Indicator of Convergence between the Economies on the Left and the Right Banks of the Nistru River

For 4 consecutive quarters, the economies on both banks of the Nistru River have been diverging from the economic point of view. If in Q2:2016, the convergence indicator constituted 97.1%, then in Q3:2016 it fell to 94.4%. This trend is due to the more acute deterioration of the economic situation in the Transnistrian region, compared to the right bank.

Even after a difficult economic year in 2015, the economy of the Transnistrian region continued to worsen in 2016. In particular, the industrial production index, which has a direct impact on the Domestic Gross Product, decreased by 2.3% in Jan-Aug:16 y-o-y, recording a more acute decline compared to the first half of the year, when this indicator increased by 2.5% y-o-y. This reduction is mainly related to the decline in exports due to the decreasing competitiveness of the Transnistrian exporters, caused by the depreciation of the currency of the region’s main trade partners and by the artificial maintenance of the “exchange rate of the Transnistrian ruble”, and by other external factors (e.g. economic difficulties in UE and CIS). Thus, the total exports of the left bank dropped by 15.5% y-o-y in Jan-Aug:16. The negative economic dynamics, coupled with the high macroeconomic, political and social uncertainties undermined the investment activity in the region. Thus, the volume of investments in fixed capital was by 14.3% lower in Jan-Jun:16 than the level of the same period of the previous year. In addition, the reduction of the households’ income and remittances cooled down the demand in the region, the retail trade in goods and services being by 5.2% y-o-y lower in Jan-Aug:16. Along with the shortage of foreign currency in the region, it contributed to a significant reduction in imports (by 30.9% y-o-y).

After an extremely stringent economic year in 2015, the worsening economic and social crisis in the region in 2016 emphasizes the need to promote more structural reforms. Essentially, the region can no longer rely on a cyclical recovery of the economy by boosting the consumption or investments using the classical market economy mechanisms. A meaningful economic recovery of the region can be triggered by initiating deep reforms, at least in three key areas: (i) fiscal (revision of the indirect taxation mechanism, in particular by introducing the VAT system); (ii) foreign currency (gradual devaluation of the "Transnistrian ruble" by at least 30-35% and revision of the "exchange rate" fixing mechanism); and (iii) foreign trade (gradual removal of customs duties and other discriminatory trade practices, to implement the rules of origin of goods and implement other basic provisions of DCFTA). The ultimate goal of these reforms should be the economic openness and diversification, as well as the augmentation of the investment attractiveness in the region.
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Main Economic Trends in the Transnistrian Region

**AGRICULTURE**

After the drastic reductions in the previous quarters, the total agricultural production grew negatively at a lower rate in Q2:16, decreasing in the first semester by 7.7% y-o-y. The livestock witnessed mixed trends, where against the backdrop of growing live cattle and poultry by 50%, the milk and egg production shrank by 15.2% and 62.1% y-o-y respectively. At the same time, the volume of the vegetable production grew by 16.3% y-o-y in the first semester.

**INDUSTRY**

The positive trends from Q1:16 were not maintained in Q2:16, the sector recording significant drops. Although in nominal terms the industrial production grew by 2.5% y-o-y in the first semester, the change in terms of sales show a negative development of -8.4% y-o-y. The energy industry recorded significant decreases -11.9% due to the new energy supply contract and the metallurgical industry -19.7% y-o-y due to global market instability and the higher prices for the raw material.

**DOMESTIC TRADE**

While the negative dynamics recorded in Q1:16 slowed down in Q2:16, the outcome of the first semester reveals that the social and economic crisis continues in the region. The domestic trade in goods diminished by 9.1% y-o-y in the first semester and the services provided to the population decreased by 1.8% y-o-y. Besides the foreign currency crisis, this decline is associated with the reduction by 3.2% of the payroll fund in Q2:16 and two-fold decrease y-o-y in remittances.
INCOME OF THE POPULATION

Despite the difficult economic conditions, the salaries did not decrease significantly due to the deflating processes recorded in the region in Q1:16. Both the actual and the nominal wage decreased by 0.1% and 1.8% y-o-y, respectively, in the first semester at a quicker pace in the construction, trade and transport sectors. At the same time, the average level of pensions increased by 0.9% y-o-y.

PUBLIC FINANCE

The payment of salary arrears in the budgetary sector, accumulated in 2015, pushed the expenses on an upgoing trend. Under these conditions, the expenses of the "republican budget" increased by 85.9% y-o-y in the first semester, exceeding accumulated revenues by 86%. At the same time, the positive dynamics of revenues was determined solely by the very low comparison base of 2015, thus recording in the first semester an increase by 38.8% y-o-y.

LABOUR MARKET

The difficult social and economic context had a negative impact on the labour market. Thus, the employed population decreased by 2.3% in Q2:16 y-o-y, and the number of vacancies declared by employers dropped by 16.2%. In addition, the number of unemployed increased by 29% in Q2:16 y-o-y. All these increased the unemployment rate up to 3.43%, which is by 0.74 p.p. more y-o-y.

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PRICES AND “MONETARY POLICY”

After a deflating period, the Q2:16 recorded a more accentuated inflationary jump, especially in June, including due to imbalances on the foreign currency market. Thus, CPI reached a value of 1.7% y-o-y in the first semester, mainly due to the increases for foodstuffs. Despite a slight devaluation of the “regional currency” against the US dollar, it does not reveal the actual difference between the official and unofficial exchange rate.

BANKING SYSTEM

In Q2:16 the amount of the granted loans grew by 11.7% y-o-y, and the deposits attracted by the banking sector from the population continued to decrease by 5% in Q2:16 y-o-y, given the difficult social and economic conditions in the region. Thus, the positive results in terms of loans were due to increase by 24.7% y-o-y of the balance of loans granted to the real sector, but not those granted to individuals, which diminished by 22.7% y-o-y.

FOREIGN TRADE

Trade performances were affected by the regional circumstances, which caused a decrease of 12.2% y-o-y in exports in the first semester. Deliveries to CIS dropped by 16.7% y-o-y (where the deliveries on the right bank of Nistru River are also included statistically) especially due to the decrease in the price for electricity, and exports to EU shrink by 5.7% y-o-y. On the background of the foreign currency crisis, the imports of fuels and metals declined by 38.4% and, respectively, 220% y-o-y.
INVESTMENT ACTIVITY
The unstable economic situation in the region narrows the investment activity. Thus, investments in capital shrank by 13.7% y-o-y in the first semester, being the lowest rate in the last 6 years. Both the investments from the organizations’ own funds and from the budget decreased (by 19.6% and, respectively, 9.7% y-o-y). The construction works decreased significantly (1.6 times y-o-y), and investments in machinery, equipment and facilities decreased only by 3.9% y-o-y.

TRADE PARTNERS
Recovery of the economies of the Russian Federation and Ukraine, in tandem with the gradual recovery of the domestic demand will foster exports to these destinations. At the same time, the prospect of DCFTA implementation throughout the country will allow to encourage the economic potential of the region. But the election process in the region will jeopardize the efforts that aim at ensuring the continuity of the previously initiated actions in favor of the election candidates’ political games.

GLOBAL MARKETS
The Food Price Index grew by 10% since the beginning of the year, reaching the value of 164 points in June. All components of the index brought a positive contribution (less for cereals), especially for sugar (maximum since Oct:2012), due to the Brazilian currency appreciation, but also for meat in the context of the shortage of pigs for slaughter in the EU. In addition, the global oil price that increased by 62% since the beginning of the year, reaching a maximum level of 52.7 USD/barrel is not negligible.
### Key Policy Developments

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| **2-3 June 2016.** A new official meeting of the Permanent Conference for Political Questions in the Transnistrian regulatory process (5+2 negotiations format) took place. | Thus, the negotiations were chaired by a new Special Representative of the German Chairmanship of the OSCE, H.E. Ambassador Cord Meier-Klodt. Besides a formal exchange of views on the possibilities of further cooperation for many topics previously discussed, the Protocol for negotiations reveals a range of sensitive topics, upon which the parties insisted, and namely:  
- application of apostille on diplomas issued in Transnistria, where parties agreed to continue their work on the basis of the European experts’ recommendations from 2014;  
- participation of vehicles with Transnistrian registration plates in the international road traffic, where parties agreed to continue their work on the basis of EUBAM technical conclusion from 2015.  
Note that the civil society from the right bank of the Nistru River fiercely criticized the two topics, as reflected in the Declaration on the Red Lines of the Transnistrian Settlement, which called upon the foreign partners not to pressure the constitutional authorities into make unilateral concessions, inconsistent with the rules and principles of the international law. |
| **9 June 2016.** The need to have a license to import petrol and diesel for personal use was removed. | Against the backdrop of worsening economic situation in the region and the foreign currency crisis, the fuels import dropped by over 30%. Thus, large enterprises and agricultural organizations in the region mentioned the shortages of fuel at the official suppliers, which could jeopardize their economic activity. As a result, the decision to remove the need to have a license to import petrol and diesel for personal use was made. At the same time, the entities whose 70% of the gross income is generated by the revenue from the sales of own products will only benefit from this right.  
If this measure theoretically intends to remove the tensions on the market and boost economic activities mainly in the agricultural sector, there is a risk of slipping toward illicit activities, including to further promote smuggling.  
Acknowledging the risks related to this initiative, these provisions will only be valid for a quite limited period – 15 June – 1 October 2016. |
| **20 July 2016.** The system for issuing permits was changed | This initiative aims to define the legal and organizational principles of the system of issuing economic permits, to set out operational mechanisms for the issuing authorities and their interaction with economic entities.  
One of these principles, set by the law, is the principle of “tacit consent” according to which, if a business entity required a permit, but did not receive a timely answer, such a permission is deemed to be received. However, it is still unclear how this mechanism will operate under the existing realities.  
Also, the document provides for the need to set up a unified register of permits that would allow business entities navigate easier within the legal environment in the region.  
Note that such initiatives involve both institutional efforts and allocation of significant financial resources, but the covering source is not clear under an acute budget deficit. |
<p>| <strong>20 July 2016.</strong> The compulsory registration of contracts related to foreign economic activity | Thus, starting with 1 January 2017 the compulsory registration of contracts related to foreign economic activity of the business |</p>
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<td>was excluded.</td>
<td>It is worth mentioning that these amendments generated contradictory discussions among representatives of the “legislative or executive powers” in the region. Moreover, representatives of the “Customs Committee” declared that the registration procedure of foreign trade contracts was introduced with the purpose to remove the risk of concluding incorrectly contracts by the Transnistrian business entities with foreign partners, and increase the speed of customs declaration. Nonetheless, the region’s “Parliament” decided that removing the compulsory registration of the contract will reduce the time required for concluding the contracts and will boost the foreign trade efficiency. Whatever the arguments for this decision, the fact is that promoting “transparency” of contractual clauses did not comply with the visions of the region’s companies in terms of loyal competition.</td>
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<td>5 September 2016. The term of applying lower customs duties was extended for a number of foodstuff.</td>
<td>Due to the foreign currency crisis the imports of foodstuffs decreased, which caused a shortage of various products on the domestic market and therefore, fueled the “food tourism”. Thus, in order to overcome this situation, in April it was decided to decrease the customs duties for a number of foodstuff (meat and fish) for a two-month term, subsequently this term was extended till 1 September. The latter decision implies the extension of the term for applying the lower customs duties for the above products, till 31 December 2016. It should also be mentioned that in order to avoid a shortage on the market and to foster these transactions, since the beginning of June, the business entities are allowed to extract big amounts of cash in foreign currency from accounts without the requirement to confirm the contracts on the procurement of goods outside the region.</td>
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<td>7 September 2016. It was decided to align the legal system of the region to the legal framework of the Russian Federation.</td>
<td>With reference to the results of the so-called referendum of 17 September 2006 on the free accession to Russian Federation, the “President” of the region issued a Decree on approximating the legal system of the region to the Russian Federation legislation. In addition, for this purpose a special commission, consisting of representatives of several specialized “institutions”, was created to implement this document in the priority directions of the domestic policy, such as the financial, fiscal, customs, social, health, education policy and so on. The plan to harmonize legislation is to be submitted to the “President” for approval until 1 November 2016. However, references to the “referendum” of 10 years ago (although it is only about the partial implementation thereof) lend more towards the format of theses exposed in the context of the election campaign to increase popularity and obtain electoral capital. At the same time it is unclear how the initiative correlates with the economic reasons that reveal the region's deep dependence on the EU markets (about 70% of exports to EU vs. 8% to Russian Federation), but also the latest efforts of DCFTA implementation in the region.</td>
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<td>7 September 2016. Extended the term for lower excise duties on petrol and diesel</td>
<td>As there is still a shortage of these products on the fuel market, the decision was taken to extend the application of lower excise duties for these products, which will set the precondition for lower</td>
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<td>prices for end users on the domestic market and will support agricultural producers. Thus, the lower duties will be applied until 1 November (the first reduction took place on 8 April 2016) in proportion of 45$/t instead of 90$/t for diesel and 100$/t instead of 189$/t for petrol. This initiative perfectly fits in the spirit of election campaign and meets the voters’ expectations, but has negative consequences on the budget revenue, which still has a deficit.</td>
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<td>20 September 2016. Formulated the idea to transfer USD 250 million to the region’s budget from “Sheriff” company, following the tax preferences gained as “special importer”.</td>
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<td>In July, the “President” of the region required an audit of the impact of the “Sheriff” company activity, following the support granted by the administration of Igor Smirnov in 2006-2011, in the context of partial payment of related payments that affected the foreign currency flow and budget revenue. According to the “customs committee” in the region, the status of “special importer” granted to “Sheriff” company offered some benefits to the payment of customs duties, excise duties and other fees and duties when importing cigarettes, alcoholic drinks, construction materials, consumer goods, equipment, vehicles, spare parts etc. According to estimations, after the withdrawal of “special importer” status, the budget revenue from the account of customs duties paid by “Sheriff” increased 7.5 times. At the same time, when having its status during 2006-2011, “Sheriff” allegedly saved USD 1 billion. Subsequently, on 20 September this year, the “President” of the region formulated the idea to force “Sheriff” to transfer USD 250 million to the regions’ budget, planning to send these resources for social purposes. These proposals were formulated in the form of a draft law and remitted to region’s “Supreme Soviet”. However, as these actions and statements were made during the election campaign, they need to be interpreted through the lens of the existing confrontations between the economic-political groups in the region.</td>
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Annex A: Methodology for calculating the economic convergence indicator

The convergence indicator represents an aggregate indicator that allows for the quantification of the degree of closeness between the economy in the Transnistrian region and that on the right bank of the Nistru river. To calculate the indicator, data series that reflect the development of the same economic variables on both banks of the Nistru river were used.

The primary information was about the quarterly statistics regarding the development of similar indicators on both banks of the Nistru river. The following indicators were used as raw data: volume of investments, agricultural production, export and import of goods, CPI, M3 monetary aggregate stock at the end of the third quarter and the exchange rates PRB/USD and MDL/USD.

To ensure the comparability of data from the two regions, i.e. for the volume of investments, agricultural production, export and import of goods, M3 monetary aggregate – several iteration were made. The M3 monetary aggregate was represented as the arithmetic mean of stocks at the end of two consecutive quarters. Q1:2010 was taken as the baseline period. To eliminate the influence of prices, the indicators were expressed in the values of the baseline period; to this end, CPI was used as deflator. The real growth indices were calculated against Q1:2010 on the basis of the adjusted series. To find the reference variable for every data series, the indicators from Q1:2010 were expressed in USD. To calculate the terms of the series, the values of the indicators from the reference period were multiplied by the real growth indices. The formula hereunder was used for the estimation:

\[ X_Q = X_{0,USD} \cdot I_{Q/0} \]

where:
- \( X_Q \) - the value of the variable in quarter Q;
- \( X_{0,USD} \) - the variable form the reference period (Q1:2010=1, USD exchange rate in Q1:2010);
- \( I_{Q/0} \) - the real growth index of the variable X

The dynamic line that represented the development of CPI was also turned into a fixed-base chronological series, where Q1:2010=1. To find out the nominal MDL/PRB exchange rate, the MDL/USD and PRB/USD rates were cross-multiplied. The real MDL/PRB exchange rate was calculated by multiplying the nominal MDL/PRB exchange rate by the ratio between the CPI in the Transnistrian region and the CPI on the right bank of the Nistru river. Q1:2010 is the reference period for the real exchange rate.

The adjusted series were related to the population on both banks. To eliminate the seasonal effects from the chronological series, 4-quarterly moving averages were calculated.

The index can have values starting with zero and to infinity. Values under 1 indicate that in the region on the left bank of the Nistru river the indicators grow quicker in comparison with the increase registered in the region on the right bank of the river, or that the decrease of economic parameters from the Transnistrian region is smaller in comparison with the decrease in the rest of the country. If the values are above 1 – the situation is the other way around.

The convergence indicator is calculated on the basis of the index. The value of the indicators are determined according to the formula hereunder:

\[ \text{Indicatorul de convergență} = 100 - 100 \cdot \sqrt{(\text{Index})^2} \]

The increase of the indicator means that the economies on both banks of the Nistru river “get closer”. The maximum value that the indicator can have is 100 – which means that convergence was reached.