay to the wine producers and for the cost of storage. Production surpluses that are exported are eligible for export subsidies.

EU production of wine has declined substantially over the past decade from 210 million hectolitres in the early 1980s to around 160 million hectolitres in the late 1990s. Expenditures on export subsidies have also declined relative to the 88 million euro base for commitments under the Uruguay Round Agreement on Agriculture. This reflects declining output and increasing intervention to encourage the use of wine for distillation into alcohol and fuel. Nevertheless, in 2001 the EU provided 1,197 million Euros in budgetary support to the EU wine sector, an amount that is more than ten times greater than the value of output of the sector as a whole in Moldova.

While the reform of the EU's wine sector policy was supposed to shift intervention away from price support, guaranteed prices in the domestic market combined with export subsidies ensure that EU policy still has a distortive effect on international trade in wine products. These subsidies, by increasing the volume of world exports and lowering world price of this quality of wine, adversely affect the very market segment in which Moldovan producers are competing. It has been estimated that a 50 percent reduction in industrial countries subsidies to wine and other beverages will results in a 1.8 percent increase in developing country exports. A 50 percent cut in tariffs, on the other hand, leads to a 4.4 percent increase in exports. The impact of the removal of these subsidies on Moldovan wine exports is likely to be limited. The impact of a tariff reduction on Moldovan producers would be larger if they were removed on a preferential basis – under the GSP, for example.

Moldova should seek to persuade the EU to include wine under the GSP and make a greater number of processed agricultural products, such as apple juice, eligible for zero duty access.

5.26 For agricultural products, relative market access conditions may worsen and there may be substantial trade diversion away from agricultural exporting CIS countries as the accession countries, especially Poland, are given substantial preferences in the EU.[32] On the other hand, duties in certain of the applicant countries are higher than EU duties and these will fall after accession. For Moldova, the impact of EU enlargement on current agricultural exports will be limited to specific commodities. The major agricultural exports to the EU at present are sunflower seeds, for which the MFN tariff in the EU is zero, and shelled walnuts, which are eligible to enter the EU without duty under the GSP. Hence, market access for these products in existing EU countries will not change. However, Poland currently levies a duty of 9 percent on sunflower seeds. This will be reduced to zero during the accession process. The impact of enlargement on Moldova could be limited if the preferences under the GSP were further enhanced.

5.27 The main agricultural exports that may be affected by EU enlargement are apple juice and wine. Here the accession countries -- Poland for apple juice and Hungary, Bulgaria and Romania for wine -- are major suppliers of the EU market. Current EU

[32] A Doha round which leads to a major reduction in EU border protection in agriculture would help to alleviate this impact.

tariffs for these products are high.[33] For apple juice duties range from 18 percent for low density juice to 30 percent of high density juice. Under the GSP, Moldova can export at rates of 9.5 percent for low density juice and 21.5 percent for high density juice. As noted earlier, however, only 21.7 percent of the exports from Moldova of apple juice entered the EU at reduced duties. Thus, the duties levied on Moldovan exports of apple juice put Moldovan producers at a strong competitive disadvantage relative to Polish producers who can access the EU market duty free. However, new opportunities may arise for exports to the new EU members. Duties in Hungary on apple juice are currently around 39 percent and those in Poland are well over 40 percent. These duties will decline as the common external tariff and preferences towards Moldova are applied.

5.28 As noted earlier, there are no GSP preferences for Moldova on its wine products. While accession countries wine exports to the EU also do not currently benefit from tariff preferences, as of mid-2004 Hungarian wine producers will have duty free access to the EU.[34] The specific EU duties that are applied to wine can amount to a tariff equivalent of around 10 percent or more. The duties in some of the accession countries, however, are considerably higher and hence tariff barriers in these countries will decline as part of accession to the EU, offering some opportunities of improved market access for Moldovan producers to these countries.[35]

5.29 In addition to tariff preferences, after enlargement agricultural producers in the accession countries will also become eligible for EU farm subsidies. This will make it even harder for Moldovan suppliers to compete in the enlarged EU market. Prices for most agricultural products are lower in the accession countries than in the EU suggesting that there will be a significant increase in production in the accession countries once the policies which generate the higher prices are applied. These higher prices will lead to a decline in demand for many agricultural products in the new EU members. Production surpluses in the accession countries are likely to arise. Part of these will be absorbed by the markets of the existing EU members, the rest may be removed from the market or exported with subsidies. The ability of the EU to expand subsidized exports, however, is limited by the commitments made under the Uruguay Round Agreement. Under this agreement, the export subsidy value commitments of the accession countries is about 9 percent of those of the EU. Hence, a large scale expansion of subsidized EU exports after enlargement will not be possible without violating WTO commitments.

Producers in Moldova that can produce to EU standards will have access to a market of over 400 million people governed by a common set of health and safety requirements.

5.30 With regard to non-border policies, the accession countries will have access to the Single Market (for some sectors, certain countries do so already). The impact will vary sector by sector according to the importance of technical barriers to trade and government procurement decisions, the key areas where market access is influenced by the Single Market. In sectors where technical regulations are important, the exporters of accession countries will have improved access to the EU market. However, in the main these are sectors where the CIS countries, through lack of FDI and technological capabilities are not effectively competing at present, and where the currently applied GOST regulations in CIS countries are a constraint upon export expansion to the EU. Hence, the direct impact on competition for products currently exported by Moldova will be very muted. However, after enlargement the EU will comprise a market of well over 400 million people governed by harmonized regulations for a large array of products. As

[33] It is worth noting that the EU has already granted Poland duty free access for these products, while for other applicant countries there are reduced duties under preferential quotas.
[34] It is still not clear at present what market access conditions will prevail for Romania and Bulgaria.
[35] Average duties on wine imports in the Czech Republic are currently around 30 percent, those in Hungary exceed 60 percent, while Poland levies duties that comprise an ad valorem duty of 48 percent plus additional specific duties which entail very high applied rates.

Although EU trade barriers on products such as wine are important, there are other factors in Moldova constraining the ability of Moldovan producers to sell in the EU market.

Major barriers to exports arise from the high cost of customs procedures, transport, and finance, together with a regulatory environment which is not conducive to the production of products satisfying modern health and safety standards.

chapter 5 indicates, if Moldova were to upgrade its system of standards and conformity assessment and rigorously adopt EU and international standards, then producers of products conforming to these standards would improve their access to this enormous market.

CONCLUSIONS

5.31 Moldova faces a changing and challenging market access environment in what should be the main overseas destination for Moldovan exports -- the EU. Moldova benefits from the biggest preferences that are available to developing countries under the EU's GSP scheme. EU trade restrictions and subsidies in agriculture are important factors affecting Moldovan access to the EU and other markets. While important, these barriers alone cannot explain the large gap between the magnitude of actual trade with the EU and the amount of trade predicted for "normal economic relations" between a country of similar economic size and location to Moldova and the EU. In other words, a country of similar economic features to Moldova facing the same market access restrictions as Moldova should trade more intensively with the EU. Hence, there are other factors which are compromising the ability of Moldovan producers to sell successfully into the EU market. As the rest of the study shows, these include the additional costs that Moldovan firms incur relative to rivals in other countries in clearing customs, in transporting their goods to the market, in financing investment and working capital, and in complying with standards and technical regulations. In the case of standards and regulations, these additional costs are in many cases prohibitive. These are issues that need to be addressed if trade is to fully contribute to raising growth and employment and in alleviating poverty in Moldova.

5.32 Enlargement of the EU will offer new opportunities for the export of manufactured goods to the new applicants, while market access conditions in the existing EU members will not change. The most significant impact of EU enlargement will be in the agricultural sector. Enlargement will lead to substantial preferences for agricultural producers in the accession countries in the market of existing EU members. The adverse change for Moldovan producers will be exacerbated by the increase in subsidies that farmers in the new EU members will receive. However, the products of most interest to Moldova are not the most heavily subsidized in the EU and a successful conclusion to the Doha Development Round of trade negotiations at the WTO is most likely to lead to further reductions in EU subsidies. In addition, duties for the main agricultural products exported by Moldova are higher in some of the main applicant countries than those of the common customs tariff of the EU, which these countries will adopt after accession. Thus, even in agriculture, new opportunities for Moldovan producers will arise. The key issue for Moldovan policy makers is to ensure that the domestic business environment is such that Moldovan firms are able to exploit these new opportunities.

5.33 The relatively high duties in the EU on processed agricultural products and substantial preferences towards competing suppliers in the Central and Eastern European countries is an issue that Moldova should raise in its bilateral discussions with the EU under the Partnership and Cooperation Agreement. An objective could be to persuade the EU, when considering the extension of the GSP scheme after 2004/5, to classify a larger number of processed agricultural products as non-sensitive under the GSP and therefore eligible for zero duties and to include for the first time products such as wine. This would have to be backed up by strong efforts to identify and alleviate constraints on the take-up of GSP preferences and to ensure that Moldovan producers are aware that new opportunities for exports may arise in the newly acceding countries in central and eastern

Europe. In the longer run, if Moldova is able to enter into negotiations with the EU towards a free trade agreement, it must ensure that these food products are not excluded.

Addressing these barriers to trade in Moldova will be crucial if Moldova is to successfully integrate into the post-enlargement architecture that is emerging in Europe.

5.34 The "new neighbors" policy of the EU offers Moldova the prospect of access to the EU single market on the same terms as existing members. An intermediate step would be provided by a free trade agreement, something that is envisioned in the partnership and cooperation agreement that the EU and Moldova have signed. However, the EU maintains that at "Moldova … does not currently possess the competitive strength or administrative capacity to take on the reciprocal obligations of an FTA". Addressing the domestic constraints on trade and investment would therefore not only stimulate trade but also bring Moldovan institutions and policies on a path whereby a free trade agreement with the EU could become a reality. This in turn would have an additional major impact on trade and particularly investment in Moldova.

CHAPTER 6. STANDARDS, CONFORMITY ASSESSMENT AND TRADE: MODERNIZATION TO FACILITATE MARKET ACCESS

INTRODUCTION – STANDARDS AND TRADE

Standards play a key role in facilitating trade and development whilst providing for governments to achieve objectives concerning health and safety.

6.1 Standards have come to be crucial elements facilitating transactions and trade both within countries and in international exchange between countries. Standards support markets and facilitate efficient transactions. Standards stipulate what can or cannot be exchanged and define the procedures that must be followed for exchange to take place. Thus, the ability to comply with the standards in overseas markets is a major factor determining access to those markets and the capacity to export. This is true both for standards that are defined as mandatory by governments (technical regulations) so as to meet their objectives regarding health and safety and environmental issues, as well as market driven voluntary standards which reflect the demands and tastes of consumers or the technological requirements of industrial purchasers.[36]

6.2 This important role of standards in trade and development arises because:

- Standards are instrumental in facilitating the flow of information between consumers and producers and, in particular, in providing information on unobservable characteristics such as quality. Thus, standards can reduce uncertainty for consumers. Standards indicate to producers the expectations and requirements of consumers in terms of quality and safety. For these reasons standards can contribute to higher levels of economic activity
- Standards allow governments to effectively achieve their objectives concerning health and safety. Such standards, which are often mandatory, are particularly important in developing countries as they seek to raise living conditions. For example, standards which improve health and sanitation will tend to complement policies to raise productivity and increase economic growth and incomes
- Standards provide an important mechanism for technology transfer to developing countries. In the main, technology is expressed through standards and hence standards help to diffuse technical information concerning products and processes. The need to satisfy recognized standards can be an effective incentive mechanism to encourage local firms to improve the quality and reliability of their products.
- Standards are crucial in allowing firms in developing countries to integrate into global production chains, especially in modern engineering sectors, by ensuring the compatibility and interoperability of components made in different places.

6.3 It is useful to distinguish product standards from process standards. The former refer to the characteristics that goods should possess, for example, maximum pesticide residues for agricultural products or performance requirements for machinery. Process standards relate to the conditions under which products are produced and packaged. These standards can define rules for the production of the final good, for example, the procedures for processing foods.

[36] The WTO Agreement on Technical Barriers to Trade (TBT) defines a standard as a "document approved by a recognized body, that provides, for common and repeated use, rules, guidelines or characteristics for products or related processes and production methods, with which compliance is not mandatory". The development, adoption and compliance with voluntary standards are dictated by the market. The term "Technical regulations" refers to mandatory standards, which are developed and enforced by governments to guarantee protection of safety, health and the environment.

6.4 There may also be standards that are concerned with issues that are indirectly related to production, such as the environment. For example, companies are increasingly requiring that sub-contractors satisfy standards relating to the use of hazardous chemicals in the workplace and chemicals that are ozone depleting. A particular good may be subject to a range of both mandatory and voluntary product and process standards. Clear information on relevant standards is therefore crucial to producers.

Effective conformity assessment and accreditation systems are crucial elements in a modern standards infrastructure.

6.5 In addition to the writing of standards, an essential element of the system of standardization is conformity assessment, the technical procedures such as testing, verification, inspection and certification, which confirm that products fulfill the requirements, laid down in regulations and standards. There is also the accreditation and recognition system – the audit system that ensures that conformity assessment is working properly. Each country needs a standards infrastructure, which meets its own domestic and trading needs. The development of such infrastructure will depend on the structure of the economy and the structure of exports, but is guided by government policies.

To participate in the global marketplace, firms in developing countries must comply with standards and therefore must invest in compliance.

6.6 Meeting standards means that firms also incur costs in terms of investments in the equipment and staff that are necessary to ensure compliance with the requirements that are laid down and the costs that arise in proving conformity to the relevant standards. For firms in developing countries, such as Moldova, to effectively participate in the global economy and to move beyond simple assembly operations, they must invest in compliance to satisfy standards. The cost of non-compliance is the loss of existing export markets or the inability to expand into new markets. The government has an important role in providing a framework by which domestic firms are able to invest in higher quality and which provides an effective and efficient conformity assessment infrastructure.

6.7 The cost of compliance is higher when the home country of the exporting firm has a system dominated by mandatory standards. The costs will also tend to be considerably higher in countries where the system of standards lacks transparency, predictability and there is a lack of effective management of information concerning standards at home and abroad. This can lead to a lack of clarity for firms in assessing which standards are relevant for their products and an unwanted degree of discretion to officials charged with implementing the standards system, for example, with regard to which products are inspected, when and where they are inspected and how they are inspected.

Standards are increasingly important in defining competitiveness

6.8 There are a range of voluntary standards the satisfaction of which can be an important element of competitiveness, especially for firms in developing countries that are trying to compete in the global markets. For example, the ISO 9000 standards relating to quality management systems provide important information to buyers concerning the way that companies deal with quality issues. Similarly, the ISO 14000 standards relating to management of environmental issues within a company and standards concerning social accountability (i.e., labor working conditions within the firm) are increasingly important in attracting attention from buyers in Western markets, who in turn need to respond to the demand for consumers in these markets for assurances relating to the environmental and social conditions in which the goods are produced.

6.9 It appears that Moldova is not doing particularly well in this regard. Table 6.1 shows the number of companies with ISO 9000 certification in several comparator countries. It is clear that Moldova is significantly behind other countries in the region in ISO 9000 certified companies. A key aspect of ISO 9000 is that companies must adopt a strategy for quality management and then have that assessed relative to international

Moldova is considerably behind other countries in the region in the number of firms having quality management systems certified as being consistent with international standards. Standards are increasingly important in defining competitiveness

norms and best practices. A key issue for Moldova is to encourage and facilitate more companies to focus on, and take responsibility for, the quality of the goods or services they produce. Without this fundamental change of attitude the prospects for generating higher value added activities and of long-run increases in competitiveness will be poor.

Table 6.1: Companies with ISO 9000 Certification

State	1995	1996	1997	1998	1999	2000	2001	2002
Bulgaria	3	14	42	96	199	259	469	883
Czech Republic	180	366	746	1443	1500	3855	5627	
Romania	42	61	214	269	466	1032	1670	
Moldova				3	4	6	10	11

Source: ISO

6.10 In many cases, satisfying these requirements, although voluntary in principle, may be necessary to permit participation in global markets. It is also important to note that the ability to meet these standards set by buyers or contractors may also necessitate an accompanying infrastructure that provides for credible independent third party testing and certification. If such facilities are unavailable, then it may be very difficult for local firms to establish links with buyers and contractors in overseas markets.

Standards can also act as significant barriers to trade.

6.11 While standards are a key element in modern markets they can also act to constrain trade between countries. Different standards and conformity assessment procedures in different countries raise the costs of exporting. Producers may have to change their product to be accepted in foreign markets with the associated costs of redesign and of running new administrative systems for control of products for separate markets. This in turn undermines the ability of firms to reap the benefits, in terms of lower average production costs that arise from larger scales of production.

6.12 Mandatory standards can act as barriers to trade, even if that is not the intention of the government concerned. For example, a EU regulation designed to protect human health requires that milk products be produced from the milk of cows milked mechanically. This effectively excludes imports from many developing countries whose farmers have been unable to invest in machinery.

6.13 There are often significant costs related to conformity assessment for exports to overseas markets. Governments often do not recognize the tests performed in the exporters home market so that exporters have to undertake expensive tests in the foreign market.

6.14 These issues underlie the concerns that led the WTO members to agree upon disciplines on the use of mandatory standards by governments to limit the impact of standards as a constraint upon international trade flows. The WTO agreements on Technical Barriers to Trade (the TBT agreement) and on Sanitary and Phytosanitary measures (the SPS agreement) imply obligations for Moldova but they also offer opportunities.

THE WTO AGREEMENTS ON TECHNICAL BARRIERS TO TRADE AND SANITARY AND PHYTOSANITARY STANDARDS

6.15 The SPS Agreement lays down disciplines for the use of sanitary and phytosanitary measures while the TBT Agreement regulates all other technical standards. Both the TBT and SPS Agreements have similar scope and structure. The aim of the Agreements is to prevent governments from using standards and conformity assessment

The aim of the SPS and TBT agreements is to limit the use of standards and conformity assessment that constrain trade while allowing governments to achieve legitimate objectives concerning issues such as health, safety and the environment.

procedures as protectionist measures. Governments are still allowed to use such measures to the extent necessary to meet legitimate objectives (food safety, animal and plant health in the case of the SPS Agreement, and issues of national security, prevention of deceptive practices, human safety, the environment, etc., in the case of the TBT Agreement), but they must not be applied in a way which unduly restricts trade.

6.16 Both Agreements are based on two key principles. First, standards and conformity assessment must be non-discriminatory. That is foreign products must be afforded the same treatment as domestic products (the principle of "national treatment") and there must be no discrimination between products from different foreign countries. This latter principle is equivalent to the well-known Most Favoured Nation principle that underpins the WTO. Second, the use of standards must be justified.

Harmonization with international standards plays a key role in the agreements.

6.17 A number of instruments are created to support the key principles. Harmonization plays a special role in the Agreement. Both Agreements encourage Members to harmonize their standards with those developed by a given set of international standardization organizations. The encouragement is strongest in the case of the SPS Agreement that obliges Members to base their SPS measures on international standards and furthermore states that a national measure that conforms to an international standard is automatically assumed to comply with the requirements of the SPS Agreement. In reality, these rules translate into an encouragement rather than a strict legal obligation for two reasons. First, standards less strict than international standards are unlikely to be questioned by trading partners who will not see them as barriers to trade and, second, standards stricter than international ones are explicitly allowed subject to certain conditions.

The agreements require that measures that deviate from international standards must be justified using scientific evidence.

6.18 The SPS Agreement is very demanding in this aspect. SPS measures that deviate from international standards must be based on scientific evidence. An assessment of the risks to human, animal or plant life and health, taking into account risk assessment techniques developed by the relevant international organizations, must be provided. A Member should either produce a risk assessment itself or, if available, provide one developed by other Members or international organizations. Disputes in the WTO have revealed that the demands of risk assessment are high even for developed countries.

6.19 The TBT Agreement allows Members to apply national standards that deviate from international standards if the latter are deemed ineffective or inappropriate means for the fulfilment of the legitimate objectives being pursued because of, for instance, climatic or technological problems. Developing countries are explicitly allowed to deviate from international standards if these are not appropriate to their development, financial or trade needs.

6.20 Control and conformity assessment procedures are subject to similar rules that prohibit discrimination in the treatment of imports and domestic products and encourage the use of international standards and practices.

Transparency of standards and conformity assessment regimes and clear and timely notifications of new standards and procedures are key requirements under the Agreements.

6.21 The trade distorting nature of standards is often related to the lack of transparency of the requirements for exporters. Therefore, the Agreements require that Members establish notification procedures through which other Members are informed of forthcoming standards. Furthermore, an Enquiry Point must be established through which other Members can obtain information about the standards and conformity assessment procedures. Also related to transparency is the existence of an SPS Committee and a TBT Committee that meet 2-4 times a year and discuss issues relating to the operation of the

Agreements. Participation in the Committees is open to all Members and allows them to be informed about and to discuss other Members standards in an informal way.

6.22 The regulation of the use of standards becomes effective through the existence of a binding mechanism of dispute settlement. When a Member believes that a standard or conformity assessment procedure of another Member violates the disciplines established by the Agreements, that Member may request consultations. If these fail to resolve the issue the complaining party may request the establishment of a panel of three independent experts that will investigate and determine whether the measure complies with the Agreements. If not the Member found in violation of the Agreements is forced to follow the recommendations of the panel report. A decision may be appealed but the subsequent opinion of the Appellate Body is final. If a Member does not abide by the ruling of the Dispute Settlement Body, the complaining Member may take punitive measures.

6.23 The SPS and the TBT Agreements have a number of implications for Moldova. The obligations concern the setting of standards, conformity assessment and the transparency of the system:

1) Where international standards exist, harmonization is encouraged yet there is still room for the design of different standards that take into account the special needs of Moldova, in particular if such standards are less strict than international ones.
2) Should Moldova desire to set standards that are stricter than the international standards, Moldova has the right to do so, but this right is conditional on the existence of a justification for the stricter standards and that the standard does not unduly discriminate against imports.
3) There are many areas where no international standard exist. In this case, Moldova may still set standards, but only if standards are justified and do not discriminate.
4) The Agreements oblige Moldova not to discriminate against imports or between different suppliers of imports in the application of conformity assessment procedures and encourages these procedures to follow international norms. Moldova should comply with the notification requirements of the Agreements procedures and maintain an Enquiry Point.

The agreements also provide important opportunities to be notified of other countries proposals to change or introduce new standards that may affect Moldovan exports and to contest those measures if they are felt to contradict the provisions of either agreement.

For Moldova to be able to benefit from the WTO Agreements, there must be effective management of information from WTO notifications and strong cooperation between government and business.

6.24 The SPS and TBT Agreements provide opportunities as well as obligations for Moldova. While the obligations concern import measures, the opportunities address export market access. The exploitation of such opportunities requires capacity building in the areas of government-business cooperation, participation in WTO Committees and in the dispute settlement system.

6.25 Moldova has access to the notifications of other Members through the WTO secretariat in Geneva. Mechanisms are necessary to provide for such information to be made available to Moldovan companies when relevant. The transfer of information may include analysis of the severity and nature of the information which, when compared with the interests of the business community, will indicate the relevance of a given notification for Moldovan export interests. Procedures must also be in place to inform the government of the interests and priorities of the business community. Effective government-business cooperation will allow Moldovan firms to be aware of upcoming changes in important legislation in the main export markets.

6.26 Moldova also has the opportunity to participate in the discussion of changes in regulatory requirements in the SPS and TBT Committees, including issuing formal comments and to suggest changes to the Member in question. This opportunity will depend on the capacity to participate effectively in the meetings. Again, good cooperation between government and the business community is key as is the availability of the necessary financial and human resources to participate in WTO meetings.

6.27 The dispute settlement system offers the Members of the WTO an opportunity to challenge the legislation of foreign countries. Yet, it must be emphasised that considerable human, technical and financial resources are necessary to formally conduct a case through the entire dispute settlement system. The demand for such resources is lowered, though, if cooperation is established with other Members that share the same interests.

6.28 Box 6.1 provides some examples of how certain developing countries have been able to defend their export interests through the use WTO consultation and dispute settlement procedures. However, in general, developing countries use these provisions to a much lesser degree than developed countries, despite the fact that barriers to trade caused by standards and conformity assessment impinge most heavily on developing country exports. The box also provides a brief description of how one developing country has developed an effective system for disseminating to local businesses information on new technical regulations and conformity assessment procedures in overseas markets that are notified to the WTO.

STANDARDS AND CONFORMITY ASSESSMENT IN MOLDOVA

6.29 Under the previous Soviet regime, standardization systems were created to serve the needs of the command economy, where the state dictated what to produce, how to produce it and in what quantities. For that to happen, the standards had to be mandatory and explicit like a recipe. Any change to the existing standards was the result of research, which was concentrated in the state-owned research institutes and reflected the guidance of the Congress of the Communist Party. Only the very big industrial factories had their own research and development units, but again they did not base their work on consumer demand and market conditions.

The system of standards and conformity assessment of the previous regime is not consistent with the requirements of a modern flexible economy.

6.30 It should be noted that technical regulations as applied in many economies are fundamentally different from the mandatory standards, which were used in the soviet system and still prevail in Moldova. Technical regulations have a public good function and their main purpose is to specify performance indicators, limits and thresholds rather than design or descriptive characteristics, which is typical of the GOST standards. For example, a technical regulation on a fire-resistant door could specify that “the door must be fire resistant with a 30-minute burn through time” and it should not specify how the product must be made, e.g., “the door must be made of steel, one inch thick”. The GOST standards provide very little flexibility to firms in satisfying the requirements.

Moldova is significantly behind other countries in the region in modernizing its standards system, with many of the features of the former system still in place.

6.31 All former Council for Mutual Economic Cooperation (COMECON) countries have undertaken steps towards modernizing their standardization infrastructure and introducing international standards. While countries such as the Czech Republic have essentially completed this process, Moldova has progressed little in this aspect of transition to a modern market economy. Moldova’s institutional structure in the area of standardization, metrology, certification and accreditation still resembles most of the features of the former system of centralized control, which results in a high degree of government control and influence over the placing of products on the market.

Box 6.1 Opportunities under the TBT/SPS Agreements

Example 1: EU and Sardines

- EU regulation only allows sardines (sardina pilchardus) found near Europe to be labeled as sardines. Other species (such as sardinops sagax) found off the coast of Peru and Chile could not be labeled as Sardine.
- Peru requested a panel to consider whether the EU regulation was consistent with the TBT agreement
- In May 2002 the panel ruled in favor of Peru citing the codex standard for canned sardines which allows for a number of different species to be labeled as sardine and the "ongoing obligation" to reassess existing technical regulations in the light of new or revised international standards (TBT Art 2.4)

Example 2: EU and Aflatoxins

- In 1997 the European Commission (EC) proposed to adopt a standard of 4ppb in cereals, edible nuts and dried fruit
- 15 Countries such as India, Mexico and Pakistan raised issue in SPS Committee and requested detailed risk assessments used in designing this new standard from the EU
- As a result of consultations, the EU revised the standard for peanuts to that of the draft codex standard and reconsidered the inspection procedures for cereals, dried fruits and nuts
- Furthermore, the formal discussion of the problem in the SPS Committee allowed exporters to be aware of the pending legislation before entry into force and drew the attention of international donors to the adjustment difficulties.

Example 3: Brazil and Notifications

- The enquiry point for TBT has developed a tool called "Alerta Exportador" which enables exporters to receive daily e-mail updates – without incurring any costs – on new WTO/TBT notifications of technical regulations and conformity assessment procedures in overseas markets.
- This system enables enquiry points to cover all business sectors without inundating firms with irrelevant information.

6.32 Three years ago, for the first time, the Government stipulated that the application of national standards would become voluntary, except where a reference in a technical regulation is provided, resulting in mandatory requirements. However, technical regulations have not yet been elaborated and at present Moldova continues to use the old approach of mandatory standards. Moldova does not have any specific regulations or requirements covering electrical safety, telecommunications equipment, medical devices and other types of equipment. This must make it difficult for the government to achieve objectives regarding human safety. [37]

Little progress has been made on a key objective of moving to a voluntary system of standardization –due to lack of commitment, in terms of budgetary funds, and failure to directly adopt international standards.

6.33 Limited progress has been made in bringing the standardization system in line with best international practice. The key reasons are that there is no budget allocation for this task and the possibility of adopting directly international or other countries' technical regulations and standards have not been explored rigorously. Members of the working groups that have been established within the relevant ministries are not experienced in drafting technical regulations, which may lead to the creation of unsuitable regulations that resemble more the existing mandatory standards. Currently there is no scope to hire consultants from outside the respective ministry to assist the established working groups with drafting regulations. More generally, little has been done to provide information to business and the public about international standards, EU requirements, the system of

[37] Ukraine is adopting a number of EU directives in these areas. These so -called "New Approach" directives allow for a more flexible approach in satisfying mandatory regulations. The directives state the essential requirements and leaves firms' flexibility in complying with these requirements. At the same time the European standards organizations (CENELEC and CEN) are given the task of drawing up voluntary standards, compliance with which are then presumed to show consistency with the regulation.

conformity assessment, how the system of accreditation is working and the importance of these issues for trade. Much needs to be done in training staff of the various agencies.

6.34 Ukraine, on the other hand, has set forth a plan of harmonization with international and European standards. In 2003 Ukraine transposed about 500 international standards into its national system. By the end of 2003 Ukraine had adopted around 1500 international standards out of about 9000 that it set as a goal under its current agreement with EU. In 2003 the Department of Standardization in Moldova transposed some 22 international and European standards into national standards. Despite the ambitious program set up by the Moldovan Government concerning the transition towards the voluntary system of standardization and elaboration of technical regulations by 2005[38], there is neither adequate financial nor technical support. Lack of capacity in most of the governmental institutions responsible for the implementation of this program remains a major constraint. Moreover, the program itself does not set down any targets such as the number of required technical regulations.

The current system in Moldova lacks transparency and simplicity – the roles of different departments are not clearly defined and there is too much scope for discretion. As a result there is a heavy burden on firms in complying with standards in the domestic and overseas markets.

6.35 *The slow progress in adopting a modern, transparent standards system contributes to a negative business environment*. The current system is overly complicated with no clear rules regarding application, which leaves too much room for discretion. Functions, relationships and responsibilities of different state bodies comprising the system are not clearly defined and very often are overlapping. Information is not readily available and the rationale behind some of the requirements is not made clear to those that have to apply them. For example, there are three bodies issuing required certificates for food – the Preventive Medicine Department within Ministry of Healthcare, the Ministry of Agriculture and Moldova Standard. Many of the items tested by each body are the same. Inspections are also overlapping, with different departments of the same agency being in charge of various aspects of the inspection process. Information from Costs of Doing Business surveys suggests that Moldovan businesses are subject to more inspections than businesses in neighboring countries, such as Ukraine ad Bulgaria.

6.36 *Under the current system the overall costs of obtaining the necessary certificates are high*. The need to certify goods and production processes is daunting both for exporters and importers because of the high direct and indirect costs. Producers are often required to certify each imported input, the production process as well as the final product. A large proportion of companies (almost half in the Costs of Doing Business Survey) report having to make unofficial payments to obtain the necessary certificates relating to standards on imported products. The survey for 2003 suggests that the official payments that must be incurred to obtain the necessary certificate confirming the compliance of an imported product with Moldovan standards averages $97, while the average unofficial payment exceeds $140.

6.37 At present, companies who seek to export to the EU market are often severely constrained by having to incur high costs to have their product tested and certified overseas in the absence of suitable local testing capacity and the fact that certificates from Moldovan bodies are seldom recognized internationally. For example, certification of organic nut production exported to Germany has to be renewed every 6 months and each visit from an international certifying company costs $5,000 plus $2,000 per production test – once before processing and once after processing. This can amount to $18,000 per year, which is a high burden for firms in an economy such as Moldova to bear when

[38] Moldova established the following two major institutional pillars in order to implement a system of voluntary standards and technical regulations: (a) an intergovernmental Steering Committee to supervise the process of conversion of mandatory standards into technical regulations and implementation of the voluntary system of standardization; and, (b) a National Program for Elaboration of Technical Regulations 2003-2008 with the priority for the agri-processing sector.

trying to compete on international markets. Upgrading testing facilities and measuring equipment is essential for reducing the costs of conformity assessments.

6.38 This highlights that without access to adequate infrastructure relating to standards and conformity assessment, companies in countries such as Moldova may have difficulty discovering the relevant requirements in overseas markets and face high costs in demonstrating compliance with those requirements. However, developing countries have only limited resources available for investment in the conformity assessment infrastructure. Of particular importance regarding exports is international recognition of accreditation bodies. For such recognition, conformity assessment bodies must show that they are competent, in terms of experience, human resources, facilities and organization. Here technical assistance, as is envisaged under the WTO/TBT Agreement plays a vital role. Such assistance needs to upgrade equipment in testing laboratories but also to facilitate greater participation of Moldovan institutions and personnel in international organizations, such as International Laboratory Accreditation Cooperation) ILAC.

The slow pace of adoption of international and European standards and the absence of appropriate testing and certification facilities means that Moldovan firms have to incur substantial costs in serving overseas

6.39 The slow pace of adoption of international and European standards in Moldova means that firms who wish to export overseas, say to the EU, as well as sell in Moldova, will often have to design different products to meet the different standards in the different markets, have to incur multiple testing costs and obtain a number of certificates of conformity. The experience of other countries in the region, such as Bulgaria, shows that once a system of voluntary standards was introduced, companies who had redesigned their export products to conform to the requirements of the EU Market were also able to expand their sales in Bulgaria as well as other Central European markets. The adoption of EU standards throughout Eastern Europe is an important factor affecting the access of Moldovan exporters to these markets. Such access will remain more difficult while the domestic system in Moldova remains mandatory with a low level of adoption of these modern standards.

6.40 One sector, of particular relevance to Moldova, where international and EU standards are becoming increasingly important is fresh fruit and vegetables. Consumers in many countries have become increasingly aware and concerned with the safety of the fresh produce that they consume and the environmental and social dimensions of production systems. These concerns have led to an array of responses from both governments and private companies. In order to minimize microbiological risks, measures have been taken to require or obtain "voluntary" adoption of Hazard and Critical Control Points (HACCP) and product traceability programs in the fresh produce sector. Countries have sought to reduce or eliminate the use of certain types of pesticides, reduce the acceptable levels of pesticide residues and strengthen residue-monitoring programs. Concerns about the possible spread of exotic pests or plant diseases have led to the strengthening of phytosanitary controls. Broader concerns have been embodied in an array of industry or company-specific "codes of practice" with which suppliers, both domestic and international, are being encouraged or required to comply. Awareness of, and compliance with, these standards will be a prerequisite if Moldova is to penetrate higher value markets in the EU and Eastern Europe. It is crucial that an infrastructure exists to provide for independent third party testing and conformity assessment. In other words, it is not only necessary to comply with these standards but also to be able to demonstrate compliance in a way that meets the requirements of buyers.

Effective government-business partnerships are necessary in addressing the increasingly complex standards issues in sectors such as processed

6.41 There are many examples from other developing countries of how effective government and private sector initiatives at the sectoral level can address such problems relating to standards in international markets and pave the way for overseas market access and significant exports, see Box 6.2 for an example. The role of the government is to provide a clear and effective institutional framework, while companies must take responsibility for quality and compliance with modern standards. There is clearly a need for increased contact and cooperation between government and business concerning standards issues in Moldova.

Box 6.2 Government and Business Collaboration on Standards: and Example from The Peruvian Asparagus Industry

The Peruvian asparagus industry provides an example of where industry leaders and government specialists realized that it was in the best interests of the industry, as well as the country as a whole, to adopt national standards in line with international norms, and have greatly benefited as a result. Over the past decade, Peru has quickly risen to become one of the world's largest exporters of asparagus. By producing products that meet international standards, Peruvian asparagus exporters have increased production and worker efficiency and generated client loyalty, while drastically reducing the industry's risk of trade disruptions due to quality, food safety or plant disease issues.

Peru has been able to gain access to industrialized country markets for its asparagus because the industry and government have worked together to market and maintain quality national products through the adoption of national standards in accordance with international norms. In 1997, Spanish sanitary authorities claimed that two cases of botulism were caused by consumption of canned Peruvian asparagus, Peru's largest market for this product. Despite Peruvian government and private sector assurances to the contrary, press coverage of the botulism scare left an unfavorable impression among consumers in European markets, causing sales to slump. This incident helped motivate the industry and government to cooperate and take action, and reinforced the fact that one careless exporter could indeed disrupt markets, such that everyone involved the asparagus export chain needed to work together to prevent future problems.

Beginning in 1998, government officials with the Peruvian Commission for Export Promotion (PROMPEX) convinced the asparagus industry to first implement the Codex code of practice on food hygiene, not because it was the easiest but because it was the most necessary. PROMPEX specialists worked closely with industry leaders and production managers to assure the proper implementation of good hygiene standards. As a result of better hygiene practices, the industry saw improved production methods, and worker efficiency and product quality. This first successful experience with an industry standard, together with commitments of government support and the increasing demands from clients for certified products, gave industry leaders the confidence to work with the Peruvian government and PROMPEX to develop and implement national standards.

Thus, when the national fresh asparagus norms were published in early 2001, because the industry was already familiar with the concept of standards, producers quickly complied with little argument. These national norms established a quality and performance baseline for the industry that allowed many to generate the skills and experience needed to voluntarily certify under other more stringent international standards. They included HACCP, traceability systems and Good Agricultural Practice (GAP) certification. Many large exporters have reached the level where they can now be certified under the even more strict Euro-Retailer Produce Working Group's standards of Good Agricultural Practices (EUREPGAP) protocol.

From: Diop, N., S. Jaffee, 2004 ' Global Trade and Competition in Fresh and Processed Fruits and Vegetables', forthcoming in Aksoy, A., Beghin, J. (eds) *Global Agricultural Trade and Developing Countries*, World Bank and OUP.

Industrial development could be facilitated if testing institutions were to become more business oriented.

6.42 *The limited modern conformity assessment infrastructure in Moldova denies businesses the services that they need to participate in global markets*. Many countries have found that they can achieve their objectives regarding health, safety and consumer protection by establishing just three national monopolies within the national standards structure: scientific metrology, in a centralised or decentralised structure; accreditation, possibly with different organizations for laboratory and certification body accreditation, and standardization

6.43 Many governments have concluded that it is desirable to leave the ever more complicated and costly conformity assessment activities as much as possible for the markets themselves to fund and establish. Following this principle, it is widely agreed, that all other conformity assessment activities, except from the three above, may be seen as technical services, where competition could be established. Industrial development is promoted when these services are provided in response to business driven demands.

Moldova should consider how to provide an environment that encourages the private provision of the services relating to inspection, sampling, testing, and certification.

Achieving international recognition and providing for greater participation in international standards and conformity assessment institutions is important in supporting Moldovan business.

A key issue is the independence of the accreditation body in Moldova

6.44 The relevant institutions in Moldova should participate more effectively in international bodies relating to standards and conformity assessment. This brings benefits not only in not only in being able to represent the interests of producers and consumers in the framing of new or amended standards but also is being aware of trends in scientific knowledge as well as consumer demands of relevance to domestic producers and standard setters so as to be able to anticipate future changes and developments. Greater participation of international bodies relating to accreditation, inspection and certification bodies would help to enhance the reputation of Moldova and assist in the modernisation of the Moldovan system through the demands that membership brings. For example, becoming a signatory of the International Accreditation Forum's (IAF) multilateral recognition agreement is an important step in developing international recognition of local accreditation. Of particular relevance here is the independence of the accreditation body, an issue that needs to be clarified in Moldova. Box 6.3 summarizes the experience of two European countries regarding the independence of the accreditation body.

Box 6.3 The Independence of the Accreditation Body: Experiences from Europe

In Denmark, since the early 1970's the national accreditation body had been organized as one of the offices in an agency within the Ministry of Enterprise. The accreditation body enjoyed full signatory status to all relevant international multilateral recognition arrangements. Yet, in peer evaluations by acceditors from other countries, recommendations had repeatedly been made suggesting changes to the management and organizational structure towards a higher degree of independence for DANAK. The criticism was based on observations that DANAK did not have a proper accreditation board and that it was under the full control of the government agency to which it reported. As a result of this and aligned with government privatization policies, in 2002 the accreditation body was established as an organizationally and economically independent non-for-profit foundation and moved from the agency into rented offices in an industrial district.

Poland had developed its national accreditation service in the 1990's as a branch of the National Centre for Testing and Certification, the PCBC. It was housed in the same building and was reporting to the same top-level management, as did several testing laboratories for which it had issued accreditation. Arrangements to ensure sufficient independence and safeguards against adverse organizational pressure were severely questioned by peer evaluators when Poland applied for signatory status to European Accreditation Multilateral recognition arrangements. The Polish application was rejected, and reorganization was necessary. Today, the accreditation body is still located in the same building as the testing and certification centre, but apart from separate management and reporting structures, internal hallways from the small part of the building occupied by the Polish Accreditation Centre have been sealed off, and a separate front door has been constructed in order to signal it's independence. Nevertheless, the time it took to reorganize the accreditation body after the initial rejection meant that Poland was one of the last Eastern and Central European countries to enter the mutual recognition arrangements of European Accreditation. Ref: ISO/IEC Guide 61.

6.45 *The current system acts to discourage foreign direct investment and constrains innovation and strategies towards product* differentiation. Adequate and appropriate conformity assessment infrastructure and transparent, non-arbitrary regulations and procedures are key factors affecting the location decisions of multinational firms. Countries meeting world standards tend to attract more investors. This constraint on FDI limits the transfer of technological knowledge to Moldova, especially of processes and procedures that would raise quality in Moldova. The current standards, some of which date back to 1938, remain too prescriptive and allow little or no flexibility to firms to introduce new materials or apply new processes. Firms wishing to make even minor change to their product will typically have to endure a long process of changing the current standard. Strict packaging requirements also stifle the competitive strategies of Moldovan firms in the domestic market. For example, it is difficult in Moldova to have promotions such as offering "25 percent more cookies for the same price".

CONCLUSIONS

6.46 To provide for its companies to effectively compete on international markets it is necessary for Moldova to modernize its system of standards and conformity assessment. This facilitation of trade should be integrated into a broad strategy towards meeting government objectives concerning raising health and safety levels in the domestic economy. At the same time an increasing focus on quality should be at the forefront of export promotion activities in Moldova. These aspects of the standards and conformity assessment system could be brought together in the context of a national quality plan. Box 6.4 briefly discusses how such plans have been useful in other developing countries.

Box 6.4 National Quality Plans: Experiences of Other Developing Countries.

In Egypt during 2001-2003 a task force was set up to arrange a national debate and to establish the future modernization and development of standardization and conformity assessment activities. Interministerial coordination and private sector participation were among the issues high on the agenda.

The Egyptian process had been inspired in part by a large project in India in the late 1990's, which lead to the adoption of a national quality plan for India.

Both of these cases were supported and facilitated by European Union technical assistance. The existence of a national quality plan has paved the way for additional funding for targeted development of laboratories, accreditation systems etc.

6.47 The essential elements of such a quality strategy, a number of which are already embedded in the Government's national program, would involve

- The *effective implementation of a transparent and open system of voluntary standards* with technical regulations to define mandatory requirements. A more simple system should be implemented with a clear delineation of tasks between the different Government departments involved.
- A *rapid adoption of international and EU standards where relevant* accompanied by a stock taking of existing standards and the removal of those which are obsolete in a modern economy. It may be useful, as in other transition countries to set targets for this process and to adopt international standards without translation, this speeds up the process, allows companies that are ready to immediately produce to these standards and avoids codifying translation into national standards. The objective should be to provide a system with flexibility for firms in satisfying standards in the domestic market and abroad while effectively allowing the government to pursue its objectives regarding health and safety. Careful consideration should be given to adopting EU "new approach" regulations in areas where there are no standards at present to protect human health, such as, electrical safety.
- Increasing links between government and business and *more effective participation of business in the process of standard setting*. More effective information management is required to increase awareness of quality issues and to allow domestic firms to be informed of proposed changes in standards in overseas markets. This requires that Moldova make the most of the opportunities created by membership of the WTO.
- With regard to conformity assessment there is a need to establish an international reputation of independence and competence for the national body responsible for the accreditation of testing, inspection and certification bodies. This requires a much greater level of participation in relevant international organizations. Greater competence would follow if local staff were to participate in assessment teams working in other countries and/or through inviting foreign accreditation

bodies to Moldova to conduct joint assessments. This is an area where foreign assistance could assist in achieving a more effective conformity assessment system.

- It is also necessary to establish a reputation for high quality and independent testing and certification bodies which can provide the services that are required for companies in Moldova to meet the demand of overseas buyers. *A more business-oriented approach is required in the conformity assessment institutions*.
- Within an overall quality strategy it will be important to identify priority sectors, such as food processing, whereby effective government-business approaches can be developed to provide a modern quality orientated industry supported by an appropriate and efficient standards and conformity assessment framework.

CHAPTER 7. CUSTOMS ADMINISTRATION: HIGH BORDER RELATED COSTS UNDERMINE COMPETITIVENESS

INTRODUCTION

Inefficient and costly border procedures exact significant cost on both the businesses that have to use them as well as the authorities that have to administer them.

7.1 Reductions in tariff barriers around the globe and changes in supply chain management practices, such as a greater reliance on just-in-time deliveries, have resulted in a relative increase in the importance of border procedure-related trade transaction costs. Inefficient and costly border procedures exact significant cost on both the businesses that have to use them as well as the authorities that have to administer them.

7.2 For businesses, border-related costs are both direct, such as expenses related to supplying information to the relevant border authority, and indirect, such as those arising from procedural delays, lost business opportunities and lack of predictability in the regulations. The cost of inefficiency to governments includes unsatisfactory revenue collection and smuggling problems, as well as difficulties in implementing trade policies. Inefficient border procedures are also likely to lead to poor export competitiveness and make a country less attractive to foreign investment and reduce the ability of domestic firms to participate in global production networks.

Despite recent improvements, customs regulations are still perceived as cumbersome and costly, imposing a significant impediment to foreign trade operations.

7.3 In Moldova, the Government has achieved some success in improving the services of the Moldovan Department of Customs and reducing the associated trade and transport impediments. Unfortunately, surveys of Moldovan businesses reveal that, despite recent improvements, customs regulations are still perceived as cumbersome and costly, imposing a significant impediment to foreign trade operations.[39] These perceptions are the result of (i) complicated, non-transparent, and often changing Customs procedures, (ii) long delays for clearing goods or proceeding through the border, (iii) difficulties in applying modern Customs standards, such as the WTO Agreement on Customs Valuation and (iv) corruption.

CORRUPTION

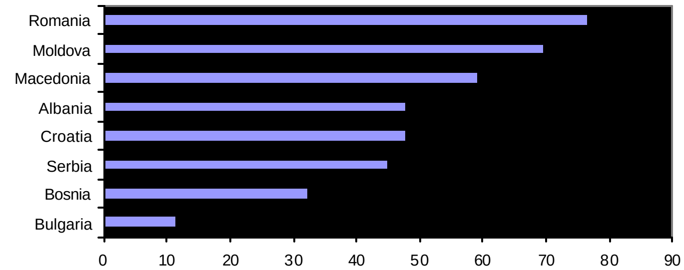
While Customs has started to take strong action against corrupt practices, nearly 70 percent of all trucks report the payment of bribes.

7.4 The new management of Customs has taken strong action against corrupt practices. So far, the main step has consisted of removing local chiefs and other officials who were reported as being corrupt. Customs' own perception is that they have successfully rid themselves of their most corrupt elements. The management of Customs considers that more favorable reports from the business community confirm that impression.

7.5 While recent business surveys no longer perceive Customs as one of the most corrupt agencies in Moldova, bribes are still considered very much part of the clearance process. As shown in Figure 7.1, nearly 70 percent of all trucks crossing Moldovan borders report the payment of bribes (down from the 82 percent reported in 2002). Among the South East European (SEE) countries recently surveyed, only Romania has a higher frequency of bribe payment in the most recent survey.[40] Insofar as corruption raises the costs of Moldovan businesses engaged in trade, ongoing efforts to reduce

[39] See, for example, the recent Cost of Doing Business and Business Environment and Enterprise Performance surveys undertaken in Moldova. It should be noted, however, that Customs is usually blamed unfairly for all difficulties encountered at border crossings even though other border agencies play a major role there.
[40] Cycle3 survey results from Interim Report III of the Trade and Transport Facilitation in South East Europe Program, February 11, 2004.

Figure 7.1 Payment of Bribes at Border Crossings
(Percent of trucks crossing borders)



Source: Cycle 3 survey conducted for TTFSE project

corruption at Customs will improve the competitiveness of these firms. It should be recognized, however, that other countries in the region have also been undertaking efforts to reduce corruption at the border. Therefore, to improve Moldova's competitiveness relative to these other countries, Moldova will have to continue striving to achieve results with its anti-corruption efforts. Reducing the range of tariff categories as well as simplifying customs rules and procedures will, in addition to reducing the administrative burden on Customs and the business community, also help reduce the scope for corruption at the border.

7.6 The current approach to fighting corruption, both through disciplinary measures undertaken by the Customs Administration itself as well as the intervention of the National Center for Combating Organized Crime and Corruption (NCCOCC), has had some success in reducing reported levels of corruption at the border. Experience in other countries has shown, however, that longer-term approaches to detecting and combating corruption will require, among other things, the reinforcement of internal auditing and the establishment of an ethics unit within Customs.

THE EFFICIENCY OF CUSTOMS REVENUE MOBILIZATION

While the efficiency with which Customs has collected revenues has increased significantly, performance lags other countries in the SEE region.

7.7 As noted in Chapter 4, Moldova has become increasingly dependent on the taxation of imports with the Customs Administration having the responsibility of collecting these revenues. In the last three years, the efficiency with which Customs has collected revenues has increased significantly. Revenues collected per customs staff has nearly doubled, as have trade volumes and the number of declarations processed. Even with these significant achievements, the efficiency of Moldova Customs lags behind other countries in the SEE region. (See Table 7.1). In 2003, the average number of declarations processed per Customs officer in the other countries of the SEE region was more than twice as large as Moldova. These other countries also managed to clear nearly three times the volume of trade and gathered over four times the amount of revenue per Customs officer as Moldova. The better performance of these other countries reflects, in part, the reform efforts made under the Trade and Transport Facilitation in Southeast Europe Program (TTFSE) project. These countries have been undertaking efforts to modernize their Customs services and aligning their performance standards with the European Union. Moldova joined the TTFSE project in 2003 and there is the expectation that by the end of the project implementation period (2006-2007) Moldova will have achieved performance levels similar to other countries in the region. Among the changes needed are reforms to current administrative and operational procedures, including the overwhelming focus on revenue mobilization.

Table 7.1. Productivity of Selected Regional Customs Administrations, 2003

	Moldova	Bulgaria	Macedonia	Romania	Serbia	Average SEE
Revenue/Staff (US$1,000s)	157	507	586	787	288	649
Trade Vol./Staff (US$1,000s)	1,577	5,156	3,101	10,251	3,945	4,370
Declarations/Staff	174	492	383	513	341	389

[a] Excluding Moldova. 2002 data for Albania, Bosnia, Croatia and Montenegro.
Source: Trade and Transportation Facilitation in Southeast Europe Project

REVENUE MOBILIZATION AND TRADE FACILITATION

Revenue goals can prove to be rigid and unrealistic, and often fail to take into account a range of relevant economic and trade factors.

7.8 While Customs has demonstrated its capacity to boost revenues, the strategy it has pursued includes the setting of ambitious revenue goals.[41] The Customs Department, in turn, has assigned specific revenue goals to each Customs office, thereby increasing pressure on local managers to increase revenues, sometimes without adequate analysis of the implications on the local economic and trade environment.

7.9 The experience of other countries suggests that such revenue goals can prove to be too rigid and unrealistic, and often fail to take into account a range of relevant economic and trade factors. As management in the field office comes under pressure to meet these goals, there is a tendency to set objectives for individual staff. As a result, there is a danger that the decision to control an import operation may be based not so much on the risk of fraud but on the potential for revenue collection that the importer represents. In addition, once monthly goals have been met, Customs officials are often under less pressure and therefore tend to relax their level of controls. Again, experience throughout the world suggests that the desire to meet revenue goals encourages staff to uplift values which, in turn, creates an incentive for importers to under-declare, thereby creating a self perpetuating cycle of non-compliance. Moreover, such an approach provides an incentive for importers to channel their imports through border stations known to have low revenue goals, thereby avoiding more stringent controls.

The marginal cost to society of Customs control mechanisms is very high.

7.10 Customs control mechanisms in Moldova are designed to increase collections on existing transactions. As discussed below, the application of risk management is still very limited and insufficient attention is paid to trade facilitation. The marginal cost of these control mechanisms to society, in terms of the additional lei collected, is very high (i.e., a high marginal cost of compliance). This higher cost is borne both by the business community and staff at the Customs Administration as they both struggle to deal with bureaucratic Customs procedures and regulations. Among the benefits of simplified Customs procedures would be the improved competitiveness of local firms and the increased efficiency of Customs.

AN OVERVIEW OF MOLDOVA'S CUSTOMS PROCEDURES

Customs tends to rely excessively on frequently changing documentary requirements with the results being inconsistent with the needs of a modern and competitive trade environment.

7.11 Moldova applies international standards for the movement and clearance of goods operating under a streamlined, EU compatible, Customs code that is, on paper, in compliance with the Kyoto convention on the harmonization of Customs procedures. Numerous surveys and discussions with a wide range of businesses suggest, however, that these standards are often interpreted in a restrictive manner. As this overview reveals, Customs tends to rely excessively on frequently changing documentary requirements with the results being inconsistent with the needs of a modern and competitive trade environment. In many cases, costs are incurred by the importer or exporter even before the goods reach the border crossing

Registration

7.12 All "Economic Agents" (i.e., intermediaries that are allowed to lodge declarations on the behalf of importer or exporters) must register with a Customs terminal. One of the major purposes of this registration process is to ensure that the importing/exporting companies are legitimate. The registration process consists in lodging with the appointed regional terminal at the time of the first import/export

[41] Customs management indicated these goals are essentially based on the previous year's performance. They do not appear to adequately take into account the changes in workload or commercial activity at the various Customs offices.

transaction up to 12 different documents. Although Economic Agents may change the terminal where they clear goods, such a change requires a special application, following which the initial terminal will issue the Economic Agent with a diskette with the registration information, together with a direct notification to the new Customs office. Changing the place of clearance for the importation of excise goods is not possible.

Confirmation

7.13 In addition to the registration process, importation can only take place if the Economic Agent (importer) has lodged a "Confirmation" form with the approved terminal, along with some 15 other additional documents. At this point, the Economic Agent must also calculate and make a pre-payment the amount of duty payable. The "Confirmation" is then accepted by Customs, and verified against the account of the Economic Agent. When the funds have been deposited into the Customs account, it is registered, and an electronic message is sent to the corresponding border crossing.[42] If an importer decides to change the border point of entry into Moldova, he must lodge a new "Confirmation" or make a written application to the originally planned border crossing. In cases when the importation does not take place, or if the quantity of goods shipped is below the quantity entered on the confirmation, it is difficult for the importer to claim an actual refund. Instead, the amout due to be refunded is usually used as pre-payment for a future operation. The processing of a "Confirmation", which has to go through the same steps as an import declaration less the actual physical examination of the imported goods, can take up to 45 minutes.

Border procedures

7.14 Although, as in many countries, final clearance of imported goods is expected to take place at the inland point of destination, there are several cases when goods must be cleared at the border. Physical persons, who import goods in excess of the EUR200 duty-free allowance, but under a maximum value of EUR500, can declare the goods themselves with a simplified declaration. Above that amount, a declaration must be lodged according to the commercial importation procedure. Cars and excise goods must also be declared at the border, and duty paid immediately. In addition to Customs and immigration control, entering trucks can be subject to road administration, ecological, veterinary, phyto-sanitary, and epidemiology procedures. In some instances, such as at the Leuseni border post, these operations have been conveniently consolidated under a single, Customs managed payment system, and all the agencies are located in the same hall, inside the cargo section of the border station. After payment has been made, vehicles are allowed to proceed.

Transit

Physical inspection of goods ranges between 90 and 100 of all income trucks.

7.15 Trucks under a border-to-border transit regime can be accompanied either by a "Transport International Routier" (TIR) carnet, or a specific Moldovan transit declaration, based on the Single Administrative Document (SAD) form.[43] When trucks arrive, local declarants prepare the transit documents (for which they charge a fee between MDL50 and 60 – approximately US$4.5). The entire transit declaration and

[42] When the border station does not have computer or fax equipment, the "Confirmation" is notified by telephone to the nearest office.

[43] As explained in Chapter 8, TIR Carnets are issued by the International Road Transport Union (IRU) of Geneva to national trucking associations in participating countries. Each association issues TIR Carnet to national carriers provided they meet the conditions and standards set forth by the IRU. The national associations also notify the IRU with the names of approved TIR carriers and provide the "TIR plate" which is placed on each authorized vehicle.

accompanying documents (invoice, Contract for the International Carriage of Goods by Road (CMR) consignment note) are then checked.[44] Although the authorities claim that the physical checks of the goods is minimal, surveys and discussions with a wide range of importers/truckers suggest between 90 and 100 percent of all incoming trucks are checked.[45] These checks can range from the simple verification of the seal to the full unloading of the trucks.

Inland clearance

7.16 Trucks must report to the inland clearance terminal within a period of 72 hours.[46] Import declarations are usually prepared by declarants (essentially clerical intermediaries), who charge a fee of US$4.5 for a simple declaration (completing a limited number of fields on the SAD form), plus US$1.8 for additional items on the SAD form. Inland clearance is based on a five-step process:

1. The declaration is submitted to Customs at the economic and financial control section, together with accompanying documents. Importers must submit up to nine documents, some of which have to be in original form. Customs officials check if the "Confirmation" was properly lodged, and the duty pre-paid.
2. A preliminary control takes place in the statistical section, where Customs ensure that all documents are attached, and in order. If there is a document missing, the declaration is returned.
3. The financial and economic control section checks all commercial documents, verifies the duty calculations, and ensures that the funds have been transferred to the Customs account. The value declared is then verified.
4. It is only after this stage that the declaration is registered, numbered, and becomes a legally binding document.
5. The cargo unit is in charge of the physical examination of the goods. In spite of claims to the contrary, it is likely that all shipments are subject to one form or another of physical examination. The importers report a rate of checking of at least 90 percent of all declarations lodged.

Box 7.1 Documentary requirements as specified by Order 384

Order 384 of October 24, 2003, was introduced to "increase the level of documentary control and preclude falsification of documents". It lists all the documents that must be attached to an import declaration, either in original form, or as a notarized copy (this latter requirement was later dropped in a trade facilitation effort). Three categories of documents can be identified:

- Documents that should always be produced in original to Customs: transport documents, invoices, licenses, and certificates of conformity and/or origin when applicable.

- Documents that in principle only need to be produced the first time an importer registers with Customs: statutes of the entity, specimen signatures, stamps, power of attorney. It is necessary to produce new specimens every time the situation of the entity changes.

- Documents that, in most other countries, would only be required if Customs had a reasonable doubt about the authenticity of a transaction, but which are apparently systematically required in Moldova: commercial contract, identity documents, technical specifications of the vehicle, banking certificates, certificate of expertise (issued by the Chamber of Commerce, this document certifies that the goods meet required conditions), proof of repatriation or transfer of funds.

All these documents must be registered by Customs, and entered in the paper file of the Economic Agent.

7.17 Goods can also be declared outside working hours, and can be inspected on the premises of importers, for a fee of Euro 20. This is a significant and positive trade facilitation measure, although the declarants still have to report to Customs, and proceed through all the documentary checks.

[44] A CMR Consignment Note ("Convention relative au contrat de transport international de Marchandises par Route".) is a transport document relating to carriage by road.
[45] See, for example, surveys undertaken for the TTFSE project.
[46] Most inland clearance locations operate between 8 AM and 5 PM, with a one-hour lunch break.

THE BURDEN OF CUSTOMS PROCEDURES

Delays in Clearing Customs

Among the important indirect border-related costs are those associated with delays in clearing the border.

7.18 Among the important indirect border-related costs are those associated with delays in clearing the border. Throughout Europe, the cost of a waiting truck is estimated at approximately US$15 per hour. Applying a simple rule of thumb, waiting one day to cross the border corresponds, on average, to an increase of one point in the customs tariff. A study carried out for the TTFSE in 2002 established a number of benchmark estimates of the average border entry waiting times (180 minutes at Leuseni and Cahul and 240 minutes at Palanka).[47] Import clearance times at the Inland terminal of Chisinau was 500 minutes. In 2003, a small survey carried out at the Leuseni border crossing showed that for most trucks (60 percent of the sample) the average clearance time was approximately 100 minutes. About 40 percent of the trucks waiting at the border, however, had arrived in the previous one to four days. Declines in border entry times have also been registered in other countries participating the TTFSE program. Border waiting times in these countries have declined significantly, from an average of 4 hours in 2001 to under 1 hour in 2003.[48] At a number of these border crossings, entry times have already fallen under 30 minutes.

7.19 In Moldova, border delays also have direct cost implications. All goods entering the country must be reported to an inland location within 72 hours. Failure to do so has an associated penalty ranging between 40 and 100 percent of the value of the goods.[49] Most of the offenses documented by Customs refer to this overtime reporting of goods.

The Effectiveness of Customs Procedures in Combating Fraud

While the intention of the Customs procedures is to control fraud, this objective is not being effectively achieved in Moldova

7.20 While the intention of the Customs procedures is to control fraud, this objective is not being effectively achieved in Moldova. Instead, complex procedures impose an unnecessary and costly burden on legitimate businesses. For example, the registration procedure, which must be regularly renewed, is unnecessarily bureaucratic, and the documentary requirements are burdensome. Most documents could be obtained directly by Customs, with less risk of forgery (e.g., bank certificate, or statistical registration numbers), so the procedure in place does not provide a guarantee of the genuineness of the Economic Agent. Similarly, the "Confirmation" procedure corresponds to a systematic advance clearance of the goods, although Customs have little means of verifying its elements.[50] As it is not a declaration, there are no grounds for prosecuting incorrect data it may contain. In effect, the "Confirmation" (i) provides dishonest importers with the possibility to test fraudulent data which they will enter subsequently on the declaration, (ii) delays clearance with no real benefit, and (iii) supports an unreasonable advance payment of duties which is not trade facilitating. Furthermore, the Economic Agents do not receive a copy of the Confirmations when they are accepted at the inland terminal, and although they are expected to be forwarded immediately to the border point, truck drivers report that these Confirmations often get "mislaid". Drivers must then contact the importers, who in turn have to visit the Customs house to ensure that the "Confirmation" is sent to the right destination. Since the timeliness of the

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[47] Under the agreed TTFSE program benchmarks, the average exit time at border crossing by the end of 2006 will be 20 minutes and the percentage of trucks examined will be reduced to 30 percent.
[48] Data is for the pilot sites under the TTFSE program.
[49] Under Article 231 of the Customs code.
[50] Advance payment systems can be offered to importers when they correspond to an accelerated release process. They should not be systematic.

confirmation is important, this situation may encourage "facilitation" payments by unscrupulous officials.

Despite the perception that fraud is widespread, detection of irregularities is rare.

7.21 Despite the perception that fraud is widespread, detection of irregularities is rare. In 2002, for example, 2,312 offense procedures were initiated throughout Moldova, which represents 2.3 percent of all import declarations, a figure usually encountered only in highly compliant countries. A review of these cases in a few Customs offices shows that: (i) most cases were due to reporting of goods after the 72 hour period, and (ii) a majority of cases are either abandoned or dismissed by headquarters, or (iii) annulled by Court decisions. Often, cases consist of a detection of minor smuggling (e.g., sugar hidden in a railway carriage), while the owner of the goods is never detected. Customs does make occasional detections of drugs, and are aware of their necessary involvement in fighting serious smuggling.

7.22 There is also a discrepancy between detections and reported cases. While local offices report a large number of irregularities, a majority of them do not seem to be followed up, because the cases are minor or formal, and prosecution is waived by headquarters. Of those that are taken to Court, an overwhelming majority are dismissed. Although it does not necessarily imply that Customs were not right, it provides an indication that judges may not have the necessary background knowledge of Customs issues to make informed decisions.

7.23 While improved performance, resulting from increased professionalism, can only start showing results after a period of time, immediate measures could be taken to (i) sensitize judges and other officials to Customs issues, (ii) improve the offense procedures to provide better guarantees to bona fide importers, and (iii) accelerate feedback mechanisms so that headquarters can make rapid rulings on abusive staff decisions.

Excessive Documentation and Repetitive Verifications

7.24 As already noted, documentary requirements in Moldova appear excessive and verifications are needlessly repetitive. The government recently issued an order (Order 384) that has institutionalized the requirement for documents that, in many EU countries, Customs might ask only under specific circumstances. Many of the documents that have to be submitted for each operation, such as the articles of association of the entity, have already been submitted by the Economic Agents when they first registered with Customs.

A single operation is subject to three consecutive checks.

7.25 A single operation is subject to three consecutive checks: (i) the "Confirmation", (ii) the transit declaration, and (iii) the import declaration. The first two steps refer to the same information as is entered on the import declaration, but they are not supported by the appropriate data (for example, the Confirmation describes the goods and their value, but it is not accompanied by an invoice, and does not show the tariff commodity code). However, they are checked and processed in the same way as the declaration. The transit declarations go through all the same steps as a declaration lodged for the clearance of the goods, and the requirement for accompanying documents is practically the same (in addition to the other documents, a photocopy of the passport and identity card of the driver, and the registration certificate of the vehicle, are required). This has no real effect, because the same data is verified three times using the same methods, and, sometimes, the same staff (in particular the "Confirmation" and the final declaration are usually checked by the same officials, removing the possibility of a double check on staff activities). Also, if a fraud is suspected, or even detected, on a "Confirmation" or a transit declaration, Customs cannot take action, because (i) the goods are not present when the "Confirmation" is lodged, (ii) there is no financial guarantee on the transit declaration, and (ii) legally, there cannot be a false declaration unless an import declaration has been lodged.

Risk Analysis

The need for more sophisticated risk profiling is well recognized. In the short-term a number of measures could be undertaken to improve trade facilitation.

7.26 Risk analysis, which allows for some selectivity in checks, is still in its infancy in Moldova. Customs has compiled a number of negative and positive lists that focus on, for example, high-risk goods and economic agents whose transactions need more careful examination, as well as Economic Agents whose high degree of credibility allows them to be subject to only documentary inspection. Despite this positive development, numerous routine examinations still take place with little results in detecting large-scale fraud to justify the burden and cost imposed on importers.

7.27 Both the TTFSE project and the Customs modernization strategy, endorsed by the Prime Minister, recognize the need for more sophisticated risk profiling. While the TTFSE project and its computerization dimension are gradually delivered, a number of short-term measures could be undertaken to improve trade facilitation. First, Customs should review all documentary requirements with a view to (i) obtaining the data directly from the source rather than impose this on Economic Agents, (ii) carry out regular checks on the validity of the information provided, and (iii) exempt companies that are considered as reliable from those documentary obligations. Customs should also consider abolishing the confirmation procedure, which does not seem to serve any purpose other than imposing advance payment of duties (which themselves contravene Moldova's obligations under the Kyoto Convention). Finally, Customs should begin to maintain a log of irregularities to identify suspicious Economic Agents, and introduce a basic form of selectivity essentially based largely on random selection of declarations; based on preliminary results, start preparing a more sophisticated data base. (The immediate result should be a reduction of 50 percent of the number of physical examinations).

Box 7.2 Best Practices in Risk Management

Risk management in Customs administrations resulted from two, quantitative and qualitative, aspects of controls:

- ?? Traffic was increasing so much that it was no longer possible to inspect everything;
- ?? Even if it had been possible to inspect everything, routine verifications would always be much less productive than those where there was a chance of making a detection.

This concept of risk management was first used for selecting declarations for further physical examination. This became known as selectivity. In a different approach, Customs started identifying individuals and vehicles which they wanted to have a closer look at. This became known as targeting. Both systems were backed by post release checks and investigations. Over time, the system evolved into a comprehensive strategy, destined to deploy resources where they were most needed. This is based on the assumptions that (i) Customs would never detect or prevent all frauds, (ii) a large number of importers would be compliant, therefore should not be submitted to the same level of controls as suspicious operators, and (iii) there is a cost for controls, both for the importers and the administration, so Customs should mainly (but not only) focus on more significant fraud.

All these points must be supported by an adequate organization, sufficient legal powers, inter-agency cooperation, and an effective penal system. IT support is necessary, but the logic of computerized risk management is not artificial intelligence, and risk management is only as good as the human inputs it requires.

Selectivity is based on the analysis of the elements of a declaration and accompanying documents, together with inputs from different data bases (record of offenders, list of goods that could be declared under different tariff headings carrying different levels of taxation, or implying different types of regulations, origins). Intelligence is also another source of information that completes the selectivity module. Elements of the declaration are compared against one another, and against the different data bases mentioned above. If there is an inconsistency, or a doubt as to the authenticity of what is declared, or a risk that a fraud could be committed by the importer, the Customs officer who is reviewing the declaration may want to inspect the consignment. (Typically, the physical inspection would take place if there was a doubt as to the real nature of the goods, or their quantity. Physical inspections are not usually necessary to check values, except in a few cases.)

Targeting relies more on the profile of the importer/driver/vehicle. It is essentially based on external intelligence, and does not depend as much as selectivity on a written import declaration (although transit documents, which include less data, can be used), but more on a pattern of behavior.

As a very broad rule, targeting would be used at a border post, and selectivity at a goods clearance location. Another rule is that operations (i.e., crossing the border, or declaring goods) that are not picked up for scrutiny will not be checked at all at this stage. Both selectivity and targeting also require a certain amount of purely random checks, to verify the validity of the current risk profiles and pick up declarations

Post clearance checks take place after the release of the goods. These take the form of desk reviews of declarations, with the possibility to ask the importers to provide further information and documentation. They may be supplemented by visits to the importers. These checks are not part of any criminal investigation process.

Investigations, which would normally take place on the premises of the importer, or any other agent involved with the imported goods, are destined to uncover criminal activities. They are usually triggered by the suspicion of fraud.

VALUATION OF IMPORTS

Valuation frauds are considered the major problem facing Moldovan Customs.

7.28 Valuation frauds are considered the major problem facing Moldovan Customs. As in many other transition countries, the Customs Administration had no culture of checking declared values in an environment of state-run foreign trade. The rapid emergence of small scale importers, combined with cross border "suitcase trade" thus generated an enormous workload for Customs, and created immediately opportunities for fraud and rent-seeking. The administration was viewed as incapable of controlling the large scale of revenue erosion that was taking place. At the urging of the IMF, a Pre-Shipment Inspection system (PSI) was introduced. The PSI contract, however, was suspended after being ruled unconstitutional by the Courts. With the expiration of the IMF program at the end of 2003, efforts to restore PSI operations in Moldova have ended.

Invoice checking

Invoice checking is repetitive and bureaucratic.

7.29 When the declarations are cleared at the inland terminal, the invoice verification essentially consists of adjusting the declared value to "minimum" price list, which is simply a quarterly computer generated average price list of previous imports (see Box 5.4). As with other documentary inspections, the invoice checking is repetitive and bureaucratic. The valuation unit in headquarters has neither the staffing, the skills nor training to provide proper advise to field staff. This prevents the valuation unit from concentrating on its core role, which is to seriously investigate major valuation cases, and handle the subsequent procedure in accordance with the principles of the WTO.

7.30 With the notable exception of the Balti terminal, where an ad hoc committee of experts has been established to make initial valuation rulings in cases of disputes between the importer and the administration, most valuation disputes result in freezing the process of clearing the imports in question. Economic Agents can then ask for conditional release, granted if they deposit the assessed difference in duty. This deposit is eventually released if the local valuation decision is overruled by Customs headquarters or a court decision.

7.31 Although Moldova, as a member of the WTO, has adhered to the Agreement on Customs Values (ACV) of the Uruguay round, which explicitly prohibits the use of

The use of minimum price lists or the application of domestic market sale values are the major sources of valuation rulings made in Moldova.

minimum price lists or the application of domestic market sale values, these two elements are the major sources of valuation rulings made in the country. Valuation cases that are appealed are often rejected either by Customs headquarters, or by Court decisions. The fact that only a few cases are actually taken to Court is probably an indication that, in most instances, importers come to an "informal agreement" with dishonest local officials, thus further discrediting the current valuation system.

7.32 Reforms to improve valuation methods will take some time to fully implement. The TTFSE project incorporates a large capacity building component designed to improve the organization of valuation checks. Customs officials have already received extensive training in valuation issues, and the critical aspect is now the introduction of well-staffed structures and adequate mechanisms to carry out serious valuation control. While these reforms are being implemented, the following actions should be taken: reinforce substantially the valuation unit in headquarters and focus valuation training on its members. Establish communications with the industry and importers to assess realistic values for major commodities, as part of an initial valuation investigation process.

Box 7.3 Minimum price list

The minimum price list, also known as an "orientation price list", is compiled from statistical data from previous imports, and consists of a quarterly average price. It is arranged according to the Harmonized System nomenclature. The major setbacks of this method are:

- The nomenclature cannot distinguish between brands that often have very different unit prices – for example, watches can be cheap or very expensive – therefore an average price is often meaningless.
- The averaging of past values inevitably incorporates under valued imports, thus dragging downwards the minimum prices.
- The use of a minimum price list does not consider technological innovation, and its impact on the manufacturing process.

CHAPTER 8. TRANSPORTATION AND LOGISTICS: HIGH COST IMPEDES ACCESS TO KEY MARKETS

INTRODUCTION

High transport costs are a barrier to growth, FDI and trade.

8.1 The cost and quality of transport and logistic services matter for trade competitiveness. As cross-country evidence suggests, even if tariff and non-tariff barriers to trade are substantially liberalized, the penalty of high transportation costs has a negative impact on growth rates and income of countries with poor international transport links. Confronted with high freight and logistic costs, Moldovan exporters must either pay lower wages to its workers, accept lower profits or increase productivity. The pressure on factor prices and productivity is even greater for firms with a high share of imported inputs. A small difference in transport costs can easily determine whether export ventures are at all profitable. Countries with higher transport are less likely to attract FDI and, since FDI is often a key channel of international knowledge and technology diffusion, these higher costs may lead an economy to be further removed from the world technology frontier and impede its rate of productivity growth.[51]

High transport costs have an impact on ability of Moldova to redirect its trade towards the EU.

8.2 Transport costs also have an impact on a country's selection of trading partners. If export markets largely consist of poor, slow-growing economies and there are significant costs (including transportation) of switching to richer, and faster growing markets, countries may be constrained in their export growth potential. For Moldova, the difficulty in redirect exports towards the richer and large EU market reflects, in part, these high switching costs.

8.3 The cost structure of firms is also affected by the quality of transport services. If services are unreliable and infrequent, or if a country lacks logistics providers who can operate efficiently, firms are likely to maintain higher inventory holdings at every stage of the production chain. Firms may also want to hold high inventories if they need to limit the risk for frequent changes in customs regulations, exchange rates or product prices.

AN OVERVIEW OF MOLDOVA'S TRANSPORT INFRASTRUCTURE

8.4 **Road**. The total length of roads in Moldova amounts to 10,351 km (excluding farm tracks and minor roads), of which 64 km are four-lane roads. Most local transport and approximately 80 percent of passenger travel is by road. The major part of the road network (7,361 km) is under local responsibility, with the remainder (3,170 km) under national supervision. As shown in Table 8.1, Moldova's road network density -- 31 km per 100 km^2 – compares favorably with other countries in the region. The density of paved roads and motor vehicle ownership in relation to population is, however, much lower.

[51] Controlling for a large number of socioeconomic, geographic, and institutional factors, Radelet, Steve, and Sachs, J. Shipping Costs, Manufactured Exports, and Economic Growth, Presented at the American Economics Association annual meeting, January 1998, found that developing countries with lower shipping costs experienced more rapid growth of manufacturing exports relative to GDP in the period from 1965 to 1990. In addition, when exploring the relationship between shipping costs and overall economic growth across economies, the study concludes that a doubling of the cost of transportation is associated with slower annual growth of slightly more than one-half of a percentage point.

8.5 **Rail**. Moldova's rail network is 1,153 km long and is the principal means of transport by volume. Railway rolling stock is antiquated, the railway tracks are wide (Russian) gauge and is not electrified. The main 222 km line is double-tracked. The major destinations for eastbound rail transport are the Ukrainian and Russian markets. Rail network density is 3.4 km per 100 km^2, which is on par with a number of neighboring and EU Accession countries.

Table 8.1. Rail, Road and Motor Vehicle Densities in Selected Countries.

	Road density km per 100 km2	**Paved road density** km per million population	**Motor vehicle density** vehicles per 1000 people	**Rail density** km per 100 km2
Moldova	**31.5**	**2,412**	**49**	**3.4**
Germany	64.7	7,895	529	11.4
Estonia	91.8	5,291	350	2.3
Latvia	88.3	8,994	214	3.7
Lithuania	104.4	14,348	265	3.1
Poland	74.2	6,336	262	7.8
Hungary	32.5	6,698	262	8.3
Bulgaria	30.6	3,854	239	3.9
Romania	30.7	3,421	135	4.8
Russia	3.3	5,087	153	0.5
Belarus	24.2	5,012	109	2.7

Source: World Bank, World Development Indicators

8.6 **Air and Sea.** Moldova has four airfields, but only Chisinau serves international connections. It has about 250,000 passengers and less than 2,000 tons of cargo per year and, as such, is considered a small volume airport. The airport uses less than 20 percent of its capacity, which is a low figure, but not uncommon among major Eastern European airports. Moldova's shoreline consists of a 900-meter wide frontage on the Danube River. A project to develop a port at Giurgiulesti was started in 1995 with EBRD funding. The project stalled, however, when the EBRD withdrew from the project. While the port is currently operational, its quays require major reconstruction and re-equipping. The port's terminals also need to be finished and access roads need to be built. The major rivers, Nistru and Prut, are used for domestic and local transport – mainly barges and small ships. Inland waterways account for less than 1 percent of goods and passenger transport.

THE IMPACT OF POOR QUALITY TRANSPORT INFRASTRUCTURE

Moldova's existing transport infrastructure, albeit extensive, has been poorly maintained.

8.7 Moldova's existing transport infrastructure, albeit extensive, has been poorly maintained and no infrastructure has been added to address the needs associated with changing trade patterns. In rapidly developing countries in transition, transport and telecommunications infrastructure investment may be 8-10 percent of GDP. In Moldova, this share is less than 3 percent, most of which is in the telecommunications sector. Systematic road maintenance has a high positive impact on road users. Technical publications often cite the statistic that for every US$1 a developing country spends on road maintenance, road users save US$3.[52] Heavy trucks and buses benefit most from proper maintenance, but private car users also benefit from reduced accidents and damages, as well as reduced travel times.[53]

Ongoing road maintenance, rehabilitation and construction efforts have been insufficient to upgrade the road network to adequate levels.

8.8 Ongoing road maintenance, rehabilitation and construction efforts have been insufficient to upgrade the road network to adequate levels. There is a considerable backlog of transport infrastructure finance. Between 1995-2002, an average of US$5.5 million,

[52] In road projects in developing countries, Vehicle Operating Cost (VOC) savings usually bring the major economic benefit (60 to 80 percent), followed by travel time savings (10 to 20 percent), accident cost savings (5 to 10 percent), and other savings, such as local road component (2 to 5 percent).
[53] Vehicle Operating Cost (VOC) of heavy trucks and buses on poor roads is often double that on good roads, when the quality of road is measured by International Road Roughness Indicator (IRI).

or around 0.3 percent of GDP, was spent each year on road construction, repair and maintenance.[54] Funds suggested in National Road Program for 2005-2010 cover only small sections of the road network and the availability of funds is uncertain. Moldova's road funds should be at or above 1 percent of GDP, or US$16 million for the coming years. This would enable road rehabilitation of the main arteries, and gradually the rehabilitation of secondary roads.

Improving road quality can yield substantial benefits to road users by reducing vehicle operating costs.

8.9 The major roads leading from Chisinau and Balti eastwards and westwards have satisfactory capacity for long-distance road transport. As a result of limited funding for road maintenance, the condition of the road infrastructure on these roads is poor to modest while the majority of the secondary roads are in poor conditions. The generally poor condition of Moldovan roads imposes a substantial cost on the economy. Table 8.2 gives a rough estimate of the impact of reduced vehicle operating costs in Moldova, assuming that all traffic moved on good roads instead of poor ones. The benefits of upgrading road quality are estimated roughly at US$100 million for all vehicle types per year. Of course, not all traffic in Moldova travels exclusively on poor quality roads, hence the expected savings of improving road quality in Moldova is likely to be more modest -- closer to US$20 to 25 million. These savings can be contrasted to the US$5million that Moldova has used in road construction and maintenance. To achieve these savings, there is a need for better road management and financing systems with a particular emphasis on road maintenance. This requires: (i) the State Road Administration to strengthen its procedures for planning and budgeting road expenditures and assessing priorities for road maintenance; (ii) a transparent road fund, for both national and local networks, be established to provide a stable source of funds for road maintenance; and, (iii) development of a multi-annual performance-based maintenance contracts.

Table 8.2. Estimated Vehicle Operating Costs in Moldova

Vehicle Type	VOC, Road in Good Condition	VOC, Road in Poor Condition	Estimated Number of vehicles	Average mileage per vehicle (estimate)	Estimated total mileage of vehicles	Difference in VOC between poor and good roads
	US$/Vehicle Km		Vehicles	Km per year	Million km	US$ million
Cars	0.06	0.08	150,000	7,000	1,050	21
Light Trucks	0.10	0.18	20,000	20,000	400	32
Heavy Trucks	0.22	0.33	4,000	70,000	280	31
Buses	0.28	0.40	3,000	45,000	135	16
Total						100

The classification of "Good" and "poor" roads refersto the International Road Roughness Indicator (IRI) values. The estimate is based on average cost per vehicle kilometers adjusted to Moldovan fleet and cost structure in poor vs. good roads and on estimated data on vehicle kilometers in Moldova. "*The Role of HDM-4 in Highway Management*". Fourth International Conference on Managing Pavements. Durbin. South Africa.

8.10 Moldova's railway rolling stock is antiquated. Most engines are old and run on diesel fuel which hampers winter operation. Wagons are often of poor quality and complaints about theft during transit are common. Nevertheless, measured in ton-

[54] By comparison, in Estonia, Latvia and Romania, road funding is approximately 1.0 percent of GDP, while in Lithuania, the funding of roads was on average 1.4 percent of GDP in 1995-2002.

Rail transport is the principal means of transport in domestic traffic and in trade with CIS-countries.

kilometers, rail transport is the principal means of transport in domestic traffic and in trade with CIS-countries. As shown in Table 8.3, transit transport constitutes the bulk of volume and transport work performed by Moldovan railways (CFM). Because of the different rail gauge and complicated connections, rail transport is not used in western traffic. Moldovan railways are operated integrally with Transnistria which affect CFM's possibility to maintain its schedules, and involves additional transit costs. The authorities in Transnistria have been known to temporarily blocked the border for export and import freight.

Domestic rail transport is heavily subsidized while high tariffs impede the export of commodities that are suitable for rail transport.

Table 8.3 Distribution of Cargo Traffic by Rail

	Domestic	Export	Import	Transit
Percent of tonnage	7	20	28	45
Percent of ton-km	5	10	17	68
Revenues (US$ million)	1.0	14.8	12.3	28.1
Costs (US$ million)	8.5	10.6	2.1	21.1
US$ per tonkm	0.010	0.072	0.035	0.020

Source: NEA Synthesis Report, 2002

8.11 While initial efforts to restruture the national railways have been positive, many shippers complain about high export freights. While the average freight revenue is US$0.0275 per tonkm and the average cost about US$0.021 per tonkm, the four market segments have large variations from these averages.[55] Revenue on domestic cargoes is about half of CFM's average cost. Import freight rate is 1.5 times the average cost, whereas transit freights equate the average cost. Export freights are over 3.4 times higher than this average cost. Thus while domestic freights are heavily subsidized, CFM is extensively utilizing its monopoly status to raise the cost of rail shipments for exporters. In import, or, in particular, transit traffic, CFM has less influence on total costs because much of the total transport takes place outside Moldova. The high cost of rail freight rate impedes trade as Moldovan export commodities that utilize rail transport have few alternative means of transport. While it is difficult to quantify this transport inelasticity, simple cost comparisons show that road freight to, for example, Moscow is cheaper. Nevertheless, more than 1 million tons is transported annually to Moscow by rail.

MOLDOVA'S UNDERDEVELOPED TRANSPORTATION AND LOGISTICS SECTOR

8.12 The Moldovan logistics market is still in an early stage of development. Freight forwarding, warehousing and other logistics-related services have been privatized almost entirely in Moldova. Compared to international standards, however, the range of services offered is narrow and the quality of these services (such as reliability, on time deliveries and timely information) is often low. The supply is generally limited to basic transport services, and there are no third party logistics providers offering extensive logistics services. Most domestic firms offer transport services in only one transport mode. There are no domestic logistics operators capable of offering a wide variety of transport, cargo handling and related information services that are commonplace in more developed markets. None of the major European freight forwarding firms have established their own operations in Moldova, citing the small size of the market, and that reliable and cost-efficient logistics solutions are difficult to arrange due to unpredictable public administration procedures and often corrupt practices.

8.13 The institutional or legal barriers for road transport operators to enter the domestic market are very low. Operators from Hungary, Romania and EU have a strong position in the Western market, and operators from Ukraine and Russia have a very

[55] This figure is derived using total freight revenue (US$56.3 million) divided by the paid freighttraffic (2,049 million tonkm).

strong position in the Eastern market. Entering the market for international haulage is difficult due to strong positions of incumbents. The shortage of road permits (discussed below) and the capital requirements – particularly for operations in the western market – also poses a problem.

Box 8.1 Logistics considerations in Apparel and textile industry

Exports of textiles and apparel reached over US$118 million in 2002, almost exclusively with EU countries. Up to 80 percent of the industry's input materials are imported from EU countries, as Moldovan producers sell only production capacity. The only means of competition is the price and, in more fashionable apparel, time to customers. Thus, the industry relies heavily on dependable and affordable transport.

Transport services are either bought by customers, or the Moldovan producers have their own trucks. A number of firms feel that the delivery reliability of own transport is much higher and transport costs are 20-30 percent lower than if transport was bought from Moldovan carriers. Because of the relatively wide range of value for apparel and textile, the share of transport cost also varies a lot from item to item. Free on Board (FOB) value of a truckload of lingerie can exceed US$300,000, whereas a truckload of carpets may well be under US$30,000. As a consequence, direct transport costs can be below 1 percent (lingerie) to well over 10 percent (carpets).

High-valued items are less sensitive to freight costs. Instead, transit time and on-time deliveries, and the related inventory carrying costs and sales planning considerations become important variables. For this reason, the predictability of customs clearance and border crossing time becomes very important.

Moldova's closeness to the EU market is an asset in apparel trade as short lead-times are sought by the customers, but due to customs procedures and border crossings, total delivery time varies by several days. Producers using their own trucks also face the problem of obtaining visas for the drivers.

8.14 The Moldovan trucking industry comprises three types of operator: (i) operators with multilateral permits to operate in European trade; (ii) operators with aging equipment engaged in CIS and non-EU trade using bilateral permits; and, (iii) operators with old equipment operating solely in the local domestic market. Overcapacity is persistent especially in the two latter groups and, despite the low operational costs, profitability is poor. The lack of trucks that maximize the number of available permits effectively hinders Moldova's trucking industry from benefiting from this cost advantage.

The high share of "own account" transport in Moldova reflects the low quality of services available in that market.

8.15 Nearly 40 percent of Moldovan firms use "own account" transport. In the more developed transport and logistics markets, this percentage of own account transport is substantially lower. For example, in the UK the percentage of own account transport is under 10 percent while in the Nordic countries it is under 15 percent and in Latvia it is around 25 percent. Moldova's high share reflects the low quality of services available in the market and the low initial investment in own equipment and transport staff. Own trucks and drivers are frequently cited as giving much more flexibility in transport operations than bought services. It also compensates the need for transport insurance – which is reportedly relatively costly and unreliable in Moldova -- when using commercial carriers. In domestic transport or distribution, it is even more common to have own transport equipment, since the availability of domestic distribution services is very low, and the reliability is also low. Moldova is also a relatively small country by area, which facilitates having own equipment for domestic operations. However, the demand for domestic distribution is low, because there are no country-wide retail operations – mainly due to the very low purchasing power and consumption.

Moldovan trucking firms have the lowest operational costs in international transport in Europe.

8.16 Moldovan trucking firms have the lowest operational costs in international transport in Europe (Table 8.4). The impact of wage levels is substantial to trucking firms' cost competitiveness. Cost and expenses of the driver from a EU country is 30-35 percent of operating costs of a 20-ton rig, and for a driver from Eastern Europe 14 -16 percent of costs. A Moldovan driver, on the other hand, costs around 10 percent of operating costs. Interest costs as well as the cost of insurance taxes, tolls and licenses are, on the other hand, more expensive in Moldova than in CEE and EU countries.

Table 8.4 Annual cost of operating a 20 ton truck in international traffic for 200,000 km per year
(€1,000)

	Moldova	Baltic average	CEE average	EU average
Personnel	6.4	12.2	16.0	56.6
Depreciation	14.0	14.9	16.2	11.5
Tax/toll/licenses	10.6	7.0	4.1	2.4
Insurance	3.6	2.2	2.4	3.0
Interest	7.0	2.6	3.2	3.6
Fuel	18.0	21.9	18.6	21.7
Tires	3.0	2.4	1.2	1.8
Repair/Maintenance	3.0	1.8	2.1	4.8
Other	3.4	15.6	16.2	15.6
Total	69.0	80.6	80.0	121.0

Sources: IRU and staff interviews.
Note: Figures do not include overhead costs as they vary significantly from one firm to the next.

VEHICLE QUALITY AND PERMITS

The shift to higher standard vehicles has hindered the ability of Moldovan carriers to enter the EU market.

8.17 The shift to higher standard vehicles in other countries reduces the absolute cost benefit of Moldova, and will effectively hinder Moldovan carriers to enter the EU or EU Accession countries' markets unless they upgrade their fleets. The rapid fleet renewal in neighboring countries to meet higher EURO-standards has mostly been financed with leasing arrangements. Leasing is, however, seldom used in Moldova. Moldovan trucking firms have been reluctant to have fixed monthly leasing hires based on the currently high interest rate. Instead, they prefer to buy new equipment with equity. As a result, the Moldovan carriers tend to treat capital costs as "sunk cost" which leads to the selling of road transport services under production costs, thereby further decapitalizing these firms.

8.18 The ability of Moldovan road transport firms to operate international depends on active participation in European Conference of Ministers of Transport (ECMT)[56] This organization issues multilateral transport permits covering the region in which Moldovan trucks operate. The actual number of ECMT permits issued is a function of the vehicles' environmental class, known as EURO-0, 1, 2 or 3, where EURO 0 is the least environmentally friendly category, and EURO-3 is the "best" category.[57] The higher the vehicle standard, the larger the actual number of multilateral and bilateral permits available. Together with bilateral agreements, these permits effectively limit the scope of Moldovan road carriers' cost advantage. These increasing technical requirements – mainly advocated by EU countries – effectively regulate the number of permits for all European carriers – including those in Moldova. The root problem of the small number of permits available to Moldova is its aging truck fleet. This understandably causes a lot of complaints by carriers towards the permit issuing national control authority, the Moldovan Agency for International Road Transportation or AMTAI -- a separate authority under the Ministry of Transportation and Communications. The issuance of the scarce permits nationally has created a grey market for the permits and may have initiated certain corrupt practices.

[56] CEMT/ECMT (European Conference of Ministers of Transport; organized under the Organization for Economic Cooperation and Development) comprises practically all European, and almost all CIS countries (Armenia is an observer).
[57] EURO-4 class will be effective on June 1, 2005.

8.19 As of 2003, there were no EURO 3 trucks registered in Moldova and the number of EURO-2 vehicles remains small. On the other hand, the shift to EURO-3 standard trucks has been rapid in all EU Accession countries. In Table 8.5, the evolution of the Moldovan and Latvian truck fleet is compared. Latvia has experienced a substantial increase in the percent of its trucking fleet that complies with the EURO-3 standards. The Moldovan trucking fleet still remains mostly comprised of vehicles compliant with the older EURO-0 standard. The number of permits issued to national road haulage firms is a function of the truck class. In 2003, Moldova received 128 multilateral basic permits, and additional permits for "Greener" (i.e. EURO-1) and "Greener and safer" (i.e. EURO-2) trucks. Because it has fewer higher-standard trucks, the total number of available permits is lower than in countries with more modern fleets.

Table 8.5 A Comparison of the Compliance of the Moldovan and Latvian Truck Fleets (in percent)

Truck class	Latvia		Moldova	
	2000	2002	2000	2002
EURO-0	73	47	95	89
EURO-1	7	8	3	3
EURO-2	20	23	2	8
EURO-3	0	22	0	0
Total no. of trucks	5,366	5,543	4,500	4,300

Source: Latvija Auto and AITA

More competitive ways of financing, such as leasing, will be needed if Moldova is to rapidly upgrade its trucking fleet to Euro standards.

8.20 The only way for Moldovan carriers to get a larger share of the highly competitive European road haulage market is to upgrade the trucking fleet so that it complies with higher technical standards. This means removing obstacles to investment in new equipment. While declining real interest rates will help, more competitive ways of finance, such as leasing and foreign loans, need to complement the excessive use of equity finance. The financial market needs to develop its financing instruments and the taxation law needs to be revised so as to not discriminate against the use of leasing.

8.21 Unlike the ECMT, bilateral permits are negotiated so that the two countries get an equal number of permits. They come in five types: universal, bilateral, transit only, bilateral and transit, and permits between third countries. Since Moldovan carriers have the lowest operations costs in Europe, their permits are likely to be used first. If the issuing country is a high cost country, some permits for carriers in this country may also be left unused. This has been the case, for example, with Finland and Russia, where all Russian permits are used well before the year-ends, while part of the Finnish quota may be left unused. Ninety percent of all universal permits to Moldova have been given by EU countries. Road carrier associations in EU countries watch their Governments very closely so that low-cost countries, such as Moldova, do not get permits too easily.

8.22 In addition to the permit to enter the country, countries may charge user fees. In Ukraine, this is US$0.2 cents/km, and in Belarus it is US$80 for a vehicle of 15-24 tons, and US$80 for vehicles over 24 tons. In Ukraine, most bilateral permits (8,000 out of the total of 10,000) are exempted from this road user fee. It is also possible to enter Ukraine without a permit, but such trucks will be charged US$380 just for entering or transiting the country. This fee comes on top of all other fees and payments, and it is very high compared to regular freights in that trade.

8.23 In general, road haulage firms want to avoid crossing Ukraine because of severe problems with unofficial payments. These tend to be problematic in the Czech Republic, Slovakia and Hungary too, but no unofficial fees were reported inside EU countries. Based on interviews in March 2003, unofficial fees on a roundtrip from Moldova to Germany, Austria or Italy amount to approx. 150 euros, and approx. 200-300 euros while transiting Ukraine. The indications on unofficial payments are in line with the data obtained in the larger survey on border crossing problems conducted by The World Bank in 2001 and 2002. With 42 respondents in 2002, the average for all nine border-crossing points was 72.8 euros per crossing. The 19 transport firm respondents' average was 77.5 euros per crossing. These payments are high when compared to information on unofficial payments in neighboring SEE countries, but payments may be higher in e.g. Ukraine and Belarus. Border crossing times in Moldova are also considerably higher than those in the SEE countries. [58]

Box 8.2 Logistics and Moldova's Future in Electronics Assembly

Electronics subcontracting or contract manufacturing (CM) is not yet an established industry in Moldova, unlike, for example, in Hungary, Romania and Estonia, which have witnessed a rapid growth in electronics FDI. Given the closeness to EU and low labor costs, Moldova has substantial potential to host such operations. Some of the main impediments that Moldova faces in attracting this type of activity are addressed below.

About 70 percent of electronics CM is in China, with a large concentration of component manufacturers in that region. The products range from home electronics and telecommunications equipments to industrial equipment. Unit labor costs are low in China, but they are even lower in, for example, Brazil and Moldova.

In electronics most components are sourced from East Asia. Reliable deliveries are essential, because of rapid changes in demand. A typical supply chain from components to finished products involves several parties, which further amplify the changes, and escalate the inventory problem. Furthermore, most components and finished products have substantial price erosion, i.e. their market value decreases quickly.

In electronics CM, the value of direct material (i.e. components or sub-assemblies) is 60 to 70 percent of the value of the finished product. The cost of production lines and testing equipment are often 20 to 30 percent of the total cost. Costs are directly related to capacity utilization, which seldom exceeds 90 percent. The share of labor costs in electronics CM is typically 5 to 10 percent of total costs. It means that cheap labor in itself is not sufficient to attract this type of production. Labor productivity is a key issue, and here Moldova has a clear advantage with is fairly skilled workforce.

Currently, global electronics industry is facing low demand, and firms are struggling to keep their capacity utilization on a bearable level. Despite – or perhaps because of - this, the industry is constantly looking for new sites and regions to combine access to market with low costs and high productivity. Moldova could provide some of these benefits. There are, however, severe trade and customs impediments on import affecting timely sourcing and on export affecting reliable distribution. The currently low quality of transport and logistics services, poor transport infrastructure and a high country risk rating make it difficult to promote Moldova as a location for FDI. Reducing the time for border crossing time and trade formalities, as has been done in EU Accession countries, could quickly change the situation.

8.24 The availability of transport permits is a key issue determining the operational range of Moldovan trucking firms. According to AMTAI statistics collected at the border stations, 90,800 trucks in international traffic either entered or exited Moldova in 2002. Ninety-four percent of that traffic involves nine countries: Russia, Romania, Italy, Ukraine, Germany, Belarus, Greece, Bulgaria and Turkey. Roughly 2/3, or 13,750 out of the total 22,700 Moldovan truck movements in international traffic are either import to or export from Moldova. The single most important trades are from Russia to Moldova (1,607 movements), and from Moldova to Romania (1,247). The remaining 1/3 of truck movements take place in transport between third countries, typically serving CIS countries' foreign trade.

8.25 This illustrates clearly the competitive region for Moldovan trucking firms: Italy and Germany are the only substantial EU markets served. The number of trucks operating there is effectively limited by the ECMT or bilateral permits. Import and export traffic to EU countries is almost in balance, which means that all available permits are used. Romania, Bulgaria and Ukraine are large markets, especially for incoming goods. 1,600 Moldovan truck movements took place in export to Russia but only 450 movements took cargo form Russia to Moldova. For Moldovan exporters this increases transport costs,

[58] See, for example, PlanConsult's Interim Report I for the TTFSE program

since trucks come back empty, but importers buying goods from Russia that can be transported by road can bargain low freights.

8.26 Data on freight revenue shows a similar pattern. Freight revenue of Moldovan trucking firms in international traffic was US$26.8 million in 2002. Fifty-seven percent of it came from trade to or from Moldova and 43 percent came from traffic between third countries, typically between Russia, Turkey, Greece and Romania. Tellingly, only 28 percent of total revenue came from traffic involving a EU country as the country of origin or destination. This is fairly close to Moldova's trade pattern with the EU.

ESTIMATING TRANSPORT AND LOGISTICS COSTS IN MOLDOVA TRADE

8.27 Transport cost is usually not the most important logistics consideration for perishable items, goods with high unit value, or for intermediate goods used in industrial processes. Transport reliability rather than cost is increasingly more important for buyers. With increasing cargo value, transport speed is an important issue, especially when distances grow. In this context, delays in border crossing become important. While total border crossing waiting time is usually around 5 to 15 percent of total transport time in import and export of Romania, Bulgaria, Bosnia & Herzegovina, and between 20 to 40 percent in Albania, it tends to be between 30 to 50 percent in Moldova in comparable cases.[59]

8.28 Just-in-time producers require reliable deliveries of input materials -- be it apple juice concentrate or components. Electronic and mechanical assembly relies on accurate inbound shipments of components, careful inventory management practices and dependable deliveries of finished goods. Garments and apparel are highly time-sensitive products. Most packaged food is distributed by retail chains using efficient customer response requiring reliable deliveries too. High transport and handling costs are a key impediment to trade for most raw materials and commodities such as chemicals, fertilizers, grain and petroleum products.

8.29 Over four-fifths of Moldova's exports and two-thirds of its imports comprise time sensitive goods (Table 8.6). The share of time-sensitive trade has risen since 1995. Time-sensitive trade especially with non-CIS countries, which is mainly trade with EU and EU Accession countries, has risen dramatically and this trend is likely to continue. Similar phenomenon has also taken place in other South European countries. It also means that the problems in western trade are different

Table 8.6 Sensitivity of Trade to Transport Cost and Time

	1995	1997	1999	2000	2001	2002
Exports (percent of total exports)						
Cost Sensitive a/						
CIS	25	33	28	31	34	30
Non-CIS	5	3	3	2	1	1
Time Sensitive b/						
CIS	38	36	27	27	27	25
Non-CIS	33	27	43	39	38	42
Imports (percent of total imports)						
Cost Sensitive c/						
CIS	47	35	32	24	25	25
Non-CIS	8	11	16	20	13	12
Time Sensitive d/						
CIS	20	15	9	9	13	14
Non-CIS	24	39	42	47	49	50

a/ Alcoholic beverages
b/ Apparel, manufactures, food, other
c/ Energy, chemicals, fertilizers
d/ Food, manufactures, machinery, other
Source: UN Comtrade database.

[59] PlanConsult (2002) TTFSE Interim report analyzed border crossing times of road-based import and export between the capitals of SEE countries and cities such as Rome, Berlin, Istanbul, Belgrade, Ljubljana.

from those in CIS trade. Border delays or time-consuming documentary practices severely affect the trade of such items. It makes imported items unnecessarily costly, forces firms to run inventories at a much higher level than in competitor countries, and hampers the competitiveness of Moldovan exporters selling goods that face intense competition from other low-cost countries.

8.30 Based on AITA statistics on the movements of its member firms' vehicles in international transport, the following calculation can be done using indicative freights for each trade. AITA members' combined revenue is estimated at US$26.8 million. Fifty-seven percent or US$15.2 million of this was generated in Moldovan imports and exports, while the remainder was generated in traffic between third countries. According to the estimate in Table 8.7, the total transport cost for Moldovan imports and exports was around US$125 million in 2002, or 6.9 percent of the estimated trade volume in 2002. This comprises freight costs only. The comparable figure for EU Accession countries is between 4 to 5 percent.

Table 8.7 Estimated Freight Revenue in Foreign Trade
(Millions of US$)

	Import	**Export**	**Total**
Road freight (AITA)	8.5	6.7	15.2
Rail freight CFM (excl. transit)	12.3	14.8	27.1
Estimated Air Moldova	0.5	0.5	1
Domestic distribution of trade	10	5	13
Total Moldovan carriers	31.3	27	58.3
Estimated foreign road carriers	15	15	30
Estimated foreign rail carriers	30	6	36
Estimated foreign airlines	0.5	0.5	1
Total foreign carriers	45.5	21.5	67
Transport costs total (2002)	76.8	48.5	125.3
Value of trade in (2002, est.)	1100	710	1810
Transport cost of trade in percent	7.0	6.8	6.9

Source: AITA, CFM, AirMoldova and UN Comtrade database.

8.31 Idle time spent while crossing the Moldovan border is a considerable burden that raises the total transport costs of trade. Reducing border-crossing time to 3 hours per truck – the average in neighboring countries according to recent TTFSE data - could reduce the total freight cost by approximately US$20 million per year. This value is arrived at using the data on trucks that crossed Moldova's borders in 2002 and the estimated average waiting times reported in a number of surveys.

8.32 Apart from pure transport costs (freight), logistics costs comprise a large group of direct and indirect costs (see Table 8.8).[60] Logistics management is a trade-off between a number of purchasing, production, distribution and marketing considerations. Integration of logistics activities between suppliers

Table 8.8 A Typology of Total Direct and Indirect Logistics Costs

	Direct Logistics Costs	Indirect Logistics Costs
Overhead or Alternative Costs	Inventory carrying costs Value of time Operational IT costs	Cost of lost sales Customer Service level costs Obsolescence costs IT maintenance
Function-related	Transport cost (freight) Cargo handling Warehouse/storage Fairway fees Documentation Telecommunications costs	Packaging IT costs (personnel) Cost of Capital in logistics equipment Administration

[60] In EU countries, measurable logistics costs in manufacturing are usually less than 10 percent of sales. Freight is usually only 1/3 of these costs. For high-valued merchandise, such as electronic equipment, freight costs may be one percent of sales or less, whereas other logistics costs are more significant. For low-valued commodities transported over long distances, freight alone can make 50 percent or more of the sales price.

and buyers, and shortening the response time from customer orders to deliveries along the chain is often called Supply Chain Management.

8.33 Apart from pure transport costs (freight), logistics costs comprise a large group of direct and indirect costs (see Table 8.8).[61] Logistics management is a trade-off between a number of purchasing, production, distribution and marketing considerations. Integration of logistics activities between suppliers and buyers, and shortening the response time from customer orders to deliveries along the chain is often called Supply Chain Management.

8.34 In Moldova, *costs for documentation* with trade and transport officials could add up to 2 to 3 percentage units of the trade value. In EU countries, this figure is on average less than one percent, albeit counted from trade with higher value and volume.

8.35 *Administrative logistics costs* by shippers, that is by exporters or importers, are caused by telecommunications, IT and administrative processes in making trade work. In EU countries, these account usually one to two percent of trade value. They are mostly indirect costs, which may be counted in various ways. Based on survey evidence from Moldovan firms, administrative logistics costs – such as working time of paperwork needed to organize for trade and transport -- correspond to 2 percent in imports and at least 3 percent in exports.

8.36 *Inventory handling costs* in low-valued commodities is usually at 3 to 5 percent of goods value, and for manufactured packed items it is usually 2 to 3 percent. These values used for Moldova are slightly higher than in more developed countries.

8.37 *Inventory carrying costs* in traded items depend on the level of inventory and the inventory turn-around cycle. These are both affected by the interest rate. In Moldova, the real lending rate has averaged around 17.4 percent. Precise data on inventory levels or inventory turn-around times were not available but other studies suggest that these are two to five times higher than in the US.[62] A conservative estimate assumes that inventory is at least two month's worth of trade or work-in-process. This would mean that the tied-up capital is around US$150 million in imports and US$100 million in exports. Using the average real lending rate, this would relate to US$26 million in imports and US$17 million in exports.[63]

[61] In EU countries, measurable logistics costs in manufacturing are usually less than 10 percent of sales. Freight is usually only 1/3 of these costs. For high -valued merchandise, such as electronic equipment, freight costs may be one percent of sales or less, whereas other logistics costs are more significant. For low-valued commodities transported over long distances, freight alone can make 50 percent or more of the sales price.

[62] See, for example, J.L. Gausch and J. Kogan, 'Inventories in Developing Countries: Levels and Determinants–A Red Flag for Competitiveness and Growth'. WPS No. 2552. Washington, DC: World Bank, 2001.

[63] There are many reasons for firms to keep high inventories, including speculation on product prices or exchange rates, high minimum or economical order sizes for a small market, and preparation for sudden changes in customs regulations. In this calculation, it is estimated that 30 percent of excessive inventory carrying cost could be reduced through more reliable trade practices and transport arrangements. As an order of magnitude, this gives for imports 0.3 x US$26 million = US$8 million, and for exports 0.3 x US$17 million = US$5 million.

8.38 Finally, *unofficial payments* in trade need to be counted in. Survey evidence on unofficial payments related to transport tends to vary a great deal. These can be around 5 to 20 percent of freights, which would put the absolute figure at approximately US$5 to US$20 million per annum using the estimate in Table 8.9. This figure seems low, and when put in relation to trade volume, would represent one percent of the value of total trade. However, even this figure is significant, when compared to average tariffs in EU countries.

Table 8.9 Estimated Logistics Costs in Moldovan Foreign Trade
(US$ millions)

	Import	Export	Total
Estimated value of trade in 2002	1,100	710	1,810
Transport costs total (2002)	77	48	125
Transport cost of trade in percent	7.0	6.8	6.9
Other logistics costs			
Documentation [a]	18	17	35
Administration by shippers [b]	18	17	35
Inventory handling costs [c]	36	17	53
Inventory carrying costs	8	5	43
Unofficial payments (estimate)	5	10	15
Other logistics costs total	85	66	181
Other logistics costs of trade in percent	*9.4*	*11.0*	*10.0*
Freight and other logistics costs total	**162**	**114**	**276**
Total logistics costs of trade in percent	**14.7**	**16.1**	**15.2**
Total logistics cost of trade, percent of GDP			17.2
Total domestic logistics cost, 5 percent of GDP			**80**
Moldova's total logistics costs			**356**
Moldova's total logistics costs, % of GDP			**22.2**

[a] 2 percent of imports and 3 percent of exports.
[b] 2 percent of imports and 3 percent of exports.
[c] 4 percent of imports and 3 percent of exports.
Source: Author's estimates.

8.39 Logistics costs of Moldovan trade, estimated at US$276 million, or 15.2 percent of trade in 2002, constitute a substantial barrier to trade (Table 8.9). These costs should be 5 percentage points lower to meet the level of EU Accession countries, and to make Moldova more competitive.

8.40 In 2000, the transport sector accounted for 8 percent of Moldovan GDP. Domestic, non-trade related logistics costs account for 4 to 6 percent of GDP in developed countries, but they can be substantially higher in developing countries. Own account transport is widely used due to the small land area of the country, low-performing transport markets, small transport volumes and the overall poor condition of the transport infrastructure. Thus, the value of domestic goods transport is not readily available in statistics. A conservative estimate of domestic logistics costs in Moldova is US$80 million in 2002, or 5 percent of GDP (Table 8.8).

8.41 With costs for domestic logistics, the total logistics cost in Moldova amounts to US$356 million, or 22.2 percent of GDP in 2002, which is the highest figure in Europe. Total logistics costs in EU and EU accession countries are in the range of 10 to 16 percent, and in Mexico, Brazil and China between 15 to 17 percent of GDP.[64] In Moldova's neighboring countries, the corresponding figure is between 15 and 20 percent.

[64] See Donald Bowersox et al., 21st Century Logistics: Making Supply Chain Integration Reality, Council of Logistics Management, Oak Brooks: IL., 1999, and European Logistics Association, Insight to Impact, Brussels 2001.

Moldova's high logistics costs are matched by those in most Central Asian and South Caucasus countries, where the share is generally between 20 and 25 percent of GDP.

8.42 Logistics costs cannot be brought down to zero, but over US$70 million could be saved through more business friendly government policies and more efficient logistics. If, for example, the Government brings trade documentation and administration to the level found in most EU accession countries, logistics costs of firms could be reduced by about US$35 million. The more predictable trade environment would lower inventory-carrying costs by over US$10 million, even when unofficial payments or inventory handling costs remain unchanged. Bringing the average border crossing time to 3 hours – as is the case in many neighboring countries -- would save at least US$20 million in waiting time costs alone. More efficient operations and increased competition in rail and road transport could lower the total transport costs by 20 percent, equivalent to US$25 million.

8.43 These actions would bring the total logistics costs of trade down to 12.4 percent of trade value, and the country's total logistics costs (including domestic logistics) down to 18.7 percent of GDP. This would dramatically improve the competitiveness of Moldovan firms, enabling them to create jobs and wealth through the skilled but low cost labor and Moldova's excellent location. It would also make Moldova a tempting location for foreign firms to establish mechanical or electronics assembly units, which are now practically absent.

8.44 In most developing countries, investing US$1 in road infrastructure brings three times that in benefits for road users. In Moldova, given its poor infrastructure and its high potential for trade and traffic, these savings are likely to be higher than that. To fully capitalize on its trade potential, and to improve mobility of people and goods inside the country, Moldova needs substantial improvement in road and rail infrastructure. Development of warehouse and cold storage facilities is also needed to facilitate market access of agricultural producers. Bringing trade and border crossing practices at par with EU accession countries, improving the efficiency of the transport sector, and rapidly reducing the severe backlog of infrastructure investment, Moldova could assume its proper trade location on the edge of EU.

CHAPTER 9. FINANCIAL SERVICES: LIMITED ACCESS AND HIGH COSTS

INTRODUCTION

The limited availability and high cost of financial services is an important constraint to the development of international trade.

9.1 Financial services are essential for the functioning of a modern economy. Such services are especially important for the facilitation of international trade, where there is a need for various services and instruments to increase speed and certainty in payments across international borders and in different currencies. Insofar as these financial services have limited availability and are costly, as is the case in Moldova, they become important constraints for the development of international trade. This chapter will briefly describe and analyze the performance of Moldova's financial sector, with special emphasis on how structural and regulatory impediments in this sector affect the provision of financial services required for international trade.

The banking sector dominates Moldova's small financial sector.

9.2 As in most transition countries, the banking sector in Moldova dominates the financial sector. Capital markets, contractual savings and specialized financial institutions are non-existent, inactive or very small. The overall depth of bank intermediation activity, as measured by the ratio of total banking sector assets to GDP is still quite low. At end-2003, the total assets of the whole banking sector in Moldova were less than US$778 million (about 38 percent of GDP). The success of the banking system in providing financial services to households and business -- in the form of payment services and savings vehicles – as measured by their capacity to attract deposits, is also low. Total banking sector deposits in Moldova were about US$436 million at end-2003 (about 21 percent of GDP). While the banking sector has grown considerably since the regional financial crisis, it remains small in comparison with Central and Eastern European economies. For example, the average size of the financial sector in the new EU members is about twice as large as Moldova's (assets and deposits of around 64 and 39 percent of GDP, respectively).

Access to finance is a considerable impediment to business development.

9.3 Almost all business surveys carried out for Moldova show that access to finance is a considerable impediment to business development.[65] The capacity of banks to appraise the creditworthiness of clients is still developing and as a result, banks are generally credit risk adverse. The dearth of medium to long term credit is not only due to the high funding risk, but also because such credits effectively reduce the capacity of bank to restructure their balance sheets when circumstances change. A legal framework that clearly establishes the rights, responsibilities and liabilities of the parties to financial transactions and which provides a means to enforce legal obligations and claims efficiently is a key ingredient of a stable and robust financial system.

Lending and deposit interest rates have been falling steadily, but still remain much higher than in other Central and Eastern European countries.

9.4 Nominal lending and deposit rates in lei have been falling progressively since 1998. The lending interest rate for credit in lei has fallen from 35.3 percent at end-1999 to 19.4 in December 2003. Rates on lei deposit have fallen from 27.8 to14.20 percent over the same period.[66] With the lending rate falling at a faster rate than the deposit rate, the lei spread has fallen progressively since the beginning of 2001, declining to 520 basis points at the end of 2003. Except for a brief period in 2001, the spread in lei has consistently remained below the spread in foreign currency. The significant reduction in inflation and macroeconomic volatility has reduced spreads in all transition countries.

[65] The BEEPS II survey showed that 69 percent of interviewed enterprises use their own funds to finance their investment and working capital needs.

[66] Expost real interest have followed a similar pattern. Rates turned positive at the beginning of 2001 and remained around 10 percent until the end of 2003 when they declined to the 5 percent level.

The average spread in Central and Eastern Europe, including the Baltics, has fallen to less than 3.5 percent. While average spreads in the other CIS countries have also fallen, they still remain high - close to 10 percent at end 2003.

Reducing the number of small banks will create a healthier banking system capable of providing efficient, better and cheaper financial services.

9.5 There has been considerable consolidation in Moldova's banking sector over the last few years with the total number of banks falling from 23 at the end of 1998 to 16 at end 2003. The banking sector is fairly concentrated with the 5 largest banks having 71 percent of the sector total assets, leaving 11 banks to share the remaining 29 percent. As the concept of economies of scale also applies to banks, the sizable number of small and very small banks suggests large inefficiencies and high costs. To attract and keep household deposits, small banks must keep depositors well compensated and this affects the average cost of funding in the banking system. These small banks also have neither a diversified business base nor sufficient capital, making them more vulnerable to unexpected shocks or market changes. The NBM is aware of the need to increase the capital of these smaller banks and has periodically increased the minimum capital requirement. Reducing the number of small banks further will be an important part of creating a banking sector that is healthier and more capable of providing efficient, better and cheaper financial services to the economy.

Foreign banks, particularly western banks, have been very hesitant to inves in Moldova. Increasing the number of foreign banks operating in Moldova would be desirable.

9.6 Ten of the 16 banks in Moldova are majority-owned by foreign shareholders, most of which are private investors or investment companies. Only in two cases are the majority shareholder a foreign bank (from Russia and Romania). Several reasons may explain the hesitance of foreign banks, particularly western banks, from any involvement with Moldova: its main international trade relations are with the CIS countries, and the interface with the western economies is very limited; it is a small economy with a low degree of financial depth and sophistication; very few international companies have economic activities in Moldova; several government and NBM restrictions and regulations affect the performance of the banking sector; and, no means are available to protect investments by owners in the capital of banks made in foreign currency from losing their value in the event of exchange rate volatility.

Banks are authorized to lend foreign currency only to importers. This restriction increases banking sector risks and reduces the competitiveness of Moldovan exporters.

9.7 The introduction of foreign banks into the Moldovan banking sector is highly desirable. A recent survey of case studies and a cross-sectional econometric analysis finds that the presence of foreign banks exerts competitive pressure on local banks and that there is a significant decline in their overhead costs following the entry of foreign banks. In addition, foreign banks can offer importers and exporters the services of their international networks and often bring new financial products to the market. A methodology for enabling foreign banks to operate with protection for the value of their foreign exchange investment in capital may be a first step towards facilitating the activity of foreign banks in Moldova (as subsidiaries, branches or partners in local banks).

REGULATORY IMPEDIMENTS

9.8 The fear of dollarization has led the regulations limiting lending in foreign currency. At present, Banks are authorized to lend foreign currency only to importers.[67] They are forbidden from lending in foreign currency to exporters to finance local expenditures. This restriction runs contrary to the reality of lending risks. From the risk aspect, exporters with expected foreign exchange revenue are the safest foreign exchange borrowers. With limited resources for local currency lending and excess resources for foreign exchange lending, the restrictions on foreign exchange loans to exporters increase

[67] Banks are also authorized to lend in foreign currency to other banks and, for a number narrow range of activities, to individuals and legal entities (i.e., education, medical treatment, etc.).

the banks' risks. They also make credit much more expensive to the exporters. They are required to pay for local currency loans above 20 percent annual interest, against an interest rate below 10 percent for Dollar loans, with inflation estimated at 4-5 percent annually.

9.9 Banks are required to process all transactions in local currencies. Dollar transactions between Moldovan entities (such as an exporter and his suppliers) require the payer to first exchange his dollars into local currency, then the local currency is transferred to the other party who then has to exchange it back into dollars. Such transactions are a burden to firms, but more important, costs substantial charges, and carry exchange rate risk to the exporters.

Fiscal agent responsibilities imposed on banks are incompatible with banking business and impose significant costs on banks and their clients.

9.10 Commercial banks in Moldova are charged with various functions that are clearly not with the scope of banking, if not incompatible with banking business. Among the fiscal agent responsibilities imposed on banks are the control over repatriation of export proceeds.[68] As noted in Chapter 3, exporters are required to receive their export earnings within a limit period, set differently for different types of exports. Delays are fined at 0.3 percent for each day, or a rate of more than 100 percent annually.[69] It seems that, at the rate of interest on loans, it is in the exporters' interest to repatriate their export revenue as early as possible. On the other hand, all of these requirement cannot and will not prevent those that have interest in sending funds abroad from doing it (there are many ways to send funds abroad; declaring export values and failing to repatriate export revenue is not one of them). While double punishing exporters, these regulations are also a costly burden for the banks that are required to monitor all transactions and report in detail to the authorities. Eliminating these regulations will save exporters a lot of administrative hassle and double punishment, while also saving the commercial banks and NBM the significant costs of monitoring, recording and reporting the related data.

The cost of financial services to exporters can be halved from current levels.

9.11 A rough estimate suggests that the costs of financial services to exporters can be halved from the current level. Allowing foreign exchange loans to exporters will immediately cut real interest rates for exporters by half. The elimination of back and forth conversion between currencies for transactions with Moldovan suppliers will substantially cut non-interest costs. While such reduction in financial services costs will provide significant benefits to exporters, they can be achieved, without causing major problems to the health of the banking sector, only if the proper adjustments are made in the financial sector. These include streamlining the sector by substantially reducing the number of banks; and eliminating all restrictions on lending, transferring and holding of foreign currency.

BANKING SERVICES FOR INTERNATIONAL TRADE AND EXPORT PRODUCTION

Letters of Credit

9.12 Exports and imports require specialized banking services, such as letters of credits (LCs), confirmation of LCs, quick and low cost facilities for international transfers of funds, exchanging from one currency to another, and a variety of guaranties. Moldova banks provide limited services due to their small size and lack of international reputation. For example, Western European banks will confirm LCs opened by Moldovan banks only against 100 percent deposit by the Moldovan bank. This problem was solved

[68] The Law on Controls on the Repatriation of Funds, Goods and Services (No. 1466-XIII, January 29, 1998).
[69] There are certain exemptions to this law and the maximum amount of the fine can not exceed the value of the non-repatriated funds.

The small size and lack of international reputation reduces the use of specialized banking services, such as letters of credit.

for 3 banks by a guaranty facility provided by European Bank for Reconstruction and Development (EBRD). The EBRD scheme, operating in many CIS countries, will guaranty LCs issued by one of the 3 participating local banks to a foreign bank, with exposure limits of US $2-2.5 million per participating bank. While this facility solves the problem for 3 banks and for limited amounts, the problem remains unsolved for the other 13 banks. With time, and increased demand, the exposure limits per bank may also limit the systems ability to support imports from Western Europe, where LCs and confirmations are the way international trade is done.

9.13 However, it seems that importers from CIS countries are unable to use LCs as means of guaranteeing import orders until the goods are received. In many cases, CIS exporters demand full payment in advance for equipment and industrial products whereas Moldovan exporters are required to send their products and then wait for payments. In general, Moldovans face these problems in their trade with CIS countries. They are required to pay for imports in advance while receiving the revenue for their exports after shipments arrive at their destination, all without the benefit of quick settlement and guarantied payments provided by LCs.

Leasing

Leasing is at a disadvantage due to several laws and regulations that prevent its development.

9.14 In many developing countries, leasing is a popular financing method for emerging businesses. In leasing, the lessee is paying a small percentage of the cost of the equipment, whereas the lessor is financing most of the cost (usually 75 –90 percent) while holding the title to the leased equipment. In Moldova, leasing is at a disadvantage due to several laws and regulations that prevent its development.

9.15 While interest paid on loans from banks carries no tax, the interest component in leasing installment payments carry VAT taxation. Further more, lessee is required to deduct 5 percent of each payment to the leasing company as tax advance and pay that amount to the tax authorities. Such tax procedure does not exist for payment of interest to banks and puts leasing at a disadvantage.

9.16 Another important facilitating mechanism for leasing is also missing in Moldova. It relates to motor vehicles. The Moldovan authorities register motor vehicle owners. There is no ability to register a lien in favor of a financial institution, as common in all developed countries. Such a lien allows the authorities to hold legal owners responsible for any illegal conduct and traffic violation by the vehicle while demanding consent or waiver by the lien holder before registering a transfer of title. In Moldova, to protect their rights, leasing companies and/or banks, financing the vehicle have to register them in their name, exposing themselves to owners' legal responsibilities.

Insurance activity in Moldova is miniscule and is incapable of providing insurance to foreign trade activities.

9.17 To facilitate leasing, VAT status of lessors should be adjusted to be the same as for banks. The motor vehicle registration system should be adjusted to allow registration of liens for the benefit of leasing companies and other providers of funds for the procurement of motor vehicles.

Insurance

9.18 The Insurance industry in Moldova suffers from too many companies with too small capital and/or expertise to offer effective services. The industry has 55 licensed insurance companies, of which 49 are actually active. At present, the minimum capital for the registration and obtaining a license for an insurance company is MDL 300,000, or about US $20,000. The total insurance activity is miniscule – total premium revenue for the whole year 2002 was US $17.1 million. The industry structure calls for immediate change – one company, QBE, with foreign partial ownership (foreign ownership in insurance companies is limited to 49 percent by law), has 30 percent market share. The 4 largest companies have a market share of 64 percent. The other 45 companies share 36 percent of the market, or annual total premium revenue of US $ 6.1 million. While there is a new insurance law in preparation, it is not clear if it will be drastic enough to enable the emergence of a healthy insurance industry, that will be able to provide professional and reasonably priced insurance services to the private sector in general and to export and other foreign trade activities in particular.

9.19 Exporters to the CIS countries almost never insure their shipments. Instead, as indicated by a number of exporters, they send a group of guards with every shipment. Their main claim is that total loss is rare; on the other hand, most shipments suffer from some of the merchandise being stolen on the way. Such losses are caused by border officials at the different borders and by others, and are very difficult to prove and claim from insurance. It is, however, clear that this solution is short-term, as long as low wages and high unemployment makes the guards available at low cost. A better performing insurance industry may be useful in the move from physical protection to the insurance of shipments.

Foreign Trade Receivables Insurance

9.20 Many countries, both developed economies and developing economies, offer exporters the benefit of insuring export receipts. Such insurance is offered against commercial and political risks, partly by privately owned insurance companies and partly by parastatals. In Moldova, such insurance is not available. In many developed economies, the export insurance facilities are intended to support exports by local companies to developing countries. This support, when provided beyond what would be economically rational, is considered assistance to both the local exporters and the developing countries. Other countries, less developed and unable to support such hidden subsidies, offer export insurance on a rational basis. In the case of Moldova, due to the reluctance of CIS importers to provide LCs and other guaranties, the service of export insurance facility may be beneficial. However, the feasibility of such service, and how to create it, should be carefully evaluated before reaching any decision.

CONCLUSIONS

9.21 The banking sector and other financial services in Moldova are unable to provide the private sector, in general, and the foreign-trade related business activities with efficient and reasonably priced services. This is due to the limited financial activity and large number of small institutions, as well as to the large number of regulations, prohibitions and limitations placed by the authorities. While there are limitations to the variety and quality of financial services in small economies such as Moldova, substantial improvement can be accomplished in a few years by following some of the recommendations discussed above.