FOR AGENDA

0451

EBS/94/196
Supplement 2
Correction 1

CONFIDENTIAL

December 23, 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

The following corrections have been made in EBS/94/196, Supplement 2 (12/16/94):

Page 4, second full para., line 9: for "expiring on March 15, 1995,"
read "expiring on March 26, 1995,"

Page 7, para. No. 2.: Paragraph revised.

para. No. 3, last line: for "December [15], 1994."
read "December 14, 1994."

Page 9, Table 1, Section IX: Deleted.

Page 11, second para., line 1: for "We are pleased...that all"
read "Preliminary information suggests that all"

signature line: for "Siim Kallas, Governor"
read "Vahur Kraft, Acting Governor"

Corrected pages are attached.

Att: (4)

Other Distribution:
Department Heads

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 arrangement expiring on March 26, 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

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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.

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 letter of the Prime Minister and the Governor of the Bank of Estonia, dated September 5, 1994 and the letter of the Prime Minister and the Acting Governor of the Bank of Estonia, dated December 14, 1994, shall be attached to the stand-by arrangement and the 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 14, 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. Systemic Transformation Facility

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 Period January 1, 1994 to: December 31, 1994	540		
II.	Limits on net lending by the general government Period January 1, 1994 to: 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 Period January 1, 1994 to: 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/ Minimum levels for: 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: Minimum levels for: 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/ Period June 30, 1993 to: 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.			

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.

Preliminary information suggests 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/
Andres Tarand
Prime Minister

/s/
Vahur Kraft
Acting 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.