

Transnistria: uncertain economic outlook

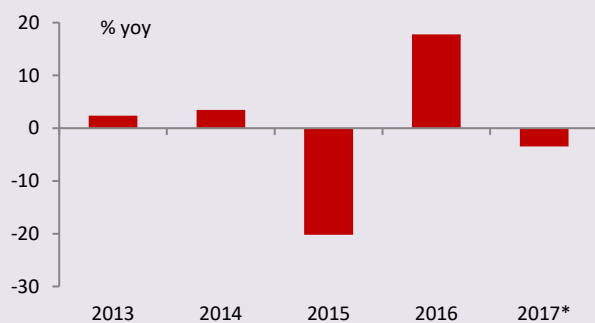
The Transnistrian economy has been in crisis mode for many years due to the undiversified structure of the economy and the precarious state of the public finances. The industrial sector, which accounts for about 30% of Transnistrian GDP, is dominated by only two companies: steel producer MMZ and the electricity plant Moldavskaya GRES. A decline in the output of either company usually results in protracted recessions. To make matters worse, an economic slowdown in the industrial sector is typically aggravated by public sector spending cuts as the large budget deficit of 23% of GDP leaves no room to compensate any revenue short-falls.

Reforms such as the implementation of the Deep and Comprehensive Free Trade Agreement (DCFTA) between the EU and Moldova and a planned public sector reform could help to address the structural problems of the Transnistrian economy. However, both require time and resources which are in short supply. Indeed, recent Ukrainian sanctions against Russian companies and American punitive tariffs on steel could halt steel production triggering the next economic crisis.

Boom and bust

In 2015, the gross domestic product of the Transnistrian region declined by about 20% as the result of a strong decline in industrial output which in turn triggered a fiscal crisis as the administration was not able to pay public sector wages and pensions in full. In 2016 the Transnistrian economy showed a strong bounce-back with economic growth of 18% on the back of a large increase in public spending financed by borrowing.

GDP development



Source: De-facto Ministry of Economic Development of Transnistria
*Estimate

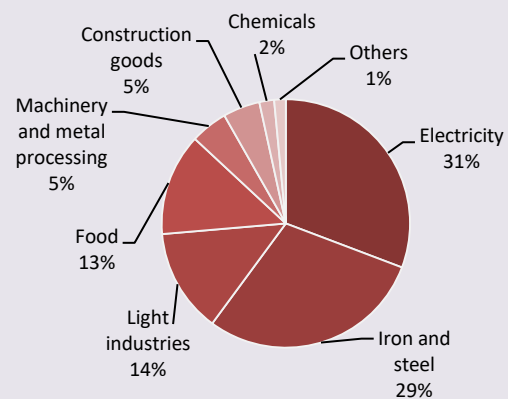
Despite some signs of stabilisation in 2017, the economy contracted by about 3% in real terms. The problematic up and down of the Transnistrian

economy is mainly due to the undiversified structure of the economy and the precarious state of public finances which need to be addressed urgently in order to put the economy on a stable growth path.

Undiversified economic structure

The Transnistrian economy features a rather large share of industry with the industrial sector accounting for about 30% of GDP. While the presence of industrial production is generally positive, a closer inspection shows that 60% of industrial output depends on only two companies, making it vulnerable to economic shocks.

Structure of industry



Source: De-facto Ministry of Economic Development of Transnistria

Namely, there is the metallurgic plant MMZ which accounted for about 30% of industrial production in 2017 when demand for steel products was favourable. In addition, there is the electricity producer Moldavskaya GRES in Kuchurgan which accounts for roughly another 30% of industrial output. While there is also a sizeable light industry sector (mainly textile and shoe production) and food production, this large concentration on only two companies makes the economy vulnerable to economic shocks.

Precarious state of public finances

A second factor explaining the large ups and downs of economic activity are public finances.

In 2017, the public finances of the Transnistrian region have shown a huge budget deficit of about 23% of GDP – very high by any standard. The main reason for the high deficit is very high public expenditures which amount to 58% of GDP. Overstretched public finances mean public spending is often aggravating economic slowdowns. For example, in 2015 and 2016 when the steel plant MMZ stood idle for some time, the

administration in Tiraspol was unable to compensate the resulting tax revenue short-fall and instead was forced to cut public sector wages and pensions. This further reduced demand and aggravated the economic slowdown.

Budget deficit



Source: De-facto Ministry of Economic Development of Transnistria
*Estimate

In 2016, the de-facto central bank directly and indirectly started financing the public deficit by issuing loans to domestic banks which in turn loaned to the authorities. That way, the administration was able to repay public sector wages and pension arrears which explains the large bounce-back of economic activity in 2016. However, this “printing of money” led to a large increase of money in circulation posing the risk of a rapid increase in inflation and a currency crisis. It was only due to some absorption measures of the de-facto central bank that an inflationary spiral could be avoided. Additionally, it is increasingly difficult to finance a deficit of this size. Currently, half of the deficit is financed through the gas fund. For the remainder the administration has only very limited options such as borrowing from local banks, companies or tax advances which seem to have been exhausted. Thus, there is an urgent need to reduce the budget deficit to avoid another fiscal crisis.

Need for reforms

The administration in Tiraspol has undertaken some reforms to address the existing problems and diversify the economy. Particularly, the EU-Moldova DCFTA, which is currently been partially implemented, represents an important instrument in order to diversify exports and the Transnistrian economy. However, substantial technical assistance is required to ensure that some of the demanding aspects of the DCFTA can be successfully implemented in the Transnistrian region.

The administration has also drawn up plans for a public sector reform which has the potential to reduce the large public sector. Indeed, there is an urgent need for a pension reform and reforming the education sector, the two areas with the largest savings potential. Additionally, the de-facto central bank also carried out a long overdue devaluation of the local currency which

has proven successful in addressing some of the imbalances and boosted trade.

Outlook: considerable risks ahead

However, those reforms take time and considerable resources to implement, both of which are in short supply. Meanwhile, the risks for the Transnistrian economy, especially for steel production, have recently increased. Due to American tariffs on steel imports, a supply glut can be expected on the EU market which is the main destination of Transnistrian steel exports. In the consequence demand and prices for Transnistrian steel products are likely to take a hit. The main problem though may result from Ukrainian sanctions against Russian individuals which also affect the steel producer MMZ. Not only do the sanctions prevent MMZ from exporting steel products to Ukraine, but the sanctions also prohibit the import of scrap metal from Ukraine which is essential for Transnistrian steel production. If this situation is to persist, steel production is likely to decline or halt entirely with knock-on effects on public finances and the risk of a repeat of the 2015 economic crisis.

Author

Jörg Radeke, radeke@berlin-economics.com

Editors

Dr Ricardo Giucci, Woldemar Walter

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Note: This newsletter is based on research carried out for the “Economic Policy Dialogue Transnistria” project. The project is funded by the German Foreign Office and is coordinated with the Government of the Republic of Moldova.

German Economic Team Moldova

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The German Economic Team advises the Government of Moldova on economic policy issues since 2010. It is funded by the German Federal Ministry for Economic Affairs and Energy and implemented by the consulting firm Berlin Economics.



BE Berlin Economics GmbH | Schillerstraße 59 | 10627 Berlin
+49 30 / 20 61 34 64 - 0 | info@berlin-economics.com | [Impressum](#)