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EBS/93/166

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October 8, 1993

To: Members of the Executive Board

From: The Secretary

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

Attached for consideration by the Executive Directors is a paper on Estonia's request for a stand-by arrangement in an amount equivalent to SDR 11.625 million and for a request expected to be received for a purchase under the systemic transformation facility, which is proposed to be brought to the agenda for discussion on Wednesday, October 27, 1993. Draft decisions appear on page 19.

Mr. Knöbl (ext. 38821), Mr. Zavoico (ext. 36288), or Mr. Saavalainen (ext. 38825) 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 Commission of the European Communities (CEC), 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

Request for Stand-By Arrangement and Purchase under the Systemic Transformation Facility

Prepared by the European II Department

(In Consultation with other Departments)

Approved by John Odling-Smee and Anoop Singh

October 7, 1993

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I. Introduction

Estonia joined the Fund on May 26, 1992, and on September 16, 1992 the Executive Board approved a twelve-month stand-by arrangement for Estonia in the amount equivalent to SDR 27.9 million (60 percent of its present quota) in support of a program covering the one-year period ending June 30, 1993. Progress under the program was reviewed by the Board on January 6, 1993, April 2, 1993 (at which time the 1993 Article IV consultation was also completed), and July 2, 1993. All purchases under the arrangement were made.

In the attached letter and accompanying Memorandum of Economic Policies (MEP) dated October 6, 1993, the Estonian authorities, in support of an economic and financial program covering the period July 1, 1993-December 31, 1994, (i) request a 17-month stand-by arrangement in the amount of SDR 11.625 million (25 percent of quota) and (ii) state their intention to request two purchases under the Systemic Transformation Facility (STF) in a total amount equivalent to SDR 23.25 million (50 percent of quota). 1/ Discussions on this package were conducted in Tallinn over the course of two missions (July 7-20 and September 1-8, 1993). 2/ The Estonian representatives included, inter alia, the Prime Minister, Mr. Laar; the Minister of Finance, Mr. Üürike; the Minister of Social Affairs, Mrs. Lauristin; the Minister of Reforms, Mrs. Hänni, and the Central Bank Governor, Mr. Kallas. Mr. Törnqvist, Advisor to the Executive Director, joined the July mission as an observer.

II. Performance Under the Stand-By Arrangement in 1992 and 1993

Estonia launched its stabilization and reform program--covering the period July 1, 1992-June 30, 1993--in the midst of high inflation and a severe contraction in output (Chart 1). At the core of the program was a commitment to maintain fiscal balance, preserve the integrity of the currency board introduced on June 20, 1992, and to complete the process of price liberalization. In the area of structural reforms, the authorities emphasized the privatization of large enterprises and the adoption of

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1/ It is anticipated that there will be a lag in excess of the normal three months between the start of the program period and the prospective date of approval of the stand-by arrangement. This has come about because of the desirability of continuity in program periods and some minor delays in concluding discussions on the new program.

2/ The mission members included Messrs. Knöbl (head), Wolf (September only), Zavoico, and Saavalainen (July only) (all EUR II), Escolano (FAD), and Ms. Coorey (PDR). Miss Norkaitis and Mrs. Padmore (both EUR II) acted as staff assistant and administrative assistant, respectively. Mr. Paljarvi (EUR II), the Fund's resident representative in Tallinn, also assisted the missions.

legislation in support of a market economy. The program was successfully implemented and all performance criteria were met, with the exception of the emergence of external arrears in early 1993 which were quickly cleared.

In the program year, Estonia's real GDP declined by an estimated 18 percent reflecting the adjustment to terms-of-trade losses associated with the rise to near world market levels of energy prices and continuing disruptions in trade with the states of the former Soviet Union (FSU). This was only a little more than the 15 percent decline originally expected. Mainly as a result of the growth of exports, however, the fall in output was arrested toward the end of the program year and more recently some recovery in industrial production has been experienced. Meanwhile, business surveys indicate that confidence in the economy is growing, suggesting that the recovery in output is likely to continue.

At the start of the economic program, the officially recorded rate of unemployment was very low, less than 1 percent of labor force. 1/ As output declined during the course of the program year, officially recorded unemployment increased, reaching 4 percent of the labor force by mid-1993.

Estonia's inflation decelerated rapidly during the program period. With price liberalization and rising import prices (especially energy) the monthly inflation rate averaged about 36 percent in the first half of 1992. However, the process of price liberalization was virtually completed by late 1992, thereby eliminating this factor as a source of price increases. Moreover, the Government implemented a firm incomes policy in September 1992 to protect the country's competitive position and to prevent excessive wage increases. 2/ With the currency board providing a strong anchor for prices and with the incomes policy keeping wages in check, the monthly rate of inflation decelerated to a range of 2-3 percent toward the end of the program year and to 0.7 percent in August 1993 (equivalent to 9 percent at an annual rate). Average wages, which had lagged behind inflation in the first half of 1992--resulting in a fall in real wages of about 45 percent during this period--increased in line with inflation during the program period with all incomes policy targets met in government agencies and state enterprises (Chart 2).

Throughout the program period, the Government implemented a tight fiscal policy characterized by surpluses in budgetary operations equivalent to 1 percent of GDP in 1992 and 1 1/2 percent of GDP the first half of

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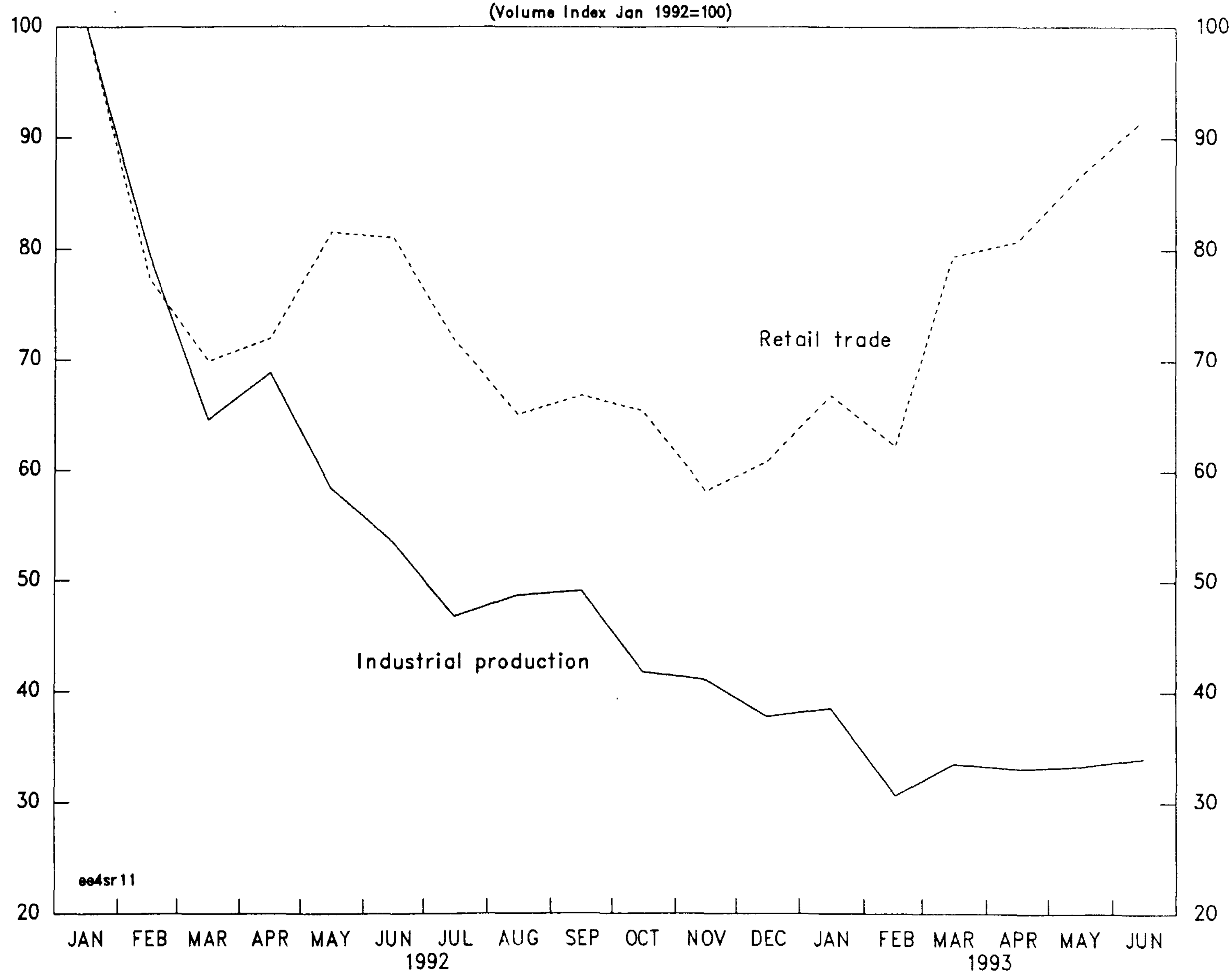
1/ Official unemployment figures underestimate actual unemployment as they do not account for workers on unpaid leave, those now only able to work part-time, and job seekers outside the official employment exchanges.

2/ Wage guidelines were set for average wage increases in the government and state enterprise sectors, and were based on the Government's inflation targets and involved a penalty tax on excessive wage increases. The implicit target was to maintain real wages at more or less constant levels through the program period.

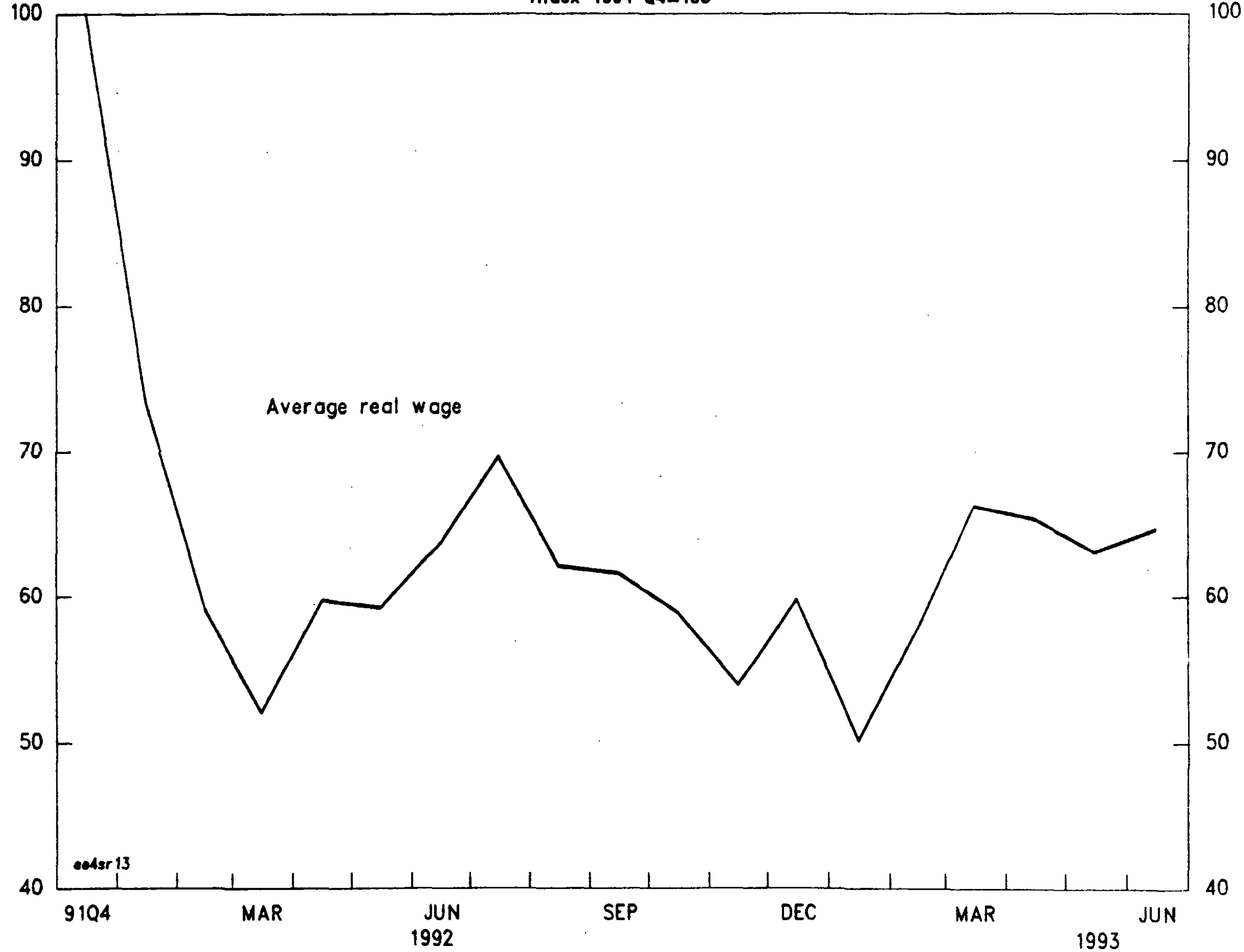
CHART 1
ESTONIA

INDUSTRIAL PRODUCTION AND RETAIL TRADE
(Volume Index Jan 1992=100)



Source: Data provided by the Estonian authorities.

CHART 2
ESTONIA
REAL WAGE DEVELOPMENTS
Index 1991 Q4=100



Sources: Data provided by the Estonian authorities; and staff estimates.

1993, 1/ which represented a stronger performance than the balanced budgets envisaged in the program. These surpluses were realized due to revenue enhancing tax measures accompanying the currency reform, a reduction in tax arrears (partly reflecting the implementation of a Bankruptcy Law during the second half of 1992), strict controls over expenditures, and lower than budgeted spending on unemployment benefits reflecting the slower than expected rise in unemployment. Capital expenditures were also kept at relatively low levels (about 1 1/2 percent of GDP) in 1992 and early 1993. During the program period, the Government focused on the removal of subsidies--with only heating and public transportation currently being subsidized--and streamlining the social safety net, including the implementation of a pension reform in the second quarter of 1993. 2/

During the first half of 1993 the character of general government operations changed somewhat as the Government started to undertake lending operations mainly to support investment by the nongovernment sector in energy and infrastructure and to finance the import of critical inputs (especially oil). This lending was financed largely using disbursements of foreign loans. Net lending operations in the first half of 1993 amounted to EEK 388 million (4 percent of GDP), of which EEK 170 million were financed by a World Bank import rehabilitation loan and EEK 202 million by loans associated with the G-24 process. In consequence, the general government borrowing requirement in the first six months of 1993 was EEK 227 million (2.2 percent of GDP).

Estonia left the ruble area in June 1992--or shortly before the program period began--with the introduction of its new currency, the kroon, in the context of a currency board. 3/ This arrangement left the authorities with very limited scope for discretionary monetary policy. During the first year of operations and consistent with the program, the Bank of Estonia fully adhered to all the provisions of the currency board and as a result confidence in the kroon has remained high.

Monetary developments during the program year were dominated by the banking crisis, the early signs of which came to light in the fall of 1992 and which culminated in the forced closure by the Bank of Estonia on November 17, 1992 of three major commercial banks. The authorities responded by recapitalizing and merging two of these banks and putting the

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1/ During these periods, total revenues and expenditures represented about 35 percent and 34 percent of GDP, respectively.

2/ The financing of the pension reform (together with road construction) was the subject of a supplementary budget adopted in June 1993. The necessary revenues were secured from new land and fuel taxes and an increase in obligatory dividends from state enterprises.

3/ Under Estonia's currency board arrangements, kroon bank notes and reserve deposits are fully backed and convertible into deutsche mark at a fixed rate of exchange. For further details, see PPAA/92/3, "Operations of the Estonian Currency Board" by Adam Bennett, dated December 1992.

third into liquidation. 1/ However, with the successful resolution of the crisis, and concurrent action by the Bank of Estonia to restructure the banking system by raising minimum capital requirements, 2/ confidence in Estonian banks was gradually restored during the spring and summer of 1993.

Growth in broad money rebounded in the second quarter of 1993 (16 percent) after falling by 4 percent in the first quarter of 1993. This was associated with a substantial growth in kroon deposits (almost 20 percent in the second quarter of 1993). Annual interest rates, which were at levels of about 80-100 percent for loans in mid-1992, had declined to a range of about 25-30 percent by mid-1993 reflecting mainly the abatement in the rate of inflation. 3/ The decline in interest rates also helped foster a resumption in the growth of credit to the enterprise sector, which increased by 21 percent during the first half of 1993 after stagnating through the latter half of 1992. Lending has been hindered, however, by inexperience in credit evaluations, poor accounting practices in the enterprise sector, and a transitional legal environment. As a result, most lending is very short-term in character and banks remain highly liquid. Meanwhile, the interbank money market remains in an embryonic form. To foster its development, in September 1993 the Bank of Estonia increased the size of its biweekly CD auctions from the initial EEK 5 million to EEK 30 million; CDs have on occasion been used by banks to support a modest amount of collateralized interbank lending.

During the first half of 1993, the external current account (including transfers) is estimated to have registered a surplus of over 2 percent of GDP, although the trade deficit widened somewhat relative to the last quarter of 1992. Both the current account and trade balances were stronger during the program year than originally projected, mainly on account of a higher than anticipated growth of exports and delays in the disbursement of external loans. Gross international reserves of the Bank of Estonia reached US$275 million at end-June 1993 (representing 4.3 months of imports). Net

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1/ The bank rescue operation was designed in close consultation with Fund staff. For further details of the bank crisis, see EBS/93/39, "Estonia - Staff Report for the 1993 Article IV Consultation and Mid-Term Review Under the Stand-by Arrangement", March 12, 1993.

2/ The minimum capital requirement was raised from EEK 600,000 to EEK 6 million effective January 1, 1993, thereby reducing the number of commercial banks from 44 at end-1992 to 24 at end-June 1993. Subsequently, the Bank of Estonia announced that the minimum capital requirement will rise to EEK 15 million on January 1, 1994 and then by EEK 10 million increments for three years thereafter. A moratorium was also placed on the opening of new commercial banks through the end of 1993 to allow supervisory mechanisms to be improved.

3/ The downward trend in interest rates was also apparent in the biweekly auctions of one-month certificates of deposit issued by the Bank of Estonia, where rates have declined from 8.9 percent in May 1993--when the first auction took place--to 6.3 percent on September 7, 1993.

international reserves (based on the definition consistent with the MEP) were US$45 million at end-June 1993, or well above the floor of US$20 million required under the program.

Export revenues increased strongly in real terms during the program year as Estonia reoriented its trade from the FSU to industrialized country markets. Meanwhile, the volume of exports and imports vis-à-vis the FSU is estimated to have remained at the low levels experienced since mid-1992 (following the sharp decline relative to the levels observed in 1990 and 1991). This decline reflected mainly the restrictions and other obstacles to trade and payments that characterize commerce with other FSU states, the appreciation of the kroon in relation to currencies of the FSU, and the fall in energy imports from Russia following the increases in prices. By contrast, exports to non-FSU countries increased sharply following currency reform in June 1992 and continued at high levels through the summer of 1993. This suggests that Estonian producers maintained competitiveness in western markets, despite the real appreciation of the kroon during the program year, and the recession in trading partner countries. During the program period, imports from industrialized countries also rose by more than had been envisaged. These imports picked up sharply in the second quarter of 1993, possibly reflecting the improvement in domestic economic conditions. The service balance registered a larger surplus than originally programmed due to higher than expected earnings by the state shipping company and a pick up in tourist receipts.

Estonia's public and publicly guaranteed external debt reached some US$68 million by end-June 1993, including a total of US$34.5 million received under the G-24 process. 1/ The Government used US$13.4 million of these resources to repay in full the loan from a Finnish petroleum company that had gone into arrears in January 1993. 2/ The balance is being used mainly to finance loans to local authorities for energy conservation investments, loans to small- and medium-scale enterprises (through the Estonian Investment Bank), and road construction (through the budget). In addition, some US$13.5 million from a World Bank loan was used to finance energy imports in the first half of 1993.

Estonia maintains a very liberal trade and payments regime. These arrangements, including the operation of correspondent accounts with other FSU states, have remained as described in EBS/93/39 (3/12/93) and EBS/93/92 (6/15/93); none give rise to any exchange restrictions. Free trade agreements were signed in 1992 with Finland, Sweden, Norway and Switzerland, although agricultural products are not covered. A nonpreferential MFN trade agreement (not covering textiles) is in force with the EC. Estonia, Latvia,

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1/ Representing US$24 million received in March 1993 from the EC Commission (first of two equal tranches) and US$10.5 million received in June 1993 from Sweden.

2/ For a fuller discussion of how these arrears emerged and their repayment, see EBS/93/39 (3/12/93) (page 9).

and Lithuania signed a free trade agreement on September 13, 1993 under which the signatories agreed to lift all existing import tariffs immediately and not to impose new tariffs on imports originating within the Baltics, other than in accordance with certain specified escape clauses. With a few exceptions, export taxes would be lifted immediately as well. Agricultural trade among the Baltic states will be regulated by a separate agreement.

In August 1993, the Government imposed tariffs on imports of wheat, rye grain, and flour from Russia to offset subsidies received by Russian producers. The tariff is set at 70 percent of the purchase price from Russia and has been imposed for an indefinite length of time. The Government has stated that it does not plan to take restrictive actions against other imports until appropriate anti-dumping legislation is enacted.

Negotiations are continuing between Estonia and Russia regarding the settlement of correspondent balances incurred prior to the currency reform, and Estonia's share of the former Soviet external debt. Estonia's position is that its share of any debt is fully offset by claims on Russia in respect of property and other assets.

The exchange system has remained broadly as described in EBS/92/132, Supplement 1 (8/25/92), except for some relaxation in the regulations relating to opening domestic foreign currency accounts and the operation of the 100 percent repatriation and conversion requirement. Effective March 1, 1993, enterprises meeting certain criteria relating to size and the scale of foreign exchange operations were allowed, subject to approval by the Bank of Estonia, to hold foreign currency accounts both domestically (with no conversion requirement) and abroad (with a two-month repatriation and conversion requirement). Effective August 2, 1993 these criteria were further relaxed, permitting a larger number of enterprises to qualify for such accounts. The holding of bank accounts abroad by individuals is not regulated by the Bank of Estonia.

III. Policy Discussions and the 1993/94 Program

1. Strategy and objectives

Substantial and tangible gains have been achieved in the first year of implementation of stabilization and structural reform policies, but much work remains to be done in continuing the transformation of the Estonian economy while maintaining macroeconomic stability. The main challenges to policymakers in Estonia over the next 18 months will be to consolidate the gains already made--especially as concerns maintaining fiscal prudence and the integrity of the currency board--while focusing on increasing investment in infrastructure within a prudent program of public investment, implementing structural policies aimed at strengthening the financial and enterprise sectors, and improving the effectiveness of markets, especially the labor market. To that end, the Government has adopted a comprehensive economic program for the 18-month period July 1, 1993-December 31, 1994, as set out in the accompanying MEP.

The concerted implementation of these policies is expected to permit real output to grow by 2 percent in the second half of 1993 and by 6 percent in 1994 (relative to 1993 as a whole). This growth is expected to be led largely by a recovery in domestic demand as real incomes rise with improving productivity and as investment (especially by the private sector) increases; continued growth in exports to industrialized countries, albeit at a slower pace than experienced earlier in 1993, would also support the recovery process. With strict monetary policies supported by a prudent fiscal stance, the annualized rate of inflation is targeted to be in single digits by mid-1994 and to decline further thereafter. The current account deficit is projected to increase, largely reflecting the projected increase in investment, and it will be financed mainly through external loans and direct investment; gross foreign reserves by end-1994 are projected at a level of about four months of imports (Chart 3).

2. Fiscal policy and the social safety net

a. Fiscal policy

Tight fiscal policy remains at the center of Estonia's stabilization effort. Accordingly, and excluding net lending, the budget of the general government in 1993 is being implemented on a broadly balanced basis, and the authorities intend to adopt a budget for 1994 that limits the financial deficit to no more than 1 percent of GDP. 1/ 2/ Taking account of net lending by the Government, the general government's borrowing requirement is programmed to be in the order of 4 1/2 percent in 1993 and 5 percent in 1994.

General government operations during the second half of 1993 are expected to result in a financial deficit equivalent to about 1 1/2 percent of GDP, largely reflecting growth of expenditures associated mainly with road construction. 3/ Receipts from the newly enacted taxes, i.e., the land tax and excise tax, plus expected growth from other taxes, are expected to offset only a part of these additional expenditures. Nevertheless, this

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1/ The "financial deficit" is defined as the general government's overall budget position, but excluding net lending which until recently has been negligible.

2/ General government revenues and expenditures in 1994 are expected to amount to 36 percent and 37 percent of GDP, respectively.

3/ The Government recently introduced its second supplementary budget for 1993. Higher expenditures for heating subsidies and transfers to local authorities are to be financed by higher-than-budgeted tax revenues, mainly from the corporate profits tax (reflecting the improved performance of private sector enterprises).

deficit is expected to be offset almost exactly by the surplus experienced during the first half of 1993, thus allowing the budget (before net lending) for the year as a whole to remain broadly balanced.

The Government is engaged in a major overhaul of the tax system through a revision of the VAT and income tax laws--which is to be submitted to Parliament shortly and expected to become effective January 1, 1994. The proposed VAT law eliminates virtually all exemptions and retains the current unified rate of 18 percent. Exports are zero rated and imports are subject to VAT. The proposed change in personal income tax envisages a uniform rate of 25 percent--as compared to the existing system with rates ranging from 16 percent to 33 percent--on all income above the exemption level of EEK 2,400 for individuals plus EEK 1,200 per dependent. Very few exemptions will be recognized and fringe benefits are subject to tax. The reform of the enterprise profits tax adopts a uniform rate of 30 percent (as compared to the existing 35 percent) and aims at avoiding the double taxation of dividends. All preferential treatment of profits associated with foreign investment is to be repealed. It is expected that the impact of these reforms will result in some decline in revenue, but is to be contained by restraining expenditures.

The Government intends to address the urgent need for improving infrastructure by formulating a Public Investment Program (PIP) for 1994. The PIP will include direct government expenditure (in the order of 1-2 percent of GDP), as well as net lending to the nongovernment sector. The PIP is expected to be primarily funded by foreign financing to be provided by the World Bank and the EBRD. Net lending operations by the Government in the second half of 1993 and in 1994 are to be limited almost exclusively to financing energy and communications projects and the financing of imports by enterprises associated with lending under the EBRD and World Bank projects (plus the parallel facility provided by the Export-Import Bank of Japan). 1/

The coordination of the Government's lending activities will become the responsibility of the External Financing Board (EFB), which was formed within the Ministry of Finance in September 1993 with the Fund's resident representative acting in an advisory role (as provided under paragraph 17 of the MEP). In addition to overseeing and monitoring foreign loans, deposits and grants, the EFB will also perform an advisory function, as needed, to assist the Minister of Finance in the assessment of whether specific loans associated with the Government's net lending program are prudent and advise

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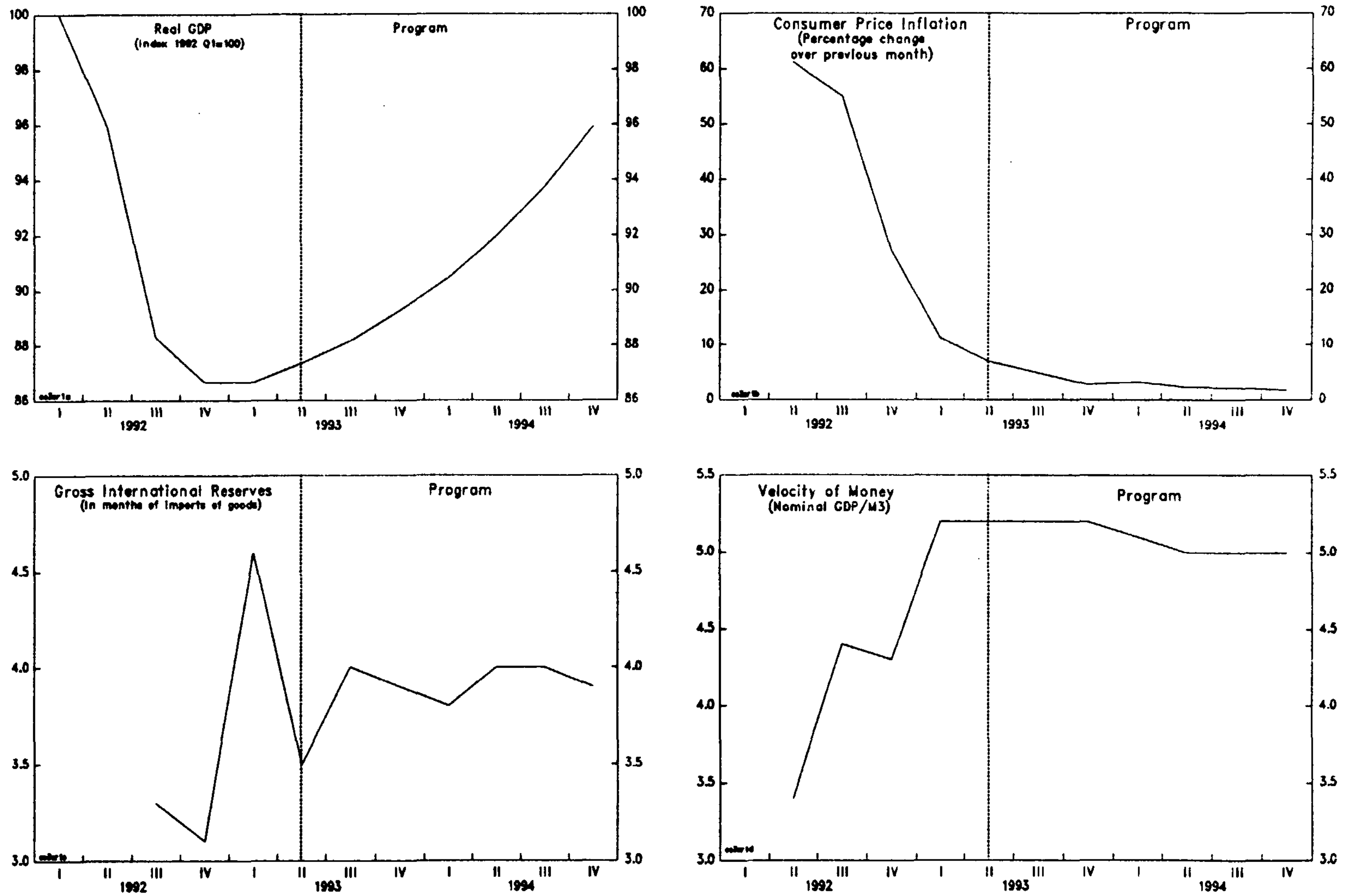
1/ Total net lending would not include amounts of G-24 assistance to be deposited by the Government with the banking system which are to be onlent by commercial banks.

CHART 3

ESTONIA

KEY PROGRAM INDICATORS



Sources: Data provided by the Estonian authorities; and staff estimates.

the Government on the appropriate margin to charge in excess of the Government's funding costs on its own loan operations, seeking to tailor the margin to the riskiness of specific loan operations. 1/

Under Estonia's first stand-by arrangement, the Government's fiscal stance was monitored exclusively on the basis of its position vis-à-vis the domestic banking system. However, as a substantial portion of lending during the remainder of 1993 and 1994 is expected to be financed from external borrowing, fiscal policy under the program will be monitored on the basis of (i) the concept of the Government's financial deficit (which is essentially equivalent to the concept of budgetary balance under the first stand-by arrangement), and (ii) net lending operations of the Government. 2/ The program has been designed to limit the financial deficit to 1 1/2 percent during the second half of 1993 and to 1 percent of GDP in 1994. As in the case under the first stand-by arrangement, it is not expected that the Government will finance its financial deficit by recourse to the banking system. Net lending is to be constrained to 5 percent of GDP during the second half of 1993 and to 4 percent in 1994; these limits were agreed so as to favor the channeling of foreign loans--other than those to be used for project finance mentioned above--through the banking system.

b. Social safety net

The Government intends to continue to strengthen and rationalize the social safety net so as to ensure that assistance is channeled effectively to those groups in the population in greatest need of support. To that end, the Government established in August 1993 the poverty line at EEK 280 per month for an individual. Effective January 1, 1994, a means-tested program of income maintenance will be implemented, targeting families with incomes below the poverty line rather than tying benefits to the minimum wage. The Government also intends to tie the child benefit program to family incomes and to use the resulting savings to finance other social programs. 3/ Meanwhile, the retirement age will be raised by six months as from January 1, 1994 and the Government's intention is not to raise pensions again until the second half of 1994.

3. Monetary policy

The monetary policy to be adopted by the Bank of Estonia during the program period will focus on (i) maintaining the strict integrity of the

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1/ The proceeds of these margins would be kept in a separate account that could be used to offset at least in part unexpected expenses associated with the lending program, including exchange losses and nonperforming loans.

2/ See Annex I of the MEP for detailed definitions of these concepts and Appendix II for further discussion of the fiscal performance criteria.

3/ Currently child benefits are paid irrespective of family incomes and are a heavy burden on the budget, representing about 2.4 percent of GDP in the first half of 1993.

currency board arrangement and (ii) improving the performance and stability of the banking system so that it can better act as a financial intermediary in support of the transition process. The integrity of the currency board will be maintained by limiting lending by the Bank of Estonia to commercial banks under emergency situations only. The limits to such lending under the program are set by targeting net international reserves (NIR)--net of currency board cover--held by the Bank of Estonia. The mission reached understandings on an NIR floor of DM 40 million for end-September 1993, DM 45 million for end-December 1993 and DM 50 million for end-March 1994. 1/ This path for the NIR floor was set to give the Bank of Estonia scope for cumulative emergency lending to commercial banks in the period through end-March 1994 in an amount equivalent to about DM 30-35 million, or roughly the same total permitted under the previous stand-by arrangement. 2/

The commercial banking sector, although gradually regaining the public's confidence in the aftermath of the banking crisis, is still in the early stages of its evolution into a modern banking system. The adoption of the currency board, which brought with it the withdrawal of the Bank of Estonia as a lender of last resort except in emergencies, and the adoption of the Bankruptcy Law in September 1992, which was followed shortly by the bankruptcy of one of the largest commercial banks in Estonia, quickly impressed on banks the importance of prudence in their operations. The result was that most banks accumulated substantial excess reserves in the period through mid-1993 as they limited lending to the most creditworthy clients (and for very short terms) and deposited surplus resources either with the Bank of Estonia or abroad. Lending operations were also constrained by the preferences of enterprises for maintaining most of their deposits in the form of demand deposits, which have been relatively volatile, by uncertainties relating to property rights and the privatization process, and by inexperience on the part of both banks and enterprises in the presentation and evaluation of loan proposals. However, evidence emerged in the summer of 1993 that some banks, building on experience gained over the past year, were becoming more sophisticated in their operational capabilities and were starting to lend more actively and for longer terms.

To support the further development of commercial banks, the authorities are implementing a number of measures. The soundness of the banking system is to be maintained by enhancements in the Bank of Estonia's bank supervision capabilities, including the imminent passage of a Credit Institutions Act which will introduce effective sanctions to ensure

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1/ The NIR floors have been expressed in terms of deutsche mark since the Bank of Estonia holds most of its reserves in that currency.

2/ The monetary implications of such lending cannot be assessed in advance as it is envisaged only to take place in support of banks in emergency situations; under these special circumstances such lending is likely to be stabilizing. In any event, the scope for these operations is to be reviewed with the authorities at the first review.

adherence to regulatory standards. It will also implement a standardized accounting plan for banks in early 1994 and develop a plan for implementing international capital adequacy standards as established by the BIS no later than the end of the program period. Support is also to be sought for technical assistance to commercial banks to enhance credit evaluation skills. The legal environment for banking operations is to be improved by, inter alia, the implementation of the recently passed Real Estate Act--which will permit fixed property to be used as collateral. These measures are expected to lead to an improvement in the capacity of commercial banks to process a higher volume of loans and to make resources available for longer terms, without compromising their financial integrity.

Continued privatization is another aspect of the restructuring of the banking system. The Government intends to privatize the Northern Estonia Bank by August 31, 1994--which in light of its current financial position may require further restructuring--and the Bank of Estonia intends to privatize the remaining two-thirds share of the Savings Bank it owns by this same date. 1/

4. Inflation and wages

After remaining in a range of about 2-3 percent per month in the spring and early summer of 1993, which largely reflected a natural correction to the substantial undervaluation of the kroon when it was introduced in mid-1992, inflation finally fell below 1 percent per month in August 1993. With the continued maintenance of prudent macroeconomic policies in the period ahead, together with the fixed exchange rate against the deutsche mark, inflation is expected to remain at about 1-1 1/2 percent per month for the next several months before falling to annualized single digits during 1994. The achievement of this objective is a key element in the authorities' program as it is vital to sustain the competitiveness of Estonia's traded goods sector.

With the price liberalization virtually completed, the emphasis in the period ahead will shift to improving wage and labor market flexibility. In light of the authorities' experience with the incomes policy implemented under the previous stand-by, when wage moderation was achieved mainly as a result of poor profitability in the state enterprise sector, it was agreed that wage formation would be best left to be decided at the level of individual enterprises. The hardened budget constraint prevailing in the state enterprise sector is believed to be a sufficient guarantee that wage developments there will be driven by developments in productivity. As regards government wages, the last increase was made in February 1993 and the Government's intention is to keep wages frozen until early 1994 when government pay is to be reviewed in light of required staffing and wage developments elsewhere in the economy. In place of a formal incomes policy,

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1/ A one-third share of the Savings Bank was sold to a major Estonian commercial bank in May 1993.

the Government has decided to announce inflation targets which can be used by enterprises as a basis for wage settlements, after taking into account firm-specific productivity developments. The initial ambitious inflation target was set at 7 percent (actual rate) over the six-month period ending March 31, 1994.

Active labor market policies will be emphasized to improve geographical and occupational mobility; training and re-training are regarded as a key element of these policies. It was agreed to keep eligibility rules of the unemployment benefit system tight and to phase out the minimum wage system. These measures should encourage more active job search and alleviate pressures on rising youth unemployment while simultaneously improving real wage flexibility.

5. External policies

The Government has essentially completed its program of liberalizing trade in goods and services and only a few restrictions remain. Regarding the recent imposition of import tariffs on Russian grain and flour, the mission urged the authorities to resist pressure to grant further protection to domestic producers. In its trade with industrialized countries, Estonia continues to face import restrictions and export subsidies, particularly for agricultural products. As regards payments arrangements, the mission advised the authorities to liberalize the remaining restrictions on capital account transactions and to accept the obligations of Article VIII as soon as possible.

6. External assistance and the balance of payments

Exports to industrialized countries are envisaged to grow strongly during the second half of 1993 and 1994--reflecting the apparent competitiveness of Estonian producers--while trade with the FSU is assumed to recover marginally after the sharp decline experienced in 1992-93. After growing at an annual rate of 38 percent in the first half of 1993, total exports (in volume terms) are projected to grow at an annual rate of almost 10 percent in the second half of 1993 and by 12 percent in 1994. Imports, mainly from industrialized countries, are expected to pick up substantially with the further disbursement of external loans and the recovery of domestic demand. Provided that loans from the EC/G-24, the World Bank, and the EBRD are disbursed and absorbed as scheduled, and that foreign direct investment remains at current levels, imports (in volume terms) are projected to increase at an annual rate of 12 percent in the second semester of 1993, and by almost 30 percent in 1994. The balance on services (excluding official transfers which are mainly for technical assistance) is envisaged to remain unchanged in real terms from 1993 to 1994. As a result, the current account (including transfers) is projected to register a deficit of US$48 million (5 1/2 percent of GDP) in the second half of 1993 and about US$180 million (some 9 percent of GDP) in 1994. This would be consistent with maintaining gross international reserves at a level of four months of imports throughout the program period, or at about the same level as in the first half of 1993. A financing gap of some US$20 million is projected for 1994 which it is expected would be filled by additional long-term public borrowing.

As of end-August 1993, some US$35 million in EC/G-24 assistance had been disbursed with another US$50 million committed, but not yet disbursed. To support longer term lending, understandings were reached with the authorities (paragraph 49 of the MEP) that EC/G-24 funds not already earmarked for direct expenditure or onlending by the Government, plus the counterpart of STF purchases, would be placed with commercial banks or the Estonian Investment Bank in the form of long-term deposits; these resources would thus not be available for budgetary financing. If the authorities judge that the banking system cannot absorb such deposits without compromising safe lending practices, these funds will be held abroad temporarily until such time as they can be used domestically.

7. Structural reforms and the transition to a market economy

Substantial progress was made during the program period in the transition to a market economy. Restitution was expedited with the setting of April 1, 1993 as the final deadline for filing claims, and the privatization process was formalized and accelerated through (i) the establishment of the Estonian Privatization Agency in October 1992, (ii) the passage of the Privatization of Housing Act in May 1993 (regulating the sale of housing) and (iii) the enactment of the Privatization Act in June 1993 (streamlining the process of privatizing enterprises). 1/ Some progress was also made in the passage of legislation in support of a market economy. Notably, a Bankruptcy Law was passed in September 1992 that was quickly implemented, imposing financial discipline on both enterprises and banks. 2/ A Real Estate Law (allowing, inter alia, property to be used for collateralized lending) and a Competition Law were also passed in June 1993.

The program envisages an acceleration in the privatization process through a variety of measures to expedite the sale of enterprises. It is foreseen that privatization against vouchers associated with the restitution and housing programs will start shortly, and the Government has decided not to support the value of vouchers with backing from the budget or the banking

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1/ Over 50 percent of small enterprises have now been privatized and it is expected that about 100 large enterprises will be privatized (or restructured) by the end of 1993 or early 1994. The bulk of the proceeds from privatization will be used to finance funds devoted to compensating restitution claimants and covering expenses associated with the privatization process.

2/ The Bankruptcy Law favors creditors by forcing bankrupt enterprises into liquidation. Several early bankruptcies had a strong demonstration effect and contributed to the effective hardening of enterprise budget constraints.

system. It also intends to give consideration in 1994 to allowing such vouchers to be traded. The restitution process is to be speeded up by assisting local authorities in the provision of legal and administrative services so as to enable them to resolve claims more rapidly.

IV. Medium-Term Outlook and Capacity to Repay the Fund

The stabilization of the macroeconomic environment following the currency reform and the concurrent implementation of strong fiscal policies, together with the maintenance of a liberal trading regime and continued progress with structural reforms, should result in a sustained improvement in the performance of the Estonian economy over the medium term. Notwithstanding the appreciation of the kroon in real terms, the traded goods sector still maintains a competitive cost structure relative to its industrialized trading partners due to the apparent undervaluation of the kroon at the time of currency reform. In addition, the high levels of foreign direct investment in 1992-93 may be expected to boost productivity in the traded goods sector. These factors are expected to contribute to the strong growth in exports projected for 1994, which would moderate to a rate somewhat below 10 percent in 1995-96 before stabilizing at a level consistent with the projected rate of growth of real GDP over the medium term of about 5 percent per annum. The high levels of external loans expected to be disbursed in 1993-94 would boost imports temporarily during this period, following which imports from industrialized countries would grow in line with the expansion of domestic demand. Imports from FSU are projected to grow relatively modestly as Estonia diversifies its energy supplies and improves energy efficiency in the economy. 1/ Exports and imports of nonfactor services are expected to increase in line with the growth of real GDP, while the deficit on the factor service balance is projected to increase moderately, reflecting the servicing of foreign capital.

Foreign direct investment is expected to grow moderately, reflecting the attractiveness of Estonia's liberal payments regime and stable macroeconomic environment. Net public long-term flows, mainly from the World Bank and the EBRD are projected to reach US$50-60 million per annum in 1995-96 before declining in later years as Estonia becomes increasingly more reliant on export revenues and private capital inflows. Reflecting a stable demand for money, net international reserves would increase at a steady pace allowing gross reserves to remain at about four months of imports throughout the medium term. Under this scenario, the current account deficit (including transfers) would decline steadily from a peak of about 9 percent of GDP in 1994 to about 3 percent of GDP by 2000. A financing gap in the order of about US$25 million may be expected in 1995 reflecting import needs

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1/ A US$46 million loan from the EBRD (currently being disbursed) and a US$30 million loan from the World Bank (under discussion) are expected to be utilized for improving energy efficiency.

as the economy is restructured. Financing gaps are not envisaged in subsequent years, however, since imports are projected to grow in line with the expansion of domestic demand and could be financed by current levels of private capital inflows and somewhat lower levels of public long-term inflows. It is possible that private capital inflows may turn out to be substantially higher than envisaged; if so, the growth of real GDP would be higher than projected and the current account deficit would not decline as rapidly as envisaged.

On the basis of the current projections, the ratio of total external public debt to GDP is envisaged to increase to a peak of about 18 1/2 percent in 1995-96 before declining to some 12 percent in 2000. Debt service as a proportion of exports to non-FSU countries is projected to remain in the range of about 5-8 percent during the period 1995-99 before rising to just over 10 percent in 2000. 1/

These projections are of course highly tentative given the rapid changes taking place in Estonia's economy and the uncertainties with regard to developments in the FSU and the rest of the world, especially as it relates to the price of energy. Thus, for example, each additional U.S. dollar increase in the price of a barrel of oil that is reflected equivalently in prices of refined products imported by Estonia is estimated to create a financing gap equivalent to about US$15 million per annum. On the other hand, the relatively low level of external debt and the high level of net reserves implies that the current account would not be significantly affected by an increase in foreign interest rates.

This medium-term scenario is predicated upon the continuation of the policies initiated under the previous stand-by arrangement, in particular the rigorous implementation of the currency board, the maintenance of a strong fiscal stance, and the continuation of structural reforms. Any material weakening in these policies over time would place at risk Estonia's capacity to service its obligations to the Fund in a timely fashion. Notwithstanding these caveats, the strength of Estonia's performance to date and the medium-term projection suggest that there can be a reasonable expectation that Estonia should be able to repay the Fund as scheduled.

V. Technical Assistance

The Fund and the World Bank, together with EC PHARE and a number of other multilateral and national official institutions, have provided extensive technical assistance to Estonia over the past year. 2/ Further

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1/ The repayment of the bulk of the loans received from the G-24 would take place in 2000 (and beyond), thus accounting for the rise in the debt ratio in that year.

2/ Technical assistance provided by the Fund in the period since mid-1992 is set out in Appendix III.

work remains, particularly in supporting the strengthening of banking supervision and effecting an improvement in macroeconomic statistics (especially the national accounts).

VI. Performance Criteria, Program Reviews, and Phasing

The quantitative criteria for monitoring performance under the stand-by arrangement are: (i) quarterly limits both on the general government's financial deficit and on net lending; (ii) limits on the amount by which actual reserves of the banking system can fall below required reserves; (iii) full foreign currency backing of the currency board liabilities; 1/ (iv) minimum targets for net international reserves, net of currency board cover; (v) limits on short- medium- and long-term external debt contracted or guaranteed by the Government and the Bank of Estonia (with maturities of less than 12 years). 2/ The ceilings (or floors) for end-September 1993 are to be regarded as indicative whereas the ceilings (or floors) for end-December 1993 and end-March 1994 are performance criteria.

The standard clauses on overdue financial obligations to the Fund, the exchange and trade system, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, and the accumulation of external arrears by the Government are also applicable as performance criteria.

Two reviews with the Fund to assess the implementation of the economic program are provided for. The first review will be completed by March 15, 1994 and the second review will be completed by September 15, 1994. Quantitative performance criteria for end-June and end-September 1994 will be specified at the time of the first review and for end-December 1994 at the time of the second review.

Purchases under the arrangement have been phased so as to provide for a second purchase under the STF to be made upon completion of the first program review. Thus, in order to provide for an appropriate distribution of resources over the period of the arrangement, the phasing provisions of the stand-by arrangement do not provide for an additional amount to be made available under the arrangement upon completion of the first program review.

1/ Including all kroon liabilities of the Bank of Estonia on its correspondent accounts with other FSU states.

2/ For purposes of monitoring short-term debt, liabilities on the correspondent accounts with FSU countries are regarded as normal import financing.

VII. Staff Appraisal

The Estonian authorities are to be commended for the successful implementation of the program supported by their first stand-by arrangement with the Fund. Considerable gains in stabilization and reform have been made in Estonia over the past year. The most significant achievement has been the substantial reduction in the monthly rate of inflation. Also noteworthy has been the early stabilization of output, with some signs of recovery becoming apparent since the summer of 1993. These achievements have been made possible mainly by the adoption and implementation of strong fiscal, monetary, and incomes policies that allowed the Estonian economy to adjust rapidly to the sharp deterioration in the terms of trade experienced in early 1992. Meanwhile, the maintenance of a liberal trade and payments regime allowed for a rapid reorientation in trade toward industrialized countries, thereby offsetting to a large degree the negative impact of the disruption of trade with the FSU. The liberal external regime, together with the improvement in domestic economic conditions, were also responsible for the sharp increase in foreign direct investment. The implementation of structural reforms, especially the passage of the Bankruptcy Law in September 1992 and the acceleration in the pace of privatization of large enterprises, made an important contribution to supporting the transition to a market-based economy.

Notwithstanding these positive developments, further progress remains to be made to help create the conditions for sustainable growth and to consolidate the reform process. Although the rate of inflation has declined substantially, it should be reduced further until it is in single digits on a sustained basis so as to maintain the competitiveness of Estonian exports. Fiscal policy must continue to emphasize restraint and the limitation of financial deficits. Care must be taken to ensure that any unanticipated expenditures, for example higher than budgeted heating subsidies, are adequately financed. Net lending should be limited to what can be financed comfortably from external borrowing. Although recent reforms of the social safety net and the tax system are welcome, the Government must remain firm in its commitment to ensure that further reforms are effectively financed within overall budget targets. Thus, expenditure cuts and/or revenue raising measures should accompany such reforms. Monetary policy should continue to emphasize the strengthening of the banking system. The liberal trade and payments regime has been crucial in speeding the transformation of the Estonian economy, and the Government should resist further pressure to shelter inefficient producers, especially in the agricultural sector, from outside competition, which can only hurt vulnerable groups in society.

Substantial progress has been made in the implementation of structural reforms, which has made an important contribution to the transition process. To sustain the momentum of reform, the Estonian authorities are urged to press ahead with their program of accelerating the privatization of large enterprises, clarifying and protecting ownership rights, and completing the restitution process.

Estonia has begun to receive external assistance under the G-24 process and the initial disbursements have been used mainly to settle external arrears and to support lending for energy conservation and other infrastructure purposes. To ensure the productive use of these resources, the Government should henceforth channel such loans through the banking system.

The Estonian authorities have designed a strong stabilization and reform program that merits support from the Fund. The staff believes that the policies set out in the MEP for the program period July 1, 1993 to December 31, 1994 represent a strong base on which to continue the stabilization and transformation of the Estonian economy. Accordingly, the staff recommends approval of Estonia's request for a 17-month stand-by arrangement in an amount equivalent to SDR 11.625 million (25 percent of quota) plus a purchase under the STF in an amount equivalent to SDR 11.625 million (25 percent of quota).

VIII. Proposed Decisions

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

A. Request for Stand-By Arrangement

1. The Government of Estonia has requested a stand-by arrangement for a 17-month period in an amount equivalent to SDR 11.625 million.

2. The Fund approves the stand-by arrangement set forth in EBS/93/166.

B. Request for Purchase under Systemic Transformation Facility

1. The Fund has received a request by the Government 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).

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: Selected Economic Indicators
(Percentage change over previous period)

	Original program						Actual program						
	1990	1991	1992	1993	1992 1/	1993 2/	1993 Q3	1993 Q4	1994 Q1	1994 Q2	1994 Q3	1994 Q4	1994 2/
Output and employment													
Real GDP	-3.6	-11.9	-28	1	-23	-5	0.9	1.2	1.4	1.7	1.9	2.3	6
Industrial production, volume	-5.6	-9.5	...	...	-39	-10	...	...	...	...	...	...	8
Total employment	-2.0	0.4	...	...	-5	-6	...	...	...	...	...	...	-1
Prices and costs													
Consumer price index	23.1	210.6	975	54	1,069	85	4.9	3.1	3.4	2.2	2.1	1.7	14
Average wage	24.5	98.3	516	61	620	93	5.0	3.1	3.8	2.8	2.7	2.4	18
Real wage	1.1	-36.2	-45	5	-39	4	0.1	0.0	0.4	0.6	0.6	0.6	4
External sector													
Export volume													
CIS and Baltics, goods	...	-15	-35	49	-42	-14	1.0	1.0	0.5	0.8	0.8	0.8	4
Other countries, goods	...	63	-4	22	178	85	2.4	2.4	0.8	0.8	0.8	0.8	13
Import volume													
CIS and Baltics, goods	...	-30	-31	15	-51	9	2.0	10.0	-4.5	0.2	0.2	3.0	10
Other countries, goods	...	11	-24	23	16	101	3.8	3.3	8.8	-0.2	7.7	-1.0	29
Current account deficit, (US$ millions) 3/	...	...	-181	-13	0	-69	-20.1	-45.4	-53.6	-43.0	-51.2	-59.4	-207
In percent of GDP	...	...	-19	-10	0	-4	-4.5	-9.9	-11.3	-8.8	-10.2	-14.5	-10
General government													
Total revenue	10.6	135.7	538	46	533	90	...	...	...	...	...	...	16
Total expenditure	6.7	122.3	570	51	607	95	...	...	...	...	...	...	19
Financial balance, in percent of GDP	...	4.8	1	0	1	0	...	...	...	...	...	...	-1
Financial market													
Domestic credit, end of period	48.9	429.2	...	...	22	41	...	...	...	...	...	...	24
Broad money, end of period	...	...	...	...	68	21	...	...	...	...	...	...	17
Velocity	...	...	...	...	4.3	5.2	5.2	5.2	5.1	5.0	5.0	5.0	5.0

Sources: Data provided by the Estonian authorities; and staff estimates.
1/ Preliminary estimates, calendar year.
2/ Staff forecasts, calendar year.
3/ Excluding official transfers.

Table 2. Estonia: Summary of General Government Fiscal Operations

	1992 (Actual)	1993 Jan-Jun (Actual)	1993 Jul-Dec (Estimated)	1993 (Estimated)	1994 (Estimated)
			(In millions of EEK)		
Total revenue	4,251.0	3,771.0	4,298.1	8,069.1	9,390.0
Tax revenue	3,927.0	3,571.2	4,109.3	7,680.5	8,816.4
Direct taxes	2,747.0	2,466.8	2,763.3	5,230.1	5,748.0
VAT and excises	1,083.0	1,012.6	1,227.4	2,240.0	2,698.4
Taxes on international trade	74.0	54.1	75.9	130.0	167.0
Other taxes	23.0	37.7	42.7	80.4	203.0
Nontax revenue	324.0	199.8	188.8	388.6	573.6
Total expenditure	4,144.0	3,609.8	4,484.1	8,093.8	9,639.6
Current expenditure	3,968.0	3,432.0	4,110.0	7,541.9	8,869.4
Expenditure in goods and services	2,722.0	2,191.7	2,716.9	4,908.6	5,735.6
Current transfers and subsidies	1,246.0	1,234.9	1,367.1	2,602.0	2,918.2
Other current expenditure	...	5.3	26.0	31.3	215.6
Capital expenditure	176.0	177.8	374.1	551.9	770.2
Capital transfers to public financial institutions 1/	...	50.0	81.1	131.1	59.9
Other capital expenditure	176.0	127.8	293.0	420.8	710.3
Financial surplus(+)/deficit(-)	107.0	161.2	-185.9	-24.7	-249.6
Net lending(-)	-40.0	-388.4	-590.4	-987.8	-1,066.4
Budgetary	-40.0	-15.7	-38.1	-53.8	-55.4
Extrabudgetary	...	-372.7	-552.3	-925.0	-1,011.0
Borrowing requirement	-67.0	227.2	776.3	1,003.5	1,316.0
Memorandum items:					
Tax arrears	719	666	...	...	...
Corporate income tax	275	170	...	...	...
VAT	239	201	...	...	...
Excises	5	4	...	...	...
Natural resources	1	4	...	...	...
Social security	199	287	...	...	
			(In percent of GDP)		
Total revenue	34.4	36.3	36.0	36.1	35.8
Tax revenue	31.8	34.4	34.4	34.4	33.6
Direct taxes	22.2	23.8	23.1	23.4	21.9
VAT and excises	8.8	9.8	10.3	10.0	10.3
Taxes on international trade	0.6	0.5	0.6	0.6	0.6
Other taxes	0.2	0.4	0.4	0.4	0.8
Nontax revenue	2.6	1.9	1.6	1.7	2.2
Total expenditure	33.6	34.8	37.6	36.3	36.7
Current expenditure	32.1	33.0	34.4	33.8	33.8
Expenditure in goods and services	22.0	21.1	22.8	22.0	21.9
Current transfers and subsidies	10.1	11.9	11.5	11.7	11.1
Other current expenditure	...	0.1	0.2	0.1	0.8
Capital expenditure	1.4	1.7	3.1	2.5	2.9
Capital transfers to public financial institutions 1/	...	0.5	0.7	0.6	0.2
Other capital expenditure	1.4	1.2	2.5	1.9	2.7
Financial surplus(+)/deficit(-)	0.9	1.6	-1.6	-0.1	-1.0
Net lending(-)	-0.3	-3.7	-4.9	-4.4	-4.1
Budgetary	-0.3	-0.2	-0.3	-0.2	-0.2
Extrabudgetary	--	-3.6	-4.6	-4.1	-3.9
Borrowing requirement	-0.5	2.2	6.5	4.5	5.0

Sources: Data provided by Estonian authorities; and staff estimates.

1/ Includes capital transfers to the Agricultural Fund, which provides loans to small farmers.

Table 3. Estonia: Monetary Survey

	1991	1992				1993	
	Q IV	Q I	Q II	Q III	Q IV	Q I	Q II
	(In millions of kroons, end of period)						
Net foreign assets	2,087.5	1,290.4	1,727.0	3,116.0	4,394.3	4,024.1	4,306.1
Foreign assets	2,551.6	1,841.1	2,822.1	3,837.4	5,177.1	4,899.0	4,833.2
In convertible currency	2,069.8	1,315.1	2,338.8	3,267.8	---	---	
Foreign liabilities	464.1	-550.7	1,095.1	721.4	782.8	874.5	527.3
In convertible currency	208.1	-238.1	791.7	369.2	---	---	
In nonconvertible currency	256.0	-312.6	303.4	352.2	---	---	
Net domestic assets	205.2	635.8	1,466.2	117.2	-541.4	-317.6	7.0
Net domestic credit	1,110.1	955.8	1,443.6	1,508.7	1,355.2	1,650.1	1,526.2
Claims on general government (net)	-89.0	-83.3	-129.1	-152.8	-230.3	-186.0 1/	-450.8 1/
Claims on state enterprises	854.4	518.8	472.7	589.4	644.4	585.0	480.0
Claims on private sector	344.7	520.3	1,145.0	1,076.6	986.1	1,243.0	1,490.2
Other items (net) 2/	-904.9	-320.0	-22.4	-1,436.5	-1,941.6	-1,968.0	-1,519.1
Broad money (M3)	2,292.6	1,926.1	3,193.2	3,233.3	3,852.8	3,705.0	4,314.2
Currency outside banks	212.4	267.9	237.0	723.4	1,040.7	1,269.2	1,707.0
Demand deposits	484.1	532.1	766.6	1,646.4	1,679.8	1,835.3	2,137.9
Time and savings deposits	305.2	298.8	278.4	144.8	248.3	219.0	319.0
Foreign currency deposits	1,290.9	827.3	1,911.2	718.7	884.0	382.0	150.0
	(Percentage change from previous quarter)						
Net foreign assets	---	-38.2	33.8	80.4	41.0	-8.4	7.0
Foreign assets	---	-27.8	53.3	36.0	34.9	-5.4	-1.3
Net domestic assets							
Net domestic credit		-13.9	51.0	4.5	-10.2	21.8	-7.5
Of which:							
Claims on state enterprises	---	-39.3	-8.9	24.7	9.3	-9.2	-17.9
Claims on private sector	---	50.9	120.0	-6.0	-8.4	26.1	19.9
Broad money (M3)	---	-16.0	65.8	1.3	19.2	-3.8	16.4

Source: Data provided by Estonian authorities.

1/ Including EEK 300 million government bonds issued as part of the bank rescue operation.
2/ The large increase in "other items (net)" in the second half of 1992 reflects the restitution of gold to Estonia.

Table 4. Estonia: Balance of Payments 1992–94
(In millions of U.S. Dollars)

	1992	1993 1st half Estimated	1993 2nd half Projected	1993	1994 1st half	1994 2nd half Projected	1994	Jul 1/92–Jun 30/93 Original Program	Jul 1/92–Jun 30/93 Revised Program
Current account	94.3	18.1	-47.5	-29.5	-84.6	-98.6	-183.2	-213	61.4
Trade balance	-51.2	-57.1	-122.5	-179.6	-148.8	-171.8	-320.6	-250.0	-83.7
FSU	-39.4	-39.2	-80.8	-120.0	-81.7	-84.2	-165.9	-146.0	-66.9
Other countries	-11.8	-17.9	-41.8	-59.7	-67.1	-87.6	-154.7	-104.0	-16.8
Exports	457.2	330.6	393.7	724.3	416.3	429.9	846.2	503.0	633.8
FSU	215.3	120.1	138.1	258.2	150.8	156.4	307.2	400.0	246.3
Other countries	241.9	210.5	255.6	466.1	265.5	273.5	539.0	103.0	387.5
Imports	-508.4	-387.7	-516.2	-903.9	-565.2	-601.7	-1,166.9	-753.0	-717.5
FSU	-254.7	-159.3	-218.9	-378.2	-232.5	-240.6	-473.1	-546.0	-313.2
Other countries	-253.7	-228.4	-297.3	-525.7	-332.6	-361.2	-693.8	-207.0	-404.3
Nonfactor services	52.8	57.7	54.3	112.0	53.7	64.3	118.0	28.0	89.0
Transport	59.8	50.9	44.2	95.1	45.6	51.1	96.8	...	82.5
Tourism	14.6	12.5	11.2	23.7	12.4	12.4	24.8	...	19.6
Other services 1/	-21.6	-5.7	-1.1	-6.8	-4.3	0.8	-3.5	...	-13.1
Factor services	-2.0	-3.8	2.7	-1.1	-1.5	-3.1	-4.6	1.0	-2.7
Interest	0.9	6.3	4.2	10.5	1.5	-0.1	1.4	1.0	8.9
Other	-2.9	-10.1	-1.5	-11.6	-3.0	-3.0	-6.0	--	-11.6
Transfers	94.7	21.3	18.0	39.3	12.0	12.0	24.0	8.0	58.8
Official 1/	95.0	21.4	18.0	39.4	12.0	12.0	24.0	--	59.2
Private	-0.3	-0.1	--	-0.1	--	--	--	8.0	-0.4
Current account (excluding official transfers)	-0.4	-3.2	-65.5	-68.8	-96.6	-110.6	-207.2	-213.0	2.6
Capital account	108.6	67.1	76.3	143.3	114.2	107.8	222.0	167.0	162.3
Foreign direct investment	57.9	61.4	25.0	86.4	32.1	57.2	89.3	20.0	101.6
Other long term	12.9	69.9	38.3	108.3	89.6	58.1	147.7	107.0	81.0
Public	13.1	54.7	38.3	93.1	83.8	50.6	134.4	91.0	66.2
Private	-0.2	15.2	--	15.2	5.8	7.5	13.3	16.0	14.8
Short term	-34.2	-48.6	12.9	-35.7	-7.5	-7.5	-15.0	-4.0	-85.3
Public	13.4	-29.7	14.3	-15.3	--	--	--	--	-36.9
Commercial banks	-36.6	-7.1	0.0	-7.1	--	--	--	-4.0	-34.3
Other private	-11.0	-11.9	-1.4	-13.3	-7.5	-7.5	-15.0	--	-14.2
Bank of Estonia	115.6	-13.4	--	-13.4	--	--	--	44.0	6.5
Correspondent accounts 2/	-24.7	-13.4	--	-13.4	--	--	--	--	-75.4
Claims on gold 3/	140.2	--	--	--	--	--	--	44.0	81.9
Errors and omissions	-43.6	-2.2	--	-2.2	--	--	--	--	58.5
Overall balance	202.9	85.1	28.7	113.9	29.6	9.2	38.8	-46.0	223.7
Net international reserves 4/	-202.9	-85.3	-28.8	-114.1	-29.6	-9.3	-38.9	-91	-223.7
Financing gap	--	--	--	--	--	--	--	137.0	0.0
Memorandum items									
Exchange rate (kroons/US$)	11.7	13.0	13.2	13.1	13.2	13.2	13.2	12.0	12.5
Gross international reserves 5/	195.1	275.4	344.9	344.9	394.0	409.8	409.8	153.0	275.4
(in months of goods imports)	4.6	4.3	4.0	4.6	4.2	4.1	4.2	2.4	4.6
Use of Fund Credit (end of period)	11.3	18.2	58.9	58.9	78.4	84.9	84.9	--	18.2
Export volume (1990=100)	157.1	244.6	290.8	267.8	297.5	302.1	299.9	140.4	231.0
FSU	49.5	42.0	43.2	42.7	43.8	44.5	44.2	75.8	46.3
Other countries	252.9	425.0	511.1	468.2	523.4	531.5	527.4	198.0	395.5
Import volume (1990=100)	54.6	82.5	105.0	93.9	113.7	120.7	117.2	86.0	76.1
FSU	34.5	33.6	41.1	37.5	41.0	41.8	41.4	64.8	35.2
Other countries	74.8	131.5	169.2	150.5	186.7	199.9	193.4	107.3	117.2
Debt service/non-FSU exports 6/	8.6	7.1	2.0	4.3	2.8	3.1	2.9	...	9.2
Debt service/exports of goods and nonfactor services 6/	3.2	3.1	1.0	2.0	1.3	1.4	1.4	...	4.0
Debt/GDP (in percent) 6/	3.6	10.8	18.3	9.7	27.7	31.7	16.3	14.6	6.0
Current account/GDP (in percent)	8.9 7/	2.3	-5.3	-1.7	-8.8	-9.6	-9.2	-20.0	4.3

Sources: Estonian authorities; staff estimates.

1/ Includes technical assistance.

2/ Assets and liabilities vis-a-vis the FSU held in nonconvertible currencies and not included as international reserves of the Bank of Estonia.

3/ Restituted gold which had been held by central banks abroad on behalf of Estonia. These assets were included in international reserves at the time the restitution took place.

4/ In convertible currency, including currency board cover (- increase).

5/ End of period. Includes restituted gold, short-term claims in convertible currencies, and SDR holdings.

6/ Includes IMF.

7/ Import data are known to have substantially under-recorded transactions with the FSU, particularly oil and metal imports from Russia which are believed to have dominated the errors and omissions item. Hence, if errors and omissions are attributed to imports of goods and services, the current account balance would amount to 4.8 percent of GDP.

Table 5. Estonia: Balance of Payments 1992-2000
(In millions of U.S. Dollars)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
	Estimated				Projected				
Current account	94.3	-29.5	-183.2	-145.0	-119.9	-109.9	-108.3	-105.8	-98.4
Trade balance	-51.2	-179.6	-320.6	-276.8	-249.8	-246.3	-253.3	-260.5	-264.8
FSU	-39.4	-120.0	-165.9	-155.1	-138.9	-129.0	-121.7	-113.0	-102.8
Other countries	-11.8	-59.7	-154.7	-121.7	-110.8	-117.3	-131.6	-147.5	-162.0
Exports	457.2	724.3	846.2	954.3	1072.7	1166.6	1256.8	1353.8	1458.5
FSU	215.3	258.2	307.2	351.6	398.6	433.4	467.0	503.0	541.9
Other countries	241.9	466.1	539.0	602.8	674.1	733.1	789.8	850.8	916.6
Imports	-508.4	-903.9	-1166.9	-1231.2	-1322.4	-1412.9	-1510.1	-1614.4	-1723.3
FSU	-254.7	-378.2	-473.1	-506.7	-537.5	-562.5	-588.7	-616.0	-644.7
Other countries	-253.7	-525.7	-693.8	-724.5	-784.9	-850.4	-921.4	-998.3	-1078.6
Nonfactor services	52.8	112.0	118.0	131.3	148.2	159.7	172.0	185.3	199.6
Transport	59.8	95.1	96.8	107.7	121.5	130.9	141.0	151.9	163.7
Tourism	14.6	23.7	24.8	27.6	31.1	33.5	36.1	38.9	41.9
Other services 1/	-21.6	-6.8	-3.5	-3.9	-4.4	-4.8	-5.1	-5.5	-6.0
Factor services	-2.0	-1.1	-4.6	-11.5	-18.3	-23.2	-26.9	-30.6	-33.3
Interest	0.9	10.5	1.4	-5.1	-11.6	-16.1	-19.5	-22.7	-25.0
Other	-2.9	-11.6	-6.0	-6.3	-6.7	-7.1	-7.5	-7.9	-8.3
Transfers	94.7	39.3	24.0	12.0	--	--	--	--	--
Official 1/	95.0	39.4	24.0	12.0	--	--	--	--	--
Private	-0.3	-0.1	--	--	--	--	--	--	--
Current account (excluding official transfers)	-0.4	-68.8	-207.2	-157.0	-119.9	-109.9	-108.3	-105.8	-98.4
Capital account	108.6	143.3	222.0	153.2	164.7	148.6	149.6	150.2	109.1
Foreign direct investment	57.9	86.4	89.3	91.6	94.0	96.4	99.0	101.5	104.2
Other long term	12.9	108.3	147.7	76.6	70.7	52.2	50.7	48.7	4.9
Public	13.1	93.1	134.4	58.2	47.4	22.2	15.7	8.7	-40.1
Private	-0.2	15.2	13.3	18.3	23.3	30.0	35.0	40.0	45.0
Short term	-34.2	-35.7	-15.0	-15.0	--	--	--	--	--
Public	13.4	-15.3	--	--	--	--	--	--	--
Commercial banks	-36.6	-7.1	--	--	--	--	--	--	--
Other private	-11.0	-13.3	-15.0	-15.0	--	--	--	--	--
Bank of Estonia	115.6	-13.4	--	--	--	--	--	--	--
Correspondent accounts 2/	-24.7	-13.4	--	--	--	--	--	--	--
Claims on gold 3/	140.2	--	--	--	--	--	--	--	--
Errors and omissions	-43.6	-2.2	--	--	--	--	--	--	--
Overall balance	202.9	113.9	38.8	8.2	44.8	38.8	41.4	44.4	10.6
Net international reserves 4/	-202.9	-114.1	-38.9	-33.2	-44.8	-38.8	-41.4	-44.4	-10.6
Financing gap	--	--	--	25.0	--	--	--	--	--
Memorandum items:									
Exchange rate (kroons/US$)	11.7	13.1	13.2	13.2	13.2	13.2	13.2	13.2	13.2
Gross international reserves 5/	195.1	344.9	409.8	444.9	479.0	496.8	517.5	551.3	556.1
(in months of goods imports)	4.6	4.6	4.2	4.3	4.3	4.2	4.1	4.1	3.9
Use of Fund Credit (end of period)	11.3	58.9	84.9	86.8	76.1	55.1	34.5	23.8	17.9
Export volume (1990=100)	157.1	267.8	299.9	326.8	356.2	377.6	396.5	416.3	437.1
FSU	49.5	42.7	44.2	48.1	52.5	55.6	58.4	61.3	64.4
Other countries	252.9	468.2	527.4	574.9	626.6	664.2	697.4	732.2	768.8
Import volume (1990=100)	54.6	93.9	117.2	119.4	125.3	131.5	138.1	145.0	152.0
FSU	34.5	37.5	41.4	42.2	43.1	43.9	44.8	45.7	46.6
Other countries	74.8	150.5	193.4	196.8	207.8	219.5	231.8	244.7	257.7
Debt service/non-FSU exports 6/	8.6	4.3	2.9	5.2	5.8	7.8	8.1	7.2	10.2
Debt service/exports of goods and nonfactor services	3.2	2.0	1.4	2.5	2.8	3.7	3.8	3.4	4.8
Debt/GDP (in percent) 6/	3.6	9.7	16.3	18.6	18.5	17.2	15.8	14.6	12.1
Current account/GDP (in percent)	8.9 7/	-1.7	-9.2	-6.6	-5.0	-4.3	-3.9	-3.5	-3.1

Sources: Estonian authorities and staff estimates.

1/ Includes technical assistance.

2/ Assets and liabilities vis-a-vis the FSU held in nonconvertible currencies and not included as international reserves of the Bank of Estonia.

3/ Restituted gold which had been held by central banks abroad on behalf of Estonia. These assets were included in international reserves at the time the restitution took place.

4/ In convertible currency, including currency board cover (- increase).

5/ End of period. Includes restituted gold, short-term claims in convertible currencies, and SDR holdings.

6/ Includes IMF.

7/ Import data are known to have substantially under-recorded transactions with the FSU, particularly oil and metal imports from Russia which are believed to have dominated the errors and omissions item. Hence, if errors and omissions are attributed to imports of goods and services, the current account balance would amount to 4.8 percent of GDP.

Table 6. Estonia: Quantitative Performance Criteria 1/

		Amounts	
		(in millions of Estonian kroon)	
I. Limits on the financial deficit of the general government			
Period July 1, 1993 to:			
September 30, 1993 2/		80	
December 31, 1993		200	
March 31, 1994		330	
II. Limits on net lending by the general government 3/			
Period July 1, 1993 to:			
September 30, 1993 2/		370	
December 31, 1993		610	
March 31, 1994		910	
		(in millions of deutsche mark)	
III. Minimum levels for net international reserves of the Bank of Estonia, net of cover for the currency board			
Position at June 30, 1993		67	
Minimum levels for:			
September 30, 1993 2/		40	
December 31, 1993		45	
March 31, 1994		50	
		(in percent)	
IV. Minimum levels for total reserve deposits of banks with the Bank of Estonia, expressed as a percent of eligible commercial bank liabilities at the end of the preceding calendar month			
Minimum levels for:			
September 30, 1993 2/		9.0	
December, 31, 1993		9.0	
March 31, 1994		9.0	
V. The currency board is to be fully backed with foreign exchange at all times			
	(In millions of U.S. dollars)		
VI. Ceilings on external short-, medium-, and long-term government and Bank of Estonia debt 4/	Maturity of 1-5 years	Maturity of 1-12 years	Maturity of 0-1 years 5/
Period July 1, 1993 to:			
September 30, 1993 2/	40	80	--
December 31, 1993	40	80	--
March 31, 1994	70	150	--
VII. The Government will not accumulate external payments arrears during the period of the arrangement.			

Source: Figures agreed between the Estonian authorities and Fund staff.

1/ Definitions of the concepts to be measured are included in the Annexes to the Memorandum of Economic Policies.
2/ Indicative limit only.
3/ All net lending, except for a quarterly amount of EEK 20 million, cumulative from July 1, 1993, shall be financed from net foreign loans disbursed to general government.
4/ Includes debt guaranteed by the Government.
5/ Except for normal import financing.

Table 7. Estonia: Schedule of Purchases Under Stand-By Arrangement and Systemic Transformation Facility (STF)

Amount	Expected Availability Date	Conditions for Purchase
SDR 2.325 million	On or after October 27, 1993	Board approval of stand-by arrangement
SDR 11.625 million (STF)	On or after October 27, 1993	Board approval of stand-by arrangement and STF purchase
SDR 11.625 million (STF)	Around March 15, 1994	Completion of first program review
SDR 2.325 million	On or after May 15, 1994	Compliance with performance criteria as of March 31, 1994
SDR 2.325 million	On or after August 15, 1994	Compliance with performance criteria as of June 30, 1994
SDR 2.325 million	On or after November 15, 1994	Compliance with performance criteria as of September 30, 1994 and completion of second program review
SDR 2.325 million	On or after February 15, 1995	Compliance with performance criteria as of December 31, 1994 and completion of second program review

Source: International Monetary Fund.

Table 8. Estonia: Projected Payments to the Fund

(In millions of SDRs; as of September 15, 1993)

	1993	1994	1995	1996	1997	1998	1999	2000	Total
1. Obligations from existing drawings									
Principal repurchases	--	--	1.0	7.7	13.0	6.3	--	--	27.9
Charges and interest 1/	0.3	2.7	3.3	3.0	2.0	0.7	--	--	12.0
Total obligations	0.3	2.7	4.3	10.7	15.0	7.0	--	--	40.0
(in percent of quota)	0.6	5.8	9.2	23.0	32.3	15.1	--	--	86.0
2. Obligations from prospective drawings									
Principal repurchases	--	--	--	--	2.0	8.4	7.7	4.2	22.3
Charges and interests 1/	--	--	--	--	0.5	1.0	1.1	0.8	3.4
Total obligations	--	--	--	--	2.5	9.4	8.8	5.0	25.7
(in percent of quota)	--	--	--	--	5.4	20.2	18.9	10.8	55.3
3. Cumulative (outstanding and prospective)									
Principal repurchases	--	--	1.0	7.7	15.0	14.7	7.7	4.2	50.3
Charges and interest 1/	0.3	2.7	3.3	3.0	2.5	1.7	1.1	0.8	15.4
Total obligations	0.3	2.7	4.3	10.7	17.5	16.4	8.8	5.0	65.7
(in percent of quota)	0.6	5.8	9.2	23.0	37.6	35.3	18.9	10.8	141.3

Source: International Monetary Fund.

1/ Projections are based on current rates of charge, including burden-sharing charges where applicable.

Note: Details may not add to totals due to rounding.

Table 9. Estonia: Projection of IMF Position During Period of Proposed Stand-By Arrangement

	1993	1994			
	Oct.-Dec.	Jan-Mar.	Apr.-June	Jul.-Sep.	Oct.-Dec.
	(In thousands of SDRs)				
Total purchases	13,950.0	11,625.0	2,325.0	2,325.0	2,325.0
Tranche policies	2,325.0	--	2,325.0	2,325.0	2,325.0
Ordinary resources	2,325.0	--	2,325.0	2,325.0	2,325.0
Systemic Transformation Facility	11,625.0	11,625.0	--	--	--
Total Fund credit					
Outstanding (end of period)	41,850.0	53,475.0	55,800.0	58,125.0	60,450.0
Tranche policies	30,225.0	30,225.0	32,550.0	34,875.0	37,250.0
Systemic Transformation Facility	11,625.0	23,250.0	23,250.0	23,250.0	23.250.0
	(In percent of quota)				
Total Fund credit					
Outstanding (end of period)	90.0	115.0	120.0	125.0	130.0
Tranche policies	65.0	65.0	70.0	75.0	80.0
Systemic Transformation Facility	25.0	50.0	50.0	50.0	50.0

Source: International Monetary Fund.

1/ Estonia's quota is SDR 46.5 million.

Eligibility for Use of the Systemic Transformation Facility

Estonia's eligibility to draw under the Systemic Transformation Facility (STF) is to be established on the basis of a substantial and permanent increase in net import costs due to an increase in the price of energy imports from Russia to world market levels.

Following a weakening economic performance in the late 1980s reflecting the gradual breakdown of the Soviet centrally planned economy, economic conditions in Estonia deteriorated further in 1990-91 paralleling developments in the rest of the FSU. Throughout this period, however, Estonia benefited from low prices of energy and raw materials from the FSU, particularly Russia, which was virtually its only source for such imports. Trade and production patterns remained distorted due to the underpricing of these imports and the orientation of exports according to the imperatives of the central planning authorities.

In early 1992, the Estonian economy experienced a severe external shock as Russia implemented a substantial increase in domestic energy prices and, shortly thereafter, raised the price of oil and other raw material exports to Estonia to near world market levels. These developments generated a significant shock to Estonia's balance of payments position. Adjustment to this shock has entailed a substanital reduction in energy imports with overall energy import volumes falling by some 57 percent in 1992.

The impact of the increase in net import costs on Estonia's balance of payments has been evaluated on the basis of the pattern of import volumes in 1992. 1/ As Appendix Table 10 shows, when the energy balance is calculated using 1992 volumes for exports and imports, the increase in energy prices between 1991 and the first half of 1993 generated an increase in net energy import costs equivalent to some SDR 86 million (184 percent of quota). These additional costs far exceed the threshold required for Estonia to be eligible for use of the STF. In the judgment of the staff, the effects of these disruptions continue to give rise to balance of payments difficulties in an amount equivalent to at least 50 percent of quota.

1/ This is consistent with the approach presented in EBS/93/58, (4/9/93), "A Fund Facility to Help Members Respond to Systemic Disruptions in their Trade and Payments Arrangements: Supplementary Information", Supplement 1, pages 6-7. However, since imports fell sharply in 1992 in large part due to the limited availability of external financing, the use of 1992 volumes substantially understates the effective increase in net energy import costs.

Table 10. Estonia: Calculation of Increase in Net Energy Import Costs, 1991–June 1993

	1991	1992	1993 1st half
Energy Balance (in U.S.$ mill)	-17.3	-74.6	-26.8
Exports: electricity			
Value (U.S.$ mill)	5.8	37.9	14.3
Volume (mill. of kwh)	4600	3495.3	1250.0
Unit price (U.S.$/kwh) 1/	0.001	0.01	0.01
Imports: fuel & gas			
Value (U.S.$ mill)	23.1	112.5	41.1
Fuel oil	4.1	17.8	...
Gasoline	9.5	29.3	...
Diesel	6.8	29.2	...
Coal	1.1	4.7	...
Gas	1.7	31.4	20.9
Volume (th. of metric tons)			
Fuel oil	1172	414	...
Gasoline	414	150	...
Diesel	460	200	...
Coal	326	245	...
Gas (th. cubic meters)	1515	849	255.9
Unit price (U.S.$/metric ton) 1/			
Fuel oil	3.5	43.0	56.9
Gasoline	23.0	195.4	223.5
Diesel	14.8	146.4	162.3
Coal	3.3	19.2	30.0
Gas (U.S.$/cubic meter)	1.1	37.0	81.2
Fixed-volume energy balance 2/ (in U.S.$ mill)	-5.2	-74.6	-126.0
Net energy import costs 3/	...	-69.4	-120.8
(in SDRs)	...	-49.3	-85.5
(in percent of quota)	...	-106.0	-183.9

Sources: Estonian authorities and staff estimates.
1/ Prices in 1991 are based on the conversion of rubles at the secondary rate of Rub 31.75/US$.
2/ Import and export volumes of 1992 valued at current prices.
3/ Difference over the fixed-volume energy balance in 1991, in U.S. dollars.

Fiscal Performance Criteria

This appendix discusses the fiscal performance criteria for Estonia. These have been designed to be comprehensive, both in their definition of Government, and in their coverage of all creditors to government. In particular, these criteria now take explicit account of access by the Government to foreign loans. The new criteria nevertheless maintains the now well-established tradition in Estonia that the Government makes little or no use of domestic bank financing for its operations; i.e., that foreign loans are used to finance mainly investment related net lending rather than current budgetary operations.

Lending to government by foreign creditors will be substantially greater during the program period than it has been in the past. Accordingly, this has required a broadening of the base for assessing fiscal operations in relation to the first stand-by arrangement. Whereas the fiscal performance criterion under the first stand-by arrangement was based exclusively on net credit to government by the domestic banking system, under the proposed stand-by arrangement, the fiscal criterion has been expanded to encompass all creditors.

In particular, the new fiscal performance criteria also reflect the fact that, at least initially, the domestic intermediation of much of the external funds will be through government. This is necessary because commercial banks in Estonia are currently not prepared to absorb the substantial increase in lending operations that would be entailed by the scale of the envisaged inflows.

The performance criteria are constructed in the following manner:

(i) all extra-budgetary funds, notably the Social Fund and Medical Insurance Fund, are included in the definition of consolidated general government on which the performance criteria are defined;

(ii) the definition of net lending of consolidated general government includes lending by the IBRD, the EBRD and other external creditors directly extending credit to Estonian importers;

(iii) the first performance criterion on consolidated general government concerns the accumulated financial deficit, i.e., the overall fiscal deficit excluding net lending;

(iv) The second performance criterion relates to cumulative net lending from July 1, 1993.

Both performance criteria have been set for end-December 1993, and for end-March 1994. The figures for end-September 1993 are indicative only. Criteria for the remainder of 1994 will be set on the occasion of the first and second performance reviews of the program.

The motive for specifying two criteria, on the financial deficit and on net lending is based on the dual roles of government under the program; first, as the provider of the normal services of government, and second, as a financial intermediator (but not the primary final beneficiary of foreign funds). The specification of two performance criteria reflects and ensures the separation of these two roles. Specifically, it prevents a stronger-than-anticipated performance on net lending from accommodating a poorer-than-anticipated performance on the other activities of government.

Measurement issues

The performance criterion on the financial balance will be measured from below the line to the greatest extent possible because these data are usually available more rapidly than data from above the line. Thus, it will be measured as the sum of net credit from all domestic and foreign creditors, less net lending.

The measurement of accumulated borrowing in foreign currency after July 1, 1993 will exclude valuation changes, since these would distort the measurement of the financial deficit. Thus, each tranche of foreign borrowing will be valued in local currency at the exchange rate applicable to it on the day it was disbursed.

Data on net credit to government from the domestic banking system will be obtained from the monetary survey, while data on all other creditors and on net lending will be obtained from the Ministry of Finance.

Estonia -- Fund Relations

(as of September 15, 1993)

I. Membership Status

(a) Date of membership	May 26, 1992
(b) Status	Article XIV

II. General Department (General Resources Account)

	(In millions of SDRs)	(In percent of quota)
(a) Quota	46.50	100.0
(b) Total Fund holdings of currency	74.40	160.0
(c) Fund credit	--	--
Credit tranche	27.90	60.0
CCFF	--	--
(d) Reserve tranche position	--	--
(e) Operational budget transfers (net)	--	--

III. SDR Department

		(In percent of allocation)
(a) Net cumulative allocation	--	...
(b) Holdings	27.75	...
(c) Designated plan amount	--	--

IV. Outstanding Purchases and Loans:

		(In percent of quota)
Stand-by arrangement	12.79	27.5

V. Financial Arrangements:

Type	Approval date	Expiration date	Amount approved (SDR millions)	Amount drawn
Stand-by	Sept.16, 1992	Sept.15, 1993	27.90	12.79

VI. Projected Obligations to Fund:
(SDR millions, based on existing use and present holdings of SDRs):

	Overdue 8/31/93	1993	1994	1995	1996	1997	1998	Total
Principal	--	--	--	1.0	7.7	13.0	6.3	27.9
Charges/Interest	--	0.3	2.7	3.3	3.0	2.0	0.7	12.0
Total obligations	--	0.3	2.7	4.3	10.7	15.0	7.0	40.0

VII. Exchange Rate Arrangement

The currency of Estonia is the kroon. The kroon replaced the ruble on June 20, 1992. Since that day, the Bank of Estonia (the Bank) has offered a fixed rate of exchange of EEK 8 per deutsche mark for kroon bank notes, coins, and reserve deposits of commercial banks. This conversion is guaranteed for all current international transactions. A 100 percent repatriation and conversion requirement for export receipts is in effect, except for enterprises granted a special license by the Bank of Estonia. Capital account transactions require the authorization of the Bank. The Bank deals only in deutsche mark, except in circumstances where banks are exceeding regulatory limits for their open position in foreign exchange, when the Bank stands ready to deal in other convertible currencies. In the latter case, rates of exchange for convertible currencies are derived from cross rates communicated daily to the Bank by the Deutsche Bundesbank. Authorized commercial banks may buy and sell convertible foreign exchange, plus the Russian ruble, at rates of their own choosing, with the proviso that the spread, including commission, should not exceed 7 percent. The ruble is traded weekly against the U.S. dollar, deutsche mark and kroon at the Tallinn Stock Exchange and the rate is not subject to any limits. Cash rubles may be converted at selected exchange locations in Estonia, and the rate is not subject to any limits.

VIII. Article IV Consultations

The 1993 Article IV consultation discussions were concluded at the Executive Board on April 2, 1993. The Premembership Review (SM/92/48, dated March 6, 1992) was considered by the Executive Board on March 31, 1992.

IX. Technical Assistance

The attached table provides information on the Fund's technical assistance activities in Estonia.

X. Resident Representative

The first resident representative of the Fund in Estonia, Mr. Jukka Paljarvi, took up his post in Tallinn in April 1992.

Estonia: Technical Assistance, 1992-93 1/

Department	Subject/Identified Need	Action	Timing	Counterpart 2/
		1992		
STA	Consumer price index and monetary statistics	Mission	June	BOE/SOE
MAE	Foreign exchange operations and banking supervision	Visit	June	BOE
MAE	Foreign exchange accounting	Visit	July	BOE
STA	Balance of payments statistics	Visit	July	BOE
STA	Consumer price index	Visit	August	SOE
INS	Course on financial programming	Visit	September	BOE/MOF
STA	Balance of payments statistics	Visit	November	BOE
MAE	Foreign operations, payments, accounting & banking supervision	Mission	October	BOE
STA	Balance of payments statistics	Visit	October	BOE
STA	Government finance	Mission	December	MOF
		1993		
MAE	Banking supervision and central bank accounting	Mission	January	BOE
STA	Monetary statistics	Visit	February	BOE
STA	Balance of payments statistics	Visit	March	BOE
LEG	Tax legislation	Visit	April	MOF
STA	Monetary statistics	Visit	April	BOE
LEG	Tax legislation	Visit	May	MOF
FAD	Tax administration	Mission	May	MOF
MAE	Banking supervision and central bank accounting	Visit	July	BOE
STA	Monetary statistics	Visit	August/September	BOE
MAE	Central bank accounting	Two month assignment	September/October	BOE

Source: International Monetary Fund.

1/ June 1, 1992 through May 31, 1993.
2/ BOE: Bank of Estonia; MOF: Ministry of Finance; SOE: Statistical Office of Estonia.

Relations with the World Bank

Estonia became a member of the World Bank on June 23, 1992. The first World Bank economic mission visited Tallinn in January 1992. It presented its initial assessment to the Estonian authorities in the form of aide mémoires, highlighting key issues and making preliminary recommendations. The Country Economic Memorandum (CEM) was published in March 1993 ("Estonia--The Transition to a Market Economy").

World Bank missions visited Estonia in April and June 1992 to prepare and appraise the first lending operation: a Rehabilitation Loan. The primary objectives of this loan are: (a) to assist the Government in the design and implementation of its economic reform program; and (b) to limit the decline in economic activity through support for the importation of essential goods for high priority sectors of the economy. The loan--amounting to US$30 million--was presented to the Board of Directors on Ocotober 1, signed on October 2 and became effective on October 6, 1992. By August 31, 1993, a total of US$17 million had been disbursed. This loan is expected to be completely disbursed by March 31, 1994.

Further Bank missions focusing on structural reform and sectoral issues have visited Estonia. A Bank mission visited Estonia in October 1992 to prepare a detailed assessment of enterprise and financial sector reform issues and intitiate the preparation of a possible lending operation focusing on enterprise reform, private sector development, and bank restructuring. A mission in September 1993 is attempting to accelerate the preparation of this lending operation. Bank missions have also visited Estonia to prepare a possible energy operation which would focus on investments promoting energy conservation and efficiency, particularly for district heating systems; this is likely to be the Bank's next operation in Estonia. In addition, there have been Bank missions focusing on the social safety net and health sector (August/September 1993) and a sector and project identification mission in agriculture (for late September 1993). A public expenditure review mission is scheduled for the latter part of October 1993.

Estonia: Stand-By Arrangement

Attached hereto is a letter, with annexed memorandum, dated October 6, 1993 from the Prime Minister of Estonia and the Governor of the Bank of Estonia requesting a stand-by arrangement and setting forth:

a. the objectives and policies that the authorities of Estonia intend to pursue for the period of this stand-by arrangement; and

b. understandings of Estonia with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Estonia will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from October __, 1993 to March __, 1995, Estonia will have the right to make purchases from the Fund in an amount equivalent to SDR 11.625 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. a. Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2.325 million until May 15, 1994, the equivalent of SDR 4.65 million until August 15, 1994, the equivalent of SDR 6.975 million until November 15, 1994, and the equivalent of SDR 9.30 million until February 15, 1995.

b. None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Estonia's currency subject to repurchase beyond 25 percent of quota.

3. Estonia will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Estonia's currency subject to repurchase beyond 25 percent of quota:

a. during any period in which the data at the end of the preceding period indicate that

(i) the limit on the General Government Financial Deficit described in paragraph 20 and in Annex I of the memorandum, or

(ii) the limit on Net Lending by the General Government described in paragraph 20 and in Annex I of the memorandum, or

(iii) the floor on the Net International Reserves described in paragraph 23 and in Annex II of the memorandum, or

(iv) the floor on Reserves of the Banking System as described in paragraph 25 and in Annex III of the memorandum, or

(v) the limit on the contracting or guaranteeing by the Government or the Bank of Estonia of external debt of maturities between 1 and 12 years described in paragraph 50 and in Annex IV of the memorandum, or

(vi) the limit on the contracting or guaranteeing by the Government or the Bank of Estonia of external debt of maturities between 1 and 5 years described in paragraph 50 and in Annex IV of the memorandum, or

(vii) the limit on the contracting or guaranteeing by the Government or the Bank of Estonia of external debt of maturities of less than one year described in paragraph 50 and in Annex IV of the memorandum, or

is not observed; or

(b) if at any time during the period of the stand-by arrangement

(i) the maintenance of full foreign currency backing for the currency board's liabilities at the end of each monthly reporting period, as described in paragraph 25 of the memorandum, is not observed; or

(ii) the limit on the accumulation by the Government of external arrears described in paragraph 50 and in Annex IV of the memorandum,

c. after March 15, 1994 and September 15, 1994, until the respective reviews contemplated in paragraph 51 of the memorandum are completed; or

d. if at any time during the period of the stand-by arrangement Estonia

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions; or

(ii) introduces or modifies multiple currency practices; or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Estonia is prevented from purchasing under this stand-by arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Estonia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Estonia will not make purchases under this stand-by arrangement during any period in which Estonia has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation (a) in respect of a noncomplying purchase pursuant to Decision No. 7842-(84/165) on the Guidelines on Corrective Action, or (b) in respect of a purchase in support of debt and debt service reduction operations pursuant to Decision No. 9331-(89/167), as amended, or (c) pursuant to subparagraph 16(a) or 33(a) of Decision No. 8955-(88/126), as amended, on the Compensatory and Contingency Financing Facility.

5. Estonia's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Estonia. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Estonia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, unless, at the request of Estonia, the Fund agrees to provide SDRs at the time of the purchase.

7. Estonia shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

8. (a) Estonia shall repurchase the amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Estonia's balance of payments and reserve position improves.

(b) Any reductions in Estonia's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

9. During the period of the stand-by arrangement Estonia shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Estonia or of representatives of Estonia to the Fund. Estonia shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Estonia in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

10. In accordance with paragraph 4 of the attached letter, Estonia will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 3 above have not been observed or because the Managing Director considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Estonia has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Estonia's balance of payments policies.

October 6, 1993

Dear Mr. Camdessus,

Considerable progress has been made in the process of transforming Estonia into a fully fledged market economy. The stand-by arrangement approved by the Fund in September 1992 played an important role in this process by helping create a coherent framework for the implementation of both macroeconomic and structural policies, as well as by providing financial support by augmenting Estonia's international reserves.

However, we believe that substantial work remains, especially in reducing the rate of inflation to Western European levels as soon as possible and accelerating the pace of structural reforms. Continued Fund support for the stabilization and reform program of the Estonian authorities would again help to ensure a consistent package of policies and in addition make an important contribution to sustaining domestic and international confidence in Estonia's economic prospects. We believe that the policies set out in the attached Memorandum of Economic Policies will help us consolidate the gains already made over the past year, maintain confidence in the kroon, and lay the groundwork for sustainable growth in output and incomes.

In support of these policies, the Government hereby requests a seventeen month stand-by arrangement in an amount equivalent to SDR 11.625 million (25 percent of quota) from the International Monetary Fund. In addition, we intend to request two purchases in the aggregate amount of SDR 23.25 million (50 percent of quota) under the Systemic Transformation Facility (STF). It is intended that the first purchase under the STF would be for SDR 11.625 million and would be made on the date on which the Fund approves the stand-by arrangement. The second purchase, also for SDR 11.625 million, would be made upon the completion of the first review under the arrangement.

The Government and the Bank of Estonia will provide the Fund with such information as it may request for the purpose of monitoring progress under the program supported by the stand-by arrangement, and will remain in close consultation with the Fund, in accordance with the Fund's policies on such consultations. Furthermore, we stand ready to take any additional measures that may become necessary to achieve the aims of the program. Moreover, we will complete with the Fund two reviews of economic developments and policies under the program, the first by March 15, 1994 and the second by

September 15, 1994. The quantitative performance criteria for end-June and end-September 1994 would be specified at the time of the first review, and for end-December 1994 at the time of the second review.

Sincerely yours

/s/
Mart Laar
Prime Minister

/s/
Siim Kallas
Governor of the Bank of Estonia

Attachment

Estonia - Memorandum of Economic Policies

I. Introduction

1. The period since Estonia regained its independence in August 1991 has been a difficult one. However, the Government and people of Estonia have made great gains, in both the political and economic spheres. On the political front, a new constitution was adopted in 1992 and elections under that constitution made possible the return of democracy. On the economic front, the introduction of the kroon in June 1992 and the implementation of the stabilization and reform program supported by the International Monetary Fund made possible substantial gains in reducing the monthly rate of inflation to low single digits, increasing trade with industrialized countries, developing the private sector, starting the process of reforming the structure of the economy, and, as signs increasingly suggest, turning around the decline of output and incomes.

2. The decisive implementation of the stabilization and reform program made possible a quick response to the terms-of-trade shock associated with the increase to world market levels of energy prices in early 1992, provided a stable macroeconomic policy framework to smooth the transition from a command economy to a market economy, and helped integrate Estonia into the world trading community. The main elements of this program were the maintenance of tight fiscal and monetary policies, the virtual completion of the price liberalization process, the successful implementation of the incomes policy, the liberalization of trade and payments arrangements, and an acceleration in the pace of structural reforms, all of which contributed importantly to the substantial progress made by Estonia in this transition process. The Fund completed all the required reviews under the stand-by arrangement supporting the program and Estonia met all performance criteria at each test date, except for the criterion relating to external arrears on the occasion of the mid-term review (these arrears were cleared shortly thereafter).

3. We believe it is crucial to continue to implement a strong and consistent stabilization and reform program so as to consolidate the gains already made and to lay the groundwork for sustained growth in the period ahead. We regard support by the Fund in this endeavor vital to enhance domestic and international credibility for our program. Accordingly, we have asked that the Fund support this program financially in the form of a stand-by arrangement covering the program period July 1, 1993 - December 31, 1994; moreover, we intend to request Fund support under the Systemic Transformation Facility. The Estonian authorities expect that the continuation of its bold commitment to a market economy will continue to elicit timely and material support from the international financial community.

II. Background and Recent Developments

4. Real output in Estonia is estimated to have declined by 23 percent in 1992. However, by the end of that year, Estonia appeared to have made substantial progress in adapting to the terms-of-trade shock experienced in early 1992 and trade with industrialized countries largely supplanted trade with the FSU. As a result, the decline in output began to flatten out and the first signs of a recovery appeared during the first half of 1993. Meanwhile, by mid-1993 the level of official unemployment had stabilized in the range of 2-3 percent.

5. By the end of 1992 the price liberalization process had been essentially completed, which was largely responsible for the increase in consumer prices of 322 percent in the program year ending June 30, 1993. Nevertheless, the maintenance of tight monetary and fiscal policies supported by the incomes policy led to a decline in the monthly inflation rate to 1 1/2 percent during the second quarter of 1993. The recent monthly rate of inflation was still somewhat higher, however, than the original program target--of less than 1 percent by the end of the program period--reflecting in part a larger than expected correction to the undervaluation of the kroon at the time of its introduction. Average wages in the public sector increased in line with the guidelines provided for under the incomes policy, reflecting in part the budgetary stringency in the general government and poor profitability in state enterprises.

6. Reflecting the Government's continued commitment to prudent fiscal policy, general government budgetary operations registered surpluses in both 1992 and the first half of 1993 equivalent to 1 1/2 percent of GDP. During the program period these surpluses were achieved mainly through ambitious tax measures (first half) and expenditure restraint (second half). Also, a decline in tax arrears helped boost revenues in 1993. The pension system was substantially reformed in April 1993 and the associated financing was secured in the first supplementary budget that was approved in June 1993. The Government also established in August 1993 a program to support families and individuals below the poverty line. Under this program, starting January 1, 1994 the scale of social benefits--with the exception of child benefits--will be linked directly to the poverty line (rather than maintaining the link to the minimum wage). The additional cost of this program will be financed by cuts in other social expenditures.

7. The Bank of Estonia maintained the integrity of the currency board by ensuring that currency issue plus commercial bank deposits with the Bank of Estonia remained fully backed by international reserves. Confidence in the kroon has been strong and was not materially affected by the banking crisis which emerged in November 1992. The crisis was resolved in January-February 1993 as substantial financial support was provided by both the Government and the Bank of Estonia in a restructuring operation. As a result, confidence in the banking system was largely restored, although the substantial liquidity that is held by commercial banks and the high spreads

between lending and deposit rates suggest that frictions still inhibit the smooth functioning of the financial system. However, evidence is emerging that once the Real Estate Law is fully implemented this fall--permitting the use of land and fixed assets for collateralized borrowing--the potential exists for a substantial expansion in bank lending. Progress has also been made in modernizing banking legislation with the recent passage of the Central Bank Law which provides the Bank of Estonia with a substantial degree of independence.

8. Estonia's trade performance has exceeded expectations, largely due to growth of trade with industrialized countries which began to pick up substantially in the second half of 1992. As a result, the current account (excluding official transfers) is estimated to have been broadly balanced in the program year, as compared with a projected deficit of US$213 million. The recent strong growth of exports suggests that Estonia has remained competitive in industrialized markets, despite the appreciation in its real exchange rate. Gross international reserves increased by US$224 million during the program year, reaching US$275 million at end-June 1993 (of which US$82 million represented the restitution of pre-war gold during the program period).

9. External assistance under the G-24 process began to be disbursed to Estonia on April 1, 1993, when the first tranche of the EC Commission loan--amounting to US$24 million--was received, followed shortly by a disbursement of US$10.5 million from Sweden. Of these amounts, about US$15 million was used to clear external arrears. Most of the balance is to be used to finance energy conservation projects, lending to the private sector through the Estonian Investment Bank (EIB) and commercial banks, lending to selected enterprises financing public investment projects, and the payment of membership dues to international organizations.

10. Estonia has engaged in the progressive removal over the program year of licensing schemes, quotas, and tariffs, with the result that virtually all trade controls have now been eliminated (see list of remaining controls in paragraph 36 below). Notwithstanding this trend, Estonia imposed in August 1993 an ad valorem tariff of 70 percent on grain and flour imported from Russia to offset subsidies paid to Russian producers. Estonia has also lifted, step by step, its restrictions on payments for current and capital account transactions. The Bank of Estonia maintains broad convertibility of the kroon for payments and transfers for current international transactions. A 100 percent repatriation and conversion requirement applies to all foreign currency receipts, except for enterprises that are permitted to have domestic foreign currency accounts.

11. The Government is committed to carrying out as quickly as possible the structural reforms necessary to complete the transformation of Estonia into a fully fledged market economy. However, privatization has been slowed by issues related to restitution and by disputes over mechanisms for the sale

of large enterprises, land, and housing. Meanwhile, the restitution process has been delayed by the sheer volume of claims, conflicts between claimants, and the limited capacity of local authorities to administer the process.

12. During the past year, the Estonian Government passed a substantial body of legislation to create a legal framework in support of a market environment. Of particular importance was the Bankruptcy Law, which took effect on September 1, 1992, and was an important milestone in introducing financial discipline to both enterprises and the banking system and has been largely responsible for the decline in tax arrears. Parliament also recently passed a new Privatization Act to unify and accelerate the privatization process, a Privatization of Housing Law to sell housing to residents, a Real Estate Law allowing real estate transactions and the use of fixed property for collateral in borrowing (related implementing legislation was introduced to Parliament in August 1993), and a Competition Law to promote competition in the market place.

III. The Government's Program for July 1, 1993 - December 31, 1994

Introduction and program framework

13. The Government's main objectives for the program period ending December 31, 1994 will be to bring the rate of inflation down close to western European levels within a macroeconomic framework that permits the early return of sustained growth and a turnaround in employment trends. It is recognized that inflation must be contained so as to protect the competitiveness of Estonia's external sector, thereby maintaining confidence in the kroon and ensuring the achievement of a sustainable balance of payments position over the medium term. The Government also intends to accelerate the pace of structural and legal reforms to allow the private sector to contribute to the recovery in growth to the greatest extent possible and to further reduce the role of the state in the economy. The successful implementation of this program is projected to allow real GDP to grow by about 6 percent in 1994 after a decline in 1993 expected to be in the order of 6 percent. Investment, which has declined sharply since 1991, is projected to recover substantially during 1993/94. Overall, growth is expected to be led mainly by exports and the revival in investment spending. Meanwhile, household savings are expected to remain low, reflecting a pent-up demand for consumer goods, while enterprise profits are expected to recover only slowly, implying that a significant part of total investment will need to be financed externally. The inflation rate is targeted to fall to an annualized rate in single digits by mid-1994 and to decline further thereafter. This would be achieved by continuing tight financial policies and reducing rigidities in wage and price formation. The external current account deficit (including transfers) in 1994 is projected to amount to about US$215 million (10 1/2 percent of GDP), but is considered financable and consistent with the economy's longer term debt-servicing capacity. The

main uncertainties associated with this program relate to the ability of Estonia to sustain the export and investment growth required to generate the targeted increase in real GDP and at the same time maintain a manageable external position. This will depend crucially on whether import restrictions in Estonia's export markets will materially hamper trade and on whether external assistance materializes in a timely fashion.

14. The main elements of our stabilization and reform program for the period July 1, 1993 to December 31, 1994 are as follows:

(i) maintaining tight fiscal policies aimed at limiting the general government's financial deficit and net lending;

(ii) adhering firmly to the principles associated with the currency board;

(iii) further liberalization of the exchange and trade system;

(iv) improving the flexibility of price and wage formation;

(v) a comprehensive package of structural measures covering further privatization, financial sector reform, fiscal reform, promoting financial discipline of enterprises and banks and promoting competition in the market place, and improving the operation of the social safety net.

Fiscal policy

15. The pursuit of a prudent and tight fiscal policy is the cornerstone of the Government's stabilization effort. Accordingly, the Government is implementing an overall budget for 1993--including two supplementary budgets--that is broadly balanced.

16. Taking account of the urgent need for public investment in infrastructure, which includes repairs and rebuilding of existing facilities as well as new construction, the Government intends to formulate by December 31, 1993, in collaboration with the World Bank, a Public Investment Program (PIP)--which would also include that part of net lending budgeted by the Government for infrastructure investment for 1994. The intention is that the PIP would be financed mainly by externally borrowed resources together with any domestically generated budgetary resources.

17. The Government will establish by October 1, 1993 an External Financing Board (EFB) that will serve as the principal mechanism for securing, monitoring, and channeling external loans received under the G-24 process; securing and monitoring all other foreign loans; and monitoring foreign grants. The EFB will also manage and monitor the servicing of foreign loans to the Government (payment of interest and repayment of principal) and all foreign deposits held by the Government. The EFB will also perform an advisory function to the Minister of Finance, providing assessments, as necessary, of whether specific loans proposed by the Government are prudent.

The EFB will seek to set the interest rate on Government loans so that the margin in excess of its own borrowing costs reflects the risks associated with each loan. The EFB will deposit the proceeds from these margins into a separate account that would be used in the event that Government loans are not repaid. The EFB will be formed within the Ministry of Finance and will include representatives from the Bank of Estonia and the IMF.

18. It is the Government's intention to aim at a balanced budget but in any event to limit the overall general government's financial deficit to 1.6 percent in the second half of 1993 and to 1 percent of GDP in 1994. Net lending would be limited to 5 percent of GDP during the second half of 1993 and to 3-4 percent of GDP in 1994, and would be financed largely through foreign borrowing. In the context of the 1994 budget, the Government's intention is to refrain from providing subsidies or subsidized loans to enterprises. The Government and the Bank of Estonia will also refrain from directing commercial banks to lend or to provide loan guarantees to specific enterprises.

19. The Government is determined to undertake further measures to ensure budgetary and tax efficiency during the coming program period. To that end the Government will by October 31, 1993: (i) complete redrafting the tax code (including the income tax law); (ii) make concrete proposals on how best to address the expected increase in work pressures in the tax administration department following the changes in the tax code and the introduction of the land tax and to meet retraining requirements following the computerization of the department expected early in 1994; and (iii) refrain from forming any new extrabudgetary funds and constrain budgetary transfers to existing funds. The Government will also (i) start with the modernization of the tax and customs administration by December 31, 1993 along the lines recommended by the recent Fund technical assistance mission; (ii) reform by December 31, 1993 the system of sharing of revenues and expenditures between the state and local governments; (iii) propose to Parliament by October 31, 1993 an amendment to the Law on the Distribution of Resources from the Sale of State and Municipally Owned Property which would reallocate the share of privatization proceeds now being transferred to the Bank of Estonia to the State Reserve Fund for Ownership Reform of Enterprises; (iv) complete a study by January 31, 1994 of compliance by the private sector with the tax code and make recommendations for early improvements in such compliance, and (v) formulate a medium-term framework for budget planning by June 30, 1994 which would establish the desired size and scope of government activity and provide for target tax ratios. The Government intends to request technical assistance from the Fund and other agencies as required to meet these deadlines.

20. The general government's financial balance which was in surplus by EEK 150 million during the first half of 1993, shall not be in deficit by more than EEK 80 million during the period from July 1, 1993 to September 30, 1993, nor more than EEK 200 million during the period July 1, 1993 to December 31, 1993, nor more than EEK 330 million during the period July 1, 1993 to March 31, 1994. Net lending by the Government, as

defined in Appendix I, and which was EEK 389 million during the first half of 1993, shall not be more than EEK 370 million during the period from July 1, 1993 to September 30, 1993, nor more than EEK 610 million during the period July 1, 1993 to December 31, 1993, nor more than EEK 910 million during the period July 1, 1993 to March 31, 1994. Both the limits for the financial deficit and net lending--as defined in Annex I are performance criteria. The Government will also, by June 30, 1994, confine all its deposits to eligible commercial banks. Eligible commercial banks would include only those banks that have been independently audited and are, and remain, in full compliance with all prudential and regulatory standards.

Social safety net

21. The transition to a market economy will continue to place a heavy burden on the social security system. The pension reform introduced on April 1, 1993, together with the heating subsidy program introduced in October 1992, improved the living conditions for an important part of the economically vulnerable population. The Government intends to continue to strengthen and rationalize the social safety net, with technical assistance from the World Bank, to ensure that aid is effectively channeled to the most vulnerable groups of the population, while taking into account budgetary constraints. In particular, it will introduce legislation to Parliament by November 30, 1993 that would relate the payment of child benefits to family incomes. During the course of 1994 the Government will also give consideration to accelerating the raising of the retirement age from the increase of six months scheduled to take place annually from January 1, 1994. In implementing these measures, the Government will ensure that their financing is consistent with the overall budgetary objectives set out in paragraph 18 above.

Monetary policy and financial sector reforms

22. The introduction of the kroon in the context of a currency board has provided Estonia with a stable monetary environment that has made possible the reduction in the inflation rate over the past year and has established the kroon as a recognized "hard currency". Accordingly, the Government and the Bank of Estonia will continue their commitment to maintaining the integrity of the currency board by ensuring that the currency issue plus commercial bank deposits with the Bank of Estonia be 100 percent backed by liquid international reserves. The Bank of Estonia will not have the capability to extend credit to the Government. Commercial banks facing transitory liquidity shortages will be able to address these through the use of their reserve deposits with the Bank of Estonia, subject to increasingly severe penalties in circumstances where the amounts required are large or are outstanding for excessive periods.

23. Lending by the Bank of Estonia will be limited to amounts consistent with meeting the Government's targets for net international reserves (as defined in Appendix II)--i.e., DM 40 million at September 30, 1993, DM 45 million at December 31, 1993 and DM 50 million at March 31, 1994.

Such lending, which it is recognized will include purchases by the Bank of Estonia of certificates of deposit issued by commercial banks, will be undertaken only in connection with well-considered emergency lending operations to commercial banks, and will not exceed a cumulative total of EEK 100 million to any individual bank without prior consultation with Fund staff. The scope for such lending by the Bank of Estonia would be re-examined at the program reviews. The total issue of certificates of deposit by the Bank of Estonia will be limited to EEK 200 million throughout the program period. The Bank of Estonia will also refrain from extending any loan guarantees beyond any obligations already assumed prior to the currency reform.

24. Although some declines in interest rates have been experienced lately, commercial bank lending rates remain high. Furthermore, the spread between deposit and loan rates at commercial banks remains very large, especially if account is taken of the prominence of current accounts in the liabilities of commercial banks. While the authorities will continue their policy of allowing commercial banks to set freely interest rates on both deposits and loans, the Bank of Estonia recognizes the need to keep under review institutional and legal factors that may be responsible for keeping interest rates and spreads at artificially high levels and will take remedial action as required.

25. To ensure uniform treatment of all commercial bank liabilities, especially as regards prudential standards, effective January 1, 1994 the Bank of Estonia will redefine liabilities against which reserves must be held to include all deposits at commercial banks, including foreign currency deposits (reserves held against foreign currency deposits will also be held in kroons). As a performance criterion, the Bank of Estonia will ensure maintenance of (i) full foreign currency backing for the currency board's liabilities and (ii) reserve requirements by commercial banks and the Savings Bank consistent with the details as set out in Annex III.

26. The Bank of Estonia recognizes that over the medium term, in keeping with international practice and as provided for in the Central Bank Law, a portion of its profits would normally be turned over to the Government to help meet budgetary requirements. In the immediate future the Bank is committed to building its capital base so as to strengthen its financial position, but it agrees that by January 31, 1994, it will, together with the Government, establish targets for the Bank's base capital and reserve capital to allow a determination to be made of the appropriate amount of Bank profits to be transferred to the state budget. However, and as an exceptional matter, the Bank of Estonia agrees to transfer to the Government by February 28 of each year a total of EEK 30 million which will be assigned to the payment of the coupons of the Government bond issue used in the bank rescue operation earlier this year (until such time as the bond issue is fully repaid). This transfer will ensure the timely payment of interest on this debt, thereby contributing to maintaining confidence in the banking system as well as in the government paper. Meanwhile, it is agreed that the minimum amount of profits to be transferred in any year to the state budget

should be 35 percent of the Bank's gross profits (with the exceptional annual transfers of EEK 30 million to be counted against the Bank's annual profit transfer obligations).

27. The Estonian financial sector weathered a major bank crisis late in 1992 and confidence in the banking system has been largely restored and the payments mechanism is functioning satisfactorily. To minimize the likelihood of further bank moratoriums and/or bank failures, it is recognized that the highest priority must be given to measures that contribute to strengthening the banking system. To that end the authorities will ensure that by November 30, 1993 (i) supervisory regulations on asset classification standards, provisioning for problem loans, capital adequacy requirements, and asset concentration guidelines are approved and published and (ii) commercial bank reporting forms are amended to include information required for comprehensive on-site monitoring. The authorities will also submit to Parliament by November 30, 1993 the Credit Institutions Act, which, inter alia, will include effective sanctions to ensure that these bank regulatory standards are adhered to throughout the banking system and that these standards are published and enforced. A program of on-site monitoring will also be established by November 30, 1993 and by February 28, 1994 the five largest banks (ranked by total liabilities) will have been made subject to such monitoring. By April 30, 1994, the Bank of Estonia will (i) implement the standardization of the accounting framework of commercial banks and (ii) adopt a plan for moving the Estonian banking system into compliance with internationally recognized capital adequacy standards as established by the BIS no later than December 31, 1994. The Bank of Estonia will also conclusively resolve with commercial banks by October 31, 1993 all claims arising from its role in operating the internal payments system during the transition from the ruble zone in June 1992. Technical assistance from the Fund will be sought by the Bank of Estonia as required to meet this timetable.

28. The authorities recognize the importance of maintaining a commercial banking system that is owned predominantly by the private sector. To that end, the Government will formulate concrete plans by October 31, 1993 to privatize the Northern-Estonian Bank no later than August 31, 1994 and the Bank of Estonia will formulate concrete plans by October 31, 1993 to complete the privatization of the Savings Bank no later than August 31, 1994. However, in recognition of the Savings Bank's limited capacity to evaluate loans and to avoid an excessively rapid extension of credit, the Bank of Estonia will limit the reduction in the reserve requirements on liabilities that are now subject to the 100 percent reserve requirement--which totaled EEK 334 million as at June 30, 1993--to 70 percent as at December 31, 1993 and, subject to review with Fund staff, will make a further reduction in this reserve requirement on June 30, 1994. The Bank of Estonia will also review its majority stake in the Estonian Investment Bank and consider reducing its participation below 50 percent.

29. The Government recognizes the importance both to the banking system and to the economy as a whole of the need to moderate the burden of nonperforming loans on both the financial and the enterprise sectors. The implementation of the Bankruptcy Law and a growing understanding of how to operate in a market environment has already resulted in reductions in arrears in the case of enterprises that have been able to sustain operations; arrears now appear to be concentrated among selected state enterprises, a number of which can be expected to go into bankruptcy in the near future. To gain a better understanding of the extent of interenterprise arrears, the authorities will establish by January 31, 1994 the total extent of such arrears and review the prospects for the eventual settlement of these arrears by the enterprises involved. Under no circumstances would any operations related to solving the problem of arrears involve either budgetary or central bank resources.

Prices and wages

30. In the context of a fixed exchange rate regime such as prevails in Estonia, it is vital that prices and wages respond quickly to external and domestic shocks so as to avoid potentially destabilizing inflationary pressures developing in the economy. Particular attention must be paid to free price and wage formation, and the smooth functioning of labor markets.

31. To that end, the Government has essentially completed the process of price liberalization. On September 1, 1993 the only goods and services prices subject to review were limited to land, natural resources (including oil shale), electricity, natural gas, precious metals, liquor, heating energy, fuels and lubricants, airport and port services, empty bottles, forest resources, and postal and telecommunications services, but only if produced and/or sold by state enterprises. Despite the existence of the review process, in almost every instance a full pass-through of costs is permitted, and the review process remains in place because of national interest or where the authorities judge that monopoly power on the part of suppliers could lead to abuse. Bearing in mind the recent contribution to inflation partly brought about by increases in prices by industries in strong monopolistic or oligopolistic positions--especially the electricity and oil shale industries--the Government will actively implement the relevant provisions of the Competition Law to encourage the greatest possible degree of competition in these industries. Furthermore, the Government will, by March 31, 1994, complete a review of the structure of the electricity and oil shale industries with a view to breaking up monopolies in these industries and possibly privatizing them. Meanwhile, the Government will continue to refrain from subsidizing any consumer goods or services (except for residential heating and public transportation) or providing subsidies or subsidized loans to enterprises.

32. To help moderate inflation, the Government will replace the existing incomes policy with a policy of announcing semi-annual inflation targets on the basis of which, together with firm-specific productivity developments, enterprises will be encouraged to base their wage settlements. The

Government does not intend to intervene in the wage bargaining process which will take place at the level of each enterprise. The Government believes that linking wages to productivity developments at the level of each enterprise will also serve to enhance mobility in the labor market and increase the efficiency of resource allocation.

33. It is expected that prices will rise at a monthly rate of about 1-1 1/2 percent for the next month or two. However, with the consistent implementation of tight fiscal and monetary policies, the Government's inflation target for the six-month period ending March 31, 1994 is 7 percent. This target will be made public no later than October 15, 1993. The target for the nine-month period ending December 31, 1994 will be established with the cooperation of Fund staff on the occasion of the first review of this program in early 1994, but current expectations are that it should be below 6 percent.

34. It is intended to pursue active labor market policies instead of only passively rendering cash support to the unemployed. The supply-oriented measures are intended to improve the matching process, geographical and occupational mobility, and the rehabilitation of hard-to-place labor. The Government will improve the availability of employment services by increasing the number of employment agencies, and in the longer run, by computerizing the employment exchange. A core element of the active labor market policy is training and re-training, which should gradually replace the passive unemployment benefit system as the main user of budget appropriations. The Government will establish a task force to prepare detailed proposals by December 31, 1993 for the implementation of training programs and other active labor market measures. The task force should also consider to what extent training and re-training can be made compulsory for those who have been unemployed for a pre-specified period and to what degree public works projects can be used as a tool of active labor market policy. To encourage active job search, the eligibility rules of the unemployment system will remain unchanged and a flat compensation will be set at EEK 200 per month as of October 31, 1993. The minimum wage legislation, with its adverse effects on employment--particularly of the young--will be gradually phased out. To preserve the real value of social benefits for the most vulnerable groups, these benefits will be adjusted according to a means testing procedure as discussed in paragraph 21.

External sector policies

35. The Government and Bank of Estonia recognize that much of the progress made over the past year in reducing inflation, reorienting trade from the FSU to industrialized countries, and fostering growth is due to the introduction and maintenance of a very liberal trade and payments regime. This has permitted the early introduction of relative prices in line with the structure of world prices, exposing domestic monopolies to competition, and the alleviation of supply bottlenecks in the domestic economy. It has also fostered confidence in the kroon by ensuring that both current and capital account payments could be settled without any material institutional

or legal obstacles. Accordingly, the Government and Bank of Estonia reaffirm their commitment to maintaining Estonia's liberal trade and payments regime and introducing further liberalization measures, as appropriate. In this light, the possibility of moving to Article VIII status will be considered in due course.

36. The Government has eliminated all import licensing requirements, while export quotas and licensing requirements have all been removed except for oil shale oil, gravel, specialized clay, quartz, and silicate sand. Import tariffs are levied only on furs and fur products, cars, bicycles, motorboats and yachts. Export taxes apply only to rapeseed oil, antiques, art work, and metals (including scrap). To avoid discriminating between domestic and foreign producers, the Government will in general by December 31, 1993 replace import tariffs with excise taxes set at levels that would not imply any sacrifice in revenues. The Government accepts the principle that protection of domestic producers from cheaper imports can only be at the expense of the consumer of the affected products, which includes the already heavily burdened unemployed and pensioners, and in that light will keep under regular review the possibility of eliminating the recently introduced tariffs on grain and flour from Russia.

37. In the context of the growing confidence in the kroon, the Bank of Estonia has liberalized step by step its capital restrictions over the past year. The Bank has adopted this cautious approach primarily to ensure that such liberalization does not result in any destabilizing inflows or outflows of currency. However, sufficient confidence has been established in the kroon and in Estonia's financial system that the Bank will eliminate all restrictions on payments for both current and capital transactions for convertible and nonconvertible currencies--along with the 100 percent repatriation and conversion requirement--by December 31, 1993.

38. Estonia is currently negotiating with Russia and other FSU countries the final settlement of balances on central bank correspondent accounts left over from 1990, 1991 and 1992. The Government and the Bank of Estonia agree that any claims on Estonia which may arise from the conclusion of these negotiations must not appear as a liability of the Issue Department of the Bank of Estonia (i.e., the currency board).

39. The Bank of Estonia now operates correspondent accounts with 13 central banks of the FSU, entirely for the benefit of enterprises wishing to trade with these countries and in the absence of smoothly-functioning commercial bank relationships in these currencies. None of these accounts provide for swing credits or overdraft facilities and balances in these accounts are settled without delay entirely at the initiative of the enterprises and banks that are the holders of these deposits. Although these accounts have worked well in maintaining trade links, the Bank of Estonia wishes eventually to shift the responsibility for effecting international payments to the private sector and to that end has urged enterprises and banks to effect payments associated with FSU trade directly between commercial banks

in other FSU countries. During the period of the arrangement, the Government will not conclude bilateral payments agreements inconsistent with Article VIII of the Fund's Articles of Agreement.

40. The Government intends to conduct Estonia's international economic relations on a nondiscriminatory basis in line with multilateral principles prevailing in the world economy. To that end, the Government will not introduce new, or intensify existing, exchange restrictions, introduce or modify multiple currency practices or impose or intensify any import restrictions for balance of payments purposes, during the period of the arrangement.

Structural policies

41. The Government recognizes that the key to the early return of economic growth, raising living standards, and promoting growth in overall employment lies in rapid resolution of both privatization and restitution issues. Progress in the sale through evaluated bids of some large enterprises and the privatization through auction of numerous small and medium enterprises has been materially slowed, partly by a lack of clarity relating to property and land ownership, and partly by problems in the effective organization of the privatization effort. The recent passage of the Privatization Act should allow substantial progress to be made in overcoming both these obstacles. To give all prospective purchasers a fair and equal opportunity, the Government has ensured that all state property to be sold will be made subject to tender or auction, with such sales announced and published in at least two major domestic newspapers at least two weeks prior to the sales date. Nevertheless, and in the context of the existing legislation, the Government also intends to take the following measures to further accelerate the privatization process: (i) in recognition of the delays associated with processing sales of state property using the evaluated bid method, effective October 31, 1993, as a rule all property with a value of less than EEK 5 million or with fewer than 50 employees shall be sold only on a best price basis; (ii) effective October 31, 1993, the Government will ensure that following the sale of state property, the new owners will have clear and unambiguous title to the property, and that they, and all subsequent owners, will be protected by a state guarantee from any claims on that property from restitution claimants; (iii) effective November 30, 1993, the Government will through the Privatization Agency decentralize the process of privatization so that the sale of state property can be effected by the public sale of shares and by institutions other than the Privatization Agency (e.g., the Estonian Investment Bank, commercial banks, stockbrokers, etc.). To help in the identification of property that will be made available for privatization, the Government will (i) by November 30, 1993 publish a list of all enterprises that will be retained indefinitely by the state; (ii) by December 31, 1993 elaborate principles to accelerate the process of identifying municipal property to be privatized; and (iii) by March 31, 1994 publish a list of all other objects of property that will be retained indefinitely by the state. In identifying property that is to be assigned to ownership by municipalities, the Government will as a rule limit

such property to objects required to fulfill local governmental and social requirements and will retain and prepare commercial property for early privatization.

42. A strong political consensus has emerged to ensure that a significant proportion of state property will be made available to be privatized against compensation and national capital vouchers. To give early effect to this consensus, and to clarify as soon as possible the precise framework for the use of these vouchers, the Government will prepare an annual Privatization Plan setting out targets for the privatization of enterprises each year, including guidelines regarding the use of vouchers (both compensation and national capital vouchers) within each Plan and the roles to be played by the Compensation and Investment Funds. The first such Plan, covering 1993, will be made public by October 31, 1993 and the Plan covering 1994 will be made public by November 30, 1993. In establishing guidelines for the use of vouchers, the Government will ensure that (i) a specified share of each enterprise to be privatized against vouchers shall not be made available for cash and vice-versa, i.e., there would be no substitution of cash for vouchers in the privatization program; (ii) the voucher program would not rely on any financial backing from the general government budget or the banking system to maintain or support the value of the vouchers; and (iii) favorable consideration be given to allowing vouchers to be traded freely during the course of 1994 so as to provide for a more efficient distribution of vouchers and also ensure that elderly recipients of vouchers are able to make immediate use of these assets. Meanwhile, in the operation of the Compensation Fund (CF), existing legislation provides that the CF will not have the right to borrow resources from any source, will not be permitted to lend resources to the Government, and will not make cumulative payments to its stockholders in excess of its total dividend and interest earnings plus any capital gains.

43. With the adoption of the April 1, 1993 deadline for virtually all restitution claims, the focus of the restitution effort will now turn to the rapid processing and resolution of these claims. As of June 12, 1993, of 203,858 restitution claims received by the Government, 38,085 had been processed and judged legitimate. However, the pace of resolution of claims has proceeded very unevenly in Estonia, with some districts resolving claims much faster than other districts. The Government's objective is not only to complete the transfer of property back to the rightful owners as quickly as possible--and in particular to accelerate the pace of land restitution--but also to help minimize any equity problems as relates to the timing of receipt of compensation vouchers (as between early and late recipients, depending on how quickly claims are resolved). To that end, the Government will, inter alia, assist local authorities, through the provision of pooled legal and administrative services and financial assistance, to resolve claims as rapidly as possible. The Government will also make use of the experience of districts with good records in resolving restitution claims to streamline the process elsewhere in Estonia and establish ambitious deadlines for local authorities in the processing of restitution claims.

The Government will keep the restitution process under close review and will take immediate measures in the event that there is evidence that it is materially slowing down the privatization of state-owned property.

44. In recognition of the important role that will be played by foreign investment in the evolution of the private sector, the Government will keep under review developments in this area with a view to removing as early as possible any obstacles--especially legal and administrative obstacles--that may be faced by entrepreneurs in starting and operating businesses in Estonia.

45. The Government intends to request, as necessary, support from the World Bank and the European Bank for Reconstruction and Development, including technical assistance, in implementing the measures in paragraphs 41 through 44.

46. With the passage of the legislative package in May and June 1993, the Estonian Government has put into place much of the essential legal framework necessary to support the functioning of a market economy. The task of the Government now will be to keep the workings of this legal framework under review to ensure that any inconsistencies or problem areas are rapidly addressed. In particular, the Government will by October 31, 1993 take measures to allow state enterprises--pending their privatization--to use their assets as collateral in support of borrowing from commercial banks. Meanwhile, work on a standardized accounting and reporting framework for enterprises remains to be completed. Accordingly, and to assist in the assessment of the viability of enterprises, the Government will by October 31, 1993 present to Parliament legislation bringing into effect a new accounting law that conforms to EC accounting standards. To help assure compliance with the new accounting standards, and to improve both the Government's ownership control of public enterprises prior to privatization and the flow of tax revenues, the Government will at the same time strengthen the Office of the State Auditor so that it can enforce auditing and tax reporting performance in the state enterprise sector through random, unannounced audits. The Government will also present to Parliament no later than October 31, 1993 legislation to ensure that it has all necessary powers and sanctions to manage effectively state enterprises.

47. The Government recognizes that weaknesses in the collection and compilation of economic and financial statistics complicates the evaluation of economic developments and the formulation of appropriate policies. Some progress has been made over the past year in refining monetary statistics, the consumer price index and in the preparation of the balance of payments, but substantial work remains to be done. The Government's objective for the next program period is to improve the national accounts data to take better account of the growing private sector, continue to make improvements in the balance of payments statistics by implementing the recommendations of the recent STA mission, to construct and publish a producer price index no later than December 31, 1993, and to establish a system of government accounts and statistics based on the recommendations of the recent STA mission, also no

later than December 31, 1993. The Government will also propose legislation to ensure that adequate sanctions are in place to ensure that enterprises, banks, and other institutions comply with official statistical reporting requirements in a timely and orderly fashion. The Government will request technical assistance to help in implementing the provisions in this paragraph.

Balance of payments prospects and external financing requirements

48. Estonia will continue to require substantial inflows of foreign financing to support the import volumes, especially of investment goods, which are required to support the projected growth in real GDP. The current account deficit is projected at over US$44 million for the second half of 1993 and around US$215 million for 1994. In addition to private capital flows (mainly through direct investment), this deficit is expected to be financed by official balance of payments support, including from the Fund, the World Bank, the European Bank for Reconstruction and Development and bilateral lenders. This will permit a further build-up of gross international reserves, to some US$380 million by the end of December 1994 (including the reserves of the currency board).

49. Estonia had received US$35 million under the G-24 process during the 1992/93 program period and expects to receive a further US$55 million during the 1993/94 program period, all of which will be devoted to financing balance of payments needs. The Government has used resources received during the first half of 1993 largely to finance the discharge of external arrears and government lending programs. However, effective October 31, 1993, the Government will direct the EFB to place directly with the Estonian Investment Bank or with eligible commercial banks (as defined in paragraph 20 above) in blocked, long-term deposits amounts equivalent to (i) all resources received under the G-24 process (including the second tranche of the EC Commission loan, but excluding the proceeds of the loan from the Export-Import Bank of Japan)--except for resources used to finance fiscal and lending operations consistent with the performance criteria set out in paragraph 20--and (ii) the counterparts of purchases from the Fund under the Systemic Transformation Facility. Banks would use these deposits to finance medium- and long-term lending to enterprises, mainly for investment purposes. If the EFB judges that the banking system would have difficulty in absorbing such deposits, it would hold any surplus funds in an interest-bearing account to be held abroad and managed by the Bank of Estonia until such time as they can be placed with the banking system.

50. As of June 30, 1993, Estonia has contracted public and publicly guaranteed foreign debt (on a commitment basis) with maturities of 1-12 years amounting to US$131 million and with maturities of 1-5 years amounting to US$16 million. Taking account of the Government's balance of payments projections and the adjustment program, it is proposed that ceilings on contracting government and government-guaranteed external debt from June 30, 1993 be set at US$80 million with a maturity of 1-12 years and US$40 million with a maturity of 1-5 years as of end-September and

end-December 1993, and at US$150 million with a maturity of 1-12 years and US$70 million with a maturity of 1-5 years as of end-March 1994 (Annex IV). The Government will not contract or guarantee loans of less than one-year maturities, with the exception of normal import financing (including liabilities on the correspondent accounts with FSU countries), and there will be no accumulation of external arrears by the Government.

Review of the program

51. The Government stands ready to take any further measures that may be necessary to achieve the overall aims of the program and will provide the Fund with such information as it may request concerning the implementation of the program. It will remain in close consultation with the Fund in accordance with Fund policies on such consultations. In addition, we will complete with the Fund the first review of economic developments and policies no later than March 15, 1994, and the second review no later than September 15, 1994. These reviews will also focus, inter alia, on the implementation of structural policies, in particular:

--at the first review, formation of the External Financing Board as set out in paragraph 17; modernization of the tax and customs administration and reform of revenue sharing arrangements between the state and local governments as set out in paragraph 19; and placement of new G-24 resources with commercial banks as set out in paragraph 49.

--at the second review, completion of the medium-term framework for budget planning as set out in paragraph 19; the transfer of all government bank deposits to viable commercial banks as set out in paragraph 20; progress in the privatization of the Northern-Estonian Bank and the Savings Bank as set out in paragraph 28; and completion of the review on making compensation and national capital vouchers tradable as set out in paragraph 42.

The quantitative performance criteria for June and September 1994 will be specified at the time of the first review, and for December 1994 in connection with the second review.

General Government Financial Balance

Performance Criteria on Financial Deficit and Net Lending

Financial Deficit Ceilings	(in millions of kroons)
July 1, 1993 - September 30, 1993 (indicative ceiling)	80
July 1, 1993 - December 31, 1993	200
July 1, 1993 - March 31, 1994	330

Net Lending Ceilings	(in millions of kroons)
July 1, 1993 - September 30, 1993 (indicative ceiling)	370
July 1, 1993 - December 31, 1993	610
July 1, 1993 - March 31, 1994	910

The general government financial deficit is defined as the sum of net credit to general government from the domestic and foreign banking systems, credit from other financial and nonfinancial institutions or households, and net foreign loans disbursed to general government, less net lending operations undertaken by general government. The financial deficit will be measured excluding valuation gains and losses on all foreign currency denominated assets and liabilities arising from exchange rate fluctuations.

The general government encompasses the central government (comprising the state budget and budgets of extra-budgetary funds) and local governments. The central government extra-budgetary funds include, but are not limited to the Social Security, Medical Insurance, Environment, and Forestry funds.

Net credit to general government from domestic and foreign banks is defined as the change in total claims of domestic and foreign banks on the general government less the change in deposits of the general government with domestic and foreign banks. Claims of domestic and foreign banks on the general government include (a) domestic and foreign bank loans to general government, (b) securities or bills issued by the general government held by domestic and foreign banks with the exception of those issued in relation to bank rescue operations, and (c) overdrafts on the current accounts of the general government with domestic and foreign banks. Deposits of the general government with domestic and foreign banks include, but are not limited to: (a) money deposits of the general government with domestic and foreign banks, and (b) securities issued by domestic or foreign banks held by the general government.

Credit to general government from other financial and nonfinancial institutions or households is defined as all increases in domestic claims on general government outside the banking system. In particular, it includes changes in holdings of government securities, debt, and bonds by nonfinancial enterprises and households, but excludes government debt issued in relation to bank rescue operations.

Net foreign loans disbursed to general government comprise total disbursements of all government and government-guaranteed nonbank loans, including drawings from the IMF under the STF, less repayments of such loans (but excluding drawings under stand-by arrangements). This definition excludes government-guaranteed foreign loans disbursed directly to entities outside general government.

Net lending by the general government consists of lending operations by the general government to the nongovernment nonbank sector, less repayments on these loans. Lending operations include direct loans, purchases of debt or equity, transactions in financial assets, and government payments of interest or amortization on debt of nongovernment which generate equivalent claims by the Government on the original debtors. They do not include deposits of general government with the domestic and foreign banking systems. All net lending operations, except for a quarterly amount of EEK 20 million, cumulative from July 1, 1993, shall be financed only from net foreign loans disbursed to general government as defined above.

The Ministry of Finance and the Bank of Estonia shall report monthly data on general government net deposits held with the foreign banking system, disbursements of foreign loans to the general government, blocked accounts held with the domestic and foreign banking systems, net lending operations, and any other data regarding the general government financial balance. Data on net claims of the domestic banking system on general government, in the agreed format, will be reported to the Fund within thirty days of the end of each month by the Bank of Estonia. The Ministry of Finance shall confirm these data.

Net International Reserves in Convertible Currencies

Performance criteria on net international reserves	Minimum limits (in millions of deutsche mark)
Actual stock at June 30, 1993	67.2
September 30, 1993 (indicative floor)	40
December 31, 1993	45
March 31, 1994	50

Net international reserves consist of gross reserves of the Bank of Estonia, foreign exchange balances corresponding to purchases from the Fund held abroad, net of reserve liabilities (including government obligations associated with Fund purchases) and net of currency board cover. These assets and liabilities will be converted to deutsche marks at current exchange rates defined as the Bank of Estonia's official rates 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 reserve assets 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 (other than those corresponding to purchases from the Fund), 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 June 30, 1993, gross reserves, as defined above, amounted to DM 460.4 million, including gold holdings valued at DM 4.1 million. As a performance criterion, the Bank of Estonia will ensure the maintenance of full foreign reserve banking for the currency board's liabilities at the end of each monthly reporting period.

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 EC, the BIS and other international financial institutions, foreign governments and foreign banks. On June 30, 1993, international reserve liabilities of the Bank of Estonia, as defined above, amounted to DM 28.8 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 June 30, 1993, currency board liabilities amounted to the equivalent of DM 364.4 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.

At the time the authorities make purchases from the Fund related to the Systemic Transformation Facility, the performance criteria for December 31, 1993 and March 31, 1994 (shown above) will be adjusted downward by the deutsche mark equivalent of the purchase.

The 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.

Reserves of the Banking System

Required reserves will be calculated as equal to 10 percent of the banking system's domestic and foreign currency deposit liabilities (excluding the Savings Bank) and 10 percent of the Savings Bank's deposit liabilities excluding individual demand deposits, as presented in the monetary survey. Required reserves on individual demand deposits of the Savings Bank--set at 100 percent of such deposit liabilities as at September 30, 1993--shall not be lowered below 70 percent of such deposit liabilities as at December 31, 1993. The deposit aggregates against which required reserves of the banking system (including the Savings Bank) shall be calculated will be referred to as "eligible liabilities". Required reserves for September 30 will be calculated in this manner from the August 31 monetary survey, for December 31 from the November 30 monetary survey, and for March 31 from the February 28 monetary survey.

Reserves of the banking system (including the Savings Bank) will not be permitted to be below required reserves of the banking system, as defined in the above paragraph, by more than 1 percent of eligible liabilities, as defined above, at end-September 1993 (an indicative limit), end-December 1993, and end-March 1994.

Henceforth, the Bank of Estonia will not extend any new credits to commercial banks, except in emergency situations and in amounts that do not violate (i) the performance criterion requiring full foreign currency backing for the currency board liabilities or (ii) the performance criterion specifying the minimum targets for net international reserves.

Limits for External Debt of the Estonian Government and the Bank of Estonia
(Includes debts contracted or guaranteed)

	Maximum limits (In millions of U.S. dollars)		
Performance criteria on cumulative net contracting of external debt	1-12 year maturity	1-5 year maturity	less than one year
During the period from June 30, 1993 to:			
September 30, 1993 (indicative ceiling)	80	40	--
December 31, 1993	80	40	--
March 31, 1994	150	70	--

External debt limits apply to the net contracting (contracting or guaranteeing less repayments) by the Government and the Bank of Estonia of all external debt of original maturities of 12 years or less. These limits differ, as shown above, according to the original maturity of the debt--of one year or less; of more than 1 year up to and including 5 years; and of more than 1 year up to and including 12 years. Neither the Government nor the Bank of Estonia shall contract or guarantee debt of an original maturity of one year or less, other than normal import financing. (Liabilities on interrepublican correspondent accounts shall be considered normal import financing). The Government is defined as comprising the state and local authorities, and all extrabudgetary funds. Excluded from the limits are use of Fund resources; but other balance of payments support of maturity of 12 years or less is covered by these limits, including loans from official creditors and foreign banks. The amount of debt contracted or guaranteed shall be valued at the relevant currencies of denomination and converted into U.S. dollars using the Bank of Estonia's official exchange rates prevailing at the time the debt is contracted or guaranteed. Repayments shall be valued at the currencies of transactions and converted into U.S. dollars at the time of repayment at the average exchange rate for the month.

In the event that negotiations with any FSU state result in the acceptance by the Estonian authorities of any liability that would require repayment within a 12-year period, this performance criterion would be redefined to include such liabilities and the relevant debt ceilings would be adjusted upward by an equivalent amount.

Compliance with the limits shall be verified for the dates shown above. Information on net contracting, guaranteeing, and disbursements of external debt, in the agreed format, will be reported monthly to the Fund within thirty days of the end of each month by the Ministry of Finance.