



Coke chemical factory located in Avdeevka, Ukraine. (Photo courtesy of: Shutterstock)

# Trade or Blockade? Economic Relations with Uncontrolled Territories in Moldova and Ukraine

By **Brian Milakovsky**

It is still too early to gauge the chances of President Volodymyr Zelenskyy's push for a negotiated settlement of the Donbas conflict which could lead to the political re-integration of the Russia-controlled portion of that region. However, it is increasingly clear that his administration is seeking an alternative economic policy to the current economic blockade for these territories.

Although there are fundamental differences between the conflicts, Zelenskyy could find lessons in the unique experience of neighboring Moldova in crafting economic policy towards a politically unreconciled, Russian-supported breakaway region. One of the

salient features of Moldova's 28-year relationship with breakaway Transnistria is how economic re-integration was decoupled from political re-integration and has greatly outpaced it.

Transnistrian leaders continue to profess unwavering political fealty to Moscow, but the breakaway region is increasingly entering Europe's economic orbit. If sales of electricity from Transnistria's huge Cuciurgun power plant to Moldova proper are excluded from the export data (Chisinau considers this internal trade), then 65-75 percent of the region's industrial exports go the EU<sup>1</sup>, first and foremost to Transnistria's *bête noire*, Romania. Just eight years ago, that figure was only 35 percent.



People circulating nearby the Central Market of Chisinau, Moldova. (Photo courtesy of shutterstock.com)

This dynamic is made possible by a series of Chisinau policies, encouraged by the European Union, that have allowed the unrecognized Transnistrian “republic” to gradually return to Moldova’s customs space. Transnistrian producers of steel, textiles, brandy, cement, and fruit are able to claim Moldovan origin for their products, a necessary condition for export to Europe. Chisinau has even avoided double-taxing Transnistrian companies, knowing that they must turn part of their profits over to the unrecognized government in Tiraspol.

This liberal approach culminated in complex negotiations to allow Transnistria to take advantage of Moldova’s Deep and Comprehensive Free Trade Agreement (DCFTA) with the European Union. According to one Moldovan official who preferred to remain anonymous, Brussels pushed for this and told Chisinau “they don’t have to do as much as you, but they have to do something.” That something was to quietly change Transnistrian trade laws to allow compliance with the DCFTA, a move that was allegedly lobbied for by export-oriented industries in the unrecognized republic.<sup>2</sup>

In an attempt to avoid the politicization of the issue, the EU and Moldova quietly agreed not to publicize Transnistria’s westward economic drift. Trade expert Vadim Gumene of the Expert-Grup think tank calls this “hidden, stealth integration.”<sup>3</sup>

Chisinau has diverse motivations for its liberal economic policy towards Transnistria. One motivation is humanitarian, says political commentator and former parliamentarian Vadim Pistrinciuc: “we don’t want to crash the economy there and make those territories unlivable.” The other, he explains, is security concerns: the few times that Chisinau has considered economic blockade, the rhetoric in Tiraspol became heated and the risk of conflict rose precipitously.<sup>4</sup>

Other commentators note that the profit motive could play a role for Moldovan policymakers, some of whom have business interests in Transnistria. A critical take on Moldova’s liberal policy frequently expressed in Ukrainian policy circles argues that it props up what would otherwise be an economically unsustainable separatist experiment. Ukrainian

political scientist Ruslan Kermach claims that “the Republic of Moldova itself, despite its official non-recognition of Transnistria, actually serves as one of the sponsors of its economic sustainability, along with Russia.”<sup>5</sup>

“Along with Russia” is a key phrase. Transnistria’s industrial economy balances on a two-legged stool of global market access via Moldova and cheap energy inputs from Russia. Moscow provides Transnistria with free gas and presents the bill to Chisinau, which understandably refuses to pay. The Russian gas continues nonetheless, keeping down both utility costs and local discontent, and allowing Tiraspol to sell electricity at artificially low prices to industrial customers like the Rybnitsia steel mill. These factories cut sweetheart deals with the Tiraspol authorities that reduce energy costs even more if they agree to avoid layoffs, improving their position in global markets where they would otherwise struggle to remain competitive.<sup>6</sup>

This, then, is the Transnistria model: an ideologically suspect but durable arrangement that has prevented economic and humanitarian collapse and reduced tensions enough for a partial social re-integration of the breakaway region, without actually facilitating political reconciliation with Chisinau. The economic results of this model should not be oversold: by any measure Transnistria is one of Europe’s most under-developed corners, a land of “total poverty” in the assessment of *Novaya Gazeta* correspondent Elena Racheva.<sup>7</sup> But the alternative of blockade and isolation is almost certainly worse.

## Comparison

At present, the blockade model persists in Ukraine between Kyiv and the separatist regions. For the

first three years of the war Kyiv allowed industrial enterprises in the Russian-controlled territories to continue shipping their products to world markets if they re-registered in the government-controlled areas and paid taxes. But in March 2017, Ukrainian war veterans and other activists began a wildcat rail blockade of the Russian-controlled territories, calling for an end to “trade in blood.” President Petro Poroshenko initially opposed it, but when the separatist authorities threatened “nationalization” of mines and factories, he formalized the blockade to avoid the impression of caving to the Russians. The separatists then seized the enterprises which disappeared entirely from Ukrainian jurisdiction.

Some industrial products, such as steel and anthracite coal, are exported to Russia from the “republics,” often for illegal re-export to markets like Poland and Turkey, or (in the case of anthracite coal) back into Ukraine. But these trade channels can engage only a small part of the industrial region’s production capacity, even with the extensive damage sustained during the war. Output is a shadow of pre-war levels: in 2018 the entire metallurgical sector of the “Donetsk Peoples Republic” produced just 75 percent as much value as a single major steel mill (the Ilich plant in Mariupol) in the government-controlled section of the Donbas.<sup>8</sup> Many factories are shuttered and mines are flooding without money to run the pumps.

In looking for an exit from this bleak scenario, Kyiv should study the path that Moldova has chosen. But, first, it is important to understand where the scenarios diverge.

## Whose assets?

The independent Moldovan state had only just formed in 1991 when Russia helped wrest Transnistria away. Serious privatization efforts in Moldova would begin only a few years later. So the industrial enterprises on the left bank of the Dnistr passed directly from one (dissolving) state ownership to another (unrecognized). Tiraspol carried out its own privatization to the advantage of local elites and Russian industrial holdings. Chisinau rigorously objected, claiming that this transfer of property will be re-adjudicated after reunification. In practice, however, the topic is rarely raised and is widely thought to be a bargaining chip that could be used in the late stages of Moldovan-Russian negotiations. This makes it easy for Chisinau to deal with Transnistrian business entities with minimal public scandal.

In the Donbas the situation is far more complicated. The “nationalized” mines and factories were stolen from Rinat Akhmetov and other leading Ukrainian oligarchs, who won control over them in the privatizations of the 1990s and 2000s. Returning industrial assets in the “republics” to the jurisdiction and customs space of Ukraine will be impossible until some arrangement is made with their influential legal owners. But any such move will be politically fraught for Moscow, Donetsk and Luhansk, where demonization of Ukrainian oligarchs is core aspect of state ideology.

Almost all heavy industry in the “republics” is currently under the management of Vneshtorgservis, a shadowy holding registered in the breakaway republic of South Ossetia in Georgia and nominally managed by Ukrainian oligarch-on-the-lam, Serhiy Kurchenko. It was likely set up

by the Kremlin to recoup some of its losses from paying for pensions and other social payments in the Donbas territories it controls. But the holding has been colossally mismanaged, or, more likely, skillfully managed to maximize plunder. It racked up debts of eight billion rubles (around \$126 million) to the “republican” coal mines whose product it until recently had exclusive rights to export to

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Russia.<sup>9</sup>This causes widespread wage arrears to miners who grumble loudly on social media but face intense pressure from the separatist security services not to strike.

Another theory is that the Kremlin gathered the enterprises under a unified holding to make it easier to cut a single large deal with Kyiv when the time comes, rather than a series of negotiations with local business elites and field commanders. But it is an open question whether these enterprises will survive until those negotiations under the weight of current mismanagement.

## Competition

The Moldovan and Ukrainian cases also differ in the extent to which the recognized sovereigns face economic competition from the breakaway regions on their eastern edge. The Transnistria conflict effectively divided the Moldovan SSR into

the agricultural economy of recognized Moldova and the industrial separatist enclave. Moldova has recently boosted its industrial sector with plants that make parts for EU auto and electronics firms, but these have little overlap with Transnistrian giants like the Rybnitsya steel mill. This lack of direct competition means there is only a limited economic lobby against integrating Transnistrian firms into the Moldovan customs space.

In contrast, the Russian-controlled portion of the Donbas is only a large fragment of the Ukrainian industrial economy based in the East. Its “nationalized” factories and mines compete with those remaining in government-controlled Donbas, Dnipro, Zaporizhia, Kriviy Rih, etc.

According to Aleksandr Kramar of *The Ukrainian Week*, the blockade produced some concrete benefits for this wider Ukrainian industrial economy.<sup>10</sup> Firstly, it ended unfair competition in steel production from plants in the “republics” where wages are depressed and unions are intimidated into silence. Russian steel makers can

attest to the dumping potential of “republican” plants, having already complained to the Kremlin about their Donbas competitors.<sup>11</sup> Secondly, the blockade inspired Rinat Akhmetov’s DTEK energy holding to accelerate the transition from anthracite coal (found only in the Russian-controlled Donbas) to brown coal that is mined in government-controlled areas.<sup>12</sup>

## Proximity to Russia

Ukraine’s dramatic turn towards the EU after the Euromaidan revolution played a role in creating the conditions for Transnistria’s westward market reorientation. According to trade expert Vadim Gumene, the nearby Odessa port in Ukraine was formerly a back channel to Russia. But today both Kyiv and Chisinau are harmonizing their customs systems with the EU and reducing chaotic re-export via the unrecognized “republic.” Transnistria’s geography, combined with Ukrainian politics, makes export to Europe a question of economic life and death.



Converter shop for the production of metal. Alchevsk, Lugansk region, Ukraine (photo courtesy of: shutterstock.com)

Russian-controlled Donbas has only one leg of Transnistria's economic "two-legged stool." Like Transnistria, it receives low-cost natural gas and subsidized iron ore from Russia, but it lacks global market access because its "nationalized" industrial economy is under blockade. As a result, the remaining industrial production in the "republics" only trickles eastward. Moscow has done far less than the separatists hoped to liberalize trade between their "republics" and Russia.

### A lesson or a warning?

Clearly, President Zelenskyy cannot follow the example of Moldovan policymakers to the letter and allow "nationalized" enterprises from the separatist zones back into global markets under the Ukrainian customs stamp. This would legitimize the separatist authorities' illegal actions and allow them to claim credit for the economic upswing that would follow renewed exports. Furthermore, there is no guarantee that the predatory managers of *Vneshtorgservis* would pass along any of the benefits of increased export sales to impoverished miners and industrial workers.

If Zelenskyy were to attempt such a policy, he would incite much larger protests against capitulation than those that he faced before attending the Normandy summit in December 2019. We can consider this policy option politically impossible.

Nevertheless, a sober assessment suggests that the *status quo* since the blockade and "nationalization" of 2017 is likewise unsustainable. The core logic of the blockade was to demonstrate the non-viability of independence for the artificial "peoples republics"; and to bring Russia and its

separatist clients to the negotiating table on terms favorable to Ukraine. But this maximum pressure has not yielded significant political dividends in the mostly stalled negotiations in either the Minsk or the Normandy frameworks.

Ukraine's current policy requires faith that, with a little more time, the blockade will force Russia's hand. In the meantime, it is contributing to the potentially irreversible degradation of the industrial economic base upon which hundreds of thousands of Donbas residents depend. Those residents clearly identify Kyiv's imposition of the blockade in 2017 as a turning point of their impoverishment, which helps deflect some of their anger away from separatist "managers" whose actions are its primary cause.

The nightmare scenario for Ukraine involves maximum blockade pressure finally succeeding in bringing the "republics" back under Kyiv's control only after they have become an economic black hole that will consume national resources for years to come.

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In searching for a new economic policy in the Donbas, President Zelenskyy must sail between the *status quo* Scylla of industrial collapse and the Charybdis of capitulation. He cannot do so without major concessions from Russia and its separatist clients that are based in shared recognition of the disastrous economic situation.

In July, 2019 Ukraine's senior negotiator in the

Minsk Contact Group, ex-president Leonid Kuchma, floated the idea of returning to the pre-blockade arrangement, when industrial enterprises in the “republics” operated in the Ukrainian legal sphere. But there are questions as to whether Ukrainian holdings could regain full control of these enterprises from *Vneshtorgservis* in the absence of a functioning legal system. Musa Magomedov, a parliamentarian in the Akhmetov-supported Opposition Bloc and former director at a large industrial plant owned by the oligarch in the frontline city of Avdiivka, claims that “as long as our state, Ukraine, is absent there it is pure fiction to talk about management of any assets. Not even worth discussing. We need to return our people, our territory, our borders. Only then is a discussion on this topic possible.”<sup>13</sup>

Nonetheless, the Opposition Bloc submitted a bill in the Verkhovna Rada to lift the economic blockade. Magomedov explains that it would be part of a step-by-step process that begins with successful pullback of forces.<sup>14</sup> The bill has little chance of passage since it did not emerge from the Servant of the People parliamentary supermajority, and because the likelihood of bilateral troop pullback has faded after recent deadly artillery attacks on Ukrainian positions. But such a gesture from the political force of the oligarch most impacted by “nationalization” suggests that there is behind-the-scenes positioning for economic liberalization, although the short bill includes no mention of how seized enterprises will be returned to their legal owners. The optimal arena for this discussion is probably not Ukraine’s parliament, but the economic sub-group in Minsk.

An important bargaining chip that Ukraine can use is

increased social payments in the Russian-controlled areas if legal control over factories and mines is returned. Despite gaining control of 70 percent of the industrial economy in 2017, *Vneshtorgservis* was given a tax holiday by separatist authorities that appears to still be in effect. To sweeten this pill, the holding signed a “socio-economic agreement” with the Donetsk authorities to pay an insultingly inadequate \$2.34 million a year to support schools, hospitals, sports facilities, public events, etc.<sup>15</sup> Kyiv and the enterprises’ legitimate Ukrainian owners could follow this precedent, agreeing to provide “socio-economic support” without paying “republican” taxes, but the greatly increased profits from restored access to global markets would make it possible to vastly increase these payments. While this might restore some economic viability to the “republics,” it would be impossible to conceal from their residents that it was Ukraine’s regaining economic sway that led to improvement in livelihoods and social support.

It is still too early to envision what resolution will be possible for the Donbas conflict, but Kyiv can begin preparing the ground for one that suits its national interests, future prosperity and societal cohesion. A clear-eyed understanding of Moldovan experience will certainly help.

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The opinions expressed in this article are those solely of the author.

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