

Regional Economic Review:

Transnistrian
region

Authors:

Adrian Lupușor
Alexandru Fala
Iurie Morcofîlo

1st issue
July, 2014





Kingdom of the Netherlands

Disclaimer

This document is published by the Independent Think-Tank EXPERT-GRUP with the financial support of the Netherlands Embassy in Bucharest. Opinions expressed in this document belong to the authors and are not necessarily the opinions of the donors.

Additional note

The authors of this publication treat the Transnistrian region as an integral part of the Republic of Moldova, and the analysis and recommendations are directed to the de facto authorities of the region with the view to improve the life of citizens and performance of the economy. However, it does not imply de jure recognition of the authorities of this region.

This document is a translation from the Romanian language.



Contents

Contents	3
Key messages of this issue	4
Executive Summary	7
Chapter 1. Transnistrian Political Economy	10
Chapter 2. Domestic Supply	13
Chapter 3. Domestic Demand	18
Chapter 4. Public Finance	21
Chapter 5. Labor Market	24
Chapter 6. Prices and Monetary Policy	28
Chapter 7. Banking System	31
Chapter 8. Foreign Sector	35
About EXPERT-GRUP	39

List of figures

Figure 1. GDP of the Region on the Left Bank of the Nistru River, Growth, %	14
Figure 2. Developments and Forecast of Economic Sectors of the Region, Cumulative Growth, %	16
Figure 3. Salaries and Transfers from Abroad, Real Growth y-o-y, %	18
Figure 4. Retail Trade and Services Provided to the Population and Investment, cumulative growth y-o-y, %	20
Figure 5. Main sources of revenue to the regional budget (equivalent in MDL million)	22
Figure 6. Distribution of budget expenses by sectors (% of GRP)	22
Figure 7. Dynamics of the unemployment rate (right axis), number of unemployed and vacancies (left axis)	25
Figure 8. Regional Beveridge Curve (2010-2014) - Relationship between the Number of Vacancies and Number of Unemployed	26
Figure 9. Developments of the Consumer Price Index and Core Inflation, y-o-y growth, %	28
Figure 10. Lending Activity of the Region's Banks, Contribution to Annual Growth, %	32
Figure 11. Deposits Attraction Activity of the Region's Banks, Contribution to Annual Growth, %	32
Figure 12. Growth of New Loans and Deposits (% y-o-y) and Quality of Bank Portfolio, %	33
Figure 13. Evolution of the Foreign Trade in Goods and Services of the Transnistrian Region, USD million	36
Figure 14. Geographic Structure of the Transnistrian Exports by Main Destinations, % of the total	36
Figure 15. Structure of Transnistrian Exports by the Main Groups of Products, USD million	37

List of tables

Table 1. Main indicators of the regional public budget (equivalent in MDL)	21
Table 2. Sectoral distribution of the labor force in the Eastern rayons of the Republic of Moldova (% of the employed population)	24



Key messages of this issue

- With the foreign trade exceeding twice the size of the local economy, Transnistrian region is extremely opened and, hence, very vulnerable to various external shocks. Therefore, in order to survive, the regional economy needs a wider access to foreign sales markets, but the unimaginable current account deficit of about 80% of GDP shows competitiveness flaws and severe structural imbalances. This problem has become even more relevant with the worsening economic situation in Ukraine and the Russian Federation, and the uncertainty caused by the Transnistrian authorities' rejection of the Association Agreement signed by the Republic of Moldova with EU. The difficult access to foreign markets, amid low competitiveness and non-sustainable model of economic growth, will be the main challenges the authorities and companies from the region will be facing in the near future.
- The denunciation of the EU Association Agreement, which was signed by the Republic of Moldova for the interest of Transnistria as well, by virtue of sovereignty within the limits of its internationally recognized constitutional borders, is likely to increase quite soon the costs of most exports by about 10% - 15%. This could occur as a result of cancellation by EU of the trade preferences for the Transnistrian companies since early 2016. In the short-run, these losses could be compensated from the companies' profit margins and eventual increase of the financial support from the Russian Federation. However, the long-term repercussions of non-compliance would be irreparable. They are related to the complete economic isolation of the region with the increasing gap from the EU standards, which are being implemented on the right bank of the Nistru River and in Ukraine. Besides, it will contribute to the preservation of systemic problems in the region and, accordingly, to the perpetuation of a non-sustainable model of economic growth.
- The Transnistrian region is eroded by a series of structural deficiencies, which, unless removed, would definitively undermine the economic growth in the near future. The economic potential has recently diminished, which implies a slowdown in economic growth, caused mainly by the erosion of fixed capital due to shortage of investments and by the waste of human capital due to migration issue. This is ultimately due to the business environment, which favors few large enterprises, while the sector of small and medium enterprises remains weak. The highly concentrated Transnistrian economy, with extensive, discretionary and non-transparent state support, reveals the close relationships between the economic and political elites. The close interdependence between these interest groups prohibits the entry of new companies and investments and forms a huge line of resistance against any attempts to reform the economy. In the short and medium term, the "intertwined" economic and political interests will be the main force that will contribute to the perpetuation of monopolies and oligopolies in various sectors, which will continue to undermine the investment attractiveness of the region.
- However, the close relations between the economic and political elites will be put to a severe test by the provisions of the Association Agreement with the EU. The community market is strategic for the businesses in the region, accounting for about half of their exports. Accordingly, the economic elites are interested in maintaining and even strengthening their presence on this market, which is in contradiction with the diametrically opposed geo-political vector that is pursued by the political elites. At present, these divergent views are discussed intensively in the region, companies being urged by the authorities to redirect their exports to other markets, mainly, to the Russian one. However, it is obvious that the Russian Federation is incomparable, both in terms of its size and structure, with the EU market, and therefore it will not be able to fully compensate the potential losses on the EU market. Therefore, one of the immediate priorities having an existential importance for the region is to find a balance between the economic interests of the companies and the geo-political interests of the Tiraspol authorities.



- It is impossible to understand the authorities' motivations and the modus operandi of the Transnistrian economy without taking into account the huge financial and political support from the Russian Federation. Thanks to this support, the region manages to survive, contrary to all economic judgments. In particular, the direct budget support for the region allows maintaining an extensive public sector, which compensates for the low rate of employment in the real sector and supports the domestic demand. Furthermore, several infrastructure projects in the region are funded by the Russian Federation. However, delivery of energy through Tiraspoltransgas-Pridnestrovie company is the most important tool used to support the region. Although it uses the Russian gas (about 1.0-1.2 billion cubic meters yearly), the company does not pay for the consumed gas. Thus, it can set tariffs for the population and business entities that are about 10 times lower than in the rest of the country, and the collected money is used to maintain a generous social protection system. The Russian support is estimated at around USD 500-600 million per year. This has caught the authorities of the region in an acute motivational trap: on the one hand, the Russian financial support allowed hiding the more fundamental structural problems, which can be solved only with a long-term vision, and on the other hand, the Tiraspol authorities are unwilling and unable to develop and implement such a vision. With the possible worsening of the economic and demographic situation in the region, the needs for Russian support will increase, so that the survival of the Transnistrian economy will depend increasingly on the political goodwill of Moscow.
- The Russian financial, political and energy support, in tandem with the autonomous trade preferences from the EU (which will be in force for the region by the end of 2015) created the illusion of a quite comfortable position for local companies and authorities. Thus, the companies can export duty-free to the EU and simultaneously benefit from competitive advantages thanks to the lower energy prices and direct support from the authorities of the region. Over the past years, it fostered job creation, higher wages and budget revenues, and consolidated the presence of the Transnistrian companies on the EU market. With the entry into force of the Association Agreement, the EU trade preferences will be conditioned on a series of reforms, which in the short term, urge the authorities in the region to leave this "comfort zone" and the companies to make further efforts to comply with the EU standards. In these circumstances, the authorities together with the oligarchic groups that control the main companies in the region take actions to maintain the status quo: to keep the autonomous trade preferences for the region without assuming the obligations stipulated in the Association Agreement. By the end of 2015, when the trade preferences extended only for Transnistria expire, the issue of maintaining the status quo versus implementing the Agreement will be the focus of the discussions between Chisinau, Tiraspol and Brussels.
- Access to funding is one of the key constraints for the companies from the region. Due to the isolation of the Transnistrian banking system from the system on the right bank of the Nistru River, and the persistent structural problems (low transparency, unclear regulation, high concentration of the sector etc.), the banks of the region do not have access to funding and the cost of credit is very high. As a result, the penetration of the banking system in the economy is very low, and the banks do not fully exercise their function of financial intermediation. Moreover, during the past months, the real cost of loans increased at a time of disinflationary trends, which will further affect the access of companies and population to the funding sources. In the context where the companies from the region, particularly small and medium ones, feel an acute need for investment, especially for modernization of the production systems to meet the European/international standards, facilitating the access to credits is of an utmost importance. In the absence of a clear political will for reforming and harmonizing the system with the one on the right bank of the Nistru River, these problems will perpetuate in the near future. This will affect significantly the ability of most companies in the region to adjust to the new economic realities following the implementation of the Association Agreement with the EU, favoring the large companies with direct links with the Tiraspol and Moscow administrations.



- The Transnistrian conflict could be settled only when at least two conditions are met simultaneously: (i) a strong political will exists on both sides; (ii) the economy on the right bank of Nistru River is sufficiently robust to absorb the deficiencies and debts accumulated in the economy of the region. Most probably, there will not be any preconditions in the short and even medium term to ensure both conditions. First, there is no political will in the Transnistrian region for reintegration of the country; the Tiraspol authorities pursue a strategic vector that is diametrically opposed to that pursued by the Chisinau authorities. Furthermore, there isn't much of a political will on the right bank of the Nistru River either, given the risk of political forces with pronounced pro-Russian and Euro-skeptical views entering the Parliament with the support of voters from Transnistria, Gagauzia and Balti municipality. Second, the Moldovan economy is, and will remain in the near future, too weak to take over the payment obligations arising after hypothetical reintegration of the country. These mainly relate to:
 - i. automatic increase in the number of pensioners and, accordingly, major pressures on the State Social Insurance Budget, which is already in a prolonged structural deficit;
 - ii. covering the high budget deficit in the region, given the national public finance deficit and limited access to the necessary funds for closing this gap;
 - iii. strengthening of central bank's official reserves, given that the reserves of the "Transnistrian Republican Bank" are over 5 times lower than the required minimum, which could put pressures on the Moldovan Leu;
 - iv. unification of customs and border infrastructure;
 - v. harmonization of quality infrastructure systems, given that during the past years the authorities of the region have adopted Russian standards, while those from Chisinau have adopted the EU standards;
 - vi. adjustment of energy and public utilities tariffs, as they are currently about 10 times lower in the Transnistrian region compared to those on the right bank of the Nistru River;
 - vii. last but not least, accumulated debt for the gas imported from the Russian Federation totaling USD 4.5 billion.
- Assuming that these adjustments will be implemented during ten years, the costs for the national economy could rise up to 20%-25% of the annual GDP, which is not sustainable in the context of the existing economic vulnerabilities, making thus the reintegration of the country an impossible task in the short and medium term.



Executive Summary

Transnistrian Political Economy

The structural and institutional reforms, implemented during the past two decades in Transnistria, were shaped to benefit a small number of economic and political stakeholders. Elements of market economy coexist with arbitrary and severe political interferences in the economy. This resulted in a fractured economic system, based on several giant enterprises, the competitiveness of which depends on the gas supplied by the Russian Federation at subsidized prices. At the same time, the SME sector is very weak, which makes the entire regional economy extremely vulnerable to external shocks. The interests of political elites to increasingly isolate the region from the rest of the Republic of Moldova and the European Union have resulted in an acute conflict with the interests of business elites to ensure the access to as many sales markets as possible, of which the European and Moldovan markets are the most important. The geographic isolation of the region, the pro-EU path of the Republic of Moldova and renunciation of Kiev, in the context of the Russian-Ukrainian conflict, to the policy of positive neutrality towards Transnistria - all these will call for significant changes in the external vector of the region and will require a gradual renouncement to the spirit of confrontation with Chisinau.

Domestic Supply

The perpetuation of structural deficiencies and high exposure to external risks led to a continuous erosion of the Transnistrian economy. The Transnistrian region experiences a sinuous socio-economic development, and the local economy has significantly diminished its growth potential. The region experienced a continuous decline of its natural growth rates from 5.1% in 2005 to 2.1% in 2013. The economic sectors have a volatile development and the medium-term growth prospects are modest. In the short-term the external factors, such as the recession in Ukraine and growth slowdown in Russia, will imply negative effects on the economy of the region. The exposure to external risks will be fueled by maintaining domestic structural imbalances. In the long term, the reluctance of the Tiraspol authorities to implement the Association Agreement between the Republic of Moldova and the European Union could affect the price competitiveness of the goods exported from the region. However, the incompatibility of technical rules of the region with the European ones, which will be applied in the rest of the territory of the Republic of Moldova, will have a more serious effect and could significantly undermine the exports of Transnistrian companies to the EU market.

Domestic Demand

The domestic demand is strongly dependent on the financial flows from Russia, which consist both of the huge financial support provided to the region, and the migrants' remittances, who mainly work in the Russian Federation. These flows feed the investments, directed primarily to social infrastructure objects, support a generous budgetary and social protection system and, accordingly, stimulate household consumption. If the Russian political support continues, the demand of the region will remain constant. However, this will hide the domestic structural problems, and thus the model of non-sustainable economic growth and vulnerable to external shocks will be maintained. Hence, in light of the economic difficulties in Russia and Ukraine, the foreign demand for the goods exported from the region can decrease. However, the main risks associated with the foreign demand come from the increasing gaps between the quality infrastructure of the region and that on the right bank of the Nistru River and Ukraine, which will continue to implement the EU quality standards, incompatible with those applied in the region.



Labor Market

The labor market dynamics in the Transnistrian region in Q1:14 followed the same trends outlined over the past years. Thus, the unemployment rate diminished by 0.2 percentage points y-o-y to 3.5%, and the inter-sectorial redistribution of labor force from the industrial sector took place. However, the labor force is used at a very low degree, with an employment rate of about 33%, by 6 percentage points lower than on the right bank of Nistru, which reveals a wide phenomenon of migration and informality. At the same time, the structural adjustment of the labor market occurs extremely slowly, the public sector playing further the dominant role in the employment amid low demand from the real sector of the economy. Thus, the problems associated with the institutional framework and business environment undermine the demand for labor force, fostering emigration and suboptimal distribution of labor among economic sectors.

Public Finances

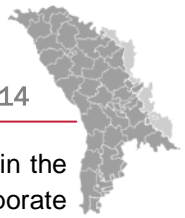
The public finance system of the Transnistrian region is in a critical situation, the budget deficit being planned at 13.2% of GDP for 2014. The main challenges relate to the narrow tax base, high level of informalization of the economy and poor fiscal enforcement and tax administration. Another essential constraint derives from the alarming demographic trends of the region, coupled with wide migration of the working age population. Thus, in 2014 for the first time the number of pensioners exceeded the number of employees in the real sector of economy, which increased the payment obligations of pensions and reduced the budget revenues. The combined effect of these processes results in excessive deficit of the social insurance budget, which accounted for 36% of the expenditures in 2014, this area contributing mostly to the consolidated budget deficit in the region. At the same time, the administrative capacities to reduce the budget deficit are low because of the deceleration of the tax base in recent years and insufficiency of fiscal tools (including the failure to apply VAT). The authorities of the region have recently taken some actions to mitigate the fiscal imbalances optimizing the costs in some areas. However, these efforts cannot bring sustainable results, since they are not accompanied by structural and institutional reforms that would contribute to streamlining the management of public funds.

Prices

The price increase over the past months has slowed amid cooling the consumption and slowdown of lending and economic activities. The disinflationary trends were also caused by the artificial maintaining of the stability of Transnistrian "ruble", as well as of the tariffs to communal services, which remain to be around 10 times lower compared to those on the right bank of the Nistru River. Generally, the system of regulated prices in the region pursues social rather than economic objectives, which prevents the companies from modernization and distorts the competition. The decrease of inflation rate during the recent months has contributed to the raise of the real rates of bank loans, which affects even more the access of companies and population to loans. Contrary to conventional economic logic, "Dniester Republican Bank" has tightened its monetary policy, which could have negative repercussions on the lending activity of commercial banks. In the context of major economic imbalances in the region and the limited level of reserves of "Dniester Republican Bank" it is necessary to adjust the monetary and currency policy to the current economic constraints. Moreover, the disinflationary trends of the region allow a gradual depreciation of the Transnistrian "ruble" without major negative implications on the peoples' income. At the same time, the main priority and challenge for the authorities of the region relates to ensuring the transition of the socially oriented system of regulated prices and tariffs to an economically sound sustainable system.

Banking System

The banking system of the region is relatively well capitalized and liquid, which ensures a relative stability in the volatile internal and external context. However, this stability hides a number of serious structural deficiencies, which pose risks for the near future and jeopardize the access to funds and the economic growth in the region. Thus, amid the increase of real interest rates on loans and worsening of the



domestic economic situation in CIS (mainly Russia and Ukraine), the lending activity of the banks in the region has slowed down steadily over the past months, the main contribution belonging to corporate loans. At the same time, the quality of bank credit portfolio has lowered because of worsening financial situation at several debtor companies. The isolation of the Transnistrian banking system from the national one, the limited access of the banks to funding resources, the economic and political instability in the region, the high level of concentration and lack of transparency in the bank activity will further compromise the credibility and banking system development. This will hit the small and medium enterprises, most of which do not enjoy political "protection" and need investments for modernization and development. The need to facilitate the access of enterprises to loans becomes more urgent in the context of signing the Association Agreement with the EU. Thus, to benefit from the provisions of the Agreement, the exporting companies need to modernize their production processes in line with the community standards - an effort that requires significant financial resources that can be made available only by a robust and functional banking system.

Foreign Trade

The sinuous development of the foreign trade of Transnistria over the past decade reflects a narrow economic base, major competitiveness problems and an acute vulnerability against the vicissitudes of foreign markets. In 2013, the level of exports did not recover the pre-crisis level of 2008, but 2014 started on a more positive note: in January-May the exports rose by about 60%, disavowing the argument of an alleged trade and economic isolation of Transnistria by Kiev and Chisinau. Remarkably, the most significant part of the growth is the exports to the EU, especially Romania and Poland. The region keeps not paying for the gas imported from the Russian Federation, escalating the external debt of the region. In the future, this debt, even if it is not part of the public debt, but a purely commercial one, might be one of the main barriers to overcome in any model of conflict settlement. Taking into account the essential geo-economic imperatives of the region - ensuring the access to foreign sales markets and securing the imports - the plenary accession to the Deep and Comprehensive Free Trade Area, which the Republic of Moldova will establish with the EU, is an opportunity that the region should not miss.



Chapter 1. Transnistrian Political Economy

The first chapter of this publication outlines the essential features of the Transnistrian political economy, highlights the major regional players and their interests, identifies the most important political and economic trends and how the objective trends will interact with the internal and external interests to influence the future of the region.

Analysis of Main Trends

The medieval fortress of Bender (Tighina) town symbolizes the dominant state of mind in Transnistria. After the active phase of the conflict since 1992, during more than two decades, the feeling of being under continuous siege has been cultivated to the population of the region, the primary imperative instilled to the public being to resist at all costs. Meanwhile, the reasons that generated the conflict have either disappeared or have been shown to be imaginary - in the Republic of Moldova the idea of unification with Romania is not part of the political *mainstream*, the ethnic minority rights are observed, Russian is widely used in all social spheres. However a significant share of the Transnistrian population continues to believe that the enemies are *ad portas*, the only ally is Russia, but it is too far.

This syndrome of "besieged fortress" allowed the political elites since early times to influence the political and economic climate of the region in a manner favorable to their interests. The structural and institutional reforms have been largely simulated being shaped for the benefit of a small number of stakeholders affiliated to the de facto power. Following several rounds of opaque privatization, the main assets of the region were taken over by the investors affiliated to the power of Russia or from obscure jurisdictions. The Moldavian Metallurgical Plant and Cement Plant from Ribnita became the ownership of "Metalloinvest" Group owned by Alisher Usmanov, one of the richest men of the Russian Federation. The Moldavian Regional Power Plant from Kuciurgan, passing through the hands of some intermediary owners became in the end the ownership of Inter RAO EAS, a Russian conglomerate affiliated to Kremlin. The textile factory "Tirotext" is the ownership of "Sheriff" Group controlled by a local businessman. The "Sheriff" Group itself appeared and became the largest real estate owner of supermarkets and gas stations thanks to the affiliation with Igor Smirnov, the former president of Transnistria. Hence, the prosperity of the region, quite literally, depends on the decisions taken by a few businessmen.

The division of properties and construction of financial and economic empires occurred without much opposition from other players of the region and without an essential material benefit for the population. The feeling of being under siege tempered the weak contesting starts of the population or opposition, and the special services were very effective in isolating and neutralizing any dissatisfied groups in the region. The conflict and border porosity provided a great screen for those who led the secession of the region to provide monopolies ensuring them individual prosperity.

However, naturally, the interests of political and economic elites developed divergently over time and today they are largely contradictory. The messages of political elites encounter increasingly often the economic reality: "Moldovan economic blockade" announced by the politicians from Tiraspol has miraculously contributed to the growth by 60% of the exports during the first five months of 2013. The decision of unification with Russia on the background of very tight trade dependence on the European Union also produces a strong cognitive dissonance. Well, the current realities are far from those of 2006,



when a referendum was held in the region, the results of which were not recognized by the international community.

Short and Medium Term Forecasts and Challenges

Institutionally, the economic system of the region shows specific elements of a centralized economy, but some elements are common for the market economy. The authorities have a key role in setting the price level, which, in other circumstances, would have led to the occurrence of the shortages and black markets. These circumstances relate firstly to the energy subsidies, direct humanitarian aid and financial support provided by the Russian Federation to the region. How long will Russia provide this support, in the situation in which the Republic of Moldova moves increasingly towards the EU and Transnistria cannot serve as a "millstone" anymore for retaining the geopolitical upturn of Moldova - remains a big question.

The industry has a key role for the Transnistrian economy generating about 25% of the GDP. However, the industrial sector looks like an economic archipelago, with 4 giant companies dominating over a very feeble SME sector. And the critical factor ensuring the competitiveness of three out of the four industrial giants is the very low price of the gas supplied by the Russian Federation. Among others, the subsidized gas makes the cement produced in Rabnita much cheaper than that made on the right bank of the Nistru river, in Rezina.

The agriculture generates a respectable share of 5-6% of GDP, whereas only 5% of the population is employed in this sector. The main advantages of the sector relate to vegetable production, while in case of animal products, the level of self-sufficiency for some products, like meat and milk, is below the critical level of 33%. The sector has great potential, and when integrated with the food and beverage industry, the agriculture can compensate in future for the economic vicissitudes caused by the instability of the heavy industry.

Over the past 4-5 years the service sector has pursued a trend of diversification in terms of branches and of diminishing the role of public services in favor of those offered in the open market. How free this market really is remains an open question, most economic sectors are controlled by monopolies, of which the most influential is the "Sheriff" Group (supermarkets, fuel stations, constructions).

The economic well-being of the region depends critically on the access to foreign sales markets, where the output of industrial giants of the region is supplied. In 2013 the exports accounted for over 55% of the regional GDP, about 40% of them being supplies on the right bank of the Nistru river and about 30% - to European countries.

The macroeconomic imbalances (trade deficit, budget deficit) are huge. In 2012 the budget deficit reached 10% of GDP and following some austere measures it was reduced to 6% in 2013. The trade deficit represents 100% of GDP. Under other conditions, such imbalances would be unsustainable. Such other conditions are exactly those above-mentioned, which are ensured by the Russian Federation.

Three essential metamorphoses, which have recently occurred in the region, will substantially alter the "balance" that the Transnistrian conflict has reached and will essentially reduce the comfort level for the political elites of the region.

- The conflict between Russia and Ukraine led to the radical change of the attitude of the Ukrainian authorities towards Transnistria, especially after the involvement of the citizens of the region in the bloody events from Odessa of 2 May 2014 was proved. Which will be the new policy remains still an open subject, but clearly it will not feed the statehood aspirations of Transnistria.



- The annexation of Crimea by the Russian Federation revived the fears of the Eastern European countries (Poland, Baltic countries, Romania) about the revanchist Russian policy and the worries thereof for their national security. After almost two decades of ignorance and complacency of the Europe and the United States of America regarding the Transnistrian conflict, this is seen now in a new light, especially considering the fact that the Russian Federation maintains the military presence in Transnistria. Finding a sustainable solution for this conflict has suddenly become a priority topic on the agendas of the Western countries.
- Through the political association and free trade with the EU, the Republic of Moldova has reached a new qualitative stage in its process of European integration. In addition, the visa liberalization by the EU for the Moldovan citizens shed new light on the advantages of Moldovan citizenship. The number of applications for biometric passports from the Transnistrian citizens has suddenly increased. It is at the discretion of the authorities of the region to fully benefit from all the opportunities of the European integration or, on the contrary, to isolate themselves even more. Any decision will change radically the incentives for the players of the region.

Policy Recommendations

- Maintaining the status quo, i.e. the "frozen" conflict, involves many costs and risks for both sides, much more serious than it seems at first sight. The limits of tolerance of the international players regarding the absence of borders between two territories having different legal, economic and institutional systems are not infinite. Although this situation is favorable to some narrow circles on both banks of the Nistru river, as well as to some international players who foster geopolitical illusions towards the region, the perpetuation of the current state of affairs is not in the interests of ordinary people.
- For Transnistria the status quo means the perpetuation of the state of uncertainty, its international isolation, high financing costs and operation of the regional economy below potential. Under these conditions, the negative demographic trends and migration, which took menacing speed in the last decade, in the best case will not reverse, compromising the demographic future of the region already by 2040-2050, through the reduction of the population by about 45-50%. It is unclear whether the Russian Federation, whose domestic economic situation becomes more shaky, will remain as generous towards the region as in 2013.
- For Moldova the perpetuation of the conflict means continuation of the bottlenecks in its affirmation as a sovereign and "complete" state, high risks for the international banks for funding the investment projects for Moldova and compromising the efforts for reducing the role of informal economy and fighting the corruption. Moreover, the conflict may be the greatest barrier for the EU accession, the vector announced by the authorities.
- Following several referenda that have not been recognized as democratic by the international community, the population of Transnistria decided to pursue the course towards independence and unification with the Russian Federation. But is Transnistria capable to ensure itself a real independence? Rather not, since it is not capable to self-maintain economically, having an outdated, non-competitive structure and fully dependent on the direct and indirect subsidies from the Russian Federation. The demographic situation and perspectives of the region are depressing. Its land isolation makes it difficult to maintain some supply corridors from the Russian Federation, and the worsening of the relations between Russia and Ukraine will only tighten the control regime by Ukraine.
- The second question, is the desire of joining the Russian Federation consistent with the economic reality? Again, the answer could be desolate for those who support this course. Although ideologically and sentimentally the population is oriented towards Russia, the economic survival of the region is fully dependent on the access to the Moldovan and European sales markets. These markets ensure together about 80% of the foreign exchange earnings of the region from exports. The economic elites are aware of these realities and it is no wonder that the



tensions between the large and medium-sized business and the supporters of the policy of further self-isolation of the region intensified.

- Hence, the two banks of the Nistru River are fated to be together. This is the dictate of history and geography, the two banks would have only to identify the optimal model of coexistence. It is clear that it will be difficult to formulate a sustainable model of settlement, and the costs of reunification, in any case, will be high. However, if the future political elites from Chisinau and Tiraspol are aware of the geographical imperatives and economic realities, they will have to make more efforts to approach Transnistria to Moldova. The time of "trenches rhetoric" has passed.

Chapter 2. Domestic Supply

In spite of a favourable agricultural year and low comparison base, the region's economy is advancing quite slowly. This is caused by the internal economic imbalances and major exposure to external shocks. At the same time, due to the eroded capital stock and emigration abroad, the economy is at the limit of its development potential, which will undermine the economic growth during the following years. The main short and medium term challenges relate to the mitigation of the economic and tax imbalances, strengthening the competitiveness of the companies from the region and maintaining the access to the EU market, without implementing the Association Agreement.

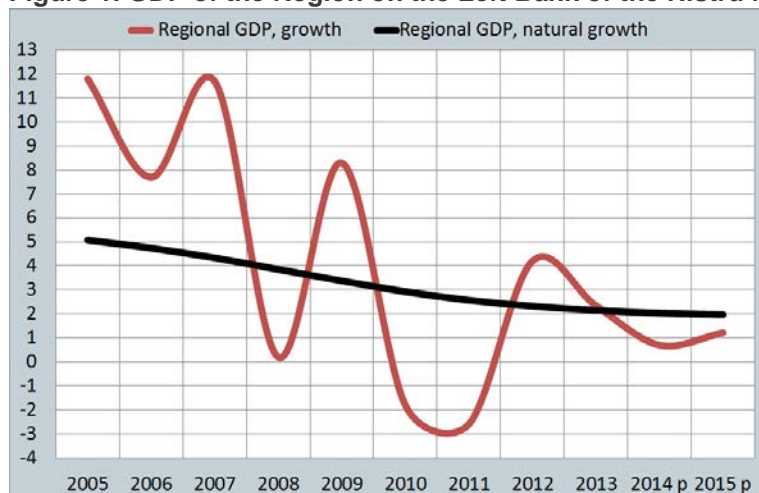
Analysis of Main Trends

In 2013 the Gross Domestic Product (GDP) of the region on the left bank of the Nistru river grew by 2.35%, much lower if compared with the situation on the right bank of the Nistru river. However, this growth allowed exceeding by 2% the GDP of 2009. In spite of this result, the region witnesses a sinuous economic development - revealing thus the vulnerability of the economy on the left bank of the Nistru river (Figure 1). The continuous decrease of the natural growth rates¹ shows that the region is at the limits of its development potential, hence in the medium term the economic growth will be modest, ranging around the value of 1%. The situation is worsened mainly by the drastic shrinking of the industry, which is the main pillar of the region's economy. In structural terms, this sector decreased its share in GDP by 11.6 percentage points during 2008-2013, mainly due to the low competitiveness of most of the enterprises that operate in this region.

¹The natural growth rate was calculated on the basis of data on potential GDP of the region. The potential GDP was estimated using the Hodrick-Prescott filter.



Figure 1. GDP of the Region on the Left Bank of the Nistru River, Growth, %



Source: "Ministry of Economic Development" from the Transnistrian region, estimates of EXPERT-GRUP

Agriculture. This sector has a secondary importance for the economy of the region. The share of agriculture in GDP is much lower than in the rest of the country. In 2013 agriculture reached a share of 5.72% in GDP, representing the maximum level for 2009-2013. The sector is very dependent on the weather conditions and therefore has an oscillatory dynamics. 2012 and 2013 are revealing in this respect: in 2012 the agriculture shrank by 31.1% due to hot temperatures, and in 2013 it grew by 85% y-o-y thanks to the favorable weather conditions. In spite of the multiple and ample variations, in 2013 the volume of agricultural products increased by 69.7% compared to 2009. 2014 started well for the agricultural sector, which increased by 21.5% y-o-y. This result was determined by the growth of the vegetable production by 65.5% y-o-y.

In structural terms the sector is dominated by the large agricultural farms, inherited from the soviet period, which have not changed significantly their operation - in 2013 these farms provided 62.7% of all agricultural production. Farmers and lessors have a minor role and produced only 7.3% of the volume of agricultural production in 2013. At the same time, about one third of the agricultural production was generated by households.

Industry. During the past years, the sector witnessed a considerable regress caused by low competitiveness, weak diversification of sales markets and persistent structural problems (imperfect competition, burdensome business environment, limited access to funds). During 2008-2013 the industry passed through 3 recession waves, bringing the production in 2013 down to 61.9% of the 2007 level (in Q1:14 the sector shrank by 32% compared to Q1:08). After the 17.7% decrease in 2013, the industry started 2014 on a promising note, with a growth of 33.4 y-o-y in Q1:14. However, not all industrial branches had positive results, many of them even decreasing. Overall, the growth of Q1:14 was fully insured by the leap in metallurgy, which increased 102.6 times y-o-y and contributed with 35% to the growth. This branch advanced thanks to the resumption of the work of the Moldavian Metallurgical Plant of Ribnita, which stagnated during the first 3 quarters of 2013. Other subsectors, including: wood industry, construction materials industry, food industry had high growth rates, but a minor contribution to the ascension of Q1:14. At the same time, the chemical, electrotechnical, printing and machinery industries decreased, and the energy sector stagnated.

The recent volatility reveals that the region's industry is very fragile and vulnerable. The activity of a number of subsectors is fully dependant on the operation of some giant enterprises, such as: Regional State Power Plant of Cuciurgan (Moldovan RSPP), Metallurgical Plant of Rabnita, Cement Factory of Rabnita, Tirotext (textile factory), Tighina (shoe factory), Litmas (Metal casting plant), while the share of SMEs in the industrial production is minimal. As a result, there isn't any functional competition that could encourage business entities to upgrade their businesses, aggravated by the non-transparent and arbitrary



mechanisms for the provision of state aid and tax facilities. Simultaneously, this exposes the region's economy to the activity of this small group of enterprises, so that the termination of the giants' activity will not only affect the sub-sectors, but will worsen the performance of the entire industry. For example, in 2013 the metal production dropped by 51.5% due to the stagnation of the Metallurgical Plant of Rabnita. At the same time, the industry is supported massively by the state, which is vital for the activity of the sector (the price paid for gas is about 10 times lower than on the right bank of the Nistru river). Besides, the Metallurgical Plant of Rabnita stopped its activity because of the tightening of the tariff policy: in 2012 the Tiraspol authorities decided to increase the gas tariff for enterprises by USD 70.

At the same time, in spite of the political non-recognition, the region is well anchored in the system of foreign trade relations. The goods produced in the region are exported both on to the East (in Q1:14, 33% of exports were oriented towards Russia and Ukraine) and to the West (in Q1:14, 60.5% of the exported products were delivered to EU). Deterioration of the relationships with the foreign partners, including those from the right banks of the Nistru bank, poses serious risks for the region's economy. The experience of 2013, characterized by the 26% decrease of the energy sector, caused by the decrease in energy procurements by the right bank and cessation of exports to Romania, support this statement.

Services. During the past years, this sector increased considerably the share in the economy of the region. During 2008-2013 the share of services in the region's GDP dropped from 53,6% to 66,1%. However, this "extension" was caused not by the ascension of the service sector, but rather by the industry regress. In general, the components of the service sector had contradictory developments. The transport of goods increased continuously and in 2013 the volume of transported goods increased by 23.4% compared to 2009, and increased by 9.6% compared to 2012. At the same time, the constructions sector did not have the same stable developments. Following the 2010 growth, the volume of contracted works decreased for two consecutive years, but the leap of 30.1% achieved in 2013 overcome the effects of recession. As a result, the volume of contracted works in 2013 exceeded by 13.3% the 2009 level. After the high growth rates of 2013, in Q1:14 the contracted works grew by 2% only. A significant impetus to the revitalization of the constructions sector came from the infrastructure projects, initiated with the financial support from the Russian Federation.

Short and Medium Term Forecasts and Challenges

- The region's economy is close to the border of production possibilities. This will cause a slow dynamics in the medium term. Thus, we expect that in 2014 the region's GDP will increase by 0.5% - 0.7%, and in 2015 the economic growth will be about 1%. Higher growth rates are possible in the future; however these developments will have a compensatory effect and will alternate with modest progresses. The long term trend will be determined by the decrease in the natural economic growth rate.
- In the medium-term the economic sectors might have lower growth rates. This evolution will be caused by 2 factors: uncertain economic development of the Ukrainian and Russian economies and structural imbalances characteristic for the region's economy. According to our forecasts, the industry will slow down its growth, and after the increase of 33.4% y-o-y in Q1:14, it will register a growth of only 9.8% at the end of 2014. In 2015 the sector might shrink by 2%. The agriculture might grow by 5.2% in 2014, and 2015 will be marked by a 4.4% growth of this sector. The volumes of contracted work could increase by 0.9% only in 2014 and will stagnate in 2015.



Figure 2. Developments and Forecast of Economic Sectors of the Region, Cumulative Growth, %



Source: "Ministry of Economic Development" from the Transnistrian region, estimates of EXPERT-GRUP

- In the short and medium run the major risk will be generated by the worsening economic situation in Russia and Ukraine and the right bank of the Nistru river. The recession in Ukraine, slower growth in Russia and economic insecurity on the right bank of the Nistru river will decrease the demand for products from the Transnistrian region, which will affect the most the industrial sector.
- In the long run, the region could encounter two severe problems. First, the reluctance of the Tiraspol authorities to implement the Association Agreement between the Republic of Moldova and the European Union could lead to elimination of the trade preferences provided by EU to companies from the region. This will erode the price competitiveness of the exported and imported goods and the most strategic markets for the region's economy will be lost. In particular, about 30% of the region's exports could become by 10%-15% more expensive, which will diminish the presence of the Transnistrian companies, specialized in light industry, on the EU market. Second, implementation of the Association Agreement will require adjustment of the quality infrastructure of the Republic of Moldova to the EU standards. This will increase significantly the gap between the existing quality standards on the 2 banks and will serve as a non-tariff barrier for the companies from the region, preventing their access both to the EU and other non-CIS markets.
- The Transnistrian economy is eroded by severe structural problems: a non-sustainable budgetary system, oversized public sector, generous state aid provided to "selected" companies. If the Russian support vanishes, the region's budget will not cope with such a large burden.

Policy Recommendations

- The worsening economic situation in the region practically forces the Tiraspol authorities to initiate a wide budgetary adjustment. Such a measure is needed to maintain the financial balance in the region. Transnistria has a permanent "life buoy" - Russian financial support. In this context the possible budgetary optimization will be of "cosmetic" nature, and will not represent a genuine solution. In essence, the hope to use forever the Russian financial support only encourages Tiraspol to perpetuate the imbalanced financial system, with a constant risk of a budgetary crisis.
- Likewise, Tiraspol should initiate deep structural reforms. The strong dependency of the business environment on the Government decreases significantly the region's economic immunity. The non-transparent support to some companies demotivates business entities from becoming more efficient, distorts the competitive mechanisms and is too costly for the authorities.
- The region needs to continue the dialogue both with Chisinau and with EU. With the economy from the right bank of the Nistru river getting closer to the European standards, it will be difficult to maintain the competitiveness of the products manufactured in Transnistria, and it will be practically impossible to export them to EU. In this context it is necessary to enter into a technical dialogue in order to find solutions and minimize the gap.



- A fundamental problem of the region's companies is their dependence on a single market (EU or Russian Federation). Respectively, sales markets diversification is an immediate priority, which can be achieved only by modernizing the production processes, which in turn depends on investments. However, the access to capital is very limited for most enterprises, given the poorly developed financial system, exaggerated costs of loans and low liquidity of assets that can be used as collateral. Hence, facilitation of the region's companies access to finance should be an immediate priority.



Chapter 3. Domestic Demand

Depending in proportion of about 30% on the inflows of remittances, the economy of the region, as well as the economy on the right bank of the Nistru river, is still very much based on consumption, which increased slightly in 2013 and early 2014. At the same time, the investment activity stayed unchanged, being supported, to a large extent, by the financial support of the Russian Federation. Though in the short run such a growth model is comfortable and ensures a certain stability in the context of foreign volatility, in the medium and long run it generates major risks for the economy.

Analysis of Main Trends

Households' Consumption. Since 2010, the retail trade and services provided to the population, which overall reflect the demand from households, have been increasing continuously, though the increase was volatile. In Q1:14 the trade kept growing and increased by 0.5% y-o-y. The positive development of salaries and revenues sent by the population from abroad encouraged population's consumption.

The disinflationary processes in the region determined an increase in the real salaries, which, in turn, fostered population's demand. As opposite to the period of until 2012, when the inflation rates eroded the purchasing power of the salaries, the disinflationary trend that started in 2012 stimulated the continuous increase of the real salary from 2.6% y-o-y in Q1:12 up to 7.2% y-o-y in Q1:14.

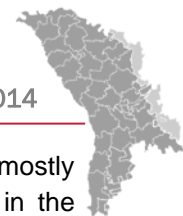
In the absence of internal drivers of economic growth, the welfare of population from this region depends essentially on the revenues sent from abroad. The ratio of transfers from abroad to the GDP of the region increased significantly, from 15.5% in 2009 to 28.9% in 2013. In spite of the volatile development of these transfers, the growth rates are very high. Thus, in 2010-2013, the average quarterly growth rate y-o-y was 15.2%.

Figure 3. Salaries and Transfers from Abroad, Real Growth y-o-y, %



Source: "Ministry of Economic Development" from the Transnistrian region, estimates of EXPERT-GRUP

Capital Formation. Altogether, the investments had a negative dynamics in the past years. Despite the significant recovering increase in 2010 (+61.3% compared to 2009) and 10.4% increase in 2013, the big decrease in 2011 and 2012 (-12.6% and -28.6%, respectively) did not allow recovering to the level achieved in 2007. Thus, in 2013 the investments accounted for only 67.6% of the 2007 level. Still, 2014 started with an intensification of the investment processes and the capital formation increased by 25.4% y-o-y, mainly based on infrastructure projects commenced with the financial support of the Russian Federation.



Generally, the investment process is strongly influenced by the Russian financial support and is mostly directed to the funding of social-type investments. At the same time, the general investments in the business environment have an ambiguous development. Thus, in Q1:14, the share of investments funded from own resources of the organizations accounted for 64.5%, having decreased by 31.6 p.p. compared to the similar period of 2013. On the other hand, in Q1:14 the share of investments funded from other sources accounted for 27.3% and increased by 26.1 p.p. compared to Q1:13.

Foreign Demand. The development model of the region is unbalanced and favors the quicker growth of imports than exports. Because of a deficient business environment, the level of internal supply does not meet the demand, which is mostly supported from foreign sources (remittances and Russian humanitarian aid). At the same time, the acute dependence of the region on the import of energy contributes a lot to the disequilibrium of the trade balance. So, in Q1:14 the deficit of the trade balance amounted to USD 247.6 million, over a half of which consisted of energy products (USD 179.5 million).

Short and Medium Term Forecasts and Challenges

- Taking into account that the evolution of people's income depends on the constant Russian support provided to the region rather than on the economic dynamics in the region, we assume that their development could stay moderately-positive in the medium term. This could generate growth of the retail trade by about 3.0% in 2014 and about 5.0% in 2015.
- The internal demand will continue to be massively supported by the direct and indirect financial support from the Russian Federation, mainly by means of: (i) addition to the pension (USD 15 per month for every retiree) and (ii) subsidies for the prices of utilities, which are about 10 times lower than on the right bank of the Nistru river. At the same time, a big share of population works in the Russian Federation and a tempering of the Russian economy does not seem to affect critically the amount of remittances sent home. This assumption is based on the hypothesis that the migrants from the Transnistrian region will most likely benefit of preferential treatment from the Russian Federation, compared to the emigrants from other countries.
- The investment activity will most likely have positive, though very slow dynamics, being supported by the infrastructure projects conducted with the financial support of the Russian Federation. In 2014 the growth is forecast to be only 0.5%-1.0%, but in 2015 the investment dynamics could strengthen up to 5%. The development of capital formation will be characterized by keeping a high share of investments in social infrastructure, funded directly or indirectly from the sources of the Russian Federation. At the same time, the component of investment activity related to the business environment will have an uncertain perspective.



Figure 4. Retail Trade and Services provided to the Population and Investment, cumulative growth y-o-y, %



Source: "Ministry of Economic Development" from the Transnistrian region, estimates of EXPERT-GRUP

- The Russian Federation will make efforts to maintain the impression of a "success story" in the Transnistrian region. The success story of the region will be opposed to the achievement of the pretended "success story" on the right bank of the Nistru river with getting closer to the EU. Most likely, in implementing its political intents, the Russian Federation will provide money to support massively the Transnistrian region, particularly taking into account that the cost of this support is insignificant for the resources of this country.
- In the long run, certain developments could diminish significantly the demand for products from this region. Transnistrian region could become an anti-European island, in an area which aims at European integration, particularly given that both the Republic of Moldova and Ukraine signed the EU Association Agreements. Both the region on the right bank of the Nistru river and Ukraine will adjust their standards to the European ones, which will deepen the discrepancies with the technical requirements applied in the region. As a result, the demand for products from Transnistria will decrease.

Policy Recommendations

- The Tiraspol authorities must make efforts to avoid discrepancies between the quality standards applied in their region and the ones used in Ukraine or on the right bank of the Nistru river. This is necessary to be able to keep a constant foreign demand for the goods produced in the Transnistrian region.
- Improvement of the business environment should have a particular role in the policies promoted by Tiraspol. The strong concentration of economic activity on the operation of some inflexible and shock-prone "giants", as well as poor development of small and medium enterprises represent a risk for the development of the region. Improvement of the business environment must become a strategic priority for the authorities of the region.
- Taking into account that the economy of the region is energy-intensive and sensitive to the change in the fuel tariffs, it is necessary to invest in re-technologization of production capacities, in order to increase their energy efficiency. At the same time, this could much easier be achieved with the support of foreign investors. However, in the context of political non-recognition and uncertain future of the region, it is very unlikely for serious foreign investors to get involved in economy modernization. In the circumstances of the Transnistrian region, a solution for the modernization of the production sector would be to start a program promoted by authorities.



Chapter 4. Public Finances

The public finances in the Transnistrian region are in a critical condition, the main symptoms being excessive budget deficit, narrow tax base and acute competition within the regional elite for the control of financial flows. Thus, the shy attempts to reorganize the budget expenses not accompanying them with structural and institutional reforms push the regional economy into a vicious circle of austerity and make the current fiscal-budgetary framework unsustainable.

Analysis of the Main Trends

After the “presidential” elections of 2011, the conflicts within the regional elites got stronger, having affected all economic sectors, including the fiscal-budgetary one. As a result of the frictions between the executive and the legislative powers, the Law on Consolidated Budget for 2013 was not approved by the leader of the region, the funding taking place according to the budget law on the previous year, with corresponding ceilings of budget expenditures. In 2014, for economic reasons, the Government of the region accepted a compromise and approved the budget for the respective year, also having developed for the first time the medium-term budgetary framework for 2014-2016.

Generally, the public finance system of the region is in a critical condition (Table 1). Because of insufficient tax base to cover the public spending, the budget deficit is worrisome (18% in 2012 with a sudden decrease in 2013 only due to the failure to approve the budget law for that year). At the same time, a decrease in the share of public spending and public revenue in GDP is forecast for the next year. This reveals that the authorities of the region are aware of these constraints, having adopted a tight fiscal and budgetary policy. The efforts for the stabilization of the public finance system are made on the account of expense optimization, without additional tax pressure. This approach is motivated by the fragile economic situation and extensive budgetary sector, which consumes about 40% of region's economy (indicating clear saving possibilities).

Despite these efforts, the budget deficit will stay much over the upper threshold of sustainability (of at least 3% of the GDP). Thus, in case of potential external shocks and with the delayed structural reforms, there is a major risk of shaking up the austerity efforts, putting the payment capacity of the region at a tough test.

Table 1. Main indicators of the regional public budget (equivalent in MDL)

	2012	2013	2014 (e)	2015 (e)	2016 (e)
GDP (million)	12 703.6	13 481.1	16 513.3	18 515.5	20 938.2
Budget revenue (million)	2 838.7	3 282.6	3 572	3 557.9	3 847.2
Budget expenses (million)	5 127.5	4 137.8	5 754.4	5 807.8	6 176.6
Deficit (million)	(2 288.8)	(855.2)	(2 182.3)	(2 249.9)	(2 329.5)
Expenses (% of real GDP)	40.4	30.7	34.8	31.4	29.5
Revenues (% of real GDP)	22.4	24.4	21.6	19.2	18.4
Deficit (% of real GDP)	18	6.3	13.2	12.2	11.1

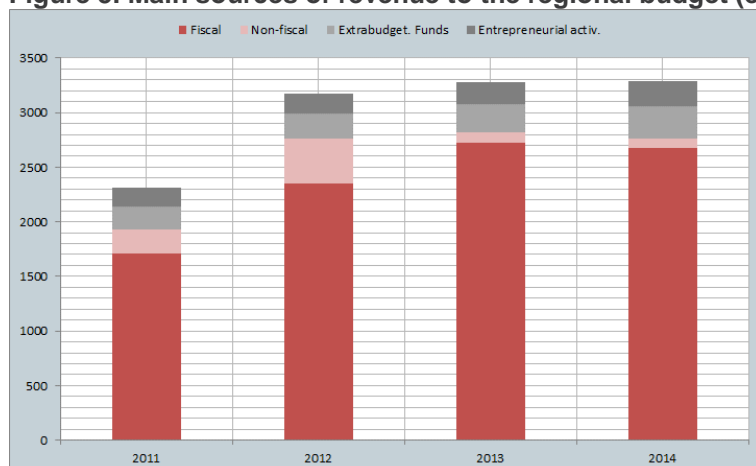
Source: “Ministry of Finance” of the Transnistrian region

One of the main reasons of the persistent budget deficit is the stagnation of tax base in the past two years. Figure 6 reveals that the budget collections decreased significantly mainly due to the deceleration of tax collections, a 6% decrease being planned for this component for 2014. Thus, the prevalence of tax revenue as a source of income for the consolidated public budget, ensuring about 75% of the total budget revenue, determines the general trend of the budget dynamics. Another structural deficiency of the budgetary system from the region is the failure to apply the value-added tax, which on the right bank of the Nistru river ensures about one third of the National Public Budget. Thus, the main pillar of the public



finance system of the region is the income tax, which contributes with about 55% (in 2013) in the total tax revenue. Hence, VAT is a sensitive point, both in terms of compatibility of the fiscal systems on right and left banks of the Nistru river, and in terms of missing a significant part of the fiscal revenue for the regional budget.

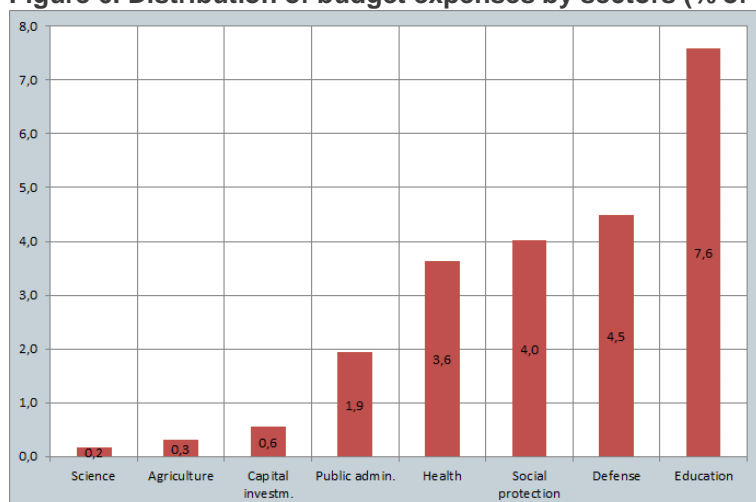
Figure 5. Main sources of revenue to the regional budget (equivalent in MDL million)



Source: "Ministry of Finance" of the Transnistrian region

Besides the narrow tax base, another major cause of the discrepancy in budget revenues and expenditures in the region is the inefficient structure of allocating limited resources from the regional budget. The biggest burden for the regional budget is the excessive number of workers in the public sector, as well as the obsolete and expensive structure of the social assistance system. The regional budget, as well as the national one, has a strong social orientation, accounting for 77% of the expenses of the regional budget or 23% of the GDP of the region².

Figure 6. Distribution of budget expenses by sectors (% of GRP)



Source: "Ministry of Finance" of the Transnistrian region

An important difference between the regional and national budgets is the share of expenses that go to defense and public order. Hence, related to the GDP, the expenses of the Transnistrian region are over 2 times higher compared to the spending on the right bank of the Nistru river: 4.5% compared to 2.0% in 2013. Concentration of financing in such a non-productive area, given the current budget deficit, diverts the scarce resources from their efficient use and slows down the optimization of the budget expenses.

²According to the regional budgetary classification, the final data for the social area include the payroll costs, social assistance, maintenance of social organizations, transfers to the territorial budgets etc.



Particularly, the defense sector, being a priority one, transfers the burden of austerity to the other sectors and perpetuates a stagnating tax base.

Short and Medium Term Forecasts and Challenges

- The economy of region depends on the development of the foreign markets and is sensitive to external shocks. The geopolitical tension in Ukraine and resistance to implement the provisions of the Association Agreement, signed between the Republic of Moldova and the European Union, amplify the risks for the regional economy and dynamics of tax collection. Currently a major challenge is the possible interruption in the gas supply as a result of Gazprom stopping the deliveries to Ukraine, which will have a negative impact both on the real sector and on the transit fee collection.
- The current social assistance system is too expensive for the current shape of the economy and diverts financial resources from the sectors with higher performance, able to stimulate the economic activity. The negative demographic dynamics, emigration processes and, as a result, the number of retirees surpassing, for the first time, in 2014, the number of workers will keep complicating the situation in the public finance system, first of all with major pressures on the Social Insurance Budget. The deficit of the Social Insurance Budget already accounts for 36% of the expenditures (2013) and keeps growing quite quickly, with a planned deficit of 38.5% in 2016. In such a way, the rapid increase in the number of retirees and amount of the pension, which is on the average 56% higher than the equivalent on the right bank of the Nistru river, is one of the biggest challenges for the public finance in the region.
- Although there no official estimates of the unobserved economy, there are signs that this phenomenon started to grow lately. The growth of tax evasion phenomena can be deducted from the quite sudden deceleration of fiscal collections in the last year and planning of a tempered growth dynamics in the medium term. As well, the political confrontations within the local elites had a negative impact on the quality and performance of public institutions, which would compromise the efficiency of measures aimed to diminish tax evasions.
- Another weakness of the current fiscal system of the region is the sub-optimal structure of taxation. Thus, the absence of VAT reduces significantly the amount of collected amounts, complicates tax administration and facilitates tax evasion. Absence of VAT also generates additional costs of financial management within the exporting companies. The cause is that the EU, Russian Federation and Ukraine (main commercial partners of the companies from the region) apply VAT, while the absence of this leverage within the region does not allow VAT return for exporters. This affects the competitiveness of the Transnistrian companies and is an additional factor that lowers the investment attractiveness of the region.

Policy Recommendations

- In order to streamline the fiscal austerity, it is critical to optimize the public spending, improving, in parallel, the quality of institutions and stimulating the activity in the real sector of the economy. The budget expenses will be optimized efficiently only by improving the business environment and enlarging the tax base.
- The reform of social assistance system (raising the retirement age, implementation of health insurance etc.), as well as the inter-sectoral redistribution of public expenses to the sectors with a higher performance is critical for the stimulation of economic growth.
- The fiscal optimization processes, accompanied by more efforts aimed at combating tax evasion, will contribute to closing the gap between the potential and actual revenue collected. Hence, it is necessary to take a set of measures aimed at minimizing the administrative barriers, optimizing the fiscal framework, as well as improving the quality of public services to diminish the tax evasion.
- An important factor in improving the fiscal-budgetary framework and diminishing the budget deficit in the medium run is to widen the range of fiscal tools, first of all - to introduce the VAT. The implementation of this tax will encourage tax collection and will strengthen the



competitiveness of companies in the region, because the exporters will be able to request VAT return.

Chapter 5. Labor Market

The labor market in the Eastern districts of the Republic of Moldova is, to the same extent as in the rest of the country, affected by the demographic and structural processes. However, the region is facing a higher under-use of labor force caused by wider migration processes, informal employment and inefficient inter-sectoral distribution. In such a way, the sustainability and speed of economic growth in the region will depend on solving these deficiencies.

Analysis of Main Trends

The Soviet-time industrialization and the urbanization of the region influenced directly the inter-sectoral distribution of labor force. Thus, only 6% of the employed population is working in the agricultural sector, while industry and services cover 23% and 31% of employed population, respectively. However, the role of the public sector in employing 39.5% of labor force is a symptom of low demand for labor force from the real sector of the economy (Table 2). Therefore, the issues with the business environment, poor financial infrastructure and oligopoly of the economy hold back the development of the small and medium enterprises sector, leading to the concentration of labor force in less productive sectors.

As a result of structural deficiencies and low competitiveness of the industrial sector, there was noticed during the past years the migration of labor force from industry towards other sectors (mainly towards services). Thus, in 2013, about 22.4% of the employed population worked in various industrial branches, by 1.3 p.p. less compared to 2012; at the same time, the share of population employed in service sector increased from 30.3% to 31.0% during the same period of time (Table 2).

In Q1:14 the number of employed people decreased by 1% y-o-y, down to 104,250 people (without small enterprises sector), so that the dynamics of the employed labor force was more accelerated than the natural decrease of the population in the region (-0.66%) in the same period. Concurrently, the trends of the past years continued, i.e. reorientation of the labor force from industry (-4.5%) to services (+3.3%). The number of staff in the public sector decreased slightly (by about 0.8%), still ranking the first in terms of number of employees.

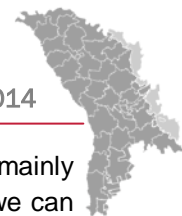
Table 2. Sectoral distribution of the labor force in the Eastern rayons of the Republic of Moldova (% of the employed population)³

Sector	2012	2013
Agriculture	5.5	6.0
Industry	23.7	22.4
Market services	30.3	31.0
Public	39.4	39.5
Other	1.0	1.0

Source: "Ministry of Economic Development" of the Transnistrian region, estimates of EXPERT-GRUP

The main labor market indicators reveal a low efficiency in the use of labor in the region. Thus, the employment rate in 2013 was only 33.2%, while the share of inactive population was 65.7%, the situation being somewhat more difficult compared to the situation on the right bank of the Nistru river, where these

³The data don't include figures about the number of employees in the Ministry of Interior, Committee for Security, Ministry of Defense and Customs Service. Thus, if these data are included, the share of the public sector in terms of employees would increase.



variables were 39.3% and, respectively, 58.6%.⁴ The category of inactive population includes mainly discouraged people, the ones who are abroad, as well as the informally employed people. Thus, we can conclude that Transnistrian region is more affected by migration and informalization of economy, compared to the rest of the country.

The unemployment rate (calculated based on the records of the employment office) reveals very low values (around 3-4% for the past years), but with a low employment rate, it rather confirms the high level of informal economy, but also strong exposure to migration processes. Particularly, informal self-employment in trade is intensely practiced by the locals (for instance, procurement of consumer goods from Ukraine and selling them in the region). At the same time, the emigration and dependence on remittances (mainly from Russian Federation), absorbs the pressure from the labor market and diminishes the motivation of other members of the households with migrants to work for small salaries. The low unemployment rate is also determined by inefficient activity of the Employment Office in the region, which, in turn, is affected by the low demand for labor force from the real sector, but also by the low level of remuneration because of chronic insufficiency of investment in the region.

Figure 7 reveals that, in the medium term, the unemployment has had a decreasing trend. At the same time, compared to the rayons on the right bank of the Nistru river, this trend is characterized by lower seasonal amplitude due to the smaller share of the agricultural sector. However, the very low employment rates that are officially registered, accompanied by an extremely high share of inactive population, emphasize how irrelevant it is to use this indicator for the evaluation of the actual situation on the labor market.

Figure 7. Dynamics of the unemployment rate (right axis), number of unemployed and vacancies (left axis).



Source: "Ministry of Economic Development" of the Transnistrian region, estimates of EXPERT-GRUP

As well, Figure 7 reveals a certain discrepancy between the number of registered unemployed and number of vacancies. Thus, there is a sub-optimal balance on the labor market and by optimal operation of the market, the unemployment rate could be halved. Persistence of these processes can be explained by the existence of structural unemployment: essential dis-balance between labor force supply and demand maintained for a long term. Thus, the Beveridge curve for the labor market in the region shows a very different dynamics compared to the one calculated for the economy on the right bank of the Nistru river⁵. As opposite to the situation in the rest of the country, which did not suffer of significant changes, the curve calculated for the Transnistrian region changed to the left, to a more optimal position and

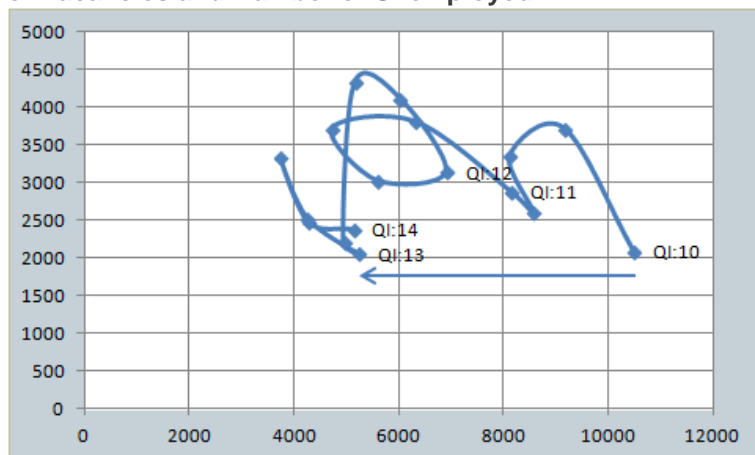
⁴Since the regional statistics authority does not publish data about age structure of the population, when calculating the employment rate and the inactive population the basis of the calculation was the share of population over 15 years old from the rayons in the right bank of the Nistru river, published by the National Bureau of Statistics of the Republic of Moldova.

⁵The Beveridge curve displays the relationship between the level of unemployment and number of vacancies at a certain level of labor market efficiency. Increasing the discrepancy between labor force and new workplaces leads to a rise in structural unemployment, causing a shift of the curve to the right.



overlapped with the descending dynamics of the unemployment rate (Figure 8).⁶ However, this shift of the curve does not suggest a decrease in the structural unemployment and streamlining of the labor market, but can rather mean a return of the curve to the old balance after the crisis of 2009 (in the absence of data it is impossible to estimate the dynamics before 2010). In such a way, the shift of the Beveridge curve of the region, compared to the national one, reveals that the labor market from the Transnistrian region is not flexible and very vulnerable to external shocks.

Figure 8. Regional Beveridge Curve (2010-2014) - Relationship between the Number of Vacancies and Number of Unemployed.



Source: "Ministry of Economy" of the Transnistrian region, estimates of EXPERT-GRUP

Another important constraint for the regional economy is the rapid growth of the number of retirees compared to the employed population. In Q1:14, the number of employed population was 141 thousand people, while the total number of retirees (in all categories of pensions) was over 140 thousand. Thus, the negative dynamics of demographic processes, burdened by inefficient allocation and use of labor make the current model of the regional economy not to be functional in the medium and long run.

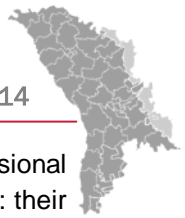
Short and Medium Term Forecasts and Challenges

- The inter-sectorial distribution of labor force will not change significantly in the medium term, with the public sector continuing to dominate the labor market due to excessive bureaucracy and low quality institutional framework. In addition, concentration of the labor force in less efficient sectors will affect negatively the dynamics of the aggregate labor productivity.
- The failure to improve the business environment and foster the development of small and medium-sized enterprises will inhibit the diminution of the share of non-active population (emigration and informal sector) and of the structural unemployment.
- The population ageing, in tandem with the decrease in the number of employed people, will create increasing pressures on the public finance system of the region. Lack of political will and institutional capacities to implement structural reforms will aggravate the imbalances on the labor market.
- The tense situation and negative economic trends from Ukraine will increase the pressures on the labor market in the region, as it affects severely the self-employed population and SMEs that buy products in Ukraine and sells them in Transnistria.

Policy Recommendations

- The structural unemployment is manifested as an increasing gap between the labor force preparedness and quality of the newly created jobs. This can be remedied by adjusting the

⁶ Expert-Grup, "MEGA – Moldova Economic Growth Analysis", Q1-2014 (#10).
<http://www.expert-grup.org/ro/biblioteca/item/947-mega-x-2014&category=178>



educational system to the needs of the market economy and by improving the professional retraining programs. Currently the staff retraining is not a well-spread practice in the region: their number is very low and accounts for about 1% of all registered unemployed, having an insignificant role in fighting the structural unemployment.

- The labor market degraded to such an extent that, in the absence of structural and institutional reforms, the region's economy could enter into a permanent stagnation. To encourage the demand for labor force from the private sector it is necessary to improve the business environment by enhancing the quality of public bodies, strengthening the competition, demonopolizing the market, and improving the access to finance.
- As for the work force, it is necessary to adjust the educational system to the standards of the market economy and improve the professional retraining programs for the unemployed. The labor force quality should be a priority in the sector programs and should be implemented consistently by the line authorities. To this end, it is appropriate to develop students/teachers exchange programs between both banks of the Nistru River.
- Given that the ratio of the employed population to retirees is inversing, the reform of the pensions and social assistance system becomes unavoidable. This reform should be comprehensive, covering a number of adjacent and interconnected sectors. Thus, besides reforming the legislative and institutional framework, it is crucial to improve the quality of and trust in the financial system of the region.



Chapter 6. Prices and Monetary Policy

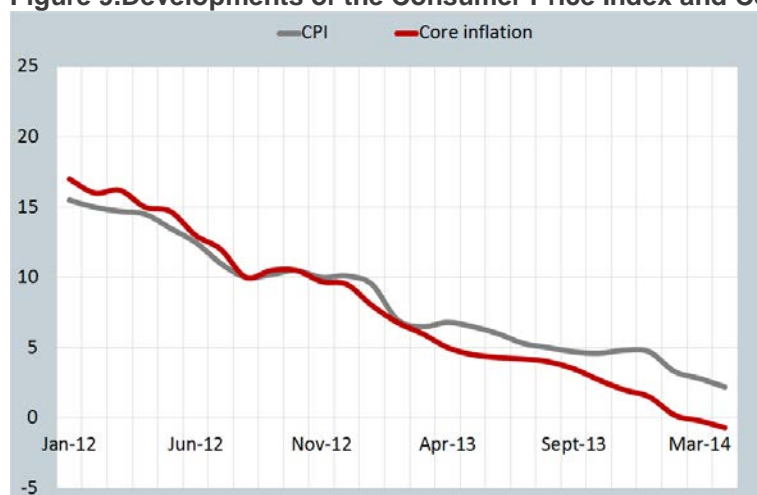
The inflationary environment remained relatively stable, but over the past months a constant disinflationary trend emerged. This is caused by the slowdown in economic growth and various institutional rigidities specific for this region: fixed tariffs and regulated prices for goods and services, administrative maintenance of the constant parity between the Transnistrian “ruble” and US dollar. Overall, the price-setting system for the key products and services consumed by the population pursues social rather than economic objectives. This prevents companies from investing in modernization, which undermines significantly the economic competitiveness of the region. Such a development paradigm is not sustainable for the long term, and its maintenance depends strictly on the direct or indirect financial support provided by the Russian Federation to this region.

Analysis of Main Trends

At the end of the first quarter of this year, the annual Consumer Price Index (CPI), calculated for the Transnistrian region, constituted only 2.2% (5.7% on the right bank of the Nistru river), under the level of 4.0% planned by the “Dniester Republican Bank”. To a high extent, this was caused by the increase in public utilities fees for companies (+0.7 p.p.) since 1 January 2014. The prices for foodstuffs constituted another important factor, contributing by 0.5 p.p. to the annual inflation level in Q1:14. This was mainly due to vegetables (+11.1% y-o-y), fruit (+7.4% y-o-y) and pastry (+1.3%). Thus, to a high extent, the inflationary pressures were determined by non-monetary factors, mainly related to higher production costs and specific situation on foodstuffs market.

At the same time, the monetary factors that can be influenced by the central bank created disinflationary pressures. Thus, the prices for non-food products decreased by 1.7% y-o-y in Q1:14. This was determined by the cheapening fuels (-17.9%), medicine (-0.5%) and construction materials (-0.2%). At the same time, the prices for market services provided to the population decreased by 1.5%. Thus, there is a gap between the inflationary pressures generated by administrative and seasonal factors and disinflationary pressures generated by monetary factors. This gap has extended over the past years, as proved by the increasing discrepancy between the developments of CPI and core inflation (Figure 9).

Figure 9. Developments of the Consumer Price Index and Core Inflation, y-o-y growth, %



Source: “Dniester Republican Bank”



The descendant trend of the core inflation, which by the end of Q1:14 decreased by 0.7% y-o-y, reveals the constant cooling of the demand in the region and slowdown of the overall economic activity. Moreover, this also has a negative impact on companies, because of the lower sales revenue and higher real interest rates for bank loans ("Banking Sector" Chapter).

Overall, the low inflation and disinflationary trends, noticed over the past few months, are not caused by economic stability in the region, but rather by the cooling of consumer demand and administrative setting of prices and tariffs for the most important products and services, as well as of the exchange rate of the Transnistrian "ruble". For example, at the beginning of this year the region's authorities decided to keep the same energy tariffs for households and increase them for business entities. At the same time, the exchange rate is set artificially at the level of 11.1 "rubles" for 1 USD - remaining practically unchanged since late 2012.

It is important to note that the exchange rate remained constant, though the demand for foreign currency is systematically higher by about 5%-6% than the offer of foreign currency in the region, which puts pressure on the Transnistrian "ruble". Thus, in spite of the necessary preconditions for its depreciation, the "Dniester Republican Bank" intervened by selling its foreign currency reserves to maintain the currency stability.

Contrary to the economic logics, with underlying slowdown in economic growth and disinflationary trends, the "Dniester Republican Bank" tightened the monetary policy in the region. Thus, it has increased in May the compulsory reserves requirement for deposits of individuals from 2% to 4%, and in June - to 6%. At the same time, for the deposits of legal entities the compulsory reserves requirement was increased from 8% to 10% in May and then to 12% in June. Hence, the banks will be forced to "freeze" larger amounts from the attracted resources, having fewer resources available for the lending activity. Such a policy limitation is usually introduced when the national economy get overheated, in order to stabilize the lending expansion, which is not currently the case in the region. The Bank rather decided to strengthen the stability of the banking system, limiting thus the crediting of the real sector.

Short and Medium Term Forecasts and Challenges

- Currently, in the region the tariffs for energy sources and public utilities for the population and enterprises are about 10 times lower than the ones applied on the right bank of the Nistru river. They are maintained thanks to the direct financial support from the Russian Federation and failure of the region's authorities to pay for the gas to Moldova-Gaz. Respectively, this maintains the companies' competitiveness and decreases the social risks in the region. Thus, these tariffs are not aligned to the economic realities and rather have a social role. But such a price-setting paradigm prevented the upgrading of public utilities enterprises, and most of the companies remained energy-intensive. To set the necessary base for the modernization of the energy and public utilities sector, the authorities will have to gradually adjust, sooner or later, the tariffs to the economic realities, in particular for business entities. Such attempts were already made in 2013 and early 2014 and most probably will continue in order to free more resources for the maintenance of gas delivery and public utilities infrastructure.
- Given that the demand for foreign currency is systematically exceeding the offer, the costs of maintaining the stability of the Transnistrian "ruble" will increase constantly. Maintaining artificially the exchange rate is not sustainable in the medium and long run, given that the foreign currency reserves of the region's central bank do not cover even one month of imports (according to the conventional rule, the reserves should cover at least 4 consecutive months of imports). Hence, a major challenge for the monetary authority of the region will be to adjust gradually the foreign exchange policy to the economic realities, without affecting the trust in the region's currency and without feeding the inflationary pressures.



Policy Recommendations

- Given the anticipated continuation of the trend of adjusting the public utilities fees, the enterprises from the region should find other ways of maintaining their competitiveness: invest more in technologies and equipment and, respectively, use more efficient the main production factors (labor and capital). Respectively, the tariffs should be adjusted in parallel with considerable enhancement of the business environment in the region and encouraging the companies' access to crediting resources.
- In the context of pronounced disinflationary pressures in the region, we do not recommend tightening the monetary policy, as practiced by "Dniester Republican Bank" during 2014. On the contrary, the necessary preconditions are now in place for a gradual adjustment of the exchange rate to the macroeconomic imbalances in the region, without affecting significantly the inflation level. Moreover, a gradual depreciation of the Transnistrian "ruble" will improve the exporters' price competitiveness and will allow funding, at least partially, the current account deficit, which is at an incredible level of 90% of the region's GDP (conventionally the highest allowed level of 5%-7% of GDP).
- It is necessary to liberalize the price system in the region in order to ensure the companies' financial viability and ensure the necessary financial base for their modernization. The authorities should not regard the price-setting system, in particular in the case of public utilities, as a social policy instrument, as there are other leverages to this effect.



Chapter 7. Banking System

During the reference period, the banking system from the Transnistrian region maintained its stability, being capitalized enough and holding an abundance of liquidities. However, some worrisome trends have emerged: the growth rates of lending and deposit attraction activity have decreased constantly, the quality of bank portfolio has worsened, and the real cost of lending has increased. Besides, the sector is encountering a series of systemic challenges: high concentration and distorted competitive framework, isolation of the Transnistrian banking system from the rest of the country, low efficiency of the banking activity and a weak penetration of the system in the economy of the region. If perpetuated, these problems will increase even more the costs in the near future, in particular in the situation of acute need for investments in the real sector.

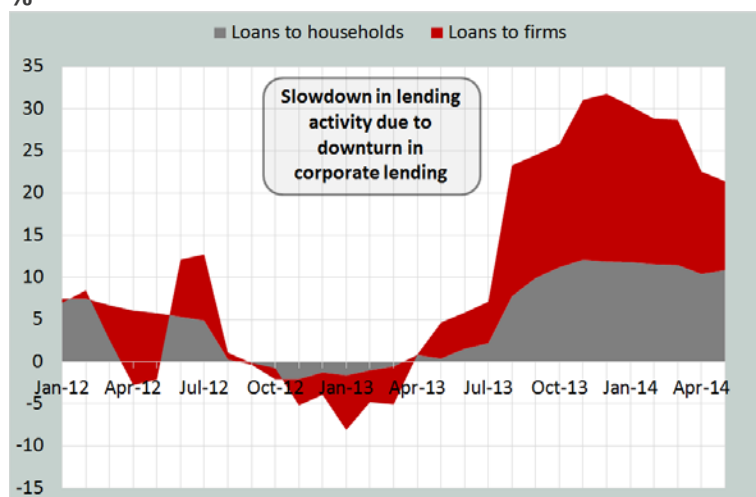
Analysis of Main Trends

The banking system of the Transnistrian region is relatively stable, with some enhancement trends registered during the past months. Thus, at the end of the first quarter 2014, the total capital for the banking system increased by 0.6% since the beginning of the year, the system remaining well capitalized: the coverage level of deposits by capital constituting 25% (about 20% on the right bank of the Nistru river), and risk weighted capital adequacy - about 70% (about 8 times higher than the minimum required in the region and over 3 times higher than on the right bank of the Nistru river). Moreover, the system has a relatively high liquidity level, the ratio of loans and deposits being under one: in May-13, the loans covered only 70% of the attracted deposits (80% on the right bank of the Nistru river), which suggest an unexplored potential of the banks from that region.

It is important to state that the banking system remained stable with an underlying robust growth of lending: the total volume of new loans for companies and individuals increased by an average of 26% y-o-y during the first five months of this year. This was mainly fostered by the loans extended to the real sector, which accounts for over 70% of all loans. However, during this year the share of consumer loans provided to individuals increased: in Jan-May:14 it grew by 50% y-o-y, while the loans provided to companies grew by about 20% y-o-y. Overall, during this year the lending activity witnessed a constant slowdown (Figure 10), which was determined both by the robust expansion of lending last year, and by the higher insecurity and worsening of the economic situation in the region.



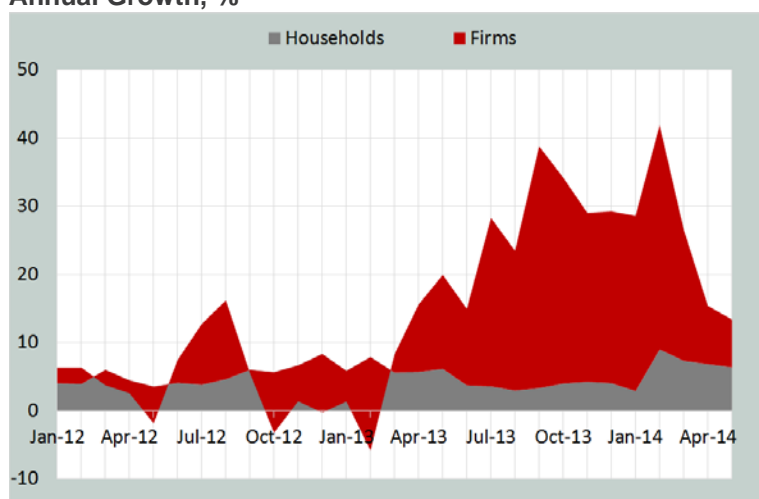
Figure 10. Lending Activity of the Region's Banks, Contribution to Annual Growth, %



Source: "Dniester Republican Bank", EXPERT-GRUP estimations

The deceleration is even more visible in case of deposits: the total volume of attracted deposits by the banks in the region increase by 13.4% y-o-y in May:14, while during the first three months of this year it increased by 32.4% y-o-y. The slowdown was mainly determined by the deposits opened by companies (from 42% y-o-y in Jan:14 to 11% y-o-y in May:14), whose share decreased since the beginning of the year from 66.5% to 61.4% in May:14. This was determined by the decrease in the corporate revenue and household income amid the recent economic trends.

Figure 11. Deposits Attraction Activity of the Region's Banks, Contribution to Annual Growth, %

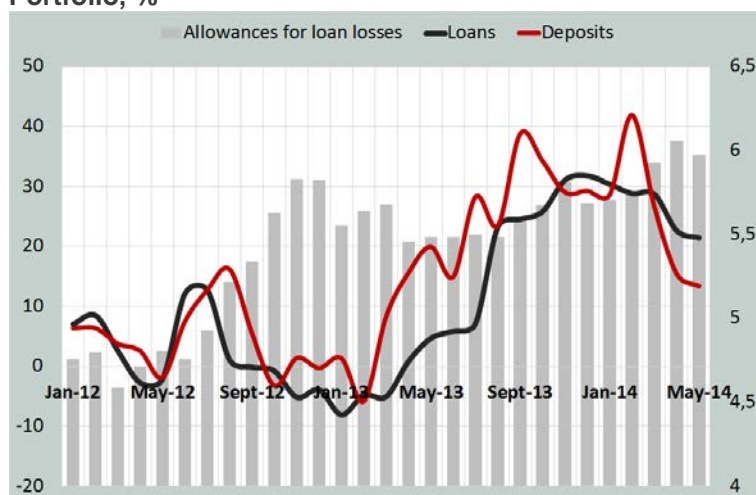


Source: "Dniester Republican Bank", EXPERT-GRUP estimations

The parallel slowdown of the growth rates of both deposits and loans is even more worrying on the background of worsening quality of bank portfolio in the region. Though there are not any data on the volume of non-performing loans, it can be derived based on the developments of the loan loss provisions. Thus, while the volume of new loans extended by banks during Jan-May:14 increased by 26.1% y-o-y, the resources allocated by banks to cover the credit risk increased quicker (by 33.5% y-o-y). Given the prudential regulatory provision on the allocation of the respective resources by the risk profile associated with the banks' loan portfolio; we may conclude that the bank's loan portfolio has worsened during the analyzed period.



Figure 12. Growth of New Loans and Deposits (% , y-o-y) and Quality of Bank Portfolio, %



Source: "Dniester Republican Bank", EXPERT-GRUP estimations

The increase of the real interest rate on loans and decrease of the real interest rate on deposits were other important factors that contributed to a lower lending and deposits attraction activity in the region (Figure 12). As a result, the banking margin increased (the difference between real interest rates on loans and deposits), reaching 12.4 p.p., which is much higher than the optimal level (3-4 p.p.). This is caused by the high insecurity in the region, associated with the well covered internal and external macroeconomic situation, and worsening of the bank loans portfolio. Hence, this determined banks to increase significantly the risk premiums on the extended loans. At the same time, the abundant liquidity (only 70% of the attracted deposits are converted to loans, the rest remaining on the banks' accounts) decreases the banks' demand for deposits, which explains the negative actual interest rates on deposits since Dec:12.

Short and Medium Term Forecasts and Challenges

- The high capitalization and abundant liquidity in the banking system from the region ensures its relative stability and immunity to eventual internal and external shocks. But the price of this immunity is the limited access of individuals and the real sector to bank loans and persistence of a huge, but unexplored potential of the system (the banks are not using fully the attracted resources). Thus, the banks from the region do not carry out fully their function of financial intermediation between those who have savings and those who need funding. The penetration level of the banking system is very modest: the share of banking assets in the region's GDP constituted only 55% in 2013 (76% in the economy on the right bank of the Nistru river). The real sector's access to funds and weak integration of the banking system in the economy of the region will constitute the main development constraints in the short and medium term.
- The high costs of loans, which has recently increased in real terms, constitute a fundamental reason for the low penetration level of the banking system in the economy of the region. This phenomenon is determined by the high risk premiums applied by banks (about 3-4 times higher than the optimal level), as well by the limited access of region's banks to funding. Thus, the high costs of loans are eventually caused by the macroeconomic and political instability in the region, high insecurity, and quality of the bank loans portfolio, which generates costs and need to be compensated by a more generous banking margin. The low banking efficiency is an additional cause, as revealed by the exaggeratedly high risk-weighted capital adequacy ratio and low coverage of deposits by loans (see the first sub-chapter). This problem is fostered by the fact that the region's banking system is not recognized and does not communicate by formal channels with the banking system on the right bank of the Nistru river, which causes important additional



costs for banks and limits significantly their investment opportunities. All these problems will continue to put significant pressures on the Transnistrian banking system in the short and medium term, and the main effects will be felt by those who, traditionally, need the most external resources and funds - the Small and Medium-Sized Enterprises.

- Besides the plenty problems identified, specific for the Transnistrian banking system, the high concentration of the sector is another constraint that will remain valid for the short and medium term. Thus, according to the latest data available, in May:14 of all 7 banks operating in the region, only 2 banks ("Agroprombank" and "Eximbank") possessed 60% of the total assets of the sector. This reveals a distorted competitive environment, which does not encourage banks to improve their activity, diversify the investment portfolio and enhance the quality and affordability of banking products for companies and individuals.

Policy Recommendations

- Given that, of the one part, the banking system has a high capitalization and abundant liquidities, and of the other part, the penetration level of the banking system in the economy is very low, the policies in this area should aim, as a general objective, at facilitating the access of companies and individuals to loans. For this, it is necessary to eliminate the major systemic constraints that determine the high costs of loans, weak diversification of banking portfolio and low efficiency of the banking activity in the region. The following policy priorities are crucial to that effect:
 - Improve the competitive framework in the sector, by eliminating the barriers prohibiting the entry of new market players and increasing the transparency on the bank performance indicators. But this objective is not feasible without the following policy priority:
 - Harmonize the banking regulatory framework on both banks of the Nistru river and, with the implementation of common prudential regulations, ensure the interconnection of both banking systems.
 - The lending activity, which is the main source of revenue for any commercial bank, generate only half of the revenue of banks from the Transnistrian region. The other half is generated by secondary activities (fees or FX transactions) or even activities that are not specific for commercial banks. Therefore, it is necessary to regulate clearer these sources of revenue in order to avoid eventual abuses against the population and business entities and, simultaneously, to motivate banks to focus more on the lending activity.
- The banks from the region need to improve significantly the corporate governance and modernize the internal procedures for credit risk management. In particular, this relates to the more efficient restructuring of the existing non-performing loans and a more rigorous assessment of the feasibility of requests for funding from individuals and business entities.



Chapter 8. Foreign Sector

This Chapter analyzes the main trends noticed in the foreign trade of the Transnistrian region over the past decade. It identifies the major challenges and opportunities of the regional decision makers. The included policy recommendations aim at balancing the major economic potential of the region with the foreign trade.

Analysis of Main Trends

The sinuous development of the foreign trade of Transnistria over the past decade (Figure 13) is a natural reflection of the narrow economic base of the region and extreme vulnerability of its industrial giants against the vicissitudes of foreign markets. Moreover that the main category of exports - metal products from the Moldavian Metallurgical Plant (MMP), which accounted for about 40% of all export income in 2012 - besides being very sensible to the global economic environment, is also facing a tight competition on the foreign markets (and the frequent breaks in the MMP work have already become a norm over the past years).

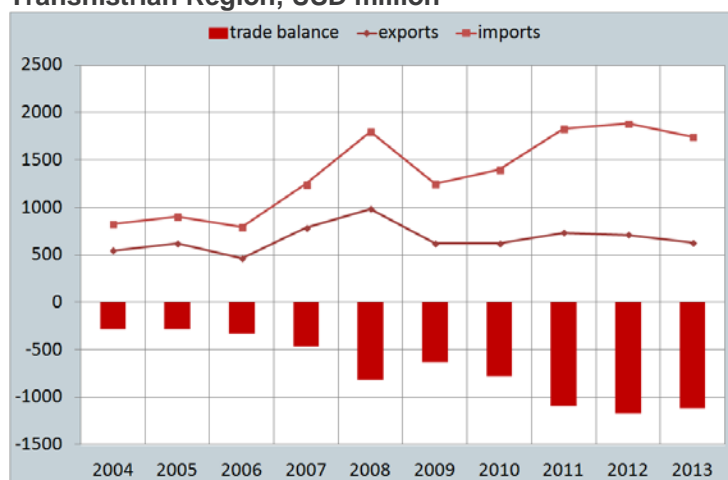
After reaching the peak in 2008 (USD 983 million), the exports entered into a stagnation period and have not yet recovered the pre-crisis level. In 2013 the region's exports dropped by about 15%, which also triggered a decrease in the demand for imports by 9%.

The year 2014 is a better one for the foreign trade of the region, with the exports reaching an amazing growth by 60% during M1-M5:14 compared to the same period of 2013. The increase by about 5% of the light industry products (textiles, clothing, footwear), by 50% - of exports of foodstuff and alcoholic beverages, over three times - of cement and over 10 times - of metal products - taken all together disavowed the complaints brought by leaders of the region against the Republic of Moldova and Ukraine that they had allegedly blocked economically Transnistria. The deliveries to the Republic of Moldova (37% of all exports) increased by over one quarter, but the main sources of growth were the exports to Romania (a 4-fold increase of the invoiced amounts) and, in particular, to Poland (where the exports of M1-M5:14 reached USD 38 million, while in 2013 there were under USD 1 million).

The trade deficit has increased constantly during the past decade, exceeding in 2011 the threshold of one billion USD. In 2013, the deficit of trade in goods and services amounted to USD 1.12 billion; this enormous gap was caused by the fact that the exports of goods and services amounted to USD 627 million, while the imports amounted to USD 1.74 billion. Given that Transnistria is not paying at all for the gas delivered by Gazprom via Moldovagaz, the trade deficit increases automatically the foreign debt.

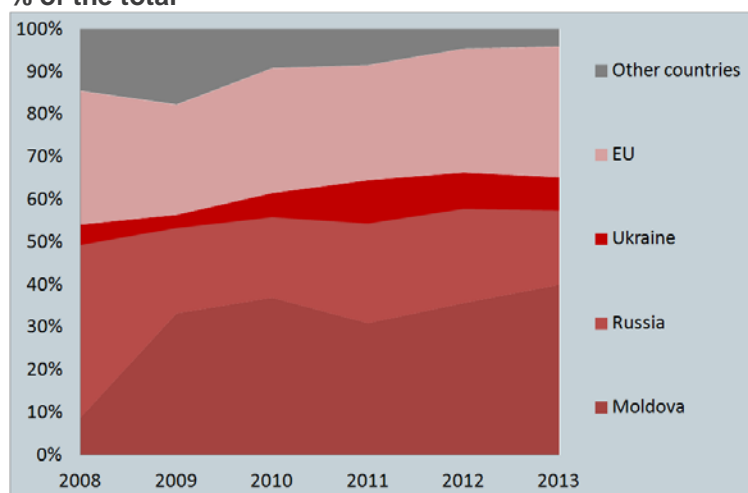


Figure 13. Evolution of the Foreign Trade in Goods and Services of the Transnistrian Region, USD million



Source: 2013 Statistical yearbook of the region, "Dniester Republican Bank"

Figure 14. Geographic Structure of the Transnistrian Exports by Main Destinations, % of the total

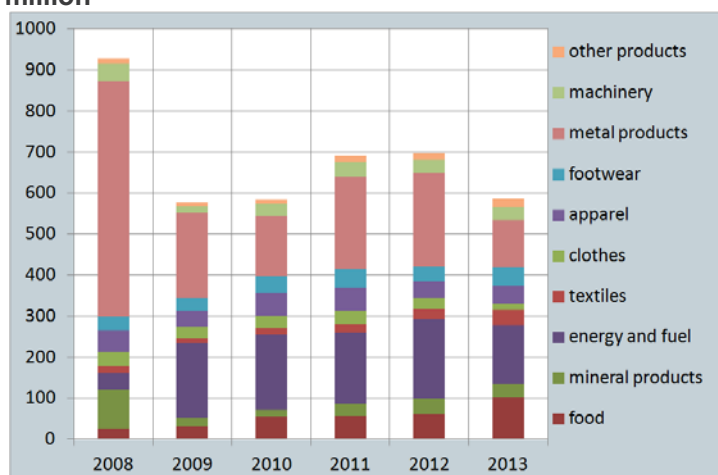


Source: 2013 Statistical yearbook of the region, "Dniester Republican Bank"

Geographically, the exports are quite balanced, tending over the past 6 years to increase the deliveries to the right bank of the Nistru river and EU and establishing a closer commercial integration with them (Figure 14). During the same period, the share of Russian in the Transnistrian exports decreased significantly, due to the absolute decrease of the volume of exports, from USD 376 million in 2008 to a bit over USD 100 million in 2013. In 2013, over 40% of exports consisted of deliveries to the Republic of Moldova (in particular electricity, for which the Republic of Moldova is the only sales market), and 31% - exports to EU (in particular textiles and metal). However, imports are less diversified, being dominated by the gas imported from the Russian Federation (accounting for about 50% of all imports). In terms of assortment, the structure of exports became a bit more diversified during 2008-2013 (Figure 15). The diversification occurred because of two factors with opposite effect: lower exports of metals (which generated 2/3 of export revenue in 2008) and much higher exports of electricity and foodstuff.



Figure 15. Structure of Transnistrian Exports by the Main Groups of Products, USD million



Source: 2013 Statistical yearbook of the region, "Dniester Republican Bank"

Short and Medium Term Forecasts and Challenges

With a very small domestic market - both demographically and economically - the Transnistrian region is highly exposed to and dependent on the foreign trade. In 2013 the foreign trade turnover exceeded 2.3 times the regional GDP – an indicator rarely seen in the international statistics. Even if admitting that a part of the foreign trade consists of re-export and re-import transactions - some of fraudulent nature - nevertheless, it is clear that the foreign trade is the central element for the survival of the region. In this context, it is imperative for the region to: 1) ensure access to foreign sales markets and 2) secure the critical imports (gas for the Moldavian Regional Power Plant from Kuciurgan, raw materials for PMM, textile raw materials for Tirotext).

The Deep and Comprehensive Free Trade Area, to be established between the Republic of Moldova and European Union, is perfectly compatible with both statements above. DCFTA would cancel all tariff barriers to about 1/3 of the Transnistrian exports, and this - corroborated with the positive effect on the investments to the region - would increase the regional GDP by about 3%. Even more important, the effective participation in DCFTA does not affect at all the interests of the Transnistrian region (neither of the entire Republic of Moldova) of engaging into free trade with Russia, Ukraine and other CIS countries. On the other hand, rejection of DCFTA is synonymous to economic self-isolation of the region, because there isn't any other legal instruments that could provide another trade regime in relation to EU than the one applied in the rest of the Republic of Moldova. The regional economy would incur significant losses - including a GDP decrease by about 5%, as revealed by some independent sources⁷. With this in mind, understanding, accepting and harnessing the DCFTA is a significant challenge – of mental and political nature, rather than of economic one - for the regional elites.

In the long run, the major challenge for Transnistria consists of transitioning to a more sustainable economic formula than the current one. The energy sources delivered for free by the Russian Federation constitute currently the central pillar of the current economic competitiveness model. An eventual problem with gas supply - caused, for example, by the Russian-Ukrainian gas conflict - poses a significant risk for the region's economy and the worrisome statements made by the region's leaders in this respect are not exaggerated at all⁸.

Policy Recommendations

⁷ Berlin Economics, „The impact of the EU-Moldova DCFTA on the Transnistrian Economy: Quantitative Assessment under Three Scenarios”, 2013, http://get-moldau.de/download/policypapers/2013/2013.06.04_DCFTA%20Transnistria_en.pdf.

⁸Feature report on Publika TV "Evghenii Sevcuic convened the meeting of the Security Council. What worried the Tiraspol leader?", http://www.publika.md/evgheni-sevcuik-a-convocat-sedinta-consiliului-de-securitate-ce-l-a-ingrijorat-pe-liderul-de-la-tiraspol_1907431.html.



- The strategy for foreign trade stabilization and development in the region is inseparably linked to SME sector development, which requires supported investments in human capital development and lower costs for capital in the entire region. In the long term, the external economic vulnerabilities can be decreased only by developing the SME sector. At the same time, it is difficult to believe that SME development is a realistic task, given the uncertainties related to the political status of the region.
- It is essential to perform a systemic assessment of the energy efficiency in the region and take enhancement measures, because the energy intensity level is very high, serving as a key long-term risk factor for the region.
- It would be advisable for the region's authorities to review their intransigent position towards DCFTA, focusing on the fundamental economic interests of the regions, rather than on the subjective ideological and geopolitical preferences. Annulment, since 2016, of the EU Autonomous Trade Preferences, enjoyed currently by the region, would generate immediate and severe consequences for the Transnistrian economy, unless followed by DCFTA implementation in Transnistria.
- An unbiased analysis of the DCFTA impact would show, inter alia, that it is favorable for the region, including also the fact that the European products would become more accessible for consumers and would enhance the wellbeing in the region. The economic giants from the region will not be affected, because they sell their products on the international markets, not in Transnistria. And the transition periods negotiated by the Republic of Moldova for the sensible sectors apply to the same extent to Transnistria. This will ensure the necessary air bad for the small producers to adjust to the new realities. The region's leaders should become aware that the only and the biggest losers due to DCFTA - who, are actually lobbying against DCFTA - are the entities that currently benefit from tax and customs evasion schemes, organized at the international level.



About EXPERT-GRUP

WHO WE ARE

Expert-Grup is a Moldovan non-governmental and not-for-profit organization specialized in economic and policy research. Expert-Grup does not represent any economic, corporate or political interests. As independent organization, Expert-Grup reflects the ideals of the young Moldovan intellectuals who have created the institution with the purpose of contributing to Moldova's development. Among other types of organizations in the Moldovan civil society, Expert-Grup positions itself as a politically and ideologically neutral think-tank.

OUR ACTIVITIES

Our core activity is economic analysis, forecast and policy research. In this area, we offer a wide range of analytical products and services helping our beneficiaries to take decisions supporting the development path of Moldova. Our key competence lies in the ability to provide professional, high-quality and objective research in such broad fields as:

- Macroeconomic analyses and forecasts;
- Political economy;
- Public finance;
- Human development and poverty reduction;
- Labor market and consumers' behavior;
- Foreign trade;
- Financial markets;
- Economy of European integration;
- Economic analysis by sectors;
- Regional and local economic development;
- Energy and economy of environment.

PARTNERS AND DONORS

During 2006-2013 the Expert-Grup implemented over 60 research and advocacy projects in various areas related to economic researches and public policies. Over 100 experts, both affiliated and not affiliated to our institution, from Moldovan and abroad, were involved in these projects. We have worked with such donors as Soros Foundation Moldova, East Europe Foundation, Konrad Adenauer Foundation, Balkan Trust for Democracy, Black Sea Trust, Friedrich Ebert Foundation, UNDP Moldova, UNICEF, European Commission, Council of Europe, Open Society Foundation, Swiss Agency for Development and Cooperation, UK Department for International Development, World Bank, Organisation for Economic Co-operation and Development. In 2010 and 2012 Expert-Grup was selected as member of the National Participation Council. Since 2008, Expert-Grup has been member of the Policy Association for an Open Society - an international network consisting of 56 think-tanks from various European countries.