NATO PARLIAMENTARY ASSEMBLY

THE ECONOMIC SITUATION IN MOLDOVA

CHAIRMAN AND ACTING RAPPORTEUR: KURT BODEWIG (GERMANY)

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I. INTRODUCTION

1. The Republic of Moldova borders Romania on the west and Ukraine on the north, east and south, and comprises the eastern part of the Romanian Principality of Moldavia (1359-1859). It has a long history of occupation, which continues to colour its political and economic culture. The Ottomans annexed it in the sixteenth century and the territory, subsequently known as Bessarabia, was ceded to the Russian Empire in 1812. The Prut River to the west, the Nistru River to the north and east, the Black Sea to the south and the Chilia arm of the Danube River to the southeast delineated the territory. It remained under Russian control until 1918, when it united with Romania. During World War II, Soviet troops occupied Bessarabia. It was briefly recaptured by Romania, but was ultimately incorporated into the USSR as the Soviet Socialist Republic of Moldova (SSR Moldova). On 27 August 1991, the former SSR Moldova declared its independence from the Soviet Union under the constitutional name of the Republic of Moldova.

2. The Republic of Moldova is the poorest country in Europe and is currently ruled by a Communist government. The Transnistrian "frozen conflict", as well as the country's dubious role as a hub of human trafficking and smuggling have led analysts to characterize it as posing one of the last serious security challenges within Europe. The Republic of Moldova, however, is now seeking a closer partnership with the EU and the West in general and this, in turn, is complicating its relations with Russia, which has supported it politically, economically and financially.

3. The Republic of Moldova is poorly endowed with natural resources, apart from its fertile soil. It is entirely dependent on imports to meet many of its consumer, manufacturing and energy needs. After achieving independence, the Republic of Moldova lost direct and indirect subsidies from the Soviet Union, which had heretofore comprised nearly 25% of its GDP; its terms of trade simply collapsed as a result ("Trade Diagnostic Study 2004", the World Bank). The Republic of Moldova also lost access to the CIS markets as the sudden influx of imports from the West and the rapid decline of disposable income eviscerated domestic demand for Moldova-made products. Although the Republic of Moldova was considered a middle-income country when it achieved its independence, the economic situation deteriorated sharply over the following decade. By 1999, the national poverty rate stood at 73%. After having launched a series of structural reforms designed to trigger growth, the poverty rate in 2005 had decreased to 14.7% in large cities, 48.5% in small towns and 42.5% in rural areas ("Moldova-Country Brief 2006", the World Bank). Strong economic growth of the last seven years fell short of returning to Soviet-era GDP levels. In 2006, the level of GDP represented still only

about 55% of the 1991 level.

4. A central question has dominated Moldovan political life: should the country link itself to the Russian and the CIS system, or should it seek integration with Europe. Five years ago, the Party of Communists of Moldova (PCRM) led by Vladimir Voronin was elected on a pro-Russia platform aiming at linguistic Russification, Russian-inspired foreign and security policies and integration in the CIS. After three years in power, President Voronin declared himself disillusioned with Russia and, in the face of intense Kremlin pressure, adopted a set of pro-Western reforms designed to tighten the Republic of Moldova's links with Euro-Atlantic institutions. This U-turn helped his party win 56 of 101 seats in the 2005 parliamentary elections. At the same time, he was able to gain the support of the main opposition parties, the right-conservative Christian Democratic People's Party (CDPP) and right-leaning Social Liberal Party (SLP). In order to win opposition support, he introduced a ten-point co-operation plan, including an important set of judicial and media reforms premised on the EU Action Plan. As a result of this partnership, the Republic of Moldova's political life has been characterized by an unprecedented period of tranquillity. President Voronin has recently adopted a somewhat more pro-Russian and anti-Romanian position, but this may reflect a short-term political electoral calculation. Burdened by scandals and in-fighting, the opposition today is rather weak. That said, the President is under increasing pressure from some political forces, allegedly for slow progress in implementing reforms.

5. The separatist region of Transnistria poses the Republic of Moldova's most pressing challenge. The region proclaimed independence from the Republic of Moldova in 1990, and engaged in a bloody confrontation with the Moldovan army in 1992. Although the warring parties signed a cease-fire that year, this failed to resolve the central source of contention: the degree of autonomy to be accorded to the region. Transnistria remains a haven for organised criminal groups, which are engaged in illegal arms sales, smuggling, and money laundering. It hosts the largest post-Soviet army depot in Kolbasna, the Russian (formerly Soviet) 14th Army and several Soviet era armament factories. Although there is an ethnic dimension to the Transnistria conflict, economic factors may well be more important. In spite of Transnistria's small size (12% of the territory and 17% of the population), most Moldovan industry is located in that breakaway region. In 1990 Transnistria was generating 40% of the former Moldovan SSR GDP, 33% of its industrial output and 90% of its energy output (Mackinlay and Cross).

6. According to the International Organization for Migration (IOM), the Republic of Moldova has the greatest number of victims of human trafficking in Eastern Europe. Law enforcement agencies identified 1643 victims between January 2000 and December 2004 (http://www.iom.int). Organised criminal groups trafficked women, children and men for sexual exploitation, to meet demands for inexpensive labour, and to support petty criminal networks. More than 80% of these victims illegally crossed international borders. Traffic routes for panhandlers and petty criminals often course through Poland and Russia, while human traffickers have used well-worn byways through the Balkans to smuggle people into South-eastern Europe and the European Union. Although the authorities together with the IOM, OSCE, UNDP (United Nations Development Programme) and other bodies have been running information campaigns and anti-trafficking programmes, it is difficult to assess the scale and effectiveness of efforts to contain the problem. Judging from the growing number of the identified victims, it is apparent that policing and prosecution mechanisms have improved over time. It is also evident that the problem remains very serious. Most victims cite extreme poverty as the ultimate source of the problem.

7. With Romania's accession to the EU in January 2007, the Republic of Moldova became part of the Union's new Eastern border. Given the Republic of Moldova's profound political divisions and disastrous socio-economic and security problems, the EU will need to pay even greater attention to that country and develop a strategy to ameliorate conditions there.

II. THE ECONOMY

8. Because the Republic of Moldova's economy is small and open, it has been extremely vulnerable to external shocks like the 1998 Russian currency crisis. At the same time, the lack of political consensus regarding economic policies of the short-lived coalitions in power often complicated efforts to initiate coherent structural reforms. The Republic of Moldova's economic challenges are rooted both in internal and international factors.

9. Needless to say, the Republic of Moldova's economic transition has suffered a range of birth pangs. The first stage, initiated in 1990, involved the liberalisation of prices, trade and enterprise operations. A second phase began in 1993 when, in co-operation with the IMF and the World Bank, the Republic of Moldova pursued massive privatisation of state-owned enterprises, introduced a new and stable national currency (leu) and established a national securities market. By 1995, however, the reform process had bogged down and the economy went into a recession, which culminated in the 1998 crisis (http://www.case.com.pl/plik--1589572.pdf?nlang=19). Land privatisation slowed, and the government swiftly succumbed to external debt. Only after 2000 did the Moldovan economy begin to recover. The 2001 elections provided the government

with a stronger reform-oriented mandate, which facilitated a more coherent and reform-oriented economic policy.

10. Privatisation began in 1991 with the distribution of vouchers (patrimonial bonds) to all Moldovan citizens. The aim was to redistribute state ownership to the Moldovan people and to create a private sector where none had heretofore existed. Only Moldovan citizens were allowed to participate in this privatisation, however, and this deprived industry of a key potential source of international capital. By 1996, 60% of industry, 93% of the agricultural raw material processing sector, and 95% of the services and trade sectors had been privatised (http://www.case.com.pl/plik--1589572.pdf?nlang=19). Between 1997-2000, the government carried out land privatisation and privatised 942 enterprises through investment tenders. The goal of the programme now was to ensure that industrial infrastructure was privately administered and generated much needed foreign investment. The Spanish company Union Fenosa, for example, purchased the South, Central and Chisinau energy distribution companies in 1999, while Israeli investors bought 83.29% of Moldovatur, a large hotel chain (http://www.naai.Moldova.md/3privat.htm). After 2001, privatisation became more ad hoc, and there was a clear tendency to sell to Russian companies in exchange for reduced debt obligations. There are several key enterprises that the state has yet to sell off. Amongst these are wineries, tobacco companies and Moldtelecom, the Moldovan telecommunications company. Several pharmaceutical companies, water utilities, the railways and civil aviation companies are well positioned to attract foreign investors, but have not yet been put on the auction bloc. Foreigners are still not allowed to purchase agricultural or forest land in the Republic of Moldova.

11. Over the past five years, the Republic of Moldova's GNP growth has averaged 7% a year, with a low 5% in 2006 (Moldova Country Report, May 2007, The Economist Intelligence Unit). There are several reasons why this figure is so robust: first of all, structural reforms had begun to pay off. The Republic of Moldova's primary trading partners, Russia, Ukraine and Romania, underwent notable economic growth and their demand for Moldovan goods subsequently rose. Production increases were surprisingly easy to manage and non-inflationary due to low capacity utilization in the previous period. Moreover, favourable weather conditions helped bolster agricultural output (agriculture and agricultural processing products account for approximately 30% of GDP). Finally, consumer spending soared, fuelled by a significant increase in real wages and pensions and an influx of worker's remittances from abroad, which accounted for 33% of GDP for two years in a row, in 2005 and in 2006 (World Bank estimates and The Economist Intelligence Unit). This influx of foreign exchange, in turn, helped stoke domestic demand.

12. Indeed, the Republic of Moldova's economic growth is primarily consumption-driven. Investment rates have remained very low. Although exports have grown significantly, reaching 52% of GDP in 2005, imports that year stood at 83% of GDP (World Development Indicators database, World Bank). In 2006, as a result of the Russian ban, the picture is even less optimistic, as exports fell by 3.6%, year on year, while imports continued to grow by 17.5%, year on year (The Economist Intelligence Unit). It is unlikely that the rate of growth experienced between 2001-2006 can be sustained over the medium and longer term, unless there is marked improvement in the investment climate or a rapid expansion in net exports. Neither seems likely given the current policy mix and demand trends among the Republic of Moldova's trading partners.

13. Although Moldovan structural reforms have resulted in the closure of enterprises, unemployment has remained relatively stable over the last five years, hovering around 8% (6.6% in 2005) according to World Bank estimates, but over 20% in the EIU statistics. Although the lower numbers may seem comforting, they conceal a rather worrying reality: 25% of the active population has left the Republic of Moldova, and 50% of those remaining have turned to agriculture for sustenance. The average monthly wage of 1695 lei (MOLDSTAT), or approximately US$129, is simply not sufficient to live on. This helps explain the existence and role of the Republic of Moldova's large shadow economy that, simply put, accounts for a significant quantity of hidden income. The economic growth of the last years did not translate into higher employment. Public administration remains the second largest employer (around 16% of the total workforce), after agriculture. The Moldovan economy is thus failing to generate a sufficient number of jobs.

14. Since the 1998 rouble crisis, inflation in the Republic of Moldova has remained relatively low (11.7% in 2004, 13.1% in 2005). Nonetheless, the inflation rate went up again to 14.1% in 2006, the highest among CIS countries, despite an austere financial policy. Interest rates have continued to fall. Between 1998 and 1999, the Republic of Moldova's monetary base expanded by roughly 40% (CASE). The Central Bank rebuilt international reserves while financing a growing budget deficit. It did so by offering direct credits to the Ministry of Finance and purchasing T-bills for its own portfolio. Although the resulting increase in money supply should have triggered inflation, this did not transpire due to mounting demand for the leu, triggered by significant GDP growth. Substantial remittances from Moldovans working abroad helped thwart a dramatic depreciation of the leu against western currencies. Although the leu did depreciate somewhat against the euro and the US dollar, it simultaneously appreciated against the Russian rouble, the currency of its principal trading partner.

15. Because Russia and the CIS are the Republic of Moldova's traditional export markets, leu appreciation against the rouble has adversely affected exports. The Republic of Moldova's export base is small and consists of a relatively small number of agricultural and textiles commodities. Russia's ban on Moldovan meat and wine, which went into effect in March 2006, has thus had a significant negative impact on the Moldovan

trade balance. Moldovan officials have engaged in bilateral discussion with their Russian counterparts on lifting the Russian embargo. These discussions have not yet produced concrete results. Because the Republic of Moldova imports virtually all of its energy needs and most of its industrial input supplies, recent Russian gas price hikes have had a particularly adverse impact on the trade balance and the terms of trade.

16. The Republic of Moldova's trade deficit is also reflected in its current account deficit. Although the capital account has registered a surplus in recent years, this has not been sufficient to compensate for the current account deficit. Foreign direct investments (FDI) fell steadily until 2003 partly as a result of the Republic of Moldova's deteriorating investment rating. That rating has subsequently improved. In 2006 Fitch rated the Republic of Moldova at B-(stable). This upgrade can be attributed to falling political risk, improved property rights enforcement, and an overall enhanced business and investment climate. FDI has picked up as a result. Potential investors, however, are avoiding equity investments, preferring instead to lend over the short and medium-terms.

17. One important transaction, statistically recorded as FDI, was the transfer of 50% of the state-owned gas company (Moldovagaz) to Russian Gazprom as repayment of the debt the Republic of Moldova owed for previous energy imports. This transaction obviously did not generate cash revenues for the state. The concern is that the Republic of Moldova's overwhelming dependence on Russian energy supplies leaves it vulnerable to unilaterally imposed Russian price hikes arising out of Russia's gas monopoly. The Republic of Moldova may, in turn, be tempted to finance energy imports through more asset giveaways. This is obviously not a sustainable policy, and there is a risk that the Republic of Moldova could turn itself into a subsidiary of Russia's energy interests if a more sustainable approach is not taken to national energy security.

18. Fiscal conditions in the Republic of Moldova have also posed a challenge. Although the Republic of Moldova's GDP fell steadily after independence, government expenditures did not. The Republic of Moldova's inevitable budget deficit, in turn, eventually threw state finances into chaos. Starting in 1997, the government implemented more sound fiscal policies to reduce government expenditures. It slashed direct and indirect subsidies to a range of sectors and borrowers (mainly state-owned loss-making enterprises), but it also reduced public outlays on health, education and social protection. The debt situation has improved, but at the expense of public access to critical services. Because tax evasion is widespread, there is an ever-present risk of fiscal crisis; and the state's capacity to squeeze the social sector has its limits.

19. The Republic of Moldova's external debt in 2006 stood at US$2.5 billion. The Republic of Moldova is primarily indebted to international financial institutions (IFIs), but Russia and other Paris Club members are also important creditors. In 2006, after signing an arrangement of US$118.2 million with the IMF under the Poverty Reduction and Growth Facility, the Republic of Moldova was able to negotiate a US$150 million debt rescheduling with the Paris Club creditors. Although debt rescheduling has eased fiscal pressures, the Republic of Moldova's huge debt continues to loom over the national economy.

III. TRADE AND ENERGY

20. Before the Russian ban, the Republic of Moldova's main export partners were the Russian Federation (39%), the EU (26.7%), Romania (11.4%), Ukraine (7.1%) and Belarus (5.2%). The EU accounts for 36% of imports, Ukraine (22%), the Russian Federation (13%), Romania (7%) and Belarus (3.6%) (UNCTAD statistics 2004). There has been a certain redirection of trade. In 2006, for example, the Russian Federation was still the leading importer of Moldovan goods (17.3%), followed by Romania (14.8%), Italy (12.2%), Ukraine (12.2%) and Germany (7%). The Republic of Moldova imported goods from Ukraine (19.2%), the Russian Federation (15.5%), Romania (12.8%), Germany (8%) and Italy (7.3%). With Romania's accession to the EU in January 2007, the EU as a whole became the Republic of Moldova's main trading partner with a share of 56.1% of exports, and 44.4% of imports, as opposed to 31.7% of exports and 39% of imports from the CIS (Economist Intelligence Unit). Notably, almost all of the Republic of Moldova's imported fuel and electricity come from Russia.

21. The Republic of Moldova's domestic oil reserves are estimated at 15 million barrels (US Energy Information Administration). In the 1960s the Soviets undertook oil and gas exploration in the southern part of the Republic of Moldova, but abandoned these fields once more promising reserves were discovered in other parts of the Soviet Union. In an attempt to develop alternatives to Russian imports, the Moldovan government granted an exclusive oil and gas development concession to the American company Redeco Energy Inc. in 1995. In 1999 Redeco concluded test drilling at Valeni oilfield and Victorovca gasfield. The estimates indicate a production potential of 100,000 tons a year for oil and five million cubic meters a year for gas. This can only cover a very small share of the Republic of Moldova's overall energy needs (Levine). In 2005 the Azeri company AZ-Petrol obtained a 99-year concession contract allowing it to invest in the unfinished Giurgiulesti Oil Terminal on the Danube River and extending to it the right to build an oil refinery and 50 filling stations. In June of that year, the Moldovan trader AZ-Petrol opened the Republic of Moldova's first oil refinery in Comrat. The refinery has a capacity of 600bbl/d, and processes domestic crude from Valeni. In November 2005 AZ-

Petrol Moldova started exporting the first domestically produced oil products to Bulgaria.

22. As suggested above, the Republic of Moldova has accumulated a huge debt to Gazprom in recent years. In January 2006, Gazprom cut off deliveries after a price dispute and only reopened the tap after the Republic of Moldova agreed to purchase gas at a price of US$3/thousand cubic feet, up from US$2/thousand cubic feet. The Republic of Moldova subsequently initiated negotiations with the Kazakh Company Ascom for alternative supplies, but transporting natural gas from Kazakhstan to the Republic of Moldova is problematic given the current state of pipeline infrastructure. Under intense Russian pressure in January 2007, an agreement between Gazprom and the Moldovan side was signed to raise the gas price over the next five years to European averages.

23. The Republic of Moldova generates little electricity, and here as well relies heavily on imports. There is one thermal plant under construction in Burlaceni, which is scheduled to go on line in 2008. Gazprom is managing the project, and the land on which the power plant is being built belongs to Itera. As late as 2001, the Republic of Moldova experienced scheduled electricity cut-offs lasting 10-14 hours per day. Due to a programme for reducing losses in the distribution grids initiated in 2002, electricity has been available around-the-clock throughout most of the country. The Spanish company Union Fenosa International S.A. acquired electricity distribution companies from the state in early 2000. In 2001, the International Financial Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD) each lent US$25 million to increase efficiency and expand existing distribution networks.

24. The eastward orientation of Moldovan trade posed a range of practical problems, the most formidable of which was that traded goods have long had to bypass Transnistria. The Republic of Moldova has consequently invested a portion of its already limited resources into diverting railways and roads to the north and south of its border with Ukraine. This has raised both transportation and export prices but has provided a modicum of export security. Although the Republic of Moldova has entered a Free Trade Agreement (FTA) with Ukraine, a free transit regime is not yet in place.

25. Moldovan authorities are anxious to reduce national dependence on Russia and Ukraine and look to do so by establishing a closer relationship with the EU. The location, size and wealth of the EU make it a natural trading partner for the Republic of Moldova. According to the EU-Moldova Action Plan, as of 2007 the Republic of Moldova benefits from a set of trade preferences, which allows it to export most products to the EU without quantitative restrictions or custom duties, exceptions being wine, baby beef and some fish products. Even if the EU has lifted some of the trade barriers, however, domestic obstacles still limit the volume of Moldovan exports. These include:

* Moldovan standards, regulations and procedures fail to conform to those of the EU;
* Inefficient, costly and corrupt border procedures;
* High transportation costs within the Republic of Moldova due to poorly maintained infrastructure;
* Restrictions limiting foreign exchange lending to Moldovan exporters;
* Time constraints governing the repatriation of export proceeds and the high costs of monitoring, recording and reporting the process to the banking system;
* A generally poor business and investment climate (World Bank).

The Republic of Moldova scored 103 in global rankings of national business climates in the World Bank's 2006 "Doing Business" survey. The scale ranges between 1-175, with 1 representing the finest business climate. In the Transparency International corruption index it occupies the 79th position out of 158 countries (World Bank, "Doing Business," and Transparency International).

IV. THE TRANSNISTRIAN MARKET AND THE MOLDOVAN ECONOMY

26. Any analysis of Moldovan socio-economic life cannot overlook the role played by the Transnistrian market, although this economy is not accounted for in official Moldovan economic statistics. Transnistria relies on three principal sources of income: legal trade, Russian subsidies and illegal trade (smuggling).

27. Although not recognized by the international community, Transnistria is exporting and importing. The Republic of Moldova has implemented a registration system for Transnistrian companies to export goods across the Republic of Moldova-Ukrainian border. This should be seen as a constructive approach by the Government of the Republic of Moldova to the peaceful resolution of the Transnistria conflict. Legal Transnistrian trade is dominated by the vestiges of Soviet industry. Steel produced in Ribnita generates 50% of total official Transnistrian export earnings. Although its main trading partners are Russia, Ukraine and the Republic of Moldova, Transnistria has diversified its commercial export markets and it exports goods to the United States, the EU, Africa and Asia. Russian subsidies are vital. Russia accords the separatist region a preferential rate for its natural gas imports, and often exempts it from paying for energy. Smuggling generally assumes the form of re-exporting schemes through which Ukrainian and Moldovan import duties and VAT are

evaded: goods arrive in Ukrainian ports with Transnistria marked as their final destination, but soon after arriving in Transnistria they are re-exported to Ukraine or the Republic of Moldova. In this manner, Transnistria has become a source of genuine fiscal burden to the countries and regions along its borders. The lack of trading accountability is also a source of worry to European and US officials who have expressed serious concerns about human and arms trafficking through the breakaway region.

28. Among the post-Soviet separatist regions, Transnistria has achieved a relatively high degree of self-sufficiency (CISR). It enjoys a reasonably robust infrastructure (railroads, gas and power supply networks, telecommunications), has introduced its own currency, and has implemented an effective export policy. When it declared "independence" from the Republic of Moldova ten years ago, Transnistria was highly centralised and dominated by state-owned enterprises. This began to change in 2000. The Transnistrian political elite altered power-sharing arrangements among leading political institutions (President-Supreme Council-Executive) and redefined the relationship between public authorities and private economic actors.

29. The self-proclaimed Republic has adopted a presidential system. The president forms the Cabinet of Ministries (the executive) without the agreement of the Supreme Council (unicameral parliament) and appoints judges. The Supreme Council, however, approves the chairpersons of the Constitutional and Supreme Courts, as well as the chairperson of the Central Bank nominated by the President. The President is also the Commander-in-Chief of the Armed Forces. This constitutional arrangement suits the "Khozyain" (patron, father figure, strongman) who casts himself as the protector of national welfare, a role the incumbent President, Igor Smirnov, plays with great relish (Ryan).

30. The Transnistrian system has also eradicated normal distinctions between public interest representation and private economic activity. The Supreme Council, comprising 43 parliamentarians, has 33 permanent full-time members and 10 delegates who mix their political roles with their commercial interests. Personal and corporate interests are thus directly represented in the Transnistrian political project, and this reinforces the view of some analysts that the Transnistrian conflict with the Republic of Moldova is strongly economic in nature, rather than ethnic or religious.

31. In 2000 the Transnistrian government privatised state-owned enterprises. Privatisation represented a pragmatic response to the rather compelling economic crisis. Transnistria's economy is very open (foreign trade turnover was 309.7% of GDP in 2006) (Ryan), and the domestic market is quite narrow. It must thus continuously adapt to the shifting external market conditions. This, coupled with the lack of investment capital and deteriorating fixed capital stocks, has led to a serious deterioration of the local economy. Privatisation was thus seen as a solution to the fiscal crisis, as well as a means to bolster the efficiency of Transnistrian enterprises. The government subsequently privatised three-quarters of state assets, selling these primarily to Russian companies. Some have alleged that this privatisation was both illegal and poorly executed. Elena Cernenco, Transnistrian Minister of Economy, suggested that privatisation has unfolded so rapidly and that it accorded such a hegemonic role to Russian capital "as not to leave anything to Moldova" (Botan). This sell-off included the strategically important Moldovan Hydroelectric Power Station in Cuciurgan (purchased by the Russian RAO EES) and the Moldovan Metallurgical Plant in Ribnita (bought by the Austro-Ukrainian Hares Group). That said, the deals did bring in much needed foreign currency to the treasury. In 2005, revenues from privatisation funded more than 50% of the region's budget. This injection of capital has been helpful, as the Transnistrian government has accumulated a massive external debt since the region's secession. This debt was more than US$1.5 billion in 2005. Most of the debt is owed to Gazprom, both for gas imports and for fines for the non-payment of outstanding bills. By January 2005, fines for outstanding gas debt reached US$525 million (Ryan).

32. Transnistria is a net importer. The composition of its exports is narrow and includes rolled metal (61.4% in 2004), textiles, electricity, footwear, machinery and equipment (Botan). Its primary export markets are Russia, the CIS (42% in 2004) and the EU (33.3%). Transnistria is almost totally dependent on food imports (20% of total imports), but it also imports energy, non-ferrous metals, machinery, transport equipment and chemicals. CIS countries are the primary source of production inputs, and Ukraine is currently the largest importer.

33. In February 1996, the Moldovan and the Transnistrian authorities signed a protocol for disbanding internal customs controls and agreed to form joint customs controls at the Transnistrian-Ukrainian border. The Republic of Moldova handed over customs stamps and seals to Transnistrian authorities, and both sides agreed to standardise customs regulations and procedures. Moreover, Moldovan authorities also agreed to exempt Transnistrian imports and exports from taxation. The Republic of Moldova has kept its side of the bargain, but Transnistria has not. As a result, Transnistrian firms export legally without paying taxes to the Republic of Moldova. As Transnistrian authorities apply very low or no taxes on imports, a highly profitable re-export business has emerged for goods from third countries. Goods imported this way are significantly cheaper than goods imported through the Republic of Moldova (as their prices include the customs duties as well). A great variety and volume of goods officially directed toward Transnistria are somehow "lost" in transit through Ukraine or the Republic of Moldova. Judging from official import statistics, for example, 500,000 Transnistrians consume 12 times as many chickens as the Germans (The Economist, 21 September 2006).

34. In 2003 the Republic of Moldova changed the custom stamps, and all the Transnistrian exporting

companies now have to register in the Republic of Moldova to obtain an export licence. In practice, however, they are still exporting without paying taxes to the Moldovan state. The primary purpose is to reassert control of the flow of goods across the border and to close the myriad loopholes that facilitate smuggling and a range of other illegal and unregulated economic activities. Many goods are smuggled, including fuel, alcohol, tobacco and food products. There have also been frequent allegations in the Moldovan media of arms exports from Transnistria to Chechnya and Abkhazia, although these allegations have yet to be substantiated (International Crisis Group (ICG) Europe Report nr. 157, 17 June 2004).

35. Since Transnistria applies very low (or zero) taxes to its imports, official revenues generated through goods re-export is insignificant. The real beneficiaries are individuals in Transnistria and their business partners in the Republic of Moldova, Ukraine, Russia and elsewhere. In the words of Moldovan President Vladimir Voronin, the Transnistrian conflict is "a conflict of interests". He once declared that the activities of shadowy players from Chisinau, Kiev and Moscow in Transnistria are preventing the conflict from being solved. He also suggested that the Transnistrian money-laundering machine is generating roughly US$2 billion a year (ZIUA, 7 February 2006). Any settlement to the "frozen" Transnistrian conflict would, almost by default, disrupt cash flows to this flourishing and illegal parallel economy. The stakeholders in the current situation are obviously dedicated to the status quo (ICG report).

36. Transnistrian leaders have been actively searching for friends and allies to legitimise their rule. They have accordingly developed close connections with a wide range of Russian institutions. Their lobby has targeted the middle strata of the presidential administration, the Russian Duma, universities, NGOs, and the Russian Orthodox Church. In Ukraine, Transnistrian authorities mobilised some support from the Presidency and the Rada, which have both recognised the value of intensified commercial ties with the region. In November 2004 then Ukrainian President Leonid Kuchma declared that an economic blockade of Transnistria would translate into a blockade of Ukraine (CISR). The Transnistrian leadership has had some success with the Republic of Moldova's leaders. Besides the Russian nationalist Equal Rights (Ravnopravie) political movement, the Republic of Moldova's government and parties are strongly anti-secessionist. Moldovan business groups, however, have participated in Transnistria's shadow economy and have helped block measures designed to curb illicit trade in the region.

37. The Transnistrian issue has recently returned to the spotlight. Internally, there are signals that a struggle for power is underway in the secessionist republic, pitting the incumbent president Igor Smirnov and his Renewal Party against the chairman of the parliament, Yevgeniy Sevchuk ("Transnistria on the Brink: Sheriffs vs. Patriots"). Moreover, Igor Smirnov seems to have fallen out with the Kremlin, after millions of dollars of humanitarian aid provided by Russia somehow vanished (EIU Country Report - Moldova, May 2007). Externally, the NATO member countries conditioned the signing of an adapted version of the CFE Treaty to the withdrawal of Russian troops from Transnistria and Georgia, in compliance with the commitments assumed by Russia at the OSCE Summit in Istanbul in 1999. Recent allegations regarding a peace plan for Transnistria, secretly negotiated between President Voronin and his Russian counterpart outside the "5+2" format, have attracted the international community's attention. (Socor, 13 April 2007)

38. Following the military confrontation between the Moldovan army and the Transnistrian separatists in 1992, there have been a series of attempts to establish a legal framework to regulate the relationship between the Republic of Moldova and Transnistria, but so far all attempts to do so have failed.

39. In 1997, the Republic of Moldova and Transnistria signed a memorandum prepared by Yevgheny Primakov, chairman of the Russian State Commission on the Transdniestrian settlement. The memorandum proposed a "common state" for the Republic of Moldova and Transnistria, without clearly defining the term. The Republic of Moldova understood the "common state" as a unitary entity, in which Transnistria would enjoy a large degree of autonomy. Transnistria, however, interpreted it as a confederation of two equal actors. Having no consensus on the fundamental issue of the "idea" of the state, the conflict between the Republic of Moldova and Transnistria remained "frozen".

40. Between 2002-2004 several federalization proposals were put forward as the only feasible way out of the conflict. One of them, known as the "Kozak memorandum", was prepared by Dimitri Kozak, Deputy Head of Administration of the President of Russia, and came very close to being signed by President Voronin. Large demonstrations in Chisinau and diplomatic pressure both from the EU and the United States prevented him from doing so. The plan envisaged an asymmetrical federation, in which Transnistria would have had veto power over federal policies that would have "contravened to its interests". Moreover, it stipulated that Transnistria and Gagauzia could organise referenda and declare independence from the Republic of Moldova.

V. OTHER SIGNIFICANT ACTORS

41. In recent years, the EU has begun to focus greater attention on the Republic of Moldova and the surrounding region. EU engagement has intensified since 2004. The Republic of Moldova's inclusion in the "European Neighbourhood Policy" (ENP) holds out the prospect of preferential access to the EU market as

well as the initiation of a deeper and more sustained political dialogue. It is an open question whether this form of association may ultimately pave the way to EU accession. Both the Republic of Moldova and its neighbour Ukraine aspire to become full-fledged EU candidates sooner rather than later, although many analysts are aware that more than a decade of consistently applied reforms and a higher degree of economic prosperity will be needed to qualify for membership. The EU itself will have to recover from its apparent enlargement fatigue and alter its institutions in such a manner as to accommodate greater diversity. The current debate over the EU constitution is thus highly relevant to the two countries' European ambitions.

42. After the adoption of the action plan based on the ENP in February 2005, a Special Representative for the Republic of Moldova was appointed, followed by the opening of an EU delegation in Chisinau in October 2005. Moreover, the EU has, like the United States, gained observer status in the OSCE-lead 5+2 negotiations aimed at resolving the conflict over Transnistria. After a promising start, the 5+2 process has been mired in a dangerous stalemate since late February 2006. Following a joint request from the Moldovan and Ukrainian governments, the EU launched in December 2005 a border assistance mission (EUBAM) to help stop contraband over the 1400 km-long border between the two states, including the almost 500 km with Transnistria. With the backing of the EU, the two governments agreed to implement tougher customs controls, under which Transnistrian goods would henceforth bear a Moldovan stamp in order to be exported eastwards. Transnistrian export companies must now also register with the Moldovan authorities in order to obtain export licences, and are thus compelled to pay taxes to the Moldovan state. Although this policy has not generated economic revenues, it has restored a degree of Moldovan leverage over the breakaway region. It does not come as a surprise, therefore, that the Transnistrian and Russian authorities have denounced this as a "blockade".

43. Ukraine's position on the Republic of Moldova has been fairly consistent. It makes no claim on the Republic of Moldova territory and has been willing to co-operate with it. Recent Ukrainian support for the EU-backed border initiative is an expression of Ukraine's professed European vocation. Ukraine is hardly indifferent to Romania's influence in the Republic of Moldova, and most analysts believe that it would not welcome unification of the two states (International Crisis Group (ICG) Europe Report nr. 157).

44. Romania was the first state to recognise the independence of the Republic of Moldova. After initially enjoying a friendly rapport in the early '90s, Moldovan-Romanian relations subsequently turned rather cold. Moldovan authorities are alarmed by the unionist discourse sometimes heard in Bucharest, and chafe at the notion that some in Romania see their country as the Republic of Moldova's "big brother". The relationship between the two states soured in 1994 following the Romanian Parliament's declaration on the adoption of the new Moldovan Constitution. That Constitution mentioned a Moldovan nation and language, and did not mention a shared Romanian cultural heritage as the Romanian Parliament had expected. The Moldovan Parliament accused Romania of interference in its internal affairs and infringement of its sovereignty. Nevertheless, the Republic of Moldova has adopted several of Romania's national symbols, including the colours of the national flag - red, yellow and blue; the national monetary unit the leu; and the coat of arms representing "the aurochs with a star between its horns". In 1992 Romania served briefly as a mediator in the Transnistrian conflict, but Russia did not welcome this. Since 1991 Romania has been one of the leading aid providers to the Republic of Moldova. A Romanian government-managed fund operated between 1991-2003, and financed a range of bilateral co-operation projects agreed at governmental level. Romania has also granted numerous scholarships to Moldovan students. Poland and Lithuania have been particularly active in the Republic of Moldova and lent strong support to the country's reform effort. For its part, the United States sees resolution of the Transnistrian conflict as vital to stabilising the Black Sea area and has conducted a dialogue with Moscow on the matter.

45. Romania's recent accession to the EU generated both emotion and practical problems in its relations with the Republic of Moldova. From 1991 up to January 2007, the two countries operated without a visa regime governing cross-border travel. Since Romania became an EU member state, however, it has had to reintroduce visa requirements for Moldovan citizens and toughen border security. These measures have disrupted the lives of thousands of Moldovans who have been studying, working or engaging in small trade across the border in Romania. In almost all large Romanian towns, there are the so-called "Russian markets" where many Moldovans sell large varieties of goods (food, shoes, clothing, rugs, cosmetics, pots, mechanical components, etc). Because few countries have consulates in Chisinau, a significant number of Moldovan citizens planning to work or travel in West European countries were accustomed to travelling to Bucharest to obtain visas. As of 1 January 2007, they are required to obtain a Romanian visa before applying for the second visa (European Voice, vol.13, nr.3 - 25 January 2007).

46. Remittances play an essential role in the Moldovan economy, effectively denying Moldovan migrant workers access to the West, which could have serious economic consequences. According to the IOM, 100,000 Moldovan migrant workers travel through Romania every year. The total active Moldovan population numbers 1,484,000 people, according to the National Bureau of Statistics. Of those, 25% are working abroad and remitting income, which accounts for 33% of GDP (World Bank estimates). The 100,000 migrant workers who have travelled through Romania account for almost one quarter of the total number of migrant workers. The Agreements with the EU on readmission and visa facilitation went into effect on 25 April 2007. Moldovan authorities, however, have unexpectedly rejected a Romanian request to open more consulates (in the cities

of Cahul and Balti). This could create new hurdles for those Moldovan citizens applying for a Romanian visa, as all Romanian consular services in the Republic of Moldova are available only in Chisinau. The newly opened European Common Visa Application Centre in Chisinau could alleviate some but not all of the pressure.

47. To avoid visa problems, a significant number of Moldovan citizens have applied for Romanian citizenship. Approximately 100,000 Moldovans became Romanian citizens between 1991-2007, making use of the provisions of the Romanian law allowing for the re-acquisition of the citizenship for those who had lost it for reasons beyond their control (i.e. as a result of the annexation of the former Romanian province of Bessarabia by the USSR). Since August 2006, there has been a surge in the number of requests to reacquire Romanian citizenship (estimates vary from 450,000 to 800,000). It is somewhat paradoxical that 21% of the Republic of Moldova's population aspire to Romanian citizenship, although the 2004 census revealed that only 1.9% declared themselves ethnic Romanian.

48. The EU and the United States have consistently supported the Republic of Moldova's aspirations to build a democracy with a functional market economy operating under the rule of law. To that end, the United States has for years been the Republic of Moldova's single largest bilateral aid donor, although the combined assistance of the EU outweighs the US contribution. The United States has called for the withdrawal of Russian munitions and troops from the region, and has offered to pay Russia for the expenses linked to that transfer. Russian authorities have resisted these overtures. After September 11 the United States focused great attention on the Republic of Moldova, since unrecognised Transnistria and its unguarded borders are perceived as a potential terrorist haven and a likely channel for smuggling components needed to construct weapons of mass destruction as well as conventional weapons (The Atlantic Council).

49. The Republic of Moldova signed on to NATO's Partnership programme in March 1994. In May 2006 the North Atlantic Council approved the first Individual Partnership Action Plan (IPAP) with the Republic of Moldova. This programme is designed to enhance the relationship between the Republic of Moldova and the Alliance, both by bringing co-operative activities under one integrated programme and by sharpening Alliance activities to provide enhanced support for the Republic of Moldova's reform efforts. Within the IPAP, the Republic of Moldova has articulated a set of reform objectives in its security sector. After the interim assessment of the IPAP in January 2007, the Republic of Moldova is undergoing the first annual assessment of the IPAP. The Allies have encouraged the Moldovan authorities to continue to develop the National Security Concept, which is expected to provide strategic guidelines for the defence reform process. This project has been harmonised with the EU-Moldovan European Neighbourhood Policy Action Plan to ensure a degree of complementarity, and to avoid overlap. In addition to the Republic of Moldova, Georgia, Azerbaijan and Armenia have also signed IPAPs with the Alliance in order to deepen relations with it. At US$8.7 million per annum, military expenditure in the Republic of Moldova is very low and constitutes only 0.4% of GDP (http://www.tkb.org).

50. On 12 December 2006 the EU and the World Bank hosted a donors' conference for the Republic of Moldova. Most key donors to the Republic of Moldova were present. The objective was to assess progress and to reaffirm donor commitments to the implementation of the country's reform programme and development agenda, as set out in the EU-Moldovan European Neighbourhood Policy (ENP) Action Plan and the Moldovan Economic Growth and Poverty Reduction Strategy (EGPRSP). The conference also sought additional financing to help the Republic of Moldova respond to recent external shocks that have opened a short-term financing gap, which is endangering the Republic of Moldova's poverty reduction and growth objectives. In this context, donors indicated financial support of close to one billion euros over the next three years.

VI. CONCLUSIONS

51. The recent EU enlargement has brought the Republic of Moldova into direct proximity with the EU and NATO. With few prospects of joining either organisation in the foreseeable future, there are concerns in the Republic of Moldova that a new "iron curtain" has descended across Europe and that it bears the overwhelming burden of this development. This must not be allowed.

52. First and foremost, the Republic of Moldova should continue to advance internal reforms. Its institutions must be strengthened, anti-corruption programmes must be implemented and the business and investment climate improved. Secondly, it would be well advised to promote its regional interests externally in a more assertive fashion. The Republic of Moldova and its supporters should lobby for better market access to the EU, and work to have the Transnistria issue placed higher on the EU agenda. Ukraine's support should be secured to help tackle the Transnistrian problem.

53. For its part, the EU should see the Moldovan question as a test of its integrative capacities and its role as a galvaniser of reform. The EU's experience in institution building could help the Republic of Moldova become a more viable state capable of sustaining a stronger economy. This will ultimately require extending greater

market access to the Republic of Moldova, as well as targeting aid to help advance the Republic of Moldova's transition process. The EU should continue to challenge the status quo of the Transnistrian "conflict" and work to achieve a solution. More needs to be done to deal with the problem of border control and smuggling, which poses myriad security risks. Border problems in this region are also contributing to human trafficking in Europe. Finally, NATO should continue to assist that country in modernising its security structures and help Moldovan society ensure the democratic control of its military.

APPENDIX

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