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What are the economic threats for Transnistrian economy in 2016-2017?

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Regional Economic Review:

Transnistrian region

#4, July 2016

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This document is published by the Independent Think-Tank Expert-Grup within the Program "Support to Confidence Building Measures", financed by the EU Delegation in Moldova and implemented by United Nations Development Programme in Moldova. Opinions expressed in this document belong to the authors and are not necessarily the opinions of the donors. Also, the authors are aware of potential risks related to quality of the statistical data and have used the data with due precaution.

This project is funded by the European Union

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The Economy of the Transnistrian Region in Figures

Table 1. Key economic indicators of the Transnistrian region

	2013	2014	2015	T1:2016	T2:2016
Gross Domestic Product, mil. USD	1048.8	1116.78	869.7	-	-
Gross Domestic Product, % y-o-y	104.2	103.43	79.8	-	-
Industrial production volume, mil. USD	738.08	904.86	767.3	178.8	-
Industrial production volume, % y-o-y	82.3	119.0	88.0	116.1	-
Retail trade, mil. USD	902.51	882.68	696.4	160.7	-
Retail trade, % y-o-y	104.8	97.5	79.5	91.1	-
Investments in fixed capital, mil. USD	139.32	131.91	95.0	12.9	-
Investments in fixed capital, % f-a-p	110.4	89.0	72.0	84.8	-
„Transnistrian ruble" exchange rate against USD	11.1	11.1	11.1	11.3	11.3
Consumer Price Index, % y-o-y	103.63	100.98	98.23	99.99	-
Mandatory reserves rate, physical persons, „Transnistrian rubles", % (end of the period)	0	10	10	10	12
Mandatory reserves rate, physical persons, foreign currency, % (end of the period)	8	14	12	12	12
Mandatory reserves rate, juridical persons, „Transnistrian rubles", % (end of the period)	6	14	10	10	12
Mandatory reserves rate, juridical persons, foreign currency, % (end of the period)	12	14	10	10	10
Exports of goods, mil. USD	556.43	677.69	567.9	115.4	-
Imports of goods, mil. USD	1648.57	1641.56	1096.7	207.5	-
Exports of services, mil. USD	68.28	65.58	57.1	18.2	-
Imports of services, mil. USD	94.56	144.97	76.9	13.9	-
Current account deficit, mil. USD	-827.2	-892.2	-480.3	-75.6	-
Average wage, USD	336.5	355.6	348.2	336.8	-
Budgetary revenues, mil. USD	257.3	286.0	209.5	-	-
Budgetary expenditures, mil. USD	324.3	366.9	279.7	-	-
Budgetary deficit (-)/surplus (+), mil. USD	-67.0	-80.9	-70.2	-	-
Loans and other financial placements, mil. USD (end of the period)	378.74	376.93	363.2	369.2	-
Term deposits, mil. USD (end of the period)	225.84	274.56	253.6	255.4	-

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

Key messages of this issue

- **The Transnistrian economy is still facing an unprecedented economic recession.** Most of risks identified in the previous edition of the publication have materialized, while the other are likely to materialize in the near future. After a 20% slump in 2015, the Transnistrian economy is anticipated to shrink by 5-6% in 2016. If the recession of 2015 was caused by almost all sectors of the region's economy, in 2016 it will be determined by two most problematic sectors: constructions and services. Hence, the compensatory growths in agriculture and industry expected for this year, which are expected to be impressive, given the low comparison base, will not be enough to ensure an economic relaunch in 2016.

- **Reduction in aggregate demand and growth in poverty rate are the main immediate risks for Transnistria.** The economic recession will continue in 2016 in Transnistria mainly due to the expected continuous worsening of the three basic components of aggregate demand. First, the household consumption will decrease by -5%, due to the decline in salaries and remittances, especially from Russia, and the accumulation of arrears in the public and private sectors. Second, the public consumption in the region will shrink due to the major budgetary constraints (the budget deficit is estimated at almost 15% of GRP in 2016). Third, the corporate capital investments are expected to slump by almost -10-12%, due to firms' reluctance in launching new projects, limited access to credit resources, and acceleration of capital outflow from the region.

- **The perpetuation of this economic recession shows that the main constraints are of domestic origin.** Certainly, many culprits for the large-scale economic and social crisis in Transnistria can be assigned to the worsening economic situation in the neighboring regions – the right bank of the Nistru river, Russia and Ukraine, coupled with the lower demand for region's exports and national currencies depreciation of the main partners of Transnistrian enterprises). However, the crisis would be less dramatic, both in terms of duration and magnitude, if the region's authorities were prepared better from fiscal, budgetary, monetary, and economic standpoints for such negative shocks. Particularly, the Transnistrian economy entered into the crisis with a serious budgetary and current account deficit, narrow tax base determined by the lack of a VAT system and a wide informal sector, large portfolios of non-performing loans at banks, old technical-material base at the main enterprises, and low international reserves coupled with a fixed exchange rate that has nothing to do with the economic realities.

- **The domestic vulnerabilities were aggravated by the electoral cycle in the region, associated with the proximity of "presidential" elections.** It worsened even more the domestic political conflicts, especially between the "legislative" and "executive" powers, delaying the implementation of reforms and fueling some populist policies with additional major risks for the near future. The prevalence of political economy ideas over the economic policies was highly visible in the case of the policymakers' resistance to the depreciation of the "Transnistrian ruble". Thus, though its necessity is obvious from the economic standpoint (the currencies of the main trade partners depreciated, affecting the competitiveness of the main Transnistrian exporters), some policymakers were against the depreciation in order to protect the poor population.

- **The rationale for maintaining the exchange rate of "Transnistrian ruble" fixed at the current level is false.** Despite its pro-poor allure, this policy actually harm the poor population, because the artificial exchange rate resulted in a severe foreign currency deficit in the region and expanded the black market, where the "Transnistrian ruble" depreciated by about 50%. In its turn, it caused an acute deficit of imported products, fueling the "food tourism" (import of foodstuffs for individual consumption), which caused a hidden inflation (the effective prices of foodstuffs increased, if taking into account the costs and the time taken to travel); in addition, the products imported by firms got more expensive, because they take into account the de facto rate, especially the one on the black market, rather than the official one. Taking into account the depreciation of the currency of Transnistrian exporters' trade partners and the huge current account deficit (similar to the value of

the region's GDP value), the depreciation is inevitable, and delaying the controlled depreciation could provoke an uncontrolled collapse of the "Transnistrian currency" with serious economic and social consequences.

- **The main five risks for the following 2-3 years for the Transnistrian economy are primarily of domestic origin and need to be addressed through urgent policy interventions.** They derive from the vulnerable banking and energy sectors, non-competitive industrial sector, inefficient public sector on the background of an excessive budget deficit, and limited economic opportunities that determined many people of working age to leave the region**:**

    1. The banking sector is threatened by the high concentration, "intoxication" with non-performing loans and decapitalization. Ultimately, this is related to the close inter-connections between political and economic circles, which affects the basic principles of risk management and allowed many banks to credit different enterprises that are currently finding it difficult to repay the loans. The problems of the banking system are already noticed from the perspective of lower liquidity indicators and capitalization.

    2. Some uncertainties hover around the energy industry from the region. If in 2015-2016 the energy supplier from the region supplied the right bank of the Nistru river with electricity, there is a probability that soon this opportunity will fade away or will narrow significantly. The constitutional authorities are under both financial and public pressure, which could make them give up on the Energy Supply Agreement, concluded in a non-transparent manner with the Transnistrean supplier, and identify alternative suppliers from Ukraine.

    3. The amalgam of extremely severe budgetary and structural constraints, which the authorities must deal with, will lead to difficult decisions that could negatively impact the households, if not in 2016, then in 2017. It is mainly about the sizeable and extremely inefficient public sector. Almost 45% of the total number of employees from the region work in the public sector, which from any point of view represents an exaggerated proportion. We think that reforming the region's public sector is inevitable, regardless the results of the autumn elections. This will impact significantly the incomes from salaries, and due to the lack of employment opportunities in the real sector, the emigration from the region will accelerate.

    4. The industrial sector will face more intensely the problem of low competitiveness, given the impaired technical base and insufficient fixed capital investments. Without a business-friendly climate, most exporters risk to be unable to compete on foreign markets, despite the energy subsidies.

    5. The continuous decrease in population is a major challenge, both on long and short term. It leaves the region with low labour supply and a shortage of labour force for potential new investment projects. Still, the most severe problem is that during the recent years, the employment rate decreased at a higher pace due to the worsening regional economic crisis. The decrease in the total and employed population will have a long-term impact on all social and economic areas of the region, especially a higher pressure on the region's public finance system and lower domestic demand.

Executive Summary

Domestic Supply

For the Transnistrian region, the 2015 economic year ended worse than the authorities had anticipated. According to the most recent available data, the GRP shrank by about 20%, although officially they expected a decrease of maximum 5%. The recession in the industrial sector was of 8%, in the agriculture – about 7%, while in the constructions and the services sectors the turnovers decreased by almost 20%. The 2016 year began apparently on an optimistic note, with the industrial production increasing by 16% in the first quarter. Still, the positive dynamics are practically limited to the industrial sector and even so we cannot speak about sustainable trends, but rather about a partial recovery of the production level lost previously. The fundamental factors that hinder the long-term economic development – political uncertainties, unfavorable general business climate, limited access to foreign sales markets and monopolistic structures – did not disappear, and in the light of coming elections in the region, some of these factors could even intensify. Taking into account, the extremely volatile character of the regional economy, making forecasts, even for the short term, is an extremely risky task. For 2016, we adopt a conservative forecast, anticipating a 5-6% decrease in GDP. The risks that might affect this forecast are rather on the downside.

Domestic Demand

A number of essential factors overlapped to result in a dramatic decrease of people's income in 2015 and in the first half of this year. These factors include the following: lower wage income in several key sectors, accumulated wage arrears, continuous decrease of remittances from emigrants from Russia, and the depreciation of the regional currency. The companies' investments in tangible assets also decreased, including due to the shrinking households' savings and companies' own investment means, which firms used to have previously. This list of factors is likely to persist in 2016 and, on the background of complex political processes, will result in a continuous decrease of the aggregate demand in the region. In particular, we anticipate that households' income will decrease by about 5%, which will trigger a proportional decrease in final consumption demand. At the same time, the demand for investment goods will decrease by 10-12%. The perpetuation of the negative investment processes, coupled with the disinvestment and capital flight phenomena, pose high risks for the reproduction of the region's productive potential.

Public Finance

The budgetary system of the Transnistrian region has been lately influenced by two contradictory factors. On the one hand, the negative economic situation in the region caused a worsening of all budget indicators in 2015 and a moderate performance since early 2016. On the other hand, the authorities of the region took a set of measures that do not contribute to the stabilization of public finance, having rather an electoral nature. Thus, a commercial loan was contracted in order to cover the salary arrears, and the parameters of the budget approved for this year are too optimistic. Both the economic and electoral factors led to a continuous increase in the consolidated public budget deficit of the region up to almost 17-18% of the GDP. In addition, the situation is complicated even more by the delayed reform of the tax system.

Labour Market

The key indicators of the labour market had an ambiguous evolution. In Q1:16, for the first time over the past four quarters, the number of newly created jobs started to increase faster than the number of closed jobs, indicating a possible economic recovery. At the same time, the number of employed persons continued to decrease, and the decreasing rates went up at the beginning of this year. This decline in the number of employed persons, regardless of the stage of the economic cycle, may be caused both by the negative demographic trends and by the unavailability of statistical data on informal employment and

external migration. If the informal employment is difficult to estimate, the demographic trends were confirmed by the last year's census, recording a 14% decrease in the population, compared to 2004.

Prices and monetary policy

In the past years, the monetary policy in the Transnistrian region aimed at stabilizing the foreign exchange market. Thus, the increased pressures on the "Transnistrian Ruble", occurred in the second half of 2015 and the first half of 2016, determined the "Republican Bank" of the region to tighten its policy. At the same time, maintenance of a stable exchange rate for a long period become almost impossible due to the depletion of foreign currency reserves. Although the official rate of the "Transnistrian ruble" remained relatively stable, the situation on the foreign exchange market is difficult. Thus, the shortage of currency in the region fostered the development of a shadow FX market, where the Transnistrian ruble exchange rate is much more depreciated than the official exchange rate. The simultaneous promotion of several conflicting measures is another cause leading to modest outcomes of the promoted monetary policy.

Banking System

The stagnation of Transnistrian economy and the negative social trends determined to a high extent the dynamics of the main banking indicators. Being strongly influenced by the foreign currency crisis and the uncertainties regarding the depreciation of the "Transnistrian ruble", the core activity of the banking sector in the region experiences an uncertain conjuncture "comeback", both in terms of crediting and attracting deposits. At the same time, the deterioration of the clients' solvency worsens the quality of the existing credit portfolio, assets' liquidity and capitalization of banks. Moreover, the general trends of the Transnistrian economy are also reflected in the general performances of the sector, i.e. the lower revenues and net results. In these circumstances, the medium and short-term prospects for banking sector development in Transnistria seem to be less optimistic.

Foreign Sector

The perpetuation of weak social and economic situation in Transnistria, on the background of a deep currency crisis, affected negatively the Transnistrian trade performances. At the same time, the low demand on the foreign markets for the main groups of goods, as well as the lower price of electricity supplied to the right bank of the Nistru river (according to the new contract) dragged down the supplies to these destinations by almost 8% y-o-y. Simultaneously, the import of goods in the region decreased by 32% y-o-y, for the same objective reason. Moreover, the reference period was marked by a shortage of foodstuffs and oil products on the domestic market due to the region's foreign currency shortage. The region's authorities should give top priority now to DCFTA implementation in order to further benefit of preferential trade treatment when exporting to UE, and to the review of the foreign currency crisis management mechanism by eliminating the counter-productive interferences in the international trade.

Chapter 1. Domestic Supply

The year 2015 was complicated for the Transnistrian region, as revealed by the estimated decrease of GRP by almost 20%. The industry – which is the region's economic driving force – dropped by about 16%, with the recession affecting almost all key industrial branches. During the first quarter of this year, the economic growth resumed in several key industries, including in metallurgy, but the recession continued to affect agriculture, constructions and services. The climate preconditions look quite favorable, and by the end of the year the agriculture is likely to grow. However, we anticipate a 5-6% decrease of GRP for 2016, because the expected recovery growth in industry and agriculture will not be able to compensate for the decrease that will continue or even worsen in constructions and service sectors.

Analysis of the Main Trends

Industry. Even if in the second half of 2015, the main industrial performance indicators improved a little[1], on annual basis the industry registered a quite strong decrease in production (**Error! Reference source ot found.**). The recession affected almost all key branches, except for electricity and printing industries. In the case of the former, the favorable dynamic was possible due to the contract for electricity supply to the business entities from the right bank of the Nistru river. This was the only lifeline for the Cuciurgan power plant in the conditions of an excess production of electricity compared to the region's demand. As for the printing industry, its spectacular growth in 2015 was fully determined by occasional factors, which will not be present in 2016.

Table 2. Total and sector-level industrial production indexes, % of the corresponding period of the previous year

	2014	*Q1:2015*	*2015*	*Q1:2016*	*2015, 2009=100%*
Total	119.0	83.7	92.3	116.1	92.6
Energy sector	121.2	110.6	115.7	95.0	103.0
Metallurgical industry	220.0	54.9	81.9	220.0	72.1
Chemical industry	98.8	98.5	64.1	96.0	166.5
Machine building	86.2	102.3	89.9	75.0	97.1
Wood processing industry	139.8	143.4	49.3	21.8	194.8
Production of building materials	124.9	78.9	68.2	94.0	119.6
Textile, apparel and footwear industries	87.8	75.5	85.5	105.4	87.4
Food industry	77.7	63.6	78.6	105.1	95.1
Milling, forage production	107.5	77.7	88.4	92.0	136.0
Printing industry	77.1	300.0	380.0	42.9	196.6

Sources: EG, based on data from the " Central Bank of the Moldovan Republic of Transnistria".

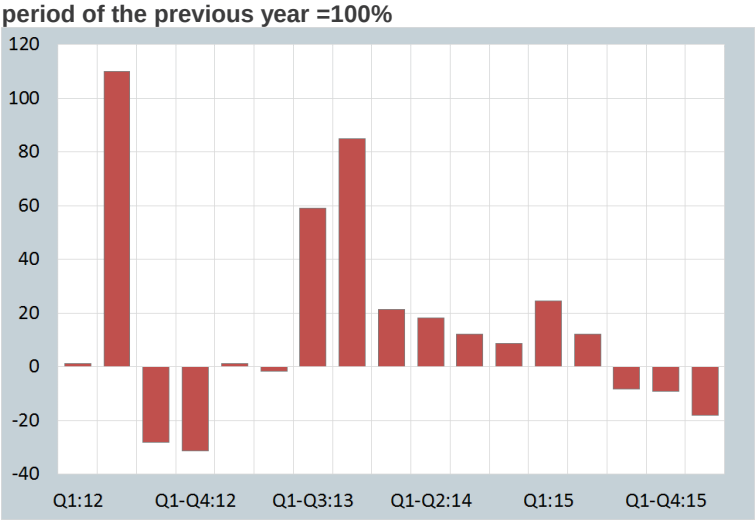
The regional industry started more resilient in 2016, cumulating, according to the "official" data, a 16% growth. The main growth source was the Moldova Steel Works (Rabnita), which in 2015 resumed its activity, and in 2016 extended it, by exporting large quantities of production to Ukraine and EU, and by supplying to the business entities from the right bank of Nistru river. In 2015, the management of the Steel Works tried even to enter into strategic alliances with international intermediaries of metal products in order to secure access to the international market. It is quite possible that by the end of this year the metallurgical industry will register a strong growth in production. However, as illustrated in the section below, its long term prospects are uncertain. A minor reinvigoration has been noticed in the "light" industry and in food industry (+5% growth of production for each of them). In both cases, however, this growth represents only a weak economic recovery after several years of recession. Even if the overall industrial production increased, some enterprises seem to face problems with actually selling the production. This is particularly

[1] We cannot overlook the huge number of inconsistencies in the statistical data, produced by the regional "authorities", including when it comes to the calculation of the actual industrial production, Gross Regional Product, intermediary consumptions, etc. However, as there are no alternatives, we draw our analysis on the only available data.

true for the case of the chemical industry, machine building industry and "light" industry, where according to the published statistical data, the stocks of production exceed the normal prudential level.

Agriculture. According to the statistical data, in 2015 the agricultural production decreased by about 7% in real terms. This was caused by the lower production in the plant-growing sector (-9%). The factors responsible for the recession in agriculture are partially linked to the unfavorable agricultural and weather conditions, and partially – to smaller sown areas (especially in the case of sunflower and vegetables cultivated in open fields). In Q1:2016 the total volume of production decreased by almost 20% (Figure 1). Even if we take into account the seasonal factors, such a decrease in production is more than significant, as it was determined by the livestock sector. It is mainly about the consequences of decreasing cattle livestock, as producers are encountering shortages in the supply of fodder. The slaughtering of dairy cows resulted, on the one hand, in higher meat production, but on the other, in lower milk production. On the positive side, the quantity of vegetables and greens harvested in greenhouses increased 9 times in Q1:2016, apparently following a major investment project to increase the installed capacity of greenhouses in 2015. Impressive results were obtained in fishery too (+25%), due to the fact that producers from this branch took advantage of the increasing demand in the region and on the right bank of the Nistru river, as well as of a favourable access to the Russian market. Even though we mainly speak about growth in some niches rather than whole branches, we believe that these developments reveal a major potential of the region's agriculture, a potential which had been ignored until not long ago due to the industrial traditions of Transnistria.

Figure 1. Evolution of agricultural production, corresponding period of the previous year =100%



Sources: "Ministry of Economic Development of the Moldovan Republic of Transnistria".

Constructions. Thanks to some construction projects, funded by external and budgetary sources, as well as thanks to favourable weather conditions that allowed the construction works to continue even during November and December, in the second half of 2015 the situation in constructions sector improved significantly compared to the first half of the year. According to statistical data, the annual volume of construction-assembly works in comparable prices is practically at the level of 2014. In Q1:2016 this sector returned to the negative slope – the volume of works decreased by almost 40% compared to Q1:2015. In particular, the volume of construction- assembly works in industrial-productive projects decreased by almost 33%. Another suggestive indicator – the volume of contracted works carried out by construction companies decreased by almost 50% during the first quarter of this year. The volume of constructions carried out by investors on their own decreased almost in the same proportion. These developments have their reflection in the lower production of construction materials (-30% in 2015, -40% in Q1:2016).

Services. The shrinking transport services branch was the most notable development in 2015: the volume of transported commodities decreased by almost 18%, and the number of transported passengers - by 6%. The retail trade and services provided to the population dropped sharply, by almost 20% in 2015. This

involution continues. In Q1:2016 the volume of services provided to the population continued to decrease (-3%), as well as the volume of retail trade (-12%). Another trend that, once confirmed, could result in a much more negative impact is the 30% decrease in the number of small firms in the trade sector[2].

Challenges and Forecasts

- Statistical data show that the metallurgical industry, the second most important in Transnistria, improved its performance indicators. We anticipate a 45-50% growth of production in 2016 compared to the previous year. However, the medium and long-term prospects are uncertain. The main risks to the operation of the Steel Works of Rabnita come from the non-transparent management structure and unclear financial commitments that the enterprise undertook when contracting a loan of USD 140 million from a Middle East financial institution. Thus, though having immediate beneficial effects, bringing the enterprise back into ”state” ownership also entails major quasi-fiscal risks. The too close connections between the plant management and the region’s political leadership is another risk that could affect its operation in the event of a radical change of the political context in the region.
- A number of uncertainties hover over the energy industry from the region. Whereas in 2015-2016 the energy supplier from the region has supplied energy on the right bank of Nistru river, this opportunity may soon disappear or narrow down significantly. The Chisinau authorities are under both financial and public pressure, which could make them give up on the supply contract, which has been concluded in a non-transparent manner with the Transnistrian supplier, and identify alternative suppliers from Ukraine. For now, we expect that in 2016 the situation will not change and the industry will maintain the same volume of production as in 2015.
- The introduction of more restrictive commercial measures for the import of meat, dairy and fish products provided a slight boost to the region’s food industry. Still it is difficult to believe that their impact will persist, because the regional industry faces fundamental competitiveness issues. Existence of smuggling opportunities, monopoly on the retail market, and the “food tourism”, as Transnistrian call the import of foodstuff for individual consumption, will offset the desired effect of these intervention measures. The serious problems of regional food industry could alleviate only by amending the anti-monopoly framework and reforming the tax system. We anticipate that the food industry will grow by 16-17% this year. Overall, the industrial sector will record a recovery growth of about 13-15%.
- The problems in constructions will persist, mainly due to the lack of confidence in the long and medium-term economic prospects of the region. Neither the decreasing population’s savings and companies’ own funds, which represent the main sources of funding for investment projects, nor the lower financing capacity of commercial banks could pass without impacting the constructions sector. We anticipate that the volume of contracted works will decrease by at least 10% in 2016.
- The agriculture has all the chances to produce more this year, thanks to the better weather conditions, and the arithmetic effect of the low basis of comparison. The improvement of fodder supply will reduce the pressures on the livestock sector, which will nevertheless drag down the agricultural production throughout the whole year. The key forecast indicator is the total volume of agricultural production, which according to our projections will increase by about 18-20% in 2016.
- In the services sector the situation will remain quite poor and will reflect the decreasing individual income and the growing pressures on the household budgets’ expenses due to the depreciation of regional “currency”. A decrease of total turnover by almost 15% seems to be a reasonable forecast for 2016. The decrease in service sector is the main factor of our negative forecast for the 2016 Gross Regional Product. According to our estimates, the GRP is likely to decrease by almost 5-6%. However, as revealed by the analysis, this forecast is extremely vulnerable to the volatile evolutions in the region. Most uncertainties and risks have a top-down orientation, and the actual decrease could be larger.

[2]Бизнес-омбудсмен сергей бобров обсудил с бендерскими предпринимателями проблемы делового сообщества [Business ombudsman Sergey Bobrov and entrepreneurs from Bender discussed the problems of the business community] , http://novostipmr.com/ru/news/16-06-27/biznes-ombudsmen-sergey-bobrov-obsudil-s-benderskimi.

Chapter 2. Domestic Demand

The decrease of real income in 2015, the accumulation of wage arrears in the budgetary sector and in the real sector during the second half of the year, coupled with the continuous decrease of emigrants' remittances from Russia, determined the shrinking by almost 20% of the households' consumption in Transnistria during the previous year. The regional authorities did not have the necessary resources to finance its planned consumption, which has decreased by 15-16%. Another major component of domestic demand – the corporate capital investments – shrank by 15%. The situation will not improve radically in 2016 – we forecast a further decrease of the major components of aggregate demand, even if at lower rates compared to 2015.

Analysis of the Main Trends

Population's income and consumption. During 2015, the actual population's income shrank by a quarter. Even though we are adepts of extreme assessments, we believe that such a decrease in income is truly a dramatic one. This is especially so because, as presented in **Error! Reference source not found.**, the ecrease has been lasting for two years already and affecting all sources of income. The real salaries decreased and the salary arrears increased in the private sector, the profit of small entrepreneurs and the population's income from bank deposits decreased, as well. Even if the official statistics do not reflect this, our sources from the region confirm the existence of salary arrears in the public sector too. On the other side, having a lot at stake in the ongoing electoral process, the regional authorities identified possibilities to pay the pensioners the arrears accumulated in 2015. However, the main factor that dragged the income down in 2015 was the shrinking, by almost 50%, of emigrants' transfers from Russia, after a 25% decrease in 2014. The decreasing purchasing power of the regional "currency" magnified the impact of the real income depreciation. These evolutions resulted in a strong contraction, by almost 20%, of the households' real consumption. During the first half of this year, income continued to decrease and the purchasing power continued to erode. According to our estimates, the real accrued salary decreased by almost 4% in Q1-Q2:2016, and if we take into account that the salary arrears increased more than 4 times compared to 2015, the actual decrease of salary income is significantly higher. The decrease by almost 23% of salaries in metallurgical industry is symptomatic, resulting in technical unemployment of workers from this branch, and shows that bringing back the Rabnita Steel Works into "state" ownership has been far from matching the employees' aspirations.

Table 3. Population's income dynamics by main sources, % compared to the previous year

	2013	*2014*	*2015*	*Q1:2016 estimates*
Total income	113.7	97.2	75.4	94.0
Salary income	112.7	105.3	87.4	96.0
Income from entrepreneurial activity	109.2	95.0	72.5	84.0
Income from social transfers	109.9	105.6	91.5	100.0
Income from dividends and interests	103.4	91.3	88.1	90.0
Income from sale of foreign currency	124.6	74.5	55.5	90.0
Other income	100.0	90.0	82.0	90.0

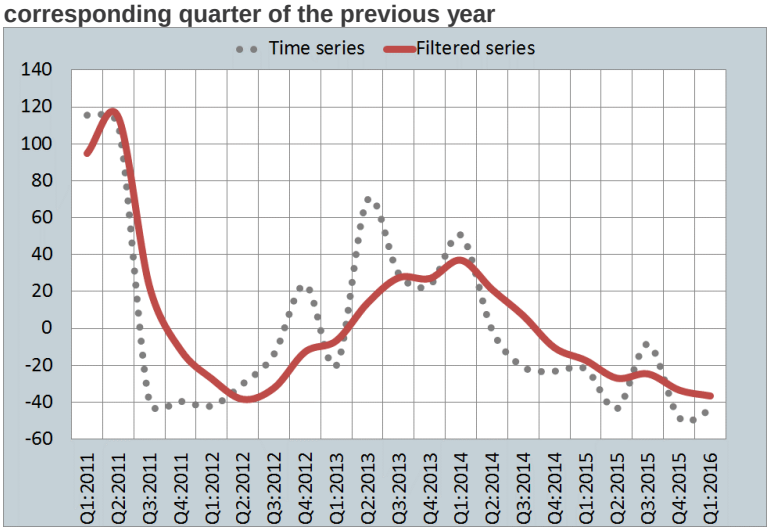
Sources: EG, based on data from the "Central Bank of the Moldovan Republic of Transnistria".

Public consumption. In 2015, the public sector revenue decreased by almost 20%, which triggered a reduction by almost 15%-16% of the 'governmental' consumption. The budget allocated to local authorities was 50% below the initial plan, for subsidies in economy – almost 35% below, and for utility and household management sector – almost 33% below the plan. Even though some investment projects in health and education sector were completed successfully, they were financed only in proportion of 80% of the planned budget.

Investments. Capital investments, like the other two basic components of the aggregate demand, shrank strongly during 2015. If in the first half of the year the investment indicator dropped by more than 40%, in

the second half the situation improved, so that the annual indicator was by "only" 15% lower compared to the previous year. The indicator of capital expenses for construction-assembly works was practically at the 2014 level, being mainly driven by the public works contracted by authorities to celebrate the "independence" of the region. At the same time, the investment expenses with direct and immediate impact over the economic potential – in equipment, machinery, vehicles and productive inventory – decreased by almost 27%. During the first half of current year the negative investment processes have even accelerated a bit (**Error! Reference source not found.**), and the financing sources reduced even more, almost 90% epresenting the own funds of enterprises. The banks practically stopped the long-term financing or provided finance only to some preferred firms. In these conditions, the risks of moral and physical depreciation of the production capacity in sectors like agriculture, wood and food industry are on the rise.

Figure 2. Evolution of capital investments in Transnistria, % compared to the corresponding quarter of the previous year



Source: Authors' calculations on the basis of "Transnistrian Republican Bank" data

Challenges and Forecasts

- In 2016, the population's income will continue to decrease, even if the anticipated rate of -5% is milder than in 2015. The salary arrears will continue to be accumulated both in public and private sectors. The actual depreciation of regional "currency" will continue inevitably, eroding even more the purchasing power of population and triggering, probably, an official devaluation. This will result in a proportional decrease of households' consumption and will worsen the financial situation of firms, especially of those from the service and construction sectors.
- Obviously, in the light of "presidential elections" of 2016, the authorities will make everything possible to limit the social impact of the economic crisis in the region and to maintain the consumption level of households. The room for maneuvering is however extremely limited, especially taking into account the escalating conflicts among political elites. The amalgam of extremely severe budgetary and structural constraints, which the authorities must deal with, will impose decisions that are going to be costly for the households, if not in 2016, then in 2017. Particularly, it is about the extended and extremely inefficient structure of public administration, in terms of staff employment. Almost 45% of the total number of employees in the region work in the public sector, which from any point of view represents an exaggerated proportion. We think that reforming the regional public sector is an inevitable choice that authorities will have to take regardless the results of the autumn elections. This will significantly impact the salary income, and due to the lack of employment opportunities in the real sector, the emigration from the region will accelerate.
- We do not see practically any factors that may favor investments in 2016. On the contrary, the decline will continue, but somewhat slower than in 2015. We anticipate that investments in productive assets will decrease by almost 10-12%, which is determined by the prudence of firms in launching new projects, but also by the more visible flight of capital from the region.

Chapter 3. Public Finances

The Transnistrian public finance system has been heavily influenced by both regional economic crisis and electoral cycles over the last two years. The former factor had a negative impact on the budgetary revenues and expenses in 2015, which decreased significantly against the previous year. However, the electoral factor undermines the adjustment of the budgetary balance to the actual and sustainable level of budgetary collections. Thus, in spite of moderate macroeconomic forecasts, the 2016 public budget was developed based on too optimistic assumptions.

Analysis of the Main Trends

The economic downturn of 2015 undermined seriously the Transnistrian public finance system. All budgetary indicators had a negative growth. The decrease in the revenue to the consolidated public budget (CPB) by more than 17% caused an expenditure reduction by more than 15% y-o-y, resulting in a contraction by 12.5% y-o-y of the budgetary deficit in absolute terms.[3] Since the fall of GDP (-20% in 2015) was larger than the deficit reduction, the latter indicator increased in relative terms. So the share of the CPB deficit in GDP increased by 1.2 p.p. up to 16.6% (Table 1).

Besides the unfavorable economic situation, public finances are also affected by the region's electoral cycles. The disputes between the "executive" and "legislative" powers, following the "parliamentary" elections of 2015 postponed the approval of the 2016 budget until April. Besides, the de facto president of the region imposed veto on some spending items on the grounds that the budgetary indicators approved by the "Parliament" were not realistic. At the same time, the "Government" by its own took several purely political steps in current economic situation, contracting a loan of about USD 26 million from "Sheriff" company. This amount was used to pay the salary and pension arrears, accumulated over the previous year.

The 2016 budget is largely influenced by the election of the regional leader, scheduled for the end of this year, being extremely optimistic. Thus, double-digit growth rates were planned for both revenues and expenses. The CPB revenue is expected to increase by 42.5% y-o-y, expenses - by 32.6% y-o-y and budgetary deficit - by 11.3% y-o-y (Table 1). These figures are very optimistic, even with the low basis of comparison of 2015. If the planned figures are achieved, the rate of CPB deficit will continue to grow, reaching a level of 18.6% of the region's GDP.

Table 4. Budget Execution in Transnistria (million USD).

	2014	2015	2016 (Planned)
Revenues	392.9	325.6	463.9
Expenses	564.7	476.0	631.2
Deficit	-171.8	-150.4	-167.3
Deficit (% of GRP)	15.4	16.6	18.6

Source: "Ministry of Finance of the Transnistrian region"

Note: Conversion was made at the official exchange rates of the "Central Bank" and does not include data of financial assistance provided by Russia

The budget execution in the first five months of 2016 shows the fact, that the planned budgetary indicators were too optimistic. During this period, CPB revenues increased only by 4% y-o-y, and expenses - by 26% y-o-y. As mentioned above, the significant increase in expenses was caused by the payment of salary and pension arrears in April and May using the loan contracted from "Sheriff". It should be mentioned that the salary expenses rose by 54% y-o-y. At the same time, this disparity between the growth rates of revenues and expenses increased the budget deficit by 72% y-o-y (Table 2). Despite the

[3] The consolidated public budget consists of "Republican Budget", "Budgets of Administrative-Territorial Units", "Single Social Insurance Fund".

annual revenue growth, the reduction of tax collections by about 3% y-o-y still represents a risk factor. In the light of these developments, if other sources to cover the budget deficit are not found, it is very likely that the current budget will be revised in the second half of the year.

Table 5. Budget Execution in Transnistrian region (million USD).

	Jan: May 2015	Jan: May 2016	Deviations (% y-o-y)
Revenue	**125.9**	**131.0**	**4.0**
Tax revenue	*107.6*	*104.8*	*-2.6*
Expenditures	**185.6**	**233.6**	**25.9**
Pensions	*79.1*	*81.2*	*2.7*
Salaries	*69.2*	*106.5*	*53.9*
Deficit	**-59.6**	**-102.6**	**72.1**

Source: "Ministry of Finance of the Transnistrian region"

Note: Conversion was made at the official exchange rates of the "Central Bank" and does not include data of financial assistance provided by Russia

The budget deficit is funded by increasing the domestic debt, which has a complex structure. During 2015, the domestic debt increased by 13.2% y-o-y, being fueled by interest-free loans of about USD 150 million to the region's budget. Such loans constitute the absolute majority of domestic debt, with a share of over 80% of the total domestic debt (Table 3). Given that the absolute majority of these loans are interest-free and some of them are classified, most probably they derive from the sale of gas. The remaining debt belongs to the "Central Bank" (5.2% of the total debt) and to the budget arrears to the energy sector (11.2% of the total debt). The 2016 budget, as in the previous years, specifies that most of the domestic debt components will not be served, and the one that expires this year will be extended until 2019.

Table 6. Structure of the Transnistrian domestic debt (million USD)

	01.01.2015	01.01.2016	Deviations (% y-o-y)
Bonds owned by the "Central Bank"	*26.7*	*26.7*	*0*
Interest-free loans from the "Central Bank"	*39.6*	*39.6*	*0*
Total due to "Central Bank"	**66.3**	**66.3**	**0**
Long-term bonds	*8.0*	*8.3*	*3.8*
Loans	*910.7*	*1060.1*	*16.4*
Total remaining domestic loans	**918.7**	**1068.1**	**16.3**
Debt to the energy companies	144.4	144.4	0
Remaining domestic debt	5.1	5.2	2.0
Total domestic debt	**1134.5**	**1284**	**13.2**

Source: "Ministry of Finance of the Transnistrian region"

The region's budgetary issues have been worsened by the reduction of the financial assistance provided by the Russian Federation. Thus, in 2015, the Russian assistance decreased almost twice compared to the previous year from USD 27.4 million to USD 14.5 million[4]. This reduction may be explained not by the smaller transfers in absolute terms, but by the devaluation of the Russian ruble, given that the transfers are made in Russian rubles to the foreign currency accounts of the regions "legislative". At the same time, the region's authorities continue to seek additional financial assistance in the Russian Federation in order to mitigate the regional public finances crisis.

The poor state of the public finance is caused by the postponement of the structural reforms in this sector. The need to restructure and adjust the fiscal framework has been recognized by the "executive" power, which undertook certain steps in this direction. Thus, in early 2015 they developed the Tax and Budgetary Policy Concept for 2016 and for the medium term, as well as a draft Tax Code. These drafts

[4] „Ministry of Finance of the Transnistrian region", Information on application of Russian financial assistance for 2014 and 2015 years

aimed at reforming the tax structure in the region, by introducing the VAT. Yet, due to the disputes between the “executive” and “legislative” powers, the implementation of these documents was postponed.

Challenges and Forecasts

- For the short and medium term, one of the main challenges for the public finance system is the continuous increase in the region’s budgetary deficit. One of the main sources to cover the deficit are the revenues from the sale of gas, accounting for over 80% of the domestic funding sources. The main risk of relates to the volatility of these revenues during recessions. Currently, it is difficult to forecast the amount of reserves accumulated from that source, given that the statistical information is not available publicly.

- The political misunderstandings in the region have a negative impact on the public finances. Decisions made by both the “executive” and “legislative” powers during the last year have only worsened the situation. On the one side, an over-optimistic budget was built for 2016, without reforming accordingly the fiscal framework. On the other side, the salary and pension arrears were paid by contracting commercial loans, without a sound basis of growth in tax revenues. Perpetuation of these trends will only worsen the situation in the field, increasing the budget deficit in the following years.

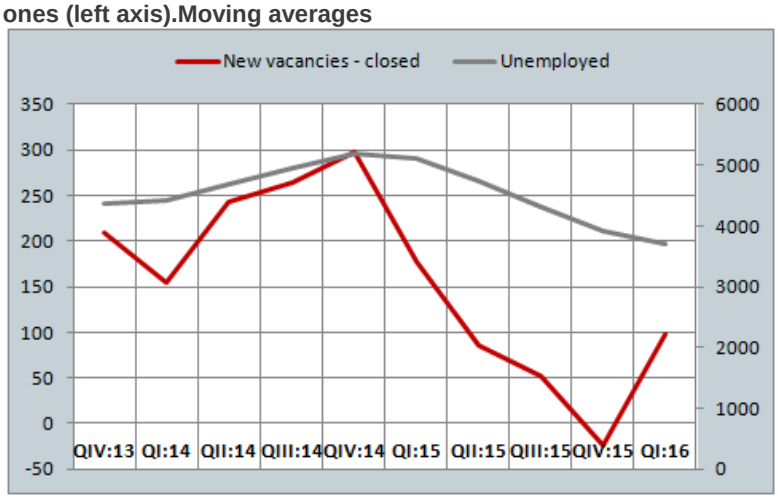
Chapter 4. Labour Market

The Transnistrian labour market represents a mixed picture in terms of its key indicators. Some of them, such as the number of the unemployed and of newly created jobs, reveal the effects of the ongoing economic recovery. Others, however, such as the number of the employed and of vacancies, show a more positive picture. One of the possible explanations of these conflicting trends would be not only the continuously decreasing labor supply, but also the inability of the region's statistics to depict the real employment structure.

Analysis of the Main Trends

At the beginning of 2016, the situation on some segments of the Transnistrian labour market started to improve. Two key indicators, such as unemployment and dynamics of newly created jobs, have improved somewhat. The number of the unemployed officially registered in Q1:16 had declined by about 28% y-o-y. However, a more relevant indicator is the dynamics of the newly created jobs, given that the official unemployment continued to decrease throughout 2015, contrary to the downsizing trend of the region's economy. Thus, the difference between the newly created jobs and the closed ones diminished constantly throughout the previous year, reaching negative values in Q4:15, confirming the decrease in the number of newly created jobs and increase in the closed ones. However, the above-mentioned trend changed in Q1:16 for the first time in the last four quarters (Figure 3).

Figure 3. Dynamics of the unemployed (right axis) and the difference between the numbers of newly created jobs and closed ones (left axis).Moving averages



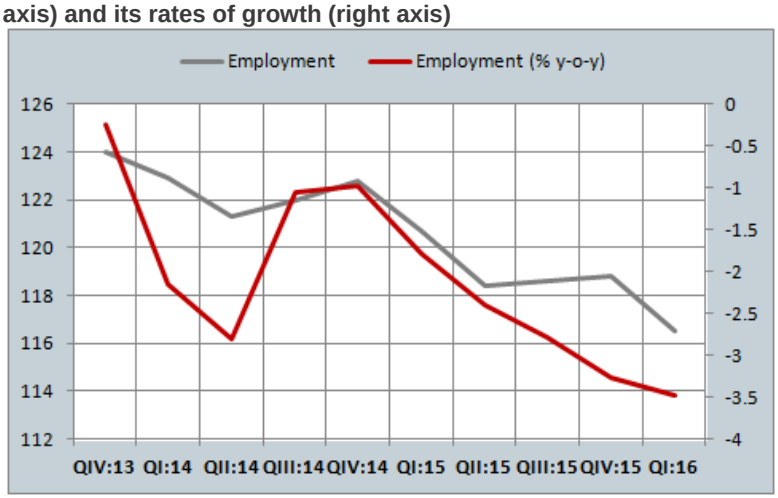
Source: "Regional Statistics Service"

On the contrary, other important indicators of the labour market continued to deteriorate. The number of the employed decreased in Q1:16 by about 3% y-o-y down to 116.5 thousand persons — a new negative record. The number of the employed has been decreasing continuously throughout the last three years, but the most worrisome trend is that the declining rates accelerated in 2015 (Figure 3). In addition, the number of vacancies is also declining constantly, even during the periods of economic growth. Thus, the continuous decrease in job vacancies, regardless of the stage of the economic cycle, may be caused not only by the decreasing labour demand, but also by the shortage of labour supply. In case of a low supply, many vacancies are closed without being filled, continuing to make downward pressure on new jobs creation.

Dynamics of key labour market indicators has conflicting trends. On the one hand, the difference between the number of newly created and closed jobs diminished, which may reveal an economic recovery. On the other hand, the number of the employed continued to decrease, with trends accelerating in the last

quarters, indicating a less positive economic situation. The conflicting trends may be explained by the fact that the regional statistics do not elucidate completely and exhaustively all processes on the labour market. Since the data on external migration, economically inactive population, and informal employment are neither calculated nor disseminated, the calculated indicators give a distorted picture. Generally, the low employment levels in the real sector, accompanied by the decrease of the unemployment and increase in number of newly created jobs, may be explained by a possible augmentation of external migration or by the extension of informal employment.

Figure 4. Dynamics of the employed population (thousands, left axis) and its rates of growth (right axis)



Source: "Regional Statistics Service"

The reduction of employment is caused, also, by the continuous decrease in the number of economically active population in the region. Thus, as mentioned above, the contraction of labour supply plays a crucial role in the constant reduction of the number of employed people. These trends are confirmed by the population census, which took place in October 2015. According to the preliminary data, in the past ten years (from the previous census of 2004), the number of population in the region decreased by 14.3% or by 79,682 persons, down to 475,665 persons.

Challenges and Forecasts

- One of the key challenges in the region is the constant reduction in the number of population. This trend leads to decreasing labour supply and a shortage of labour force for potential new jobs. The most severe problem is that during the recent years, the employment rates decreased at a higher pace due to the worsening economic crisis in the region. The decrease in the total and the employed population will have a long-term impact on all social and economic areas of the region, implying higher pressures on the region's budget and lower internal demand.

- As mentioned above and in other editions of this report, the quality of the economic policies is another challenge for the labour market. Statistics is one of the weaknesses of the analysis and decision-making processes. The current data, provided by the statistical authority reflects conflicting trends and do not reveal all processes on the labour market. In fact, these data do not allow implementing a set of active and structural policies on the labour market, as they provide only some aggregated indicators and in some cases present conflicting figures.

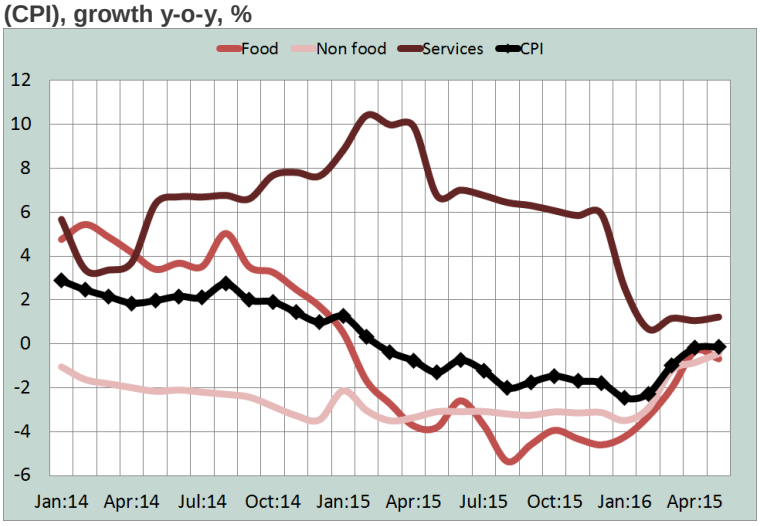
Chapter 5. Prices and Monetary Policy

The monetary policy in the Transnistrian region was adjusted depending on the FX market evolution. Thus, the pressures on the "region's currency" in the second half of 2015 and the first half of 2016 determined the "Republican Bank" to tighten its policy. At the same time, foreign currency reserves were practically depleted and, as a result, maintaining a fixed exchange rate for a long period is almost impossible. Although the official rate of "Transnistrian ruble" remained relatively stable, the situation in the foreign exchange market is difficult. The shortage of foreign currency fostered the development of a shadow FX market, where the "Transnistrian ruble" has already depreciated by up to 50%. Besides, the simultaneous promotion of several conflicting measures is another cause undermining the outcomes of the promoted monetary policy.

Analysis of the Main Trends

Deflationary processes that emerged in 2015 stopped in the first half of 2016. Thus, if the Consumer Price Index (CPI) decreased in Jan:16 by -2.5% y-o-y, than in May:16 it registered an insignificant increase of 0.1% y-o-y. Also, in May:16 the prices for foodstuffs and non-food goods decreased insignificantly by 0.7% y-o-y and 0.4% y-o-y, respectively. The CPI evolutions during Jan-May:16 were caused by the shortage of currency, which made it difficult to secure the imports of tradable goods and, as a result, the supply of these products decreased and the deflation stopped.

Figure 5. Main Components of the Consumer Price Index (CPI), growth y-o-y, %

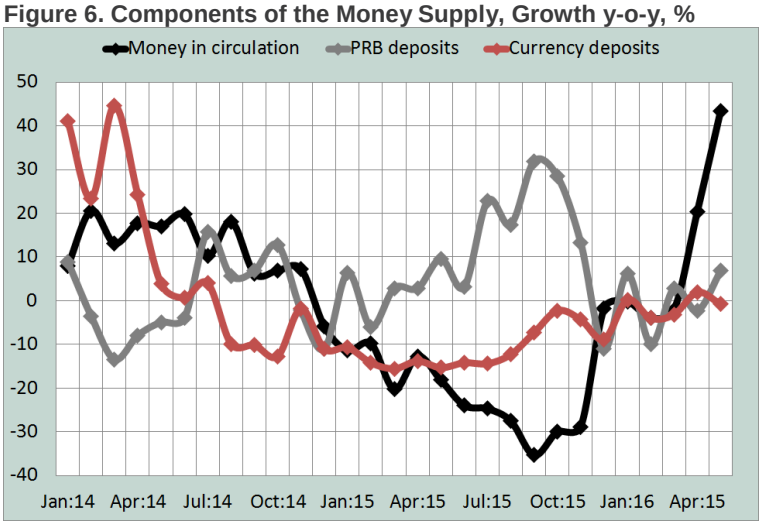


Source: "Dniester Republican Bank", EG calculations

During Jan-May:16, the FX market evolution influenced the dynamics of the monetary aggregates. The decreasing balance of foreign currency deposits is followed by a higher amount of money in circulation. During the first five months of 2016, the downward trend in foreign currency deposits continued, although at a lower intensity. The diminution of foreign currency deposits was mainly caused by the shrinking supply of foreign currency, determined by the lower financial inflows into the region. Reduction of foreign currency placement on bank accounts, conversion of deposits in non-bank savings and use of savings for consumption are other causes of the smaller balance of foreign currency deposits. For instance, people have recently started to buy more foodstuffs outside the region (in Ukraine or on the right bank of the Nistru river) due to lower food supply in the region, and this also leads to more withdrawals from foreign currency deposits. Thus, people use their savings, withdrawn from the foreign currency deposits, to buy goods outside the region. Although the official rate of the "Transnistrian ruble" has not changed significantly, the foreign exchange crisis caused a major depreciation of the "Transnistrian ruble" on the "black market". In this situation, in order to buy foreign currency people reduced their placements in deposits and started to withdraw actively their savings in "Transnistrian rubles" from bank accounts. Thus, in the first months of

2016 the balance of "Transnistrian ruble" deposits grew at a smaller rate than in 2015, and decreased in Feb:16 and Apr:16. On the other hand, the monetary aggregate M0 (money in circulation) decreased at a slower rate in Q1:16, and money in circulation increased significantly in Apr:16 and May:16 (by 20.4% and 43.4% y-o-y). The lower required reserves ratio and premium rates for the contributions to the Deposit Insurance Fund in the first half of 2015 also influenced the dynamics of the monetary aggregate M0.

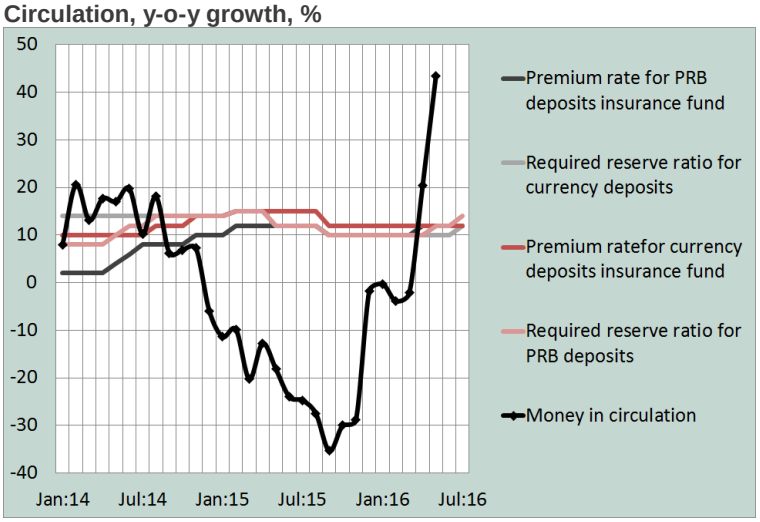
Figure 6. Components of the Money Supply, Growth y-o-y, %



Source: "Dniester Republican Bank", EG calculations

The monetary policy promoted in the region appears to be highly discretionary. At the same time, the attempt to simultaneously achieve several objectives led to insignificant results. During recent years, the main goal of the region's monetary policy has been to maintain a stable exchange rate of the "Transnistrian ruble". In addition, in 2015 the authorities also aimed at increasing the money supply. The "Republican Bank" used extensively transactions in the foreign exchange market in order to ensure a stable exchange rate of the "Transnistrian ruble". As a result, the foreign currency reserves decreased drastically. In early 2016, the reserve assets reached a ridiculous level of USD 19.8 million. In such circumstances, the possibility to intervene actively on the foreign exchange market was brought to a minimum. Other monetary policy tools, such as the mandatory reserves rate (applied to corporate deposits) and premium rate for the contributions to the Deposit Insurance Fund (applied to individual deposits) were changed depending on the evolution on the foreign exchange market. The higher rates of monetary policy tools aim at reducing the money supply in "Transnistrian rubles" in circulation in order to decrease the demand for foreign currency. A more calm foreign exchange market allowed for an easier monetary policy in Q3:15. But the worsening situation on the foreign exchange market in the first half of 2016 led to the tightening of the monetary policy: the premium rate for "Transnistrian ruble" deposits increased from 10 to 12% in Mar:16, the required reserves ratio for deposits in "Transnistrian ruble" grew from 10 to 14% by the amendments made in May:16 and then in Jul:16, and the required reserves ratio for foreign currency resources increased from 10 to 12% in Jul:16. The last phase of policy tightening is an appropriate measure, as on the background of the depleting reserve assets, the foreign exchange risks can be mitigated by increasing the rates of monetary policy tools. At the same time, providing market liquidity by financing the region authorities' projects or by crediting the commercial banks (deposits amounting to 120 million "Transnistrian rubles" were placed in 2015) undermines the efforts made to maintain a stable exchange rate. The reason is that the increase in the volume of "Transnistrian rubles" in circulation leads to bigger demand for foreign currency, which puts additional pressure on the foreign exchange market.

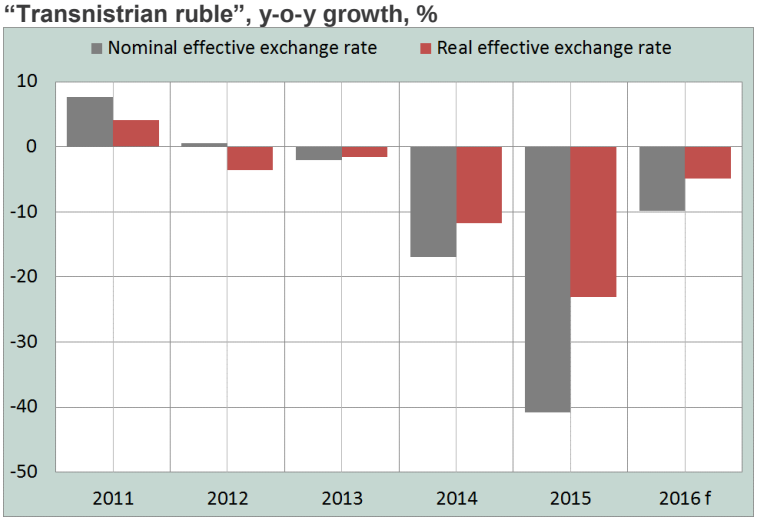
Figure 7. Rates of Monetary Policy Tools, % and Money in Circulation, y-o-y growth, %



Source: "Dniester Republican Bank", EG calculations

The rigid monetary policy affects negatively the economic competitiveness of the region and undermines its ability to adjust to external shocks. In 2014 and 2015, due to the fixed "Transnistrian ruble", its nominal effective exchange rate and the real effective rate appreciated significantly. Thus, the nominal effective exchange rate appreciated by 16.9% in 2014 and by 40.8% in 2015, while the real effective exchange rate – by 11.7% and 23.1%. We anticipate that the "Transnistrian ruble" will continue to strengthen during 2016: the nominal effective exchange rate will appreciate by 9.9% and the real effective exchange rate will strengthen its position by 4.9%. Appreciation of the "Transnistrian ruble" is a sign of lower competitiveness, because the products manufactured in the region become more expensive compared to products from other countries. Although the policy of a fixed exchange rate has some short-term benefits related to a certain extent to price stability, the region's competitiveness is affected in the long term and the economic growth is influenced adversely.

Figure 8. Nominal and Actual Effective Exchange Rate of "Transnistrian ruble", y-o-y growth, %



Source: "Dniester Republican Bank", http://www.imf.org/, EG calculations

Challenges and Forecasts

Three features could be mentioned in terms of monetary risks: inappropriateness to maintain a fixed exchange rate, limited set of tools to maintain a stable exchange rate, inconsistencies between the policies promoted by "Republican Bank":

- “Transnistrian ruble” depreciation is imperative. The "Republican Bank” actually recognizes it officially[5]. As 2016 is an electoral year in the region and the fixed exchange rate policy inspires a certain sense of stability, it is hard to predict if it will be devalued before the elections of the region’s leader. Postponing this decision will worsen the economic situation. Maintaining a fixed exchange rate for a longer period will erode the competitiveness and will affect negatively the companies, leading to higher risks of wage decrease and unemployment increase. At the same time, postponing the depreciation would imply the need to significantly devalue the “Transnistrian ruble” and, as a result, inflation could increase significantly.

- Currently, as the foreign currency reserves diminished, a stable exchange rate can be maintained only by tightening the monetary policy. However, the monetary policy has an asymmetric effect: its influence on the exchange rate and prices is lower than its impact on the economic activity[6]. In this context, the policy tightening could have an insignificant effect on the exchange rate, but could worsen instead the economic situation in the region.

- The "Republican Bank" often promotes contradictory policies. Thus, the tight monetary policy in the region is accompanied by pumping liquidity into the economy. Such practices only undermine the efficiency of the monetary policy. Moreover, the "Republican Bank” allowed financial institutions to apply light prudential rules related to the lending activity[7]: the non-completion of the risk funds will not be reflected in the Bank's financial statement, and the non-performing loans may be restructured in order to provide facilities to debtors. These decisions pose a high risk to the stability of the banking sector, although they may have some short term positive effects on the economic activity. In fact, these decisions of the "Republican Bank" stimulate the accumulation of non-performing loans, which could lead to a liquidity crisis. At the same time, the involvement in the financial intermediation between "Agroprombank" and "Sheriff" company affects negatively the credibility of the "Republican Bank".

[5] http://www.cbpmr.net/resource/prbvd204.pdf
[6] Conclusions based on results of the restricted VAR model
[7] http://www.cbpmr.net/resource/prbvd205.pdf

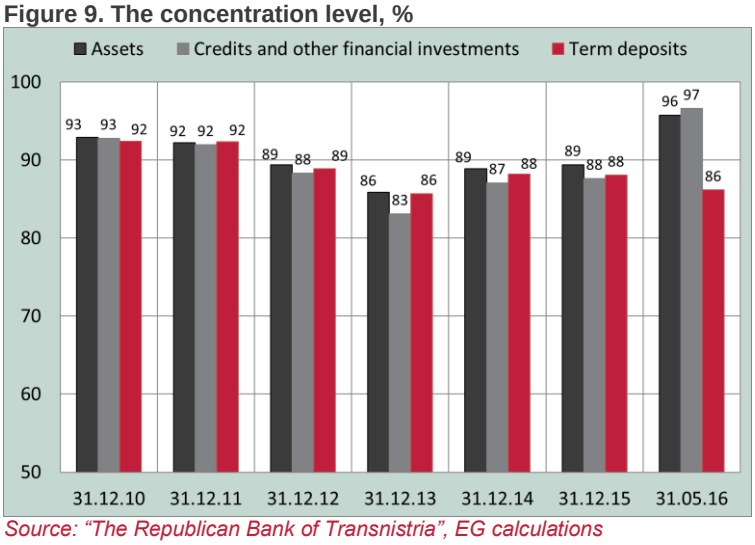
Chapter 6. Banking System

The poor general economic situation in the Transnistrian region leaves its negative trace over the activity and results of the banking sector, which records low or even negative growth rates. The economic unpredictability for individuals and business environment, fueled by the currency crisis and uncertainty linked to the exchange rate, decreases the lending activity and deteriorates the banks' assets quality. In these circumstances, the reduction in both general and individual revenue and financial performance is imminent. Moreover, in the context of the pessimistic expectations regarding the dynamics of the regional economy, the immediate growth prospects of the banking sector remain quite grim, too.

Analysis of the Main Trends

The complicated and unpredictable economic situation in the region creates real preconditions for new structural changes in the Transnistrian banking sector. In Q1:16, it consisted of 6 commercial banks, with a territorial infrastructure of 287 banking units, by 40 units more y-o-y. However, after a slight improvement over the recent years, the concentration increased rapidly in Q1:16, exceeding the highest level of the past 7 years. Four financial institutions, including: "Agroprombank", "Ipotecinâi", "Pridnestrovskii Sberbank" and "Eximbank", hold over 90% of the banking market in Transnistria. Thus, these four institutions account for 96% of the sector assets, 97% of total loans, and 86% of total deposits in Transnistrian banks. At the same time, the high banking concentration is also the key structural element of the Transnistrian banking sector, indicating the weaknesses of the competitive environment, which constitutes a source of risk to its stability.

Figure 9. The concentration level, %

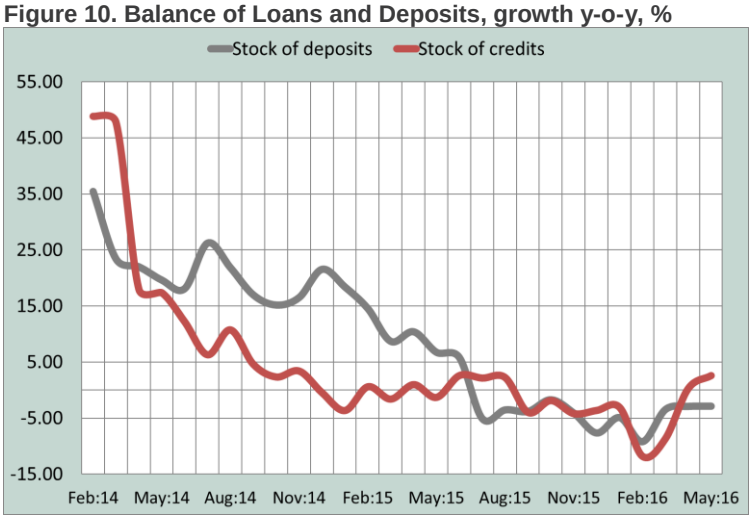


Source: "The Republican Bank of Transnistria", EG calculations

The banking sector in the region experiences an uncertain conjectural "comeback", both in terms of crediting and attracting deposits. The results of Q1:16 were strongly influenced by the uncertainty related to the "Transnistrian ruble". Deterioration of the overall macroeconomic framework, paralleled with the risk of significant depreciation of the "ruble" resulted in restructuring the balance sheets of several banks in terms of loans granted. Respectively, in the first 3 months of 2016 the share of foreign currency loans increased significantly at the expense of "ruble" loans. Under these circumstances, during Jan-May:16 only the share of foreign currency loans in total loans grew by over 15.7 p.p., reaching about 60%. At the same time, the ratio of "ruble" loans to foreign currency loans has changed significantly, constituting 1:1.5 in May:16, compared to only 1:0.8 in Jan:16. Fueled by these structural changes and the slight depreciation of the "ruble" in early 2016 against US dollars and Euros, the stock of loans increased slightly in the first 5 months of 2016, reaching the value of 4,460 million "rubles" in May:15, by 3% more y-o-y and by 5% more compared to the beginning of the year. However, this does not represent an actual increase in the balance of loans, but was based on a statistical effect, namely the depreciation of the "Transnistrian ruble" and

dollarization of loans. On the other hand, the growth rate in the balance of total deposits has been diminishing steadily since 2014, reaching negative values in Q3:15, a trend that continues to this day. The stock of total deposits continues to decrease, reaching 2,844 million "rubles" in May:16, by 2.9% less y-o-y. The main determinants are characterized by declining household income and the difficult financial situation of companies, but the erosion of trust in the Transnistrian banking sector and the possible moving of capital towards the right bank of the "Nistru River" or Ukraine should not be neglected as well. It is also typical for the Transnistrian banking sector to keep their deposits in foreign currency (about 95%), which proves the deficit of confidence in the Transnistrian currency.

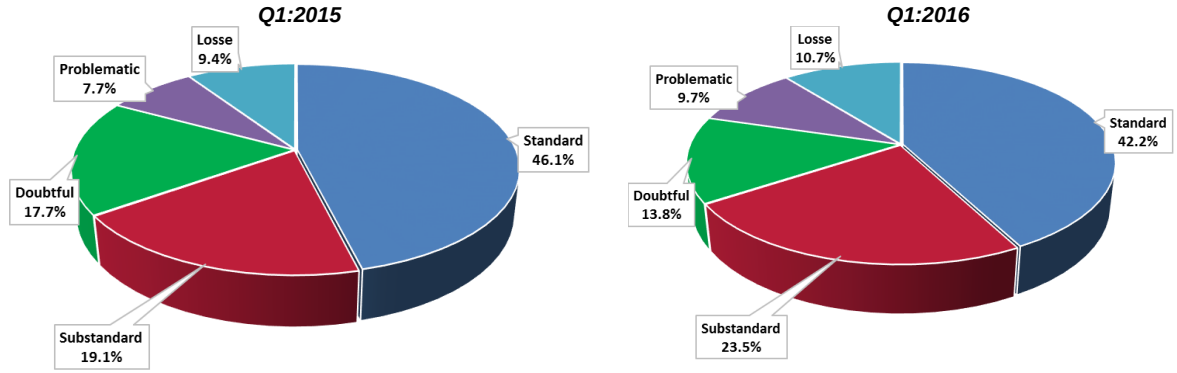
Figure 10. Balance of Loans and Deposits, growth y-o-y, %



Source: "The Republican Bank of Transnistria", EG calculations

Deterioration of economic conditions in the region has a negative impact on the quality of bank assets. It is worth noting the expansion in non-performing loans by 1.3 p.p. y-o-y in Q1:16, up to 10.7%. The following category of loans, the problematic ones, also increased by 2 p.p., up to 9.7% of the total loans granted. The category of top quality loans was also affected by negative changes. Thus, the share of standard loans decreased by 3.9 p.p. y-o-y, down to 42.2% of total loans.

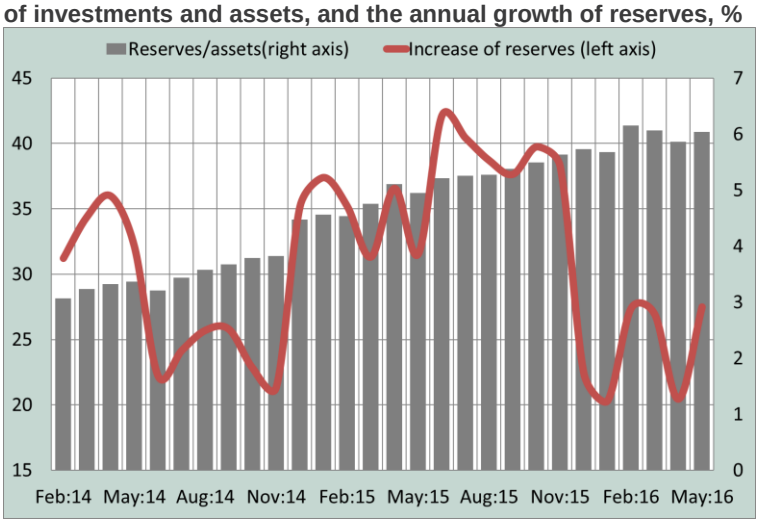
Figure 11. Classification of Loans Granted by Commercial Banks



Source: "The Republican Bank of Transnistria" *Source: "The Republican Bank of Transnistria"*

Under these conditions, the probability of default of bank loans forces banks to create larger prudential reserves in order to cover the growing risks. Deterioration of the loan portfolio and the forecasts on the depreciation of the "ruble" lead directly to larger reserves for credit risk and for covering the impairment losses of investments. Observations covering Jan-May:16 show that the monthly growth rates varied around the average level of 30%, and the ratio of reserves to assets increased monthly by an average of 0.1 p.p., reaching 6% in May:16.

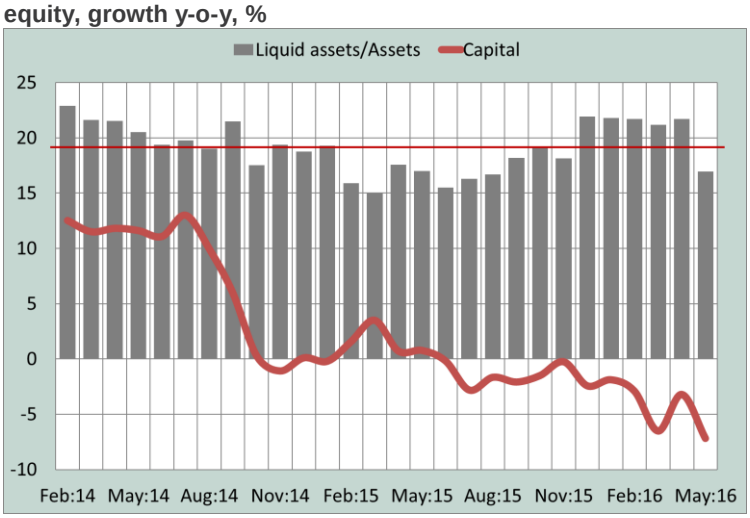
Figure 12. The relationship between reserves for credit risk and for losses from depreciation of investments and assets, and the annual growth of reserves, %



Source: "The Republican Bank of Transnistria", EG calculations

Amid the latest signals generated by the loan portfolio, the liquidity situation in the banking sector recorded a sharp downward trend in Q2:16. In the first months of 2016, the liquid assets were fairly stable, and their share in total assets recorded an acceptable level over 20%. However, following the growing negative trends in the quality and structure of the loan portfolio, as of May:16, the level of liquidity in the banking sector fell by about 3 p.p below the recommended minimum of 20% (Figure 13). At the same time, due to the deterioration of loan portfolio quality and increasing reserves for credit risk, the equity is decreasing continuously. Since the beginning of 2015, the equity growth slowed down continuously, and in Jun:15 a negative trend started and continues so far. In late May:16, the equity of the existing commercial banks reached 1,285 million "rubles", by 6% less compared to the beginning of the year (81.6 million "rubles") or by 7% less y-o-y. Even though the equity decreased in Q2:16 due to a cyclical event, specifically profit distribution and payment of dividends, still the analysis of a longer period shows a downward trend that started in 2014, proving that the equity level is affected mostly by structural factors.

Figure 13. The share of liquid assets in total assets (%) and the equity, growth y-o-y, %



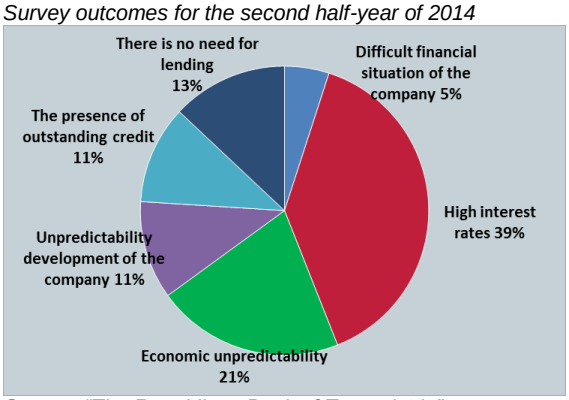
Source: "The Republican Bank of Transnistria", EG calculations

The difficult financial situation of companies was the main factor that affected the their access to bank loans. The survey conducted by "Republican Bank" shows that lately more and more respondents claim that it is the company's poor financial situation that prevents their access to bank loans. This denotes largely the result of the economic conditions of the recent years, the vulnerability of companies and banks to the decreasing domestic and foreign demand, as well as the high level of uncertainty that makes

companies even more reluctant to launch investment projects. Businesses invoke more and more often such reasons as existence of an overdue loan or insufficient collateral, which ultimately determines the difficult financial condition of companies.

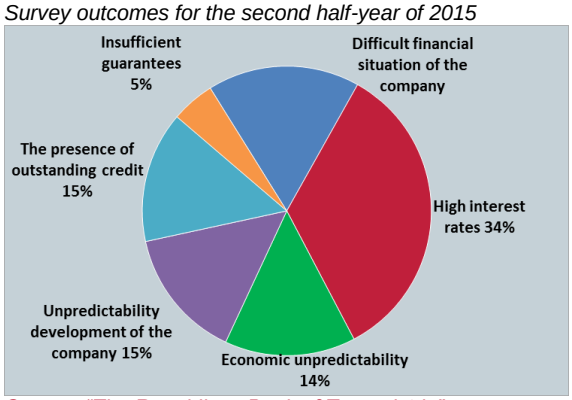
Figure 14. Factors that Hinder the Access to Bank Loans for Transnistrian Companies, survey conducted in the first half of the current year

Survey outcomes for the second half-year of 2014



Source: "The Republican Bank of Transnistria"

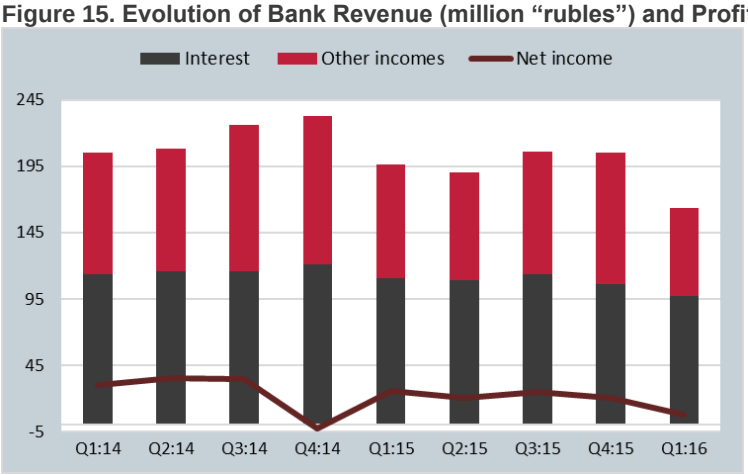
Survey outcomes for the second half-year of 2015



Source: "The Republican Bank of Transnistria"

The negative trends on the loans and deposits market affect strongly the overall performance of the banking sector. Under these circumstances, the interest income resulting from lending activity decreased in Q1:16 by 12.5% y-o-y, or 13.9 million "rubles" and reached 97.1 million "rubles". This change was influenced mainly by the decreasing interest income on loans granted to individuals, which dropped by 12.9 million "rubles" or 24.8% y-o-y. The bank revenue from related activities also recorded an important decrease, by 19.3% y-o-y, amounting to about 66.2 million "rubles". The acute domestic currency crisis affected the number and value of foreign exchange transactions, which in Q1:16 generated only 38.4 million "rubles" in revenue, by 16 million (or by 29.7%) less y-o-y. Overall, the outcome of the activity of commercial banks in Q1:16 was approximately three times smaller y-o-y, the net profit reaching only 7.7 million "rubles". The relative performance indicators were affected as well, the return on equity dropped in Q1:16 to 2.3% (7.3% in Q1:15) and the return on assets decreased to 0.5% (1.7% in Q1:15).

Figure 15. Evolution of Bank Revenue (million "rubles") and Profitability, %



Source: "The Republican Bank of Transnistria", EG calculations

Challenges and Forecasts

- The medium-term prospects (even the short-term ones) for the development of the banking sector in the Transnistrian region does not appear to be optimistic. The lower household income and economic activity will affect adversely the operation of banks, and the situation in the financial sector could worsen significantly.

- On the background of lower business activity and decline in personal income, the withdrawal of resources from the banking sector continues at a steady pace. In a short while, banks might face liquidity shortages, which will decrease their levels of capitalization. Moreover, we cannot rely too much on a consistent intervention of the “central bank”, which being driven by its main goal - to maintain the stability of prices and of the exchange rate, has virtually depleted its foreign reserves.

- The acute currency crisis and the dim prospects in terms of stability of "Transnistrian ruble" cause an intense dollarization of people’s loans and savings, which puts even greater pressure on the exchange rate. However, during an election year it is hard to believe that the policy makers from the region will free the exchange rate to allow its adjustment to the actual conditions. Though a depreciation of at least 15-20% appears to be imminent, it seems that authorities are less prepared than the region’s economy for such a scenario.

- The currency crisis led to some agreements that seem financially illogical ("Agroprombank" offered to the "Republican Bank of Transnistria" an interest-free loan of USD 15 million for a period of 5 months that was given to “Sheriff” Company on the same day[8]), which undermines the credibility of the financial sector and the trustworthiness of the region’s regulatory and control institution.

- The economic decline, which is reflected as the deterioration of the loan portfolio and reduction in bank revenues, further aggravates the individual and collective performance of the Transnistrian banking sector. Under these circumstances, given the high level of banking concentration, certain individual shocks can be spread quickly to the entire financial system in the region.

[8] http://novostipmr.com/ru/content/kommentariy-prb-po-besprocentnomu-zaymu

Chapter 7. Foreign Sector

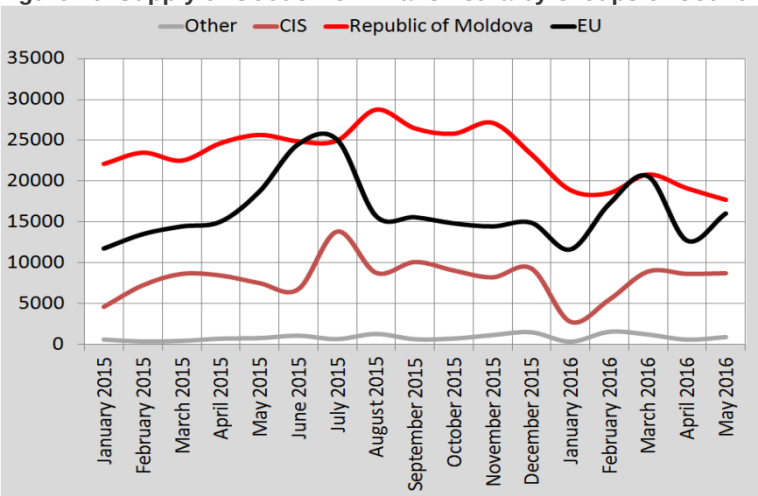
The economic drawbacks, amplified by the deep currency crisis registered since February 2016, influenced the trade performance of Transnistria, which was affected by the reduction of foreign demand since 2014. At the same time, the expiry, on 1 January 2016, of the asymmetric preferential trade regime offered by EU to the Republic of Moldova since 2008 (Autonomous Trade Preferences), forced the regional authorities to accept the new conditions deriving from the new DCFTA agreement. Therefore, the main challenge for the region in the immediate period is the implementation of DCFTA in order to further benefit of preferential trade treatment when exporting to EU.

Analysis of the main trends

The perpetuation of weak social and economic situation in Transnistria, on the background of a deep currency crisis, affected negatively the Transnistrian trade performances. During Jan-May:16, the supply of goods was by 8.1% lower than the previous year, amounting to USD 213 million. At the same time, the imports during Jan-May:16 amounted to USD 353 million, which is by 32% less y-o-y.

Maintenance of instable economic conditions on certain sales markets reduced the supply of goods. The industry from the region could not recover from the 2015 collapse, registering during Jan-May:16 a diminution of the value of industrial production volume (in USD) by almost 7% y-o-y. In its turn, the low demand on foreign markets for the main groups of goods contributed to the reduction in supplies to these destinations. Thus, during the reference period, due to these factors, the supplies to the right bank of the Nistru river decreased by almost 20% y-o-y and amounted to USD 95 millions. At the same time, the supplies of goods to CIS dropped by 5.2% y-o-y, amounting to USD 34.6 million, while to EU and other countries - increased by 6.3% and 63.6% y-o-y respectively, amounting to USD 78 million and USD 4.5 million (Figure 16). However, we draw the attention to the initial low basis of comparison of 2015, when all categories of supplied goods decreased massively.

Figure 16. Supply of Goods from Transnistria by Groups of Countries, thousand USD

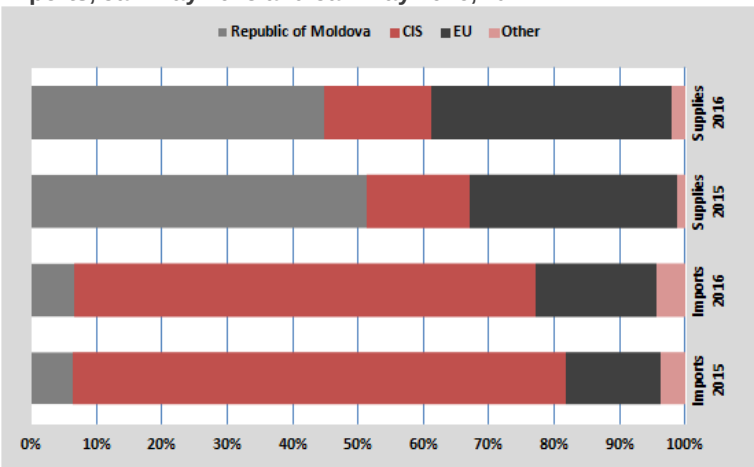


Source: "Regional Statistics Service of Transnistria", EG calculations

The right bank of the Nistru river remains the main destination of goods from the region, amounting to USD 95 million, which is by 19.8% less y-o-y (Figure 16) with a share of 44.7% in total supplies (51.2% in 2015). These decreases were not determined by the introduction of the so-called barriers to trade, but rather by the low demand for products from the region and their cheapening (first, the electricity), but also by the substitution of imports with products from the region in the context of difficulties occurred on the currency market, which made the imports impossible.

Supplies to EU offset the decreases on the other markets. If we exclude the supplies to the right bank of Nistru river, the EU would have a 66% share in the total exports of the region (Jan-May:16). This increase was generated mainly by the increase in supplies for the most important group of goods - base metals and items thereof, with almost 25% y-o-y. For the other two main groups, like textiles and textile products, as well as footwear, the exports to the EU did not change significantly. The main partner countries from UE (almost 85% of this group) are still Romania, Italy and Germany, accounting for 17.7%, 7.4%, and 6% respectively in total supplies.

Figure 17. Geographical Structure of the Transnistrian Exports and Imports, Jan-May 2015 and Jan-May 2016, %

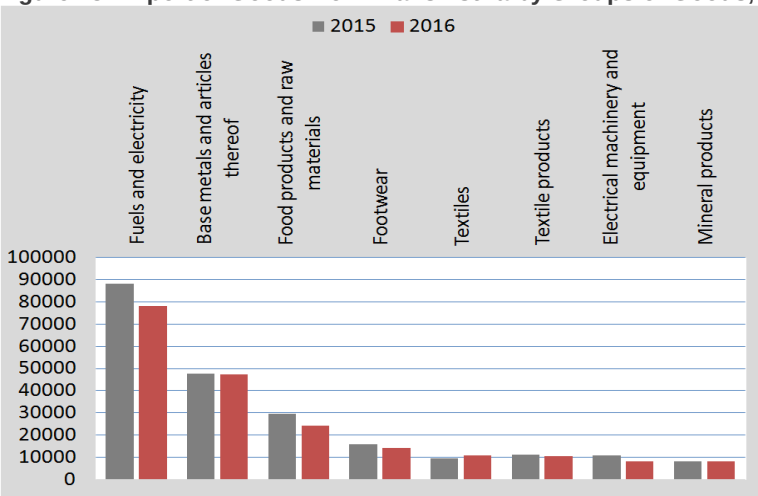


Source: "Regional Statistics Service of Transnistria", EG calculations

Exports to CIS countries decreased in the context of economic stagnation in the Russian Federation. During Jan-May:16, the CIS countries accounted for 16.3% in the Transnistrian exports (in 2015 - 15.8%), amounting to USD 34.6 million. The exports to these countries decreased by 5.2% y-o-y (Figure 16). This diminution was mainly determined by the decrease of exports of electrical machinery and equipment, as well as textiles, textile products, and footwear. The exports to Russian Federation decreased the most (-20.3% y-o-y), amounting to USD 15.8 million, with a 7.4% share in total supplies (8.6% in 2015). At the same time, in the context of amelioration of the armed conflict in eastern Ukraine, the exports to this destination increased by almost 17.3% y-o-y, amounting to USD 17.7 million. As for other countries, the significant increase of exports to Serbia should be mentioned, which amounted to USD 2.9 million, or by 59.1% more y-o-y. The exports to the other countries from this category were insignificant.

The energy products and base metals are still the main exports of the region. During Jan-May:16, the supplies of fuels and electricity decreased by almost 11.1% y-o-y, amounting to USD 78.3 million (Cart 18) which accounts for almost 36.9% of the total supplies of the region (in 2015 – 38.1%). This is also due to both the decrease of electricity demand on the right bank of the Nistru river, and the lower sales price according to the new contract, signed with the Chisinau authorities. The supplies of base metal and articles thereof are still at the same level, amounting to USD 47.2 million (Figure 18), with a 22.2% share in total supplies (in 2015 – 20.6%). The food products had a negative dynamic of -17.9% y-o-y (Figure 18),amounting to USD 24.2 million, with a share of 11.4% (in 2015 – 12.8%). This is also due to the substitution of imports with domestic goods, as a result of the currency crisis and imports reduction.

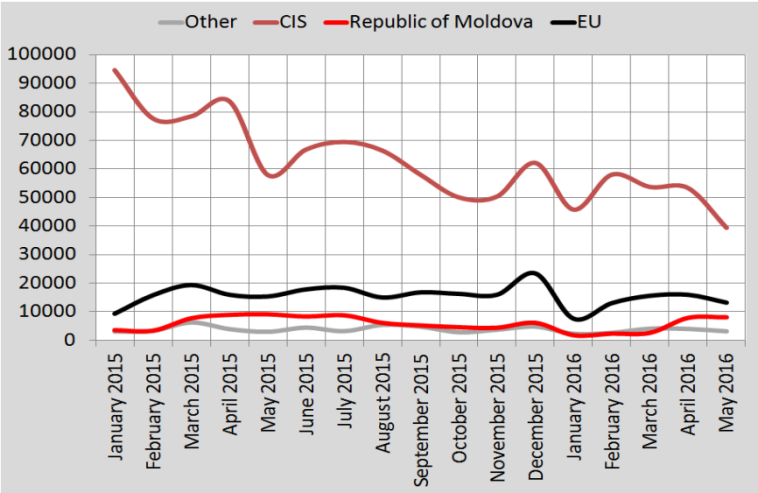
Figure 18. Export of Goods from Transnistria by Groups of Goods, thousand USD



Source: "Regional Statistics Service of Transnistria", EG calculations

The worsening economic situation in the region, on the background of a currency crisis, decreased the imports of goods. During Jan-May:16, the imports decreased by 32% y-o-y, amounting to USD 353 million. The highest decrease (-36.3% y-o-y) was registered in the CIS and constituted USD 250 million, followed by the right bank of the Nistru river (by 30.5%), amounting to USD 23 million. At the same time, the imports to EU and the group of other countries decreased at a more tempered rate, by -17.6% and -14.1% y-o-y respectively (Figure 19).

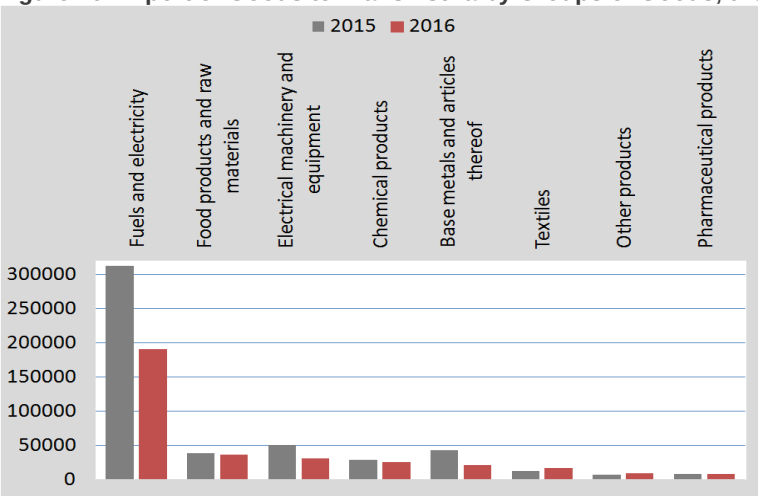
Figure 19. Import of Goods in Transnistria by Groups of Countries, thousand USD



Source: "Regional Statistics Service of Transnistria", EG calculations

On the background of the reduction of domestic and foreign demand, and the currency crisis, the import of fuels diminished drastically. Thus, during Jan-May:16, the import of fuels decreased by almost 39% y-o-y, reaching USD 191 million (Figure 20) with a 54% share in total imports of the region (in 2015 – 60.1%). As for the main oil products (diesel oil and gasoline) during the reference period, there was a deficit of these products on the domestic market due to the currency crisis in the region and the impossibility to settle the import transactions in foreign currency. Hoping to improve the situation, particularly in the context of agricultural works, in June it was decided to cut the excise tax rate from USD 90/t to USD 45/t for diesel oil, and from USD 189/t to USD 100/t for gasoline.

Figure 20. Import of Goods to Transnistria by Groups of Goods, thousand USD



Source: "Regional Statistics Service of Transnistria", EG calculations

Due to the currency crisis the imports of food products decreased, which caused a deficit of various products on the domestic market and therefore, fuelled the "food tourism". The import of food products decreased by almost 6% y-o-y, amounting to USD 36.1 million (Figure 20), with a 10.2% share in total imports of the region (in 2015 – 7.4%). It should be mentioned that in order to avoid a shortage on the market and to stimulate these transactions, beginning of June, the business entities are allowed to extract big amounts of cash in foreign currency from accounts without the requirement to confirm the contracts on the procurement of goods outside the region.[9]

The low demand on foreign markets reduced the raw materials imports for metallurgic industry. During the reference period the import of base metals and articles thereof for the main economic driving force from the region – the Metallurgical Plant of Rabnita – decreased by 50.9% y-o-y reaching USD 21 millions (Figure 20) and having a 6% share in total imports (in 2015 - 8.2%).

Challenges and Forecasts

- From the perspective of benefiting from the new commercial regime within DCFTA, in the context of ATP (Autonomous Trade Preferences) expiry on 1 January 2016, the main challenge for Transnistria is to implement the preconditions imposed by EU, once all parties (including Transnistria) agreed on a Set of measures aimed to improve the Transnistrian trade with EU, as documented in Decision No 1/2015 of the RM – EU Association Council of 18 December 2015.

- Though this is not made public, the following are among the conditions that should be met: a) abolish custom duties for 50% of all tariff lines representing imports from EU during 2016; b) abolish custom duties for all tariff lines representing imports from EU until 2018; c) introduce a new taxation system that would include a VAT; d) harmonize the classification of goods from the Transnistrian region to HS 2012; e) establish an institutional cooperation mechanism in order to meet the SPS norms, including the part related to the issuance of certificates; f) implement the technical regulations envisaged in DCFTA.

- Nevertheless, given that there is no mechanism to monitor the DCFTA implementation by Transnistria, the progress with the implementation of these measures is still uncertain. Moreover, as the Republic of Moldova has guaranteed to the European partners an accurate implementation of the undertaken commitments (despite the risks arising from the lack of an effective control over the region), the main challenge for the Chisinau authorities will be to avoid the sanctions for Transnistria's failure to comply with the Agreement.

[9] http://president.gospmr.ru/sites/default/files/zakon/ukaz_no_232.pdf

- On the other side, though Transnistria declares that the DCFTA implementation is not agreed, the economic isolation by giving up on the regime's expansion will have a severe negative impact on the economy. The Transnistrian authorities' reluctance to implement DCFTA will fuel the growing discontent of the business environment, and the impossibility to access the EU market will undermine their competitiveness.

- Nevertheless, taking into account the elections that will take place in Transnistria this autumn, can be anticipated from political players provocations and speculations regarding the economic appropriateness of DCFTA for the region, in an attempt to raise electoral support.

- In the currency crisis context, the main challenge is to reassess its management mechanism, taking into account the Transnistrian economic realities. In addition, it will be necessary to give up on the sporadic initiatives over-regulating the international foreign trade transactions, aimed at preventing the drain of foreign currency and supporting artificially the exchange rate, as they hold back the value-added economic processes. A very good example is the recently imposed obligation to sell a part of foreign currency from export transactions performed by business entities from the region (since March - 7%, and since May - 25% of total income). It should be mentioned that there are some discussions to increase this threshold up to 100%.

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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:

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- 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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