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September 15, 1992

To: Members of the Executive Board
From: The Secretary
Subject: Estonia - Request for Stand-By Arrangement - Recent Developments

The attached supplement to the staff report on Estonia's request for a stand-by arrangement (EBS/92/132, 8/25/92) has been prepared on the basis of additional information.

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 on Wednesday, September 16, 1992.

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INTERNATIONAL MONETARY FUND

ESTONIA

Recent Developments

Prepared by European II Department

Approved by John Odling-Smee

September 15, 1992

For the information of Executive Directors, this supplement summarizes recent developments in the Estonian economy.

1. Output and Employment

In the period June-July 1992 the decline in industrial output accelerated marginally, with the volume of industrial output 38 percent lower than a year earlier. On the other hand, July data on retail trade turnover suggests that the decline in the volume of sales may have stabilized, but the data remains too sketchy to reach any firm conclusions. Meanwhile, officially recorded unemployment continued to increase and reached 7,500 persons in the beginning of September (or about 1 percent of the labor force), up from 6,500 persons in August.

2. Prices and wages

After a 24 percent price hike in July, the consumer price index rose by 18 percent in August, or more rapidly than anticipated. Major items contributing to the increase in August were clothing and footwear, leisure time products (including radios, TV sets, etc.), and personal services. However, the authorities believe that the inflation figures for July and August are subject to an upward bias. In particular, prior to the currency reform, foreign currency shops were not covered by the consumer price survey and the prices they charged were excluded from the consumer price index; these prices have now been included in the price survey starting in July. Furthermore, the selection of goods generally has undergone considerable change in the last two months as higher priced goods imported from industrial countries have started to replace merchandise imported from the former Soviet Union. The improvements in the quality of the consumption basket are particularly pronounced for clothing, footwear, and electric appliances and the price index does not make any allowances for these quality changes. Similar distortions were also apparent in recorded price increases for personal services which include, inter alia, former hard currency restaurant and hotel services. Excluding the contribution of items subject to these factors, the rise in the consumer price index in August would have been 8 percent.

Preliminary data suggest that average nominal wages increased by 29 percent in July, before declining by 5 percent in August. However, the authorities believe that these figures are seriously distorted because of (i) the deferral of wage payments from June to July in anticipation of the currency reform, and (ii) in many areas, wage data for July included the prepayment of wages in advance of vacations.

3. Monetary Policy

The liabilities of the currency board (comprising kroons in circulation and bank reserves) increased by 58 percent during the first month of the currency reform (from June 20 to July 17), reaching a total of EEK 1,084 million on July 17. By end-August, the liabilities of the currency board reached EEK 1,170 million, implying a further 8 percent increase in the monetary base since mid-July. The Bank of Estonia has not engaged in any emergency lending to commercial banks. Meanwhile, by early September interest rates have fallen somewhat relative to the levels experienced in July; with time deposit rates at commercial banks falling from about 20-40 percent per annum to 15-25 percent per annum and loan rates falling from about 60 percent per annum to 50 percent per annum.

The Bank of Estonia has initiated the process of subdividing its operations into two departments with the preparation, beginning with end-July 1992, of separate balance sheets for the currency board (Issue Department) and its other operations (Banking Department).

4. Fiscal Policy

The state budget for the second half of 1992 was passed in Parliament on August 26, 1992, broadly along the lines set out in the Memorandum of Economic Policies (MEP). Although the special ad valorem excise tax on selected fuel products was not adopted, offsetting reductions to expenditures were made to ensure maintenance of a balanced budget, including an adequate prudential cushion to meet unforeseen contingencies.

5. Incomes Policy

The Government has established an incomes policy commission to implement the wage guidelines. Negotiations with the labor unions started in August but the guidelines and decrees for taxation of excess wage increases have not yet been issued. In part this delay reflects the confusion related to recent wage and price developments coupled with the run-up to general elections on September 20. According to the MEP wage guidelines, pay increases should not exceed 12 percent in September and 13 percent in November. Trade unions have initially demanded a 50 percent increase in minimum wages to compensate for inflation. The outcome of these negotiations and actual wage developments in August-September will be reviewed as part of the first program review in November.

6. External Sector Policies

The Bank of Estonia has maintained full foreign reserve backing for the liabilities of the currency board. Meanwhile, the operations of the currency board have maintained the fixed relationship between the kroon and the deutsche mark in the foreign exchange market. Trading of the kroon has also moved offshore, with quotations offered by a major Finnish bank for its commercial customers (based on the corresponding cross-rates for the deutsche mark and the Finnish markka). In early September, the kroon was traded in the Tallinn exchange market at 18 Russian rubles per kroon (as compared to the initial conversion rate of 10 rubles per kroon).

Discussions with Russia on a number of economic issues have recently intensified. A trade agreement was concluded in early September providing for liberalized trade, although the details of this agreement remain to be clarified.

As noted in a recent supplement to the Latvian Staff Report ("Latvia - Recent Developments" (EBS/92/131, 9/11/92, Supplement 2) provisional financial commitments have been made by the EC/G-24 to cover almost all of the projected residual financing gap for Estonia of US\$105 million for the program year.

7. Structural Reforms

During its abbreviated session in August, Parliament adopted legislation that grants the Government authority to establish a privatization agency modeled on the German Treuhand permitting the privatization of most state enterprises. Other legislation was also adopted to accelerate the pace of privatization and restitution.

