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CONFIDENTIAL

August 25, 1992

To: Members of the Executive Board

From: The Acting Secretary

Subject: Estonia - Request for Stand-By Arrangement

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 27.9 million, which is tentatively scheduled for discussion on Wednesday, September 16, 1992. A draft decision appears on page 28.

Mr. Knöbl (ext. 38821) or Mr. Zavoico (ext. 36288) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

ESTONIA

Request for Stand-By Arrangement

Prepared by the European II and Policy Development and Review Departments

(In Consultation with other Departments)

Approved by Eduard Brau and Thomas Leddy

August 24, 1992

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I. Introduction

Estonia became a member of the Fund on May 26, 1992, and has not yet used Fund resources. In a letter and accompanying Memorandum of Economic Policies dated August 14, 1992, the Estonian authorities have requested a twelve-month stand-by arrangement in the amount of SDR 27.9 million (90 percent of quota) and have agreed to an economic and financial program in support of this request covering the period July 1, 1992-June 30, 1993. Discussions on this program were conducted in Tallinn over the course of three missions (April 3-16, June 4-19, and July 20-August 3). The Estonian representatives included Mr. Vähi, Prime Minister; Mr. Miller, Minister of Finance; Mr. Taal, Minister of Economy; Mr. Vitsur, former Minister of Economy; Mr. Kuddo, Minister of Labor; Mr. Kallas, Governor of the Bank of Estonia; and senior officials from these and other agencies. 1/

Article IV consultations have not yet been held with Estonia, although there were extensive discussions with the Estonian authorities in November 1991 and January 1992 in the context of the premembership review. The resulting report (SM/92/48, 3/6/92) was considered by the Executive Board on March 31, 1992. At that meeting, Directors commended Estonia on its progress toward a market economy in the face of considerable economic shocks. They welcomed Estonia's commitment to a balanced budget and the dismantling of the network of consumer subsidies and price controls. However, they noted that progress had slowed on important components of the reform program, especially as regards privatization, and they encouraged the authorities to persevere with key reform measures.

II. Background and Recent Developments

1. Developments to 1991

a. 1980-1990

The deterioration of the Estonian economy in the 1980s paralleled the gradual breakdown of the Soviet centrally planned economy. These economic difficulties were reflected in the economy's weakening performance towards the end of the decade; by 1990 real GDP was falling by about 4 percent.

1/ These missions included Messrs. Odling-Smee, Knöbl, Zavoico, Saavalainen (all EUR II), Mr. Bennett (PDR), Mr. Faria (FAD), and Mr. Luu (STA). Mrs. Padmore (EUR II), Miss Jezierska (PDR) and Miss Jones (PAR) served as staff assistants. Mr. Paljarvi, the Fund's Resident Representative in Tallinn, assisted the missions. Mr. Solheim, Alternate in the Nordic Executive Director's Office, also participated in some of the discussions.

During the 1980s prices were fixed administratively leading to chronic excess demand for, and shortages of, goods. Repressed inflation caused prices in state stores and the private markets to diverge substantially--by as much as 100-500 percent in the case of certain food products (Chart 1). The price liberalization process began in December 1989 (initially confined mainly to the retail sector) and, as a result, price differentials between state stores and private markets were gradually reduced and by end-1991 had virtually disappeared.

Full employment prevailed throughout the 1980s, due mainly to the virtual employment guarantee written into the Soviet Constitution. However, towards the end of the decade growth of total employment ceased, and in 1989 and 1990 actual declines set in as disruptions in trade with other Soviet republics developed. Nevertheless, officially recorded unemployment remained nonexistent, although a census study conducted in 1989 indicated that about 2 1/2 percent of the labor force was either unemployed or searching for a job.

b. <u>1991</u>

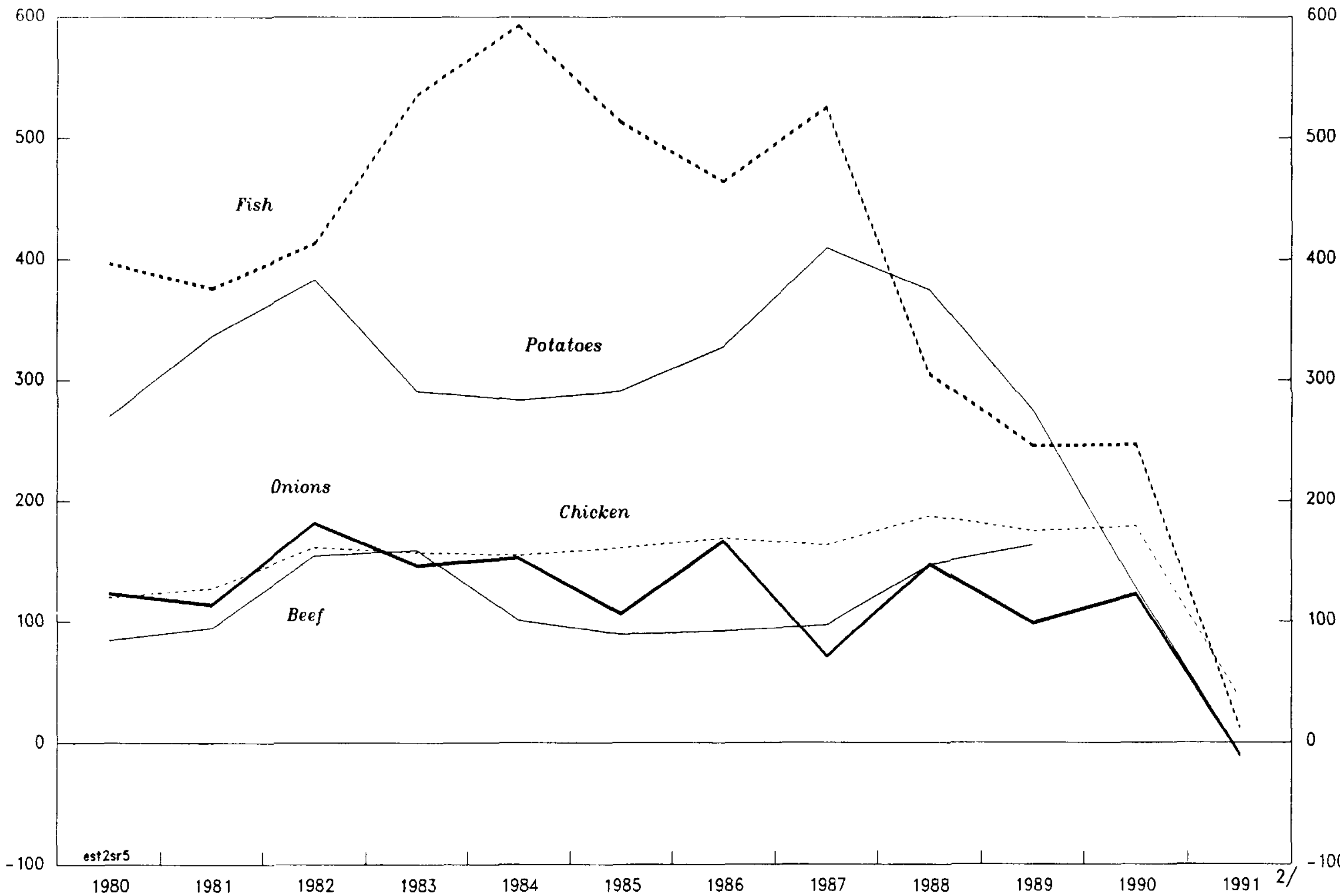
In 1991, Estonia's economic performance deteriorated further. Real GDP declined by 13 percent and industrial production by 9 percent. For the most part, this was due to an intensification of supply disturbances caused by the disruption of trade between Estonia and other republics. Furthermore, the acceptability of the ruble as a medium of exchange progressively deteriorated, leading suppliers in Russia and other republics to seek payment in hard currency or to arrange barter transactions, adding to the problems of maintaining interrepublican trade. Sales in the domestic market also declined as falling real wages began to restrain purchasing power and the decision of the Soviet authorities to block Savings Bank deposits in Moscow prevented the use of accumulated savings to sustain consumption in Estonia.

Despite the sharp fall in output in 1991, employment fell by only 1 percent, reflecting partly the monopolistic structure of the Estonian economy. With the liberalization of prices, enterprise profits remained buoyant, thereby allowing firms to avoid large scale lay-offs of employees. At end-1991, officially registered unemployment was still less than 1,000 persons.

In response to price liberalization the level of consumer prices increased by 210 percent in 1991. Nominal wages rose by only 97 percent, implying a considerable loss in real purchasing power. Due to the Government's efforts to alleviate the economic position of the most vulnerable groups, and increases in nonwage incomes (e.g., sales from private plots, etc.), household real disposable incomes declined by considerably less than real wages, perhaps by 25 percent.

On the external side, Estonia's traditional trade deficit turned into a surplus in 1991, owing mainly to a decline in imports, but also because of

CHART 1
ESTONIA
REPRESSED INFLATION 1/
(In Percent)



Source: Data provided by the Estonian authorities.
1/ Measured by price differentials between parallel markets and state stores.
2/ As of fourth quarter 1991.

an improvement in the terms-of-trade as the price liberalization process advanced more quickly in Estonia than in Russia--Estonia's main trading partner. However, trade and production patterns remained distorted as imports were based on underpriced energy and raw materials.

Even after Estonia achieved independence in August 1991, the scope for autonomous macroeconomic policies remained limited. With the ruble as legal tender, monetary policy remained dependent on Gosbank (USSR). Towards the end of 1991, the supply of rubles from Russia became increasingly constrained and a serious ruble cash shortage developed in Estonia, resulting in the increasing use of hard currency in goods markets and sporadic delays in the payment of salaries and pensions. As for fiscal policy, some scope for independent policy was attained with the tax reform in 1990, which formally reduced Estonia's dependency on all-Union budget allocations. The reform also radically transformed the tax structure--providing for a new value-added type indirect tax and reforms of corporate and personal income taxation--which together increased the tax system's responsiveness to inflation. As a result, in 1991 the consolidated general government balance was in substantial surplus, reflecting mainly the strong response of revenues to rising prices and delays in making corresponding adjustments to expenditures.

2. The Estonian economy in 1992 1/

In early 1992, the Estonian economy experienced a new external shock as Russia substantially liberalized its prices and at the same time raised the price of oil and other raw material exports to Estonia (and the other Baltic states) towards world market levels. The terms-of-trade shock--equivalent to almost 20 percent of GDP--immediately reduced Estonian real incomes. Adjustment to this shock, together with continued trade dislocations, is expected to result in a decline of real GDP of about 30 percent in 1992 (Table 1); in comparative terms, this will represent a loss of output in Estonia over the period 1990 to 92 more severe than has been experienced in Eastern Europe or in Russia (Chart 2). In the first five months of 1992, industrial production had already dropped by 35 percent compared to a year ago, and the volume of recorded retail sales was down by even more. Furthermore, a drought developed during the summer, and the expectation is that agricultural output over the year would be well below normal levels. Officially registered unemployment still remained low in Estonia, but temporary lay-offs, unpaid leave, and shortened working weeks have become more widespread.

Inflation accelerated sharply in the beginning of 1992 reflecting higher imported energy prices and the rise in other import prices due to

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1/ For presentational purposes, nominal aggregates in the first half of 1992 are expressed in terms of kroon (even though the currency reform only took place on June 20). For this purpose, rubles have been converted into kroon at the initial conversion rate of rub 10 = EEK 1.

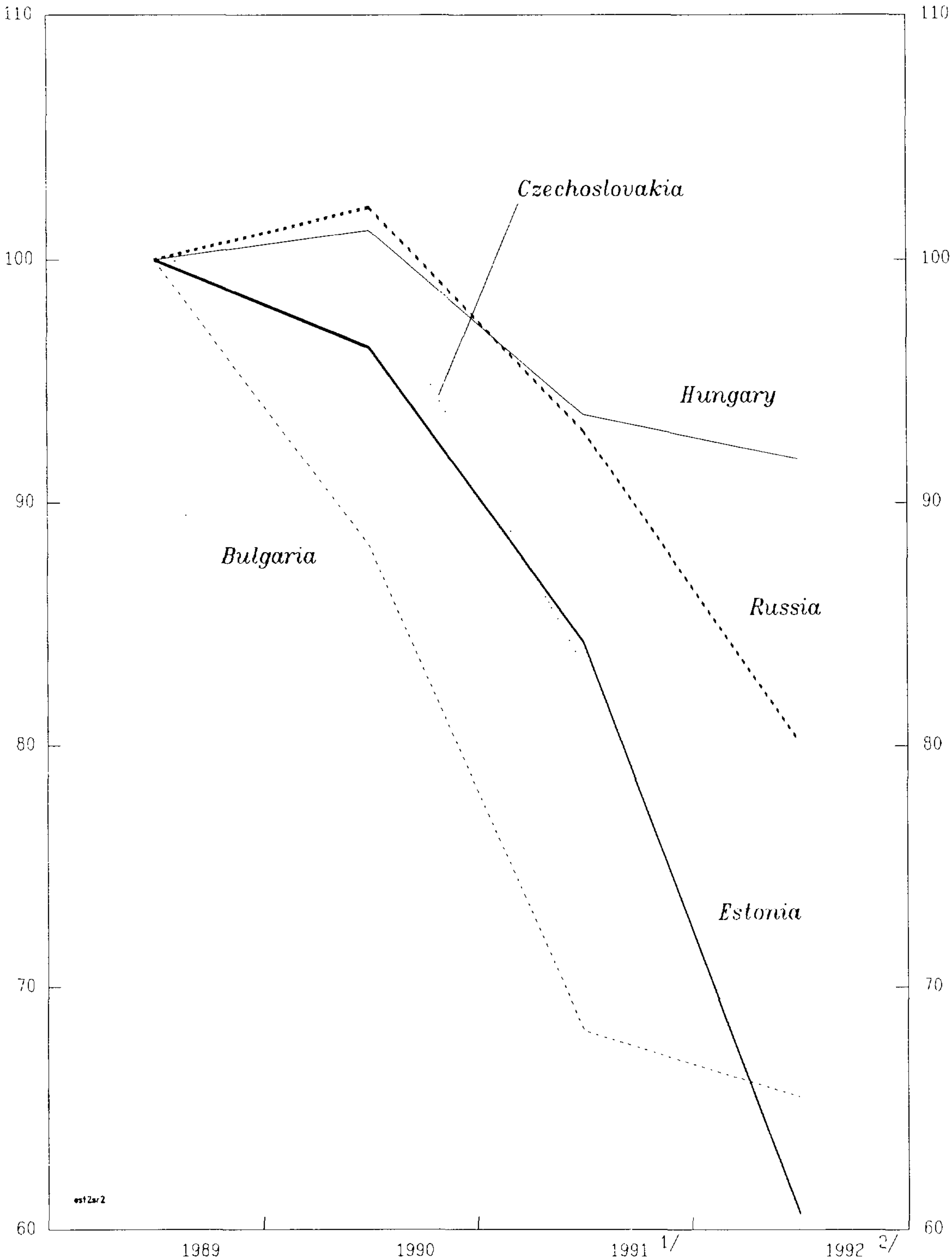
price liberalization in Russia, with the monthly rate of inflation reaching an average of about 80 percent in January and February. Thereafter, and in the absence of further major price shocks from abroad, the monthly rate of inflation declined to an average of about 9 percent during the second quarter of 1992. By June, consumer prices had risen by 1,080 percent relative to their level a year earlier--in line with price increases in Russia (Chart 3). In July, the monthly inflation rate rose to 24 percent reflecting an 8 percentage point increase in the VAT rate and the use by shopkeepers of the conversion process under the currency reform to introduce a one-time increase in prices. However, there is some evidence that weak demand has led to some roll-back in retail prices in late July.

Average wages in 1991 again lagged the rise in consumer prices. Government wage increases were restrained in the face of increasing difficulties in maintaining a balanced budget. In the enterprise sector, depressed profitability among state enterprises and a reluctance to dismiss labor also restrained wage increases. As a result, real wages fell by 52 percent during the first quarter of 1992. Despite some catch-up in the second quarter, average real wages still remained 45 percent below the level of the last quarter of 1991.

The general government budget, which was in surplus in 1991 and had remained broadly in balance through the first two months of 1992, deteriorated sharply in March 1992, mainly because of inflation adjusted increases in the wage bill, the reintroduction of milk, public transport, and home-heating subsidies (the latter in response to higher imported energy prices), and a slower than anticipated growth in consumption-based tax receipts. The situation was exacerbated by a build-up in corporate tax and value-added tax payment arrears of state enterprises amounting to about EEK 105 million (8 percent of total tax revenue). Initially, this deficit was financed by a rundown of deposits, but the Estonian authorities subsequently took emergency measures to restore a balanced budget, including the elimination of the above-mentioned subsidies in May, and the requirement that selected state enterprises make advance profit distributions to the budget. As a result, the overall general government budget for the first half of 1992 is estimated to have registered a surplus of EEK 61 million (1.6 percent of GDP).

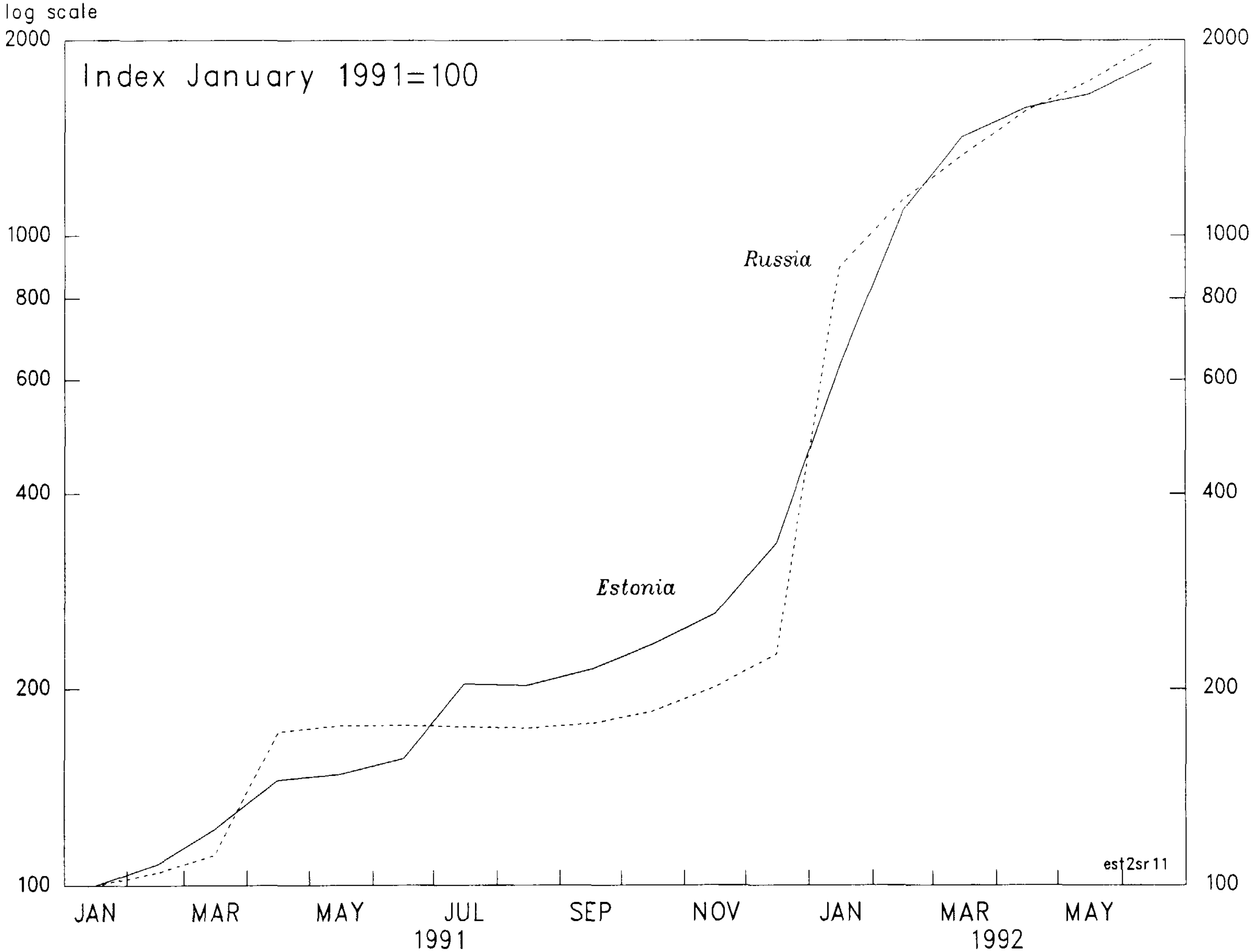
Developments in monetary aggregates during the first half of 1992 reflected uncertainties relating to price shocks experienced early in the year and the impending currency reform (Table 2). The first quarter of 1992 witnessed a substantial withdrawal of bank deposits, mainly foreign currency deposits held with domestic banks, to purchase imported goods or to switch assets into accounts abroad, with the result that the banking system's net foreign assets fell by some US$120 million (excluding restituted gold). Much of this switching of funds abroad was reversed in the second quarter, as the cap on foreign currency accounts in Estonia introduced as part of the currency reform (see section III 6(d) below), created an incentive to boost

CHART 2
ESTONIA
REAL GDP
(Index 1989 = 100)



Sources: Data provided by the Estonian authorities; and staff estimates.
1/ Preliminary estimates.
2/ Forecast.

CHART 3
ESTONIA
CONSUMER PRICES IN ESTONIA AND RUSSIA



Sources: Data provided by the Estonian and Russian authorities.

the initial level of deposits. As a result, the net foreign assets of the banking system (again excluding restituted gold), increased by about US$40 million during the second quarter.

Overall, broad money (including foreign currency deposits) expanded by only about 41 percent during the first half of 1992, implying a 75 percent contraction in the real money stock. However, the implied monetary squeeze was partly cushioned by the strong liquidity position of the enterprise sector at end-1991. The relatively slow growth in the money supply occurred partly because Estonia did not receive sufficient financial resources from Russia, especially cash rubles, but mainly because credit expansion by the Bank of Estonia was restrained. Net transfers of foreign currency deposits abroad, as described above, were also a contributing factor. Furthermore, highly negative real interest rates and restrictions on deposit withdrawals discouraged savings and financial intermediation. The absence of sufficient liquidity was evidenced by a sharp increase in the velocity of money which rose from 1.1 at end-1991 to 2.7 in end-June 1992. The rise in velocity also reflected the rapid growth of interenterprise arrears which were estimated to have reached EEK 800 million (with resident and nonresident enterprises), or about 9 percent of GDP, in mid-1992.

On the external side, foreign trade volumes remained depressed in the first half of the 1992. After a virtual collapse of trade in the first months of the year, trade recovered, but lack of external financing and malfunctioning of payments arrangements with the other states of the former Soviet Union (FSU) kept trade volumes at low levels. The trade arrangement agreed with Russia in February provided for the exchange of Estonian electricity and food products for Russian fuel products, but it has not proved very effective in securing adequate supplies of fuel for Estonia. Problems have arisen because Russian demand for Estonian electricity has fallen sharply due to the contraction of output in Russia and because the price of electricity actually paid by Russia was significantly below agreed levels. On the other hand, prices negotiated for Russian energy supplies to Estonia effectively remained some 25 percent below world market prices throughout the first half of 1992. Meanwhile, interenterprise trade has continued to be hampered by delays in making cross-border payments and in securing the necessary export licenses from Russia.

The Government's ability to stabilize the economy was substantially enhanced with the currency reform of June 20, 1992, which was prepared in close cooperation with the Fund staff. The ruble was replaced with the new Estonian currency, the kroon, in the context of a currency board (see section III.3). The exchange rate was fixed to the deutsche mark at a rate of EEK 8 = DM 1. 1/ The reform also incorporated broad current account convertibility and limited capital account convertibility.

1/ The conversion took place at an implicit exchange rate equivalent to about rub 125 = US$1, and corresponded broadly to the market rate at the time.

In connection with the currency reform, a comprehensive stabilization package was introduced on June 20. This package comprised an increase in the single VAT rate from 10 to 18 percent; a consolidation of the previous three-tier corporate tax rate structure, with an average rate of 27 percent, to a single rate of 35 percent; and the introduction of a top rate of 50 percent on all monthly incomes in excess of ten times the minimum monthly wage of EEK 200. Overall, this package is expected to generate revenue equivalent to about 5-6 percent of GDP and to ensure a surplus of about 1 percent of GDP in the consolidated general government operations for the second half of 1992. As part of the stabilization package, the Government also announced a wage freeze for July, to be followed by the implementation of a tax-based incomes policy.

III. Policy Discussions and the Program for 1992-93

1. The policy framework and strategy

The challenges to economic policy makers in Estonia are enormous. By June 1992, the Estonian economy was in the midst of a severe contraction, prompted partly by the need to adjust to substantial external shocks, especially the collapse of traditional trading patterns with former Soviet republics and the sharp deterioration of the terms-of-trade arising from the move of energy prices to near world market levels. Meanwhile, the labor market was experiencing serious imbalances and a large employment overhang, especially in the state enterprise sector, and industry was operating with an aging and largely obsolete capital stock.

Notwithstanding these obstacles, the Government has put into place the basic elements of a strong stabilization and structural program. In particular, fiscal balance has been maintained despite a sharp decline in output, thereby laying a strong foundation for the currency reform. The price liberalization process has been largely completed, thus avoiding any material inflationary impulse associated with further liberalization and creating a relative price structure consistent with an improvement in allocative efficiency. The successful establishment of a currency board has contributed to a more stable monetary environment. Finally, the privatization of a large number of smaller enterprises and several larger enterprises, and the adoption of legislation in support of a market economy contributed to the development of a rapidly expanding private sector (albeit from a very low base).

The Estonian authorities recognize that further measures will be necessary to stabilize the economy and thereby obtain the external financing needed to ensure a successful transition to a market economy and set the stage for sustainable growth. To that end, the Government has adopted a comprehensive economic program for the 12-month period July 1, 1992-June 30, 1993, as set out in the accompanying Memorandum of Economic Policies (MEP). The program has two main objectives: macroeconomic stabilization and structural reform. The main elements of the program as regards stabilization are (i) completion of the price reform process, (ii) restrictive fiscal policies, (iii) monetary discipline under the currency board arrangement, (iv) strict incomes policy to contain excessive wage increases and (v) further liberalization of the exchange and trade system. With regard to structural reform, the main elements of the program include (i) an acceleration in the privatization process; (ii) substantial completion of the restitution process; (iii) financial sector reform; (iv) improvement of the social safety net; (v) restructuring or closure of nonviable enterprises and banks; and (vi) establishing a legal framework consistent with a market economy.

Through the concerted implementation of these policies, it is expected that Estonia will progressively restore economic stability and create the basis for sustained economic growth. In particular, the fall in real output could be limited to 15 percent in the program period (with some resumption of growth toward the end of the period) (Chart 4 and Table 1). The projection assuming no corrective measures or external financing would have implied a contraction in output in the order of about 25-30 percent. A smaller decline in output is projected under the program because access to external financing would be substantially greater, and therefore the availability of raw material and intermediate inputs required to contain the fall in output. On the other hand, the low level of demand--reflecting low real incomes--has begun to limit domestic production and will partly offset the positive growth impulse from increased external financing, further price liberalization and the acceleration of the privatization process (Chart 5).

With tight fiscal and monetary policies, supported by the incomes policy, the rate of inflation is expected to decelerate to an annual rate of about 6 percent (or close to western European levels) by the end of the program period. Although the annual inflation rate during the program period is likely to exceed rates in western Europe, the initial undervaluation of the kroon should ensure the maintenance of cost competitiveness in the tradable goods sector. Real wages are not assumed to decline further in the absence of unforeseen external shocks. The external current account would remain in deficit throughout the program period. However, gross foreign reserves by mid-1993 are projected to be at a level equivalent to more than two months of imports. Over the longer term, the capacity to service external debt contracted during the course of the program and in later years appears adequate.

2. Price liberalization and inflation

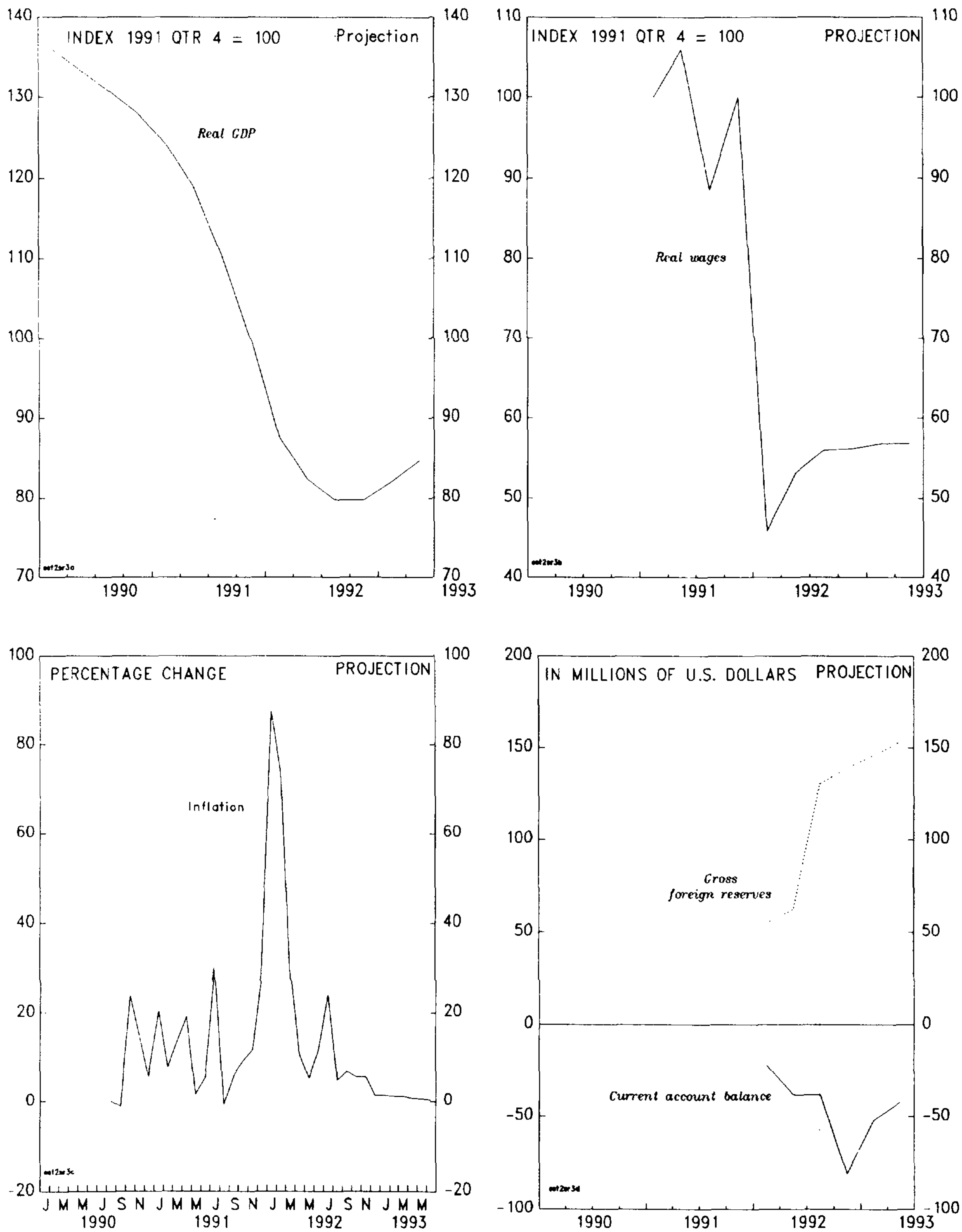
Since 1989, price liberalization was used by the Estonian authorities to relieve product shortages associated with trade disruptions, and to improve allocative efficiency. By mid-1992 most price controls had been dismantled. The most significant recent steps have entailed increases in domestic energy prices--starting in the last quarter of 1991--that entailed the full pass-through of higher import prices to final consumers. For example, retail prices of gasoline and diesel have been increased on several occasions, most recently on May 30, 1992, and are currently about 70 times higher than a year ago. As a further step in the liberalization process, the Government decided on July 9 to remove the authority of municipalities to regulate the prices of state enterprises operating in their locality.

Currently, the Government has the right to regulate only prices charged by certain state owned enterprises deemed to be of special importance; no goods or services produced in the private sector are subject to controls. The regulations consist either of (i) a requirement to have the Government approve any proposed price change, or (ii) a requirement to notify in advance the Price Department or relevant Ministry of a price change. Items sold by state enterprises whose prices are set by the Government include liquid fuels, land, natural resources (including oil-shale), electricity, natural gas, central heating, standing timber and communications services. Notification to the Price Department is required for changes in the prices of bread and flour, macaroni, salt, sugar, alcoholic drinks (except beer), lubricants and tobacco products. The relevant ministries have to be notified regarding changes in bus fares, prices of medicines and returnable bottles. Finally, price regulations apply to a list of 28 companies whose market shares exceed 50 percent and which sell 21 items that are deemed to be of special importance (including various meats and meat products, building materials, textiles and matches). Local governments may regulate the prices of certain municipal services, products sold by municipally owned enterprises, and rents on dwellings owned by the state or local governments. The authorities stressed that the main reason for the remaining price controls is to prevent monopolistic enterprises from taking advantage of their market position.

The program includes further measures to reduce the degree of intervention by the Government in the process of price formation where such control was determined to be of marginal benefit. These include specific commitments to remove a number of items from price control (bread, flour, grains, sugar, macaroni and bottles) by October 15. In addition, the shift of energy prices to world market levels is expected to continue this fall with further increases in the prices of natural gas and fuel oil. Moreover, the authorities plan to initiate shortly a study of tariff-setting procedures for services provided by municipalities and public sector companies in order to extend the application of cost based pricing principles.

The authorities realize that although existing price controls are not accompanied by explicit subsidies from the state budget, they still involve rigidities that can be detrimental to an efficient allocation of resources. They view the removal of the remaining regulations as part of the overall process of structural transformation of the Estonian economy. As state enterprises are privatized and the degree of competition increases, the rationale for the current price regulations will gradually disappear. Accordingly, significant progress in completing the price liberalization process is expected in 1993.

CHART 4
ESTONIA
KEY PROGRAM INDICATORS



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

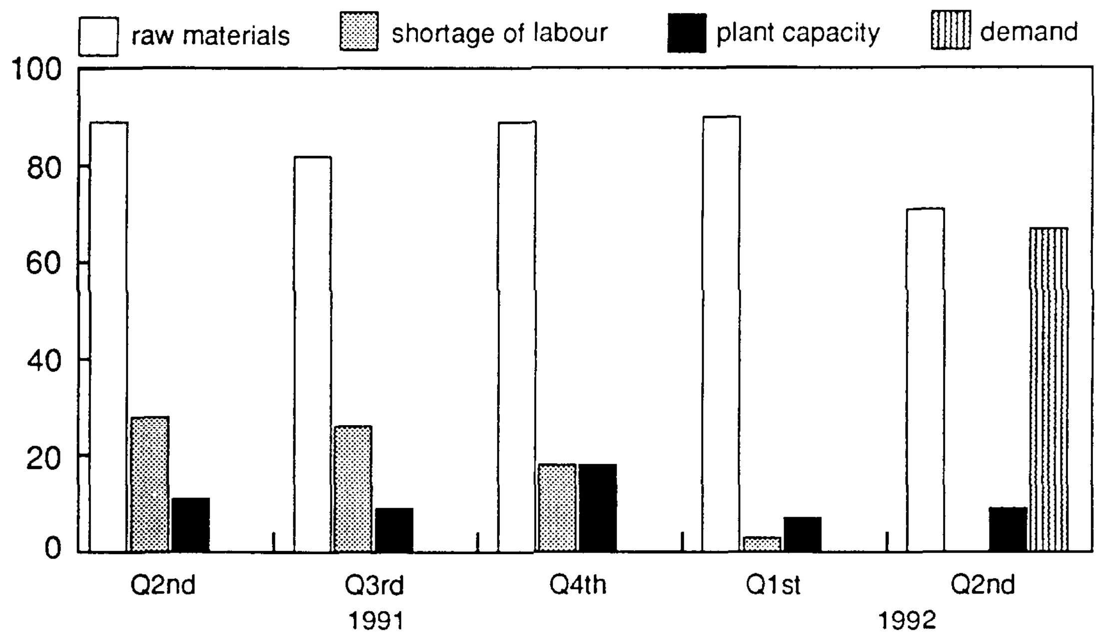
CHART 5

ESTONIA

PRODUCTION CONSTRAINTS

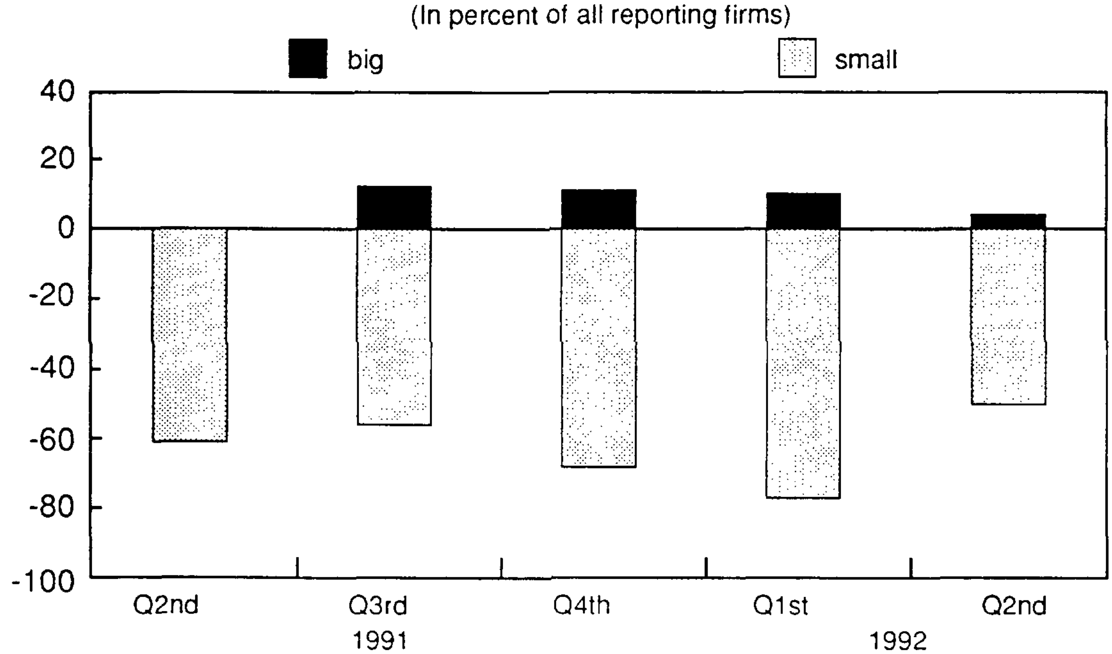
Primary Production Bottlenecks

(In percent of all reporting firms)



Stock of Raw Materials and Semimanufactured Products

(In percent of all reporting firms)



Source: Konjunktuur, No.2, Estonian Institute for Market Research, June 1992.

The deceleration in the rate of inflation is expected to continue in the second half of 1992. The financial discipline imposed by the currency board regime will support the nominal anchor provided by the peg of the kroon to the deutsche mark, which will help to ensure that prices of traded goods will rise at moderate rates. However, since a number of specific price increases are expected to take place later in the year, some further cost push inflation can be expected in the period ahead. These increases include the aforementioned increases in energy prices, and the large increases expected in October in the prices of central heating, bread and flour (following the removal of controls). Reflecting these developments, the prices of services and selected nontraded goods are expected to rise quite rapidly during the first half of the program period. Meanwhile, inflationary expectations seem to be set at relatively high levels, and may have been validated by the jump in prices following the currency reform. On balance, however, it is expected that with the implementation of the stabilization program, overall inflation will continue to decelerate, reaching a monthly rate of less than 2 percent by the end of the year and 1/2 percent by mid-1993.

3. Monetary policy and currency reform

On June 20, 1992, Estonia introduced its new currency, the kroon, and replaced the ruble as legal tender on its territory. The kroon was backed by gold and foreign exchange and operated according to the principles of a currency board (Table 3). According to these arrangements, kroon bank notes and reserve deposits of banks are fully backed and convertible into deutsche mark at a fixed rate of exchange. Initially, and if full cover for the liabilities of the Savings Bank are also taken into account, the currency board was 90 percent capitalized during the first days after the reform. However, the return of further pre-war gold to Estonia by Sweden permitted full capitalization of the currency board operation by mid-July, including a comfortable margin of excess reserves to meet unforeseen demands. Meanwhile, the assets of the currency board also increased because of a steady demand for kroon notes which have been exchanged for deutsche mark in the prescribed way.

The conversion of existing rubles into kroon proceeded smoothly. Individuals were permitted to convert cash rubles amounting up to rub 1,500 into kroon at the standard exchange rate of 10 rubles per kroon. 1/ 2/ Amounts above this threshold were convertible at a punitive rate of 50 rubles per kroon, reflecting concerns about their legitimate origins. Enterprises and banks were required to surrender cash rubles to the Bank of

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1/ This amount represented the equivalent of less than two weeks salary, on average.

2/ The Bank of Estonia collected cash rubles amounting to rub 2.3 billion from individuals, enterprises and banks during the course of the reform. The return of these cash rubles to the CBR is being coordinated with the settlement of the correspondent accounts with Russia.

Estonia, and amounts up to legal limits were converted at the standard rate. All ruble bank accounts and bank loans were redenominated at the standard rate. 1/

Under the terms of the currency reform, the Bank of Estonia will not interfere with the setting of interest rates by the commercial banks, since this will be the principal mechanism by which the currency board arrangement will equilibrate the demand and supply of foreign exchange and the demand for cash. The Bank of Estonia will not lend to the Government or enterprises, or even to banks, except in the event of a general banking crisis or in the context of restructuring an individual bank. In the event that such lending takes places, it will involve only the excess external reserves of the Bank of Estonia (i.e., balances surplus to the currency board's requirements), and therefore will not be allowed to undermine the commitment to the full backing of the currency board. The proper operation of the currency board should thereby ensure that the note issue, coins and reserve deposits of banks with the Bank of Estonia are always fully, or more than fully, backed by foreign exchange (which will consist primarily of deutsche mark).

The Bank of Estonia is itself to be subdivided into two departments in the immediate future to reflect its new responsibilities. The currency board is to be contained in the "Issue Department", which will be concerned only with ensuring the proper operation of the board and will retain external reserves equal in amount to the relevant liabilities. The "Banking Department" will hold those external reserves that are in excess of the requirements of the currency board. It will, if necessary, conduct emergency lending operations, but only to the extent made possible by its excess reserves. The Banking Department will also assume relevant liabilities with regard to the Fund and hold the reserves corresponding to Fund purchases. 2/

The commercial operations that had been inherited from Vneshekonombank were earlier hived off into the Northern Estonia Bank (NEB), a commercial bank fully owned by the Bank of Estonia. The NEB is to be privatized in due course. 3/

1/ Special arrangements were made for correspondent accounts with the states of the FSU as described in section III 6(c).

2/ The Banking Department would also manage correspondent accounts with the states of the FSU (which are currently not very active). To preserve the integrity of the Bank of Estonia's balance sheet, the staff has suggested that these operations be transferred to a commercial bank(s), and this issue is to be reviewed in due course.

3/ The Bank of Estonia also owns the majority share (60 percent) in the Estonian Investment Bank (the balance is owned by the EBRD). This institution is currently responsible, inter alia, for processing FIM 50 million in official Finnish trade credits.

The banking system itself is to be strengthened by a number of reforms, covering both structural aspects and reporting standards (as set out in the MEP). Strict regulations apply in ensuring compliance with reserve requirements of banks, under which increasingly severe penalties apply to banks that fail to observe their legal requirements, and broad adherence to these requirements for the banking system as a whole is a performance criterion (as set out in Appendix II of the MEP). These reserve requirements currently stand at 10 percent of eligible kroon bank liabilities.

The Savings Bank, however, presents special problems, since all its assets represented a claim on the former Gosbank (USSR) and there is little likelihood that any of these assets will be recovered. Since this bank held virtually all personal savings, the Government and the Bank of Estonia decided to guarantee the encashability of all savings deposits (amounting to about EEK 230 million at the time of the reform). Fears that large scale withdrawals from the Savings Bank would occur during the first days of the reform failed to materialize. However, the contingent liability that this guarantee entailed was not formally reflected in the accounts of either institution, although the currency board has implicitly taken this commitment into account. The Bank of Estonia plans to formally recapitalize the Savings Bank by writing into the accounts of the Savings Bank the necessary amount as a claim on the Bank of Estonia. At the same time, and pending a final decision regarding its future, the Savings Bank will be subject to 100 percent reserve requirement on all current and savings accounts, which currently represent 99 percent of its liabilities.

Immediately following the reform many enterprises took the opportunity of the ready convertibility of account kroons into cash kroons--in contrast to the ruble era--to improve their own liquidity (wages are traditionally paid in cash). As a result, the positions of many commercial banks were strained as they could not liquidate their asset positions, which included, in some cases, nonperforming loans to ailing enterprises and collective farms. Reflecting this development, as well as inflationary expectations heavily influenced by recent price movements, interest rates in the banking system remained high (20-40 percent per annum for deposits and 80-100 percent for loans). Liquidity management among banks was also hindered by the absence of an interbank market, which prevented banks with surplus liquidity from assisting banks in temporary shortage.

Under Estonia's currency board arrangement, monetary conditions will be determined primarily by developments in Estonia's external accounts, i.e., a surplus (or deficit) in the overall balance of payments would increase (or decrease) the supply of high powered money. The staff's balance of payments projection, in the absence of any emergency lending to banks by the Bank of Estonia, would be consistent with broadly unchanged net cover for the currency board from the fourth quarter of 1992 to the end of the program period. Apart from such lending, growth in base money during the program period could also occur through autonomous capital inflows that may result from interest rate differentials in favor of Estonian assets, or if residents continue to draw upon foreign currency deposits held abroad for conversion into kroons. 1/ The balance of payments projection does not assume such inflows although, if confidence in the kroon remains strong, they may well occur. Finally, tight monetary conditions will give rise to higher interest rates in Estonia, which is likely to result in a decline in the demand for cash balances and a corresponding increase in the money multiplier, thus allowing the same stock of high-powered money to be consistent with a higher stock of broad money (thereby reducing somewhat the reliance on external flows to support increases in broad money).

4. Fiscal policy and social safety net

a. Fiscal policy

The overall general government budget was in surplus in 1991, and is projected to remain so in 1992, reflecting the elimination of most direct budget subsidies to households in May and the introduction of a substantial revenue package in June (Table 4). As already noted, measures already taken are expected to be sufficient to ensure a surplus in the general government budget in the second half of 1992 equivalent to about 1 percent of GDP.

Fiscal policy under the program will shift away from the passive role played during the pre-independence period and will instead focus on the budget as an instrument to help bring about macroeconomic stabilization and structural reform. The chief indicator for monitoring the fiscal policy stance will be a consolidated general government budget drawn up to cover the operations of the state budget, 21 local government budgets and all extrabudgetary funds (after netting out intergovernmental transfers).

The process of preparing the budget for 1993 is well under way and a budget proposal is expected to be presented by the Government to the new Parliament in October. The Estonian authorities have expressed their continuing commitment to a balanced general government budget. To that end, they accept that over the medium term the revenue system should be made more responsive to economic growth, primarily through the elimination of provisions in the tax structure that undermine the revenue base (mainly selected tax exemptions), and significant improvements in tax administration. At the same time, the authorities expect to be able to contain expenditure growth through tighter control of the wage bill, elimination of the remaining explicit subsidies, 2/ and reduction of

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1/ In due course, the Bank of Estonia is also considering restructuring the Savings Bank. This will entail a phased reduction in its reserve requirement (now 100 percent) at the currency board, thereby providing additional high powered money to the banking system.

2/ Explicit subsidy payments are currently being retained only for public transportation.

implicit subsidies in the social sphere through the adoption of cost-sharing arrangements. They also expect to initiate a reform of the civil service and of intergovernmental fiscal relations.

b. Social safety net

As regards the social safety net, there are currently four main social security programs covering pensions, medical expenses, family and unemployment benefits (all funded through Social Security and Medical Insurance extrabudgetary funds). Pensions and family benefits are tied to the monthly minimum wage, in the former case on a flat-rate basis and in the latter as a predetermined multiple of the minimum wage. 1/ As part of the program, the Estonian Government has undertaken to review by end-1992 the entire social security system, consistent with budgetary constraints, with a view to (i) evaluating the groups eligible for state assistance to ensure adequate benefits are provided to the most vulnerable groups; (ii) rationalizing the pension system, including raising the retirement age in early 1993; and (iii) designing a system for retraining displaced workers, including providing the necessary financing for this effort.

5. Incomes policy

The Government has introduced an incomes policy in order to prevent recent price shocks from spilling over into wage inflation. Although these price shocks for the most part represented discrete increases due to further price liberalization, the risk exists that any wage catch-up could lead to a wage inflation and a squeeze on enterprise profitability. With the implementation of a prudent incomes policy, this risk can be substantially eliminated. Price instability can also be fueled by stubbornly high inflation expectations which may have developed during the price liberalization process and the pass-through of prices due to the sharp terms-of-trade change. Therefore, an important task of the incomes policy would be to dampen these expectations.

During 1991, wages rose broadly in line with prices. However, after the terms-of-trade shock in the early 1992, when inflation accelerated rapidly, wages largely failed to keep up, falling in real terms by 52 percent in the first quarter (Chart 6). In the second quarter, some catch-up took place, but by end-June 1992 the level of real wages was still 45 percent below the end-1991 level.

The incomes policy that will be implemented by the Estonian authorities will cover the general government and the state enterprise sector. The private sector is excluded so as to provide incentives for labor mobility from the large state sector where productivity is low. Under this policy average wages will be permitted to rise by 26 1/2 percent from

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1/ In 1992, the monthly minimum wage was adjusted upward in January to EEK 41, in February to EEK 60, in March to EEK 100 and in July to EEK 200.

August to December 1992 in two installments--by 12 percent in September, and by 13 percent in November, and will imply--if the actual prices rise in line with expectations--that the average real wage will remain at its July 1992 level. The incomes policy will be enforced at the state enterprise level by the imposition of a punitive tax on wage increases in excess of the announced guideline. The workings of this policy will be first reviewed in November. If at that time the actual increase in the consumer price index is substantially different from the expected increase, any such deviation will be taken into account in setting the wage guideline in subsequent periods. In this review, particular attention will be paid to the factors underlying the deviation of actual from expected inflation. Given that wages are linked to consumer prices--not to producer prices--any further changes in the terms-of-trade would also be taken into account. Finally, productivity developments would also be considered when adjusting wage guidelines so as to help maintain the profitability of the enterprise sector.

The implementation of this incomes policy provides for no further growth of real wages for the remainder of 1992, and thus would imply a decline in real wages in the order of 45 percent in 1992 (year-on-year). According to staff calculations, this decline would exceed the loss of Estonia's real income caused by the terms-of-trade shock and a one-time downward shift in productivity resulting from the new relative price structure. Hence, provided that real wages can be held at these levels, the adjustment to the terms-of-trade shock would have been essentially completed.

The announced incomes policy implies a targeted rate of inflation higher than consistent with the exchange rate peg in the longer run, and the authorities recognize the risks associated with this approach. As a result, the real appreciation of the kroon against the deutsche mark would be in the order of 30-40 percent during the program period (depending on productivity developments). However, given the undervaluation of the kroon at the outset--as illustrated by an average monthly wage equivalent to about US$40 at end-June 1992--this appreciation is not likely to undermine significantly the credibility of the kroon or the cost competitiveness of the tradable goods sector. Moreover, the inflation path built into incomes policy includes some exceptional price increases (the increases in the prices of bread, heating and natural gas) implying that the underlying inflation rate in the second half of 1992 is lower than the rate actually projected.

6. External sector policies

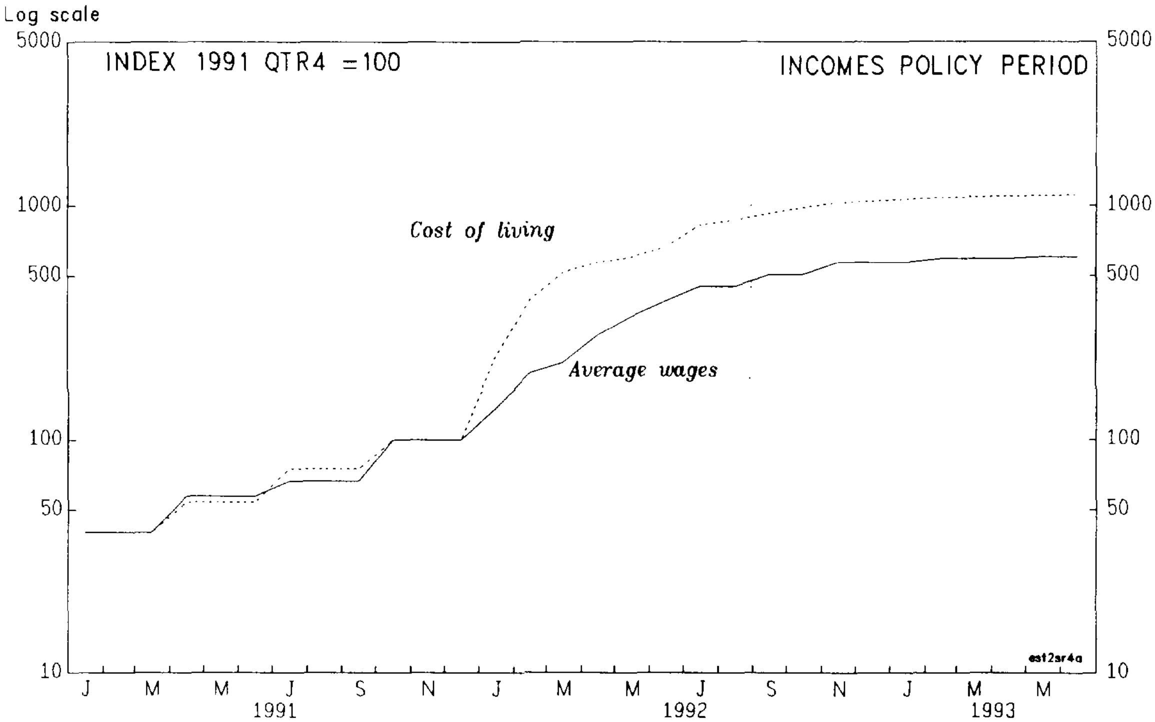
a. Balance of payments in 1992-93

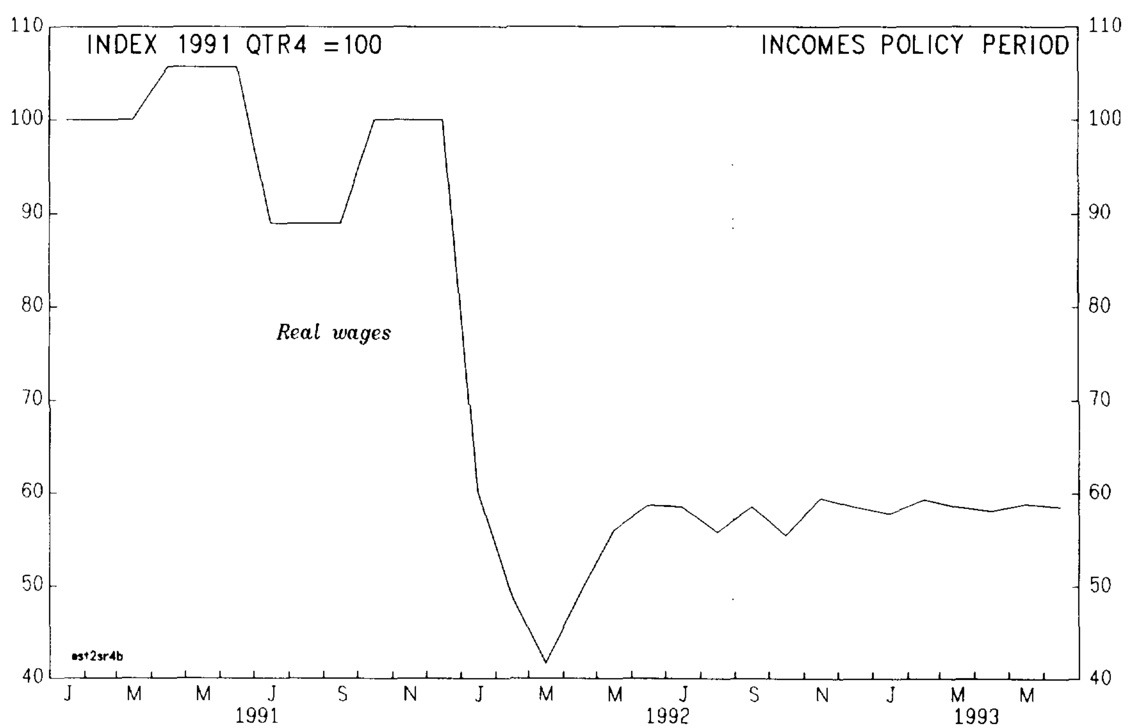
Trade with the FSU, and particularly Russia, largely collapsed over the winter months of 1991 to 1992. In an effort to restore trade relations, Estonia signed a number of agreements with the states of the FSU, the most important and substantive of which was the agreement with Russia, signed in general terms in December 1991 and set out in detail in February 1992. This

CHART 6

ESTONIA

AVERAGE WAGES AND COST OF LIVING 1/





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

1/ Monthly figures for 1991 represent quarterly averages.

agreement was intended from the Estonian side to secure a resumption of fuel imports, albeit at world market prices as opposed to the artificially low prices that had prevailed before, but as noted above, trade under this agreement has fallen well short of expectations. Trade with industrial countries, on the other hand, has fared comparatively well, although it still represents a relatively small share of overall foreign trade.

After a sharp recovery observed in the second quarter from the very low levels of the first quarter, nonfuel trade with the FSU is expected to grow more modestly, especially following the introduction of the kroon which appears to have added to the confusion concerning payments arrangements. In 1992 as a whole, non-energy export and import volumes are both expected to fall by about 37 percent. Exports to industrial countries are expected to show a small increase by the end of the year. Imports from industrial countries, which should recover in the fourth quarter following the availability of finance, will still have fallen some 24 percent over the year as a whole.

Imports of fuel are expected to pick up sharply in the second half of the year, assuming the availability of finance, as the winter months approach. Reflecting the depressed levels of imports and consumption in the first half of the year, overall fuel imports in 1992 will now fall short of what had been originally agreed with Russia. Insofar as trade with Russia continues to be disrupted, Estonia will be expected to turn to markets elsewhere to make up the shortfall. Fuel imports during the program period are nonetheless in line with what has been estimated by the Estonian authorities to be necessary for an orderly resumption of activity in the economy.

Mainly reflecting carry-over effects from the recovery of trade from the virtual halt recorded in the first quarter of 1992, trade volumes with the FSU in 1993 are expected to show significant growth relative to 1992, though they will remain well below historical levels. Trade with industrialized countries, on the other hand, will be above pre-independence levels, although the trade balance will remain in deficit. Estonia's overall current account position nonetheless will improve to some extent reflecting higher service sector receipts from tourism, shipping and port services. The current account deficit in the program year 1992 to 1993 is projected at US$213 million (Table 5).

Most of Estonia's gross reserve build up, apart from that financed from Fund purchases, has already been accomplished by virtue of the return of pre-war gold by the Bank of England, the BIS and Sweden. Some additional growth may occur through continued cash issuance by the currency board, but the projection of gross reserve levels of US$139 million by end-1992 does not rely upon this (beyond what has already occurred). At this level, reserves, including those of the currency board, will represent about 2 months of imports. After allowance is made for other private sector flows, 1/ other identified financing including official export credits, 2/ World Bank lending (US$30 million) and EBRD lending (US$46 million), it is envisaged that the residual financing gap of about US$100 million is to be filled from expected G-24 commitments. To help secure this financing, discussions with G-24 countries have taken place in Brussels on July 10 and July 29, 1992.

Discussions with Russia on the external debt of the FSU will resume in November 1992. By Estonia's calculations, their share of the debt is fully offset by property claims on Russia and claims on the FSU's external assets, and for this reason associated servicing has not been taken into account in the balance of payments projections for the program period. 3/ The expectation is that negotiations with Russia will conclude with a general cancellation of claims and counter-claims, and with no subsequent transfer of assets or liabilities.

b. Trade system

Estonia maintains relatively liberal trade arrangements. Except on a small list of items such as alcohol, motor vehicles and tobacco, there are no import tariffs or licensing requirements. This applies equally to trade with both industrial countries and the FSU. The list of goods subject to export licensing was shortened considerably in February 1992 and again on June 29. The quotas that remain--on alcohol, tobacco, grain, cable, peat, shale, clay, limestone, dolomite and hide--will be removed by January 1, 1993, unless the government deems such licensing is necessary for reasons of security or health. Quotas on exports of ferrous and non-ferrous metals

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1/ Direct investment includes a payment for a joint venture in the Tallinn cement works, involving a payment of US$10 million in the third quarter.

2/ This includes US$6 million preferential credits for US grain, under the "Food for Peace" program and the equivalent of US$10 million (FIM 50 million) in Finnish capital equipment trade credits. It does not include C$10 million in Canadian trade credit signed but until recently held up pending resolution of the question concerning Estonia's share of the external debt of the former Soviet Union. This credit has now been released by Canada following recognition that there is no necessary obligation on the part of Estonia to service this debt.

3/ If Estonia accepted responsibility for the share it has been assigned in the debt of the FSU (0.61 percent), it would add about US$20 million to its annual financing gap in interest servicing alone. Estonia was not, however, a signatory to the Memorandum of Understanding on external debt of October 28, 1991.

were also removed, and substituted instead with export taxes ranging from 5 to 25 percent. 1/ Also subject to export taxes are rapeseed oil and artwork.

Trade agreements have been signed with a number of FSU countries, the most important of which was with Russia (see above). Only the latter agreement envisages trade occurring between government bodies and specifies prices. The other agreements chiefly list goods that each party hopes can be traded by enterprises in the respective republics. 2/ In the present rather chaotic trading environment, they appear to have little relevance.

Of greater importance are agreements that have been negotiated, but not yet signed, on the basis of which trade with Russia, Belarus and the Central Asian republics stipulating that the re-export (re-import) of imported (exported) semi-manufactured goods and raw materials will be free from the export and import taxes of the respective states. Free trade agreements have been signed with Finland, Sweden and Norway, and a non-preferential trade agreement was signed with the EC in May. The details of these agreements remain to be worked out, but in general agricultural products are not included.

c. Payments with the FSU

Trade with Russia and the other republics of the ruble area, especially since early 1992, has also been handicapped by a payments system that has been plagued by frequent changes, inefficient clearing and poorly defined settlement arrangements.

Prior to January 1, 1992, all payments cleared through the centralized Gosbank system, although each republican Gosbank branch maintained numerous correspondent accounts with other republican and regional Gosbank branches. This system, although cumbersome and dependent mainly upon a relatively slow postal system, appeared to function with an acceptable degree of efficiency. From January 1, 1992, the Central Bank of Russia (CBR) channelled all ruble transfers in the ruble area through 81 payments centers; to reinforce the centralization of all payments, nonresident commercial banks were forbidden to have correspondent relations with Russian commercial banks. Under these arrangements, payments balances of each republic vis-a-vis all other republics were maintained separately and credit balances on one account could not in principle be used to settle a debit balance in another account. Difficulties in clearing immediately materialized due to the inability of the CBR to process the vast increase in the volume of payments documents; payments delays commonly stretched up to

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1/ These have been imposed to discourage recent thefts of metal (e.g., railway sleeper, cables, etc.) which is then exported in the form of scrap.

2/ As of July 27, 1992, such trade agreements had been signed with Azerbaijan, Georgia, Kazakhstan, Kyrghyzstan, Lithuania, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

several months and frequent complaints were made that payments documents had disappeared completely. As a result, many enterprises reverted to using cash (thereby exacerbating the cash shortage), barter, or devising elaborate schemes to circumvent the interrepublican clearing hurdle.

Early in 1992, and looking forward to the currency reform, the Bank of Estonia initiated discussions with Russia and other republics regarding the payments mechanism to be implemented after the introduction of the kroon. Negotiations with Russia were concluded only on June 20 (the same day that the kroon was introduced) and provided for closing the ruble correspondent accounts as of June 20, and opening new correspondent accounts at the Bank of Estonia and the CBR, which would henceforth become the principal clearing vehicle for all interstate payments, including the financing of the former Soviet army on Estonian territory. Maximum technical credits amounting to rub 500 million for the Bank of Estonia and EEK 50 million for the CBR were agreed; the expectation was that balances would be cleared periodically using convertible currencies. Initially, only half these amounts (i.e., rub 250 million and EEK 25 million) were actually paid into the accounts, with the payment of the remaining balance to be determined later. It was also agreed that the remaining balances in the ruble correspondent accounts would be settled in due course. 1/ Agreement was also reached on the operation of a correspondent account with the Ukraine, but negotiations with all other republics largely stalled, in some cases (especially Latvia and Lithuania) because of their preoccupation with introducing their own currencies.

During the first few weeks after the currency reform, it appears that these correspondent accounts have been largely ignored, partly due to difficulties in establishing a basis for converting rubles into kroon and vice versa because of restrictions placed by the CBR at the time of the reform whereby rubles were to cease circulating as a medium of exchange on the territory of Estonia. These problems have contributed to a further decline in interrepublican trade in July. The view of Estonian authorities is that payments arrangements would benefit from greater liberalization and decentralization, and to that end, they have discussed with the CBR allowing commercial banks to open correspondent accounts in Russia and other republics (which apparently are not permitted under CBR regulations) and investigating the possibility of starting ruble/kroon auctions in Tallinn. Meanwhile, trading in account rubles has resumed at the Tallinn Stock

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1/ During the period January 1-June 20, 1992, Estonia accumulated an overall debit balance of rub 2.5 billion in these accounts; the largest positions were vis-a-vis Russia (rub 4 billion-debit), Ukraine (rub 3.7 billion-credit) and Belarus (rub 1.1 billion-debit). For the two year period 1990-1991, Estonia had a cumulative credit balance in its correspondent account with Gosbank (USSR) of rub 2.3 billion (balances prior to 1992 were not disaggregated by republic).

Exchange, whereby rubles are traded for U.S. dollars by banks, and thereby indirectly by exporters and importers in connection with trade with the ruble area.

d. Exchange system

As noted above, the convertibility of the kroon is guaranteed by the Bank of Estonia, in the sense that, for valid current account transactions, the Bank of Estonia will exchange kroon bank notes and reserve deposits of banks with the Bank of Estonia into deutsche mark and vice versa in unlimited quantities and at the exchange rate of EEK 8 per DM. This convertibility was made possible by the substantial endowment of the Bank of Estonia by virtue of the return, at various stages, of significant quantities of gold from the Bank of England, the BIS and the Swedish government. Conversions of kroon into other currencies, and vice versa, is left to the commercial banks, which are free to set their own rates provided these rates (including commission) do not diverge by more than plus or minus three percent from the central rates published by the Bank of Estonia based on the cross rates provided by the Bundesbank on the previous day.

Capital account transactions are subject to approval by the Bank of Estonia, except for repatriation of capital by overseas investors. In practice, the strength of the kroon has allowed the Estonian authorities to take a relaxed line with regard to the provision of documentary proof of import or travel requirements. The banks themselves are subject to prudential controls that limit their open positions in foreign exchange.

Foreign currency accounts of resident individuals and enterprises with domestic banks were permitted to be retained after the currency reform, but balances therein could not be augmented. Anticipation of this measure led to significant additions to these accounts just prior to the reform, mostly from accounts abroad. In July an additional decree permitted enterprises to re-open accounts abroad to facilitate trade with the industrial countries and in recognition of the fact that many such accounts had not been closed as required. The existing legislation foresees the closure of domestic accounts at the end of the year, but the staff urged the authorities to extend or eliminate this deadline.

Enterprises have, since the day of reform, been subject to a 100 percent surrender requirement on all export proceeds. Sale of foreign exchange, at the market rate of exchange, to any authorized bank constitutes surrender. With regard to overseas accounts, they have two months in which to effect the surrender, but for domestic accounts the deadline is only two days. Enterprises have complained that this latter deadline is too short and that banks have converted foreign exchange into kroon immediately upon receipt in enterprise accounts, at rates that have not been very competitive, in the sense that maximum use was made of the permissible deviation from the official rates. The Bank of Estonia, upon the advice of the staff, is currently reviewing this provision with the aim of extending the surrender deadline applying to foreign currency deposited with domestic banks.

7. Structural reforms and the transition to a market economy

The Estonian government recognizes that structural and systemic reforms are essential complements to macroeconomic stabilization. Passage of the 1989 Law on Enterprises facilitated the establishment of new enterprises while substantial progress in privatizing smaller enterprises was made following the passage of the 1991 Law on Privatization of State-Owned Trade and Service Facilities; by mid-1992, about one half of eligible establishments had been privatized. Furthermore, seven larger enterprises have also been privatized to gain experience in the process, but each of these required special Parliamentary approval. Nevertheless, progress in privatization has substantially slowed since late 1991 owing mainly to disputes between Government and Parliament regarding the privatization mechanisms and the resolution of restitution issues. Up until the currency reform, there was also resistance in Parliament to allowing the sale of state property against rubles.

In order to accelerate the privatization process, the Government is about to undertake major initiatives across a broad front. 1/ The principal vehicle will be the formation of the Estonian Privatization Office (EPO) modeled on the German Treuhand, which will benefit from substantial technical assistance from Germany, and has as its main objective the completion of the privatization process within a period of two years. 2/ 3/ Unlike the earlier practice of favoring manager-worker buy-outs, the EPO will give preference to buyers that undertake to invest new capital and provide for the maintenance or expansion of employment levels. In support of this effort, a bill will be considered by Parliament shortly to permit the privatization of 260 medium and large enterprises. Parliament has also passed legislation that would permit the privatization of virtually all residential housing, mainly through the issuance of housing

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1/ In accelerating this process, the Government has recently also been motivated by the recognition that the appeal and value of state property is rapidly diminishing, partly due to the difficult economic situation, but also because needed repairs to both residential housing and enterprises is being neglected and because in a number of cases, state enterprises are being deliberately decapitalized by managers and workers.

2/ This will involve the privatization of 3,500-4,500 smaller enterprises and 300 large companies.

3/ Financing needed to prepare enterprises for sale is expected to come from abroad and to be repaid from privatization proceeds. No net impact on the general government budget is foreseen from these operations.

vouchers (with no initial monetary value) to all residents based on a formula of 1 square meter per year of employment in Estonia. The first residential units are expected to pass to their new owners by October 1992.

All land is still owned by the State and the Estonian Government has made a commitment to restitute or compensate owners in Estonia prior to 1940 (including their descendants). Although the filing of restitution claims by residents was completed on January 17, 1992, nonresidents are in principle not subject to any deadlines for filing claims. However, to allow clear title to pass in the privatization effort, the Government intends to establish December 31, 1992 as the cut-off date by which restitution claims will be settled by transfer of real property; thereafter, valid claims will be honored only with compensation vouchers (which will have a monetary value). Such compensation vouchers, which will also be distributed to former owners whose property cannot be restituted due to a material change in its subsequent use, can be used in the privatization process or for the purchase of housing. The authorities are still debating whether these vouchers can be sold or traded.

The Government has made a relatively slow start in creating a legal framework compatible with a market economy. Bankruptcy legislation was passed in June 1992, and will take effect on September 1, 1992. The underlying philosophy is to preserve the interests of creditors through the forced sale of assets. Competition legislation, as well as mortgage and contract laws have largely been drafted and will be ready for review by Parliament in October-November 1992. At the same time, the Government has undertaken to begin the process of de-monopolization by breaking up and restructuring the ten largest state-owned monopolies by November 30, 1992. Finally, one of the main obstacles to the efficient operation of enterprises, including the evaluation of credit risk by banks and valuation for the purposes of privatization, has been the absence of a meaningful accounting framework. Accordingly, the Government is preparing a new accounting law establishing EC-based accounting standards, which will be adopted no later than December 31, 1992.

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

Taking into account the liberal trading regime that has been in place since the beginning of the year, the introduction of the kroon and the strong fiscal stance, the structural reforms to be undertaken over the course of the program year 1992 to 93 should lead to a sustained and continuous improvement in the performance of the Estonia economy, especially as no further major changes in the terms of trade are foreseen through 1997. The traded goods sector starts with the advantage of a very competitive cost structure. Accordingly, a rapid recovery in exports is projected for 1993 (mainly reflecting carry-over effects from late 1992). Thereafter, the growth of both exports and imports is projected to stabilize at a level consistent with a projected rate of growth of real GDP over of the medium-term of about 5 percent per annum.

As production recovers in 1993, the volume of exports to industrial countries is expected to grow strongly (22 percent), but then slow down to 16 percent per annum thereafter. By 1997, this projection is consistent with merchandise exports to industrial countries reaching nearly 30 percent of the total, as compared to only about 5 percent during the 1980s. Imports from the industrial countries, after rising strongly during the 1992 to 1993 program--mainly reflecting investment and the restocking of raw materials--are expected to slow significantly in 1994, before resuming a growth of 10 percent per annum during 1995 to 1997. Trade with the FSU is projected to stagnate after mid-1993, remaining flat in volume terms, as Estonian trade is reoriented to the rest of the world and as imports of fuel decline reflecting expected improvements in the energy efficiency of the economy. 1/

Under this scenario (Table 6), gross reserves are projected to rise to US$139 million by end-1992--equivalent to about 2 months of imports in the final quarter--and to US$165 million by the end of 1993--about 2 1/2 months of 1993 imports. 2/ Reserves are projected to increase strongly thereafter, rising to the equivalent to 3 months of imports over the period 1993 to 1997. Meanwhile, the financing gap is expected to peak over the winter months of 1992 to 1993, when Estonia will need to restock its fuel reserves from the almost nonexistent levels of the summer months, and to decline steadily thereafter. 3/ Although there will be a need for further G-24 financing in 1993 to 1994, it would appear that in later years financing requirements could be closed with a combination of continued World Bank lending and other private sector flows. External debt should reach a level of about 22 percent of nominal GDP by the end of 1997, with debt service representing about 6.4 percent of total exports of goods.

These projections are of course extremely tentative, given the greater than usual uncertainties regarding the general trading environment, the effects of the reforms and the impact of changes in energy prices. Every 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 would worsen the financing gap by about US$15 million per annum. The low starting level of debt, on the other hand, implies that the current account is not materially affected by changes in interest rates.

This scenario is, of course, predicated upon the continuation of the policies initiated under the stand-by arrangement, with particular reference to the strong fiscal stance and the rigorous implementation of the currency

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1/ In 1990, Estonia's per capita energy consumption was some ten times that of neighboring Finland. The EBRD has promised US$46 million in credits for improving the efficiency of the energy industry and other energy related projects.

2/ Total imports, i.e., imports from the FSU and all other countries.

3/ It is assumed that unidentified gap financing will be provided on terms incorporating a grace period in excess of six years.

board. Any material weakening of these policies over time would put at risk Estonia's capacity to service its Fund obligations in a timely fashion (Table 7). Notwithstanding these caveats, the projection suggests that there can be a reasonable expectation that Estonia should be able to repay the Fund as scheduled.

V. Prior Actions and Performance Criteria

The economic program includes a number of prior actions in the areas of pricing policy, fiscal policy, monetary policy, incomes policy, external policy and economic management, all of which have already been implemented. In particular, the price liberalization process was largely completed prior to the currency reform. Moreover, average prices for heating, natural gas, oil shale, and electricity were adjusted to reflect full operating costs and the Government has removed the authority of local authorities to regulate prices of state enterprises in their localities.

In the area of fiscal policy, important prior actions were measures to balance the budget for the second half of 1992. These measures, which were adopted in connection with the currency reform, included (i) a rise in the VAT from 10 to 18 percent; (ii) an increase in the effective corporate tax rate from 27 to 35 percent; and (iii) the introduction of a new top tax rate of 50 percent on personal incomes above EEK 2000 per month. On monetary policy, the commercial activities of the Bank of Estonia were separated from its central banking functions before the currency reform. To attain better control on inflation, the Government introduced a tax-based incomes policy effective July 1, 1992. On the external side, all foreign exchange holdings of the Government in the Bank of Estonia have been converted into domestic deposits with commercial banks and the foreign currency budget has been abolished. Finally, action to improve economic management has been taken with the appointment of an interministerial commission, including the Bank of Estonia and the Fund's resident representative, to monitor the implementation of the stabilization program.

The quantitative criteria for monitoring performance under the stand-by arrangement are: (i) quarterly ceilings on the net position of the general government with the banking system; (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; (iv) minimum targets for net international reserves, exclusive of currency board cover; (v) quarterly limits on new Governmental external debt with maturities of less than one year, except for normal import financing; 1/ and (vi) limits on cumulative net disbursements of new medium- and long-term external debt contracted or guaranteed by the public sector and the Bank of

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

Estonia (Table 8). Apart from the backing of the currency board and the ceilings on external debt with maturities exceeding one year, these criteria are first set for September 30 and December 31, 1992.

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 during the program period.

Three reviews with the Fund to assess the implementation of the economic program are provided for. Purchases after November 14, 1992 will be subject to the completion of the first review (Tables 9 and 10). Similarly, purchases after February 14, 1993 and purchases after May 14, 1993 will be subject to the second and third review, respectively. The reviews will examine the implementation of policies set out in the Economic Policy Memorandum. Quantitative performance criteria for March and June, 1993 will be established at the time of the second review.

VI. Staff Appraisal

The Estonian authorities have committed themselves to a broad-based economic reform program aimed at transforming Estonia into a fully-fledged market economy. They realize that the challenge for the economic strategy is enormous. At present the Estonian economy is in the midst of a severe contraction, not only because of the collapse of the command economy at home, but also because of the sharp contraction of trade with the FSU, and the need to adjust to a substantial worsening of the terms of trade resulting from the shift toward world market prices. The authorities are aware of the short-term costs that the population will have to bear, but they regard these short-term sacrifices as unavoidable for future welfare gains. They hope that external assistance will be forthcoming expeditiously as it will play a crucial role in smoothing the adjustment path, thereby making the program of stabilization and structural reform politically and economically sustainable.

The Estonian authorities had made an early start with price liberalization, and significant further progress has been made this year. Moreover, even those prices which remain under state control, such as energy, have been adjusted for increases in costs, thus passing higher import prices on to consumers. The staff stresses the importance of continuing this policy so as to facilitate the rationalization of energy consumption and avoiding any subsidies that could endanger the budget. The staff also encourages the Government to further reduce intervention in the process of price formation and strongly supports the Government's intention of freeing prices of a number of items, including bread, later this year.

Now that most of the boost to prices stemming from liberalization has taken place, the task confronting the authorities is to bring inflation under control. The financial discipline imposed by the currency board, with the link of the kroon to the deutsche mark, underpinned with a strong fiscal policy, and supported by a tax-based incomes policy, should help bring inflation down sharply once the specific price increases expected this fall are out of the way. The staff stresses the importance of reducing the annual inflation rate to single digits to maintaining confidence in the kroon, establishing a stable macroeconomic framework, and smoothing the transition toward a market economy.

Monetary policy is strictly circumscribed by the operation of the currency board, with the issue of kroon notes, coins and bank reserves limited to changes in foreign reserves held by the board. There will be no credit by the Bank of Estonia to Government, enterprises, or commercial banks, except, in the latter case, in the event of emergency situations and in limited amounts (and under no circumstances involving the resources of the currency board). The authorities recognize the importance of not compromising this institutional framework as pressures on banks and industry intensify. Enterprises will need to adjust to the new environment as they can no longer rely on bail outs through bank credit.

The smooth functioning of the currency board will also require a strong fiscal policy. To this end the Government took substantial action, mainly on the tax side, at the time of the introduction of the kroon, to ensure that balance is maintained on the general government accounts in the second half of 1992. The staff strongly supports this action. It will be important to maintain a prudent fiscal stance in 1993, and the Estonian authorities have expressed their continuing commitment to a balanced general government budget. The authorities must also stand ready to take remedial measures in the event that shortfalls in tax revenues or a rapid increase in social safety net spending threaten their budgetary stance. The staff supports the intended shift in emphasis from discretionary tax changes toward structural reform of the fiscal system, including better targeting of social safety net expenditure.

The staff commends the Government's decision to support financial policies by an incomes policy, which should help prevent wage inflation and a squeeze on enterprise profitability that eventually could undermine confidence in the kroon. Moreover, although Estonia's competitive position at the time of the currency reform was underpinned by a highly undervalued kroon, there are limits to how much inflation can be tolerated before this competitive edge is eroded. The incomes policy should be broadly acceptable to the population as it would not result in any further reductions in real incomes--which had already fallen sharply--unless there is an unforeseen change in external circumstances.

Estonia maintains relatively liberal trade arrangements. There are virtually no import tariffs or licensing requirements, and the list of goods subject to export licensing was shortened considerably this year. In this connection, the staff welcomes the Government's intention to remove the remaining export quotas by the beginning of next year.

The kroon is fully convertible for valid current account transactions though most capital account transactions are subject to approval by the Bank of Estonia. In practice, provision of documentary proof of import or travel documentation has not been required, and the staff encourages the authorities to continue this practice. The staff also urges the authorities to liberalize the right of enterprises to maintain foreign currency deposits with Estonian commercial banks, so as to facilitate a smoothly functioning payments mechanism.

Problems associated with the clearing of interrepublican payments has been a major factor in undermining trade with the former Soviet republics. These problems have intensified following the currency reform, partly because of difficulties in establishing mechanisms for the efficient and timely exchange of rubles for kroons and vice-versa. The Estonian authorities have taken the view that payments arrangements would benefit from greater liberalization and decentralization, and the staff fully supports this approach. In time, the objective should be that payments in rubles be handled in the same fashion as payments in any other foreign currency.

The process of privatization has largely stalled in Estonia since the beginning of 1992, owing mainly to the debate over privatization procedures and the resolution of restitution issues. However, the Government recognizes the central role played by structural reforms in effecting a rapid transition to a market economy and providing a basis for sustainable economic growth. Accordingly, it will shortly undertake a major initiative in Parliament to accelerate privatization; it is hoped that the process can be largely completed within a two year period. The staff supports this effort and would encourage the authorities to also move rapidly in the area of enterprise and bank restructuring, completion of the restitution process, and establishing a legal framework consistent with a market economy.

Although projections of the external current account are highly uncertain, it is clear that it would be in substantial deficit if the decline in output is to be limited (to about 15 percent over the program period). Thus, the staff predicts a current account deficit in the program year 1992 to 1993 of over US$200 million, despite the restrictive stance of monetary and fiscal policies, and the present strong competitive position of the kroon. After allowing for private capital flows, identified official export credits, World Bank and EBRD lending and after including the envisaged build-up of reserves, mainly financed from Fund purchases, the residual financing gap of about US$100 million is expected to be filled from G-24 commitments. It is crucial that a substantial part of this financing becomes available early in the program period. In that connection, discussions with the EC and the G-24 are underway and the staff will report to the Executive Board on progress in securing the needed financing closer to the time of the Board meeting.

Although there will be a need for further G-24 financing in 1993 and 1994, it is expected that in later years the financing gap could be closed with a combination of continued World Bank and EBRD lending and private sector flows. The overall level of Estonia's external debt is expected to remain moderate and thus the capacity to service its debt adequate. It is therefore expected that Estonia will be able to repay the Fund as scheduled.

The Estonian authorities have designed a strong stabilization and reform program that merits international support. The staff believes that the policies set out in the Government's Memorandum of Economic Policies for the program year July 1, 1992 - June 30, 1993 represent a strong effort to transform the Estonian economy toward a market economy. Accordingly, the staff recommends approval of Estonia's request for a one-year stand-by arrangement in the amount of SDR 27.9 million (90 percent of quota) in support of their program.

VII. Proposed Decision

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

1. The Government of Estonia has requested a stand-by arrangement for a twelve month period in an amount equivalent to SDR 27.9 million.

2. The Fund approves the stand-by arrangement set forth in EBS/92/132 (Supplement 1).

Table 1. Estonia: Selected Economic Indicators

	1990	1991 1/	1992 2/	1993 2/	1992 Q1	1992 Q2	1992 Q3	1992 Q4	1993 Q1	1993 Q2
							Program			
					(Percentage Change Over Same Period In Previous Year)					
Output and employment										
Real GDP	−3.6	−12.6	−28	6	−29	−32	−29	−22	−8	3
Industrial Production	−5.6	−9.0	...	...	−34	−33	...	...	...	...
Total Employment	−2.0	−1.0	−10	...	...	...	...	...	...	...
Prices and costs										
Cost−of−living index	23.1	210.0	975	54	854	1029	1073	902	185	81
Average wage	24.5	98.3	516	61	356	486	660	492	248	93
Real wage	1.1	−36.0	−45	7	−52	−48	−35	−42	22	7
					(Percentage Change Over Previous Period)					
External sector										
Export volume, goods and services	...	−18	−27	42	...	...	...	...	...	...
Interrepublican, goods	...	...	−35	48	43	63	17	15	5	5
Third country, goods	...	...	4	22	16	12	22	4	3	3
Import volume, goods and services	...	−29.7	−28	19	...	...	...	...	...	...
Interrepublican, goods	...	...	−31	15	−53	127	44	45	40	3
Third country, goods	...	...	−24	23	−28	−11	−2	62	7	1
Current account deficit, (US$ millions)	...	546	−149 3/	−137	−22	−38	−39	−82	−51	−41
In percent of GDP	...	...	−19	−11	...	...	...	...	...	...
					(Percentage Change Over Same Period In Previous Year)					
Public finance										
Total revenue	10.6	136.2	538	...	...	...	...	...	...	...
Total expenditure	6.7	122.3	570	...	...	...	...	...	...	...
Balance, in percent of GDP	...	4.9	1	...	...	1.6 5/	...	0.9 5/	...	...
Financial market										
Domestic credit 4/	48.9	429.2	...	...	−13	54	...	...	...	...
Interest rates (loans, percent)	...	...	...	...	...	80−100	...	...	...	...
State banks	2−5	6−11	...	...	...	...	...	...	...	...
Private commercial banks				...	...	...	...	...	...	...
Short−term	...	20−30	...	...	...	...	...	...	...	...
Long−term	...	10−15	...	...	...	...	...	...	...	...
Interest rates (deposits, percent)	...	...	...	...	...	20−40	...	...	...	...
Refinancing rate	...	...	...	...	...	67 6/	...	...	...	...

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

1/ Preliminary estimates.
2/ Staff forecasts.
3/ Including official transfers.
4/ Compared to previous period.
5/ First and second half of 1992, respectively.
6/ June, 1992.

Table 2. Estonia: Monetary survey

(In millions of kroons; end of period)

	1991	1992	
	Qtr.IV	Qtr.I	Qtr.II
Net foreign assets	2,087.5	1,290.4	1,727.0
Foreign assets	2,551.6	1,841.1	2,822.1
In convertible currency	2,069.8	1,315.1	2,338.8
Of which: BoE's gold holdings	--	662.3	114.0
In nonconvertible currency 1/	481.8	526.0	483.3
Foreign liabilities	-464.1	-550.7	-1,095.1
In convertible currency	-208.1	-238.1	-791.7
In nonconvertible currency 1/	-256.0	-312.6	-303.4
Net domestic assets	199.5	635.8	1,490.7
Claims on general government (net)	-94.7	-83.3	-149.6
Central government (net)	-65.6	-49.6	-67.0
Local government (net)	-29.1	-33.7	-82.6
Claims on state enterprises	854.4	518.8	472.7
Claims on private sector	344.7	520.3	1,145.0
Other items (net)	-904.5	-320.0	22.6
Liquid Liabilities (M2)	2,286.9	1,926.1	3,217.8
Currency outside banks	212.4	267.3	237.0
Demand deposits	478.4	532.1	791.2
Time and savings deposits	305.2	298.8	278.4
Foreign currency deposits	1,290.9	827.3	1,911.2

Source: Data provided by the Estonian authorities.

1/ Include circulation of rubles before currency reform and rubles exchanged for kroons after currency reform.

Table 3. Estonia: Currency Board Balance Sheet
(In millions of EEK)

(As of June 20, 1992)

ASSETS		LIABILITIES	
Foreign assets	684.6	Kroons in circulation	293.2
Gold	662.4	Banks deposits	460.6
Deposits with foreign banks	22.2	Required reserves	280.7
		Of which:	
		Savings Bank	230.0
Cash	--	Other deposits	179.9
		Capital	-69.2
Total	684.6	Total	684.6

--As of July 17, 1992--

ASSETS		LIABILITIES	
Foreign assets	1,084.1	Kroons in circulation	682.3
Gold	--	Bank deposits	401.8
Deposits with foreign banks	1,072.5	Required reserves	291.3
		Of which:	
		Savings Bank	230.0
Cash	11.6	Other deposits	110.5
		Capital	-- 1/
Total	1,084.1	Total	1,084.1

Source: Bank of Estonia.

1/ This treatment leaves reserves surplus to the requirements of the currency board equivalent to EEK 121 million (or about US$10 million), of which the equivalent of EEK 114 million was held in the form of gold.

Table 4. Estonia: Summary of Consolidated General Government Operations 1991-92 1/

(In millions of kroons)

	1991	1992		
	Total/ Actual 2/	Total	1st half (Prov.)	2nd half (Proj.)
Total general government revenue	667	4,083	1,438	2,645
Tax revenue	619	3,825	1,234	2,591
Taxes on income and profits	257	1,264	473	791
Taxes on goods and services	181	1,319	331	988
Taxes on property	17	--	--	--
Taxes on international trade	4	46	19	27
Payroll taxes	143	1,093	380	713
Other taxes	17	103	31	72
Nontax revenue	48	258	204	54
Total general government expenditure	582	3,972	1,377	2,595
Current expenditure	520	3,850	1,301	2,533
Wages and salaries	74	583	193	390
Other goods and services	234	2,117	656	1,461
Interest payments	2	...	...	...
Subsidies/current transfers	210	1,134	452	682
Capital expenditure	62	138	76	62
General government budget balance	85	111	61	50
Of which: (- = deficit)				
State budget	17	313	192	112
Local budget	30	-16	-91	77
Extrabudgetary funds	38	-186	-40	-139
Memorandum items:				
Ratios to GDP (in percent)				
Overall budget surplus	4.9	1.2	1.6	0.9
Total general government revenue	38.6	42.3	38.0	45.1
Of which: tax revenue	35.9	39.6	32.6	44.2
Total general government expenditure	33.7	41.2	36.4	44.2
Of which: current expenditure	30.1	39.9	34.4	43.2
Intergovernmental transfers (gross)	143	917	316	601
To state budget	14	185	13	172
To local budgets	44	325	189	136
To extrabudgetary fund budgets	85	407	114	293

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

1/ Excluding intergovernmental transfers.
2/ Converted from rubles into kroons at a conversion rate of EEK 1 = rub 10, to facilitate comparison.

Table 5. Estonia: Balance of Payments 1991-1993

	1991 1/	1992	1992 QI	1992 Q2	1992 Q3	1992 Q4	1993	1993 Q1	1993 Q2
			(In millions of U.S. dollars)						
Current account balance	546	-181	-22	-38	-39	-82	-137	-51	-41
Trade balance	534	-203	-23	-41	-48	-92	-179	-61	-50
CIS and Baltics	686	-123	-3	-18	-39	-63	-83	-28	-17
Other countries	-152	-80	-20	-23	-8	-29	-95	-33	-33
Exports	2,866	344	42	79	103	120	591	135	145
CIS and Baltics	2,814	256	24	58	79	94	480	109	118
Other countries	52	89	18	21	25	26	110	26	27
Imports	2,332	548	65	120	151	211	770	196	195
CIS and Baltics	2,128	379	27	77	118	157	564	137	134
Other countries	204	169	37	44	33	54	206	59	60
Services (net)	12	17	--	3	7	7	34	7	7
Interest (net)	...	1	--	--	--	1	-2	--	--
Private transfers	...	3	--	--	2	2	10	2	2
Clearing arrangements	...	21	3	18	--	--	--	--	--
Reserves (increase -)	...	-139	-55	-6	-68	-9	-26	-7	-7
Financing	...	234	76	26	84	47	96	33	34
Claims on gold	...	99	55	--	44	--	--	--	--
Short-term credits	...	--	4	--	-4	--	--	--	--
Private flows	...	23	1	6	14	2	--	--	--
Direct investment	...	18	--	5	10	3	16	3	4
Trade credit (official)	...	16	--	--	10	6	--	--	--
Official transfers	...	31	16	15	--	--	--	--	--
Medium and long term (net) 2/	...	29	--	--	--	29	59	23	23
IMF purchases (net)	...	18	...	...	11	7	21	7	7
Financing gap	...	66	-1	--	23	44	67	25	13
Memorandum items:									
Exchange rate (rub/$)	1.7	...	113	113	...	...	...	...	...
Exchange rate (EEK/$)	...	...	...	...	12	12	12	12	12
Export volume (1990=100)									
CIS and Baltics	85	55	34	56	66	75	81	79	83
Other countries	163	169	137	154	188	196	206	201	207
Import volume (1990=100)									
CIS and Baltics	70	48	19	43	61	89	55	54	55
Excl. energy	69	43	16	58	46	51	58	56	58
Other countries	111	84	81	72	70	114	104	122	123
Reserves (gross)	...	139	55	62	130	139	165	146	153
Reserves (mths of imp)	...	3.0	2.6	1.5	2.6	2.0	2.6	2.2	2.4
Reserves (net)	...	121	55	62	119	121	126	121	121
					(In percent)				
Debt/GDP (Incl IMF)	...	11.0	--	--	2.5	11.0	18.4	11.2	14.6
Debt service/Total exports	...	0.1	--	--	--	0.2	2.2	2.7	1.6
Debt service/Non FSU exports	...	0.2	--	--	--	0.9	11.6	13.7	8.7
Current account/GDP	...	-22.6	-11.2	-18.9	-19.4	-40.7	-10.7	-16.0	-12.7

Sources: Estonian authorities and staff estimates

1/ Figures are distorted by exchange valuation effects.
2/ World Bank and EBRD.

Table 6. Estonia: Medium-Term Outlook, 1991-1997

	1991 1/	1992	1993	1994	1995	1996	1997
			(In millions of US dollars)				
Current account balance	546	-181	-137	-69	-66	-59	-42
Trade balance	534	-203	-179	-115	-112	-106	-91
CIS and Baltics	686	-123	-83	-70	-69	-67	-59
Other countries	-152	-80	-95	-45	-43	-39	-32
Exports	2,866	344	591	630	673	727	787
CIS and Baltics	2,814	256	480	497	515	538	561
Other countries	52	89	110	133	158	189	226
Imports	2,332	548	770	744	785	833	878
CIS and Baltics	2,128	379	564	567	584	605	620
Other countries	204	169	206	178	201	228	258
Services (net)	12	17	34	38	40	43	46
Interest (net)	...	1	-2	-7	-10	-13	-15
Private transfers	...	3	10	15	16	17	18
Clearing arrangements	...	21	--	--	--	--	--
Reserves (increase -)	...	-139	-26	-10	-11	-12	-14
Financing	...	234	96	55	54	44	42
Claims on gold	...	99	--	--	--	--	--
Short-term credits	...	--	--	--	--	--	--
Private flows	...	23	--	--	--	--	--
Direct investment	...	18	16	25	30	35	40
Trade credit (official)	...	16	--	--	-2	-2	-2
Official transfers	...	31	--	--	--	--	--
Medium & long term (net) 2/	...	29	59	30	27	25	22
IMF purchases (net)	...	18	21	--	-1	-14	-18
Financing gap	...	66	67	24	23	27	14
Memorandum items:							
Exchange rate (rub/$)	1.7	...	...	...	...	...	...
Exchange rate (EEK/$)	...	...	12	12	12	12	12
Export volume (1990=100)							
CIS and Baltics	85	55	81	81	81	81	81
Other countries	163	169	206	239	277	321	372
Import volume (1990=100)							
CIS and Baltics	70	48	55	55	55	55	55
Excl. energy	69	43	58	58	58	58	58
Other countries	111	84	104	87	95	105	115
Reserves (gross)	...	139	165	175	186	198	212
Reserves (months of imports)	...	3.0	2.6	2.8	2.8	2.9	2.9
Reserves (net)	...	121	126	136	149	175	207
			(In percent)				
Debt/GDP (Incl IMF)	...	11.0	18.4	20.9	22.3	22.7	21.8
Debt service/Total exports	...	--	2.2	2.6	3.7	5.7	6.4
Debt service/Non FSU exports	...	--	11.6	12.3	15.7	21.7	22.4
Current account/GDP	...	-22.6	-10.7	-5.0	-4.4	-3.6	-2.3

Sources: Estonian authorities; and staff estimates.

1/ 1991 figures are distorted by exchange valuation effects.
2/ World Bank and EBRD

Table 7. Estonia: Projected Payments to the Fund
(in millions of SDRs; as of July 31, 1992)

	1992	1993	1994	1995	1996	1997	1998	Total
Obligations from Existing Drawings								
1. Principal Repurchases	-	-	-	-	-	-	-	-
2. Charges and Interest 1/	-	-	-	-	-	-	-	-
Total Obligations	-	-	-	-	-	-	-	-
(percent of quota)	-	-	-	-	-	-	-	-
Obligations from Prospective Drawings								
1. Principal Repurchases	-	-	-	0.9	10.1	12.9	3.7	27.9
2. Charges and Interests 1/	0.1	1.4	2.0	2.0	1.7	0.8	0.1	8.3
Total Obligations	0.1	1.4	2.0	3.0	11.8	13.8	3.9	36.2
(percent of quota)	0.2	4.6	6.6	9.6	38.3	44.6	12.5	116.9
Cumulative (Outstanding and Prospective)								
1. Principal Repurchases	-	-	-	0.9	10.1	12.9	3.7	27.9
2. Charges and Interest 1/	-	1.4	2.0	2.0	1.7	0.8	0.1	8.3
Total Obligations	-	1.4	2.0	3.0	11.8	13.8	3.9	36.2
(percent of quota)	0.2	4.6	6.6	9.6	38.3	44.6	12.5	116.9

Source: International Monetary Fund.

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

Table 8. Estonia: Quantitive Performance Criteria 1/

Variable and periods	Amounts	
	(in millions of Estonia kroon)	
I. Limits on net credit of the banking system to the general government		
Position on June 30, 1992	-150	
Limits for:		
September 30, 1992	-105	
December 31, 1992	-150	
	(in millions of U.S. dollars)	
II. Minimum targets for net international reserves of the Bank of Estonia, net of cover for the currency board 2/:		
Position on June 20, 1992	-5.5	
Targets for:		
September 30, 1992	12.0	
December 31, 1992	12.0	
	(in percent)	
III. Minimum targets for total kroon 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		
Targets for:		
September 30, 1992	9.0	
December 31, 1992	9.0	
	(in millions of U.S. dollars)	
IV. Limits on disbursements of public and publicly guaranteed medium- and long-term external debt 3/:	Maturity of 1-12 years	Maturity of 1-5 years
Limit for the period of July 1, 1992 to:		
December 31, 1992	130	80

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/ The currency board is to be fully backed with foreign exchange at all times. This is also a performance criterion.

3/ In addition, the Government will not contract or guarantee loans of less than one year's maturity, with the exception of normal import financing (to be monitored at the end of each calendar quarter), or accumulate external arrears.

Table 9. Estonia: Schedule of Purchases
Under Stand-By Arrangement

Amount	Scheduled Availability Date	Conditions Necessary for Purchase
SDR 7.7500 million	On or after September 16,1992	Board approval of stand-by arrangement
SDR 5.0375 million	On or after November 15, 1992	Compliance with quantitative performance criteria as of September 30, 1992, and completion of program review
SDR 5.0375 million	On or after February 15, 1993	Compliance with quantitative performance criteria as of December 31, 1992, and completion of program review
SDR 5.0375 million	On or after May 15, 1993	Compliance with quantitative performance criteria as of March 31, 1993 and completion of program review
SDR 5.0375 million	On or after July 31, 1993	Compliance with quantitative performance criteria as of June 30, 1993

Table 10. Estonia: Projection of IMF Position
During Period of Proposed Stand-By Arrangement

	1992		1993		
	July-Sept.	Oct.-Dec.	Jan.-Mar.	May-June	July-Sept.
	(In thousands of SDRs)				
Purchases	7,750.0	5,037.5	5,037.5	5,037.5	5,037.5
Tranche policies	7,750.0	5,037.5	5,037.5	5,037.5	5,037.5
Ordinary resources	7,750.0	5,037.5	5,037.5	5,037.5	5,037.5
Total Fund credit outstanding (end of period)	7,750.0	12,787.5	17,825.0	22,862.5	27,900.0
Tranche policies	7,750.0	12,787.5	17,825.0	22,862.5	27,900.0
	(In percent of quota) 1/				
Total Fund credit outstanding (end of period)	25.00	41.25	57.50	73.75	90.00
Tranche policies	25.00	41.25	57.50	73.75	90.00

1/ Estonia's quota is SDR 31 million.

Estonia -- Fund Relations

(as of August 15, 1992)

I. Membership Status

(a) Date of Membership	May 25, 1992
(b) Status	Article XIV

II. General Department (General Resources Account)

	(In millions of SDRs)	(In percent of quota)
(a) Quota	31.0	100.0
(b) Total Fund Holdings of Currency	31.0	100.0
(c) Fund Credit	--	--
Credit Tranche	--	--
CCFF	--	--
(d) Reserve Tranche Position	--	--
(e) Operational Budget Transfers (net)	--	--

III. SDR Department

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

IV. Outstanding Purchases and Loans: none

V. Financial Arrangements: none

VI. Projected Obligations to Fund (SDR millions):

	Overdue	1992	1993	1994	1995	1996	1997	1998	Total
Principal	--	--	--	--	0.9	10.1	12.9	3.7	27.9
Charges/Interest	--	0.1	1.4	2.0	2.0	1.7	0.8	0.1	8.3
Total obligations	--	0.1	1.4	2.0	3.0	11.8	13.8	3.9	36.2
(in percent of quota)	--	0.2	4.6	6.6	9.6	38.3	44.6	12.5	116.9

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 EEK8 per DM for kroon bank notes, coins, and reserve deposits of commercial and other current account transactions. A 100 percent surrender requirement for payment receipt is in effect. Capital account transactions require the authorization of the Bank. The Bank deals only in DM, 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 at rates of their own choosing, with the proviso that the rate of exchange including commission should not diverge from the official central rate, or rates derived from cross rates, by more than plus or minus 3 percent. The ruble is traded weekly against the U.S. dollar at the Tallinn Stock Exchange and the rate is not subject to any limits.

VIII. Article IV Consultations

Article IV consultations have not yet been held. 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, 1991-92

Department	Subject/Identified Need	Action	Timing	Counterpart 1/
MAE	Bank accounting, payments and clearing banking systems, foreign exchange operations and monetary policy	Pre-diagnostic mission	Nov 91	BOE
MAE	Bank accounting, payments and clearing banking system, bank supervision, foreign exchange operations and monetary policy	Mission	Feb 91	BOE
STA	Balance of payments, government finance, and money and banking statistics.	Mission	Mar 92	BOE/MOF/SOE
FAD	Tax policy and administration, budgetary controls and social programming.	Mission	Mar 92	MOF
STA	Consumer price index and monetary statistics	Mission	Jun 92	BOE/SOE
MAE	Foreign exchange operations and banking supervision	Visit	Jun 92	BOE
MAE	Foreign exchange Accounting	Visit	Jul 92	BOE
STA	Balance of Payments statistics	Visit	Jul 92	BOE
STA	Consumer price index	Visit	Aug 92	SOE

1/ BOE: Bank of Estonia; MOF: Ministry of Finance; SOE: Statistical Office of Estonia.

Estonia: Relations with the World Bank

Estonia became a World Bank member on June 23, 1992. The first World Bank economic mission visited Tallinn in January 1992. The objectives of the mission were to: (a) assess the economic situation; (b) identify main issues at the macroeconomic and sectoral levels; (c) initiate a policy dialogue with the authorities in order to assist in the design of appropriate economic adjustment policies; and (d) make a preliminary assessment of external creditworthiness and financial prospects, with a view to identifying the features of a prospective cooperation program between Estonia and the World Bank.

The economic mission presented its initial assessment to the Estonian authorities in the form of aide memoires, highlighting key issues and making preliminary recommendations. A draft Country Economic Memorandum (CEM) is under preparation, and will be issued shortly.

World Bank missions have also visited Estonia in April and June 1992 to prepare and appraise the first lending operation, a Rehabilitation loan. The primary objectives of the proposed 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 is expected to be presented to the Board of Directors in September 1992 and disbursed over a period of about 12-18 months.

Estonia: Stand-By Arrangement

Attached hereto is a letter and annexed Memorandum (the "Memorandum") dated August 14, 1992, from the Prime Minister of Estonia and the Governor of the Bank of Estonia, requesting a stand-by arrangement and setting forth (i) the objectives and policies that the authorities of Estonia intend to pursue for the period of this stand-by arrangement; and (ii) 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 of 12 months from ..., 1992, Estonia will have the right to make purchases from the Fund in an amount equivalent to SDR 27,900,000, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.

2. (a) Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 7,750,000 until November 15, 1992, the equivalent of SDR 12,787,500 until February 15, 1993, the equivalent of SDR 17,825,000 until May 15, 1993, the equivalent of SDR 22,862,500 until July 31, 1993.

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

3. Purchases under this stand-by arrangement shall be made from ordinary resources only.

4. Estonia will not make purchases under this arrangement that would increase the Fund's holdings of its currency in the credit tranches beyond 25 percent of quota:

(a) if the maintenance of full foreign reserve backing for the currency board's liabilities at the end of each weekly reporting period, as referred to in paragraph 34 of the Memorandum, has not been observed;

(b) during any period in which the data at the end of the preceding period indicate that:

(1) the maintenance of reserve requirements by commercial banks consistent with the Bank of Estonia's regulations, in the manner referred to in paragraph 34 and specified in Appendix II of the Memorandum; or

(2) the limits for net claims on the General Government referred to in paragraph 27 and specified in Appendix I of the Memorandum; or

(3) the minimum holdings of net international reserves, exclusive of currency board cover, as referred to in paragraph 51 and specified in Appendix V of the Memorandum; or

(4) the limit on contracting or guaranteeing of new 1-12 year external debt, referred to in paragraph 52 and specified in Appendix VI of the Memorandum; or

(5) the limit on contracting or guaranteeing of new 1-5 year external debt, referred to in paragraph 52 and specified in Appendix VI of the Memorandum; or

(6) the quarterly limit on contracting or guaranteeing of new external debt of less than one year's maturity, other than normal import financing (including liabilities on the correspondent accounts with FSU countries), referred to in paragraph 52 of the Memorandum, have not been observed; or

(c) after November 14, 1992 and February 14, 1993 until the reviews referred to in paragraph 54 of the Memorandum have been completed and, with respect to the second review, appropriate understandings have been reached on suitable performance criteria for the remainder of the stand-by arrangement or, after such performance criteria have been established, while they are not being observed; or

(d) after May 14, 1993 until the review referred to in paragraph 54 of the Memorandum has been completed; or

(e) during any period of the stand-by arrangement, if Estonia

(1) imposes or intensifies restrictions on payments and transfers for current international transactions; or

(2) introduces or modifies multiple currency practices; or

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

(4) imposes or intensifies import restrictions for balance of payments reasons; or

(5) accumulates Governmental external payments arrears, as referred to in paragraph 52 of the Memorandum.

When Estonia is prevented from purchasing under this arrangement because of this paragraph 4, 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.

5. Estonia will not make purchases under this stand-by arrangement during any period of the arrangement in which it has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase or pursuant to Decision No. 9331-(89/167) as amended.

6. Estonia's right to engage in the transactions covered by this 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 6, 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.

7. Purchases under this arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Estonia, the Fund agrees to provide them at the time of the purchase.

8. Estonia shall pay a charge for this arrangement in accordance with the decisions of the Fund.

9. (a) Estonia shall repurchase the outstanding 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 related to repurchase as Estonia's balance of payments and reserve position improves.

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

10. 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.

11. In accordance with the authorities' letter dated August 14, 1992, Estonia will consult with 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 4 above have not been observed, or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement

and while Estonia has outstanding repurchases 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.