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December 31, 1992

To: Members of the Executive Board

From: The Acting Secretary

Subject: Estonia - Recent Developments

The attached supplement to the staff report for the first review under the stand-by arrangement for Estonia (EBS/92/209, 12/11/92) has been prepared on the basis of additional information. A revised draft decision appears on page 7.

Mr. Knöbl (ext. 38821) or Mr. Zavoico (ext. 36288) is available to answer technical or factual questions relating to this paper prior to the Board discussion scheduled for Wednesday, January 6, 1993.

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INTERNATIONAL MONETARY FUND

ESTONIA

Recent Developments

Prepared by European II Department

(In consultation with Legal and Policy Development and Review Departments)

Approved by John Odling-Smee and Thomas Leddy

December 30, 1992

I. Introduction

For the information of Executive Directors, this supplement summarizes recent developments in the Estonian economy. In particular, it reports on the recent visit to Tallinn of a staff team -- over the period December 8-11 -- in response to a request from the Estonian authorities to review and advise on a bank rescue operation. 1/ On this visit, the team met with the Prime Minister, Mr. Laar; the Minister of Finance, Mr. Üürike; the Central Bank Governor, Mr. Kallas; and other senior government officials.

Since the Executive Board meeting on the first review of the stand-by arrangement will take place after the second test date (December 31, 1992), a waiver of applicability will be required for Estonia's second purchase of Fund resources, subject to end-September 1992 performance criterion. Accordingly, an amended draft decision is attached for consideration by Directors.

II. Problems in the Banking Sector

a. Recent developments

As described in EBS/92/209 (December 11, 1992), on November 17, 1992 the Bank of Estonia forced the closure of three major commercial banks -- Union Baltic Bank (UBB), Northern Estonian Bank (NEB) and Tartu Commercial Bank (TCB). All deposits held by the customers of these banks were frozen. The closure of NEB and UBB was precipitated largely by the freezing of their

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1/ The staff team consisted of Messrs. Knöbl (head) and Zavoico (all EUR II), Bennett (PDR), and Mr. Frecaut (MAE). Mr. Paljarvi, the Fund's resident representative in Tallinn, also assisted the mission.

foreign currency deposits with the former Vneshekonombank (VKB) in Moscow. 1/ The Bank of Estonia immediately formed a commission to make recommendations on remedial measures and created three task forces to examine the financial position of each of these banks.

Following the initial work of these groups, the Bank decided on December 1 that sufficient liquidity was available at each bank to permit partial access by clients to their deposit claims, pending the implementation of a comprehensive solution to the crisis. Accordingly, individuals were permitted access up to a maximum of EEK 5,000 per month from their current accounts and enterprises were permitted access up to a maximum of 10 percent of their deposits at NEB and UBB and up to a maximum of 5 percent at TCB. Furthermore, all clients making new deposits at these banks after December 1 would have full access to all newly deposited funds.

Although the combined deposit liabilities of the three banks account for almost 40 percent of broad money and their closure would suggest the emergence of a major systemic crisis, in fact the consequences for both the economy and the financial system, although serious, do not appear to have been severe. This may be because access to deposits at these banks by clients had already been sporadic since the currency reform (June 20, 1992). Initially this was caused by inefficiencies in the clearing system -- which were corrected in late summer -- and more recently by the banks' illiquidity. As a result, clients had already adapted to not having immediate access to their deposits at these banks, and appear to have managed to maintain operations since the banks were shut down. Moreover, the closure of the banks has not precipitated a run on other healthy banks. Instead, there has been a major shift in banking business to the remaining banks that are perceived as being healthy.

Nevertheless, some fallout from the bank closures was becoming evident towards end-1992, with some delays in effecting payments through the banking system -- which came on top of the payments backlog of EEK 333 million that had developed at the three banks by November 17 -- and increases in unpaid taxes.

b. Proposed solutions

After reviewing the balance sheets of the three banks and discussing alternative options with the Bank of Estonia, the mission elaborated for the consideration of the authorities a package involving the takeover of all

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1/ Deposits at the VKB materialized when the correspondent accounts of the NEB and UBB at the VKB were credited with payments to Estonian exporters; payments were made through the VKB under foreign contracts negotiated mainly with Soviet Foreign Trade Organizations prior to 1992. Corresponding credits were made at NEB and UBB in favor of these Estonian exporters. Total frozen convertible currency deposits at the VKB amounted to about EEK 890 million at November 17, 1992.

three banks by the government and their merger into one bank. The solvency problem would be addressed by recapitalization through a Government bond issue amounting to EEK 850 million. 1/ The Bank of Estonia would also convert existing loans to the three banks (totalling EEK 135.2 million) into equity, while the equity of all existing shareholders in the three banks would be regarded as lost. Deposit holders (including other banks) would participate in the costs of the operation through a 10 percent reduction in their deposits. Some immediate short-term liquidity could be provided by the Bank of Estonia. Following comprehensive restructuring, the new bank would be made available for sale, possibly to an established and well-known foreign bank. The staff also urged the Bank of Estonia to seek technical assistance in support of its banking supervision work and to help in the restructuring of the banks.

The authorities' initial reaction to this package was favorable. However, over the past several weeks the Government and the Bank of Estonia have evolved the following broad approach to the banking crisis, which represents a shift from the package proposed by the staff.

- The NEB and UBB would be merged and reopened on January 18, 1993. The Bank of Estonia would essentially take over the operations of the merged bank. It is estimated that the cost of recapitalizing this new bank would be in the order of EEK 375-475 million and it would appear that the Government and the Bank of Estonia would share in this burden. The Government has indicated that to ensure the Bank of Estonia's financial integrity the maximum contribution that could be envisaged for the Bank would be EEK 260 million. The balance would be provided by the Government in the form of a bond issue. As for the Bank's contribution, it is considering limiting the use of its surplus reserves to EEK 120 million. This is equivalent to US$10 million, or a quarter of the total available; this will leave the Bank with a balance of about US$30 million surplus to the requirements of the currency board. The balance of the Bank's contribution will be in the form of Bank of Estonia bonds. Immediate liquidity would be limited to the surplus reserves provided by the Bank of Estonia. Further liquidity could be marshalled by the sale of both Government and Bank of Estonia bonds to commercial banks with excess reserves and to the public. The intention of the Government is to sell the merged bank once it has become viable and when an appropriate purchaser can be found.

- The liabilities and assets associated with the frozen VKB deposits would be taken off the books of the merged bank. The liabilities associated

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1/ A portion of this bond issue would be in the form of short-term bonds (one year in maturity) -- paying a competitive interest rate -- that would be tradable and could be sold by the recapitalized bank to supplement its liquidity.

with these claims would be paid off at a discount to be determined, 1/ while the assets -- the claims on VKB (Moscow) -- would be taken over by the Bank of Estonia. There remains some hope that a portion of these assets could be recovered from Moscow.

- The TCB was closed on December 21 and will be liquidated, with the sale of its physical assets (including its branch network) to begin in early 1993.

III. Other Recent Developments

1. Prices, wages and employment

After rising by 6.6 percent and 7.7 percent in September and October, respectively, the monthly rate of inflation increased to 9.5 percent in November. About six percentage points of the November increase was due to the liberalization of bread and flour prices that took place in October -- which broadly doubled as compared to the previous month. Preliminary data indicates that wage inflation was modest in November, when the average nominal wage rose by only 1.1 percent (following an increase of 3.6 percent in October). Meanwhile, official unemployment rose to 12,579 persons -- or 1.5 percent of the labor force -- on December 1, 1992.

2. Fiscal Policy

Preliminary estimates suggest that while the general government budget was broadly balanced in October and November 1992, shortfalls in revenues associated mainly with rising tax arrears (partly due to the closure of the three banks) may give rise to a small deficit in December 1992. However, the Government indicated that it intends to implement offsetting reductions in expenditures -- mainly spending on goods and services -- as necessary to maintain balance in December. This would satisfy the performance criteria set for the last quarter of 1992. As regards the 1993 general government budget, this was submitted to Parliament on December 14 and shows a small surplus resulting from planned additional savings in expenditures on goods and services. Consideration of all reform measures, including pension increases and changes in the tax structure, have been postponed at least until April 1993 and perhaps to mid-year, and have not been included in the 1993 budget estimates.

1/ The NEB and UBB did not always distinguish on their balance sheets between deposits corresponding to assets held at VKB and held with correspondent banks abroad. Thus, some clients drew down deposits totalling EEK 357 million corresponding to frozen VKB deposits in the first months of 1992, with the result that deposits that could be identified as corresponding to the frozen VKB claims amounted to EEK 533 million as at November 17, 1992.

3. Structural Reforms

As reported in EBS/92/209 (December 11, 1992), in mid-November 1992 the Estonian Privatization Agency (EPA) offered for sale a total of 38 enterprises. Bids were to be submitted by December 22, 1992. Initial indications were that substantial international interest was expressed in a number of these enterprises. However, on November 26 the Government announced that it was reviewing the legal status of the enterprises listed for sale, which in some cases may have been subject to restitution and thus could not be sold with clear title. In addition, it would reevaluate the procedures used to select between the bids -- indicating that it would prefer to place greater emphasis on the price and less emphasis on investment and job maintenance.

IV. Staff Appraisal

Although the Estonian Government and Bank of Estonia have successfully implemented the economic stabilization and reform program agreed with the Fund in September 1992, recent developments in the banking sector suggest that vigorous and timely action will need to be taken to restore confidence in the Estonian financial system. In particular, the authorities must recognize the need for the early formulation and implementation of a comprehensive bank rescue package, lest the financial repercussions endanger the stabilization program and undermine the credibility of the authorities to deal resolutely with crises in the economy. To be successful, a bank rescue package would need to address the problem of solvency--which will involve the commitment of substantial public resources--as well as the problem of liquidity.

The staff believes that the best option remains the one recently elaborated during the course of the December visit, involving a recapitalization and takeover of the banks by the Government. However, it appears that the authorities intend to implement a package that would involve the recapitalization of the NEB and UBB by both the Government and Bank of Estonia and that the TCB will go into liquidation. In the staff's view, this package would be consistent with the program, provided that the financial involvement of the Bank of Estonia in the bank rescue operation was strictly limited to EEK 260 million, with a maximum of EEK 120 million to be provided from its surplus reserves. Any greater financial involvement by the Bank could eventually undermine the integrity of the currency board and the credibility of the kroon. Both the Government and the Bank of Estonia fully recognize this danger and are adamant that use of the Bank's reserves be limited. To further ensure the integrity of the Bank of Estonia, the staff would also recommend that upon the sale of the merged bank the Government should undertake to use any proceeds on a priority basis to restore the Bank's contribution. The staff intends to review the final proposals for the bank rescue operation in the context of an MAE technical assistance mission scheduled for mid-January and also in the context of the mid-term review of the stand-by arrangement which is expected to start in end-January.

V. Proposed Decision

The following amended draft decision is proposed for adoption by the Executive Board.

The Fund decides that the review contemplated in paragraph 4(c) of the stand-by arrangement is completed and Estonia may proceed to make purchases in accordance with the stand-by arrangement, provided that Estonia may proceed to make a purchase through February 14, 1993 for up to a cumulative amount under the arrangement equivalent to SDR 12,787,500, notwithstanding the nonavailability of the data for end-December 1992.