NEWSLETTER

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Bank fraud: Avoiding a double shock to public finances

In November 2014, three Moldovan banks were affected by fraudulent lending in the amount of USD 1 bn. This equates to about 20% of Moldova's GDP. There is little chance of recovering the misappropriated loans, which means none of the banks are able to fully repay their deposits; the banks are insolvent. Since the previous government generously guaranteed the deposits and no significant deposit insurance exists, the state will be saddled with an enormous fiscal burden. We estimate that the state will be responsible for covering deposits worth between USD 0.5 bn and USD 1 bn. The rapid increase in public debt and the resulting increase in interest costs threaten to lead to an expenditure shock.

At the same time, international partners have frozen a large share of their grants and preferential loans due to the fraud scandal. This threatens to present the state budget with a further shock to revenues and financing. The "double shock" resulting from higher spending to service public debt and lower income in the form of donor funds threatens the fiscal stability of the Moldovan state.

The only viable option for the Moldovan government to deal with the bank scandal is therefore to cooperate with foreign donors, in particular to agree with the IMF on a new programme. Such cooperation would include a thorough investigation into the bank fraud. This is the only way to prevent the banking scandal from turning into a "double shock" for public finances, strongly destabilising the fiscal and macroeconomic situation of the Republic of Moldova.

Background

Fraudulent lending, combined with inadequate supervision of the banks, has led to the embezzlement of an estimated amount of USD 1 bn from the Moldovan banking system. The banks Banca de Economii, Banca Sociala, and Unibank were affected by the banking fraud. Given the scale of the fraud, questions arise to the extent of the resulting economic impact—particularly on national debt and public finances—and the steps the government should take to limit the negative impact.

The banking scandal's costs for the state

In concrete terms, the bank fraud means that a significant part of the banks' loans will no longer be repaid and neither interest payments will be made. Thus the claims have become worthless and the banks no longer have sufficient funds to repay depositors or loans from other banks. Since banks' liabilities exceed assets, they are insolvent without external support. There are two ways in which authorities can react to the banks' insolvency: (i) liquidating the banks concerned or (ii) re-capitalising these banks.

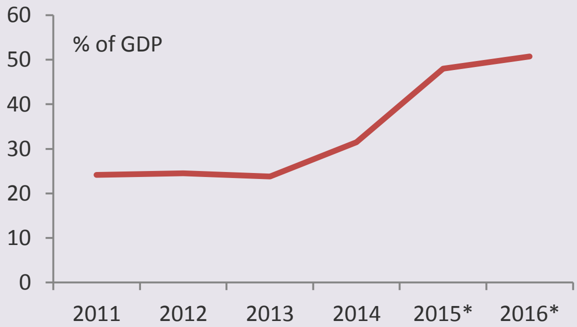
Liquidation is the option favoured by foreign donors. It represents a clear cut, because the banks cannot continue to be used as vehicles for embezzlement. However, this option is also associated with costs, because the previous government agreed to guarantee all deposits ahead of the parliamentary elections in late 2014. Since existing deposit insurance is not nearly sufficient to repay deposits, the state has to use funds from its budget to cover the majority of deposits. In fact, Banca de Economii alone already owes the National Bank USD 460 m, which have been used to pay off depositors.

Alternatively, of course, the bank´s shareholders could provide them with new capital. Since the state is the largest shareholder of Banca de Economii, however, this option would also result in high costs to the state budget. The danger also remains that additional bad loans will surface or funds will again be embezzled. Regardless which option is chosen, the state will likely be confronted with costs in the range of USD 0.5 bn - USD 1 bn.

Expenditure shock due to increased interest costs

What impact will this have on public finances? In the event of liquidation, the state will have to take on new debts to make good on the generous guarantees it made to depositors. If, as assumed, the total costs fall somewhere between USD 0.5 bn and USD 1 bn, the national debt would increase by 8-17% of GDP.

Moldova's public debt



*Source: IMF, *Forecast*

In comparison, the government's debt to GDP ratio was just under 30% in 2013. The cost of bank fraud is therefore an important driver behind the increase in public debt projected by the IMF. This enormous increase in the national debt came without the repair of a single hospital or modernisation of even one kilometre of road.

The increase in debt translates into vastly higher government expenditure on interest payments, particularly as the interest rate for Moldovan government bonds currently lies at about 15%. This results in an annual increase in expenditures of USD 75-150 m for interest payments alone. This corresponds to 5-10% of current public expenditure, meaning that the Moldovan state must either cut its spending by 5-10% or has to raise taxes accordingly.

Revenue shock due to suspended donor support

The current cessation of international financial assistance presents an additional shock to the state budget. International donors are unwilling to provide further direct financial support to the Moldovan state as long as the risk remains that the money will be stolen elsewhere. Both the European Union and the World Bank have suspended their "budget support programmes" and an IMF mission planned for June 2015 was cancelled. The fiscal risks of a prolonged stoppage of international financial cooperation would be enormous. In 2014 the Republic of Moldova received grants worth USD 165 m (equivalent to 2.9% of GDP) as well as a further USD 80 m (1.4% of GDP) in the form of low-interest loans. A permanent loss of these cash flows would have enormous implications for the state budget.

Conclusions

The only viable option for the Moldovan government is to cooperate with its international partners. Without such cooperation, the state budget is facing a "double shock" because it is not only faced with higher expenditures on interest payments, but because the permanent loss of a large part of the international grants would mean the loss of a significant amount of revenue. Both together would hardly be manageable and would threaten the fiscal stability of the Moldovan state.

In order to avert this "double shock", the Moldovan government must meet the conditions of international donors. The World Bank and European Union have made it clear that there will be no continuation of their "budget support" without a new IMF programme. The essential conditions for an agreement with the IMF are a serious investigation into the bank scandal, the liquidation of the three banks, the reform of the National Bank and banking supervision, and – as far as possible — the recovery of embezzled funds.

The priority for the Moldovan government now is to limit damages. Even in the "best case" scenario of an orderly liquidation of banks with the help of international partners, the fiscal costs will be enormous and a significant weakening of the economy will be unavoidable. But it is also clear that all other alternatives carry far greater economic and political costs.

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