

Transnistrian economy at the crossroads?

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The Economy of the Transnistrian Region in Figures

Table 1. Key economic indicators of the Transnistrian region

	2013	2014	T1:2015	T1-T2:2015	T1-T3:2015	2015
Gross Domestic Product, mil. USD	1048.8	1116.78	225.3	462.5	710.4	1005.0
Gross Domestic Product, % y-o-y	104.2	103.43	85.0	88.5	90.0	90.0
Industrial production volume, mil. USD	738.08	904.86	182.53	374.71	575.62	795.0
Industrial production volume, % y-o-y	82.3	119.0	83.7	87.5	90.2	88.0
Retail trade, mil. USD	902.51	882.68	181.92	342.95	519.32	706.1
Retail trade, % y-o-y	104.8	97.5	87.4	81.2	79.6	80.0
Investments in fixed capital, mil. USD	139.32	131.91	14.72	41.63	64.97	95.0
Investments in fixed capital, % f-a-p	110.4	89.0	73.1	59.8	74.2	72.0
„Transnistrian ruble” exchange rate against USD	11.1	11.1	11.1	11.1	11.1	N/A
Consumer Price Index, % y-o-y	103.63	100.98	99.19	100.22	98.06	N/A
Mandatory reserves rate, physical persons, „Transnistrian rubles”, % (end of the period)	0	10	12	12	10	N/A
Mandatory reserves rate, physical persons, foreign currency, % (end of the period)	8	14	15	15	12	N/A
Mandatory reserves rate, juridical persons, „Transnistrian rubles”, % (end of the period)	6	14	15	12	10	N/A
Mandatory reserves rate, juridical persons, foreign currency, % (end of the period)	12	14	15	12	10	N/A
Exports of goods, mil. USD	556.43	677.69	118.28	265.91	NA	406.6
Imports of goods, mil. USD	1648.57	1641.56	345.16	617.49	NA	984.9
Exports of services, mil. USD	68.28	65.58	17.84	27.58	NA	45.9
Imports of services, mil. USD	94.56	144.97	18.36	36.04	NA	101.8
Current account deficit, mil. USD	-878.52	-849.67	-194.16	-337.26	NA	-820.0
Average wage, USD	336.5	355.6	337.7	340.2	340.9	300.0
Budgetary revenues, mil. USD	257.3	286.0	48.1	96.3	152.6	190.0
Budgetary expenditures, mil. USD	324.3	366.9	66.0	132.7	196.6	230.0
Budgetary deficit(-)/surplus(+), mil. USD	-67.0	-80.9	-17.9	-36.4	-44.0	-40.0
Loans and other financial placements, mil. USD (end of the period)	378.74	376.93	404.32	391.91	385.76	390.0
Term deposits, mil. USD (end of the period)	225.84	274.56	264.54	259.47	249.79	260.0

Source: de facto Central Bank and the de facto Ministry of Economic Development from the Transnistrian region.



Key messages of this issue

- **The Transnistrian region is facing an unprecedented economic crisis.** By the end of the current year, the region's GDP could contract by about 10-12%, due to an accumulation of negative external and internal shocks. The unfavourable context on external markets (instability in Ukraine, economic downturn in Russia and on the right-bank Moldova, falling demand in the EU, devaluation of national currencies in the region) have led to a decline in demand for the region's exports by almost a quarter. This resulted in a lower rate of industrial production, which in the first 9 months of the current year decreased by about 10%.
- **The economic crisis is likely to turn into a major social crisis.** Households' incomes shrank by about 30% following the decline in all sources of revenue (remittances, wages, income from entrepreneurial activity, social payments and pensions). Overall, the estimated real revenues for 2015 are lower than in 2007. As a result, the final consumption decreased by about 21-22%, i.e. slower than the revenues. This gap between current income and consumer spending adjustments shows that the population is intensely spending previously accumulated savings, which could generate a faster slowdown in consumption in the near future if the economic situation does not recover.
- **Social risks are fuelled by labour market issues, as well as by budgetary constraints.** The capacity of the economy to generate new jobs is turning down, some jobs are closed and in the remaining ones wages are being cut. Moreover, wage arrears in the public and private sectors increased by nearly 4.5 times. Due to economic difficulties, the budget spending decreased and the public debt increased. In the context of a growing budget deficit and a narrow fiscal space (caused by receding economic activity and growth of the informal economy), the authorities have very limited room for manoeuvre, which could lead to further budget austerity measures.
- **The Transnistrian region turned to be unprepared for such an economic and social shock.** In particular, with a high budget deficit and public debt, the public finance system was already highly unbalanced before the crisis. The situation got worse due to an ineffective tax system (featured by a lack of VAT and prevalent focus on direct taxation of the private sector), to worsening demographic crisis and growing pressures on the pension system (in 2015 the number of retirees exceeded the number of employed population).
- **Amid the budgetary constraints, the regional authorities have increased pressures on the private sector.** Large arrears in the payment of public contracts have been accumulated and a part of public spending was effectively transferred on private business. A telling example is the recent opening by the Rabnita Metallurgical Plant of a network of social stores. Another example is the case of large agricultural farms financing community and social development investment (repairs of the culture houses, museums, gasification projects, rehabilitation of administrative buildings). Most likely these practices will continue, further weakening the economic and financial situation of the enterprises.
- **For the upcoming 2-3 years, we foresee at least three major economic risks affecting the region: (i) acceleration of the decline in export; (ii) a faster decrease in consumption; and (iii) a severe increase in inflation and poverty rate.**
 - *Acceleration of the decline in exports* could be caused by Tiraspol authorities' rejection on the implementation of the provisions of the Moldova-EU Association Agreement. This will make the EU replace the autonomous trade preferences that anyway are going to expire in 2015, with the import tariffs on products from the region. This could increase the prices of Transnistrian exporters on the EU market, on average, by about 15%. Besides the appreciation of the "Transnistrian ruble" against the Euro, this will serve as an additional factor undermining the competitiveness of the region.



- *A faster decrease in consumption* might be caused by the depletion of household savings that people in the region have recently started consuming to counterbalance the current income reduction. If the aforementioned risk materializes because of rejection of the Association Agreement, a sharp fall in consumption and a further worsening of the economic situation in the region will be unavoidable.
- *The risk of a sharp increase in inflation* is fuelled by two main factors. First, the regional authorities cover the budget deficit by increasing public debt and by financing it at a preferential rate through the "Transnistrian Republican Bank". This results in increasing the monetary base that is not covered by the production of additional goods and services and thus generates imminent inflationary risks. Second, fixing the exchange rate and ignoring the economic realities cannot last forever, especially given that currency reserves of the "Transnistrian Republican Bank" are already low, and the gap between the demand and supply of currency is substantial. Further maintenance of the fixed exchange rate of the "Transnistrian ruble" against the US dollar could, at some point, force the monetary authority to rapidly devalue the currency, with obvious inflationary and social consequences. The materialization of this risk will have major effects on poverty in the region, particularly by worsening the living standards of those who are already below the poverty line and have limited opportunities to emigrate or to specialize in other fields of activity.
- **Given the economic and social trends and risks, we call on the authorities from the region to take the following urgent measures:**
 - *Implementing the minimum requirements of the Association Agreement concerning region's external trade.* It is of primary importance to focus on the technical cooperation between the authorities from Chisinau and Tiraspol on issues related to certificates of origin, customs duties, sanitary and phytosanitary standards, competition policy, public procurement and fiscal policy.
 - *Giving up the practice of transposing the social protection commitments on the private sector, especially amid extremely austere economic circumstances.* The continuation of such practices can lead to the degradation of the productive capital (companies will not have sufficient resources to invest) and can even generate a capital flight from the region. At the same time, it is also obvious that public expenditure policy should be reviewed and rationalized.
 - *Reforming the tax system in the region.* Currently, tax revenues are excessively concentrated on direct taxation, without applying VAT. This creates major pressures on the private sector and undermines the competitiveness of exporters, since most of the region's trading partners apply VAT whereas the region lacks a VAT refund mechanism. Tax reform could be based on two key elements: (i) implementation of a transparent and simple VAT system; and (ii) ensuring compatibility between the tax systems on both banks of Nistru river and aligning them to international standards. The focus should be transposed from taxing profits and investments towards taxing consumption.



Executive Summary

Supply

In 2015 the Transnistrian economy has been passing through one of the most difficult periods of the past twenty years. Several internal and external factors overlapped, causing a deep economic recession, that we estimate at 10-12%. The economic and security instability in Ukraine, the economic recession in Russia and in the Republic of Moldova, the falling demand in the EU, the devaluation of national currencies in countries from the region – combined with a number of domestic factors, caused a drop by almost one quarter of the demand for the region's exports, which automatically generated a lower rate of industrial production. The major problems that the region's budget is facing and the decreasing volume of remittances led to the recession of the domestic demand, followed by a strong contraction of the activity in the service sector. We forecast a dramatic GDP recovery of up to 8-10% in 2016 if the regional authorities accept to implement the DCFTA and if the Russian and Ukrainian economy get more buoyant. Otherwise, in case of the DCFTA rejection and further economic stagnation in Russia and Ukraine, a decrease of GDP by 4-5% is perfectly possible.

Demand

In 2015, the domestic demand recorded dramatic decreases in all components. The households' incomes from all sources declined, including income from wages and remittances, which resulted into the compression of the consumer expenditures by about 21-22%. The administration of the region faces major budgetary challenges caused by the worsening financial and economic situation of the key industrial enterprises and by external revenues shortfalls. Thus, the public budget could not cushion the private demand shocks. At the same time, the capital investment of enterprises is at historic lows, due to long-term thinning of all financing sources, including the enterprises own revenues, but also bank loans and budget subsidies.

Public finances

In 2015, the public finances of the Transnistrian region were influenced by two important factors. One factor was the holding of "parliamentary and local" elections in late November, which influenced the initial forecasts on all the components of the consolidated budget, as those forecasts proved too optimistic about the current economic circumstances. The economic slowdown that started in late 2014 has been affecting the budget execution and the authorities had to reduce the public sector wages and pensions down to 70% of nominal value. Nevertheless, these payments have been reinstated as of the 1st of November, due to new loans and a lower y-o-y deficit following savings obtained from withholding those payments throughout the year. At the same time, the main challenges for the budgetary framework of the Transnistrian region derive more from structural failures rather than from the current macroeconomic context alone. The main challenges for the upcoming years are related to the weak growth of the tax base, to the public debt above 100% of the region's GDP and to the financing of the Social Security Unified Fund that is currently covered by own-source only in the amount of 50%.

Labor market

The negative trends in the Transnistrian economy also reflected in the dynamics of the labor market indicators. Almost all those indicators performed poorly throughout 2015. For instance, since Q4:2014 the job openings rate started to decrease sharply so that in Q3:2015 it equalled the rate of jobs closure. The vacancies rate is at a three years low. At the same time, the unemployment rate had a counterintuitive behavior for the current economic context as it decreased throughout the year. The current unemployment



outflows could be explained by the probable increased migration and by the expansion of informal employment, as well as by some shortcomings in the calculation methodology of the indicator.

Prices and monetary policy

During 2014-2015, the Transnistrian region registered a clear disinflationary tendency (deceleration of the growth rate of consumer prices). In the second half of 2015 that trend has turned into deflation (decrease in consumer prices). Along the economic downturn, the deflation made the "Transnistrian Republican Bank" relax its monetary policy in the second half of the year. However, the monetary easing effects are still modest, being reflected only in the monetary base indicators, while the lending activity kept receding. The foreign exchange policy has remained rigid and based on administrative fixing of the exchange rate for the "Transnistrian ruble" against the US dollar. While creating a temporary illusion of some macro-financial stability of the region, fixing the exchange rate while ignoring the economic fundamentals undermined the competitiveness of Transnistrian exporters, which are already in a difficult situation due to the economic problems in Russia, Ukraine and the EU.

Banking sector

Amid the worsening economic situation, the banking sector is also contracting. In the Transnistrian region there has been observed an anaemic lending activity and a diminishing attraction of deposits by banks. Poor economic conditions generate an increase in toxic assets, and therefore decreases the capitalization rate of the banking sector. The deterioration of the asset quality and the decreasing deposits balance reduce liquid assets and the liquidity rate. The development prospects on the banking sector are directly dependent on the macroeconomic dynamics in the region.

External sector

The foreign trade of the region is decreasing. Worsening economic conditions in Russia and the recession in Ukraine are among the key factors that caused significant reduction in export. These two countries are the destination for more than 90% of exports to CIS. The economic problems in Russia also generated a lower inflow of remittances and therefore lowered household income and imports demand. At the same time, the downturn in exports was caused by the contraction of the industrial sector, led by both domestic/structural and external factors. One of the main challenges for 2016 is related to the dilemma of the Transnistrian administration to implement or not the provisions of the Association Agreement. Its rejection could generate a decrease in the region's GDP of about 3-4% in 2016, whereas its acceptance will offer a life buoy to the region's economy.



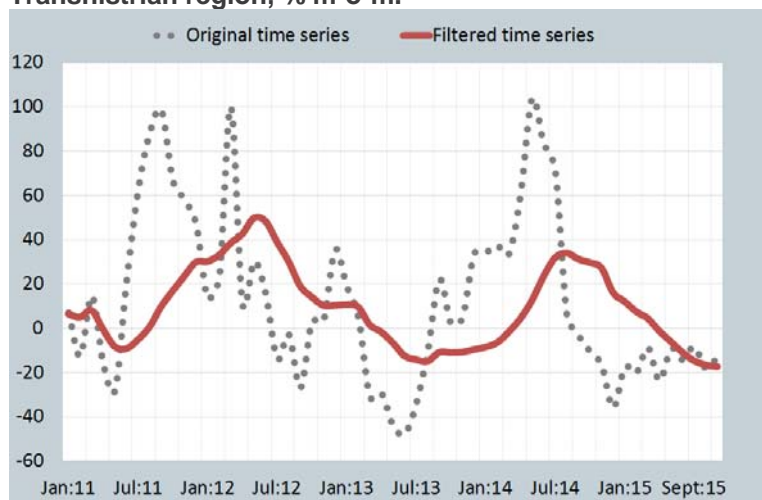
Chapter 1. Domestic Supply

In late 2015 the economic situation in Transnistria is very complicated as a result of an accumulation of negative external and internal factors. Unfavorable conditions on the external markets (the instability in Ukraine, the economic downturn in Russia and Moldova, falling demand in the EU, devaluation of national currencies in the region) have led to a decline in demand for the region's exports by almost a quarter. This resulted in a lower level of industrial production. Meanwhile, the recession of domestic demand in Transnistria caused by the major financial troubles of the region's budget and by the lower volume of remittances, triggered a strong contraction of activities in the services sector. In 2015, we expect the GDP to fall by about 10-12%. For 2016, in the best case, the GDP is expected to grow by about 8-10%, while in the case of an unfavorable scenario (with the DCFTA rejection) a fall of 4-5% is likely to occur.

Analysis of recent trends

Manufacture, which is the key economic sector in Transnistria, is currently a burden on the regional economy. Although 2014 ended with an increase of 19% of the industrial output, the statistics show that since August 2014, the industrial sector has started to lose steam quickly (Figure 1). The year 2015 is extremely difficult for the sector, the production having decreased by 10%. Although a very high volatility has been a key feature of the Transnistrian economy over the last decade, the periods of industrial recessions last typically 6-7 months and not more than 1 year as it is happening now. Several major industrial enterprises were forced to ask for state support in the form of tax concessions and price reductions for energy resources. According to data for the first half of the year, all major industries recorded a decrease in production (-30% in metallurgy, -17% in light industry, -26% in food and beverage industry). Some indirect indicators suggest that these dynamics continue in the present. The notable exception is the energy sector, as its production increased by almost 20%. The sector has received an unexpected boost after Moldova has ceased in 2015 to purchase electricity from Ukraine and the Kuchurgan power station came to provide more than 70% of electricity needs on the right bank of the Nistru river.

Figure 1. Evolution of the industrial production in the Transnistrian region, % m-o-m.



Sources: EG, based on data provided by the "Central Bank of the Transnistrian Moldovan Republic".

The situation in the constructions sector reflect the following confidence in the region's economic perspectives. The sector is practically freely falling, as the volume of construction-assembly works in January-September fell by about 40%. In the residential sector, the volume of performed works continued to fall by about 55%. The sector still shows some positive indicators due to social infrastructure rehabilitation projects in progress implemented with the support of the Russian Federation. But the decline in private financing in the construction sector is by far a more important indicator. This reflects a greater public mistrust towards short- and medium-term economic perspectives in the region.



The agricultural sector has been hit by the drought in 2015. The main branches in the agricultural sector had a divergent evolution in 2015. While the livestock sector recorded a good increase in production volumes (+50% in the first half of the year and around +30-35% in the first nine months of the year), the crops sector encountered certain problems. The less favorable weather conditions hit particularly crops of a higher value: according to our estimates, the vegetables harvest in 2015 fell by about 30% compared to the previous year, the fruits harvest – by 25%, the sunflower harvest – by about 30%. Besides the problems caused by drought, there are more difficult challenges such as accessing foreign markets. The year will be closed with a production loss of about 4-5%.

The market services reflect the negative dynamics of the domestic and external demand. The service sector dropped sharply in 2015, the turnover decreasing to our estimates by about 20%. While the services rendered to population met the level of 2014, the services rendered to enterprises receded and closely reflected the unfavorable financial-economic situation of the region's industrial giants. The transport enterprises were among those suffering the most, especially ones serving the external trade of the region. At the same time, the dramatic situation of the region's budget (with revenues falling 30% short of the planned expenditure) led to the accumulation of arrears to suppliers who work with medical, social protection and education institutions in the region.

Challenges and forecasts

- There are no good news about the real economy of the region in 2015. Excluding the energy sector, all major economic sectors will close the year with significant decreases in production and sales. According to our estimates, the GDP decline will reach the two-digits level of 10-12%, which will negatively impact the budgetary and social parameters. Wages arrears and social pay arrears will continue to build up, as well as arrears to payment of procurement contracts and public investments.
- The regional administration made use of extraordinary measures in order to deal with budgetary pressures, including by running huge arrears on public contracts. They also transposed a part of public expenditure on private sector enterprises. A good example is the opening by the Rabnita Metallurgical Plant of a network of social stores. Another example is the financing by large agricultural farms of investments for community and social development (such as repair of cultural houses, museums, gasification projects, rehabilitation of administrative buildings). These practices will most likely continue, so further weakening the economic and financial situation of enterprises.
- In 2016 the economic situation will crucially depend on the acceptance or rejection of DCFTA by the region's administration. If the implementation of the DCFTA is accepted, the economy will quickly return to a positive trajectory, recording a GDP increase that can even reach 8-10%. However, the negative scenario seems most likely, in which the DCFTA is rejected and the recession continues, with GDP falling by additional 3-5%.



Chapter 2. Domestic Demand

In 2015, all the components of the domestic demand dramatically decreased. Because of the sharp fall of the household income from almost all sources, the final consumption fell by about 21-22% and in the near future the situation is not likely to improve. Government consumption also decreased due to lower budget revenues. The regional budget will be subject to greater pressures due to worsening financial and economic situation of large enterprises. Capital investments in the business sector are at historic lows due to thinning long-term financial resources and of enterprises' own incomes.

Analysis of the recent trends

Household consumption is strongly declining in 2015 due to weakening of all income sources. The decreasing production, the deepening crisis of the Transnistrian budget, and the economic recession in Russia which is the main destination country for labor migrants from Transnistria, have strongly cut household income and consumption. Compared to the 2014 level, the total real household income fell by about 30%, while final consumption expenditure fell by 21-22%. Combined with lower long-term bank deposits (down by approximately 17-18%), this striking gap between the adjustment of current income and the consumer expenditure shows that the population actively spends previously accumulated savings. The main cause of the drop in income is the fall of migrants' remittances by nearly a half (Figure 1). Income from wages is declining in real terms (-18%), due to lower average wages, closure of 4-5% of the jobs and the salary arrears growth by almost 4.5 times. Although income from entrepreneurial activity has a lower share in the structure of household income, its decline (estimated at -30% by official data, but in fact it could be worse) serves as a litmus paper for the situation of the SMEs. For the first time in the recent decade, the effective income of the pensioners is below the minimum subsistence level. Overall, the estimated income for 2015 is in real terms lower than in 2007.

Figure 2. Evolution of consumption expenditures (year 2001=100%) and of the share of remittances (% of total households' income)



Source: EG, based on data provided by the "Central Bank of the Transnistrian Moldavian Republic".

Government consumption is on negative path as well, reflecting a very precarious budgetary situation. Public sector revenues are also in free fall this year, which was reflected in government consumption. Financing of the economic sector fell in 2015 by about 30%, while that of public utilities sector - by about 33%. Budgetary deficiencies of the central regional administration boil down to local communities through the ever smaller transfers, which represent only half of the previous year level.

Investments have posted the sharpest decline compared to all other components of the aggregate demand. Capital investments, as in case of other key aggregates, have strongly contracted over the last year. In fact, investment began to fall in real terms already in May 2014. According to the available data, in



Q2:2015 the investment index was down by over 40% and in Q3:2015 by 8-10%. Our estimates show that the situation remained very bad in the last quarter of the current year (-48%), thus the volume of the capital investment in 2015 is about 33-35% lower than a year ago (Figure 3). Business own resources represent 80% of the financing sources of capital investments, but more than a half of companies in the region believe that they do not meet the financing requirements for investment. Over 50% of the resources allocated are used for the maintenance of functional production capacities and less than 25% for modernization and replacement¹.

Figure 3. Evolution of capital investments in the Transnistrian region, % change compared to corresponding quarter last year



Source: EG, based on data provided by the "Central Bank of the Transnistrian Moldavian Republic".

Challenges and forecasts

- Our estimates show that in 2015 the real decline of total household income will be around 28-30% y-o-y, mainly due to lower remittances and wages. Consumer expenditure will decline slightly slower, as the population is using previously accumulated savings to absorb the shock. In the first half of 2016, this trend will continue while further on, depending on the decisions regarding the DCFTA, it may then get worse or reverse.
- The administration will face major budgetary problems in 2015 and 2016. The prospect of benefiting of external financing is getting more uncertain and increasingly dependent on political processes in the region. At the same time, businesses are more tempted to operate "in grey economy" to avoid extremely oppressive taxes which are assessed by many as very unfair².
- The investment processes will not return soon on the positive slope due to weakening resource base of the banking sector, strong growth of the region's external financing risks and depletion of the company's own investment. In fact, the expectations of company managers in the region are mostly negative and very negative, and every third company plans to reduce its production in 2016. At the same time, many companies may still return to the previous level of production without major investments since the existing capacity is used at a rate of only 45-50%. However, a large part of the production capital is depreciated morally and physically, and the process could accelerate unless maintenance investments are made at least.

¹ Анализ финансово-хозяйственной деятельности субъектов реального сектора в I полугодии 2015 года, Вестник Приднестровского республиканского банка №9'2015.

² Idem.



Chapter 3. Public Finances

The fiscal balance of the Transnistrian region in 2015 continued to worsen given the difficult internal and external macroeconomic conditions. At the same time, most of the sector problems have rather a structural than cyclical nature. In particular, this feature makes that the tax base, expenditures and deficit financing structure not to comply with the key parameters of a sustainable economic growth model.

Analysis of recent trends

Despite the pessimistic macroeconomic expectations, the Transnistrian authorities have adopted a quite optimistic budget for the current year. Consolidated budget revenues were planned at a level of USD 263.2 mil. (2921.6 million "rubles"), posting a slight growth of 0.1% y-o-y. For expenditure, on the contrary, it has been reported an increase by 9.8% y-o-y, up to USD 402.9 million (4472.6 million "rubles"), the budgetary deficit increasing by 34.4% y-o-y up to - USD 139.7 mil. (-1551 million "rubles" or 12.5% of GDP).³ Most likely, this budgetary planning was influenced by the electoral period.

The economic reality has forced the authorities to introduce new austerity amendments to the Transnistrian budget. Since the 1st of March 2015, the public sector wages and pensions have been paid at a 70% rate, being explained to the public that the cumulative debts (the outstanding 30%) would be paid after the improvement of the economic and financial situation in the region. This measure has contributed to the fact that in the first 10 months of the current year, the budget expenditure was much under the planned level and compared to the previous year, significantly reducing the deficit y-o-y (**Table 2**). Reducing the budget deficit and contracting a loan of USD32.9 million in the first half of this year created certain preconditions for restoring as from the 1st of November 2015 the 100% payment of pensions and 90% payment of salaries. Nevertheless, since the economic situation has not improved so far, this measure seem more of an electoral favour.

Table 2. The budget implementation in the Transnistrian region (USD mil.), Jan:15-Oct:15

	"RB"	BATU	SSTF	Total	Deviations (mil, y-o-y)	Deviations (%, y-o-y)
Revenue	107,1	63,4	94,9	265,4	-60,1	-18,5
Expenditure	147,9	72,0	135,8	355,6	-99,1	-21,8
Deficit	-40,8	-8,6	-40,9	-90,2	39,0	30,2

Source: "Ministry of Finance of the Transnistrian region"

The current budgetary crisis is not just a result of worsening of the economic trends in the Transnistrian region, but also a result of a set of fundamental perpetuating systemic constraints. First, it highlights the share of expenditures and the deficit of the Social Security Trust Fund (SSTF) in the Transnistrian budget, which has reached alarming levels. Table 2 shows that the share of expenditures and the SSTF deficit exceed the respective indicators for the "Republican budget" (RB), which is the main budget of the Transnistrian administration. In terms of revenue, the share of these budgets is approximately equivalent and if transfers from the "RB" to SSTF are excluded, the deficit of the latter would increase even more. Thus, the Transnistrian budget framework is mainly focused on supporting the expenditures of the retired population, which is constantly growing (Chapter 4), this being one of the main challenges for the public finances of the region.

The problem of the Transnistrian budget system resides both in its deformed character, dominated by SSTF, and in the structure of the latter. Specifically, the critical point of the SSTF is insufficiency of its revenue base. Thus, in 2014 the tax and non-tax incomes of this fund represented only 50.1% of the total revenues. The remaining revenues were covered by "RB" transfers (8.3%), by Russian assistance

³ The consolidated budget consists of the "Republican budget" and the budgets of administrative territorial units. Also, the given data does not include the financial assistance of the Russian Federation and revenues from securities issued by the transnistrian authorities. Also, the share of budget deficit in regional GDP was is given in comparison with GDP in 2014 year, due to the lacking of more recent statistics and any official forecasts for current year.



(9.0%) and by contracting interest-free loans (32.6%). In the first half of 2015, this structure was maintained with little variation, as in the previous year. Thus, it could be observed that one of the main sources of deficit financing is loans, which are converted into public debt, leading to growing indebtedness of the region.

Table 3. The structure of the budgetary framework in the Transnistrian region, (%)⁴

	2013	2014	2015 (January to October)
Revenue			
"RB"	39,9	42,1	40,4
BATU	19,4	18,1	23,9
SSTF	40,8	39,9	35,8
Total	100	100	100
Expenditure			
"RB"	37,0	39,3	41,6
BATU	18,4	17,6	20,2
SSTF	44,6	43,1	38,2
Total	100	100	100
Deficit			
"RB"	28,7	31,3	45,2
BATU	15,6	16,3	9,5
SSTF	55,7	52,3	45,3
Total	100	100	100

Source: Expert-Grup calculations based on data provided by the "Ministry of Finance of the Transnistrian region"

Another important issue is the growing public debt. At the beginning of 2015, the domestic public debt constituted an enormous amount of USD 1172.5 mil. (13014.8 million "rubles" or 105% of GDP) and the external one was USD 62.3 mil. (691.5 million "rubles" or 5.6% of GDP), the total being USD 1234.8 mil. or 110.6% of GDP. Maintaining such a high level of indebtedness is possible since the absolute majority of the contracted loans, including the ones from the "Central Bank", are obtained at a 0-1% annual interest rate, which is contrary to the international practice.⁵ At the same time, the missing transparency in reports on public debt does not allow us to identify the creditors who grant loans to the public administration at such a low interest rate.

The Transnistrian budget austerity is also caused by underdeveloped fiscal instruments used by relevant authorities. First of all, it must be mentioned the lack of VAT in the current version of the Tax Code. Nevertheless, the public authorities of the Transnistrian region began to make certain steps to improve tax collection. For instance, the current year brought a new Tax Code, which for the first time provided VAT for the Transnistrian region. This code is still being debated and could be approved after the completion of the electoral process.

Risks and forecasts

- One of the most significant challenges for the stability of public finances is the ability of the Transnistrian region to finance its SSTF. The income of this fund only covers half of the costs required and the situation will continue to deteriorate due to demographic pressures. The temporary solution for the government is to contract loans, which fuels the indebtedness of the region.
- The public debt has reached alarming levels, threatening the fiscal stability of the Transnistrian region. This fact gets more complicated since it is the "Central Bank", which lends to public administration. Such kind of deficit financing can spur the inflation, and run out of control in the near future (see Chapter 5).

⁴ Revenues of Unique National Fund for Health Insurance (UNFHI) are provided without contracted loans. These sources must be included as a source of deficit financing.

⁵ The Legislation on the status of the "Central Bank" and the public debt do not allow direct lending to the public administration by the "Central Bank".



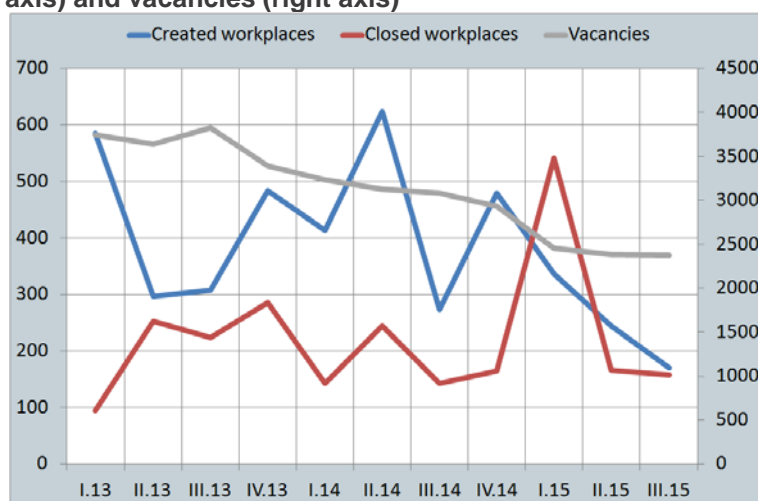
Chapter 4. Labour Market

The negative trends on the labour market in the Transnistrian region continued during 2015. The majority of indicators have worsened except the unemployment rate, which unexpectedly has dropped due to certain statistical peculiarities. Nevertheless, the number of employed population in the region continued to decline quite rapidly, undermining the medium-term growth prospects of the Transnistrian region.

Analysis of recent trends

The dynamics of labor market indicators in 2015 reflected the overall state of the economy in the Transnistrian region and it recorded a significant deterioration. First, the economy's ability to generate jobs decreased. Thus, over the past four quarters, the job creation rate has relentlessly decreased, almost equaling the job destruction rate by Q3:2015 (up to 160-170 workplaces). At the same time, the vacancies rate fell by 23% y-o-y and reached the lowest level of the last three years - 2378 jobs (Figure 4), revealing the diminishing real economy's ability to create jobs.

Figure 4. Dynamics of job creation and destruction (left axis) and vacancies (right axis)



Source: "The Regional Statistical Service" of the Transnistrian region

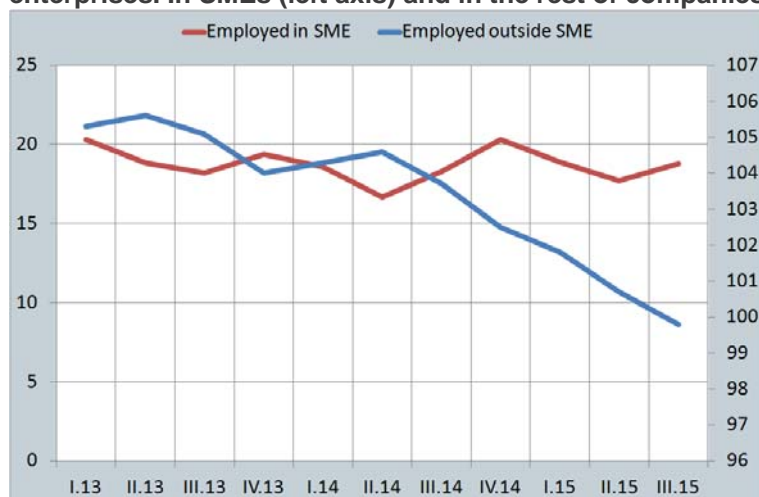
This year, the contracting trend of the number of economically active population, especially of the occupied one, has accelerated. Over the last two years the dynamics of this indicator was permanently negative, falling in Q3:2015 by 2.8% y-o-y, and attaining the historical low of 118,6 thousand people. At the same time, it did not occur uniformly in among enterprises. Thus, the employment in large enterprises and in the public sector was in a permanent decline, which could be a result of restructuring process and optimization within companies, public and private institutions. Meanwhile, the number of employees in SMEs fluctuated at around 18-19 thousand people, even during economic deceleration (Figure 5).⁶

The decrease in employed population has reached critical levels for both the economic growth and the sustainability of public finances. Firstly, the Transnistrian authorities proved to be unable to stimulate the development of SMEs that have proven their flexibility and ability to maintain a stable number of employees. Secondly, **at the end of 2014 there were 141,300 retired, exceeding the number of employees and continuing to grow.** Increasing this discrepancy between the numbers of employed and retired without reforming the public pension system, will increase the pressures on the public budget and generate further costs to reform this system.

⁶ According to the reports of the regional statistical service, the number of employees in the SME sector include those from non-governmental and religious organizations.



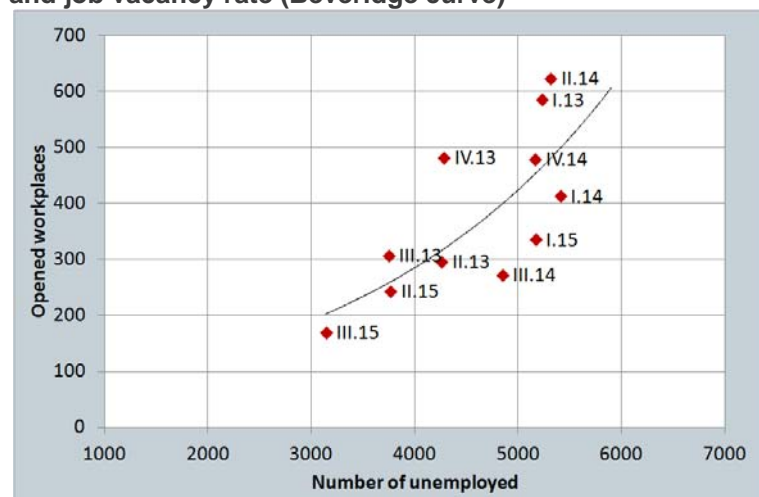
Figure 5. Dynamics of employed population (thousand persons) by types of enterprises. In SMEs (left axis) and in the rest of companies (right axis)



Source: "The Regional Statistical Service" of the Transnistrian region

Despite the economic slowdown, the number of officially registered unemployed has surprisingly and significantly diminished. In Q3:15 there were registered 3139 job seekers, 35% less y-o-y and reaching 2.6% rate of the economically active population. Basically, it has been established a direct relationship between unemployment rate and the number of vacancies (the Beveridge curve), contrary to a normal relationship that involves an increase in unemployment in periods when the economy cannot generate enough jobs (Figure 6). This creates a paradox specific to Transnistrian labor market, which has recorded an inverse relationship for the Beveridge curve.

Figure 6. The relationship between the unemployment rate and job vacancy rate (Beveridge curve)



Source: „The Regional Statistical Service” of the Transnistrian region

The paradox of declining unemployment is rather a statistical artefact. Since the regional statistical authority estimates the data on unemployed rate based not on labour surveys / questionnaires, but on request to the employment offices, the real unemployment rate may be much higher. Also, falling unemployment rate could be explained by increasing labour migration process or by employment in the informal economy. However, statistics on these areas are not published, which undermines the analysis of real processes on the regional labour market.

Challenges and forecasts



- As a result of the economic crisis in the regional economy, the negative trends on the labour market will intensify. In particular, the capacity of the regional economy to generate new jobs will remain limited, further lowering the rate of economically active population and stimulating migration outside the region.
- A medium-term challenge is the increasing discrepancy between the number of employees in real sector of the economy and the number of retired. In this context, postponing retirement reform and structural reforms able to reverse recent trends of decreasing employment will exponentially increase pressures on public finances.



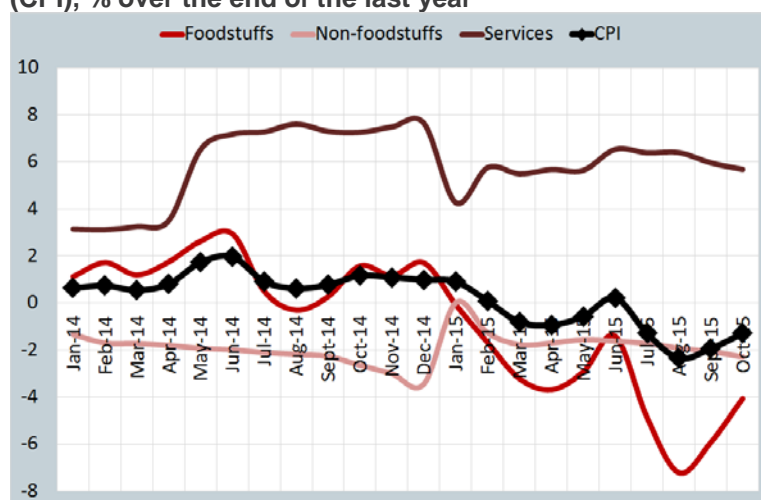
Chapter 5. Prices and Monetary Policy

Throughout the analysed period, in the Transnistrian region there have been outlined deflationary trends. They resulted from the reduced domestic consumption in the context of economic recession and from the appreciation of the "Transnistrian ruble" against the Russian ruble and the Euro (the rate against the US dollar remaining fixed at the same level). Therefore, the "Transnistrian Republican Bank" has changed in mid-2015 its monetary policy stance by gradually easing its policy. The phenomenon of deflation in parallel with economic recession, rigid foreign exchange policy and slow transmission channels of monetary policy pose a major threat to the macro-financial stability in the Transnistrian region.

Analysing recent trends

During 2014-2015, there has been outlined a clear disinflationary tendency (growth deceleration of consumer prices), which since the second half of 2015 has turned into deflation (a fall in consumer prices). Thus, in Oct:15, the Consumer Price Index (CPI) fell by 1.29% compared to Dec:14, and in 2015 a deflation average of about 1.5% is expected. The main causes of deflation phenomenon relate to the reduced consumption and the appreciation of "Transnistrian ruble" against the Russian ruble and the Euro. As a result, the most substantial fall in prices was recorded for foodstuffs (in Oct:15 by 4.06% compared to Dec:14) and for non-foodstuff products (in Oct:15 by 2.29% compared to Dec:14), for which the demand is more sensitive to income fluctuations and which heavily rely on imports of raw materials or finished products. At the same time, prices for services kept growing (in Oct:15 by 5.68% compared to Dec:14), mainly due to the increase in tariffs for public utilities at the beginning of the current year, which fuelled the poverty risks among the low-income population.

Figure 7. The main components of the Consumer Price Index (CPI), % over the end of the last year

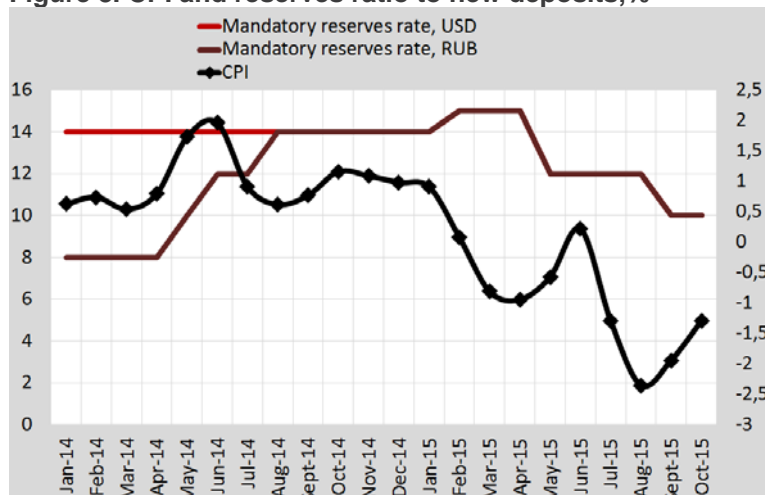


Source: "Transnistrian Republican Bank"

The "Transnistrian Republican Bank" has eased its tight monetary policy. Since May:15, the monetary authority of the region began to cut reserves ratio for deposits attracted in "Transnistrian rubles" and in "foreign currency" from 15% to the current 10%. Monetary easing is motivated by deflation, economic recession and decline in the bank credits and deposits. However, this adjustment of monetary policy came rather late (Expert Grup called on easing monetary policy in Jul:14 edition of the current publication).



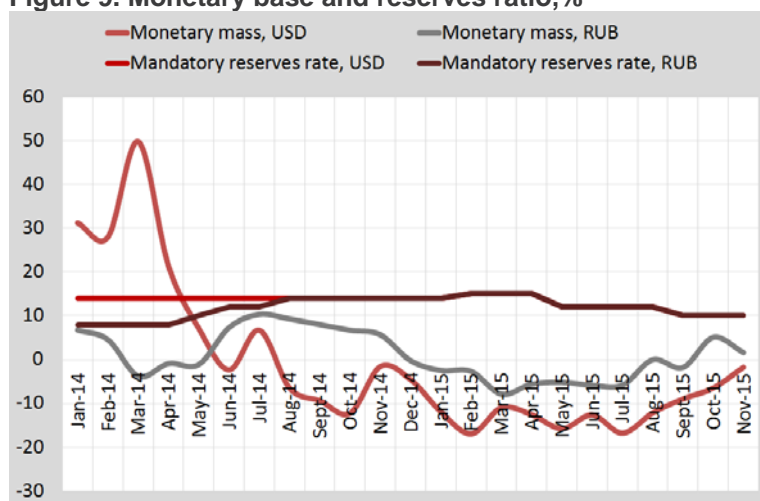
Figure 8. CPI and reserves ratio to new deposits, %



Source: "Transnistrian Republican Bank"

The effects of the monetary easing are still modest. After having reduced the reserves ratio, there was registered a certain improvement in the monetary base indicators: the monetary base in foreign currency slowed down its downfall (from -15.8% in Apr:15 to -1.73% in Oct:15 y-o-y) and the monetary base in "Transnistrian rubles" recorded a growth of 1.6% in Oct:15 y-o-y, after the decline by 5.2% in Apr:15. Yet, the effects on the stabilization of deflation trends are still not clear. Moreover, the delayed monetary policy easing is likely to have no stimulatory effects in the short-term (typically, any adjustments to the monetary policy during economic crises are less effective compared to adjustments during economic growth).

Figure 9. Monetary base and reserves ratio, %

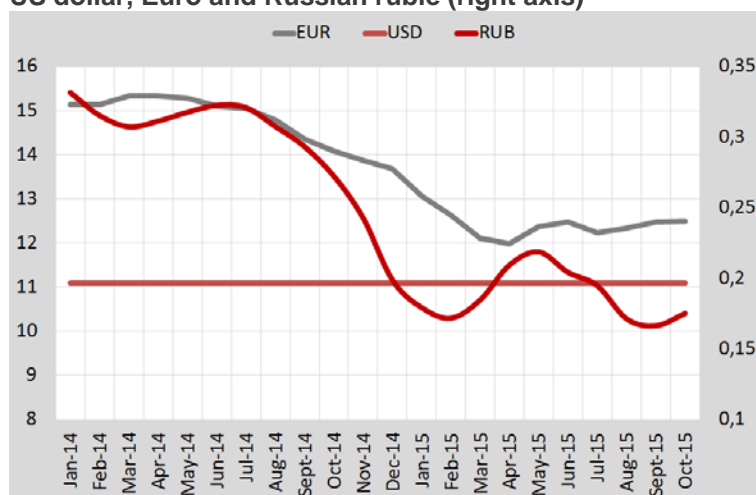


Source: "Transnistrian Republican Bank"

The rigid foreign exchange policies undermine the ability of the Transnistrian economy to adjust to economic shocks. Despite economic difficulties and limited international reserves held by the monetary authority in the region, the "Transnistrian ruble" exchange rate against the US dollar remained administratively fixed. Moreover, during the analysed period, the "Transnistrian ruble" appreciated against the Euro and the Russian ruble. Although fixing the exchange rate offers some temporary social benefits (lowering the import prices) and inspired to the society a certain sense of stability, it undermines the competitiveness of exporters and the ability of the economy to adjust to economic shocks. In addition, it is not sustainable in the long term, fuelling the risk of a harsh and unexpected depreciation of the exchange rate, at a point when the monetary authority will not be able any more to keep the exchange rate at the same level.



Figure 10. The exchange rate of the Transnistrian ruble against the US dollar, Euro and Russian ruble (right axis)



Source: "Transnistrian Republican Bank"

Challenges and forecasts

- Fixing artificially the exchange rate has major short-term and long-term risks to the macro-financial stability of the Transnistrian region.
 - In the short term, it undermines the competitiveness of exporters from the Transnistrian region and aggravates the current account deficit, which in 2014 reached the dangerous level of 93% of GDP. This problem is particularly acute in the current context of economic recession and falling exports. Given that the exporters represent a crucial source of employment in the region, further erosion of competitiveness fuels the risk of downturn in wages and surge in unemployment, with obvious social repercussions.
 - In the long run, setting an artificial exchange rate and ignoring the economic fundamentals cannot last forever, feeding the risk of a sudden devaluation when the monetary authority will not be able to cope with the gap between the demand and supply of foreign currency in the region's economy.
- In addition to the economic recession and decline in consumption, the deflationary processes in the region are also determined by administrative factors: political control of prices and tariffs on goods and services of social importance (namely the public utilities, electricity, heating and natural gas, bread, cereals etc.) and the artificial maintenance of the exchange rate (described in the previous paragraph). In the future, these administrative levers could be cracked under the pressure of macroeconomic imbalances. As a result, the current deflation risks to transform in the near future into inflation, manifested either by shortage of some socially important products (hidden inflation) or by a visible increase in consumer prices.



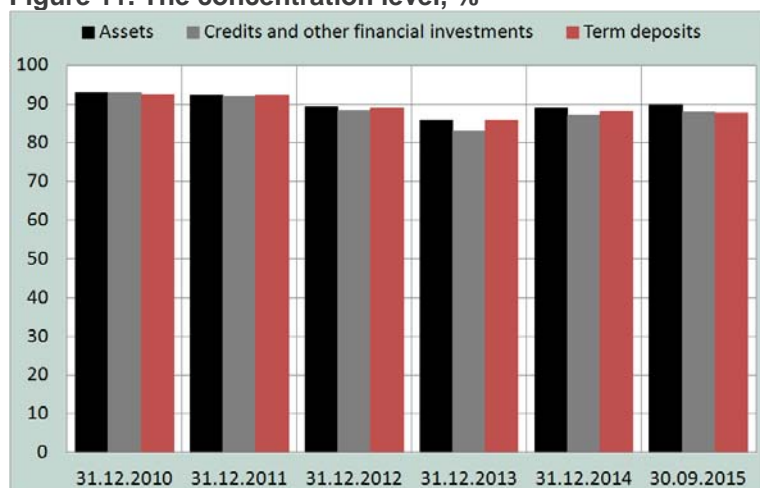
Chapter 6. Banking System

The weakening economic conditions had a negative impact on the banking sector from the Transnistrian region. The cooling economic activity and decreasing incomes made lending process contract and the deposits balance decrease. At the same time, the precarious economic environment undermined the quality of bank assets. As a result, the bank capital and liquidity indicators diminished. Thus, as of the pessimistic expectations on the dynamics of the regional economy, the outlook for the banking sector growth remains rather bleak.

Analysis of recent trends

The banking sector in the Transnistrian region is characterized by a small number of operating financial institutions and their high concentration. Four financial institutions, including "Agroprombank", "Ipotecinii", "Pridnestrovskii Sberbank " and "Eximbank" hold approximately 90% of the banking market in Transnistria. Thus, on 31.09.2015, those banks owned 89.7% of the sector assets, 88% of total loans and financial investments and 87.8% of term deposits attracted by Transnistrian banks. Such a high concentration points on the weaknesses of the sector's competition environment and represents in the long term a source of risk for the stability of the banking system in the region.

Figure 11. The concentration level, %

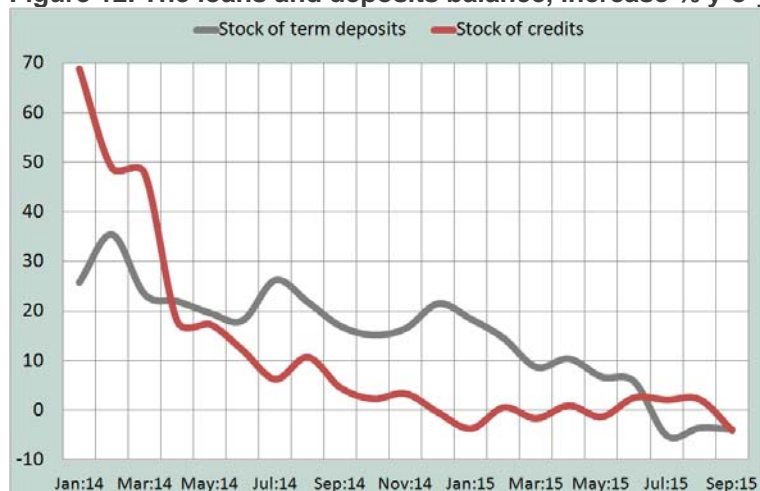


Source: The Republican Bank of Transnistria, EG calculations

The activity of the region's banking sector is contracting, both in terms of lending and deposit attraction activities. The decrease of household income generated a decline in newly attracted bank deposits. Thus, since the beginning of 2014 to Q2:15 the growth rate of term deposits balance decreased steadily and in Q3:15 it entered in red. The term deposits stock decreased in Jul:15 by 5.1% y-o-y, in Aug:15 by 3.5% y-o-y and in Sept:15 by 3.8% y-o-y. Also, the worsening economic situation has diminished the lending activity. During 2014, the loans' balance growth slowed down and in Jan-Sept:15 showed an anaemic dynamic, characterized by alternating negative rates with modest increases. For example, in Aug:15 the loans balance increased by 2.2% y-o-y, while in Sept:15 it registered a 4% y-o-y decrease.



Figure 12. The loans and deposits balance, increase % y-o-y

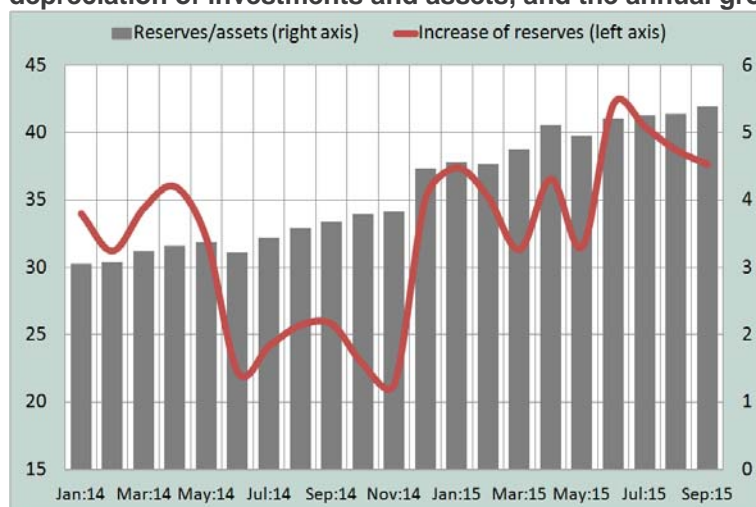


Source: The Republican Bank of Transnistria, EG calculations

The deterioration of economic conditions had also a negative impact on the quality of bank assets.

The worsening economic situation increases the probability of a default of bank loans and in this context the financial institutions are forced to assure larger prudential reserves to cover growing risks. At the end of 2014 it was observed a more intense growth of reserves for covering credit risks and losses from depreciation of investments. The latest observations, comprising the period Jun-Sept:15, show that the annual growth rates ranged around a 40% level. Similarly, the reserves and assets ratio increased, e.g. in Sept:15 this indicator increased by 1.7% y-o-y.

Figure 13. The relationship between reserves for credit risk and for losses from depreciation of investments and assets, and the annual growth of reserves %



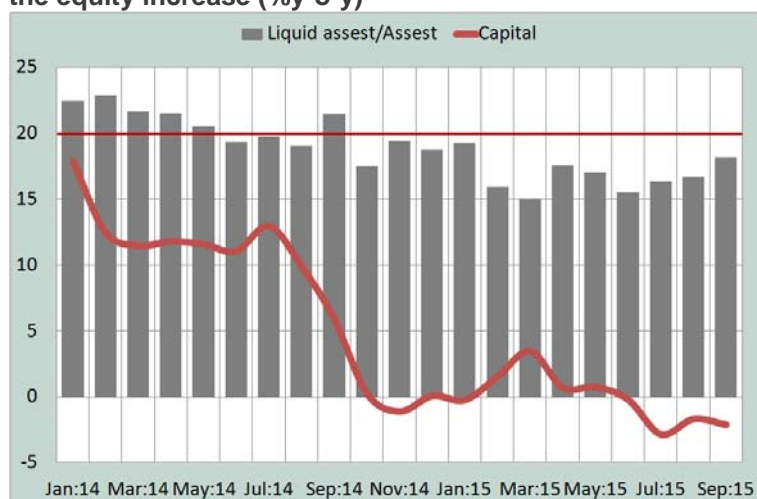
Source: The Republican Bank of Transnistria, EG calculations

The deterioration of the assets quality and the diminishing deposits have a negative impact on the capitalization and liquidity levels of the banking sector.

The degradation of assets leads to a growth in the reserves for covering credit risks, thus causing capital reduction. Since the beginning of 2014, the equity growth has been continuously slowing down and from Jun:15 a negative trend was recorded. For example, during Q3:15 there were registered the following declines in capital: in Jul:15 -2.8% y-o-y, in Aug:15 -1.7% y-o-y and in Sept:15 -2.1% y-o-y. Also, the greater difficulties related to loans repayment and the decreasing balance of deposits determine a reduction in the liquidity rate. Thus, since Oct:14 the share of liquid assets in total assets is below the minimum acceptable threshold of 20%, revealing major challenges facing the banking sector of the region.



Figure 14. The share of liquid assets in total assets (%) and the equity increase (%y-o-y)



Source: The Republican Bank of Transnistria, EG calculations

Challenges and Forecast

- In the context of worsening economic situation, the medium term outlook for the banking sector development in the Transnistrian region is rather negative. The decrease of households' incomes and the downturn in the economic activity will have negative implications for the region's banking sector..
- The continuous decline in foreign currency inflows (remittances and export earnings), will reduce household income, and therefore will decrease the level of savings. Consequently, the volume of deposits attracted by banks could diminish. At the same time, due to the economic and industrial recession, companies will reduce the volume of their deposits in banks. Another important side effect is the deterioration of banks' portfolio quality, due to accumulating non-performing loans.
- In the context of decreasing deposits and degrading quality of loan portfolio, banks might face some liquidity deficit. Similarly, increasing toxic assets will lead to a downturn in bank capitalization.



Chapter 7. Foreign Sector

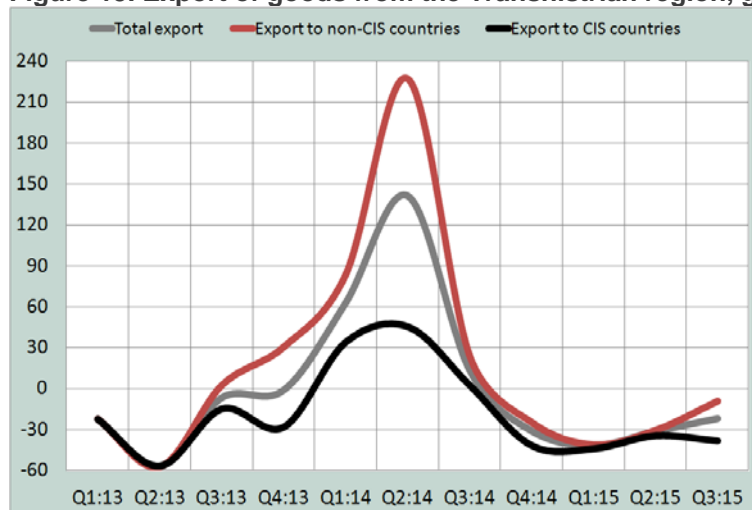
Because Transnistrian economy is highly dependent on foreign trade, it is heavily exposed to external shocks. Thus, the worsening economic situation in Ukraine and in the Russian Federation has negatively affected the external foreign trade. On the other hand, the industry contracts as a result of domestic factors, which have negatively influenced exports in the region. At the same time, Tiraspol authorities are put in front of important decisions regarding the implementation of the EU Association Agreement, which is crucial for the long-term development of the region.

Analysis of recent trends

The worsening economic situation, among major trading partners both outside and inside the Transnistrian region, generated the reduction of foreign trade. During Jan-Sept:15 the region's foreign trade exceeded slightly one billion USD and fell by 27.4% y-o-y. The trade with CIS countries shrank by 24.3% y-o-y, and trade with the rest of the world fell by 33% y-o-y.

The recession in Russia and Ukraine, as well as the industrial recession in the region caused a reduction in merchandise exports. The Russian economy records negative growth for two consecutive quarters (GDP fell by -2.2% y-o-y in Q1:2015 and by -4.6% y-o-y in Q2:2015) and In Ukraine the economic decline has deepened (GDP fell by -17, 2% and -14.6% y-o-y). Also, due to the industrial recession (see Chapter 1), in Jan-Sept:15 the region's exports decreased by 31.6% y-o-y. Exports to CIS countries dropped by 38.9% y-o-y. The exports to other markets also declined and accounted 27.4% y-o-y. Although the downward trend has been lasting for four consecutive quarters, the negative growth rate has moderated. So, if in Q1:15 the decline was of 42.1% y-o-y, then in Q2:15 and Q3:15 the decrease was of 31.5% and 22.2% y-o-y.

Figure 15. Export of goods from the Transnistrian region, growth, % y-o-y

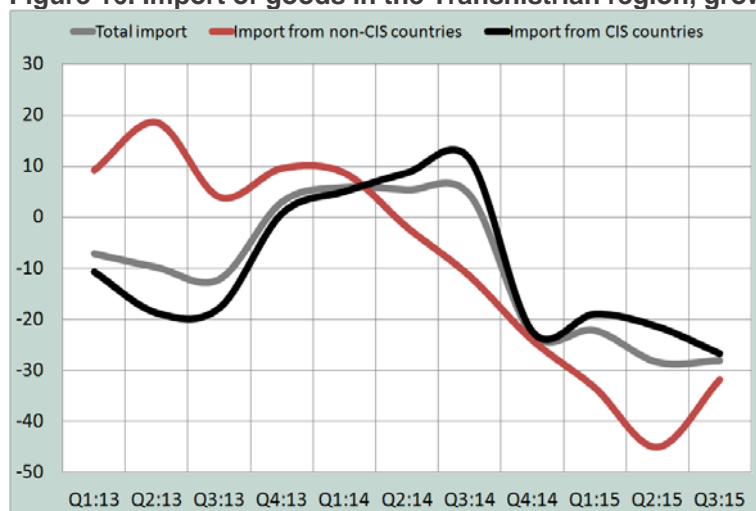


Source: State Statistics Service of Transnistrian region, EG calculations

The deterioration of economic conditions in the Transnistrian region generated a decreased import of goods. In the first nine months of 2015 imports decreased by 26.1% y-o-y. The decrease in imports from the CIS countries was of 22.2% y-o-y, while the decrease in imports from the rest of the world was more significant - 37.4%. At the same time, the decrease in import is lasting for 4 consecutive quarters and the trend is augmenting. Thus, while in Q1:15 imports decreased by 22.1% y-o-y, in Q2:15 and Q3:15 decreases were higher and exceeded 28% y-o-y.



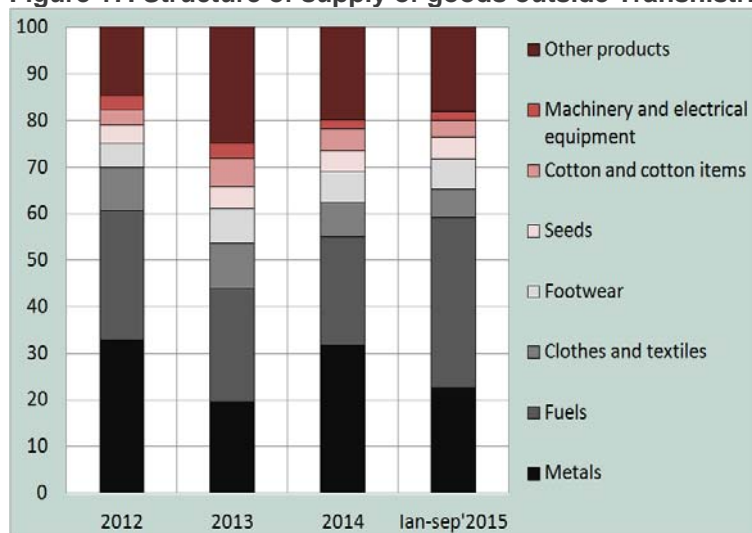
Figure 16. Import of goods in the Transnistrian region, growth, % y-o-y



Source: State Statistics Service of the Transnistrian region, EG calculations

The export of goods from the left bank is highly concentrated, and is a significant risk factor for the foreign trade activities of the region. During the last 4 years, more than a fifth of exports were represented by metals, and in Jan-Sept:15, their share accounted for 22.6%. In fact, any failure of Ribnita Metallurgical Plant can significantly alter the total metal supply and region's exports. In this regard, the year 2012 is conclusive since the metallurgical production decreased by 51.5% y-o-y and therefore metal trade outside the region declined by 49.8% y-o-y and region's exports decreased by 15.7% y-o-y. At the same time, another exported item, fuels, during the same period, posted a share of 36.6%. The share of clothing, textiles and footwear is higher than of other products sold outside the Transnistrian region. In the first 9 months of 2015 clothing and textiles share was of 6.1% and of the footwear - 6.5%.

Figure 17. Structure of supply of goods outside Transnistria, % *



Source: State Statistics Service of the Transnistrian region, EG calculations

Note: Goods supplied outside the Transnistrian region include the actual export and goods supply on the right bank of Nistru river

In terms of geographical orientation of the foreign trade, it has been observed a significant contrast between exports, which are mainly oriented towards EU, and imports, which originate mainly from CIS.. In the first nine months of 2015 the goods supplied to EU represented 63.3% of the export value of the Transnistrian region, while the share of supplies to the CIS was only 32.1%. In terms of imports, the situation is totally opposite. The share of imports from the CIS was 78.4% and the share of goods imported to the EU from the Transnistrian region was 15.7%. Trade with other countries had a significant share in



the region's foreign trade. Thus, the share of exports to other countries was 4.6% and the share of import from other countries was 5.9%.

Figure 18. Geographical structure of exports and imports of the Transnistrian region, % *



Source: State Statistics Service of the Transnistrian region, EG calculations

Challenges and Forecasts

- Forecasts on economic developments in Russia and Ukraine are pessimistic. The Russian GDP is expected to decrease by 3.8% in 2015 and by 0.6% in 2016. Regarding Ukraine, in 2015 it will record a downturn of 9% and in 2016 its economic growth will not exceed 2%. In these circumstances, the region's exports will continue to be negatively affected. Considering that currently 95.6% of the region's exports to the CIS countries go to the Russian and Ukrainian markets, it is obvious that the negative dynamics of these two economies will lead to a reduced demand for goods produced in the Transnistrian region.
- Although there has been a certain improvement, the trade deficit remains a serious problem for the region's economy. In Jan-Sept:15 the ratio between the region's exports and imports was of 51.5% and it increased by 5.5% y-o-y. However, the worsening economic situation in the Russian Federation could lead to some reduction in the trade deficit of the region, while the inflow of remittances from Russia will remain an important source of financing imports. The recession in the Russian Federation will make remittances diminish and the income of the population will decrease, and in this context imports will be reduced as well.
- Exports from the region are highly concentrated on a limited number of giant enterprises, which are strongly supported by the region's authorities. The unbalanced budget will determine the Tiraspol authorities to identify new sources of tax revenue and to reduce public expenditure. In this context, the support given to enterprises could considerably reduce, and this will affect the external competitiveness of companies and will make exports decrease in Transnistria.



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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.

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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.

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