

■ Economic Convergence Indicator between the Left and Right Banks of the Nistru River

Authors:

- Adrian Lupusor
- Alexandru Fala
- Ana Popa

Transnistrian Economic Review is a quarterly publication about the main economic and political developments in the eastern districts of the Republic of Moldova. Its readers are policymakers, CEOs of domestic and international companies and banks, representatives of the international institutions and foreign embassies, political parties and economic journalists who work on both banks of the Nistru River.

Economic Convergence Indicator

The indicator measures the closeness between the economy of the Transnistrian region and that on the right bank of the Nistru River. It is computed on the basis of similar economic indicators for both areas. The indicator encompasses the following parameters: indicators related to the number of the population (investments, agricultural production, export and import of goods, the M3 monetary aggregate), CPI and the real exchange rate MDL/PRB (find more details in Annex A).

List of acronyms and abbreviations

y-o-y – year on year; q-o-q – quarter on quarter; m-o-m – month on month; e-o-p – end of period; p.p. – percentage points; Q3:15 – third quarter 2015; Jan:15 – January 2015; NBM – National Bank of Moldova; NBS – National Bureau of Statistics; RB – “Republican Bank of the Transnistrian region”; MED – “Ministry of Economic Development of the Transnistrian region”; MDL – Moldovan Leu; PRB – “Transnistrian Ruble”, CPI – Consumer Price Index, DCFTA – Deep and Comprehensive Free Trade Agreement.

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Contact data:

Republic of Moldova, Chisinau Municipality
45 Puskin St., 2nd floor, MD-2005
Telephone: +373 22 929 994
E-mail: info@expert-grup.org

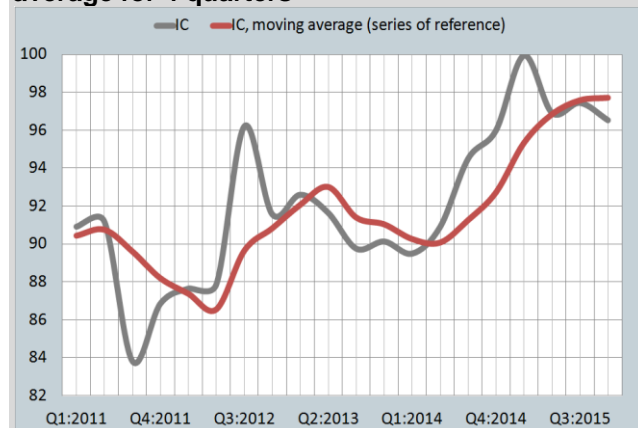
Paradoxically, over the past 2 years, the convergence occurred on the background of a worsening economic situation on both banks of the Nistru River. The convergence indicator increased from 90.3 points in Q1:14 up to 97.7 points in Q3:15 (according to the latest available data).

Nonetheless, the downturn in the Transnistrian region was faster than on the right bank of Nistru.

The main factors that affected the convergence indicator are related to the dynamics of investments, foreign trade and trends in inflation on both banks of the Nistru River. The increasing economic uncertainty in the Transnistrian region decreased the investments: in 2015, capital accumulation (excluding SMEs) decreased by 20.3% y-o-y (the decrease in the capital accumulation on the right bank is estimated to range between -5.4 and -6.2%). The foreign trade dropped on both banks, although exports decreased to a greater extent on the right bank (15.9% compared to 14.7%), whereas import – on the left one (30.4% compared to 25%). At the same time, the national currency depreciated on the right bank by about 25% during 2015, whereas the nominal exchange rate of the “Transnistrian Ruble” has stayed the same since Q1:13 at PRB 11.1 per 1 USD. On the right bank, the national currency depreciation fuelled a dramatic increase in inflationary pressures (the level of inflation reaching 9.7%). At the same time, the region on the left bank of the Nistru River went through a deflation of 1.1%.

The evolution of the economic convergence indicator revealed yet another time that the economies from both banks of the Nistru River deal with similar issues. First, in both cases the economic growth models are unsustainable since they are prevalently supported from external sources that are currently declining (remittances and financial assistance – from the west on the right bank, and from the east on the left bank). Second, both economies are very small and depend, thus, on foreign markets (particularly – EU and CIS), while having to cope with severe competitiveness issues. Third, both sides have to deal with a worsening political instability on the background of protests and the likelihood of having early elections to the right of the Nistru River and presidential elections on the left bank, planned for 2016. Lastly, these constraints pushed both sides into a vicious circle of political economy: the economic and social downturn undermined the trust in public institutions and caused, thus, political instability, which slows down the implementation of reforms that would get these regions out of the economic and social deadlock. To break this vicious circle, the public authorities need to change, and the decision of 18 December 2015 to implement the DCFTA provisions in the region is of good omen in this respect.

Convergence Indicator, raw data and moving average for 4 quarters



Source: NBM, NBS, RB, MED, EG estimation

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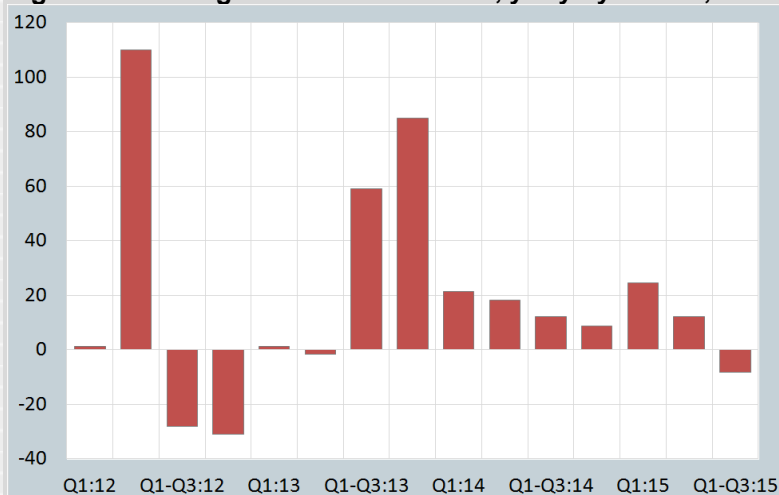
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*Empowered lives.
Resilient nations.*

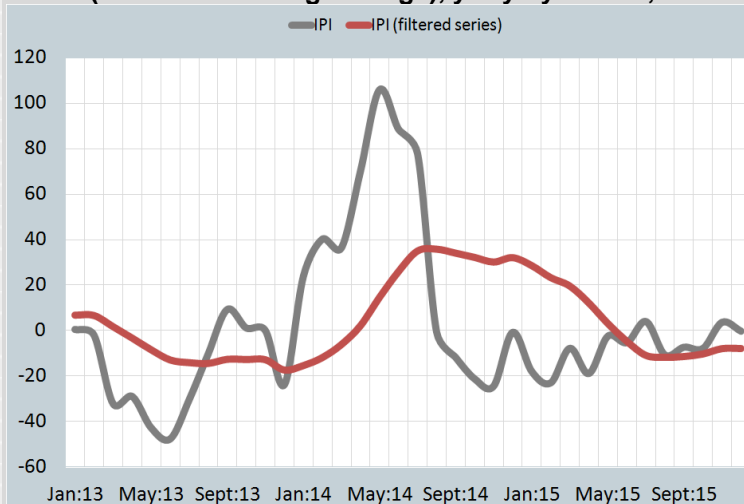
■ Main Economic Trends in the Transnistrian Region

Figure 1. Total Agricultural Production, y-o-y dynamics, %



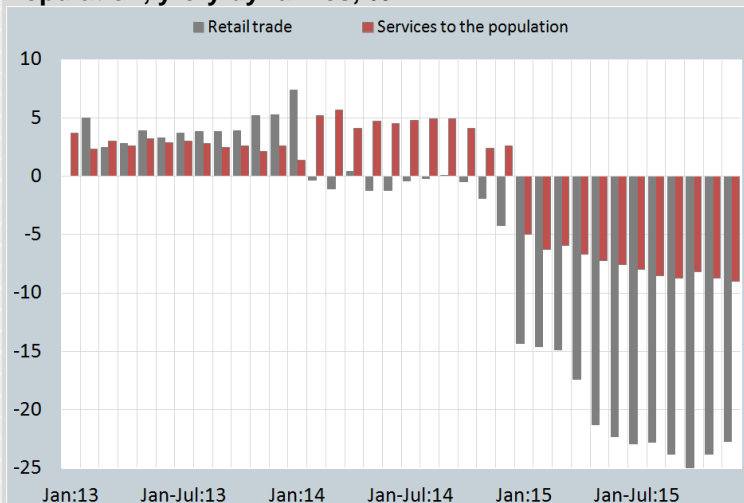
Source: MED

Figure 2. Industrial Production Index (IPI), raw series, filtered series (12-month moving average), y-o-y dynamics, %



Source: RB, EG estimates

Figure 3. Retail Trade and Services Provided to the Population, y-o-y dynamics, %



Source: MED

AGRICULTURE

The agricultural sector was affected severely by droughts in 2015. Crop production took on a downward trend since the beginning of the year, the drought affecting particularly crops of high value: vegetables and fruits. With a predictable delay of several quarters, animal production has also decreased since Q3:15, particularly the production of milk and eggs. Thus, total agricultural production decreased by **8.3% Q1-Q3:15 y-o-y**.

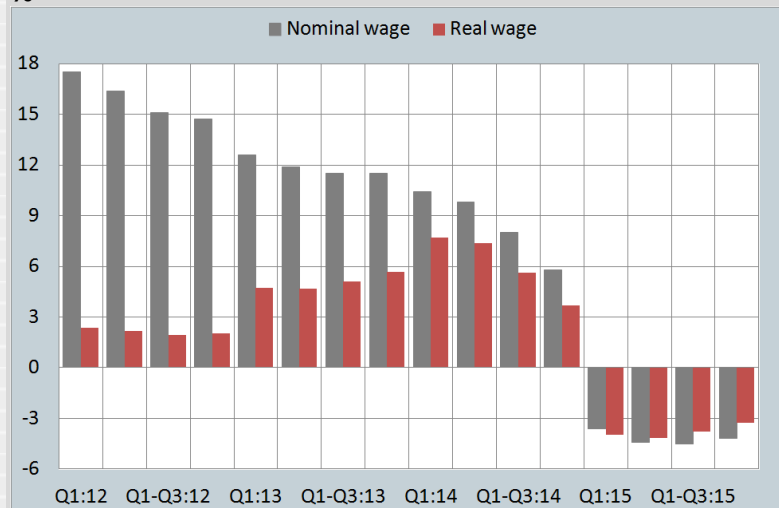
INDUSTRY

After a long recession, in Nov:15 the industrial production increased by 3.6% y-o-y, followed by a slight decrease by 0.3% y-o-y in Dec:15. The sector is still strongly affected and only a few branches took back on an upward trend: metallurgy, production of electric equipment, of construction materials, light industry and production of milling products and fodder.

INTERNAL TRADE IN GOODS AND SERVICES

The economic crisis in the region is fully reflected in the dynamics of internal trade, which in 2015 decreased by 19.6% y-o-y. Retail trade, which fell by **22.7%**, contributed the most, whereas the volume of services provided to the population decreased by **9%**. The strongly negative trend was due to the decrease in production, the budgetary crisis and the economic crisis in Russia.

Figure 4. Average Nominal and Real Wage, y-o-y dynamics, %



Source: MED, EG calculations

INCOME AND EXPENDITURES OF THE POPULATION

The economic crisis in the region reflected, inevitably, on the level of wages Both the nominal and the real wage decreased in 2015 y-o-y by **4.2%** and **3.3%**, respectively, at a quicker pace in the agricultural, trade and construction sectors. At the same time, the total revenue of the population was also affected by the reduction of jobs, wage arrears and less remittances from abroad in 2015.

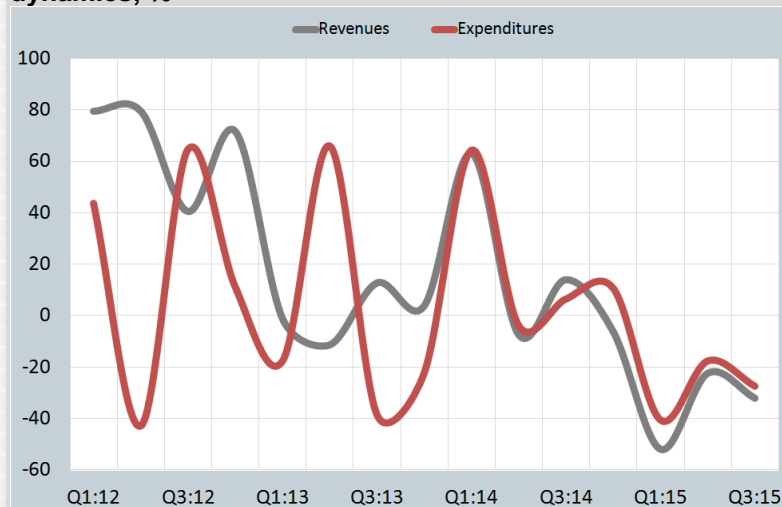
PUBLIC FINANCE

The situation of public finance reveals how strong the crisis is in the region and authorities' incapacity to plan and anticipate shocks. Budget revenue decreased by **37.6%** in Q1-Q3:15 y-o-y, with the decrease rate slightly abating in Q2-Q3:15. This is why some austerity measures were implemented, so that budget expenses also decreased by **29.8%** in Q1-Q3:15 y-o-y. Nevertheless, the ratio of the budget deficit to expenses reached **27.9%** in the aforementioned period.

LABOR MARKET

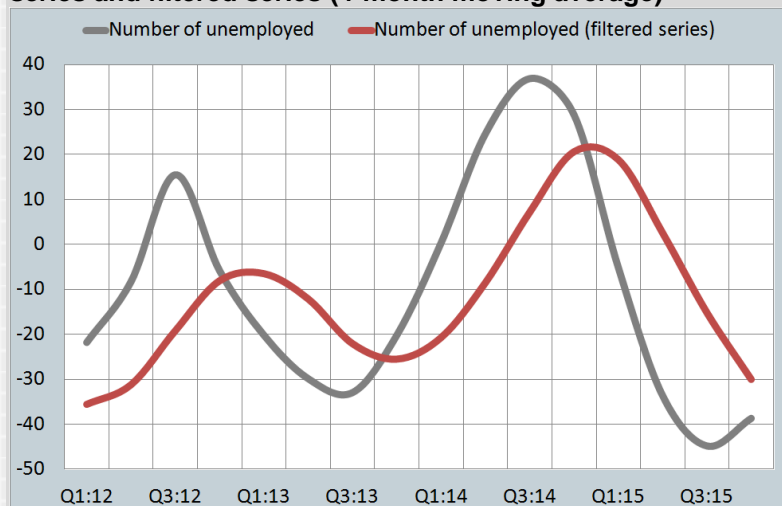
Despite the economic slowdown, the number of officially registered unemployed decreased. At the end of 2015, there were **2684** officially registered unemployed persons, –by **38.7%** less y-o-y. This trend is explained by the manner of computing the unemployment, i.e. according to the number of applications registered by employment offices. As a matter of fact, the situation on the labor market worsened as both the total number of jobs and vacancies has decreased.

Figure 5. Central Budget Revenues and Expenses, y-o-y dynamics, %



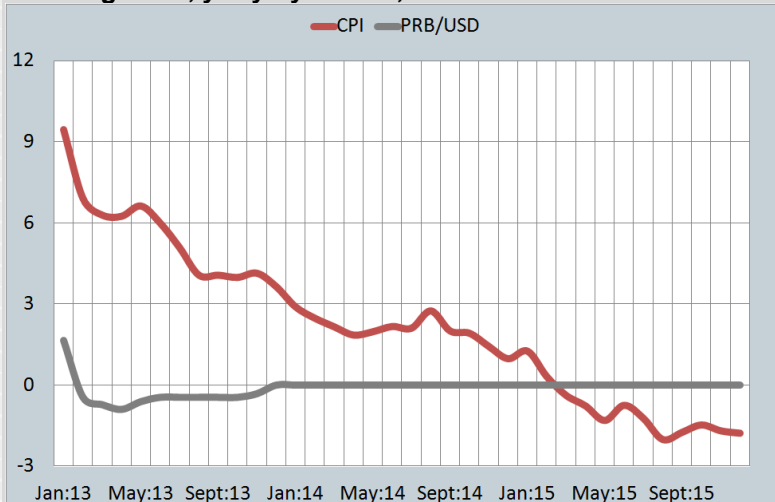
Source: Ministry of Finance

Figure 6. Changes in the Number of the Unemployed, raw series and filtered series (4-month moving average)



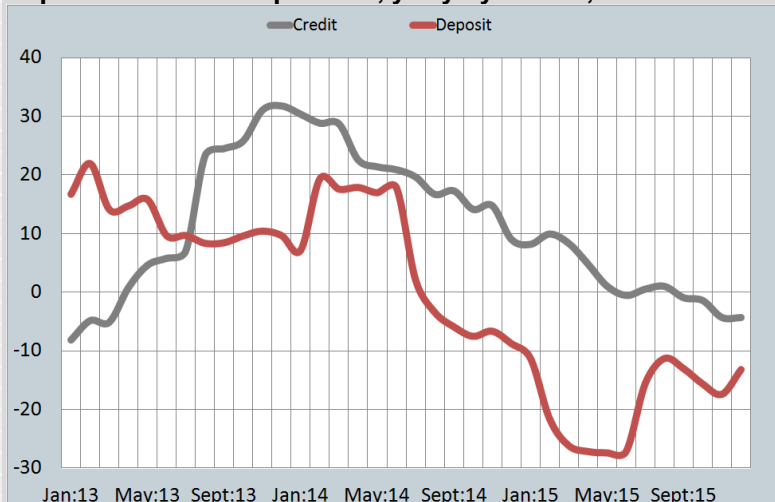
Source: MED, EG calculations

Figure 7. Consumer Price Index (CPI) and PRB/USD Exchange rate, y-o-y dynamics, %



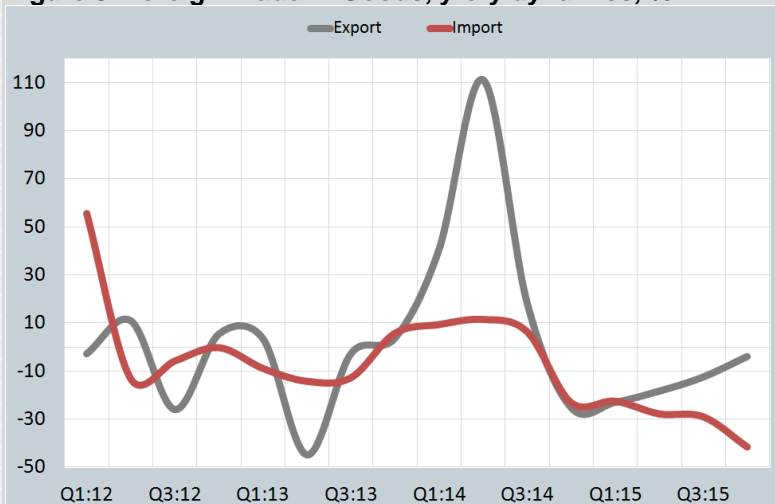
Source: RB

Figure 8. Loans for the Real Sector and the Population, and Deposits from the Population, y-o-y dynamics, %



Source: RB

Figure 9. Foreign Trade in Goods, y-o-y dynamics, %



Source: RB, MED

PRICES AND MONETARY POLICY

The deflation trend was typical of 2015, therefore, at the end of 2015, CPI decreased by 1.77% since the beginning of the year.

The prices for foodstuff and non-foodstuff decreased, whereas the prices of services increased by 5.92%. Even though the exchange rate of the "Transnistrian Ruble" in relation to USD stayed fixed, it appreciated against EUR and RUR in 2015, a trend that continues in 2016. In Jan:16, it appreciated by 0.5% and 5.4%, respectively.

BANKING SYSTEM

Both borrowing and lending activities contracted at the end of 2015.

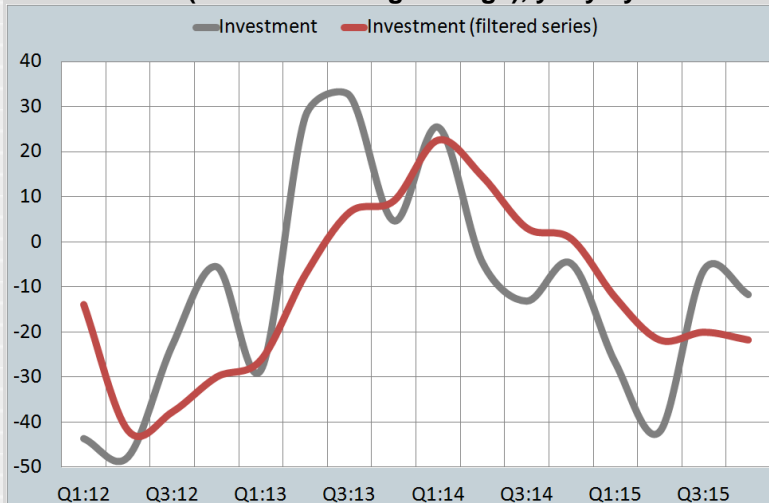
The reduction of population's revenues was accompanied by a significant decrease in individuals' deposits, which in Q4:15 decreased by 15.5% y-o-y. The lending activity took on a negative trend in Q4:15, as the stock of loans decreased by 3.3% y-o-y. However, only the loans to the population shrank, whereas those for the real sector of the economy increased moderately.

FOREIGN TRADE

The economic situation of the main partners and the internal issues caused the foreign trade to shrink in 2015.

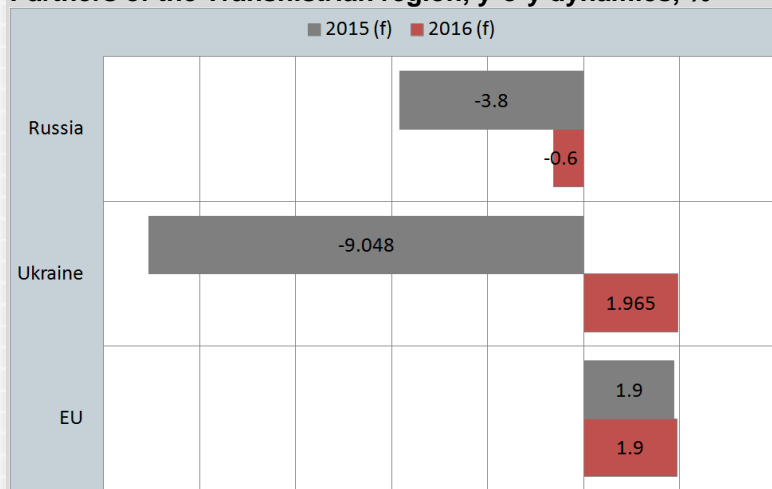
By the end of the year, the negative dynamics of exports tempered, they having decreased by 3.9% y-o-y in Q4:15. In this same period, exports to CIS decreased slower than exports to other states. The imports decreased at a higher pace, dropping by 41.6% y-o-y in Q4:15.

Figure 10. Investments in Fixed Capital, raw series and filtered series (4-month moving average), y-o-y dynamics



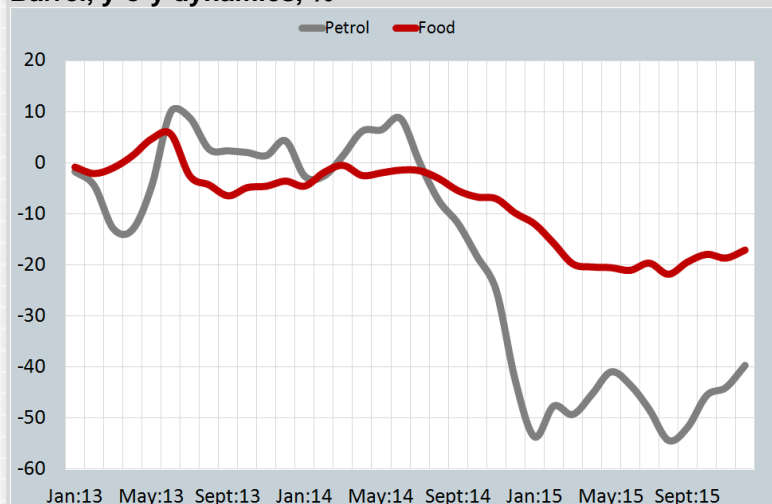
Source: MED, EG estimates

Figure 11. Economic Growth Forecast of the Main Trade Partners of the Transnistrian region, y-o-y dynamics, %



Source: IMF

Figure 12. World Food Price Index and Average Price per Oil Barrel, y-o-y dynamics, %



Source: IMF, FAO, UN

INVESTMENT ACTIVITY

The decline in the investment activity tempered, but the structure by funding sources of investments reflects the economic deficiencies of the region. In Q4:15, the volume of investments in fixed capital shrank by 11.7% y-o-y. The investments funded from organizations' own sources dropped by 12% y-o-y, whereas there were almost none funded from bank loans. Given the major budget constraints, the investments funded from budgetary sources were quite modest.

TRADE PARTNERS

The expected economic growth in EU in 2016, coupled with Transnistria joining the DCFTA could foster exports towards that destination. The expectations, however, cannot be too optimistic, considering that many companies were already exporting to EU on the basis of advantageous trading regimes. In parallel, the enhancement of eastern partners' economic situation, particularly Ukraine's, could help put exports back on a positive trend.

GLOBAL MARKETS

The pace at which world prices of agri-food products and oil dropped in 2015 gained velocity, and tempered slightly only in Q4:15. Thus, the World Food Price Index is already going down for the fourth year in a row, decreasing by 17.1% in Dec:15 y-o-y, the greatest cuts being for meat and cereals. The price for oil dropped by 39.6% y-o-y, reaching USD 36.56 per barrel in Dec:15.

■ Key Policy Developments

Policy Developments	EXPERT-GRUP Comments
<p>10 December 2015. The executive body of the Transnistrian region approved the 2016 draft budget law, with the highest deficit ever.</p>	<p>The 2016 draft budget law of the Transnistrian region envisages more indulgent austerity conditions and a deficit that is almost equal to the revenues (about USD 200 million). The budget structure is influenced by the worsening of the main macroeconomic indicators that caused a pronounced decrease in budget revenues, as well as by their forecast for the coming period. Also, when the policy was adopted, the risks that the preferential treatment in the trade with EU might end were also taken into account, but considering that the solution to the issue was found in the end, the draft shall be amended in the near future. The focus was also on the social situation in the region, i.e. payment of pensions and wages in their full amount, as well as of the arrears for 2015. In such conditions, the decision-makers in the region must identify and provide information with regards to the deficit funding sources as soon as possible, and declassification of the information about the funds accumulated on the special account for the collection of payments for gas could be a hint in that regard. At the same time, the 2016 budget of the Transnistrian region proves yet another time that the economic model in the region requires ample tax reforms in order to ensure its sustainability over time. The first step is about implementing a transparent and simple system to levy VAT, which is an idea that was frequently discussed by the leadership of the region and the business environment.</p>
<p>18 December 2015. The EU-Republic of Moldova Association Council adopted Decision No 1/2015 on the application of Title V of the Association Agreement between the European Union and European Atomic Energy Community and their Member States, on one side, and the Republic of Moldova, on the other side, on the entire territory of the Republic of Moldova.</p>	<p>Starting with 1 January 2016, all business entities from the Republic of Moldova, including the ones from the Transnistrian region, shall export goods to the European Union on the basis of the same free trade regime – DCFTA. At the same time, Moldovan authorities allow access to all the internal procedures that need to be gone through in order to get the documents accompanying goods meant to be exported on the community market. On the other hand, to draw advantages from the trade facilities, the Transnistrian region undertook to provide preferential access for goods and services coming from the European Union, this playing an essential role in the maintenance of free trade in the local business environment. The implementation of DCFTA provisions by the Transnistrian side is crucial inasmuch as this region has to cope with economic recession and exorbitant tax and current account shortages. What is more, this could be an important premise for the convergence of economies on both banks of Nistru River, as the estimations show that DCFTA shall bring along net advantages to the Transnistrian region, making the economy grow, thus, by about 3-4% annually.</p>
<p>14 January 2016. The “State Secret Protection Inspectorate” subordinated to the de facto President of the Transnistrian Region decided to raise certain restrictions regarding the dissemination of information about the funds gathered in the special account for the collection of payments for gas, as well as about how these funds are used.</p>	<p>The special account for the collection of payments for gas represents a fund wherein money paid for the use of gas by individuals and legal entities in the region are accumulated. Taking into account the fact that the greatest enterprises in the region (the iron and steel plant in Rabnita, Cuciurgani power plant, the cement plant in Rabnita and Tirotext) use great volumes of gas, we can assume that the total consumption of gas in the Transnistrian region is equal to the one from the right bank of Nistru, i.e. the fund would annually collect USD 400–450 million. Thus, considering how important this fund is for the administration in Tiraspol, disclosing secret information about the collected amounts as well as about how the money is used would represent an interesting step towards making the activity of the fund more transparent. On the other hand, a decision in this regard could</p>

Policy Developments	EXPERT-GRUP Comments
	<p>be made as an electoral move and it is unlikely that sensitive information will be disclosed.</p>
<p>15 January 2016. The de facto President of the Transnistrian region signed the Order suspending the planned control measures applied to legal entities and individuals, including sole proprietorships.</p>	<p>This is about a moratorium on state controls – a welcome measure, even if it is for a period as long as one year – and aims at supporting the private sector and, particularly, the small and medium enterprises. Such a moratorium was also applied on the right bank of Nistru River, but for a much shorter period of time – three months only. On the other hand, we must take into account that 2016 is an election year in the region (“Presidential Elections” in autumn), and the current “President” keeps losing popularity, which was also confirmed by the results of the “Parliamentary Elections” in November 2015. This measure can, thus, be regarded as an electoral one, with a view to normalizing trust-based relations between the de facto President of the Transnistrian region and the business environment.</p>
<p>25 January 2016. The de facto President of the Transnistrian region signed the legislative initiative amending and making addenda to the Law on Organizations’ Income Tax.</p>	<p>According to this draft, the enterprises – in the revenues structure of which by the end of 2015 the turnovers shall rise up to 70% – shall not pay the “tax on losses”. The goal of this initiative is to “support enterprises struggling with a negative external economic environment, as well as to lessen the tax burden of enterprises that register losses”. So far, for the enterprises whose sales revenue did not cover the expenses incurred for production, the tax base used to be determined by taking into account a profitability of 5%. Thus, at the end of the year, the enterprises that used to operate at a loss, were obliged to pay taxes not for the profit they gained, but for the costs of the products they produced. Nevertheless, in the first half of 2015, as the demand on foreign markets decreased, as many as 131 enterprises from in the region had losses, 40 of them being industrial enterprises. The situation did not go better in the second half of the year, many of these enterprises lacking the resources to pay taxes.</p>
<p>3 February 2016. During a meeting of the de facto President of the Transnistrian region and the representatives of producing and exporting enterprises from the region, the latter demanded the devaluation of the Transnistrian Ruble.</p>	<p>On the background of a pronounced inflation in the region (for 2015: Republic of Moldova – 13.6%, Russian Federation – 12.9%, Ukraine – 43.3%), it was for the first time that the Transnistrian region experienced the opposite phenomenon – deflation. Its value reached 1.77% for the entire year of 2015, according to the data of the “Ministry of Economic Development” of the region. The deflation is caused by the artificial set of the “exchange rate of the Transnistrian Ruble” against the USD, as well as to the harsher “monetary policy” implemented in the recent period in the region. At the same time, the representatives of the producing and exporting enterprises asked the leadership for the devaluation of the “Transnistrian Ruble” as they are no longer competitive in exports, given that in Ukraine, Russia and Moldova – which are important trading partners – the inflation reached two-digit levels. Thus, taking into account that the economy in the region is strongly oriented towards export, the “central bank” of the region will have to review its policy of fixed “exchange rate” sooner or later. The key issue is about the short-term economic policy dilemma: support the exporters by devaluation the currency or support the poor by keeping the exchange rate fixed and, in this way, providing an anti-inflation buffer and maintaining the illusions of macro-financial stability.</p>

■ Annex A: Methodology for calculating the economic convergence indicator

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

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

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

$$X_Q = X_{0,USD} \cdot I_{T,0}$$

where:

X_Q - the value of the variable on the quarter Q;

$X_{0,USD}$ - the variable from the reference period (Q1:2010=1, USD exchange rate in Q1:2010);

$I_{Q,0}$ - the real growth index of the variable X

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

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

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

The indicator of convergence is calculated on the basis of the index. The value of the indicators shall be found out according to the formula hereunder:

$$\text{Indicatorul de convergență} = 100 - 100 \cdot \sqrt{(\ln \text{Indice})^2}$$

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