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WHY DO WE NEED TRADE LIBERALIZATION WITH THE EUROPEAN UNION

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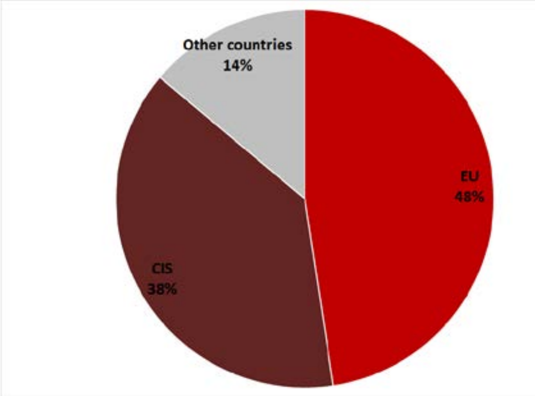
The Association Agreement undoubtedly marks a higher level in the bilateral relations between our country and the European Union. This will grant Moldovan products a larger access towards the EU market and will involve a large-scale modernization process of state institutions and, lastly, will contribute to improving the population's welfare. One of the main provisions of the Agreement is to create the Deep and Comprehensive Free Trade Area (DCFTA) with the EU, which entails removing barriers for bilateral trade from both sides. In this analytical note, we will analyze how DCFTA provisions will contribute to unlocking Moldova's exports and we will bust some of the myths related to this subject.

Background

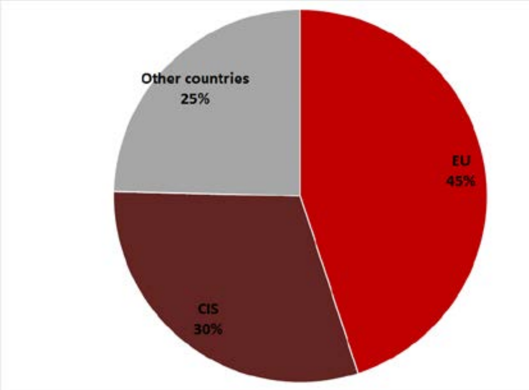
The European Union is Moldova's main trade partner holding about 48% of the exports and 45% of the imports (2013) (charts 1 and 2). The intensification of bilateral relations was possible due to a gradual opening of the community market to Moldovan exports since 2006 in the framework of the Generalized System of Preferences (GSP and GSP plus), and from 2008, of the Autonomous Trade Preferences. It led to more foreign direct investments (mostly coming from the EU), contributing to the development of both existing industries (ex: textiles, footwear, furniture, leather goods, juices production, etc.), and totally new industries to Moldovan economy (ex: electric machines, electric wires and cables).

Chart 1. Structure of Moldova's exports, 2013 (excluding Transnistrian)



Source: National Bureau of Statistics

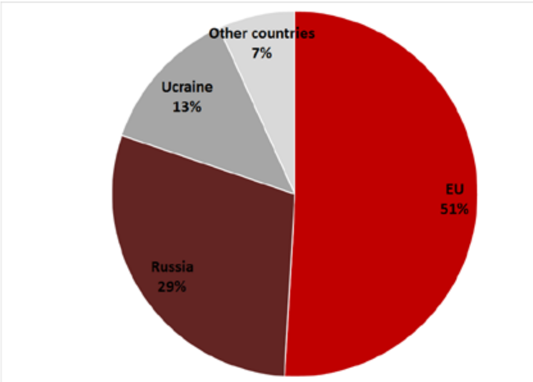
Chart 2. Structure of Moldova's imports, 2013 (excluding Transnistrian)



Source: National Bureau of Statistics

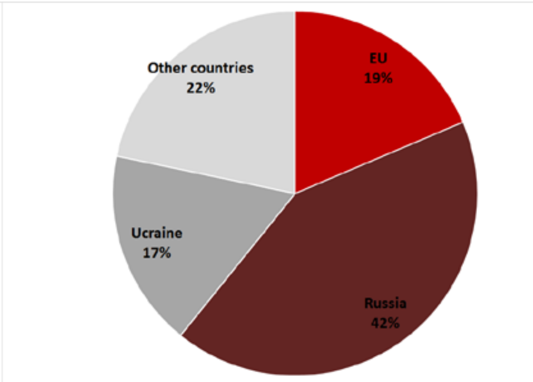
The European Union is the main market for companies from the eastern districts of Moldova. Thus, despite the (geo)political vector promoted by the Tiraspol authorities, about 51% (2013) of the region's export is destined for the community market, the main exported goods being: clothes, footwear, textiles and metals. The European Union is less important for the Transnistrian region from the imports perspective because of the high protectionist tariffs applied by the authorities, but also because of the relatively high importance of the Russian Federation as main energy provider. Still, the companies in the region depend on the import of raw materials and equipment from the EU on which their competitiveness depends (charts 3 and 4).

Chart 3. Structure of Transnistrian exports, 2013



Source: The Monetary Authority from the Transnistrian region

Chart 4. Structure of Transnistrian imports, 2013



Source: The Monetary Authority from the Transnistrian region

Traditionally, the free trade areas are created between trade partners that show both interest and ability to develop bilateral trade. In this context, **DCFTA fits the natural tendencies of intensification of trade relations between the European Union and Moldova over the recent years.** Thus, eliminating the obstacles for export and import to and from the main trade partner will evidently contribute to a further intensification of trade and economic relations between both parties.

Busting the myths regarding the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU

The quantitative estimations confirm the positive impact of the liberalization of bilateral trade between Moldova and the European Union. Yet, ***there is a series of myths circulating in the society regarding the side effects of DCFTA on Moldovan economy.***

The first myth is related to dramatic DCFTA repercussions on domestic producers as a result of eliminating the import tariffs. The second myth is about the poor quality of goods produced in the EU "invading" the domestic market. The third myth is that the Association Agreement will not allow increased exports to the EU due to very low quantitative quotas applied to Moldovan goods. A forth myth refers to various internal EU market protection mechanisms that will not allow Moldovan companies to enter it.

Thus, the general myth is that DCFTA will "ruin the domestic producer" and will not provide any additional opportunities for export. Further bellow we will bust each of these myths based on a detailed analysis of the Association Agreement provisions and the economic realities in the country.

Myth nr 1: The Association Agreement will "ruin the domestic producer"

This myth is based on the concept of liberalization of trade relations with the EU by eliminating custom taxes on import from the EU. Still, this hypothesis is not fully understood by the society, and the dramatic effects on the domestic producer are nothing more than an ungrounded myth. Here are several reasons:

i. **The liberalization of trade will take place gradually, and there will be transition periods for the most sensitive goods** (of 3, 4, 5, 6, and even 10 years). Therefore, the domestic producers will have enough time to adapt to the EU standards and to having competition from European producers. Moreover, for less sensitive industries shorter adaptation periods have been foreseen, while for agricultural and food products, the transition periods are longer. Specifically:
   a. *Liberalization over a period of 10 years:* meat and meat products, milk and cream, fresh sweet cherries;
   b. *Liberalization over a period of 6 years*: furniture, footwear, clothes;
   c. *Liberalization over a period of 5 years*: cheeses, vegetables (tomatoes, cucumbers, etc.), fruits (sour cherries, nectarines, currant, raspberry, etc.), juices, wine, jams, spirits, bakery products;
   d. *Liberalization over a period of 4 years*: tubes, pipes, doors, windows, cables etc.
   e. *Liberalization over a period of 3 years:* pasta, bell pepper, corn, vegetable mixes, etc.

ii. **For some products, the Agreement enters into force only in 5 years after implementation.** This refers to fresh apples, beef or beef offal (cooked or preserved and vacuum–packed), as well as edible pork offal and liver.

iii. **The Association Agreement foresees mechanisms through which the state can interfere to protect the domestic producer.** Unlike the Association Agreements signed by Ukraine and Georgia, the one signed by Moldova regulates establishing bilateral safeguarding mechanisms meant to protect the domestic producer. Specifically, if as a result of the trade liberalization a rapid import increase occurs for certain products jeopardizing the domestic producers of those goods, the Government will be able to apply the following measures (according to Section 3, article 165 of the Association Agreement):
    a. Suspend decreased import custom taxes for that specific product;
    b. Increase import custom taxes.

Myth busted: The Association Agreement cannot have dramatic effects for domestic producers because the liberalization will take place gradually, depending on products sensitivity to foreign producers' competition. Moreover, the Agreement foresees clear mechanisms through which the Government can interfere to protect certain domestic industries. It is obvious that, overall, eliminating import custom taxes, even gradually over a period of several years, could create some difficulties for the domestic producers that up until now have benefited from a relatively high level of tariff protection. However, supporting the domestic *producer* should not happen at the expense of the domestic *consumer*, whose interests count just as much. Thus, as a result of implementing the Agreement and liberalization of trade with the EU, the domestic companies and especially their managers will be motivated to be more efficient and produce at a higher quality level. Therefore, ultimately everyone will benefit: (i) domestic companies, by an increase in their productivity and competitiveness; (ii) the consumers, by having a greater diversity, quality and accessibility of products (due to lower prices); (iii) the state, by increased tax collection due to an increased consumption and intensification of economic activity. At the same time, several narrow circles of interests controlling certain monopolistic or oligopolistic companies will be at a loss, these having to learn to compete in market conditions.

Myth nr 2: The Association Agreement will cause an "invasion" of the domestic market by poor quality goods imported from the EU

This hypothesis is ungrounded for at least two reasons:

- Firstly, the quality standards of the European Union are the most exigent in the world, which contributes to ensuring consumer safety in the EU community.
- Secondly, for the most sensitive products, the liberalization of imports will remain only partial. Considering the specific of Moldovan economy and the vulnerability of some agricultural and food industries, quantitative quotas have been established for custom tax-free import of similar products from the EU. Thus, for import of such products exceeding the stipulated quotas, protective custom taxes will be applied, which will render impossible any

"invasion" of domestic market by EU goods. The respective import quotas have been established for the most sensitive branches of agriculture and food industry, the main being: pork meat and pork meat and products, chicken meat and chicken meat products, milk and cream, butter and other dairy products, sausages, various types of sugar.

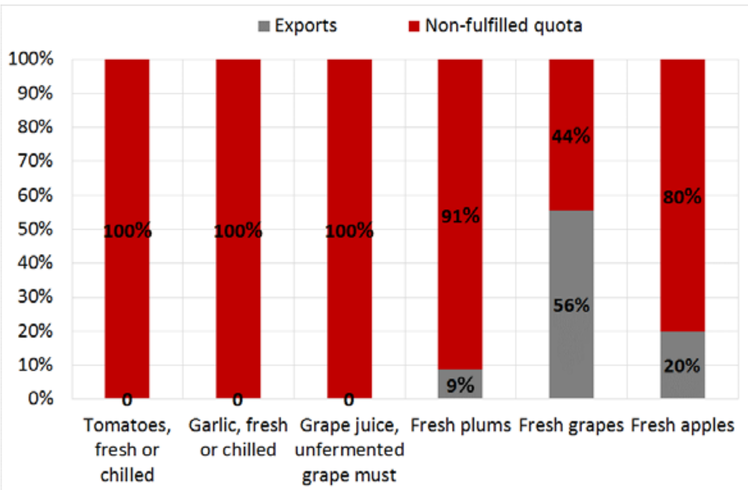
Myth busted: The Association Agreement foresees an asymmetrical liberalization of bilateral trade, so that the Moldovan market will not fully open to the import of most sensitive agricultural and food products from the EU. For those products, the tax-free imports of our country from the EU will only take place within specific quantitative quotas. This mechanism will diminish the risk of abundant increase of imports of certain agricultural food products, allowing for the domestic producer to be protected. Unlike the transition periods foreseen for some products, the quantitative quotas established for the most sensitive products are fixed for an unlimited period, ensuring a higher protection level for agricultural and food industries that are strategic for Moldova.

Myth nr 3: The access of Moldovan producers on the EU market will be restricted by quotas that are too small

Just as Moldova has established quantitative quotas on import from the EU, the later has also established quotas for a series of products that are important for the European Union. This way, exports exceeding the quotas stipulated in the Agreement are to be subject of EU custom taxes. Nevertheless, this measure cannot restrict Moldovan exports because the quotas applied are high enough in comparison with the exports to the EU in the previous years.

Thereby, in 2013, we exported only 1785,7 tons of grapes, the quota established by the Agreement being of 5000 tons; we exported 3310,7 tons of fresh apples, the quota being of 20000 tons; we exported 399 tons of nectarines, the quota being of 5000 tons. Moreover, for other products that have established quotas, Moldova did not even manage to export at all over the previous years: tomatoes, garlic, grape juice and must (figure 5).

Chart 5. Volume of Moldovan exports to the EU for 2013 reported to quotas established by the Association Agreement



Source: Calculated based on UN Comtrade data

It is true that the quotas foreseen by the Agreement do not allow to indefeasibly redirect exports from other markets (for ex: Russian Federation) towards the EU market. Still, after the Agreement enters into force, the quotas and other provisions can be adjusted depending on the economic tendencies and realities. Thus, the Agreement is not a rigid document, but can be adjusted accordingly during implementation, based on the decisions commonly adopted by Moldova and the European Union (article 147, p.4, 5, and 6).

Besides the abovementioned quotas, the Agreement includes an Annex with a longer list of products for which quantitative quotas have been established, so that if Moldovan exports will exceed these quotas, the European Union will apply non-preferential tariff treatment. Anyhow, this measure cannot become a major barrier for domestic producers at least for two reasons:

(i) these are floating quotas and can be increased if a certain industry shows a justified increase in production and exports to the EU that are close to reaching the maximum limit established in the Agreement (art. 148, p. 5);

(ii) most products for which quantitative quotas have been established till now have not yet been exported to the EU (pork and poultry, dairy products, eggs, wheat). At the same time, the quotas for the products that have been exported have taken into account the average export numbers for Moldova for the past three years. Thus, the quotas cannot be smaller than the export capacity and, accordingly, cannot restrict access of domestic producers to the community market.

Myth busted: The quotas applied for Moldova's exports to the EU cannot restrict the access of domestic producers to the community market. First of all, they are higher than Moldova's export capacity to this market. Second, the quotas, and other provisions of the Agreement as well, can be adjusted during implementation, as commonly agreed by both parties. Thus, the Association Agreement is not a rigid one, but can be adapted to new economic conditions. For example, the document includes the necessary leverage to increase quotas at the right moment in order to replace the Russian Federation market if the later will apply additional import restrictions (ex: grapes and apples).

Myth nr 4: The EU will protect its market, which will keep domestic companies from accessing it

It is true that the EU applies a relatively protectionist policy towards certain sensitive industries, especially agricultural and food products. An important tool in this regard is the minimum entry price mechanism: if a company exports products at a price lower than what is established by the EU legislation, high customs tariffs are applied in order to protect the European producers from eventual dumping practices of other foreign producers. However, this measure can in no way affect Moldovan exporters because:

i. A large part of the products subject of minimum entry prices is made up by citric fruits, in the production of which Moldova cannot specialize. The other products, have until now mostly not yet been exported by Moldova to the EU (cucumbers, pears, apricots, sweet and sour cherries), and accordingly, are not affected by the EU minimum entry prices.

ii. Due to a small production scale and less efficient technologies, Moldovan products are expensive in comparison with a big part of the European products. Accordingly, the application of minimum entry prices is not relevant for domestic exporters. For example, the average export price for nectarines (one of the few products from the list of those subject of minimum entry price that have been exported to the EU) was of about USD98 for 100 kg in 2013, while the minimum price accepted by the EU is of USD55,2 for 100 kg.

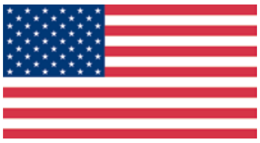
Myth busted: Moldova's economy is too small to pose a threat for producers from the European Union. Hence, the protection measures stipulated by the Agreement are not relevant for domestic companies. Thus, most products to which the minimum entry price mechanism applies, up until now, have not been exported to the EU. Few of them that managed to enter the EU market were exported at much higher prices in comparison with the minimum entry prices established by the community legislation.

Conclusions

- The Association Agreement with EU corresponds to both Moldova's integration vector pursued since 2005, and natural tendencies of intensification of the bilateral relations between our country and the EU. In the context where the EU is the main market, the main source of raw materials, technologies and consumption goods, as well as the main source of direct foreign investments, a further liberalization of bilateral trade will create benefits for Moldova.
- The need to facilitate trade between the EU and Moldova is determined also by the fact that both economies are rather compatible than competing with each other. This way, while the EU specializes in in exporting products with high added value and capital intensive, Moldova's specialization level is lower, exporting goods with lower added value and less labor intensive.
- The Association Agreement cannot serve as a reason to leave the CIS market and Russian Federation in particular, because it is compatible with the CSI free trade area. In addition to that, the Agreement provides cost mitigation mechanisms for eventual restrictions that could be unilaterally applied by the Russian Federation to imports from Moldova.
- The Association Agreement should not be regarded as a rigid document, but rather as one that can be adapted over the implementation period in order to avoid certain risks for domestic producers. Thus, in case of a too speedy liberalization of imports or in case the assigned quotas for exports to the EU are too small, both parties can renegotiate the provisions of the Agreement in order to minimize costs and maximize mutual benefits.
- The EU Association Agreement cannot have dramatic effects on the domestic producers because it does not entail an immediate trade liberalization, transition periods of 5-10 years being foreseen for the most

sensitive products. Moreover, the liberalization will not be a full one: Moldova will limit tax-free imports for meat and meat products, dairy products and sugar, quantitative quotas being established. At the same time, the Agreement provides the possibility to include safeguarding measures in case if certain major costs for some domestic industries occur. Therefore, the Agreement contains all mechanisms needed to avoid adverse effects for domestic producers.

- Consequently, trade liberalization will:
    - provide advantages to honest and efficient companies, interested in modernizing their production;
    - be an advantage for consumers who will have access to a wider range of higher quality and lower price products (due to removal of customs tariffs and increasing competition);
    - be an advantage for the state due to increased budget revenue as a result of increasing consumption and economic activity;
    - negatively affect the monopolistic and oligopolistic companies that currently benefit from protective tariffs and are not used to the free market principles.
- The myths created around the Association Agreement and DCFTA in particular are caused by the low level of information of the business environment and society in general regarding the provisions and the implications of this document. Nevertheless, the perception of civil society and of the business environment in particular are crucial for the successful implementation of the Agreement provisions. In this regard, a constructive public-private dialog, paralleled by improving the business environment and strengthening capacities of public institutions are vital conditions that need to be met in order to benefit from the Association Agreement. At the same time, most risks that persist are not related to the content of the Agreement itself, but rather to the internal vulnerabilities and low level of competitiveness of Moldova's economy for which the decision-making factors from Chisinau are responsible in the first place.



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