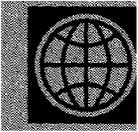


Report No. 17886-MD

Republic of Moldova Economic Review of the Transnistria Region

June 1998

Europe and Central Asia Region



Document of the World Bank

Currency Equivalents

Lei

TR – Transnistria Ruble

(local currency of the Transnistria region)

1995 (annual average)

US\$1.00 = Lei 4.49

US\$1.00 = TR 61,300

1996 (annual average)

US\$1.00 = Lei 4.60

US\$1.00 = TR 410,083

1997 (annual average)

US\$1.00 = Lei 4.62

US\$1.00 = TR 650,417

January 1998

US\$1.00 = Lei 4.71

US\$1.00 = TR 680,000

ACRONYMS AND ABBREVIATIONS

CIS	Commonwealth of Independent States
ECA	Europe and Central Asia Region
FSU	Former Soviet Union
GDP	Gross domestic product
GOM	Government of Moldova
NBM	National Bank of Moldova
OGRF	Military contingent of the Russian Federation in Transnistria
OSCE	Organization for Security and Cooperation in Europe
PREM	Poverty Reduction and Economic Management Unit at ECA
PRM	Parliament of the Republic of Moldova
SME	Small and medium-size enterprises
TDS	Transnistrian Department of Statistics
TRB	Transnistrian Republican Bank
TSS	Transnistrian Supreme Soviet (regional Parliament)

FISCAL YEAR

January 1 – December 31

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**REPUBLIC OF MOLDOVA: ECONOMIC REVIEW OF THE TRANSNISTRIA
REGION**

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PREFACE

- i. This report presents an analysis of the quantitative and qualitative information on the economic situation in the separatist Transnistria region of Moldova. The necessity to produce the report was dictated by the current lack of information on the state of the economy of this important region of Moldova because of political tensions between the two parts of the country and the still undefined status of the region. Currently official publications do not include data on Transnistria with very few exceptions.
- ii. The Bank team collected, systematized, and analyzed economic data provided both by the Government of Moldova and the Transnistrian authorities. An attempt has been made to perform comparative analysis in some key areas, although the analysis is certainly incomplete and in most cases is based on rough estimates rather than on detailed statistical data with the notable exception of the 1997 Household Budget Survey. The Bank team was not able to verify the data through field visits. In addition, it is clear that the informal economy is quite active in Transnistria and unlikely to be reflected fully in official statistics. The report does not incorporate analysis of developments during the first half of 1998, including the sharp fall in the Transnistrian ruble in March which may have had an important impact on purchasing power and living standards. Therefore, the conclusions presented are incomplete and, in many instances, subject to confirmation of the underlying data. However, it is hoped that this analysis will foster a better understanding of the economic situation in the Transnistria region and the problems likely to be encountered on the way to the economic reintegration of Moldova.
- iii. The report was prepared by a team from the World Bank resident mission in Moldova. The team members were James Parks (team leader), Elena Nickulina, and Marina Prodan.
- iv. The Bank team is grateful to the Government of Moldova - in particular, Mr. Ion Gutu, former Deputy Prime Minister, as well as to the authorities of the Transnistria region for invaluable support. Information was provided by the following organizations: the Ministry of Economy and Reforms of Moldova, the Department of Statistics of Moldova, the National Bank of Moldova, the Transnistrian Department of Statistics, the Transnistrian Department of Finance, and the Transnistrian Republican Bank.
- v. The peer reviewer was Arup Banerji (ECA, PREM Economist). The Sector Leader was Hafez Ghanem and the Country Director was Roger Grawe.

EXECUTIVE SUMMARY

I. Since 1992, the Transnistria region, an economically important part of the Republic of Moldova located on the east bank of the Nistru river, has suffered self-imposed isolation from the rest of the country and, for the most part, from the world at large. This isolation arose as a consequence of unsettled conflict in which ethnic and language factors exacerbated the marked differences in approach to economic reform.

II. In Soviet times, Transnistria was considered the most economically developed region of the Moldovan Soviet Republic. According to rough calculations, it accounted for more than a quarter of the republic's gross domestic product (GDP). It produced more than a third of total industrial output, including about 90 percent of electricity, all steel and rolled metal, and most heavy industrial equipment, construction materials, and light industrial products. Transnistria's contribution to agricultural output was less important (about 10–15 percent), but agriculture was more productive compared with that of the rest of the republic. Due to its geographic location, the region has always been a natural hub for Moldova's trade with the east in respect to both land transportation and energy pipeline connections.

III. The Transnistrian conflict has considerably complicated Moldova's transition to a market economy. Disintegration of the internal market has weakened the economic potential of the country. Already extremely high dependence on energy imports has deepened. Competitiveness of exports has suffered as use of the most convenient transport routes to major export markets has been blocked for the majority of economic agents. De facto separation and lack of structural reforms in the Transnistria region have provided a large window for opportunity for various forms of shadow economic activities. Moldovan authorities have repeatedly expressed concern about governance problems arising from the Transnistria situation, including numerous cases of unrecorded foreign trade, tax evasion, and smuggling resulting from the lack of effective control over the eastern border with Ukraine. Compounding the tangible economic damage has been the negative effect of the conflict on the image of Moldova in the eyes of the international community; this has hurt its chances of competing for new markets, making new trading partners, and attracting foreign investors.

IV. Transnistria's move towards isolation was manifested in a number of radical steps taken in 1992–93 to establish separate economic institutions. The Transnistrian Republican Bank (or the Transnistrian central bank, TRB) issued a separate currency that is not recognized outside the region. Fiscal policy is also managed independently from the rest of the country. The region has established its own customs service and maintains a distinct trade regime. Trade with the west bank territory of Moldova is treated as foreign trade. Although division of the energy sector, which is crucial for the whole country due to its dependence on imported energy resources proved to be impossible, coordination between the two parts of the country is limited. The fundamental legal framework for market economy adopted by Moldova in recent years has not been accepted by the Transnistrian authorities and does not function in the region. No statistical data have been provided officially from the Transnistria region to Moldovan authorities since 1992.

V. It would be wrong to say that the central planning system has remained unmodified in the Transnistria region. Although no official program of market reforms has been implemented in Transnistria, the regional authorities did not cancel liberalization measures already undertaken in Moldova before separation. Furthermore, they have attempted to introduce some new, select elements of a market economy while maintaining many aspects of the old Soviet style economic system. In addition, in several areas de facto liberalization took place during the initial period of

economic chaos and lack of supervision by regional authorities. The majority of prices are now free of controls and the foreign exchange market is developing. Commercial banks operate actively and new private firms have begun to emerge. The actual trade regime is much more liberal than the one proclaimed officially as a consequence of weak customs controls and the unsolved problem of regulating trade relations between the east and west bank territories.

VI. Selective liberalization measures were not supported by macroeconomic stabilization and structural reform, which resulted in a severe economic crisis. For several years, monetary policy in the Transnistria region was characterized by chaotic developments and the absence of any real control mechanisms. Budgetary and credit policy remained largely a tool of politicians, who used it without regard to economic consequences. Few, if any, structural reforms have been implemented in Transnistria. Executive and legislative authorities have failed to achieve consensus on the main principles of reform, including the role of private property and the functions of the state in the economy. As a result, the public sector dominates production and distribution, and the private sector is relegated to a minor role. This stands in sharp contrast with the rest of Moldova.

VII. Starting in late 1995, the Transnistrian authorities appeared to make more concerted efforts to respond to the deteriorating economic situation. Measures were taken to keep the monetary and financial crisis from deepening further. The role of the TRB was strengthened, and a concerted effort was made to establish its control over the monetary and credit situation in the region. A tougher stance was taken in issuing new currency. The TRB refinance rate began to be adjusted to inflation and it replaced the symbolic interest rates fixed by the Transnistrian Supreme Soviet (or regional Parliament, TSS). The TRB began to intervene more actively in the foreign exchange market. Parallel measures were undertaken to reduce the fiscal deficit and to find nonmonetary sources for its financing. However, budgetary policies remained contradictory, as soft budget constraints persisted and the Soviet-type pattern of public expenditures essentially remained the same. Supervision over commercial banks was strengthened through the introduction of prudential standards and the gradual increase in required minimum statutory capital. Some steps were taken to reanimate the process of privatization. The basic legal framework for expansion of nonstate forms of ownership in the region was approved by the TSS. However, the legislators' inability to reach consensus on the implementation mechanisms resulted in the failure of most of the laws to work in practice. The authorities made visible efforts to attract foreign investors to the region. Various forms of cooperation between the Transnistrian enterprises and foreign partners were encouraged, with some modest results.

VIII. Internal measures aimed at redressing the crisis were accompanied by a number of partial steps in the direction of economic reintegration with the rest of Moldova. In 1995–97, several important economic agreements were signed between the Government of Moldova and the Transnistrian authorities, which were aimed at eliminating some of the most distortionary inconsistencies in economic regulation between the two territories. These agreements, which include, *inter alia*, measures to simplify foreign exchange and trade relations, could form a substantial basis for future economic reintegration in case of their full implementation. An agreement on the relations between the monetary and credit systems was signed in mid-1995. In particular, it envisaged official introduction of the parallel circulation of the Moldovan leu as legal tender for noncash transactions in the territory of Transnistria. The National Bank of Moldova subsequently opened a branch office in Tiraspol, which functions as a settlement center for transactions between the commercial banks of the two territories. However, Transnistrian commercial banks prefer to maintain direct correspondent relations with the banks in Chisinau, and the level of transactions channeled through the settlement center remains insignificant. A customs agreement was signed at the beginning of 1996, which envisaged the Transnistrian

authorities taking some important measures to adapt their foreign trade regime and eliminate most differences with the national trade regime. Although import tariff rates for nonfood products, tobacco, and beverages have been increased to the national levels, the greatest part of the customs agreement remains to be implemented. These agreements were followed by the signing in May 1997 of a memorandum on the principles for settlement of the conflict. The memorandum envisages a final status that would accord Transnistria a substantial amount of economic autonomy within a unified national framework. However, the timetable for reaching a final settlement remains uncertain.

IX. Although the recent efforts of the Transnistrian authorities to stop the deepening of the crisis and to upgrade economic ties with the west bank have brought partial results, the measures undertaken have not been sufficient to stabilize the economy. The deliberate policy of isolation, combined with the lack of comprehensive macroeconomic stabilization efforts and a reluctance to carry out structural reform, has resulted in major economic difficulties in the Transnistria region. Measured by most comparators, these difficulties are considerably greater than those faced by the rest of the country. After a period of accelerated deterioration in economic conditions, which reached a peak in 1995, some relative improvement occurred in 1996–97. Nevertheless, the region's economy is mired in a deep recession, and living standards have dropped sharply.

X. The monetary and financial situation remains very unstable. The region continues to suffer from high inflation, although price growth significantly decelerated in 1997. The average monthly inflation rate was below four percent in 1997, compared to more than 50 percent in 1995. In step with the inflation rate, depreciation of the Transnistrian ruble (TR) slowed down, but has not yet stopped, even with active TRB interventions. Indeed, the local ruble fell sharply in March 1998. Local economic agents generally substitute foreign currencies for the local currency. After a near collapse of the regional budget in 1995, some rehabilitation of the budgetary system has taken place, but the overall financial situation remains extremely fragile. Payment arrears have become chronic. The largest and most acute financial problem is the huge amount of accumulated external arrears to Russia for energy resources which makes up about half the energy debt of the whole country. These arrears have become, in fact, a massive subsidy to the economy of the region and a major liability for the future.

XI. Both industrial and agricultural outputs continue to decline. In 1997, industrial output was about 70 percent below the 1990 level. According to rough estimates, the relative share of the region in the Moldova's total industrial output has fallen by about 7 percentage points due to higher rates of decline compared to the west bank territory. However, at the micro level, the situation is differentiated. Amid the continuing decline in physical output of most industrial products, there are some exceptions. More favorable trends in the production of a number of products (e.g., steel, rolled metal, slate, cement) are associated with more effective management policies at a few leading enterprises. In general, these firms had better starting conditions in terms of internal organization, management and labor skills, and competitiveness. They managed to adjust more quickly when the command economy was dismantled de facto. Agricultural output has also been declining at a faster pace than in the rest of the country. The fall in agricultural output has been accompanied by a decline in yields relative to the rest of Moldova. This has resulted in a loss of a comparative advantage for many important agricultural products (cereals, sunflower, vegetables) which Transnistria used to enjoy in the Soviet times.

XII. Recession in the main productive sectors has generated high levels of hidden unemployment in the form of forced underemployment in the public sector. Even though a large part of those underemployed succeed in finding alternative jobs, the underlying unemployment rate is estimated to be at least 7 percent of the labor force.

XIII. Poor economic policies followed by a long-lasting economic crisis in the region has led to a sharp fall in living standards. In 1995–96, average wages were about 20 percent below the average for the rest of the country. In comparison, at the time of the breakup of the Soviet Union, Transnistria had better starting conditions in terms of wage levels than the west bank territory. In 1997, however, the difference in wage level practically disappeared. This is probably a temporary phenomenon, since it is primarily a consequence of administrative increases in wages decreed by the regional authorities. Indeed, the Transnistrian ruble depreciated sharply in mid-March 1998, from TR 650,000 to TR 1,200,000 per US dollar, implying a potentially important erosion in real wages. Total household revenues on average do not exceed US\$35 per capita. The urban majority of the Transnistrian population appears to be significantly poorer than the rural minority and the urban population of the west bank territory. The two major factors that probably prevented household revenues from an even deeper fall are: (a) populist social policies of the Transnistrian authorities conducted at the expense of financing the economy through the accumulation of external arrears; and (b) the availability of alternative revenue sources, including a large share of revenue earned from household agricultural production.

XIV. It is clear that the policies followed by the Transnistrian authorities of isolation and piecemeal reforms combined with heavy reliance on external subsidies are associated with high risks and are inadequate to create internal conditions for stabilization and economic growth in the region. It is true that, despite all the difficulties, the region's economy has avoided collapse so far. The following three factors are probably the major determinants behind this phenomenon: (a) de facto liberalization in a number of areas, which in many cases took place spontaneously; (b) massive external subsidy to the whole economy; and (c) partial reforms undertaken by the authorities under the danger of full economic collapse. The first two of these factors are not under the control of the regional authorities and could exert destabilizing influences in the future. Only the last factor can really contribute to the conditions for stabilization and growth in the longer term. Partial efforts to reform some elements of the economic system should be developed into a comprehensive market reform program. To achieve this, much greater effort is needed on the part of the Transnistrian authorities, particularly in the areas of macroeconomic stabilization, privatization, external trade liberalization, and general reform of the legal framework, in order to create conditions for stability, growth, and economic reintegration. Most elements of this reform program exist within the national framework already adopted by the west bank of Moldova. In practice, this framework could be readily expanded to include Transnistria while making the adjustments required to take into account the specific characteristics of the region.

XV. Economic benefits of reintegration for both parts of the country are clear. Only through economic reintegration can Moldova realize its full internal economic potential and maximize external competitiveness. For the Transnistria region, reintegration would precipitate accelerated economic reform and provide stable economic linkages with the rest of the country and the outside world, without which its tiny economy would be unlikely to survive and prosper in the long term. However, economic reintegration cannot be expected to happen by itself. The prospects depend on achieving a final political settlement of the conflict which is a great challenge facing the Moldovan Government and Transnistrian authorities. There are obviously many social, ethnic and linguistic factors to be taken into account. A strong will, as well as great effort are needed from both sides to reverse the process of separation which has developed over the last five years.

CHAPTER I

BACKGROUND

1.1. The conflict over the status of the Transnistria region within the Republic of Moldova is still awaiting a final political settlement. As a consequence of its complex history, Transnistria has developed specific ethnic and linguistic characteristics. Despite its small size, the region is of major economic importance for the country, since it is relatively more industrialized, plays a very important role in the country's energy sector, and has always been a natural center for Moldova's trade and transport links with the east. Self-isolation of the region from the rest of the country has weakened the economic potential of the country as a whole and considerably complicated Moldova's transition to a market economy.

A. HISTORY

1.2. The history of the Transnistria region of the Republic of Moldova, a strip of land located primarily along the eastern (or left) bank of the Nistru river, is complex. Prior to the revolution in 1917, this territory formed part of the Russian tsarist empire. Unlike Bessarabia (the historic name of the land between the Nistru and the Prut river on Moldova's western border), Transnistria did not join Romania in 1918. In 1924, the region was incorporated into Ukraine as the Moldovan Autonomous Soviet Socialist Republic. In 1940, it was detached from Ukraine and added to most of Bessarabia, annexed by the Soviet Union, to form the Moldovan Soviet Socialist Republic. After the Republic of Moldova gained independence as a result of the disintegration of the USSR in August 1991, deteriorating relations between the east bank and west bank parts of the country led to a tense standoff in which ethnic and language factors exacerbated the marked differences in approach to economic reform. An armed conflict followed in early 1992. Since the signing of the cease-fire in July 1992, the two sides have engaged in regular, high-level talks. The so-called Moldovan Republic of Transnistria (or Pridnestrovskaya Moldavskaya Respublika in Russian) already formally proclaimed its independence in September 1990, but has never been recognized as a sovereign state by Moldova or the international community.

1.3. Negotiations on the status of the Transnistria region are ongoing with the intermediation of Russia, Ukraine, and the Organization for Security and Cooperation in Europe (OSCE). The Russian Limited Military Contingent (OGRF), the successor of the 14th army, is present in the region. In 1994, Moldova signed an agreement with Russia on the phased withdrawal of the OGRF troops from Transnistria. However, the agreement has not yet been ratified by the Russian Duma. In 1996-97, the staff of the Russian military contingent was cut by more than half and is being reduced further. Some military equipment has already been returned to Russia and the process continues, although at a slow pace. The Russian side has repeatedly confirmed that the withdrawal of the OGRF from Moldovan soil will be synchronized with the settlement of the Transnistrian conflict.

1.4. The Government of Moldova has offered Transnistria regional autonomy under a formula similar to that agreed with the Turkish-speaking Gagauzia region in the south of the country. However, the Transnistrian authorities have been holding out for a confederation of two sovereign states. In May 1997, the Government of Moldova (GOM) and the Transnistrian authorities signed a memorandum that would form the basis for normalization of relations between the two parts of Moldova. This document is seen as an important step towards final

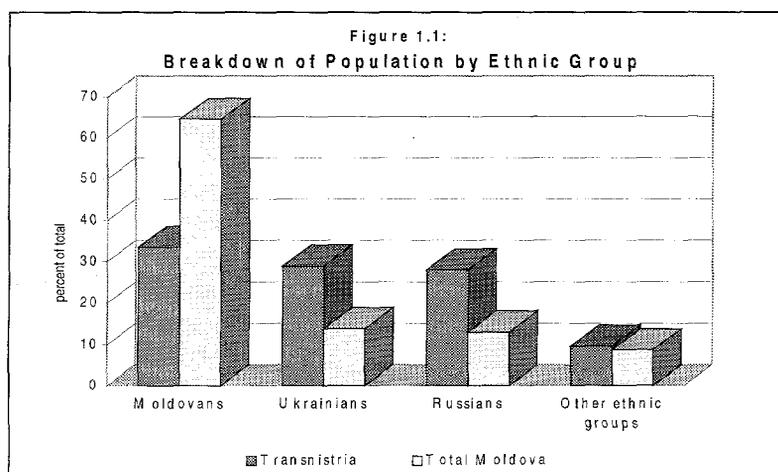
political settlement of the Transnistrian conflict. However, the timetable for reaching such settlement remains uncertain.

B. TERRITORY

1.5. The Transnistria region occupies about 12 percent of the territory of Moldova (4,200 sq. km.) and is situated in the eastern part of the country. It covers the whole area along the east bank of the Nistru River and includes some territories on the west bank. To the east, it borders Ukraine.

1.6. The territory of Transnistria is divided into seven administrative regions, among which are the two largest cities, Tiraspol and Bender, and five *rayons* (namely, Grigoriopolsky, Dubossarsky, Kamensky, Rybnitsky, Sloboziysky). Tiraspol is the capital of Transnistria and the second largest city in Moldova. Bender, Moldova's fourth largest city, is the most important west bank territory of the region and "the gateway" to Transnistria, since the main road linking Chisinau and Tiraspol with the Black Sea port of Odessa passes through the city. In total, there are four cities in the region (including Rybnitsa and Dubossary in the north), eight towns, and 140 villages.

C. POPULATION



1.7. The Transnistrian population totals about 670,000 people¹ or about 16 percent of the population of Moldova. Transnistria is an ethnically diverse region. Ethnic Moldovans represent the largest share of the population, although they constitute less than 40 percent of the total, in contrast with the rest of the country where they account for nearly 70 percent (Figure 1.1). Ethnic Russians and

Ukrainians each make up almost 30 percent of the population, and the remainder is comprised of a broad range of other ethnic groups, including Bulgarians and Tatars. Until the 1960s, Moldovans made up the absolute majority on the east bank but their proportion declined as a result of centrally promoted immigration, particularly from the Russian Federation, into the cities to man industrial enterprises. This population flow was rather large up to the 1990s, and many of today's east bank inhabitants emigrated from remote areas of Russia during the 1980s.

1.8. The languages of the three largest ethnic groups--Moldovan², with the Cyrillic alphabet, Russian, and Ukrainian--have equal "official" status in Transnistria according to local law, while the Moldovan constitution defines Moldovan as the single official state language.

¹ All data on population refer to the end of 1995.

² After independence, the Republic of Moldova re-introduced the Latin alphabet in place of the Cyrillic alphabet used in the former USSR.

1.9. The ratio of urban to rural population in the Transnistria region differs from that in the rest of the country. About 70 percent of the population lives in cities, while the average share of urban population for the entire country is 46 percent. Nearly 50 percent of the Transnistrian population lives in the two largest cities, Tiraspol (183,000 inhabitants) and Bender (128,000 inhabitants). In the Grigoriopolsky, Kamensky, and Sloboziysky rayons, most people live in rural areas.

D. ECONOMIC IMPORTANCE OF THE TRANSNISTRIA REGION IN SOVIET TIMES

1.10. Despite its small size, Transnistria is an economically important region. Although never distinguished as a separate administrative territory, it was considered the most economically developed part of the Moldovan Soviet Republic. According to the estimates of the Ministry of Economy of Moldova, before the disintegration of the USSR, the region accounted for more than a quarter of the republic's GDP. Due to its geographical location, the region has always been a natural hub of Moldova's trade with the republics of the former Soviet Union (FSU) in terms of both land transportation and energy pipeline connections.

Table 1.1: Selected Indicators for 1991

% of Moldova total

Territory	12.4
Population	17
Industrial output	38
Agricultural output	15

1.11. The Transnistria region is relatively more industrialized than the rest of the country. Prior to isolation from the rest of Moldova, it used to produce more than 35 percent of the republic's total industrial output (table 1.1). The largest power station in Moldova, Moldovskaya, is situated in the region. In Soviet times, the Moldovskaya plant generated about 85 percent of all electricity produced in the republic. Its

capacity was enough to supply electricity not only to Moldova but to neighboring Soviet republics and abroad. Moldova's single metallurgical plant was built in Rybnitsa. It is the only producer of steel and rolled metal in the republic. The largest of the country's two cement plants is also situated in Rybnitsa. In the past, this plant produced more than 50 percent of cement in Moldova, more than 30 percent of prefabricated structures and parts, and all of the slate. The largest electrotechnical and machine-building plants are concentrated in the region. In the USSR, these enterprises were important not only for Moldova, but for the whole union. A large proportion of light industry is also located in the region. All silk and cotton fabrics and more than 50 percent of footwear produced in Moldova used to originate on the east bank of the Nistru.

1.12. Transnistria's contribution to the agricultural output of Moldova is less important (it was about 10-15 percent in Soviet times). However, during the Soviet period, agriculture was more productive compared with the rest of the republic, as the best-irrigated lands were situated there. Crop yields for many agricultural products, in particular for cereals, sunflower, potatoes, vegetables, and fruits, were normally higher in Transnistria than on the west bank of the Nistru.

E. IMPACT OF SEPARATION ON THE ECONOMY OF MOLDOVA

1.13. Self-imposed separation of the Transnistria region through armed conflict has made Moldova's transition to market economy more difficult. One of the smallest FSU economies, formerly highly integrated with other parts of the Soviet Union, Moldova was actually divided into two even smaller economies. This internal shock coincided with the disintegration of the Soviet Union, the external shock of higher energy prices and loss of traditional markets, as well as the initial phase of radical price and trade liberalization, and severe natural calamities.

Altogether, these shocks resulted in one of the steepest economic declines among the FSU countries. In 1996, Moldova's GDP was nearly 60 percent below the 1991 level according to official statistics.

1.14. The Transnistria conflict has weakened the economic potential of the country as a whole. Although the armed conflict in 1992 was rather short, it brought direct losses as expenditures were diverted to military purposes and some important infrastructure was damaged, including several bridges over the Nistru. However, the most destructive consequence was that the already very small internal market of Moldova was broken into two parts, one highly specialized in agricultural production and another highly specialized in industrial production. Barriers to the exchange of goods between the two parts of the country emerged. Traditional commercial links between domestic economic agents were damaged. Private investment has suffered from the splintering of the local market, new trade barriers and the uncertainties engendered by the conflict.

1.15. As a result of the Transnistria problem, the country's already extremely high dependence on imported energy resources has increased. The loss of effective control over the major power plant by the Moldovan authorities, combined with financial crisis in Transnistria, caused the plant facilities to fall into disrepair. As a consequence, physical conditions of the plant's assets have deteriorated sharply, and a full stoppage of the enterprise is now a real possibility. In contrast to the situation during Soviet times when the republic exported electric energy, Moldova now imports more than 20 percent of its total electricity consumption from Ukraine. Additional political obstacles have emerged which are complicating the restructuring of the national energy sector. The huge energy debt to Russia, half of which is owed by the Transnistria region, has grown into a serious macroeconomic problem for the entire country.

1.16. Competitiveness of the most important exports was affected by the separation, since the most convenient transport routes to major export markets have been blocked in practice for the majority of economic agents. The unilateral establishment by Transnistria of customs stations along the "border" with the west bank territory, the destruction of several bridges across the Nistru, and the generally insecure situation on the east bank, for a long time prevented west bank companies from using the roads passing through Transnistria.

1.17. De facto separation and lack of structural reforms in the Transnistria region have provided a large window of opportunity for various forms of shadow economic activities. The Moldovan authorities have repeatedly expressed concerns about governance problems arising from the Transnistria situation. Moldova's eastern border with Ukraine remains virtually unregulated resulting in large scale unrecorded foreign trade, tax evasion, and smuggling through the Transnistrian territory. The situation is aggravated by the high level of armed crimes committed inside and outside the region by inhabitants of Transnistria (see Box 4.1).

1.18. No less important than the tangible economic damage has been the negative impact of the conflict on the image of Moldova in the eyes of the international community. Uncertainty about the future, embodied in the label of a "country of unsettled conflict" reduces Moldova's chances to compete for new markets, make new trading partners, and attract foreign investors.

CHAPTER II

ECONOMIC POLICY TO MID-1995: ISOLATION AND FAILURE TO REFORM

2.1. Since the breakup of the Soviet Union, the Transnistria region has pursued its own economic policies. These policies have been characterized by marked differences from Moldova's official approach to economic reform and restructuring. This has resulted in the isolation of the region from the rest of the country and, to a significant degree, from the world at large although economic contacts with CIS countries remain extensive. In 1992-93, a number of radical steps were undertaken to establish separate economic institutions in the region. At the same time, the macroeconomic stabilization and structural reform program launched in Moldova was not accepted by Transnistria. Nevertheless, it would be wrong to classify the Transnistrian economy as a pure central planning system. Limited liberalization efforts have been undertaken in the region. These efforts were supplemented by some further spontaneous liberalization that occurred during the initial period of economic chaos and lack of economic supervision after the armed conflict. In late 1995, both internal economic policies and the approach to relations with the west bank territory underwent some important, but still partial, modifications that were dictated by the sharply deteriorating economic situation.

A. ECONOMIC ISOLATION

2.2. Transnistria has a separate currency, and monetary policy is conducted independently from the rest of Moldova. Transnistria did not accept the Moldovan leu as legal tender when it was introduced in 1993. Russian rubles with special stamp marks circulated in the region as local currency until mid-1994, when a new local currency, the Transnistrian ruble (TR), was introduced. The region established its own central bank, which is subordinated to the Transnistrian Supreme Soviet (regional parliament, TSS). The Transnistrian Republican Bank (TRB) is responsible for monetary policy and supervises the activities of commercial banks located on its territory. The TRB does not coordinate its policy with the National Bank of Moldova (NBM). Basic monetary parameters, for example, the refinance rate and the reserve requirement ratio, are set by the TRB independently and differ from those fixed by the NBM. Prudential ratios for commercial banks are also different. Most Transnistrian commercial banks have dual registration by the NBM and the TRB, and hold general licenses from the NBM. Nevertheless, they report to the TRB and are obliged to comply with its rules.

2.3. Fiscal policy is managed independently. The region has its own budgetary system, which consists of a central budget, local budgets, and a pension fund. The Department of Finance is in charge of budget implementation. Both the central budget and the pension fund budget are approved by the TSS in the form of annual budget laws. Transnistria has not received transfers from the national budget since 1992. Since that time, the region has not contributed to the national budget. The tax regime in the region follows to a large extent the standard pattern for CIS countries. However, the tax rates differ from those in the rest of the country.

2.4. Transnistria has established its own customs service and maintains a distinct trade regime. The customs service controls the border of the region with the rest of Moldova along the Nistru River, as well as most of the country's eastern border with Ukraine. Until 1996, there was no coordination at all between the customs services in the two parts of Moldova. Transnistria's

initial trade regime, introduced in 1993, differed dramatically from the official trade regime of Moldova. While exports were liberalized in the rest of Moldova, they remained subject to licenses and customs tariffs in Transnistria. On the other hand, in contrast with the national regime, imports were not subject either to customs tariffs or to excise taxes. No proper transit regime was put in place. As explained in Chapter III, Transnistria's trade regime has recently undergone significant modifications and moved closer to the official trade regime of the republic. However, numerous differences still remain.

2.5. Transnistria treats trade with the west bank territory of Moldova as foreign trade, while Moldova considers trade with the Transnistria region as internal turnover. Introduction of a separate trade regime and unilateral establishment of customs control posts along the Nistru River by the Transnistrian side negatively affected economic cooperation between economic agents in the two parts of the country. However, the level of integration prior to the conflict was so high that trade links have been partially maintained despite all the difficulties, and the exchange of goods remains rather intensive (see Box 4.2 in Chapter IV for more details).

2.6. Until recently, the Transnistrian authorities were reluctant to restore normal transport links between the two banks of the Nistru River. These links were seriously disrupted as a consequence of the armed conflict, when two of the four road bridges across the Nistru were damaged and became unsuitable for auto transport. These two bridges are situated along the "border" between the two parts of the country. One bridge at Vadului Vody was partially repaired soon after the armed conflict, but remained unsuitable for heavy trucks until 1996. The second damaged bridge at Dubossary still cannot be used by mechanized transport. This creates serious obstacles to normal transport communication, since the Dubossary Bridge is part of the shortest auto transport route linking Moldova with the capitals of Ukraine and Russia. Until 1997, the Transnistrian authorities blocked initiatives on the part of the west bank side to repair the bridge.

2.7. Coordination with the rest of Moldova in the crucial energy sector is limited to essential requirements. The division of the sector proved to be technically impossible, because it could result in dramatic consequences for both parts of the country. The whole of Moldova is heavily dependent on imported energy. Over 99 percent of primary energy requirements are covered by imports, with Russia as the main supplier. All the major pipelines cross the territory of Transnistria. The largest power station, Moldovskaya, which traditionally produced about 85 percent of the electricity generated in Moldova, is situated in Transnistria. After the self-proclamation by Transnistria of independence, the electrical system of Moldova continued to function as a single net technically coordinated from Chisinau. Relations of the Moldovskaya power station with MOLDENERGO, the west bank electricity company, were put on a commercial basis. The west bank territory continues to consume about half the electric energy produced at the station. A complicated scheme of mutual settlements has been introduced based mainly on the barter exchange of energy for fuel. Relations in the gas sector remained unclear until mid-1995, when a joint stock company was established with Russia's GASPROM, the main supplier of natural gas to Moldova, holding 50 percent of the shares, and the distribution companies of Transnistria and the rest of Moldova as minority shareholders. At the same time, the liabilities of the two parts of the country with respect to GASPROM were separated, and each side began to keep its own record of external settlements for gas deliveries. Transnistria conducts an independent energy tariff policy. Tariffs for the main types of energy for the east bank consumers have been maintained at artificially low levels. In 1995, they were on average about ten times lower than the tariffs applied in the rest of Moldova, which in turn were well below cost.

2.8. The fundamental legal framework for the market economy passed by the Parliament of the Republic of Moldova (PRM) in recent years was not accepted by the Transnistrian authorities and does not function in the region. Transnistria has established its own legislative body, the TSS, which is entitled to pass "official" Transnistrian legislation. The TSS does not coordinate its legislative activities with the PRM. Transnistria's basic economic legislation reflects to a large extent the laws of the former Soviet Union passed during the *perestroika* period of 1985-91. Many of these laws have remained in force since that time with only a few changes. Most of the economic laws passed by the TSS in recent years follow the principles of economic legislation of other CIS countries. Conceptual contradictions with official Moldovan legislation exist, first of all, in relation to property rights and privatization. Numerous obstacles in the Transnistrian legislation hamper normalization of the economic situation in the region, as well as its economic reintegration with the rest of Moldova and establishment of economic ties with the rest of the world.

2.9. No statistical data have been provided officially from the Transnistrian region to Moldovan authorities since 1992. Initially, statistical data were classified by the regional authorities practically as top secret. Up to mid-1995, there was an informal information blockade vis-à-vis the outside world and the west bank territory in particular. In mid-1995, a formal agreement on limited exchange of economic data between the two parts of Moldova was reached in the context of a broader agreement on relations of the monetary systems. However, in practice, no regular information on the situation in the Transnistria region is available to GOM. As a consequence, recent statistical publications on Moldova refer only to the west bank territory, although it is important to note that the GDP figure published by the Moldovan DOS includes an estimate for Transnistria. The region has its own Transnistrian Department of Statistics (TDS), which regularly prepares reports on the economic situation in the region. Statistical bodies of the two parts of Moldova do not exchange information officially, and do not coordinate methodologies used for data collection and processing. To a large extent, the TDS continues to use old Soviet methods and techniques. This makes Transnistrian statistics very unreliable and to a large extent incomparable with international standards.³

B. LIMITED LIBERALIZATION EFFORTS

2.10. The central planning system in the Transnistria region has not remained unmodified. While no official program of market reforms has been implemented, the Transnistrian authorities did not cancel the liberalization reforms already undertaken prior to separation from the rest of Moldova. Furthermore, they attempted to introduce some selected elements of a market economy while maintaining many aspects of the old Soviet-style economic system. Certain progress was achieved in introducing market principles in some sectors. In addition, in a few areas, liberalization took place de facto during the initial period of economic chaos and lack of supervision by regional authorities.

2.11. Moldova initiated price liberalization in the whole territory in January 1992, before the Transnistrian armed conflict. At that time, prices for most industrial products and some consumer goods and services were freed. After the separation of the Transnistria region from the rest of the country, price controls that had been eliminated were not restored. Currently, consumer prices for a number of basic food products, including bread and milk, are still

³ The new household budget survey launched in 1997 with World Bank financial and technical support is an exception in that it is being implemented throughout the country.

regulated, as are tariffs for communal services. All other consumer prices are free of controls. Energy tariffs for all types of consumers and procurement prices for agricultural products are still administratively regulated in the region.

2.12. After the introduction of the Transnistrian ruble in 1994, the regional authorities took some steps to establish foreign exchange and credit markets. Commercial banks were allowed to carry out foreign exchange operations and open exchange offices. No limits on the level of the exchange rate were set. The official exchange rate was periodically adjusted to the commercial exchange rate. The commercial banking sector was allowed to develop rapidly. Regional authorities introduced only minimal administrative controls on commercial banking activities. During the period immediately following separation, the minimum statutory capital requirement remained very low. Commercial banks situated in the region enjoyed maximum operational freedom. The regional central bank was very weak, and the banks had broad opportunities to benefit from the unstable economic situation and the lack of supervision. In 1995, the banking sector already comprised 18 banks with 28 branches in total.

2.13. Small private businesses inherited from the Gorbachev period were not officially prohibited in the region. Some small and medium-size enterprises (SMEs) have survived despite the absence of positive conditions for their development. SMEs have continued to expand spontaneously, albeit at a slow pace, mainly in the trade and services sectors. This process contributed to the development of commercial trade and created the basis for an emerging private market for services.

2.14. The Transnistrian trade regime was liberalized de facto. According to trade regulations introduced in 1993, Transnistrian exports were formally subject to licensing and customs tariffs, while imports to the Transnistria region were not subject to restrictions. However, economic agents had numerous opportunities to avoid trade regulations as the border with Ukraine remained virtually open because of weak customs controls. As already mentioned, until 1996, there was essentially no coordination between the customs services in the two parts of Moldova. The newly established Transnistrian customs service was the only body controlling Moldova's eastern border with Ukraine.

C. ABSENCE OF REFORMS AIMED AT MACRO STABILIZATION

2.15. Selective liberalization measures implemented in Transnistria were not accompanied by a macroeconomic stabilization effort. This resulted in a severe macro-financial crisis that reached its peak in 1995. When the Moldovan leu⁴ was introduced and the stabilization program was launched in the rest of Moldova in late 1993, the Transnistria region remained within the Russian ruble zone and continued to experience the negative influence of this monetary environment. In fact, the chance was lost to avoid destructive consequences of hyperinflation, which the region has experienced since then.

2.16. The introduction of the Transnistrian ruble in the middle of 1994 was not supported by a stabilization program, and the opportunities to stop the developing inflationary crisis were not utilized. Monetary policy was something absolutely new for the authorities of the region. They ignored the necessity to support the introduction of a separate currency with appropriate monetary instruments and to rely on these in conducting macroeconomic policy. The reform

⁴ Here and below leu is used for singular while lei is used for plural.

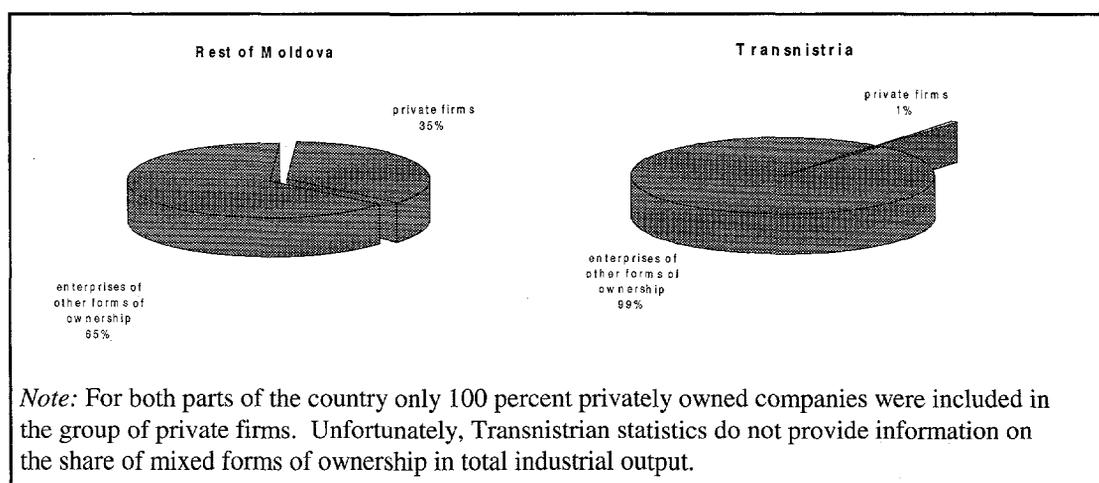
effort was limited to an arithmetic exercise of substituting the new local currency for the formerly used Russian ruble in the proportion of 1 to 100. The so-called central bank (TRB) was established but, until late 1995, it played a small substantive role and did not perform the usual functions of a central bank. This resulted in the absence of any real monetary policy. Budgetary and credit policies of the Transnistrian authorities was also very weak. In fact, the newly independent budgetary system was created mainly to finance the expensive attributes of proclaimed independence, such as the administrative apparatus, army, and police. In this situation, the easiest but most unsustainable solution was chosen. The need to adjust the structure of public spending to fit budget constraints was ignored. Budgetary policy continued to be determined by political arguments, while economic consequences were not taken into consideration. The traditional Soviet pattern of expenditures was maintained with a focus on generous social spending and extensive subsidies to producers. All this 'luxury' was generously financed through money creation and accumulation of external arrears. As a consequence, in 1995, the average inflation rate exceeded 50 percent per month, the money supply (M2) increased by about 50 times, and the Transnistrian ruble depreciated about 70-fold within a year.

D. RELUCTANCE TO CARRY OUT STRUCTURAL REFORM

2.17. In contrast with the rest of Moldova, no structural reforms were implemented in the Transnistria region following the breakup of the former USSR. This was due to inability of the regional authorities to achieve consensus on the main principles of economic reform, including the role of private property and the change in the economic functions of the state. To this day, the public sector dominates production and distribution in the region (Figure 2.1).

2.18. Formally, the Transnistrian Law on Property, approved in early 1992, declared equal status for state, collective and private forms of property. A key difference with official Moldovan legislation concerns the land property issue. Land remains the property of the state,

Figure 2.1:
Share of Industrial Output Produced by Wholly Private Firms in 1995



but can be passed to individuals to be used by them and their legatees for their whole lives. However, in contrast with the national legislation, land is not tradable in Transnistria.

2.19. In Transnistria, a comprehensive basis for private sector development does not exist in practice. The role of nonstate forms of property in the economy, and especially the mechanisms providing for their development, became a subject of endless discussions among the region's legislative and executive authorities. As a consequence, the transformation of ownership of productive assets proceeded very slowly, and little visible progress was achieved. Privatization in industry was limited to corporatization of about 12 percent of the large and medium-size enterprises in 1992 (Box 2.1). Attempts to relaunch corporatization were undertaken only in late 1995, but with little success.⁵ No mass privatization program was implemented. Transnistria has become a unique region where the Soviet-planned system in agriculture was preserved almost untouched. No structural reforms took place in the sector, which remains dominated by old *kolkhozes* and *sovkhozes*. Privatization efforts in other areas were limited to the transfer of urban dwellings to individuals in conformity with the Transnistrian Law on Privatization of Housing passed in 1992. As mentioned earlier, small private businesses were not prohibited officially. However, their development has been hampered by general economic instability, and they continue to play only a minor role in the economy. The SMEs have become a ghetto of timid private entrepreneurship, mainly in the trade and services sectors. Individual agricultural production on household plots traditionally has been widespread in the region and remains an important source primarily of in-kind revenue for the majority of households. However, the absence of an appropriate legal framework and active land reform program has prevented such production from developing into the basis for an efficient private farming sector.

Box 2.1: First Privatization Attempts in Industry

Privatization of industrial assets was launched in the Transnistria region before the disintegration of the USSR, but was stopped with the armed conflict in 1992. Eight⁶ large enterprises, among which figure the most important electrotechnical plants, light industry enterprises and furniture factories, were included in the Soviet privatization program. Decisions on their transformation were taken by the corresponding supervisory ministries of the Soviet Union. In 1992, those enterprises became joint stock companies in conformity with the Law "On Privatization," which was adopted by the TSS in end-1991. This legislation was copied from the similar law of the USSR. As the Law granted substantial privileges to enterprise workers and managers, all such enterprises became closed-type joint stock companies predominantly owned by the employees, with 25 percent of the shares held by the state. In the same period and in conformity with the same law, about 10 medium-size enterprises, mainly in the light industry and furniture manufacturing, became so-called peoples' enterprises. They were, in fact, collective enterprises fully owned by the workers and managers. In 1994, after the Law on Privatization was slightly amended, such enterprises were obliged to transfer 25 percent of their shares to the state, and the difference between them and the few joint stock companies mentioned previously disappeared in practice.

⁵ These attempts will be described in the next chapter in more detail.

⁶ There are about 130 large and medium-size industrial enterprises in Transnistria in total.

CHAPTER III

RECENT POLICY DEVELOPMENTS: PARTIAL STEPS TO REFORM AND REINTEGRATION

3.1. The dramatic deterioration of the economic situation by 1995 forced the Transnistrian authorities to make more concerted efforts to respond to the developing crisis. Some positive changes took place both in internal economic policies and in economic relations with the west bank territory. Although a comprehensive reform program was still not adopted, a few important, but partial, reform steps were taken. Monetary policy was tightened significantly. Some fiscal tightening took place as well, although the authorities remained reluctant to reform the structure of public spending. Efforts were undertaken to reanimate privatization processes, albeit with few concrete results. A modest move towards economic reintegration with the rest of the country was observed, as a number of important agreements were signed. These agreements aimed at eliminating the most distortionary inconsistencies in economic regulations between the two territories. Unfortunately, a major part of the agreements is still awaiting implementation.

A. ATTEMPTS TO ESTABLISH CONTROL OVER THE ECONOMIC SITUATION IN 1995–97

Monetary and Financial Measures

3.2. Most of the new monetary and financial measures were initiated and implemented by the TRB. The TRB's institutional authority and role in economic policymaking were strengthened. The TRB made a persistent effort to establish control over the monetary and credit situation in the region. In particular, a tougher stance was taken to limit currency printing.

3.3. The TRB's first measures in the monetary and credit sphere were aimed at introducing realistic monetary parameters and making them the basis of monetary policy. Establishment of a more realistic refinance rate in late 1995 and its replacement of symbolic interest rates for budgetary credits constituted the most important step. The refinance rate was set initially at 120 percent per annum. While still negative in real terms, this was six times higher than the interest rate for budgetary credits established earlier in conformity with a TSS decision. In 1996, the refinance rate was further increased with the aim of adjusting it to inflation. At the end of the year, the refinance rate approached zero in real terms. By the middle of 1997, the TRB refinance rate was equal to 80 percent per annum, compared to 71 percent cumulative inflation rate for the previous 12 months. Direct credits to the government were extended at 50 percent per annum. These were supposed to be used for financing the productive sectors and special government programs. The TRB stopped providing direct credits to economic agents. A system of credit auctions was established. Special ratio requirements were introduced for the commercial banks wishing to take part in the auctions. The interest rates at the credit auctions, and the interbank market that functions in parallel, are dominated by the TRB, as it still provides about 90 percent of all the credit resources circulating in the region. As of mid-1997, the reserve requirement was six percent. In 1997, funds in foreign currencies were included in the calculation of the reserve base.

3.4. In 1996, the TRB began to implement a more active policy in the foreign exchange market as well. It initiated regular interventions aimed at establishing control over depreciation of the local currency. The total amount of interventions exceeded TR 2.2 trillion (about US\$5 million if converted at the annual average exchange rate) in 1996. This is a very significant figure given that the total stock of cash in circulation (M0) as of end 1996 was estimated by the TRB at TR 3.5 trillion. These interventions obviously contributed to the significant slowing down of exchange rate depreciation in 1996-97 (see Chapter IV, para. 4.3 for more details). Obligatory repatriation of export revenues in foreign currency by economic agents was introduced. In 1997, this was supplemented by a surrender requirement of 10 percent of export proceeds. The funds obtained by the TRB through these measures are currently used for intervention in the foreign exchange market. The TRB has also initiated a campaign against the substitution of local currency by foreign currencies. Administrative controls on the use of foreign cash for various payments have been gradually tightened, but with little success so far.

3.5. A number of steps were taken to reorganize the banking sector. One of the objectives was to achieve higher centralization and concentration of banking activities and through this to reduce risks associated with the functioning of the banking system. Control and supervision over commercial banks were strengthened. The TRB set prudential standards for the banks. The minimum amount of statutory capital was increased from US\$200,000 to US\$500,000 in 1996, but it remained lower than in the west bank territory. A further increase was planned in the minimum statutory capital to US\$750,000 by the end of 1997 and to US\$1 million by the end of 1998. As of mid-1997, 15 banks were operating in the region, down from 18 banks in 1995.

3.6. Although budgetary policies remain contradictory, some measures have been undertaken to reduce the fiscal deficit and to find alternative sources for its financing. In addition to eliminating the practice of preferential crediting, closer cooperation between the Department of Finance and the TRB was established. This improved to a certain extent monitoring of the use of budgetary resources. Some limits for budgetary expenditures were introduced, and priority spending items were defined. Alternative sources were used to help finance the budget deficit. Instead of unlimited money creation as practiced in earlier years, the 1996 budget deficit was partially financed with the profits of the TRB. In addition, the Transnistrian authorities began to issue bonds in the internal market. However, overall budget constraints remain soft. The Soviet-type pattern of public expenditures has not undergone significant changes. The regional authorities are reluctant to reform the main items of public spending, in particular, salaries and social expenditures. During 1996, the minimum salary was administratively increased in the region by about 18 times. In the 1997 budget, the basic parameters were defined in conditional units equivalent to the U.S. dollar, thus providing for automatic indexation of all pensions and salaries in the budget sector in line with changes in the exchange rate of the Transnistrian ruble to the U.S. dollar. The Transnistrian authorities continue to support extensive social infrastructure inherited from the Soviet times, as well as to provide a broad range of untargeted social benefits and subsidies to households. In particular, prices for communal services and energy tariffs have been maintained at artificially low levels.

Steps to Relaunch Privatization

3.7. Starting in mid-1995, the Transnistrian authorities became more persistent in their efforts to reanimate privatization processes. However, no significant practical results have been achieved so far. The major visible achievement was the approval by the TSS of a number of

potentially important laws providing the basis for expansion of nonstate forms of ownership in the region. However, the legislators' failure to agree on the mechanisms of implementation of these laws prevented most of them from working in practice.

3.8. The Law "On Joint Stock Companies", passed in August 1995, is a fairly progressive and comprehensive law that could provide the basis for a mass corporatization program, if implemented. In practice, only a few state joint stock companies with 100 percent of shares held by the state have emerged in the region since the approval of this law. A compromise decision on the possibility of establishing such companies on the basis of the strategically most important enterprises was passed by the TSS in January 1996 in the form of an amendment to the above Law. The hope was that, in the future, the authorities would be able to sell part of the shares in such enterprises directly to strategic foreign investors. The status of the state joint stock company was designed to ensure full control of the Transnistrian authorities over such sales (see para 3.14).

3.9. The Law "On Lease," passed at the same time, appeared to be another compromise between the executive power and TSS, which strongly opposed any attempts to launch a standard type privatization program. This law copied the transitional Soviet law of the Gorbachev period. The status of the leased enterprise does not allow for change in the type of ownership, but it does give the enterprise relatively more operational freedom compared to a traditional state enterprise of the old Soviet pattern. Currently, most of the enterprises in the region have such status.

3.10. Work on drafting a mass privatization program for the region is under way. No details are available so far, except for the intention to use some type of voucher scheme. It is also not clear whether the program has any chances to be supported by the region's legislative authorities.

Attempts to Attract External Investments

3.11. While disputes on whether local capitalists should be allowed to emerge have not been resolved, a consensus on the necessity of attracting foreign investors to Transnistria, regardless of their status and form of ownership, has been achieved. In late 1995, the basic legal framework for foreign investment was created. In addition, enterprises were granted more freedom in searching for potential investors.

3.12. The law "On Foreign Investments", approved in August 1995, defined the procedures for establishing joint ventures in the region, the status of such ventures and the rights and obligations of foreign investors. Results of implementation of the law are modest, as only nine enterprises in the region have official status as a joint venture with non-CIS participation, and their contribution to industrial output is insignificant. Western companies have been reluctant to assume the risk of investing in the Transnistrian economy given the region's unstable economic situation and undefined political status.

3.13. The Transnistrian authorities have begun to encourage other forms of cooperation with foreign partners, for example, specific bilateral agreements on delivery of products in return for investments or loans. Significant interest has been manifested by companies of Ukraine and Russia which historically had economic ties with the region. According to the regional authorities, about 160 Transnistrian enterprises have special arrangements with CIS partners similar to a joint venture status, but are not formally registered as joint ventures. Although statistical data is unavailable, the contribution of these enterprises to regional output could be

significant. The majority of such enterprises are small businesses. However, some of them are large and important enterprises.

3.14. The amendment to the Law “On Joint Stock Companies” allowing for 100 percent of enterprise shares to be held by the state was aimed directly at providing the basis for the sale of blocks of shares in the most attractive enterprises to foreign investors. According to available information, the Transnistrian authorities are now seriously discussing with potential investors plans for establishing joint ventures on the basis of several important enterprises, including the Moldovskaya power station. If these plans are eventually realized, the role of external capital, particularly capital from CIS countries, might become very significant in the region.

B. FEW STEPS TOWARDS REINTEGRATION WITH THE REST OF MOLDOVA

3.15. Internal measures aimed at redressing the crisis have been accompanied by a number of partial steps in the direction of economic reintegration with the rest of Moldova. Most of these steps were fixed by formal bilateral agreements signed by top Moldovan officials and the Transnistrian authorities. These include: (a) the Agreement on Relations Between the Monetary and Credit Systems; (b) the Customs Agreement; and (c) the Memorandum on the Principles of the Settlement of the Conflict. These documents and the stage of their implementation are described in detail below. One additional concrete step towards reintegration is worth mentioning: restoration of the two transport bridges across the Nistru River that were damaged during the armed conflict. The Vadului Vody Bridge was opened for all forms of motor transport in 1996, and repairs on the Dubossary Bridge are now under way.

Agreement on the Relations Between the Monetary and Credit Systems

3.16. An agreement “On the relations between the monetary and credit systems of the Republic of Moldova and Transnistria in the initial stage” was signed by the heads of the NBM and the TRB in July 1995. The agreement envisaged official introduction of the parallel circulation of the Moldovan leu as legal tender for noncash transactions in Transnistria. The NBM undertook the obligation to supply cash lei at the request of Transnistrian banks in amounts corresponding to the noncash lei balances on their accounts. The Transnistrian side agreed to allow official exchange of lei at exchange offices, to take measures to eliminate discrepancies between the exchange rate of cash and noncash Transnistrian rubles, to increase reserve requirements for commercial banks, and to improve banking supervision norms. The Transnistrian authorities agreed to bring the region’s economic and financial legislation into conformity with international standards. The agreement included a provision on the exchange of macroeconomic data between the two territories of Moldova, and the two sides agreed to coordinate exchange rate regimes, regulations and import tariffs.

3.17. Unfortunately, this important agreement has been implemented only partially. The most evident result was the opening of an NBM branch in Tiraspol. This branch was to function as the settlement center for transactions between commercial banks of the two territories of Moldova. Transnistrian banks maintaining relations with west bank banks were obliged by the TRB to open correspondent accounts with the NBM branch in Tiraspol. However, according to TRB experts’ estimates, not more than one third of all operations between the banks of the two parts of Moldova are carried out through the settlement center. Commercial banks prefer to establish direct correspondent relations with west bank partner banks. The declared demand for

lei from Transnistrian banks has proved to be insignificant. It is obvious that the banks prefer to carry out lei transactions directly, thus avoiding the NBM. Provisions regarding the exchange of macroeconomic and monetary data have remained largely unfulfilled, and the requirement to adjust Transnistrian legislation to international standards has remained at the level of broad formulations.

Customs Agreement

3.18. In February 1996, an agreement was signed between GOM and the Transnistrian authorities on the settlement of problems related to the functioning of the customs services of the Republic of Moldova and the Transnistria region. In particular, the agreement envisaged: (a) elimination of the customs control units established by the Transnistrian authorities on the border with the rest of Moldova; (b) establishment of joint customs control units on the eastern border with Ukraine; (c) application of a transit regime for the transit of goods imported to and exported from the west bank territory through Transnistria; (d) adjustment by Transnistria of its import tariffs for nonfood products (except for tobacco products and alcoholic beverages) in line with official Moldovan import tariffs; and (e) unification of the methodology of foreign trade statistics collection and exchange of customs data.

3.19. Certain progress has been achieved in fulfilling the customs agreement:

- A number of measures to improve customs controls have been implemented. Joint customs teams are currently present at the three most important customs stations on the eastern border with Ukraine. The stamps used by those teams read: "Republic of Moldova. The Transnistria region." Imports to the west bank territory from abroad and exports from the west bank are now treated by the Transnistrian customs as goods in transit. The transit regime is also applied to vehicles crossing the territory of the region.
- The Transnistrian import regime has undergone important changes. In March 1996, work started on the introduction of import tariffs and their gradual increase to official Moldovan levels. According to the tariff list introduced in September 1996, import tariffs for nonfood products became identical to the west bank tariffs fixed for 1996. Tariffs for agricultural products of strategic importance for Moldova, including wine, tobacco, and fresh fruits, have also been adjusted to the west bank levels. For the majority of other food products, Transnistrian tariffs were fixed at zero. New discrepancies in import tariffs appeared in 1997, as tariff lists are revised annually in both parts of the country in the context of the budgetary laws for the corresponding year, and no general coordination mechanism exists in this area.
- Excise taxes for imported products (previously nonexistent in the Transnistria region) were introduced. In 1997, the tax rates were adjusted to official Moldovan levels.
- Export tariffs previously applied in Transnistria were eliminated. However, the export regime remains significantly less liberal than in the rest of Moldova. All

Transnistrian exports are subject to licensing and obligatory registration at the Transnistrian Department of External Economic Relations.

3.20. Despite the progress, many provisions of the customs agreement have yet to be implemented. Actual customs control on Moldova's eastern border remains weak. Discrepancies in official statistics, as well as some anecdotal evidence, provide grounds to conclude that Transnistria remains an important window for unregistered exports and imports to and from the territory of the Republic of Moldova. A mechanism for regular coordination and adjustment of foreign trade taxes in Transnistria to national levels does not exist. Unification of the methodologies for collection of customs statistics has been delayed.

Memorandum on the Principles of the Settlement of the Conflict

3.21. In May 1997, a memorandum on the principles of settlement of the conflict was signed by the top officials of Moldova and Transnistria. The document establishes the basis for determining the final status of the Transnistria region within a unified national framework. The document covers mainly political issues. It lays down the basic principles of political relationship between the two parts of the country. The basic principles governing economic relations are also covered. The memorandum envisages substantial economic autonomy for Transnistria, including the right to establish independent external economic relations. In November 1997, a follow up agreement on socio-economic cooperation was signed. This agreement set up bilateral commissions and working groups for a broad range of economic issues. Further discussions on the modalities of economic relations between the two parts of Moldova are under way. However, the timetable for final political settlement is not clear.

CHAPTER IV

ECONOMIC CONDITIONS: STEEP FALL BUT NOT A COLLAPSE

4.1. The policy of economic isolation combined with insufficient stabilization efforts and reluctance to carry out structural reform have adversely affected the Transnistrian economy. Economic conditions were deteriorating at an accelerated rate up to 1996, when the pace of deterioration slowed as a consequence of the policy measures described in the previous chapter. Comparison with the west bank territory of Moldova, which has also experienced serious economic difficulties, shows that economic conditions in the region are worse in many aspects. Transnistria's comparative advantages inherited from the past have largely been lost. Inflation remains high, and the exchange rate of the local currency has not stabilized yet (Table 4.1). Budgetary arrears are chronic. Transnistria's external energy debt makes up about half the energy debt of the whole country. The decline in the main production sectors in Transnistria appears to be deeper than on the west bank. Real wages recovered to the national average level only in 1997, whereas during the Soviet era, wages were relatively higher in the region. Moreover, this recovery may be only temporary, since it was based on administrative adjustment of wages.⁷ Even though average per capita revenues in the region appear to be above the national average at present, according to available data, the urban majority is significantly poorer than the urban population of the west bank.

Table 4.1:
Selected Macroeconomic Indicators for 1995-97

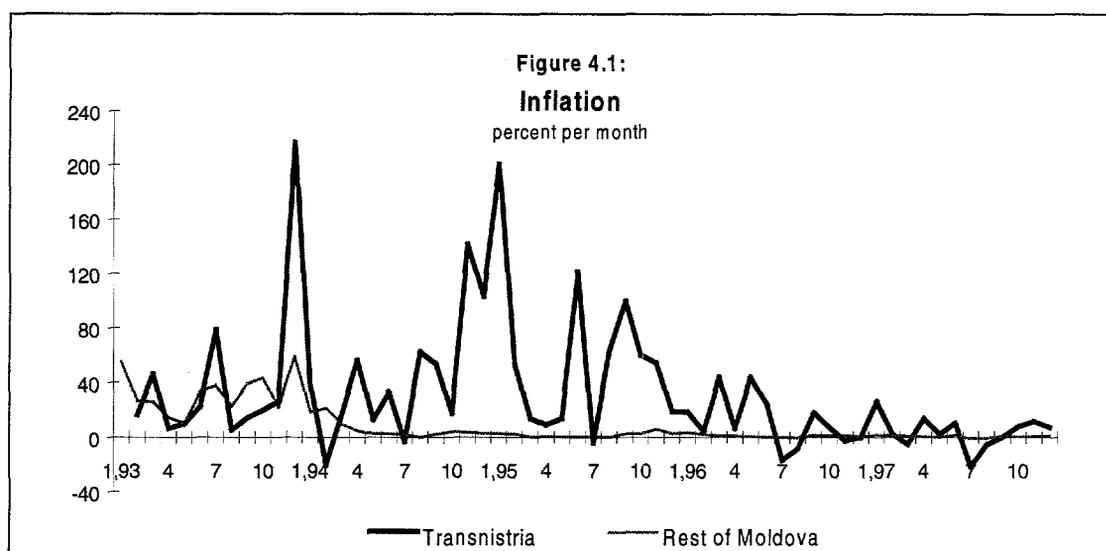
	1995	1996	1997
Average monthly inflation (%)	50.4	10.4	3.7
Annual average exchange rate (TR/US\$)	61,300	410,083	650,417
Industrial output (% , 1990=100)	36.2	31.3	31.1
Agricultural output (% , 1990=100)	32.7	30.0	n.a.
Exports (millions of US\$)	n.a.	225	n.a.
o/w: exports to non-FSU countries	n.a.	70	n.a.
Foreign debt, end-year (millions of US\$)	n.a.	328	n.a.
o/w: debt to GASPROM.	n.a.	300	335
Average monthly wage (US\$)	26	39	50

⁷ Indeed, the Transnistrian ruble depreciated sharply in mid-March 1998, from TR 650,000 per US dollar to TR 1,200,000 per US dollar, implying a potentially important erosion in real wages.

A. MONEY AND FINANCE

Inflation

4.2. In contrast with the rest of the country, where prices stabilized relatively quickly, the Transnistria region has suffered from extremely high inflation since 1992 (Figure 4.1). Officially reported figures⁸ show deterioration of the situation up to 1995, when the average monthly inflation rate reached more than 50 percent and prices increased by about 134 times within a year. Since end-1995, some deceleration of price growth has occurred as a consequence of the implementation of monetary and budgetary measures described in Chapter III (para. 3.2-3.6). In 1996, the average monthly rate of inflation was equal to 10.4 percent and in 1997, it fell further to 3.7 percent. However, prices remain highly unstable and sharp fluctuations of inflation rates from month to month are recorded.



Currency and Exchange Rate

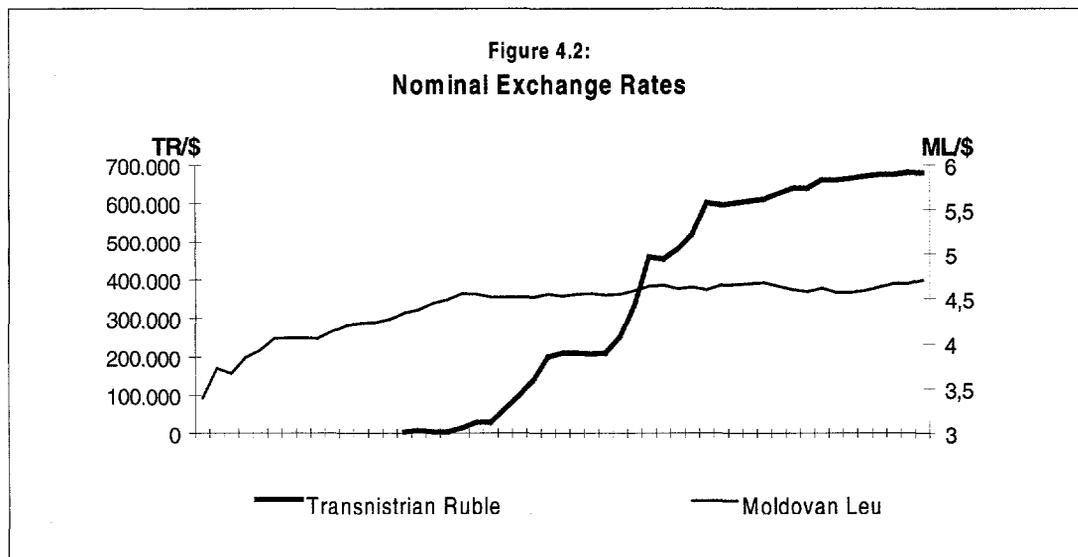
4.3. The Transnistrian ruble has remained very unstable since its introduction in 1994. This stands in sharp contrast with the Moldovan leu, which stabilized already in mid-1995. In conformity with local law, the Transnistrian ruble remains formally the single currency recognized as legal tender for all domestic transactions. Moldovan lei can be officially used only for noncash transactions. In 1995⁹, the Transnistrian ruble depreciated by about 70 times, from about TR 3,000 per U.S. dollar in January to TR 210,000 per U.S. dollar in December¹⁰ (Figure

⁸ The TDS is the only source of information on inflation rates for Transnistria. Consumer prices for a representative group of goods and services are registered regularly and serve as the basis for computing inflation rates. However, the methodology has not been fully adjusted to international standards.

⁹ The earliest year for which regular exchange rate data are available is 1995.

¹⁰ Here and below, unless mentioned otherwise, the average exchange rate of commercial banks is referred to. This rate was estimated by the authors as a simple average of rates offered by a representative group of

4.2). In 1996, exchange rate depreciation slowed down in parallel with deceleration of inflation. Substantial direct intervention of the TRB in the foreign exchange market played an important role. During 1996, the Transnistrian ruble depreciated by about three times. During 1997, cumulative depreciation was only about 13 percent. However, the situation is not yet stable. A black market exists indicating an underestimation of the commercial exchange rate as managed by the TRB. As of end-1997, the difference between the black market rate and the commercial rate was about 10-15 percent.



4.4. Lack of trust in the local currency has led to a high level of substitution by foreign currencies. This is one of the biggest concerns of the region's monetary authorities. It is much easier to sell foreign currency in Transnistria than to exchange Transnistrian rubles for another currency, as many exchange bureaus simply refuse to buy them. Despite administrative controls, foreign currency is widely accepted for payment. According to TRB rough estimates, about half the cash in circulation in Transnistria is not in local currency. Households' lack of trust in the Transnistrian ruble is illustrated by the results of the first quarterly round of new household budget survey (April-June 1997). According to the survey, only 40 percent of households' cash assets are held in local currency, while the largest portion (42 percent) is held in U.S. dollars. Other popular currencies are the Moldovan leu (10 percent) and the Ukrainian grivna (8 percent).

4.5. The high level of currency substitution indicates that the region experiences significant inflows of foreign exchange from the outside world. The sources of such inflows are probably numerous, many arising as a consequence of general anarchy in the economy and lack of economic management for a rather long period after the armed conflict. However, one channel of transfers is obvious. That is the presence of the military contingent of the Russian Federation in Transnistria (OGRF). Even conservative estimates indicate that the annual transfer for salaries to the OGRF staff could exceed US\$10 million, based on the fact that the OGRF

commercial banks. These rates are reported weekly by the TRB. The official rate fixed by the TRB is usually lower than the commercial rate.

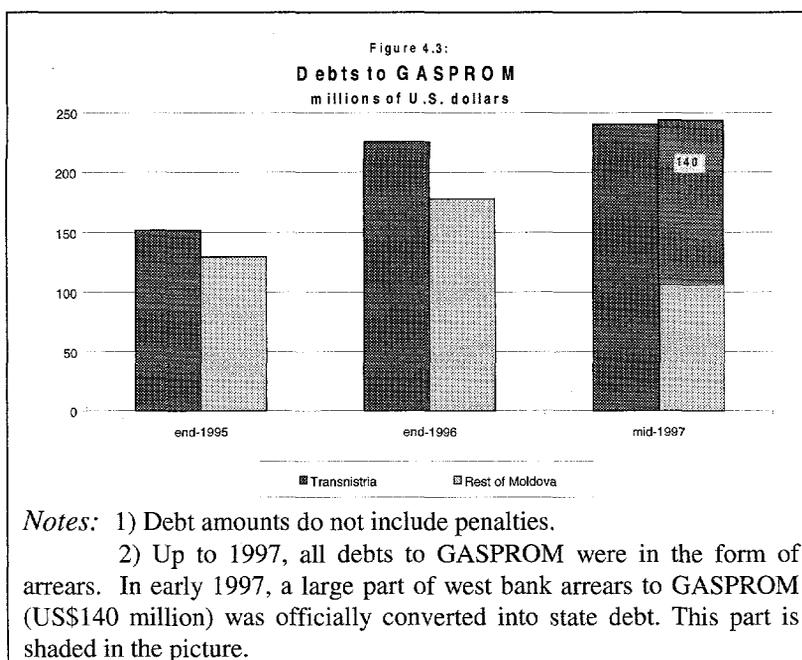
employed about 6,500 people¹¹ in 1996. However, this source of transfers is currently becoming comparatively less important as, according to local media reports, OGRF staff was cut by more than half by mid-1997, and might be reduced further.

Financial Situation

4.6. Although no reliable statistical information on the financial situation is available for the period prior to 1996, analysis based on discussions with the Transnistrian authorities and the partial data provided by them indicate that the region has experienced severe financial crisis. As shown in Chapter II (para. 2.17), the roots of the crisis lie in ignorance of the importance of budget constraints and reluctance to adjust the structure of public spending. The most critical year for the region's budget was 1995 when it nearly collapsed.

4.7. Monetary and financial measures undertaken since mid-1995 and described in Chapter III (para. 3.2-3.6), have brought some improvement, but the overall financial situation remains volatile. Certain ceilings for budgetary expenditures were introduced in 1996 when money emission was curtailed. However, those ceilings were not realistic enough to prevent accumulation of arrears in all sectors of economy. In total, as of end-1996, internal arrears in the region exceeded TR 20 trillion (about US\$33 million). In particular, salary arrears have become a chronic phenomenon. According to the household budget survey data, during April-September 1997, every third household in the region was owed salary payments for the previous months. Various schemes of netting out between the budget and economic agents have been in use since 1996, including the issue by the authorities of promissory notes and other money substitutes. As of mid-1997, tax arrears to the budget amounted to TR 4 trillion (equivalent to US\$6.6 million or about 10 percent of total tax revenues expected in 1997). At the same time, the central budget owed about TR 0.5 trillion (equivalent to US\$1 million) in salary payments to employees of budgetary institutions.

¹¹ This figure is taken from the September 1996 publication in *Janes Intelligence Review* by Dr. Trevor Walters who visited Moldova and had meetings with the representatives of the OGRF in Tiraspol.



penalties), and US\$28 million are loans from the Russian Federation received in 1992-94. In fact, gas deliveries without payment by GAS PROM have become a massive subsidy to the economy of the region, and remain a crucial factor for its survival. Debts to GAS PROM were officially divided between the two parts of Moldova in 1995 when a joint venture company for gas transmission was established. According to data from the Moldovan Department of Energy, as of end 1995, east bank arrears were estimated at US\$160 million without penalties. In 1996, this amount grew by more than US\$70 million (Figure 4.3). This is a very significant sum for Transnistria. Annual budget revenues were equivalent to about the same amount (Table 4.2). In

Table 4.2: Selected Financial Indicators for 1996 (millions of U.S. dollars)

Budget revenues	71.3 ¹²
Budget deficit	5.4 ¹²
Increase in arrears to GAS PROM	73.3

this context, the official budget deficit of about 6.7 percent of revenues appears to be absolutely artificial. Recently, GAS PROM has notified the Transnistrian authorities that the practice of chronic nonpayments must be stopped and that future deliveries would be made only against payment. In 1997, the growth of arrears decelerated, but did not stop. Further reliance on financing the economy through accumulation of energy arrears is problematic at best. GAS PROM has been recently more persistent in requesting settlement of the debt. Negotiations are under way on possible settlement schemes. The options under discussion include swaps of debt for equity in Transnistrian enterprises.

4.8. The largest and most acute financial problem for the Transnistrian authorities is the huge stock of accumulated external debt, the greatest portion of which is in the form of arrears for energy imports. The total stock of external debt recognized by the Transnistrian authorities, fixed in the text of the regional budget law for 1997, was US\$328 million as of the beginning of 1997. Of this sum, US\$300 million is owed to GAS PROM (including

¹² Authors' estimates are based on the official data on budget implementation and converted at the annual average commercial exchange rate (TR 410,000 per US\$1 in 1996). These estimates differ significantly from the official budget figures. Analysis has shown that, due to the weaknesses of the budget methodology currently used in the region, official budget revenues and expenditures are significantly overestimated, as they include some elements of financing, as well as a large share of double-counting.

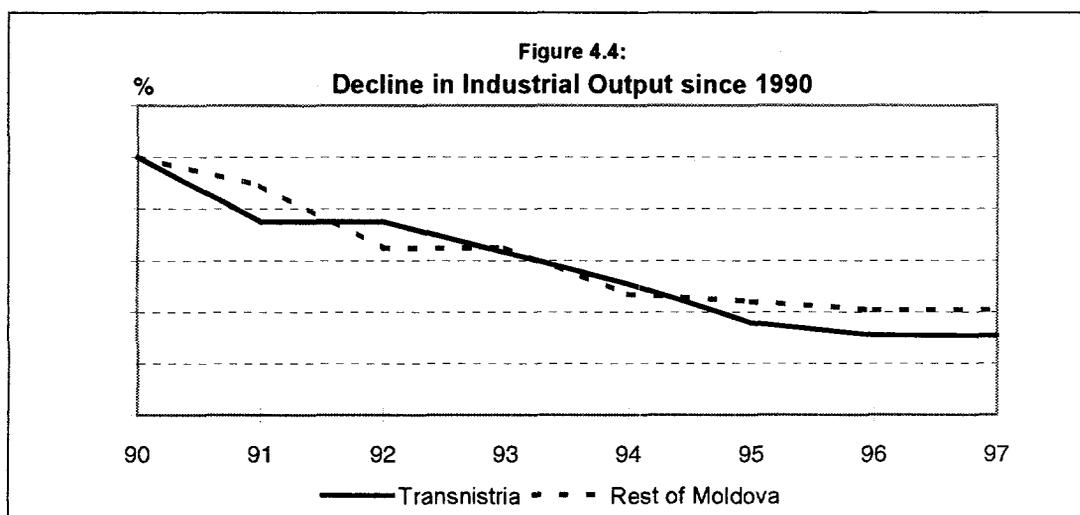
B. OUTPUT

Industry

4.9. Economic production in the region is dominated by industry, which is the key sector of the Transnistrian economy. Industry provides jobs for about 40 percent of the region's working population. According to TDS rough estimates, industry's contribution to gross value added in the region¹³ is about 70 percent.

4.10. Disintegration of the former USSR, economic isolation, and lack of reform have led to a sharp fall in Transnistria's industrial production. In 1997, according to TDS data, industrial output was about 70 percent below the 1990 level (Figure 4.4). Prior to separation, the share of Transnistria in Moldova's total industrial output was estimated at about 35–40 percent. Rough estimates show that the relative share of the region in the country's total industrial output has fallen by about seven percentage points due to higher rates of decline compared to the west bank territory.

4.11. A combination of specific factors contributed to the deep decline in industrial production. On the one hand, the starting conditions were very unfavorable, even compared to the rest of Moldova. Industry was dominated by large enterprises, many of which were an integral part of the former Soviet military complex. In the planned economy, these plants supplied enterprises throughout the FSU, and the scale of their output was adjusted to the needs of the whole Soviet economy. Such enterprises suffered disproportionately from the disintegration of the USSR and the resulting loss of economic ties. Armed conflict was an additional shock that coincided with the collapse of the Soviet economic system. On the other hand, the highly unstable macroeconomic environment prevailing in the region prevented industry from recovering. The lack of structural reforms left industrial enterprises with few instruments to adjust to new conditions and overcome the crisis.

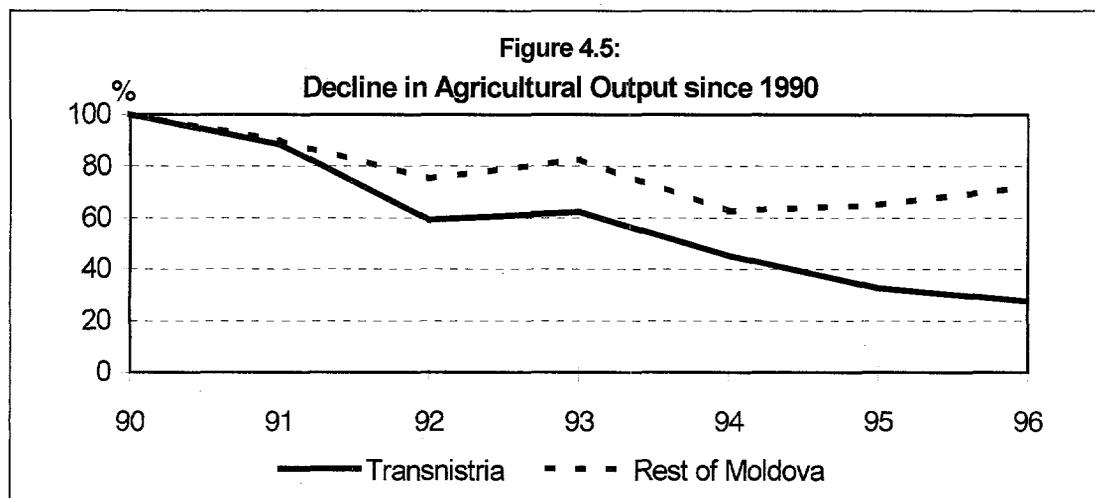


¹³ In 1996, TDS attempted to calculate Gross Value Added as a measure of GDP for the region. The methodology used does not fully correspond to international standards.

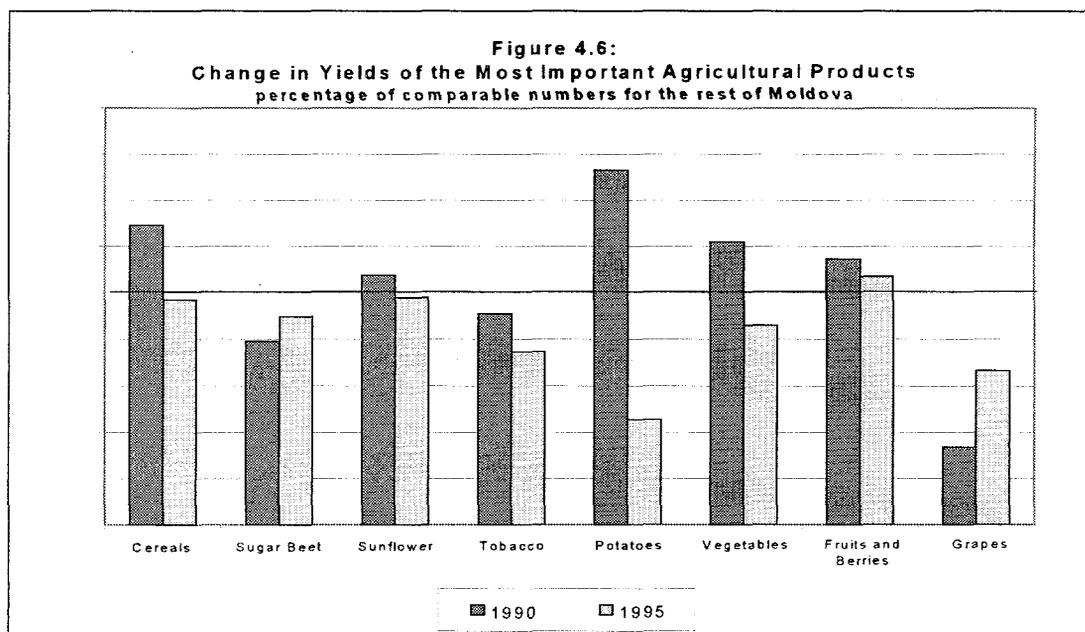
4.12. In fact, the situation in industry could be even worse if the Transnistrian authorities had managed to keep control over industrial enterprises as they initially intended. However, the command system was rather quickly replaced by anarchy and chaos in the economy. In conditions of de facto liberalization, those enterprises that were in a comparatively better situation because of their organizational form and profile, and where managers adjusted more quickly to the extremely difficult macroeconomic environment, were able to survive. Analysis of trends in physical output of the most important industrial products shows that there are some exceptions amid the continuing decline registered for most products. For example, output of steel has continued to grow since 1991, and the decline in rolled metal production has been small compared to other industrial products. In 1996, production of slate, cement, cable products, and cotton fabrics seemed to stabilize and in few cases even began to grow. Deeper analysis shows that in most cases, positive trends for individual products are associated with management policies at a few leading enterprises. For example, steel and rolled metal are produced by a single Rybnitsa plant, cement and slate production are concentrated at the Rybnitsa cement plant, and so on. In particular, a very significant factor in the survival and recovery of a number of important enterprises was the success of their management in attracting external partners and/or investors. Publications in the Moldovan press indicate that many of the region's leading enterprises have succeeded in establishing external cooperation ties, including with western companies in some cases, and benefited from various forms of foreign investment. In part, this foreign investment may be attracted by de facto access to cheap or even free energy which generates artificial profits at the expense of external payment arrears and longer term macroeconomic stability. As mentioned in Chapter III (para. 3.11-3.14), the Transnistrian authorities have begun to encourage various forms of external cooperation. However, concrete examples show that the leading role in the process has been played by enterprise managers.

Agriculture

4.13. According to TDS data, agricultural output has been also declining in Transnistria at a faster pace than in the rest of Moldova. In 1996, it was 70 percent below the level of 1990, compared to about 30 percent for the rest of the country (Figure 4.5). Transnistria is relatively less dependent on agriculture. However, the sector is of strategic importance for the region as it is the basis of the food industry, which accounts for about 30 percent of total industrial output. Agriculture also employs about 20 percent of the working population. The TDS estimates the current contribution of agriculture to the gross value added produced in the region at about 10 percent.



4.14. Since 1990, the situation in the Transnistrian agricultural sector has seriously deteriorated. Crops of all the most important agricultural products have decreased dramatically. This process has been accompanied by a decline in yields. As can be seen from Figure 4.6, by 1995, Transnistria's relative advantage in terms of yields for cereals, sunflower, vegetables, potatoes was lost. For fruits and berries it was reduced significantly. The livestock population in public agriculture has been falling rapidly. The decline has been partially compensated by the growth of the livestock population in the household sector. However, this process is being hampered by a regionwide shortage of fodder.



4.15. Reluctance of the Transnistrian authorities to implement any structural reforms in agriculture is the major determinant behind the poor performance of the sector compared to the west bank since 1991. Most other factors negatively affecting agriculture development are common to both parts of the country (e.g., terms of trade shock, a series of natural calamities, and the heavy burden of bankrupt agricultural enterprises inherited from Soviet times). The

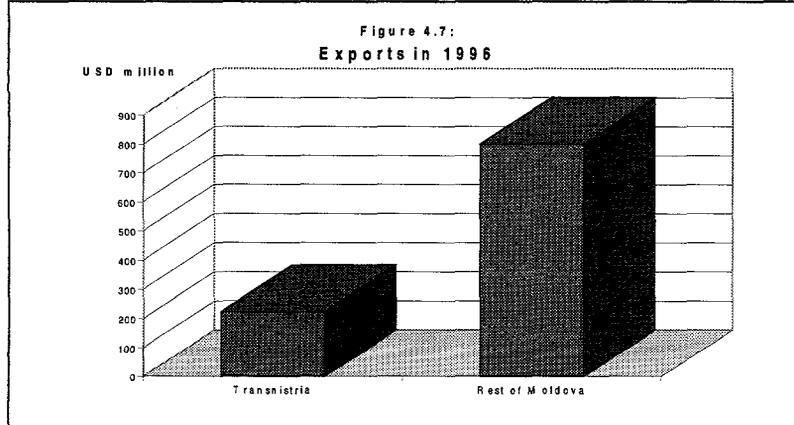
Transnistrian authorities attempted to substitute structural reforms with direct state support through preferential credits, subsidies, and centralized procurement of agricultural products at fixed prices. This policy failed. As mentioned in Chapter II (para. 2.19-2.20), no legal framework for land reform has been created in the Transnistria region. The sector is mainly composed of various forms of old Soviet *kolkhozes* and *sovkhazes* supplemented by production on household plots. Although widespread, and important for survival of individual households, household agriculture has not evolved into an economically efficient private farming sector due in the first instance to the absence of an appropriate land reform and supporting legal framework.

Box 4.1: Governance and Growth

An important link can be drawn between poor output performance in the Transnistria region and governance problems deriving from chaotic economic management, lack of reforms and de facto separation. Although empirical evidence on governance in Transnistria is extremely limited and no systematic research has been done so far, some of the symptoms of weak governance are evident. The Government of Moldova has repeatedly expressed concerns about non-observance of law and public order in the Transnistria region. Moldovan mass media regularly report on armed crimes committed in Transnistria and outside it by its inhabitants. According to these reports, the region suffers from organized crime and appears to be a source of illegal arms supply for Moldova and neighboring countries. Substantial, although mainly anecdotal, evidence indicates that customs controls on the eastern border with Ukraine remain weak and provide a large window of opportunity for unrecorded foreign trade and smuggling. Evidence suggests that stable channels through Transnistria may have been established for illegal exports of Moldovan wine and tobacco products to CIS countries. The Ministry of Finance estimates considerable revenue losses from smuggling of petrol products to Moldova through Transnistria. While governance in the rest of Moldova in its turn suffers from weak institutions and incomplete structural reforms, the fact that economic reform in Transnistria has lagged considerably behind implies that governance may be a more significant problem for the region.

The low quality of governance in Transnistria could prove to be a serious threat to growth prospects in the region and the country as a whole. Worldwide experience shows that growth and investment suffer due to poor governance. According to a survey conducted in 69 countries for the 1997 World Development Report (WDR), crime and theft, as well as corruption, were ranked by local entrepreneurs among the top three obstacles to economic activity. The same survey has shown that investors do not consider credible those governments which are unable to perform core functions properly, i.e., to ensure law and order, protect property, and apply rules and policies predictably. The 1997 WDR found a close correlation between the index of governments' credibility and the rates of growth and investment in their economies. This topic is so complex and potentially important for understanding the economic situation in Transnistria, that it is well worth further study.

C. EXTERNAL TRADE

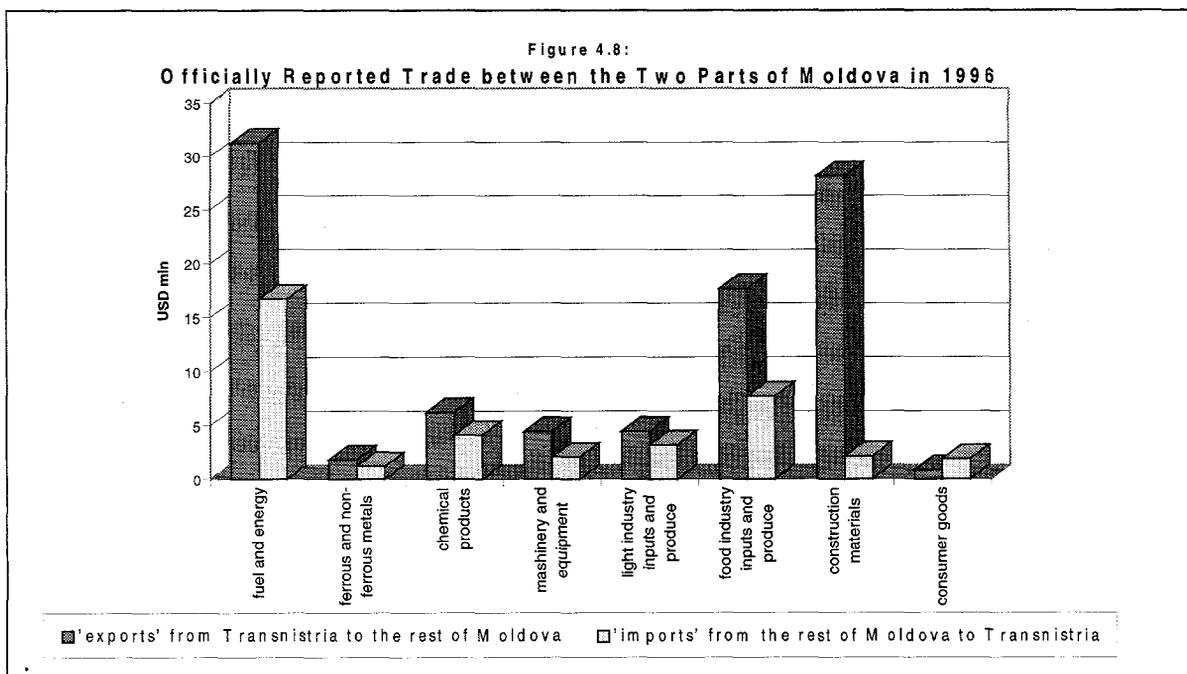


4.16. The main conclusion from the available data on Transnistria's foreign trade is that, despite all the economic difficulties, the region has not fully lost its external potential thus far. In 1996, registered exports amounted to about US\$225 million (Figure 4.7), equal to about 28 percent of the exports

registered for the rest of Moldova. Registered exports to non-CIS countries amounted to US\$70 million (for the rest of Moldova, US\$256 million). Official Transnistrian foreign trade statistics are not accurate enough to support deeper analysis. These inaccuracies are a consequence of the open border and general weakness of customs controls, as well as methodological problems with data collection. In particular, analysis shows that a large share of energy imports is not reflected in foreign trade statistics, creating an artificially positive trade balance. While official 1996 imports are reported to be about US\$183 million, or US\$42 million lower than exports, underreporting of energy imports does not allow estimation of the real trade balance. The continuing accumulation of external energy arrears (para. 4.8) indicates that the real trade balance is most probably negative.

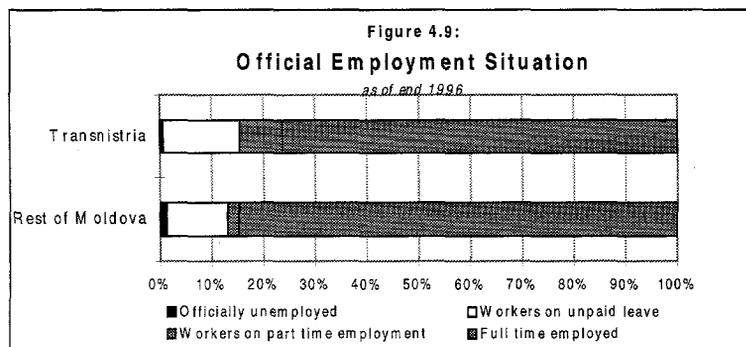
Box 4.2: Trade Between the Two Parts of Moldova

According to official Transnistrian statistics, which treat trade with the rest of Moldova as external trade, in 1996 about 31 percent of all officially registered outflows of goods from the region (evaluated at about US\$95 million) were destined for the west bank of the country. About 18 percent of all inflows of goods (estimated at US\$40 million) originated from the west bank. About half of all outflows from the east bank to the west bank captured by official statistics are comprised of electricity from the Moldovskaya power station. Among other relatively important products are construction materials, and food industry inputs and products. Of officially registered deliveries from the west bank territory to Transnistria, the largest percentage share is comprised of fuel. It is very likely that deliveries of fuel from the west bank to the east bank are also underreported by the foreign trade statistics, since those are mainly barter operations through which the settlements for electricity deliveries from Moldovskaya power station are carried out.



D. EMPLOYMENT SITUATION

4.17. Recession in the main productive sectors lies behind the employment situation in Transnistria. Its main characteristic is large hidden unemployment in the form of underemployment in the public sector combined with a very low number of officially registered unemployed.



According to official statistics, as of end-1996, only 1,456 persons were officially registered as unemployed, or 0.6 percent of the labor force (Figure 4.9). At the same time, about 35,000 people (15 percent of the labor force) were on unpaid leave, and more than 19,000 people (8.3 percent of the labor force) had to work

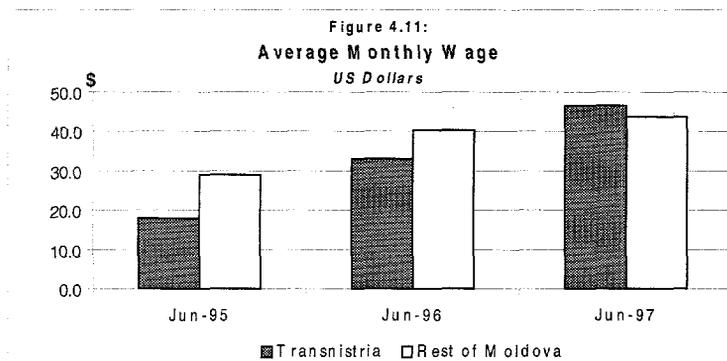
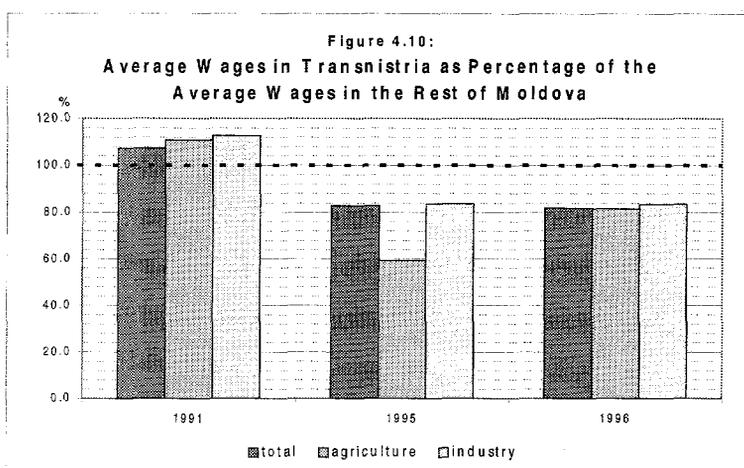
part-time because their enterprises did not operate at all or were functioning only a few days (or hours) per week. Official statistics, however, reflect mainly the situation in the public sector and practically do not capture employment in the private sector, individual economic activities, or informal economy. The household budget survey launched in 1997 shows that the majority of those underemployed in the public sector do find alternative jobs. The rate of unemployment for the Transnistria region based on the more comprehensive household budget survey data¹⁴ averaged about seven percent of the labor force for the period April-September 1997, slightly lower than the similar average for the rest of Moldova. Unfortunately, the survey does not

¹⁴ The rate takes into account two population groups that might be classified as unemployed: (a) those who had a job but did not work, and (b) those who had no job and were looking for work. In both groups, only those individuals who reported zero working hours for the past seven days were counted as unemployed.

provide enough information to analyze more deeply the structure of employment. The simplest explanation might be that alternative jobs are provided by the shadow economy, development of which has been stimulated by the unstable policies and general lack of regulation in the region.

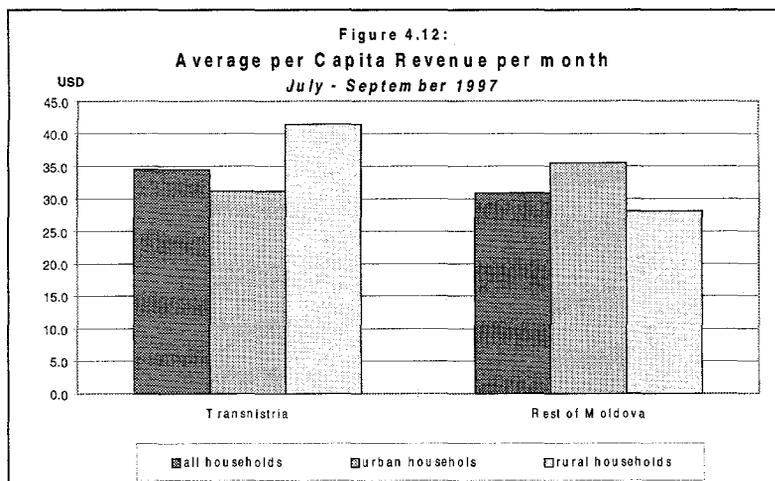
E. LIVING STANDARDS

4.18. Poor economic policies followed by the long-lasting economic crisis have led to a sharp fall in household living standards in Transnistria. The highly unstable macroeconomic situation and, in particular, very high inflation and rapid depreciation of the local currency, have played a major role in this process.



average monthly wage in Transnistria was about 20 percent lower in U.S. dollar terms than in the rest of Moldova. The hardest year for the local population was 1995. As of mid-1995, the average wage dropped to the equivalent of about US\$18 and was about 40 percent lower than in the rest of the country (Figure 4.11). In 1996, with deceleration of inflation and administrative increases in wages on the eve of the election for the region's "president," this difference was reduced substantially. In 1997, after the new regional administration was formed, another administrative increase in wages was implemented. The difference in official average wages between the two parts of the country has now disappeared. This is probably a temporary phenomenon as evidenced by the 100 percent devaluation of the Transnistrian ruble in March 1998.

4.19. In the first instance, the economic crisis has affected the level of average wages, which is the only comparative indicator available for the period prior to 1997. Statistical reports from the Soviet period show that the region had better starting conditions in terms of wage levels than the west bank territory. The major factor was the large share of employment in heavy industry where the highest wages were paid. In 1991, the estimated average wage in Transnistria was more than six percent higher, and the average wage in industry was some nine percent higher than the corresponding indicators for the whole country (Figure 4.10). During 1995-96, the



4.20. According to the household budget survey, by mid-1997, per capita household revenues in the Transnistria region recovered to the national average level. It is worth mentioning that, prior to disintegration, per capita household revenues were most probably higher in the Transnistria region than in the rest of the country, since in the Soviet period, wages accounted for about 70

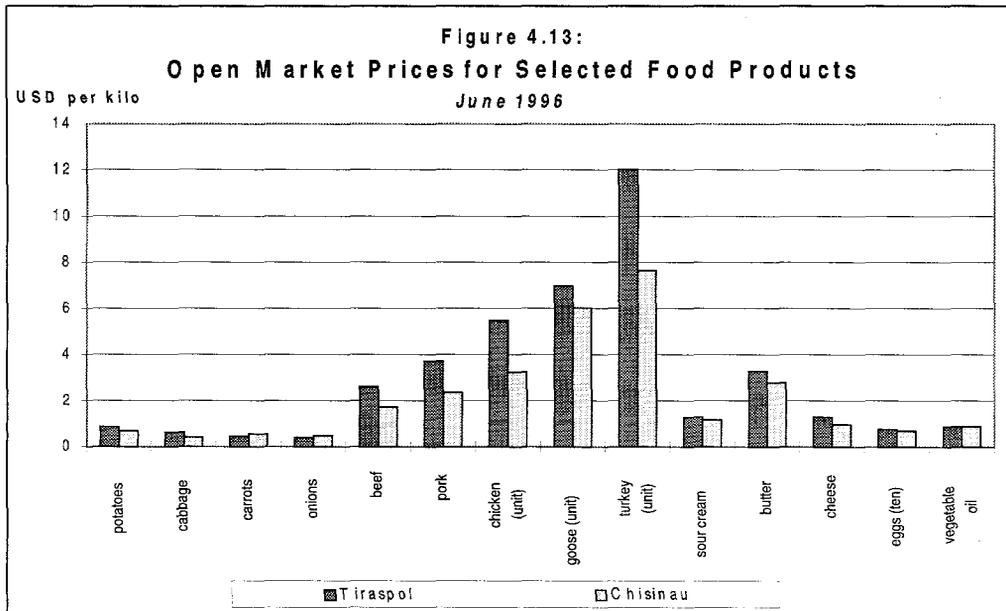
percent of household revenues.¹⁵ In February 1997, average monthly revenue in Transnistria amounted to US\$26 per capita and was about the same as in the west bank territory. The July–September quarterly round of the same survey shows the average per capita revenues for the Transnistria region to be equivalent to US\$35 or about 10 percent higher than in the west bank territory (Figure 4.12). This is likely to be a temporary phenomenon caused by the administrative increase in wages. At the same time, the survey data clearly indicate that the urban majority in Transnistria is poorer than the rural minority and poorer than the urban population of the west bank.¹⁶ In July–September 1997, average per capita revenues of the urban population in Transnistria were about 14 percent lower than the same indicator for the west bank:

4.21. Comparison of household revenues between the two parts of Moldova should be referred to with caution since the purchasing power of Transnistrians is different from that of west bank inhabitants. In particular, there is statistical evidence that open market food prices in Tiraspol, Transnistria’s major city, are generally higher than food prices in Chisinau, the capital of Moldova (Figure 4.13).¹⁷ On the other hand, prices for communal services, in particular energy tariffs for households, are lower in the Transnistria region than in the rest of Moldova. Also, economic policies in Transnistria may limit the availability of consumer goods, thereby inflating purchasing power.

¹⁵ No statistical data on household revenues in Transnistria are available for the Soviet period, as republic level data were never broken down by region.

¹⁶ The Transnistria region is not an exception in this respect, as the same situation where the urban population is poorer than the rural population is observed in most CIS countries. This is explained by the high share of revenues in kind from domestic agricultural production by the rural population. At the same time, the household survey has revealed a very atypical situation of the west bank territory where the rural majority appears to be significantly poorer than the urban minority, despite the availability of land plots and deep-rooted agriculture traditions. This unexpected result of the survey requires separate investigation.

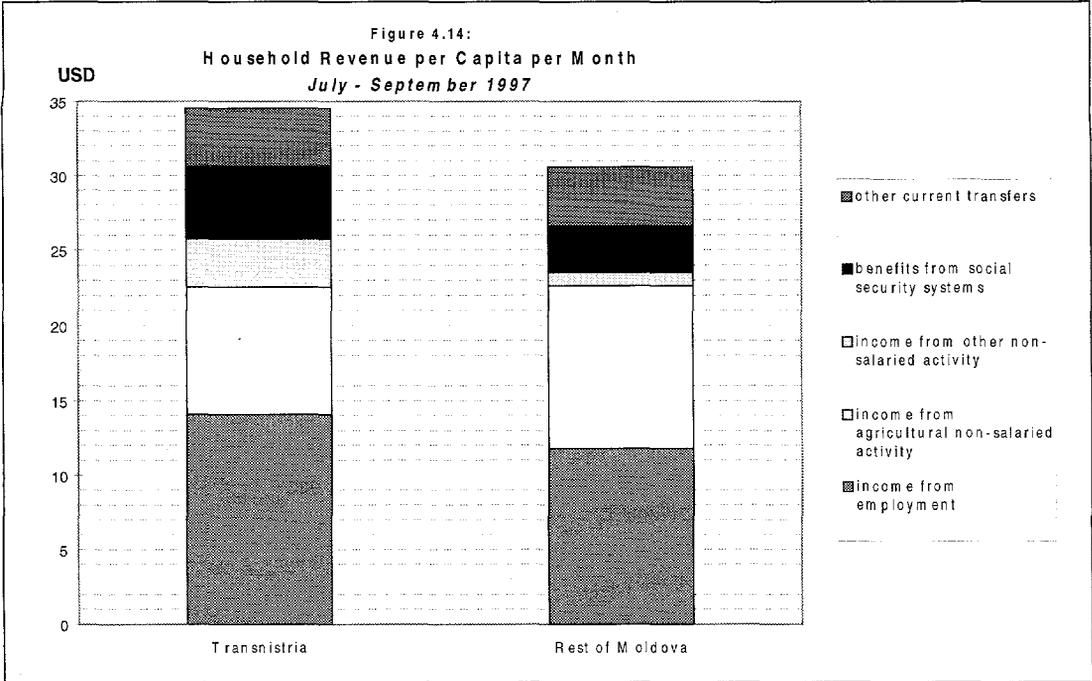
¹⁷ Comparison of food store prices would make little sense since in the west bank territory of Moldova the majority of food products are bought in the open market. This is even more the case in the Transnistria region where reluctance to privatize the trade sector generates periodic shortages of basic food products in the stores and the long queues so typical of the Soviet period.



4.22. Analysis of the structure of per capita household revenues in Transnistria shows that there are two major factors without which the fall in revenues could be much greater and the recent relative improvement would not have been possible. These factors are: (a) the populist social policy of the regional authorities conducted at the expense of accumulating external arrears; and (b) the availability of alternative revenue sources, including revenue earned from domestic agricultural production and individual off-farm activities.

4.23. As for the political aspect, it is clear that maintaining the image of a socially oriented economy has been one of the major goals of the Transnistrian authorities. Examples of policy measures aimed at artificially maintaining the level of household revenues have already been given in Chapter III (para. 3.6). Figure 4.14 is also quite illustrative, since it shows the relatively greater importance of social security revenues in Transnistria. This is indicative of a paradoxical situation: the region where macroeconomic conditions are comparatively worse than in the rest of the country is trying to maintain a more generous system of social benefits.

4.24. The importance of alternative revenue sources to Transnistrian households is demonstrated by the large share of income from nonsalaried activities (about 34 percent). Another 11 percent of revenue is composed of current transfers. More than 70 percent of revenue from nonsalaried activity is revenue from domestic agricultural production, of which about 60 percent is revenue in kind. In fact, household plots "feed" the Transnistrian population. Among other important areas of nonsalaried activity are commercial activities, including the trade of agricultural products produced by households and commercial trade in the cities, which is the most developed form of small business in the region. Current transfers are another important factor helping to sustain the level of household revenues. In the answers to the survey questionnaire, these transfers were identified in the majority of cases as "presents." One of the simplest explanations is that they represent a form of repatriation of income earned outside the region. The multiethnic Transnistrian population historically has had links with other CIS countries, first of all Ukraine and Russia, where many families have relatives.



CHAPTER V

CONCLUSIONS

5.1. Self-isolation of the Transnistria region from the rest of the Republic of Moldova at the initial stage of implementation of market reforms in the country has resulted in high economic and social costs. Both the east and west bank economies continue to experience negative economic consequences of the Transnistria problem. Although the region's economy has avoided collapse so far, the people of Transnistria have continued to suffer through a long-lasting economic crisis which in many respects is more severe than that experienced by the rest of the country, with no real end in sight. The need for comprehensive stabilization and structural reform is clear. The partial, piecemeal measures introduced to date by the Transnistrian authorities have been inadequate. Comprehensive economic reform would clear the way for reintegration of Transnistria's economy with the rest of Moldova and the development of ties with the international community. Economic reintegration would benefit the entire country. However, it requires a strong will and persistent effort from both sides.

5.2. The costs generated by the Transnistrian conflict have been significant for each of the two parts of Moldova and for the country as a whole. The west bank economy has been directly affected through the loss of effective control over the major power plant and the eastern border with Ukraine, as well as through loss of access to important transport routes. The Transnistria region has isolated itself not only from the rest of Moldova but, to a large extent, from the world at large. Reluctance of the Transnistrian authorities to implement comprehensive economic reforms has exposed the region to severe economic crisis. Transnistria's economic conditions are significantly worse in many aspects compared to the west bank of Moldova where the first signs of economic recovery appeared in late 1997. A particularly high price has been paid by the population of the Transnistria region, whose living standards have fallen dramatically. Disintegration of the already very small internal market has weakened the economic potential of the whole country. Lack of structural reforms combined with de facto separation of Transnistria have provided a favorable environment for various forms of shadow economy, including its criminal component. These governance problems negatively affect the economy of both parts of the country. Another nationwide consequence of the Transnistrian conflict has been increased dependence on energy imports and, associated with this, accumulation of a very substantial external debt. In addition to the tangible economic damage, the conflict has negatively affected the image of the country in the eyes of the international community. This has discouraged foreign investment and hindered Moldova's integration into the world economy.

5.3. It is true that despite serious economic difficulties, the Transnistrian economy has avoided a full collapse so far. The following three factors are probably the major determinants behind this phenomenon:

- de facto liberalization in a number of areas, which occurred in many cases against the will of the Transnistrian authorities and as a consequence of their poor economic policies;
- availability of a massive external subsidy to the whole economy, in particular in the form of practically free of charge energy resources from Russia; and

- partial reform and reintegration efforts of the regional authorities pushed by the danger of full economic collapse.

5.4. It is clear that the policies of piecemeal reforms and heavy reliance on external subsidies followed by the Transnistrian authorities are associated with high risks and are inadequate to create internal conditions for sustainable economic growth in the region. The factors that have propped up the economy so far are not under the control of the regional authorities and could exert destabilizing influences in the future. It is quite possible that the region could continue to benefit from external support of some sort for quite some time. However, reliance on such support obviously can not form the basis for true macroeconomic stabilization and does not provide the predictability required for attracting substantial private investment. The only factor that could provide for stabilization and economic growth in the longer term is development of the partial efforts to reform certain elements of the system into a comprehensive market reform program within the national framework already adopted by the rest of Moldova. The recent measures in the monetary and budgetary areas, as well the few steps towards economic reintegration with the west bank, have had a positive impact on local economic conditions in 1996-97. However, it is also clear that these partial efforts are insufficient. Much stronger reform effort is urgently needed on the part of the Transnistrian authorities. This effort must include:

- A comprehensive macroeconomic program that would result in definitive stabilization of the monetary and financial system in the region: in addition to providing a framework for resolving the east bank's financial crisis, stabilization would create the conditions for reintegration of the monetary system on the basis of the national currency, the leu.
- Structural reforms (in particular, privatization of state enterprises, enterprise restructuring, agricultural reform, public expenditure reform, and further banking sector reform) would set the basis for recovery of the region's economy from the numerous external and internal shocks: combined with stabilization, structural reform will create the conditions for overcoming the economic crisis, which currently threatens future development prospects of the region.
- Full trade and price liberalization, in context of unification with the national regime: this is a prerequisite for restoring growth in Transnistria. It is equally essential for the development of economic ties with the rest of Moldova, as well as with international trading partners and foreign investors.
- Establishment of a transparent legal and regulatory framework for a market economy on the basis of national regime: this is needed, in particular to protect property rights, determine the proper role of state, and promote private investment.

5.5. The economic benefits of reintegration for both parts of the country are clear. Through economic reintegration, Moldova could strengthen its internal economic potential and increase external competitiveness. For the Transnistria region, economic reintegration would mean, *inter alia*, stable ties with economic agents within Moldova and the outside world, including greater access to international markets, and financial and technical assistance from the international community. Reintegration would also precipitate much-needed economic reform, since the rest of the country has progressed a great deal further in the transition to a market economy. Moreover, reintegration would help to improve governance throughout the country and eliminate

the rent-seeking opportunities created by the de facto separation. For the entire country, reintegration would remove a major question mark concerning the future, thereby improving Moldova's image in the eyes of foreign investors and the international community as a whole.

5.6. Economic reintegration cannot be expected to happen by itself. The prospects depend on achieving a final political settlement of the conflict which is a major challenge facing Moldovan and Transnistrian authorities. The history of the Transnistria region this century shows that there are many social, ethnic and linguistic factors to be taken into account. The process of separation has developed substantially over the past five years and there are a number of special interests which have benefited from the situation. Reversing these negative consequences requires strong will and persistent effort from both sides.