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December 16, 1994

To: Members of the Executive Board

From: The Secretary

Subject: Republic of Estonia - Second Review Under the Stand-By Arrangement and Request for Purchase Under the Systemic Transformation Facility

Attached for consideration by the Executive Directors is a supplement to the staff report on the second review under the stand-by arrangement for Estonia (EBS/94/196, 9/29/94) and also a request expected to be received for a second purchase under the systemic transformation facility in an amount equivalent to SDR 11.625 million, which is proposed to be scheduled for discussion on Monday, January 9, 1995. Draft decisions appear on pages 7 and 8.

Mr. Wolf (ext. 37413) or Mr. Geadah (ext. 38830) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Commission (EC), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

# Second Review Under the Stand-By Arrangement and Request for Purchase Under the Systemic Transformation Facility

Prepared by the European II Department

(In consultation with other Departments)

Approved by John Odling-Smee and Susan Schadler

December 16, 1994

## I. Introduction

This supplement updates the information contained in the staff report for the second review under the stand-by arrangement (EBS/94/196, 9/29/94) which had been submitted to the Executive Board with the decisions set out in the staff report proposed for adoption on a lapse-of-time basis. However, the staff subsequently proposed to postpone the completion of the second review under the stand-by arrangement as developments connected with the Social Bank had raised uncertainties about the program (EBS/94/196, Supplement 1, 10/17/94).

A staff team visited Tallinn during October 26 - November 3, 1994 to discuss a satisfactory resolution to the situation surrounding the Social Bank. 1/ The Estonian representatives included the outgoing Prime Minister, Mr. Laar; the incoming Prime Minister, Mr. Tarand; the Governor of the Bank of Estonia, Mr. Kallas; and senior government and central bank officials. Subsequently, the staff team reached understandings with the authorities on a supplementary letter of intent (Attachment).

Preliminary information strongly suggests that Estonia met all quantitative performance criteria for end-September 1994, as set during the first review under the arrangement (see EBS/94/61, 3/25/94). In light of this, and since the review will be completed after end-1994, the authorities are no longer requesting that the end-September performance criteria be modified as contemplated in their letter of intent of September 5, 1994 (see

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1/ The staff team included Messrs. Wolf (head), Geadah, and Kammer (all EUR II), and Olafsson (consultant to MAE). Mr. Zavoico (EUR II), the Fund's resident representative in Tallinn, also assisted the mission.

EBS/94/196, 9/29/94). 1/ The authorities continue to propose the establishment of end-December 1994 performance criteria as specified in the letter of September 5, 1994, except for the floor on net international reserves (which is specified in the annex to their letter of December 14, 1994, and amounts to DM 45 million as compared with DM 42 million in the September letter). 2/ A summary of the quantitative performance criteria for December 31, 1994 appears in Table 1.

The proposed end-December performance criterion on net international reserves (NIR) reflects both an upward stock adjustment based on revised data available on foreign assets and liabilities of the Bank of Estonia (DM 17 million), and the projected deterioration in the NIR position in the final quarter of 1994 due largely to Bank of Estonia liquidity support to the Social Bank and the Development Bank (see below). 3/ A decline in the NIR during the month of December is due to expected debt service and other routine expenditures by the Bank of Estonia without any further lending to banks.

It is proposed in the draft decision presented in Section VI that the Executive Board complete the second review of the stand-by arrangement for Estonia and approve a request for the second purchase under the STF. 4/

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1/ Preliminary information also suggests that these performance targets for end-September were met.

2/ Because the present review under the stand-by arrangement will be completed after December 31, 1994, but before the necessary data are available to determine whether the performance criteria for the end-December test date have been met, the staff recommends that the Fund waive the applicability of the end-December performance criteria through January 11, 1995. This will enable Estonia to purchase the amount to be made available upon completion of the present review without having to demonstrate that the end-December performance criteria have been met; however, purchases requested after January 11, 1995 would be subject, inter alia, to compliance with the end-December performance criteria.

3/ The revised NIR target for end-December also reflects valuation losses experienced during July-November 1994 of DM 2 million.

4/ In their letter of September 5, 1994, the authorities had proposed the addition of a new performance criterion on required reserves on demand deposits of individuals held at the Savings Bank; this performance criterion was to remain effective throughout the remainder of the program period ending on December 31, 1994. As the review will now be completed after December 31, 1994 and the staff will then know whether this ceiling had been complied with, it is no longer proposed that the ceiling be established as a performance criterion.

## II. Recent Economic Developments

The Government's financial surplus 1/ increased from 2 1/2 percent of GDP in 1993 to about 3 percent of GDP during the first nine months of 1994. Parliament passed a second supplementary budget in late September approving expenditures roughly equivalent to revenue collections during the year in excess of earlier budget forecasts. For 1995, Parliament has approved a balanced state budget. After strong growth in 1993, base money--in line with a weaker overall balance of payments--increased by only 2 1/2 percent during the first three quarters of 1994. Over the same period broad money increased by 15 1/2 percent, compared to almost 60 percent in 1993. The average monthly inflation rate has fallen from 6 1/2 percent in the first quarter of 1994 to just under 2 percent in the eight months ending in November. Average monthly inflation would have been around 1 percent during this eight-month period in the absence of periodic administered price increases on important services (such as housing rents, electricity and public transportation) remaining subject to price controls.

## III. Developments Involving the Social Bank

Problems at the Social Bank (SB) surfaced in February/March 1994 when the rapid withdrawal of government deposits from the bank revealed substantial loan losses and poor management which were not effectively dealt with by Bank of Estonia (BOE) supervision. Liquidity problems became acute in early August and the BOE suspended the SB's operations in mid-August, pending the implementation of plans to liquidate it. 2/ On September 26, 1994, however, the BOE reversed its position and reopened the bank against the advice of the Government and Fund staff, and provided the bank with liquidity support to meet a possible withdrawal of deposits. The BOE's shift in position was attributed to concerns about the effect of a bank failure on confidence in the banking system, expectations that a higher portion of the SB's loans would be recoverable if the bank stayed in operation, the prospects that formal bankruptcy would involve a long, drawn-out process, and the possibility of lawsuits from remaining depositors which could unwind the earlier sale of some of the SB's branches.

Following its reopening, the SB faced withdrawals of over one-half of its deposits and other short-term liabilities, including by government agencies. Additional BOE liquidity support allowed the bank to stay afloat. In light of the implications for (i) net international reserves and the margin of currency board cover, (ii) the public's confidence in the banking system, and (iii) the increased direct involvement of the BOE in the

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1/ The financial surplus (deficit) is defined as the overall surplus (deficit) excluding net lending by the general government, the latter being mainly financed with foreign official disbursements.

2/ A more detailed description can be found in EBS/94/196, 9/29/94 on pages 5, 6, and 10.

commercial banking system, the staff proposed to postpone the completion of the review until a satisfactory solution to the SB situation could be found. On October 24, 1994, the BOE effectively took the decision to merge the SB with another insolvent bank, the Development Bank (DB), and as a result the BOE was now committed to ensuring that depositors of the merged bank would suffer no losses. Despite accelerated repayments of credits to the BOE by other banks (notably the government-owned North Estonian Bank), the above actions with respect to the SB and the DB led to a net extension of credit by the BOE to the banking system during July-November 1994 of EEK 128 million (or 3 percent of end-June currency board liabilities). 1/

## IV. Policies for the Near-Term

On the basis of its discussions with the authorities during the October/November mission, the staff prepared an action plan containing three essential principles which have received the basic support of the authorities. First, the BOE and the Government have agreed on the necessity to articulate fully by February 15, 1995 a joint plan to resolve as quickly as possible the SB/DB situation in a way which will avoid any further drain on the financial resources of the BOE. In the meantime, the BOE will not provide any additional liquidity support to the SB/DB. In this connection, the Government and the BOE, in close consultation, have indicated that they stand ready to take any measures that might be necessary to ensure that the December 31, 1994 performance criterion on net international reserves will be met.

Second, the BOE and the Government have agreed to establish close and continued consultation with each other, not only to resolve the SB/DB issue and to ensure that the NIR performance criterion is met, but also to ensure that a concerted approach will be taken in the future with respect to problem banks. While the authorities intend to avoid bank bailouts as a rule, in the event of any future agreed bank rescue operation necessitated by a systemic threat, the BOE role will be limited to liquidity support. The mission reached understandings that for the duration of the current stand-by arrangements expiring on March 15, 1995, any such new liquidity support will be fully collateralized and will not exceed EEK 100 million, unless the Government agrees to additional support. The Government will accept financial responsibility for any losses that might be incurred in this connection.

Third, in light of the SB/DB experience, the BOE is taking immediate actions to strengthen bank supervision and the enforcement of regulatory guidelines. The mission reached understandings that the BOE will develop a

1/ Total net loans extended by the BOE to the SB/DB as of November 30, 1994 amounted to EEK 231 million, compared to an implicit limit on well considered emergency lending of EEK 100 million in the authorities' September 5, 1994 letter.

short-term program for enhanced supervision and outline by December 31, 1994 an action plan for materially strengthening bank supervision during 1995. The BOE has requested that an MAE team visit Tallinn in early 1995 to review the plan and to provide practical advice on its implementation as well as to discuss the terms of reference for a resident advisor in bank supervision. The BOE stands ready to implement immediately the enhanced enforcement power and sanctions available to it under the Credit Institutions Act once it is enacted by the Parliament, which is expected within the next few months.

## V. Staff Appraisal

Estonia's policies under the current economic program have generally been successful. All the quantitative performance criteria have been met and macroeconomic stabilization continues. Inflation has subsided and the pursuit of a tight fiscal policy combined with strict adherence to the currency board should help keep inflation under control. Reflecting the successful stabilization and supported by a liberal trade and exchange regime, foreign direct investment remains buoyant.

The staff is satisfied that the concerns which led it to recommend postponement of the completion of the second review under the stand-by arrangement have been removed by the authorities' policy commitments. Based on current information, the staff believes that the performance criterion for net international reserves for December 31, 1994 will be met and that any further erosion of the margin of currency board cover during the program period will be correspondingly limited. While the NIR performance criterion accommodates BOE lending beyond that which was foreseen during the August mission, the staff has decided to recommend the adjustment of this performance criterion in light of the still adequate cushion of BOE reserves beyond those necessary to back the currency board, as well as its assessment that it will be consistent with the continuation of positive macroeconomic policies and performance.

While the rapidly changing situation with regard to the SB/DB, recent uncertainties related to the change in government, and the possible need to secure parliamentary approval for allocating budgetary resources have prevented the authorities thus far from formulating a viable medium-term plan for the SB/DB, the staff has discussed with the authorities the key elements that should be included in the plan they are committed to articulate by February 15, 1995. On this basis, the staff considers that the plan will be consistent with the need to accelerate the reform of the banking system more generally and to reduce the involvement of the BOE and the Government in the banking system in particular. The elements of this plan would be reviewed at the time of discussions on a possible successor to the current stand-by arrangement.

The staff also considers that the policy measures described above, including the plan for strengthening bank supervision and enforcement, should help strengthen confidence in the banking system. In light of these developments and the commendable performance under the program in most areas, the staff recommends that the second review under the stand-by arrangement be completed.

With regard to the authorities' request for the second STF purchase, staff balance of payments projections for 1994 remain broadly in line with the original program projections. The staff is satisfied that Estonia continues to experience balance of payments difficulties in an amount at least equivalent to 50 percent of quota as a result of factors set out in the STF decision. 1/ The staff therefore recommends approval of the authorities' request for a second STF purchase.

1/ The STF purchase will be channelled through the External Financing Board given constraints on currency board lending activities, as explained in EBS/94/91 (3/25/94), page 16.

## VI. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board.

### A. Review Under Stand-By Arrangement

1. Estonia has consulted with the Fund in accordance with Paragraph 3 (c) of the stand-by arrangement for Estonia (EBS/93/166, Supplement 2, 11/02/93) and the last paragraph of the letter of the Prime Minister and the Governor of the Bank of Estonia, dated October 6, 1993.

2. The letters of the Prime Minister and the Governor of the Bank of Estonia, dated September 5, 1994 and December 14, 1994, shall be attached to the stand-by arrangement and their letter dated October 6, 1993, with annexed memorandum, as modified, shall be read as supplemented and modified by the letters dated September 5, 1994 and December 14, 1994.

3. Accordingly,

a. Paragraph 3 (a)(iv) of the stand-by arrangement shall be deleted in its entirety and replaced with "the floor on Eligible Assets of the Banking System described in Annex IV of the letter dated September 5, 1994, or".

b. The performance criteria set out in Paragraphs 3 (a)(i), and 3 (a)(ii), and in Paragraphs 3 (a)(iv) through 3 (a)(viii) of the stand-by arrangement for December 31, 1994 shall be as specified in Annexes I, III, and IV of the letter dated September 5, 1994.

c. The performance criteria set out in Paragraph 3 (a)(iii) of the stand-by arrangement for December 31, 1994 shall be as specified in the Annex of the letter dated December [15], 1994.

4. The Fund decides that the second review contemplated in Paragraph 3 (c) of the stand-by arrangement is completed and that Estonia may make purchases in accordance with the provisions of the stand-by arrangement through January 11, 1995, notwithstanding that the end-December 1994 data for the performance criteria specified in Paragraph 3 (a) of the stand-by arrangement are not available.

B. <u>Systemic Transformation Facility</u>

1. The Fund has received a request by the Government of the Republic of Estonia for a purchase equivalent to SDR 11.625 million under the Decision on the Systemic Transformation Facility, (Decision No. 10348-(93/61) STF, adopted April 23, 1993), as amended.

2. The Fund approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3 (b)(iii).

Table 1. Estonia: Quantitative Performance Criteria 1/

| | | Performance Criteria | | |
|---|---|---|---|---|
| | | (In millions of Estonian kroon) | | |
| I. | Limits on the financial deficit of the general government<br>Period January 1, 1994 to:<br>December 31, 1994 | 540 | | |
| II. | Limits on net lending by the general government<br>Period January 1, 1994 to:<br>December 31, 1994 | 740 | | |
| III. | Limits on domestic financial deficit and net lending. The financial deficit and net lending by general government shall be financed entirely from net foreign loans disbursed to general government, except for<br>Period January 1, 1994 to:<br>December 31, 1994 | 20 | | |
| | | (In millions of deutsche mark) | | |
| IV. | Minimum levels for net international reserves of the Bank of Estonia, net of cover for the currency board 2/<br>Minimum levels for:<br>December 31, 1994 | 45 | | |
| | | (In percent) | | |
| V. | Minimum levels for total reserves of deposit money banks, expressed as a percent of eligible liabilities of deposit money banks at the end of the preceding calendar month:<br>Minimum levels for:<br>December 31, 1994 3/ | ... | | |
| | | (In millions of U.S. dollars) | | |
| | | Maturity of 1-5 years | Maturity of 1-12 years | Maturity of 0-1 year 4/ |
| VI. | Ceilings on external short-, medium-, and long-term debt 5/<br>Period June 30, 1993 to:<br>December 31, 1994 | 100 | 200 | -- |
| VII. | The currency board is to be fully backed with foreign exchange. | | | |
| VIII. | The Government will not accumulate external payments arrears during the period of the arrangement. | | | |
| IX. | Required reserves on demand deposits of individuals held at the Savings Bank shall not be less than 60 percent of deposit liabilities of the Savings Bank through December 31, 1994. | | | |

1/ Definitions of the concepts to be measured are included in the Annexes to the Letter of Intent.
2/ Figure reflects the first purchase under the Systemic Transformation Facility.
3/ Eligible assets of the banking system shall not be below required reserves of the banking system by more than 1 percent of eligible liabilities.
4/ Except for normal import financing.
5/ Debt contracted or guaranteed by the Government and the Bank of Estonia.

December 14, 1994

Dear Mr. Camdessus:

The Government and the Bank of Estonia continue to be fully committed to implementing the stabilization and reform policies as set forth in a letter to you dated October 6, 1993 and in the Memorandum of Economic Policies attached to that letter, and as amended in our letters of March 11, 1994 and September 5, 1994. In particular, we would also like to reaffirm our commitment to the continued reform and strengthening of the Estonian financial system. In this connection, it is our intention to proceed with our plans to reduce the ownership of both the Government and the Bank of Estonia in commercial banks, and to take concrete measures aimed at strengthening confidence in the banking system.

With a view to strengthening confidence in and continuing the reform of the banking system, the Bank of Estonia, in close cooperation with the Government, will decide on a viable plan to remove the Bank of Estonia's involvement with the Social Bank/Development Bank as quickly as possible. This plan will be fully articulated by February 15, 1995. Until this plan is put into effect, as well as in the context of such a plan, the Bank of Estonia will not provide any liquidity support above the EEK 231 million already provided to the Social Bank/Development Bank; meanwhile the Government has subordinated EEK 35 million of its deposits in the Social Bank/Development Bank.

In the future it will be our general intention to avoid bank rescue operations, except in the possible case of a clear systemic threat to confidence in the banking system. While future instances may arise in which the Bank of Estonia may see the need to lend to commercial banks for well-considered emergency liquidity purposes, any such new liquidity support during the remainder of the current stand-by arrangement will be fully collateralized and will not exceed EEK 100 million, unless the Government agrees to additional support and accepts financial responsibility for any loss that might be incurred in this connection. Such lending will also be limited to amounts consistent with meeting the end-December 1994 performance criterion for net international reserves under the economic program supported by the Fund under the current stand-by arrangement, as set forth in the Annex to this letter. The Government and the Bank of Estonia, in close consultation, stand ready to take any measures that might be necessary to ensure that this target for December 31, 1994 will be met. The Bank of Estonia will keep the Government informed on all aspects of any emergency lending. Accordingly, aside from possible emergency liquidity lending, the Bank of Estonia will acquire no new claims on or equity in commercial banks.

We also intend to take immediate actions to strengthen bank supervision and the enforcement of bank regulation guidelines. In this connection, an action plan for materially strengthening such supervision during 1995 will be developed by December 31, 1994. The Bank of Estonia is requesting that Fund staff visit Tallinn in early 1995 to review the plan and to provide practical advice on its implementation as well as to discuss the work of a prospective resident advisor in bank supervision from the Fund. The Bank of Estonia stands ready to implement immediately the enhanced enforcement power and sanctions available to it under the Credit Institutions Act once it is enacted by the Parliament.

We are pleased to be able to confirm that all the performance criteria for September 30, 1994 as specified at the time of the first review under the stand-by arrangement have been met. As the data for end-September are now available, we would no longer propose that the end-September performance criteria be modified as contemplated in our letter of September 5, 1994. We would, however, continue to propose the establishment of the end-December, 1994 performance criteria (except for the lower limit on net international reserves which is specified in the annex to this letter) as indicated in the letter of September 5. In addition, during the period ending December 31, 1994, required reserves on demand deposits of individuals held at the Savings Bank shall be not less than the level specified in our letter of September 5.

It is our intention to request a second STF purchase equivalent to SDR 11.625 million upon completion of this second review under the stand-by arrangement.

Sincerely yours,

| | |
|---|---|
| /s/ | /s/ |
| Andres Tarand | Siim Kallas |
| Prime Minister | Governor |

Mr. Michel Camdessus
The Managing Director
International Monetary Fund
Washington D.C. 20431

Net International Reserves in Convertible Currencies

| Performance Criterion on Net International Reserves | Minimum Limits (In millions of deutsche mark) |
|---|---|
| Actual stock at November 30, 1994 | 57.1 |
| December 31, 1994 | 45 1/ 2/ |

1/ The limit for net international reserves has been set at a level which reflects the first purchase under the Systemic Transformation Facility.

2/ This minimum limit will be adjusted upward/downward by the amount of gains/losses arising from fluctuating cross-currency exchange rates and securities prices. Such gains or losses will be measured as the cumulative change from November 30, 1994 in the Bank of Estonia's revaluation accounts relating to foreign exchange and securities price revaluations, and converted to deutsche mark at the official exchange rates of the Bank of Estonia prevailing at each test date. At November 30, 1994, the balance of the securities price revaluation account was minus EEK 36.780 million and the balance of the foreign exchange revaluation account was minus EEK 53.521 million.

Net international reserves consist of gross reserves of the Bank of Estonia and foreign exchange balances of the Government corresponding to purchases from the Fund held abroad, net of reserve liabilities (including government obligations associated with Fund purchases) and currency board cover. These assets and liabilities will be converted to deutsche mark at current exchange rates defined as the official rates of the Bank of Estonia prevailing at each test date.

For the purposes of the program, gross reserves of the Bank of Estonia shall be defined as monetary gold, holdings of SDRs, any reserve position in the IMF, and holdings of foreign exchange in convertible currencies by the Bank of Estonia. Excluded from gross reserves of the Bank of Estonia are capital subscriptions to foreign financial institutions, long-term nonfinancial assets of the Bank of Estonia, assets held abroad by the general government and enterprises, and any assets in nonconvertible currencies. For the period of the program, monetary gold will be valued at DM 497.4 per ounce. Fund staff will be informed of details of any gold sales, purchases or swap operations during the program period, so that adjustments can be made to exclude changes in the measurement of gross reserves that arise merely from a different valuation of gold. On November 30, 1994, gross reserves, as defined above, amounted to DM 694.5 million, including gold holdings valued at DM 4.1 million.

For the purposes of the program, reserve liabilities shall be defined as the Bank of Estonia's convertible foreign currency liabilities to nonresidents, with an original maturity of up to and including one year, and the use of Fund credit. Excluded from reserve liabilities are any liabilities arising from balance of payments support loans of maturity longer than one year, including such loans from the EU, the BIS and other international financial institutions, foreign governments and foreign banks. On November 30, 1994, international reserve liabilities of the Bank of Estonia as defined above, amounted to DM 116.9 million.

Currency board liabilities will comprise kroon notes and coins in circulation, total reserve deposits of banks (including the Savings Bank) with the Bank of Estonia, certificates of deposit issued by the Bank of Estonia and kroon liabilities of the Bank of Estonia in its correspondent accounts. Currency board cover will equal currency board liabilities, expressed in terms of foreign exchange using the official exchange rate of 8 kroons per deutsche mark. On November 30, 1994, currency board liabilities amounted to the equivalent of DM 520.4 million. As a performance criterion, the Bank of Estonia will ensure the maintenance of full foreign reserve backing for the currency board's liabilities at the end of each monthly reporting period.

The performance criteria on net international reserves (shown above) will be adjusted downward by the deutsche mark equivalent of new purchases from the Fund under the Systemic Transformation Facility for all test dates subsequent to the value date of the transaction.

Performance will be monitored from information supplied monthly by the Bank of Estonia in the agreed format. The monthly data will be provided to the Fund within seven days of the end of each month throughout the program period.