

Regional Economic Review:

Transnistrian
region

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Additional note

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

This document is a translation from the Romanian language.



Contents

Key messages of this issue.....	5
Executive Summary	7
Chapter 1. Domestic Supply	10
Industry - Rapid, but Temporary Growth	10
Investments - Sinuous Developments due to Negative Expectations	11
Agriculture - Sufficient Production, Insufficient Demand	12
Short and Medium Term Forecasts and Challenges	12
Policy Recommendations	14
Chapter 2. Domestic Demand.....	16
Analysis of Key Trends and Developments	16
Short and Medium Term Forecasts and Challenges	17
Policy Recommendations	18
Chapter 3. Public Finances.....	20
Analysis of Key Developments and Trends	20
Short and Medium Term Challenges and Forecasts	21
Policy Recommendations	22
Chapter 4. Labour Market	23
Analysis of Key Developments and Trends	23
Short and Medium Term Forecasts and Challenges	24
Policy Recommendations	24
Chapter 5. Prices and Monetary Policy	26
Balancing between Inflation and Deflation.....	26
Short and Medium Term Forecasts and Challenges	27
Policy Recommendations	28
Chapter 6. Banking System	29
Analysis of Key Developments and Trends	29
Short and Medium Term Forecasts and Challenges	32
Policy Recommendations	32
Chapter 7. Foreign Sector.....	34
Analysis of Key Developments and Trends	34
Short and Medium Term Forecasts and Challenges	36
Policy Recommendations	37
About EXPERT-GRUP	39



List of figures

Figure 1. Volume of Industrial Production, growth y-o-y, %	10
Figure 2. Industrial Branches that Increased or Decreased in Jan-Sept:14, y-o-y	11
Figure 3. Volume of Fixed Capital Investment, y-o-y, % change*	11
Figure 4. Distribution of Answers about the Expectations of the Companies' Managers in the Region by the end of 2014, %	12
Figure 5. Volume of Industrial Production, Historical Trends and Forecasts for 2014 and 2015, million rubles	13
Figure 6. Volume of Fixed Capital Investments, Historical Trends and Forecasts for 2014 and 2015, million rubles	13
Figure 7. Key Hindrances to the Activity of the Companies in the Transnistrian Region, comparison between the first half of 2014 and 2013, %	14
Figure 8. Number of Employees Affected by Salary Arrears	16
Figure 9. Volume of Goods and Services Purchased by the Population, growth y-o-y, %	17
Figure 10. Money in Circulation in "Transnistrian Rubles" and Money Supply in Foreign Currency, increase y-o-y, %	17
Figure 11. Structure of CBR Revenues (million USD), Q1-Q3:14	20
Figure 12. Evolution of Unemployment Rate and Vacancies (%), mobile average figures (n=4).	23
Figure 13. Evolution of the Number of Employed and Resigned People (left axis), and of the Share of Dismissed People in Total Resigned People (right axis). Mobile average figures (n=4).	24
Figure 14. Consumer Price Index and Core Inflation, y-o-y growth, %	26
Figure 15. The amount of currency in circulation, y-o-y growth and required reserves for deposits of legal entities in foreign currency and "Transnistrian rubles", %	27
Figure 16. Sales and Procurements of Foreign Currency, USD million	27
Figure 17. Volume of New Loans Provided to Companies and the Population (million Transnistrian rubles) and y-o-y Growth Rate of New Loans (%)	30
Figure 18. Dynamics of the Increase in Deposits of Individuals and Legal Persons (million Transnistrian rubles) and of the Deposits Growth Rate y-o-y (%)	30
Figure 19. Dynamics of the Lending Volume and Outstanding Credits (million Transnistrian rubles) and Share of Outstanding Loans in Total Loans (%)	31
Figure 20. Factors that Hinder the Access to Bank Loans for Transnistrian Companies, survey conducted in the first half of the current year	32
Figure 21. Dynamics of the Main Groups of Products Exported in Jan-Oct:14, y-o-y, %	35
Figure 22. Structure of Exports from the Transnistrian Region during 2014	35
Figure 23. Structure of Exports from the Transnistrian Region during 2013	35
Figure 24. Dynamics of the Main Groups of Products Imported in Jan-Oct:14, y-o-y, %	36
Figure 25. Structure of Imports from the Transnistrian Region during 2014	36
Figure 26. Structure of Imports from the Transnistrian Region during 2013	36



Key messages of this issue

- ***The economic year 2014 was marked by the overlapping of positive and negative shocks for the Transnistrian region, leading to stagnation of the economy during this period.*** First, the economic growth was compromised by the Ukrainian crisis, accompanied by the Ukraine's measures of tightening the control at the border with Moldova (which includes the Transnistrian segment), and in parallel with the economic problems of the main trading partners of the companies from the region (EU, Ukraine and the Russian Federation). The depreciation of the Russian ruble eroded the purchasing power of the migrant families, aggravated by artificial fixing of the exchange rate of the "Transnistrian ruble" against the US dollar. As a second-round effect, these factors increased the arrears in the budgetary sector, undermining the consumption and fuelled the pessimism of the population and firms from the region. On the other hand, these factors were mitigated by the resumption of the work of Moldovan Metallurgical Plant - the largest employer, investor and taxpayer in the region. This had an essential impetus on entire industrial activity, in particular due to the rapid growth of the metallurgical industry and electricity production. At the same time, the favourable weather conditions contributed positively to agricultural production and employment in this sector. Overall, the positive and negative factors complemented each other, and the region's economy stagnated in 2014.
- ***The year 2015 is expected to be much more difficult than the current year, given the expected economic recession of about 3%-5%.*** The reason is that the factors that mitigated the negative shocks and allowed to keep the Transnistrian economy afloat in 2014 are expected to vanish in 2015. At the same time, a range of risks persists. Thus, the economic difficulties of Ukraine and the Russian Federation, in parallel with the slow recovery of the EU economy will undermine the foreign demand and the Government efforts to reorient from the Eastern to the Western market. Along with the depreciation of the Russian ruble, it will also affect the welfare of migrant families. At the same time, the more austere budget anticipated for 2015, along with possible increases in public utility fees and delays in wage payments in the public sector will affect adversely the domestic demand. Due to lower consumption and exports, investments do not have good prospects either. Surveys in the region show an increasing pessimism among the managers of major industrial enterprises, which is due to the economic crisis and security in Ukraine, and to the worsening domestic economic conditions. In addition, the expected recession in the Russian Federation in 2015 will limit the appetite for investment of banks and other companies from the region, which have Russian capital. An additional constraint is related to the high probability of less favourable weather conditions compared to 2013 and 2014, when the region recorded significant increases in agricultural production.
- ***The economic difficulties have been reflected in the labour market: the employment rate decreased and the number of dismissals and unemployment rate increased.*** This phenomenon manifested mainly in the private sector, affected by the limited domestic and foreign demand, higher fiscal pressure and increased uncertainty. At the same time, it also reflects the tendency of private companies to optimize the expenses in order to survive in difficult economic conditions. Thus, the labor market was the main pathway by which the worsening economic situation was transposed upon worsening the social situation.
- ***Authorities of the region had a totally inadequate reaction to the worsening economic conditions.*** In particular, instead of supporting the private sector, which is the main source of budget revenues, investments and employment, the authorities increased the burden and tax audits for companies, which was attested by the managers of enterprises. Instead of motivating the commercial banks in the region to provide more credits to the real sector, the monetary authority of the region tightened the monetary policy during 2014, which made the banks' credit resources more expensive. Instead of steering the economy towards an extensive and prosperous sales market, the authorities took actions to redirect the exports from EU towards the Russian Federation, whose economy will enter into recession in 2015 and whose national currency is depreciating



continuously. Instead of eliminating tariff barriers to trade and integrating the companies of the region into foreign sales markets - a crucial requirement for a so small and open economy - the authorities of the region, continue to denounce the EU Association Agreement. Thus, the economic, fiscal, monetary and trade policies currently applied in the region, condemn the Transnistrian economy to recession, self-isolation and, respectively, to a bigger dependence on the financial and energy support from the Russian Federation.

- ***The fundamental constraint that affects the long-term development of the region is the divergence between economic and (geo)political interests.*** This problem has become extremely topical in the context of signing the EU Association Agreement. Authorities of the region, following a diametrically opposed vector (getting closer to the Russian Federation) are strongly against the implementation of this agreement, despite the fact that it involves liberalization of trade with the most important sales market for the companies from the region. Thus, while about 60% of exports of the Transnistrian region are directed to EU, the authorities of the region to diminish the exposure to the Community market, take actions to redirect exports to the CIS market and, in particular, to the Russian Federation. Besides the fact that the CIS market is over 6 times smaller than the EU market and is very different in terms of its structure from the Community market, it is also cooling down and posts negative forecasts for 2015. Particularly, the economies of the Russian Federation and Ukraine are expected to shrink in 2015, which along with the depreciation of their national currencies undermine the export opportunities to this markets. Thus, besides the fact that the CIS market cannot replace the EU market due to smaller size and different specifics of the demand, its potential is decreasing. Thus the divergence between the economic interests of the companies and the (geo)political interests of the authorities in the region may lose the most important sales markets, without which the Transnistrian economy cannot survive.
- ***Implementation of the EU Association Agreement, contrary to the widely spread opinion in society on both banks of the Nistru River, does not necessarily come against the (geo)political interests of the authorities of the Transnistrian region.*** First, the Association Agreement, which provides for the establishment of the Deep and Comprehensive Free Trade Area with the EU, is compatible with the Free Trade Agreement with CSI countries (including the Russian Federation). Second, the implementation of the Agreement provisions correlates as well with the Russian Federation tendencies to adopt internationally recognized standards. Thus, the authorities of the region can implement the Association Agreement, at least partially, without leaving behind the Russian Federation, in economic and political terms. Hence, this Agreement should be rather regarded as a source of additional opportunities to increase and diversify the exports, which are crucial for economic development of the region. In this respect, the authorities of both banks of the Nistru River should cooperate more intensively on the technical dimensions related to the harmonization of statistical, fiscal, quality, infrastructure systems, banking and financial regulation etc.
- ***The year 2015 is expected to be particularly difficult for the region because of the worsening economic and social situation and the need to take very difficult political economy decisions.*** The 2015 budget is approved with a deficit of about 11% of the Gross Domestic Product of the region (the maximum admissible level is about 3%), which is partially covered by the direct and indirect financial support from the Russian Federation. However, the budgetary constraints in the Russian Federation increase similarly to the financing needs of the Transnistrian region. At the same time, the accumulation of wage arrears in the budgetary sector should be a very clear warning about the fact that the Russian Federation cannot cover absolutely all expenditures of the region. Therefore, the authorities from the region will be forced to make available additional domestic sources to complement financing needs. In this respect, the main targets could be to optimize public sector, which is oversized (over 40% of the employed population), and to increase the public utility fees that are about 10 times lower than those of the right bank of the Nistru River. These reforms are extremely unpopular and involve political and social costs, however, higher are the costs of postponing them, which could bring the region to bankruptcy, despite the generous financial support from the Russian Federation.



Executive Summary

Domestic Supply

Although the data the Gross Domestic Product in the Transnistrian region were not published in 2014, we anticipate an economic stagnation for 2014-2015. During 2014, the Transnistrian industrial sector was stimulated by 2 major factors: (i) compensatory growth in the metallurgical and energy sectors, as a result of resumption of the Moldavian Metallurgical Plant activity; (ii) direct and indirect financial support provided by the Russian Federation to develop the social infrastructure, that stimulated the sector of construction materials (in particular, the production of concrete and cement). Except for these sectors, the industrial production decreased, with the harshest slump being felt by small and medium enterprises. The investment activity decreased due to the worsening of the economic situation, high uncertainty associated with the domestic and foreign economic environment, as well as a strong pessimism among managers. Agricultural production grew thanks to favorable climate conditions, but the problem of producers' access to the foreign markets has remained acute. As a result, given a low domestic demand, the unit prices for agriculture products decreased, affecting thus the local farmers. For prospects for 2015 a rather gloom: the industrial production will decline by about 3%-4%, the volume of investments in fix capital - by 10%-12%, while further denunciation of the Association Agreement could lead to the economic self-isolation of the region. In the current economic context, the policies should target two major priorities: (i) to enhance the competitiveness of the Transnistrian companies on the foreign markets, and (ii) to increase the companies' flexibility and ability to orientate to other markets and adjust to the changes in the domestic and foreign economic environment.

Domestic Demand

Given the high level of internal and external uncertainty, people became more cautious about consumption, postponing many purchase decisions for the future. Thus, despite the fact that the population's consumption remained higher compared to the previous year, its growth rate decreased continuously in 2014. The causes are related to the slower wage growth, as well as the salary arrears in the budgetary sector, which generated uncertainty and pessimism. Thus, in the first 10 months of this year, the total volume of goods and services purchased by the population stagnated compared to the previous year, while the growth rate of money supply decreased. For 2015, we anticipate a decrease by 10% of domestic trade in consumer goods and services. Such a gloomy forecast is determined by the exposure of the Transnistrian economy to foreign risks, that influence directly the wellbeing of the population. The problem is worsened by the low capacity if the economy to adapt to changing economic context, caused by the unfriendly business climate and by an oversized public sector, as well as by the activity of a number enterprises of high systemic importance, but low efficiency. Another challenge for the consumption in the region is related to the rapid depreciation of the Russian ruble during 2014, while the "Transnistrian ruble" remained artificially fixed at the same level (11.1 "rubles" per 1 USD). It automatically impoverished the migrants and their families, who used to convert the revenues earned in the Russian Federation into dollars and transferred the money in the Transnistrian region.

Public Finance

The Transnistrian public finance system is characterized by a persistent disequilibrium, with a budget deficit of 11% from the Transnistrian GDP in 2014 and 2015. The main source to cover the deficit are loans from the Transnistrian banks and the issuance of securities by "Transnistrian Ministry of Finance", which are purchased by "Transnistrian Central Bank". It contributes to the continuous growth of the domestic debt, which already exceeded the GDP value (101.1% of the region's GDP in 2014). Recognizing this fact, as well as having financing difficulties, the authorities are working on consolidation of public expenditures and on medium-term planning framework. Thus, according to new MTBF, a significant decrease of the budget deficit and of domestic debt is planned until 2017. But, this tax adjustment is not accompanied by structural measures to maximize the revenue, which would widen the tax base, stabilize revenues in the medium



term and make the financing problem of budget deficit less acute. Also, the adjustment of expenditures at the expense of investments, as well as the lack of cheap external financing sources does not allow the tax and budgetary policies to contribute to the sustainable growth in the region. To mitigate the effects of economic slowdown on the region's budget, the budgetary and fiscal policy should focus mainly on the tax base extension. This is mainly related to fostering the entrepreneurial activities, as well as introduction of VAT in the region. In this respect, it is critical to improve the business environment and to strengthen the institutional capacity of the tax authorities. At the same time, the optimization should not affect the already scarce investments in the region, but rather some budgetary sectors with excessive expenditures.

Labor Market

The symptoms of economic slowdown are reflected in the main performance indicators of the region's labor market. Thus, the unemployment rate reached its minimum values at the beginning of the year and began to grow in the second half. Also, the pressures on labor market were felt as a result of the decreasing employment and dismissal flows, as well as due to the significant decrease in the available jobs in the economy. From the structural point of view, the trend in labor force redistribution from the industrial sector to the agriculture and services sector continued. At the same time, public sector still plays a disproportionate role on the Transnistrian labor market, worsening the problem of efficient use of the limited and decreasing labor force. In this context, it is appropriate to optimize the public sector, accompanied by the development of retraining programs, and fostering the development of small and medium enterprises. At the same time, it is necessary to reform the education sector, both in terms of quantity and quality, which employs about 21% of the workforce and ranks the second in share after industry.

Prices and Monetary Policy

Disinflationary pressures emerged in 2014, amid consumption and economic growth slowdown. Actually, if we exclude the growth of regulated prices for some services, we notice that the region was affected by deflation. The deflationary trends will continue in the coming months, due to the expected worsening of slowdown conditions and fixing of the "Transnistrian ruble" to the US dollar in spite of the depreciation of the national currencies in the countries of import for the region (Ukraine and Russia). The pro-cyclical monetary policy promoted by the "Dniester Republican Bank" represented an additional factor that fostered deflationary trends in the region. The restrictive monetary policy was also supported by a foreign exchange policy that fixed artificially the exchange rate of the "Transnistrian ruble" to USD at 11.1 "rubles" for 1 USD. "Dniester Republican Bank" should ensure a graduate and controlled depreciation of the "Transnistrian ruble" in order to increase the competitiveness of local producers and to finance, at least partially, the huge current account deficit in the region. At the same time, in order to ensure the necessary conditions that would encourage lending to small and medium enterprises, the monetary policy should be relaxed.

Banking System

During 2014, the banking system in the Transnistrian region was relatively stable. However, some worrisome trends emerged that could undermine this stability in the next year. Thus, the system remains well capitalized and the risk weighted capital adequacy is over 8 times higher than the minimum required level. Still, certain worrying signals are noticed in the second half of the current year. Amid worsening of the internal economic situation, as well as in Russia and Ukraine, a continuous slowdown in the lending activity has been registered. At the same time, the decrease of population' and business entities' income has reduced the volume of bank deposits, in particular of those attracted from individuals. Due to worse financial conditions of firms and population, the volume of outstanding loans increased, which was mainly due to the loans provided to firms. Banks' portfolio quality worsened mainly due to diminishing corporate revenues, which were affected both by the lower purchasing power of the population and the failure of some Ukrainian suppliers to meet their obligations against the companies in the region. In 2015, the lending volumes could stagnate and the quality of the banking portfolio could deteriorate further. The lending potential in the region could be explored, if the authorities and banks follow 3 main priorities: (i) fostering the competition in the sector; (ii) harmonize the regulation principles and prudential norms from the sector



with those on the right bank of the Nistru River; and (iii) improve the banks' internal procedures, prioritizing the corporate governance, assessment of creditworthiness of current and potential debtors and development of collecting and restructuring procedures for non-performing loans.

Foreign Sector

During 2014, the slowdown in domestic demand in tandem with the resumption of the operation of the Moldavian Metallurgical Plant led to higher growth rates for exports than for imports. However, the robust growth in exports in 2014 is temporary, being determined by the compensation of losses caused by the suspension of the operation of the Moldavian Metallurgical Plant activity last year. This increase was determined by the exports to the European Union market, which strengthened its position as the main export market for companies from the Transnistrian region. If in terms of exports, the Transnistrian region is dependent mainly on the EU market, then in terms of imports, the CIS market plays a more significant role. The dynamics of imports reflect the slowdown in economic activity in the region, amid low propensity to consume of the population and lower companies' appetite for investments. A fundamental challenge remains to be the huge deficit of the current account, which is estimated to be in 2014 at around 90% of the Gross Domestic Product of the region. The main source of these imbalances result from the trade with CIS and, in particular, from the imports of energy resources from the Russian Federation. Tiraspol authorities together with the companies from the region should come to a Pareto optimal compromise between the economic interests, i.e. maintaining the EU market, and (geo)political interests, i.e. keeping close to the Russian Federation. Ignoring the economic interests could lead to the loss of the most important sales market of the region and, respectively, could compromise the efforts made so far by the companies to increase their presence and to maintain their position on that market.



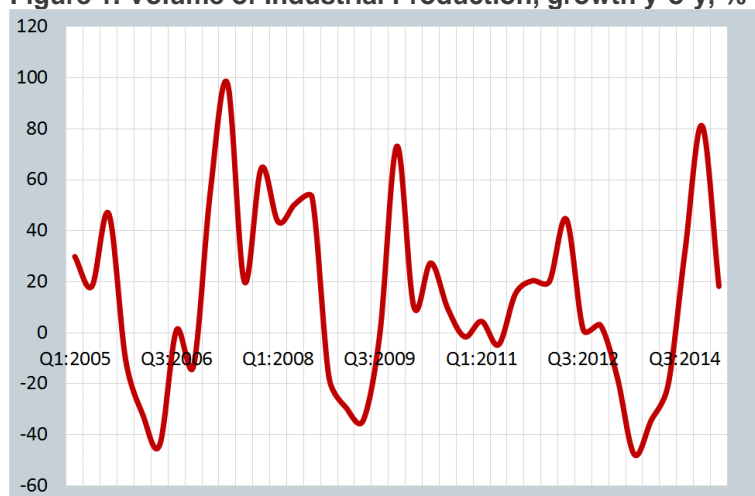
Chapter 1. Domestic Supply

The year 2014 witnessed contradictory trends for the economy of the Transnistrian region. The growth in industry was impressive, but it occurred due to the resumption of the operation of the Moldavian Metallurgical Plant and most probably, it will not last in the long-run. At the same time, the investment activity diminished and companies' confidence in the macroeconomic environment worsened. The year 2015 is expected to be more difficult for the region's economy. Without structural reforms and substantial improvements in the business climate, the economy is likely to decline in the next year.

Industry - Rapid, but Temporary Growth

The industrial production have been fuelled by the metallurgical, electrical energy and construction materials' production. During Jan-Sept:14, the industrial production in the Transnistrian region was by 33.9% higher in terms of value¹ and by 30.4% in terms of volume compared to the previous year (y-o-y). This evolution was driven by the compensatory growth in the metallurgical sector (27% of the total industrial complex) due to resumption of activity at the Moldovan Metallurgical Plant, which did not work in the first quarters of the last year. Thus, the volume of metallurgical production increased 4.7 times during the same period. In its turn, it had an essential impetus on the energy sector, which advanced in Jan-Sept:14 by 30.4% y-o-y. Both branches (metallurgy and electricity) provide about 60% of the industrial production and were the main engines of the sector's growth during the reference period. Another important industrial sector that registered an ascending development during Jan-Sept:14 (+40.9% y-o-y) is the production of construction materials, determined by production of cement (+47.6%) and concrete (+82.2%).

Figure 1. Volume of Industrial Production, growth y-o-y, %



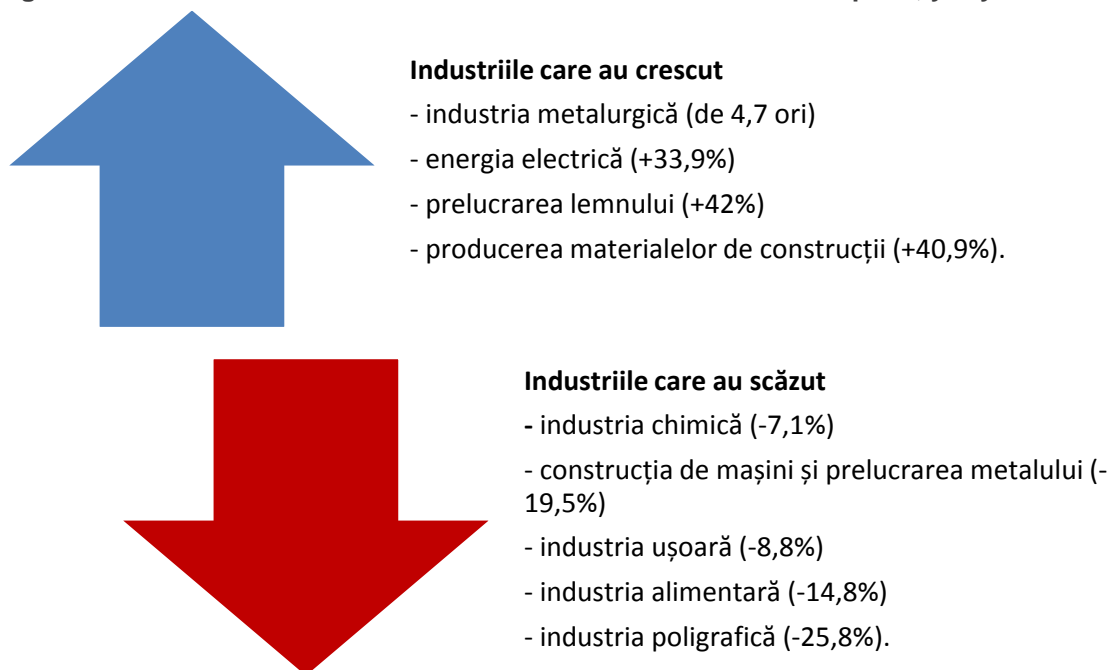
Source: "Ministry of Economic Development" from the Transnistrian region

However, **if we exclude the recovery effect in metallurgical and energy industries, we find a less favourable dynamics.** Thus, about half of the enterprises have registered a decrease in the production volume. For example, the light industry, which in Jan-Sept:14 formed 13.2% of total industrial production, decreased by 8.8%, but the food industry (12% of industrial production volume) declined by 14.8% y-o-y. As a rule, these industrial branches are represented by small and medium firms, which are the most vulnerable to current volatility in domestic and foreign demand, but also to the unfavourable business climate.

¹ Total volume of industrial production during Jan-Sept:14 constituted USD 680 million.



Figure 2. Industrial Branches that Increased or Fecreased in Jan-Sept:14, y-o-y

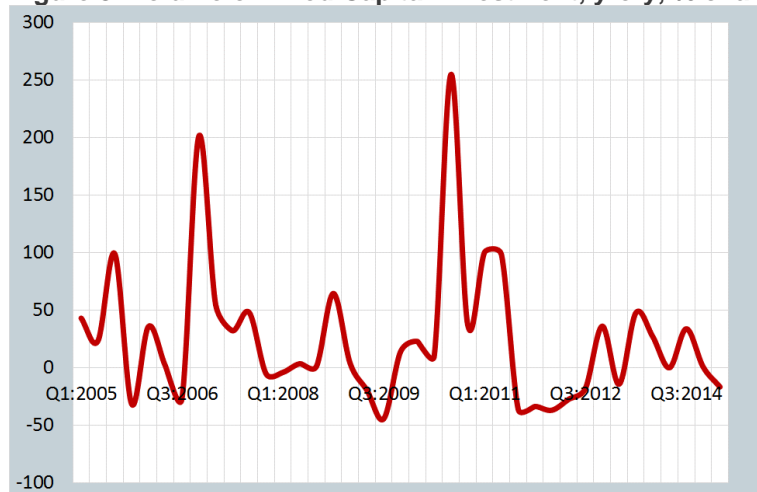


Source: "Ministry of Economic Development" from the Transnistrian region

Investments - Sinuous Developments due to Negative Expectations

The investment activity declines amid worsening of economic conditions and high uncertainty. In the analysed period (Jan-Sept:14), the volume of fixed capital investments operated by local enterprises diminished by 2.6% y-o-y. Even more worrying is that the decrease was driven by investments' structure that includes machineries, equipment, means of transport, tools and inventory (-11.3% y-o-y). In contrast, an increase is seen in the volume of construction and assembly works (by 14.3% in Jan-Sept:14, y-o-y). This is explained by the implementation of social infrastructure development projects, financed by the Russian Federation. Another worrying fact is that the investments in the two sectors, which influence the competitiveness of the region's (industry and education) decreased by 11.8% and 54.9% respectively, in the same period, y-o-y.

Figure 3. Volume of Fixed Capital Investment, y-o-y, % change*

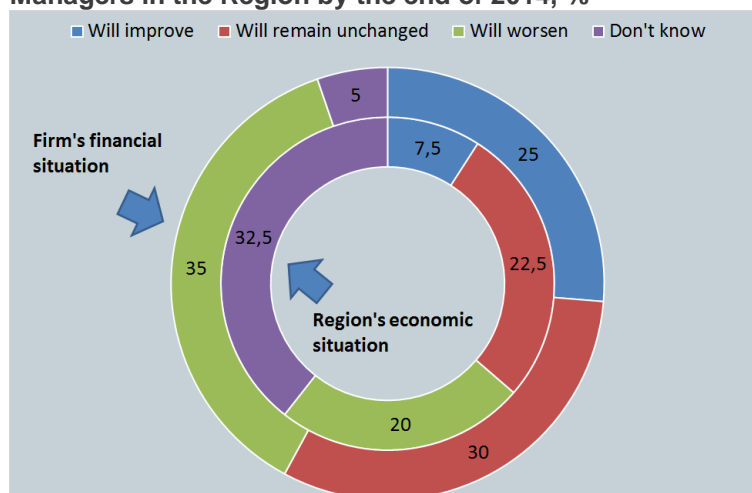


Source: "Ministry of Economic Development" from the Transnistrian region



In general, **the investment activity maintained a sinuous path over the past years (Figure 3), as shown by the high level of uncertainty, worsening economic and financial situation of most companies, as well as negative expectations of most top companies' managers in the Transnistrian region.** According to a survey conducted among the companies' managers in the region², 60% of respondents said that after the first half of 2014, the region's economic situation worsened, and for 55% of managers the financial situation of enterprises under their control has worsened as well. In addition, 42.5% of the surveyed managers believe that by the end of the current year the economic situation in the region will remain unchanged or will worsen, while 65% of respondents said that the financial situation of the enterprises under their management will remain unchanged or will worsen (Figure 4). Such a high level of pessimism affects the companies' investment plans and this fact explains the low volume of investments in fixed capital.

Figure 4. Distribution of Answers about the Expectations of the Companies' Managers in the Region by the end of 2014, %



Source: "Ministry of Economic Development" from the Transnistrian region

Agriculture - Sufficient Production, Insufficient Demand

Agriculture, with a share of about 6% in the GDP of the region, plays a less important role in the Transnistrian region's economy, compared to the rest of Moldova. The agricultural year 2014 was relatively favourable, which allowed to increase the physical volume of agricultural production in Jan-Sept:14 by 12.2% y-o-y. The growth was high for both crops growing (+11.5%) and animal farming (+18.4%). Yet a major problem is the limited sales market for these products, due to failure in implementing the necessary quality standards, which would offer export opportunities for agricultural products. As a result, the farmers depend mostly on the domestic market. Due to low demand and limited export opportunities, the unit prices for agricultural products decreased. Thus, in spite of impressive growth in physical volume (12.2% y-o-y), the value of agricultural production increased by only 4.7% in Jan-Sept:14 y-o-y.

Short and Medium Term Forecasts and Challenges

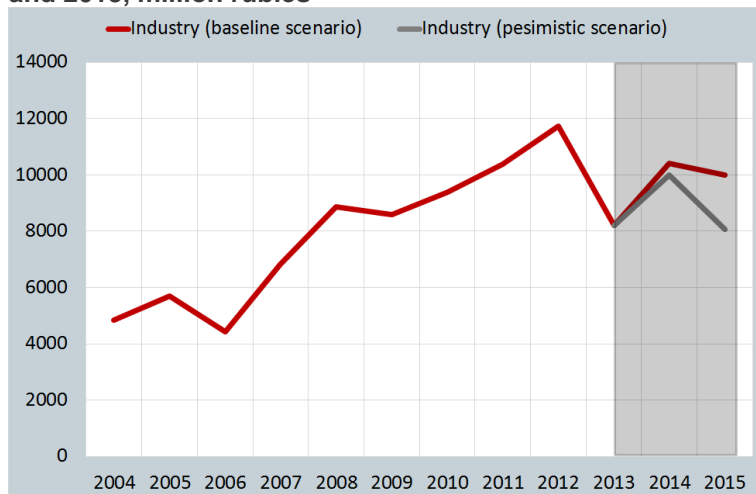
- Although the data on evolution of the region's Gross Domestic Product for the period under review were not published, we anticipate an economic stagnation for 2014-2015. Moreover, the potential for economic growth will further decline, on the background of eroded fixed capital stock (due to fewer investments) and human capital stock (due to massive emigration).
- The volume of industrial production could grow by about 25% in 2014 (+20% according to the pessimistic scenario). However, an additional challenge for 2015 is the fact that the compensatory growth's effect in industry will dissipate, which will make it impossible to maintain such a high growth level in future. Moreover, amid the low domestic and foreign demand, the volume of

² Source: "Dniester Republican Bank", monthly bulletin No 10 (185), October 2014



industrial production is expected to decrease by about 3.0%-4.0% according to the baseline scenario. The pessimistic scenario cannot be excluded, according to which the industry sector could compress by about 20% in 2015 (Figure 5).

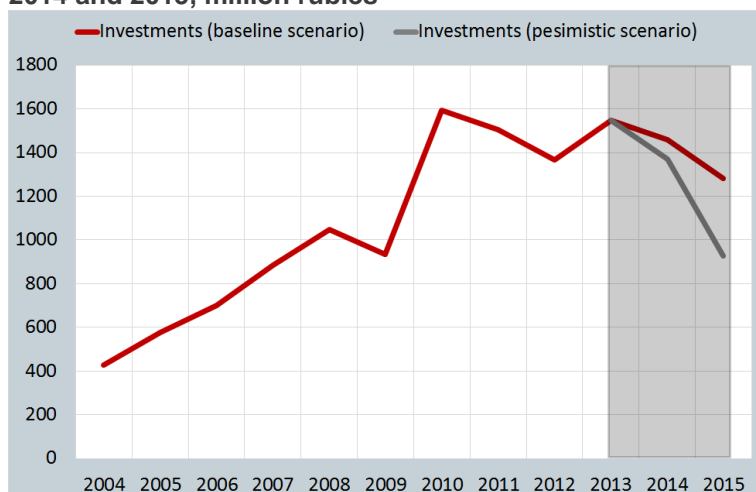
Figure 5. Volume of Industrial Production, Historical Trends and Forecasts for 2014 and 2015, million rubles



Source: Authors' calculations based on data from the "Ministry of Regional Development";

- The investment activity will be determined by the high level of uncertainty and pessimistic expectations from the business environment in the region. Therefore, more than half of top managers in the region stated that the financial situation at their enterprises worsened in 2014, and in the coming period it is expected that things either will not change or will continue to worsen. In this context, the volume of fixed capital investments is expected to diminish by 5%-6% in 2014 and by 10%-12% in 2015. The pessimistic scenario cannot be excluded, according to which investments will decrease by 10%-11% in 2014 and by as much as 30% in 2015. This might be induced by the tense situation in Ukraine, capital migration, higher fiscal pressure and worsening economic situation in the region (Figure 6).

Figure 6. Volume of Fixed Capital Investments, Historical Trends and Forecasts for 2014 and 2015, million rubles



Source: Authors' calculations based on data from the "Ministry of Regional Development";

- Another challenge consists in the continuously growing financing needs of the region on the background of worsening economic situation and demographic crisis, while the financial capacities of the Russian Federation are shrinking because of domestic economic problems. This discrepancy could reduce the contribution of the financial support for economic growth in the region, without



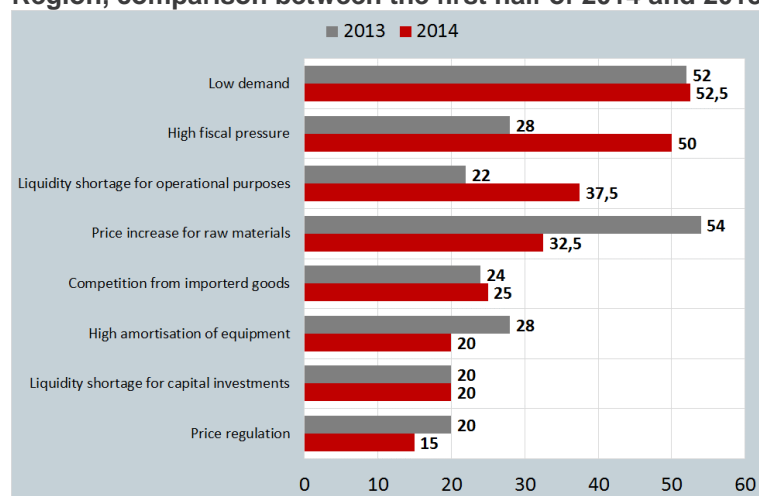
mobilizing additional domestic sources for economic growth. As a result, the region's economy could enter into an extended period of economic recession or stagnation.

- This challenge is worsened by the fact that both Chisinau and Kiev authorities started to implement the association agenda with the European Union. Given the fact that the regional authorities pursue a strategic integration on a totally opposite path, there is a risk of economic self-isolation of the region. This will become particularly critical starting with 2016, when the provisions of the Autonomous Trade Preferences expire, which are currently enjoyed by the leading exporters in the region. Thus, if the authorities continue to denounce the Association Agreement with the EU, the Transnistrian companies will not be able to export under preferential regime to the Community market. Therefore, the risk of losing the most important sales markets for the region entails negative economic consequences.

Policy Recommendations

- In the current economic context, the policies should target two major priorities: (i) to enhance the competitiveness of the Transnistrian companies on the foreign markets, and (ii) to increase the companies' flexibility and ability to orient to other markets and adjust to the changes in the domestic and external economic environment. To achieve these objectives, an immediate priority should be the removal of obstacles to business environment. The main hindrances to entrepreneurship were identified by the key companies' managers in the region, and include weak demand (52.5% of respondents), high fiscal pressure (50% of respondents) and insufficient liquidity to finance the current operations (37.5% of respondents).

Figure 7. Key Hindrances to the Activity of the Companies in the Transnistrian Region, comparison between the first half of 2014 and 2013, %



Source: "Dniester Republican Bank"

- The problem of low demand, perceived by over half of managers, relates directly to the limited size of the domestic market and restricted access to foreign markets. Hence, it is necessary to encourage investments in the modernization of enterprises, adoption and implementation of international standards and supporting the companies' promotion and marketing efforts. In this respect, the denunciation of the Association Agreement with the EU by the Tiraspol authorities will further worsen the problem of demand; hence cooperation aimed at implementing the Agreement is of crucial importance for the companies and for the entire economy in the region.
- The problem of the high fiscal pressure can be solved by rethinking the fundamental principles of fiscal policy in the region. First, it must be pro-business and pro-profit, aiming at encouraging the entrepreneurship development rather than collection of taxes by all means. Second, it should not be discretionary: all businesses should be treated equally by the law and the practice of granting



facilities or applying tax penalties in an arbitrary way needs to be curbed. Third, the fiscal policy should be predictable and transparent for each taxpayer.

- The problem of insufficient liquidity to finance current operations arises from limited access to bank loans, insufficient long-term sales contracts, as well as payment delays by partners (business customers). Like the issue of fiscal pressure, it worsened in 2014 due to the volatile domestic and foreign economic environment. In this respect, it is necessary to develop the financial and banking system by adjusting it to the regulatory norms across the entire country and stimulating competition and transparency in the sector.



Chapter 2. Domestic Demand

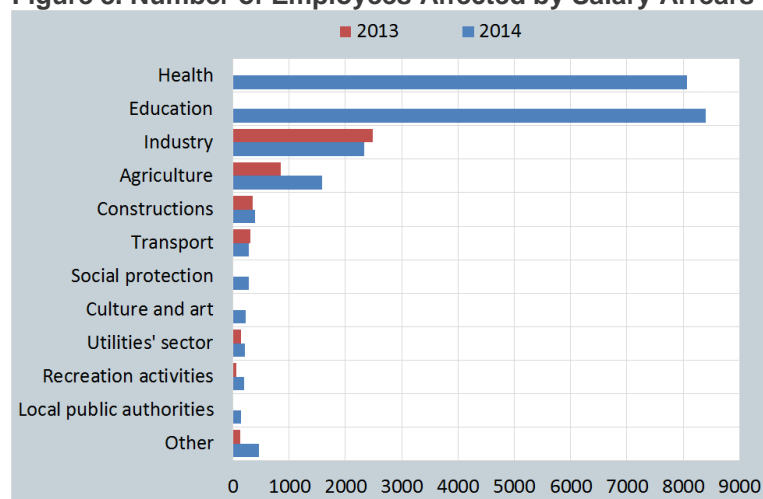
The worsening internal and external economic situation, high levels of uncertainty and pessimism of economic entities and population undermined the propensity to consume. Thus, the domestic demand continued to slow down on the background the lower growth rates of people's income and postponement of major purchases for an indefinite period. During 2014-2015, the domestic demand is expected to continue the downward trend due to economic difficulties and to probabilities of optimization policies in the public sector.

Analysis of Key Trends and Developments

During the current year, population's revenues maintained growing trends compared to the previous year, but registered a gradual slowdown of the growth rates. By the end of the first half of 2014, the total revenues increased, in real terms, by 2.2% y-o-y, mainly driven by the 10.6% salary increase (salaries are the main source of revenue in the region, with a share of 37% in total revenues). However, the salary growth rate decreased to 8.0% in Jan-Sept: 14 y-o-y, which is part of a downward trend outlined at the beginning of the current year.

Moreover, the financial difficulties of key enterprises in the region and the slowdown in budgetary revenues contributed to the accumulation of salary arrears. Thus, during Jan-Oct:14, the corporate debt owed to employees increased by 54% y-o-y and amounted to about USD 3.5 million. Moreover, the number of employees affected by salary arrears increased 4.6 times in Jan-Oct:14 (from 4343 in Jan-Oct:13 to 19787 in Jan-Oct:14). The higher salary arrears were mainly noticed in the public sector. Thus, health care, education, social protection institutions and local governments have concentrated the largest share of employees with salary arrears (73.6% of total employees, in Jan-Oct:14), although these sectors did not have such debts last year (Figure 8)

Figure 8. Number of Employees Affected by Salary Arrears



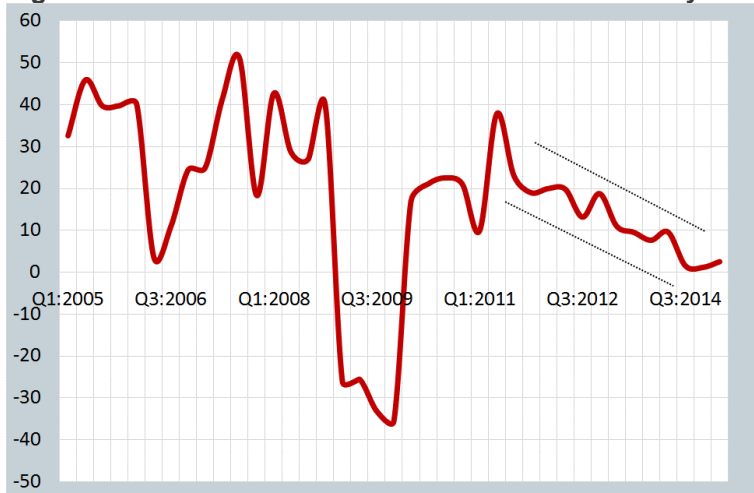
Source: "Ministry of Regional Development"

As a result of economic difficulties in the region which have influenced the acute shortage of liquidity in the public and private institutions, people's consumption activities have declined continuously during 2014. In fact, the consumption slowdown trend began in 2011 and continues until present (Figure 9). During Jan-Oct:14, the total volume of goods and services purchased by people increased by only 0.5% y-o-y, and if the downward trend continues, this indicator will show already negative values in the coming months. In fact, the volume of consumption goods sold to people is already decreasing: it declined by 0.5%, in real terms, in the same period. At the same time, the volume of services



provided to the population has maintained its growing trend (+4.1% y-o-y), but this was mainly due to the tariffs increase for services with regulated prices (e.g. tariffs for utilities). However, the share of services in the consumption basket of the population is only 22.4% (in Jan-Oct:14). Therefore, the downturn in economic growth and its impact on revenues will significantly affect the consumption levels in the near future.

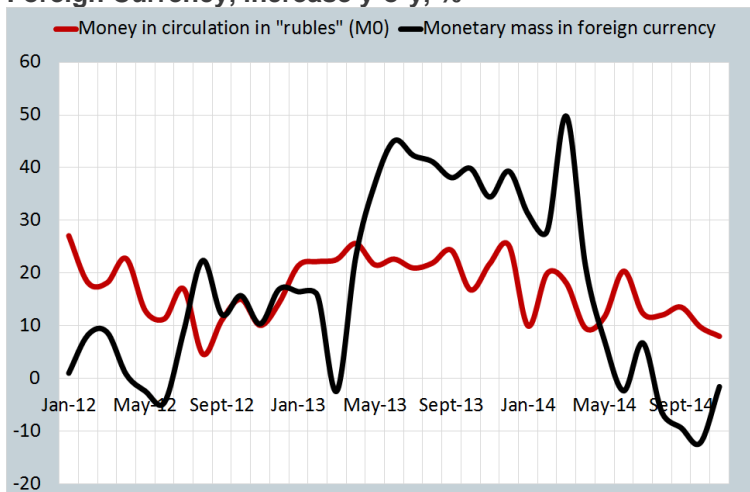
Figure 9. Volume of Goods and Services Purchased by the Population, growth y-o-y, %



Source: "Ministry of Regional Development"

The reduced consumption and economic activity are generally explained by the lower increase of the volume of money in circulation during the current year. This phenomenon is even more obvious for the money supply in foreign currency, which fell below the last year's level in the second half of this year (Figure 10). This occurred despite the increase in bank loans and massive withdrawal of deposits from banks. In such circumstances, reducing the volume of money in circulation could be determined both by the slowdown of economic activity in the region and increasing salary arrears (discussed above), as well as by the migration of capital abroad or informal transactions increase.

Figure 10. Money in Circulation in "Transnistrian Rubles" and Money Supply in Foreign Currency, increase y-o-y, %



Source: Authors' calculations based on "Dniester Republican Bank" data

Short and Medium Term Forecasts and Challenges

- The lack of liquidity in public institutions and private companies as a result of the worsening economic situation in Transnistria, will affect significantly the demand of the population. In particular, the domestic trade with consumer goods and services will fall by about 0.8% -1.0% in



2014, and in 2015 will decline even more (-10%). Thus, the forecast was revised downwards compared to the previous edition of the Regional Economic Publication (about 3% in 2014 and 5% in 2015) due to the worsening economic situation and budgetary constraints in the region. However, there is a high probability for a more pessimistic scenario according to which the volume of goods and services purchased by people in 2014 will diminish by 3%, and in 2015 - by 25%.

- Such a gloomy forecast for 2015 is determined by the exposure of the Transnistrian economy to foreign shocks that influence directly the wellbeing of the population. The problem is worsened by the low capacity of the economy to adapt to changing economic context, caused by an unfavourable business climate and by an oversized public sector, as well as by the operation of several enterprises of high systemic importance, but low efficiency. In addition, the public finance system is not self-sufficient, being strictly dependent on the financial support from the Russian Federation. As a result, the economic slowdown in 2014, despite the resumption of the operation of the most important company in the region (Moldavian Metallurgical Plant), caused massive salary arrears in the public sector.
- The year 2015 is expected to be more difficult than 2014 because the effects of industrial activity resumption will dissipate, and other growth factors will be undermined by the difficult economic situation in the region, and the worsening financial situation of the enterprises and public institutions. Thus, the household budgets will be affected both on the revenue side, due to salary arrears, and on the expenses side, due to the higher tariffs for services with regulated prices.
- On the background of increased uncertainty, the population will focus more on savings rather than consumption. This phenomenon is expected to create at least 2 challenges: (i) reduce domestic demand that will affect particularly small and medium enterprises, which are most vulnerable to economic volatility, and this could even make many companies go bankrupt resulting in increased unemployment; and (ii) most savings are stored in foreign currency and about a quarter of people's income is automatically converted into foreign currency, which puts pressure on the "Transnistrian ruble" and generates risks for the massive outflow of capital from the region. Both challenges could worsen the economic recession anticipated for 2015.
- Another challenge for the consumption in the region is related to the depreciation by about 30% of the Russian ruble during 2014, while the "Transnistrian ruble" was artificially fixed at the same level (11.1 "rubles" per 1 USD). It automatically impoverished the migrants and their families, who used to convert the revenues earned in the Russian Federation into dollars and transferred the money in the Transnistrian region. The artificial fixing of the exchange rate in the coming period will continue to affect consumption in the region (about 30% of the region's economy relies on remittances) and will affect the economy's capacity to adapt to changing external economic environment.

Policy Recommendations

- The trend of increasing tariffs for services with regulated prices that began in the last period is considered necessary, given that the prices are not sufficient to cover the costs of operators and maintain a good quality of the provided service. However, given the visible deterioration of economic activity, this measure is pro-cyclical and, respectively, contributes even more to lowering the consumption level. Before increasing the tariffs, the regional authorities must ensure that service providers are operating at their maximum efficiency (e.g.: do not allow unjustified expenditures). In this respect, it is necessary to streamline corporate governance in these companies by increasing managerial accountability for their performance. In parallel, the authorities should increase investment in infrastructure modernization for distribution of drinking water, electricity, heating, gas, etc., to minimize losses in the network. Adjusting tariffs to real costs is a necessary measure, but it is better to be postponed for the period when the region's economy enters into the recovery phase.
- In the context of limited employment opportunities and salary arrears in several public and private institutions, the authorities must remove the existing barriers in entrepreneurship to increase the self-employment opportunities for the population. In this respect, the top priority must be the



development of SME sector by simplifying the business registration, obtaining permissive documents, implementing new ICT tools for the communication between authorities and entrepreneurs and strengthening the competition framework by removing entry barriers to different markets, which are currently controlled by a small group of large companies.



Chapter 3. Public Finances

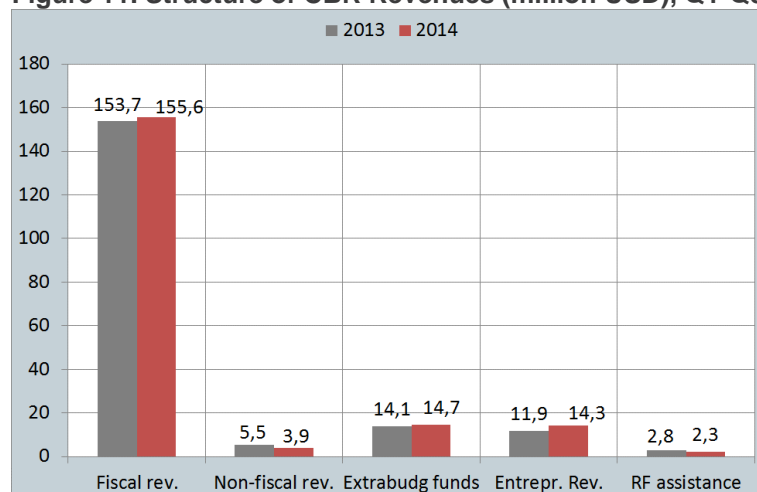
Thanks to the economic growth registered in the first half of the current year, the budgetary revenues were collected according to the plan. However, the moderation of the growth rates in the second half of the year and the maintenance of the pessimistic growth perspectives influenced the final figures of the new budgetary and fiscal policy on the medium term, approved for the next three years. The regional authorities continue to consolidate the expenditures, with the purpose to decrease the budget deficit and domestic debt.

Analysis of Key Developments and Trends

In the first three quarters of the current year, the budgetary revenues increased significantly against the previous year. Thus, the total revenues were USD 217.3 million (2412.5 million rubles), which constitutes 101.7% of the plan for this period and an increase of 15.6% y-o-y. These revenues include the humanitarian assistance from the Russian Federation and the revenues from the issuance of bonds by "Ministry of Finance" in the amount of USD 20.6 million (228.7 million rubles). In addition, in order to cover the deficit, loans were contracted in the amount of USD 47.9 million (531.4 million rubles).

From the structural point of view, the revenues increased for most of the financing components, if compared with the previous year. As shown in Figure 11, during the first 3 quarters of 2014, the tax revenues, which have a share of 72% of total budgetary revenues, increased by 1.2% y-o-y up to USD 156 million (1727 million rubles), and in this way the revenue plan was achieved in proportion of 104.8%. But, the revenue plan was not achieved for non-tax revenues (95.3%), the off-budget revenues (93.3%), revenues from entrepreneurship activity (86.5%), despite the fact that the last two revenue sources registered an y-o-y increase.

Figure 11. Structure of CBR Revenues (million USD), Q1-Q3:14



Source: "Transnistrian Ministry of Finance"

Generally, the public budget of the region is still very unbalanced; the budgetary deficit for 2014 was planned in the amount of 29.1% of expenditures, or 11.3% of the Transnistrian GDP. The deficit is covered mainly by the loans from Transnistrian banks and the issuance of securities by "Transnistrian Ministry of Finance", that are purchased by "Transnistrian Central Bank", increasing thus the domestic debt. In 2014 the cumulative domestic debt amounted to USD 1172.5 million (13014.8 million rubles), being equivalent to 101.1% of the Transnistrian GDP. The external debt constituted USD 62.3 million, due to the loans provided by the Russian Federation during 1992-94 in the amount of USD 30.4 million and the interest



of USD 31.9 million, which has not been paid since 2000. In fact, the debt to the Russian Federation is preserved and represents another source of financial support for the region.

Due to the economic slowdown and major misbalance in the regional public finance, the tax plans were amended by amplifying the austerity measures. Thus, the Budget Law for 2015 and Medium Term Budgetary Framework (MTBF) for 2016-2017 foresee a more drastic adjustment of the expenditures against the ones planned in the MTBF of 2013. Table 1 reflects that the budgetary expenditures for 2015 are by 8.3% lower than those planned in the MTBF of 2013, and for 2016 - by 11.8% lower. Also, the values of budget deficit were also adjusted significantly, decreasing in 2015 from 11% to 9.4% of GDP, while for 2016 from 10.5 to 8% of GDP, a decrease of up to 7.2% of the Transnistrian GDP being planned for 2017. Also, the share of domestic debt in the GDP is planned to decreased to 81.4% of GDP in 2017 by introducing some growth limits, except only for the payment of domestic debt. However, the credibility of this tax scenario decreases, given the absence of some well developed fiscal rules and the discretionary conversion of social payments' obligations into domestic debt.

Table 1. Key Indicators of the Transnistrian Public Budget for the Medium Term, approved in 2013/2014 (million USD)

	2014	2015/2015	2016/2016 (e)	2017 (e)
Revenue	280.9	272.5/ 263.2	294.7/ 282.4	302.2
Expenditures	450.8	439.8/ 402.9	467.8/ 412.3	430.3
Deficit (% of GDP)	11.3	11.0/ 9.4	10.5/ 8.0	7.2
Internal debt (% of GDP)	101.1	95.5	88.6	81.4
Investments in fixed capital (% of GDP)	16.0	15.3	14.7	14.0

Source: "Transnistrian Ministry of Finance"

The planned budget consolidation is to affect first the investments, but the social expenditures could also be optimized. Thus, a cut on investments is planned, which will decrease from 16% of GDP in 2014 to 14% in 2017. However, maintaining or increasing the current expenditures at the expense of investments, undermines the sustainable growth of the Transnistrian region. At the same time, the social expenditures do not seem to be immune to the budgetary optimization either, given that over 40% of the employed population work in the oversized budgetary sector, and in 2014, the salary arrears in the educational and health care sectors have increased significantly.

Short and Medium Term Forecasts and Challenges

- The economy in the region is small and open and, hence, is very much exposed to the external conditions. Thus, the structure of budgetary revenues, which is dominated by the income taxes (20% of the revenues) and customs duties (30% of the total revenues), make the budgetary and tax policy very susceptible to external business cycles. The worsening of the economic situation in the near future could lead to the failure to implement the 2015 budget and the need to review the MTBF until 2017.
- The drastic consolidation of expenditures is pro-cyclic and will augment the economic fluctuations. In addition, the austerity measures are not distributed evenly among all groups of expenditures, with the investments in fixed capital being subject to the most significant cuts, though they represent



an acute need for the Transnistrian economy. Thus, this method to save money will diminish significantly the economic growth rates in the medium term.

- The unfriendly and unpredictable business environment along with the large share of the informal economy in the region undermine the tax base and the fiscal collections. In addition, the lack of coordination with Chisinau authorities in the fiscal area hinders the access to favourable financing sources from the international financing institutions, worsening thus the issue of budget deficit financing.

Policy Recommendations

- To cushion the effects of economic slowdown on the region's budget, the budgetary and fiscal policy should focus mainly on the extension of the tax base. This is mainly related to fostering the entrepreneurial activities, as well as introduction of VAT in the region. In this respect, it is critical to improve the business environment and to strengthen the institutional capacity of the tax authorities. At the same time, the optimization should not affect the already scarce investments in the region, but rather some budgetary sectors with excessive expenditures.
- The tax and budgetary discipline in the region could be strengthened by approving some tax regulations. Approval of regulations on capping the budget deficit and of rules to protect some expenditures groups, and first of investment, will contribute to anchoring the public finances in the model of sustainable growth of the economy.
- A measure that can strengthen the Transnistrian financing capacity is to sign contracts and to cooperate with the central government from Chisinau. Thus, new financing sources from the international institutions will open, as well as the capacities to prevent and combat tax evasion (if the tax services cooperate) will improve.



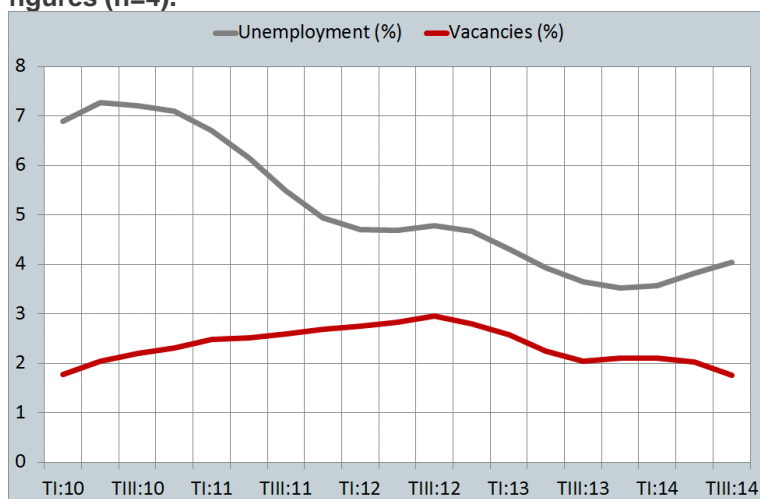
Chapter 4. Labour Market

The symptoms of economic slowdown in the Transnistrian region are reflected in the domestic labour market. Thus, the key performance indicators of the labour market began to deteriorate since Q3:13, continuing the negative dynamics throughout the current year. The bleak medium-term growth outlook and pro-cyclical policies of the regional authorities will further intensify the negative trends on the labour market.

Analysis of Key Developments and Trends

During the first three quarters of the current year, the situation on the regional labour market continued to worsen, registering negative trends for all monitored indicators. Thus, the number of employed population decreased by 0.5% y-o-y to 122 thousand people, and the number of registered unemployed increased by 29.3% during the same period up to 4,844 people, equivalent to an unemployment rate of 3.97%. The number of vacancies in the economy also followed a downward trend, reaching 1.59% of the economically active population (Figure 12). This value has been the lowest since Q4:09, the crisis year when it reached 1.60%.

Figure 12. Evolution of Unemployment Rate and Vacancies (%), mobile average figures (n=4).



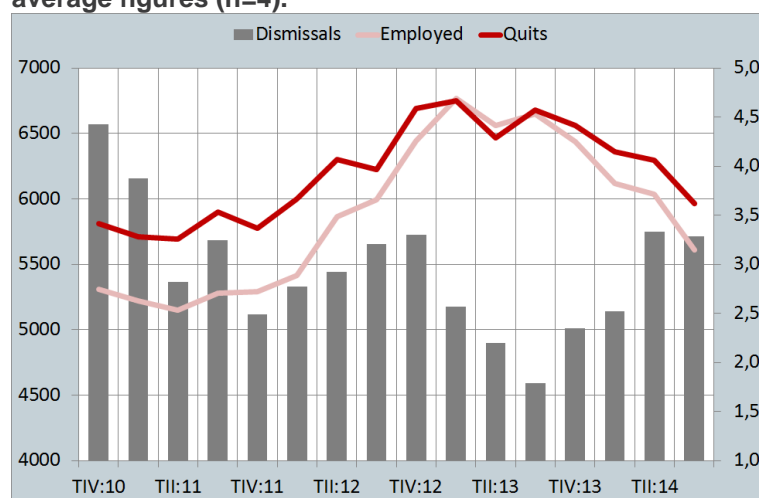
Source: "Regional Statistics Service"

Other signs of labour market deterioration are the evolution of dynamic variables, namely the number of employed and dismissed people, both of them having a pro-cyclical behaviour. Thus, Figure 13 shows clearly that since Q4:13 the number of employed and dismissed people in the regional economy has decreased continuously³. In addition, during the same period the decreasing number of dismissal was accompanied by an increasing share of resignations from 1.8% to 3.3%. Therefore, if the labour market reached dynamic balance of flows in 2013, where the numbers of employed and dismissed people were almost equal, then in 2014 the gap between these two flows began to grow again.

³If the relationship between economic growth and the number of employees is clear, then the pro-cycle nature of workers resignation is manifested by the fact that over 95% of resignations are on their own initiative and they increase with the confidence of workers in the state of the economy.



Figure 13. Evolution of the Number of Employed and Resigned People (left axis), and of the Share of Dismissed People in Total Resigned People (right axis). Mobile average figures (n=4).



Source: "Regional Statistics Service"

From the structural point of view, the negative trends of the past years continued on the labour market. Namely, during the first three quarters of the current year the share of employed population in the industrial sector decreased from 26.9% to 26.1%.⁴ The employed population moved to agriculture (+0.2 p.p.) and the service sector, mainly to transport (+0.7 p.p.) and trade (+0.4 p.p.). At the same time, the public sector remains an extremely important employer for the regional workforce. Thus, the share of people employed in the institutions completely financed by public budget accounted for 43.2% (-0.1 p.p.).⁵

Short and Medium Term Forecasts and Challenges

- The economic slowdown will continue to put pressure on the labour market, contributing to the rise in the unemployment rate, to the decrease in the number of vacancies and will undermine job creation throughout 2015. Also, the pro-cyclical monetary and fiscal policies will contribute to the expansion of these negative trends.
- A significant challenge for the regional economy is the perpetuation of the current pattern of excessive concentration of workforce in the public sector. Besides the pressures on public budget in terms of quality and quantity, the concentration of labour in unproductive sectors generates huge opportunity costs for the economy and undermines the quality of the economic growth.
- A constraint factor for the regional economy remains the underdeveloped small businesses sector, which currently employs fewer than 20% of the workforce and practically has not increased over the past years.

Policy Recommendations

- To reduce the negative effects of the economic slowdown on the labour market, the competent authorities in the region should relax the monetary and fiscal policies. The outcome of these measures will be the lower growth rates of unemployment and creating new jobs. However, the countercyclical measures will have a short-term effect and will not solve the structural problems of the labour market.
- Medium term imbalances in the structure of workforce can be solved through active policies of employment, combined with the optimization of the number of employees in the public sector. Thus,

⁴ The number of employed population does not include data from the small businesses sector (according to regional classification).

⁵ Regional Statistics for the institutions financed by public budget, including those of commercial aspect (state-owned enterprises with different legal status). The previous issue of the Regional Economic Review, indicated only the public sector share, excluding the state-owned enterprises.



upgrading and improving the retraining programs and incentive programs for the economically inactive population will help to maximize the number of workers in the real sector of the economy.

- The reform of the education sector, which employs about 21% of the workforce and ranks the second in share after industry, is necessary both in terms of quantity and quality. It is obvious that the number of workers in the sector is excessive compared to the demographic realities and should be optimized. At the same time, the educational system must be adjusted to the realities of the market economy, and it would be appropriate to establish relations of cooperation between educational institutions of both banks of the Nistru River for exchange of experiences and programs.



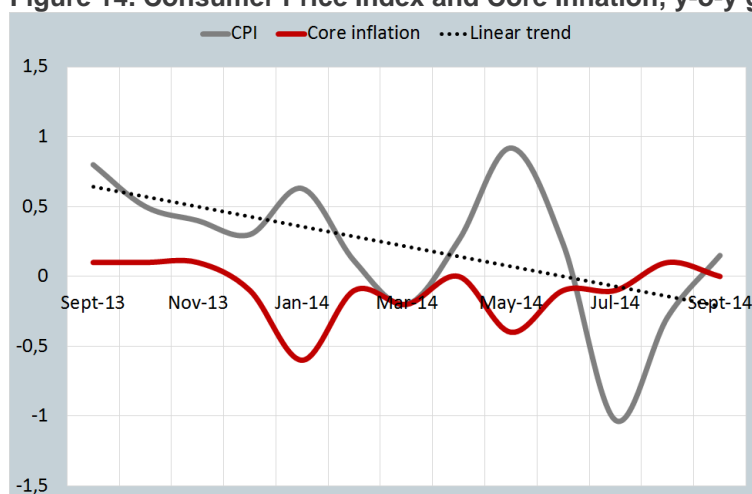
Chapter 5. Prices and Monetary Policy

The economic slowdown and the lower consumption fostered the risk of deflation, which affects adversely the lending and investment activity due to the increasing real interest rates. Although the currencies of the main trade partners from the region depreciated during 2014, the regional monetary authority continued its policy of fixing the exchange rate of the "Transnistrian ruble" against the USD, which affects significantly the competitiveness of domestic producers on foreign markets. Moreover, "Dniester Republican Bank" tightened its monetary policy, which could further inhibit the banks' lending activity.

Balancing between Inflation and Deflation

During this year, the Consumer Price Index (CPI) posted a very volatile development, following a downward trend. By the end of Q3:14, the Consumer Price Index in the Transnistrian region was only 0.2% y-o-y, and it was stimulated by the higher prices for some services (pre-school education services: +9.8% and household services: +0.6%). Except for these price increases, actually the region was affected by deflation. Thus, if compared to the previous year, the prices for foodstuff decreased (i.e.: goats: -0.8%; sunflower oil: -0.9%; honey: -3.2%) as well as for non-foodstuffs (tobacco products: -0.8%; fuels: -0.6%; medicines: -0.4%; IT equipment: -0.3%). The deflationary trends will continue in the coming months, due to the economic slowdown, decreasing consumption and fixing of the "Transnistrian ruble" against the US dollar in spite of the depreciation of the national currencies of the region's main importers (Ukraine and Russia).

Figure 14. Consumer Price Index and Core Inflation, y-o-y growth, %

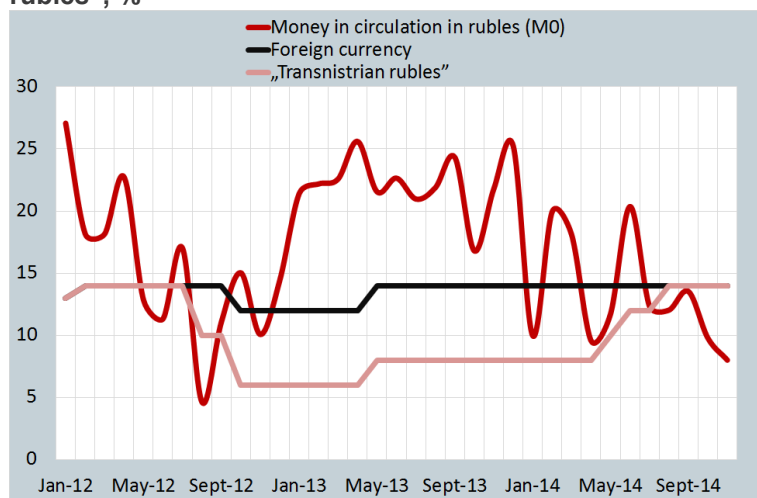


Source: "Dniester Republican Bank"

The pro-cyclical monetary policy promoted by the "Dniester Republican Bank" formed an additional factor fuelling the deflationary trends in the region. Thus, despite the economic slowdown, high uncertainty and pessimism among entrepreneurs, the monetary authority continued tightening the monetary policy, contrary to the economic logic. Thus, the requirement for mandatory reserves for deposits of legal entities held by banks in "Transnistrian rubles" was raised from 8% to 14% during 2014. At the same time, the mandatory reserves for deposits of the population was increased from 10% to 14% during 2014 for deposits in foreign currency and from only 2% to 10% for deposits in "Transnistrian rubles". These measures aimed at strengthening the banking system stability and immunity to potential economic shocks, but they forced banks to "freeze" the much larger volume of resources to the detriment of lending activity. As a result, the amount of currency in circulation had a descending trend (Figure 15).



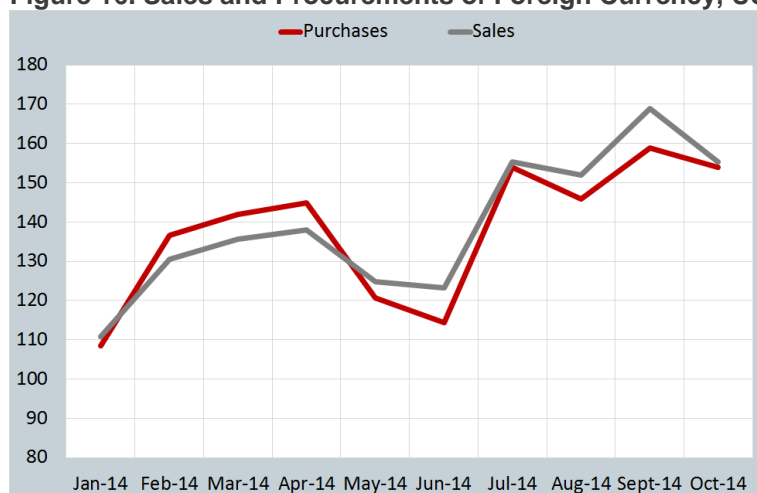
Figure 15. The amount of currency in circulation, y-o-y growth and required reserves for deposits of legal entities in foreign currency and “Transnistrian rubles”, %



Source: “Dniester Republican Bank”

The tight monetary policy was also supported by a foreign exchange policy that fixed artificially the exchange rate of the “Transnistrian ruble” to USD at 11.1 “rubles” for 1 USD. Given the depreciation of the currencies of the region’s main trade partners (Russia, Ukraine, Republic of Moldova) against the USD, the administrative maintenance of the exchange rate undermines the competitiveness of the local producers on both local and external markets. However, we should mention the surprising evolution of the foreign exchange market in the region in the second half of the current year, when the amount of foreign currency sales started to exceed the procurements. Perhaps, this phenomenon was caused by the currency inflows from the exports of Moldavian Metallurgical Plant, which resumed its activity in 2014, as well as by the new tranches of financial support from the Russian Federation. This certainly provided valuable time out for monetary authorities concerning the fixation of “Transnistrian ruble”, unlike the first half of the year when there were clear pressures of currency depreciation (Figure 16).

Figure 16. Sales and Procurements of Foreign Currency, USD million



Source: “Dniester Republican Bank”

Short and Medium Term Forecasts and Challenges

- The exchange rate of the “Transnistrian ruble” cannot be maintained artificially forever on the background of depreciating national currencies in the neighbouring countries. This could result in a rapid depreciation once the monetary authority does not have sufficient resource to maintain the fixed exchange rate. In a difficult economic context, with unfavourable forecasts, the fixing of the



"Transnistrian ruble" against the US dollar will require much more resources, which will be a major challenge for "Dniester Republican Bank" in the near future.

- The effects of pro-cyclical monetary policy cannot be beneficial for the economy. Tightening the monetary policy with the help of such a harsh mechanism as the mandatory reserves rate could affect negatively the commercial banks' lending activity. In this context, the access of enterprises, in particular the small and medium ones, to bank loans will worsen in the near future. The disinflationary trends aggravate this problem due to increasing loans' real interest rates.

Policy Recommendations

- Although the policy of fixing the exchange rate of the "Transnistrian ruble" to USD avoids the undesirable nervousness on local the foreign exchange market, this policy needs to be rethought in terms of its sustainability. "Dniester Republican Bank" should ensure a graduate and controlled depreciation of the "Transnistrian ruble" in order to increase the competitiveness of local producers and to finance, at least partially, the huge account deficit in the region. The disinflationary trends outlined in the last period, coupled with the depreciation of the national currencies from neighbouring countries provide a favourable economic and political environment for such a decision. A notable fact is that keeping at any cost the exchange rate is not sustainable in the long run, given that the currency reserves from the region do not cover even one month of imports (the convention rule foresees a minimum of 4 consecutive months of imports), and the economic situation is worsening.
- Pro-cyclical monetary policy involves great risks, especially in the context of a difficult economic environment, both internally and externally. In order to ensure the necessary conditions that would encourage lending to small and medium-sized enterprises, the monetary policy should be relaxed. In this respect, the mandatory reserves rate should be gradually lowered to the levels from the beginning of this year. On the one hand, this would mobilize additional resources of banks, that could be channelled into the real sector, and on the other hand, would manage the disinflationary pressures, reducing the real interest rates on loans.



Chapter 6. Banking System

The banking system in the Transnistrian region remains one of the few relatively stable sectors of the regional economy. However, if in the short run, the system remains profitable, with a sufficient level of capitalization and abundant liquidities, then in the long run, its resilience is exposed to some worrisome trends. During the period under review, the lending growth rate continued to slow down, while the volume of attracted deposits decreased. The portfolio quality worsened significantly, which was reflected both in the increasing volume and rate of non-performing loans and in the significant increase of allowances for loan losses. As a result of institutional changes that occurred in the middle of this year, the number of banks in the region decreased by 1 unit, the management of the largest bank in the region took control of the capital of a smaller bank, thus contributing further to the increased concentration level of the banking system in the region.

Analysis of Key Developments and Trends

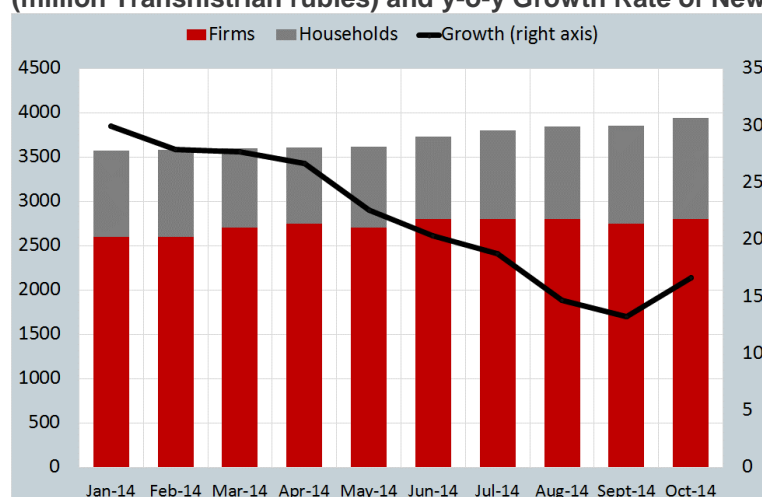
Despite the fact that during 2014, the banking system in the Transnistrian region was relatively stable, some worrisome trends that could undermine this stability in the next year emerged. During the first 3 quarters of this year, the total capital of the banking system in region declined by 3% against the volume recorded at the beginning of this year. The decrease was caused by the redistribution of profit and payment of dividends. However, this level remained almost the same against the same period in the previous year, registering a 0.5% decrease. Although the total volume of the capital in the region remains relatively stable, its structure registered some changes due to the fact that “Agroprombank” undertook control over the capital of the “Tirotex Bank”, and as a result the level of capital concentration increased, reaching 47.1% for “Agroprombank”.

Overall, the system remains sufficiently capitalized: the coverage level of deposits by capital constituting 25.2% and risk weighted capital adequacy - about 66.7% (about 8.3 times higher than the minimum required), that represents by 6.4 p.p. less than the level at the beginning of the current year. The liquidity level remained high, in Oct:14 the loans covered only 70.5% of the attracted deposits, thus during the whole year a significant unexplored potential of the banks from that region was maintained.

On the background of worsening economic situation in the region, as well as in Russia and Ukraine, a continuous decline in the lending activity is registered. If in the first half of the year the volume of new loans increased at an average rate of 26% y-o-y, then during Jul-Oct:14, the growth rate decreased to 16% y-o-y, followed by a descending trend (Figure 17). Most of the new loans were provided to the real sector of the economy, constituting 71.6% of the total in the first 10 months of 2014. The total volume of lending increase solely due to consumer loans provided to population, which grew by 25.9% y-o-y, while the loans provided to companies decreased by 6.9% y-o-y, and were directly affected by the economic instability in the region.



Figure 17. Volume of New Loans Provided to Companies and the Population (million Transnistrian rubles) and y-o-y Growth Rate of New Loans (%)

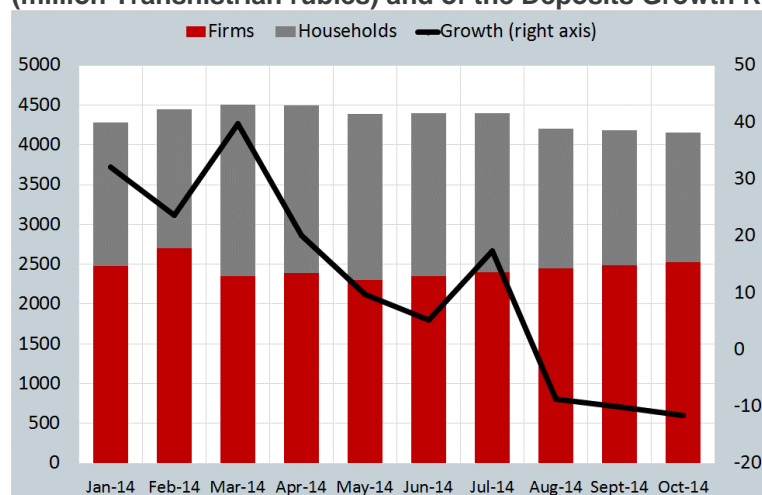


Source: "Dniester Republican Bank", EXPERT-GRUP estimations

Due to the lower income earned by the population and business entities, the volume of bank deposits decreased as well. In the first 4 months of the year, the volume of deposits increased by an average of +30% y-o-y, during May-Oct:14 the average growth rate was about of 0% y-o-y, while in August, September and October the volume of the attracted deposits shrank. Generally, after 3 quarters, the total volume of deposits shank by 9% y-o-y and stagnated against the level at the beginning of this year.

The reduction of the deposits is mainly due to the deposits attracted from the population, which decreased in the first 9 months of this year by 9.5% against the beginning of the year, while the deposits attracted from the legal entities registered a slight increase of +1.9%, in the same period (Figure 18). The reduction of volume of deposits attracted from the population and, at the same time, the increase in the volume of loans provided to the same customers reveals that the purchasing power of the population in the region worsens.

Figure 18. Dynamics of the Increase in Deposits of Individuals and Legal Persons (million Transnistrian rubles) and of the Deposits Growth Rate y-o-y (%)



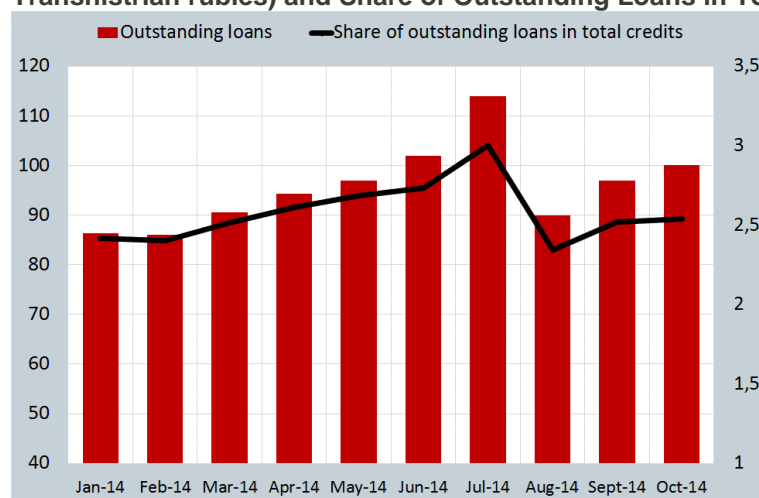
Source: "Dniester Republican Bank", EXPERT-GRUP estimations

The worsening financial situation of companies and the population contributed to the increase in the outstanding loans. In the first 3 quarters of this year, the volume of outstanding loans exceeded the growth of new loans (123.1% versus 110.3%, compared to the beginning of the year). In October 2014, the volume of outstanding loans accounted for 2.5% of total loans (Figure 19). The portfolio quality worsened mainly due to the credits provided to legal entities, where the share of the outstanding loans increased by



+32.4% against the value recorded at the beginning of this year. The loans provided to the population registered a smaller but still significant increase of +9.3%.

Figure 19. Dynamics of the Lending Volume and Outstanding Credits (million Transnistrian rubles) and Share of Outstanding Loans in Total Loans (%)



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

High growth rates of outstanding loans impacted also the quality of the entire bank loans portfolio.

The share of non-performing loans reached the rate of 5.4%, while the volume of non-performing loans increased by 14.8% more than the level registered at the beginning of this year. Due to the worsening quality of the portfolio, the banks from the region were forced to increase the volume of allowances for loan losses, that registered an increase of +34.1% against the beginning of this year. Respectively, a larger volume of bank resources were "frozen", with adverse effects on subsequent lending activities.

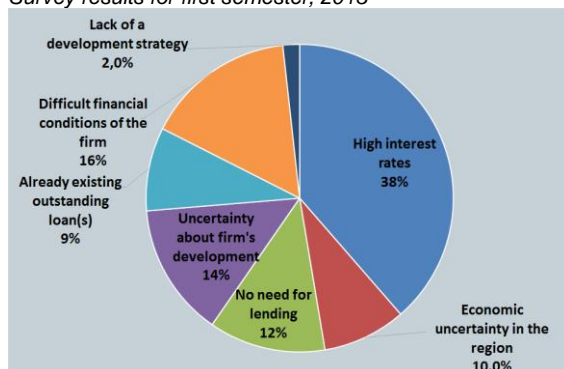
The portfolio quality worsened mainly due to the diminishing corporate revenues, which were affected both by the lower purchasing power of the population, and the failure of some Ukrainian suppliers to meet their obligations towards the companies in the region. According to the results of a questionnaire based on the responses of 40 largest industrial enterprises from the Transnistrian region, 70% of respondents stated that the unstable situation in Ukraine affected directly the activity of their companies.

On the background of worsening portfolio quality, lower volumes of attracted deposits and decreasing lending activity, the banking margin stayed relatively high. On 1 October 2014, it constituted 11.1 p.p., about three times higher than the optimal level. This was caused by the higher interest rates for some bank loans, which affected even more the access of the real sector to loans. According to the questionnaire run on 40 managers of the most important companies from the region (previously mentioned), at least 39% of the interviewed enterprises reported the high interest rates as the main factor that prevents them from taking bank loans (Figure 20). Another factor is the economic unpredictability in the region: one in five companies from the region is reluctant to take a bank loan due to this reason.



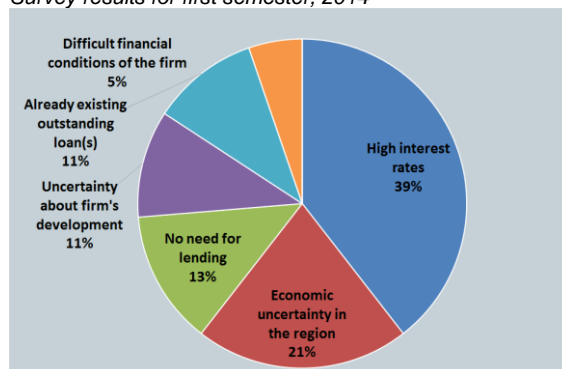
Figure 20. Factors that Hinder the Access to Bank Loans for Transnistrian Companies, survey conducted in the first half of the current year

Survey results for first semester, 2013



Source: "Dniester Republican Bank"

Survey results for first semester, 2014



Source: "Dniester Republican Bank"

The increasing economic volatility is the main factor that affected the companies' access to bank loans. If in first half of the 2013 only 10% invoked that the economic uncertainty in the region is one of the major barriers in the access to bank loans, then in 2014 this percentage has doubled, constituting 21% of the interviewed managers. This denotes the vulnerability of companies and banks to the decreasing internal and external demand in the region, as well as the high level of uncertainty that makes companies even more reluctant to launch investment projects in the region and banks reluctant to finance such projects under current economic conditions.

Short and Medium Term Forecasts and Challenges

- The isolation of the banking system from the rest of the country will impact even more the activity of the Transnistrian banks, in the context of an obvious intensification of the inter-banking activities during the last months. The current financing is both a short-term challenge for the system and an unexplored financial opportunity, given the isolation of this region.
- The rapid worsening of the loan portfolio quality creates both challenges related to the enforcement of non-performing loans, and pressures on banks budgets, that already must increase significantly the volume of allowances for credit losses.
- The high assets concentration is another problem of the Transnistrian banking system. After "Agroprombank" took control over the assets of "Tirotex Bank", the number of institution in the system decreases from 7 to 6 banks, thus increasing the concentration in the sector, to the detriment of competition.
- In 2015, the lending volumes could stagnate, and the quality of the banking portfolio could worsen. The main underlying causes are related to the worsening economic situation in the region, the population's reluctance to consume and the companies' reluctance to invest, and the adverse selection of banks in the context of unclear internal and external economic conditions.

Policy Recommendations

- The demand for bank loans in the region is very high. According to the survey, only 13% from the interviewed companies declared that they do not need bank lending. Respectively, the Transnistrian region has a significant lending potential, which is yet unexplored, mainly due to high loans cost. This could be harnessed, if the authorities and banks in the region followed 3 main priorities: (i) increase the competition in the sector, by eliminating entry barriers and increasing transparency in the bank activity; (ii) harmonize the regulation principles and prudential norms from the sector with those on the right bank of the Nistru River - which will solve the problem related to isolation and non-recognition of the banking system in the region and, respectively, will increase the banks' access to additional sources and will stimulate lending; (iii) improve the banks' internal procedures, prioritizing the corporate governance, assessment of creditworthiness of current and potential debtors and development of collecting and restructuring procedures for non-performing loans.



- The increasing share of non-performing loans in the banks portfolios, trend that emerged in 2014 and will continue in 2015, determines the stringent need to strengthen the banks' internal procedures. In order to prevent accumulation of non-performing loans, the banks need to improve the assessment of potential debtors (e.g.: analysis of the bankruptcy probability, detailed analysis of the business plans and of the financial stability of potential debtors). At the same time, in order to ensure a more rapid restructuring of non-performing loans, banks should improve the enforcement of non-performing loans.



Chapter 7. Foreign Sector

The economy of the region depends crucially on foreign markets, both in terms of export markets, especially for industrial products (EU market), and imports of energy resources, raw materials and consumer goods (CIS market). If 2014 showed the advantages of this dependence on foreign markets, then 2015 and especially 2016 will reveal the costs of this exposure. Thus, in 2014, in spite of the worsening internal economic situation, the exports increased significantly when the Moldavian Metallurgical Plant resumed its operation, which accounts for approximately one-third of the total exports and has the European Union as the main sales market. At the same time, with the worsening of the economic conditions in Ukraine and the Russian Federation and with the depreciation of the national currencies from these countries, in conjunction with the lower growth rates of exports to EU, the exports and the entire economy will slow down. Additional risks are stemming from the denunciation of the Association Agreement by the regional authorities, which could lead in 2016 to the loss of the most important sales market for the companies from the region and could lead to economic self-isolation.

Analysis of Key Developments and Trends

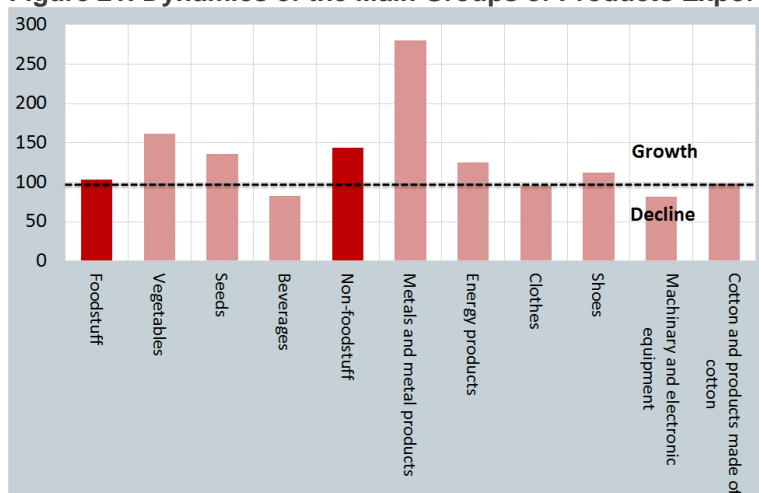
During 2014, the decrease of domestic demand in tandem with the resumption of the operation of the Moldavian Metallurgical Plant made exports grow faster than imports. During Jan-Oct:14, the volume of exports from the Transnistrian region amounted to USD 623.3 million⁶, by 37.3% higher y-o-y. At the same time, the imports amounted to USD 1347.4 million, having increased only by 5.8% y-o-y. As a result, the trade imbalances marginally decreased: the coverage level of imports with exports increased up to 46.3% comparing to 35.6% during Jan-Oct:13.

The explosive growth of exports in 2014 is temporary, being determined by the compensation of losses caused by the suspension of the operation of the Moldavian Metallurgical Plant activity last year. The exports growth in 2014 was determined by the higher sales of metals abroad (2.8 times higher in Jan-Oct:14 y-o-y), which accounts for one-third of total exports and is the most important category of the exported products by the companies from the region. The exports were also driven by the electricity supplies on the right bank of the Nistru River: total exports of energy resources, which constitute 23% of total exports, by 24.6% higher in Jan-Oct:14 y-o-y. Both the metallurgical and energy industry registered compensatory growth, considering the fact that in previous year they decreased significantly: in Jan-Oct:13, the exports of metals shrank by 57.3%, while energy products - by 28.4% y-o-y. Therefore, more than half of exports in 2014 increased due to very low comparison base, and in 2015, most probably, they will stagnate. Thanks to favorable climate conditions, the exports of vegetables also increased (+61.6% y-o-y) and seeds (+36.2% y-o-y). However, these trends are also temporary, considering the forecasted worsening of the weather conditions for 2015 and lower prices for the agricultural and food products at the regional markets. At the same time, low foreign demand in 2014 led to decreasing exports of clothes (-4.3% y-o-y), cotton fibres (-1.4% y-o-y) and electrical machines and devices (-18.2% y-o-y).

⁶However, if we exclude the sales of the left bank of the Nistru on the right bank (mainly electricity), which cannot be regarded de jure as exports, the total volume of exports during Jan-Oct:14 amounted to about USD 381 million.



Figure 21. Dynamics of the Main Groups of Products Exported in Jan-Oct:14, y-o-y, %

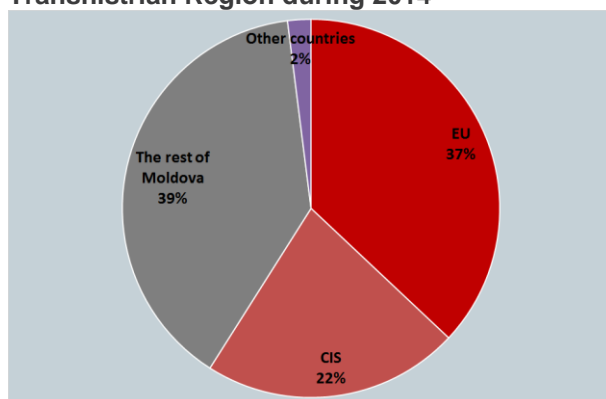


Source: "Dniester Republican Bank"

The increase of exports in 2014 was determined by the sales to the European Union market, which strengthened its position as the main sales market of the companies from the Transnistrian region.

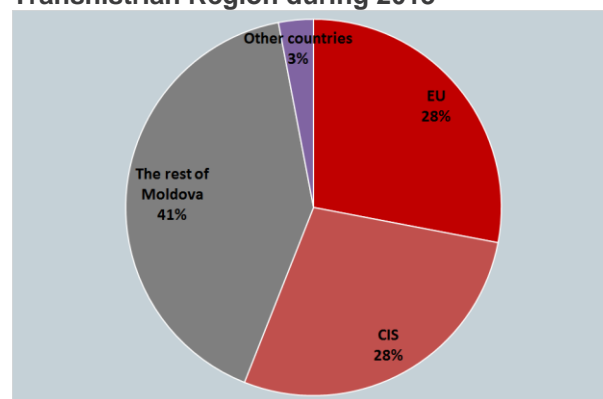
The explosive growth of exports to Romania (2.4 times y-o-y) and Poland (5.7 times y-o-y) had the largest contribution to the export growth during Jan-Oct:14, that have a cumulative share of 22.3% of the total volume of exports. Most of these sales were due to the resumption of the work of the Moldavian Metallurgical Plant, which ensures about one-third of the region's exports, with the European Union being the main market. As a result, the EU share in total exports increased from 28% in Jan-Oct:13 to 37% in Jan-Oct:14, while the CIS share (without deliveries on the right bank of the Nistru) decreased from 28% to 22% in the same period of time (Figure 22 and Figure 23). It is important to note that if we exclude the sales (mainly of electricity) on the right bank of the Nistru, that cannot be considered as de jure exports, the EU share in the total exports from the Transnistrian region, during Jan-Oct:14, accounted for 61%, and recorded an increase, if compared to previous year (48%). Hence, it is the most important sales market for companies from the region.

Figure 22. Structure of Exports from the Transnistrian Region during 2014



Source: "Dniester Republican Bank"

Figure 23. Structure of Exports from the Transnistrian Region during 2013



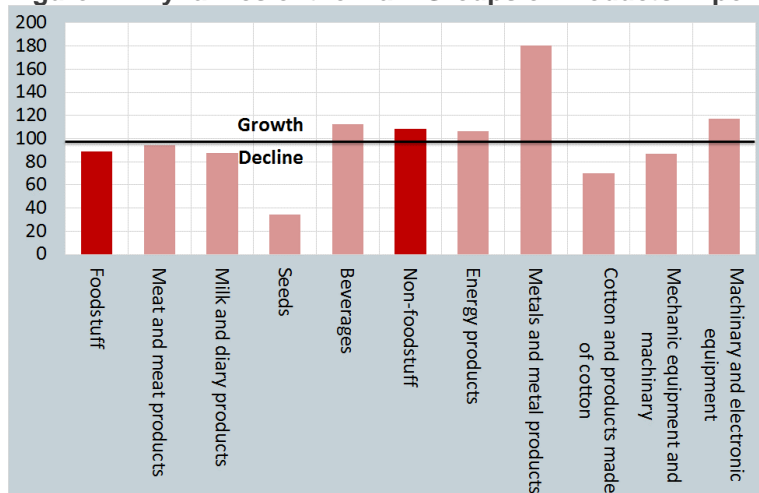
Source: "Dniester Republican Bank"

The dynamics of imports reflect the slowdown in economic activity in the region, amid decreasing population's propensity to consume and companies' appetite for investments. During Jan-Oct:14, the total volume of imports increased only by 5.8% y-o-y, and it was determined by an increase of the necessary inputs for metallurgical industry. Thus, the imports of metals and metal products increased in the same period by 81%, while the imports of energy resources - by 6.5% y-o-y. In the same period, due to the decreasing consumption, the imports of foodstuffs shrank by 11.3%, in particular after the decrease in imports of meat and meat products (-5.7% y-o-y) and dairy products (-12.7% y-o-y). At the same time, the



decreasing exports of textile and cotton products also shrank the demand for raw materials from these companies (the imports of cotton and cotton products decreased by 30% y-o-y).

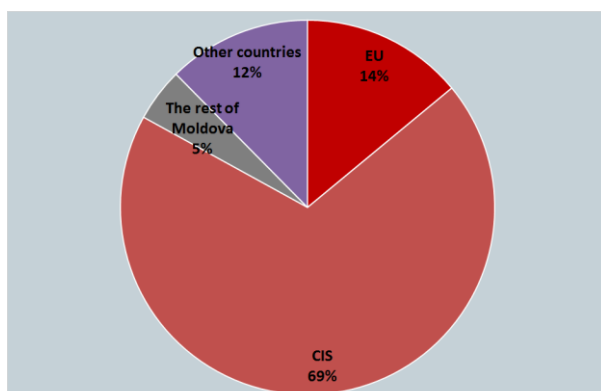
Figure 24. Dynamics of the Main Groups of Products Imported in Jan-Oct:14, y-o-y, %



Source: "Dniester Republican Bank"

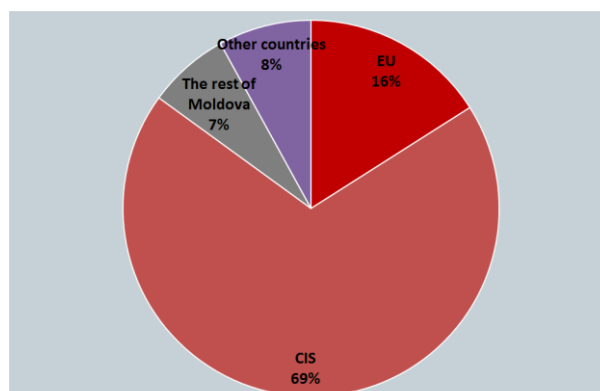
While in terms of exports, the Transnistrian region is dependent mainly on the EU market, in terms of imports, the CIS market plays a more significant role. In Jan-Oct:14, the share of imports from CIS was 69%, as in the previous year. The cause for such an acute dependence on CIS is related to the imports of energy resources from Russian Federation, that constitute about 45% from the total volume of imports. Thus, with the revival of metallurgical activity, the import from Russian Federation also increased by 15% y-o-y. At the same time, on the background of economic and security crisis in Ukraine, as well as with the tightening controls from the Transnistrian region on the Transnistrian border area between Moldova and Ukraine, the imports from Ukraine decreased by 26% y-o-y. This situation is based on the decrease of the local demand and increase of impediments for small and medium business, which was affected the most by the Ukrainian crisis.

Figure 25. Structure of Imports from the Transnistrian Region during 2014



Source: "Dniester Republican Bank"

Figure 26. Structure of Imports from the Transnistrian Region during 2013



Source: "Dniester Republican Bank"

Short and Medium Term Forecasts and Challenges

- In 2015, the export will have a less impressive dynamics if compared to 2014, with an expected growth of only 3-5%, given the fragile external demand. The main cause is related to the economic recession, expected in Russia and Ukraine in 2015, as well as the slow recovery of the EU economies. In addition, the less favourable climate conditions for 2015, in conjunction with the



decreasing price indexes at the international agrifood markets will negatively affect the exports of the agrifood products. At the same time, the volume of imports could stagnate in 2015, on the background of lower consumption and export slowdown.

- A fundamental challenge remains to be the huge deficit of the current account, which is estimated to be at about 90% of the Gross Domestic Product of the region in 2014. The main source of these imbalances results from the trade transactions with CIS and, in particular, from the imports of energy resources from Russian Federation. Thus, trade relations with the Russian Federation create about 75% from the total current account deficit. At the same time, the region has a surplus of the current account in relation to the European Union. In this way, the trade with EU contributes to the partial compensation of the macroeconomic imbalances from the region. Nevertheless, the exports do not cover even a half of the total volume of imports, causing a huge current account deficit. It would be rather impossible to maintain it without the support (direct and indirect) from the Russian Federation, at least through three channels: (i) direct financial support; (ii) energy subsidies; (iii) maintenance of stability of the “Transnistrian ruble”.
- In the context of the worsening economic situation in Russia, its financial possibilities also decrease, considering also the need to finance the Crimea region. As a result, in the long run, there is the risk of lower financial support from the Russian Federation, which endangers the macroeconomic stability in the region. The problem is worsened also by the region’s continuously increasing needs of financing, given the inflation, population aging and the narrowing tax base. Another risk, which emerged in 2014, is related to the depreciation of Russian ruble against US dollar and against the “Transnistrian ruble”. On 31 October 2014, 1 Russian ruble was equivalent to 0.25 “Transnistrian rubles”, and it was depreciated by 30% if compared to the same period of the previous year. This erodes the volume of financial support from the Russian Federation with a negative impact on the financing the budgetary sector, which also explains the increase of the salary arrears from the budgetary sector from this year (Chapter “Domestic Demand”).
- Further denunciation of the Association Agreement with the EU is another major risk to macroeconomic stability in the region. The cause is related to failure to implement the Association Agreement provisions, which will force EU to abolish the regime of Autonomous Trade Preferences for the companies from the Transnistrian region and to impose import duties for products originating from this region. This could increase the costs by 12%-17% for most of the items exported from the region to EU, depending on the product category, and thus, it affects significantly the companies’ competitiveness on the community market. Besides the implementation of tariff barriers, non-tariff barriers also will be implemented on the EU market, in particular, in the form of quality standards. Therefore, the denunciation of the Association Agreement will contribute to the region’s economic self-isolation and to the loss of the most important markets for Transnistrian companies.

Policy Recommendations

- Tiraspol authorities together with companies from the region should come to a Pareto optimal compromise between the economic interests, i.e. maintaining the EU market, and (geo)political interests, i.e. keeping close to the Russian Federation. Ignoring the economic interests could lead to the loss of the most important sales market for the region and, respectively, could compromise the efforts made so far by the companies to increase their presence and to maintain themselves on that market. At the same time, the Russian market and even the entire market of CIS will not be able to substitute the community market due to much smaller dimensions, worsening of the economic conditions in Russia and Ukraine, depreciation of national currencies of these countries and different peculiarities of the demand in this region. The compromise between economic and political interests could result from the technocratic and, respectively, depoliticized approach to the implementation of the Association Agreement.
- The technocratic approach of the Association Agreement implementation implies, first, that the region authorities are able to keep close contact with the Russian Federation and at the same time to cooperate with the Chisinau authorities on the most important technical dimensions of the Agreement. This means approving the community standards, upgrading the quality infrastructure, compliance and verification of the rules of origin, harmonization of tax and statistics systems, increase in transparency of state aid schemes provided to companies etc.



- Chisinau authorities should use motivational leverages to encourage companies and authorities from Tiraspol to implement the Association Agreement with EU. In this regard, it is necessary to provide more information to the region's population, companies and authorities about the provisions of the Association Agreement, to facilitate the technocratic dialogue between authorities from both banks of the Nistru River, as well as to ensure an easy and transparent process of receiving export licenses by companies (if companies comply with the legal requirements).



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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;
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