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FOR AGENDA

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CONFIDENTIAL

December 11, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Estonia - Review of the Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on the review of Estonia's stand-by arrangement, which is proposed for discussion on Wednesday, January 6, 1993. A draft decision appears on page 17.

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

Review of the Stand-By Arrangement

Prepared by the European II Department

(In Consultation with other Departments)

Approved by John Odling-Smee and Jack Boorman

December 10, 1992

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I. Introduction

On September 16, 1992 at EBM/92/119, the Executive Board approved a twelve-month stand-by arrangement for Estonia in the amount of SDR 27.9 million, representing 90 percent of quota, 1/ in support of an economic and financial program covering the period July 1, 1992-June 30, 1993. 2/ Immediately thereafter, Estonia made its first purchase of SDR 7.75 million, representing the first credit tranche. Of the four remaining purchases, each of SDR 5.0375 million, the first three are contingent, inter alia, on the completion of Board reviews of the program.

Discussions relating to the first review under this arrangement were held in Tallinn during the period October 28-November 10, 1992. 3/ The Estonian representatives included Mr. Laar, Prime Minister; Mr. Üürike, the Minister of Finance; Mrs. Lauristin, Minister of Social Affairs; Mr. Leetsar, Minister of Agriculture; Mrs. Hänni, Minister of Reforms, and Mr. Kallas, the Governor of the Bank of Estonia. The mission also met with senior officials from these and other institutions and with representatives from selected private banks and enterprises. Mr. Solheim, Assistant Executive Director, also participated in some of the meetings as an observer.

The mission established that all the quantitative performance criteria for the third quarter of 1992 have been met (Table 1). In addition, three of the four structural policies noted in paragraph 53 of the Memorandum of Economic Policies (MEP) for special attention at the first review have been implemented; substantial progress was made in implementing the fourth policy. 4/ The Prime Minister--who had established a new Government on October 22, 1992 following the general elections on September 20--also transmitted a letter to the Managing Director committing the Government of Estonia to carrying out the policies set out in the MEP (Annex I). 5/

1/ Or 60.0 percent of Estonia's post-Ninth Review quota. Estonia paid its increase on November 30, 1992, thereby raising its quota from SDR 31 million to SDR 46.5 million.

2/ See EBS/92/132 (8/18/92), Supplement 1 (8/25/92) and Supplement 2 (9/15/92).

3/ The staff team consisted of Messrs. Knöbl (head), Messrs. Zavoico and Saavalainen (all EUR II), Bennett (PDR), Faria (FAD), and Luu (STA), with Miss Rome (EUR II) as administrative assistant. Mr. Paljarvi, the Fund's resident representative in Tallinn, also assisted the mission.

4/ Some delay was experienced in the presentation to Parliament of the competition law. See section II, paragraph 6 below.

5/ The new Government, which represents a coalition of three political groupings, has a majority of 3 seats in the 101 seat Parliament.

It is proposed in the draft decision presented in section V that the Executive Board complete the first review of the stand-by arrangement with Estonia and that Estonia be permitted to make a second purchase equivalent to SDR 5.0375 million.

II. Performance Under the Stand-by Arrangement

Preliminary data suggest that the economic program is starting to have a stabilizing effect on overall economic activity. In particular, the decline in industrial output appears to have been arrested, the core rate of inflation is abating, and confidence has grown in the currency board, with the kroon remaining pegged to the deutsche mark at its initial rate. In recent months, Estonia has also experienced a substantial increase in the volume of trade with industrial countries, suggesting that the reorientation of trade from the states of the former Soviet Union (FSU) may be proceeding more rapidly than envisaged earlier. However, the economic and social environment remains difficult owing to the low levels of production and consumption. Furthermore, a banking crisis developed in mid-November when growing payments problems led the Bank of Estonia effectively to close three major commercial banks. A number of enterprises, mainly those whose trade was directed to the FSU, are in major financial difficulties and are expected to lay off a large number of employees, which would lead to a substantial rise in unemployment. It is clear that the adjustment process will continue to cause hardship and dislocation for some time to come. Nevertheless, economic developments remain broadly in line with expectations at the time the Estonian program was discussed by the Executive Board, so that the earlier projection of a decline in real GDP during the program period of about 15 percent remains unchanged (Table 2).

1. Output, employment and prices

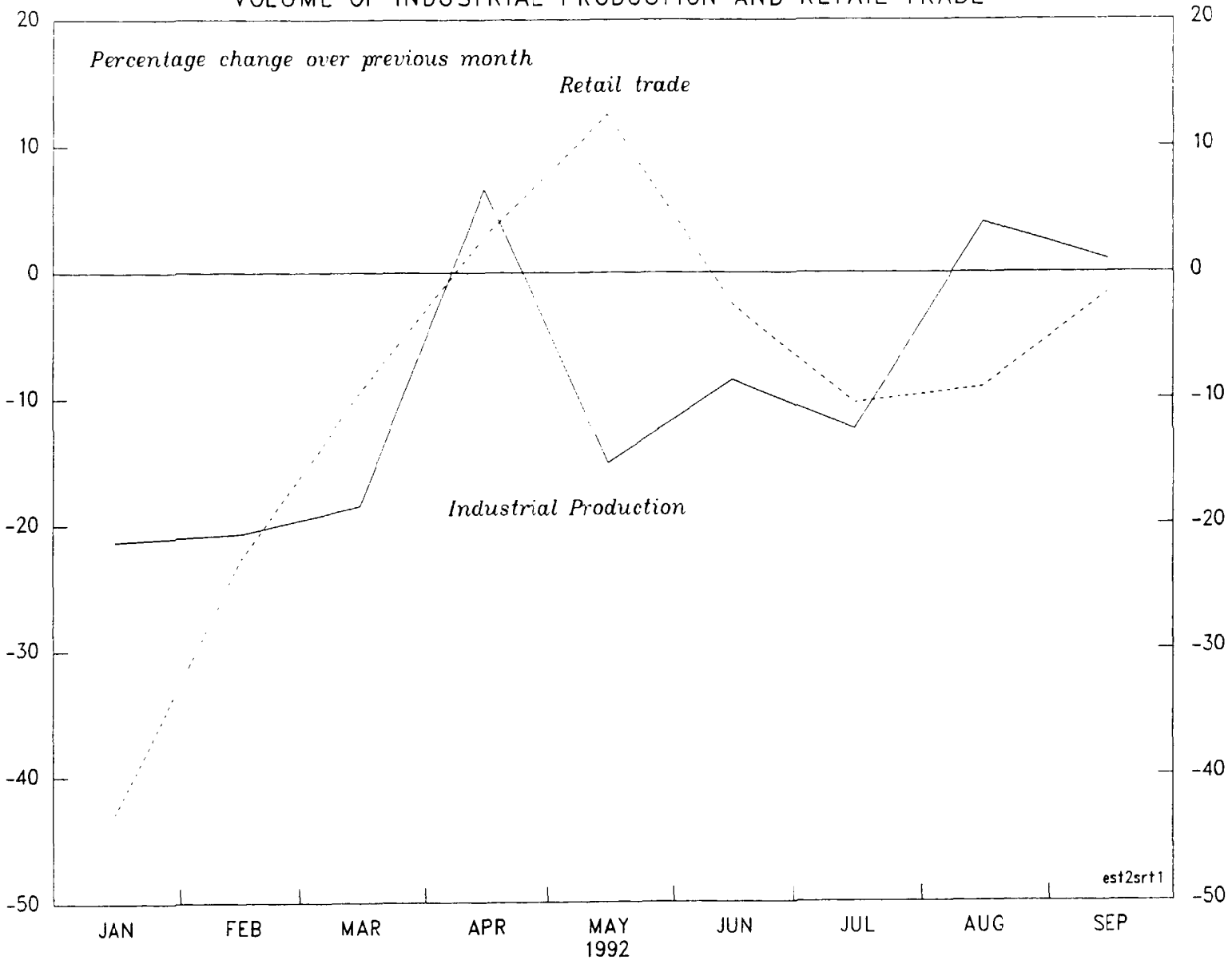
a. Output and employment

Industrial output fell in the third quarter of 1992 by an estimated 40 percent relative to the same period in the preceding year. This fall reflected the adjustment to the terms of trade shock and the new relative price structure, as well as the continued disruption of trade with the FSU. Month-to-month data suggest that modest increases in production may have taken place in both August and September (Chart 1). However, with tight credit, problems in obtaining raw materials, and weak demand, it is likely that recovery in the industrial sector will be modest at best in the near term; early receipt of foreign financial assistance will, of course, be crucial for promoting the recovery.

In the agricultural sector, the effects of the summer drought proved less severe than expected but the 1992 harvest will still be down by about 20-30 percent relative to last year. Nevertheless, substantial imports of wheat, barley and feed grain are expected to be provided in grant form from EC and US intervention stocks. Meanwhile, high prices for some domestically

CHART 1
ESTONIA

VOLUME OF INDUSTRIAL PRODUCTION AND RETAIL TRADE



Source: Data provided by the Estonian authorities.

produced items in relation to subsidized imports, especially butter and meat, have resulted in growing substitution by consumers of imports for local products and in the accumulation by food processors of substantial inventories.

Total employment was estimated at 760,000 persons in the third quarter of 1992, implying a decline in employment of about 20,000 workers compared to end-1991. Officially, only 8,700 persons--or about 1 percent of labor force--were classified as unemployed on October 1, 1992. However, actual unemployment is probably much higher. Estimates of hidden unemployment (i.e., individuals without unemployment benefits, on unpaid leave, and subject to temporary lay-offs), range between 30,000 and 50,000 persons, or 4-6 percent of the labor force. Most unemployment is concentrated in northeastern and southeastern Estonia and in industries heavily committed to the FSU market.

b. Prices and wages

Following the currency reform, the official consumer price index surged by 24 percent in July and by a further 18 percent in August (Chart 2). Part of the July rise was due to the 8 percentage points increase in the VAT rate and the use by shopkeepers of the conversion from rubles to kroon to introduce one-time increases in prices. Moreover, there is reason to believe that the price index overestimated the true rate of inflation in July-August, mainly because there has been a widespread replacement of goods produced in the FSU with higher quality imports from industrial countries since the currency reform, thereby creating technical difficulties in price comparisons.

In the fall, price inflation slowed down, with the consumer price index rising by 6.6 percent and 7.7 percent in September and October, respectively. The core rate of inflation was lower because an important part of the price increase reflected the implementation of price liberalization measures identified as structural reforms in paragraph 53 of the MEP (especially higher charges for heating, hot water and natural gas). 1/

Since mid-1992, average wages rose broadly in line with inflation reaching EEK 640 per month in September 1992, leaving real wages more or less unchanged (Chart 3). In September, real wages remained about 45 percent lower than at the end of 1991.

2. Fiscal policy

Fiscal policy under the program--covering the third quarter to end-September--was tighter than originally envisaged (Table 3). Instead of

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1/ Bread, flour and sugar prices were also freed in October, but these increases will only be reflected in the November index.

a programmed general government cash deficit during the third quarter of EEK 45 million, broad budgetary balance was achieved. This favorable outcome reflected the combined effect of the tax increases introduced in June 1992 and the containment of expenditures. As a result, the performance criterion on net bank credit to general government was observed by a comfortable margin. This outturn is particularly striking when viewed against the worrisome increase in tax arrears--comprising mainly enterprise tax and VAT owed by a small group of cash-strapped state enterprises--which increased from EEK 105 million at end-June to about EEK 350 million at end-September.

3. Monetary policy

Following the introduction of the kroon in June 1992, confidence in the currency has grown steadily, as evidenced by the beginning of trading of the kroon by Finnish and Swedish banks and the steady rise in the currency board's foreign exchange backing for the kroon. 1/

The stock of broad money increased by only 4.8 percent during the third quarter of 1992, or substantially less than the rate of inflation (Table 4). The velocity of money rose from 2.8 percent at end-June 1992 to 3.6 percent at end-September, reflecting increasing liquidity problems; there is also some anecdotal evidence of a further accumulation of interenterprise arrears, which were estimated at about 9 percent of GDP in mid-1992. The composition of broad money also underwent a dramatic change: the public substituted currency and demand deposits for foreign currency deposits; and the ratio of currency to M2 jumped from 7.4 percent at end-June to 21.6 percent at end-September, 2/ mainly reflecting a growing loss of confidence in the commercial banking sector. The increase in the Bank of Estonia's foreign exchange holdings was primarily responsible for the increase of EEK 1.4 billion in net foreign assets. 3/ Meanwhile, net domestic credit extended by banks remained virtually unchanged due mainly to growing illiquidity in the banking sector combined with difficulties in identifying creditworthy borrowers. The performance criterion relating to the adherence to the reserve requirement by the banking system as a whole was met during the third quarter of 1992. 4/

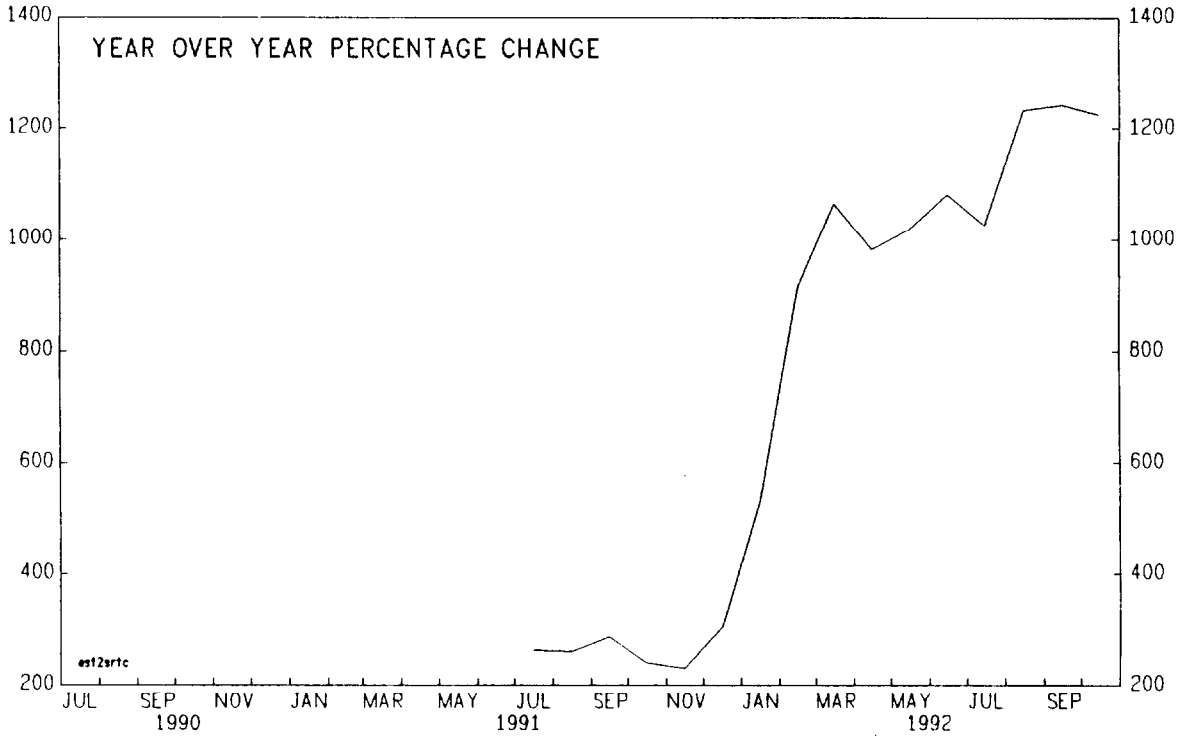
1/ See EBS/92/132, Supplement 1, pages 9-12, for a description of the operations of the currency board.

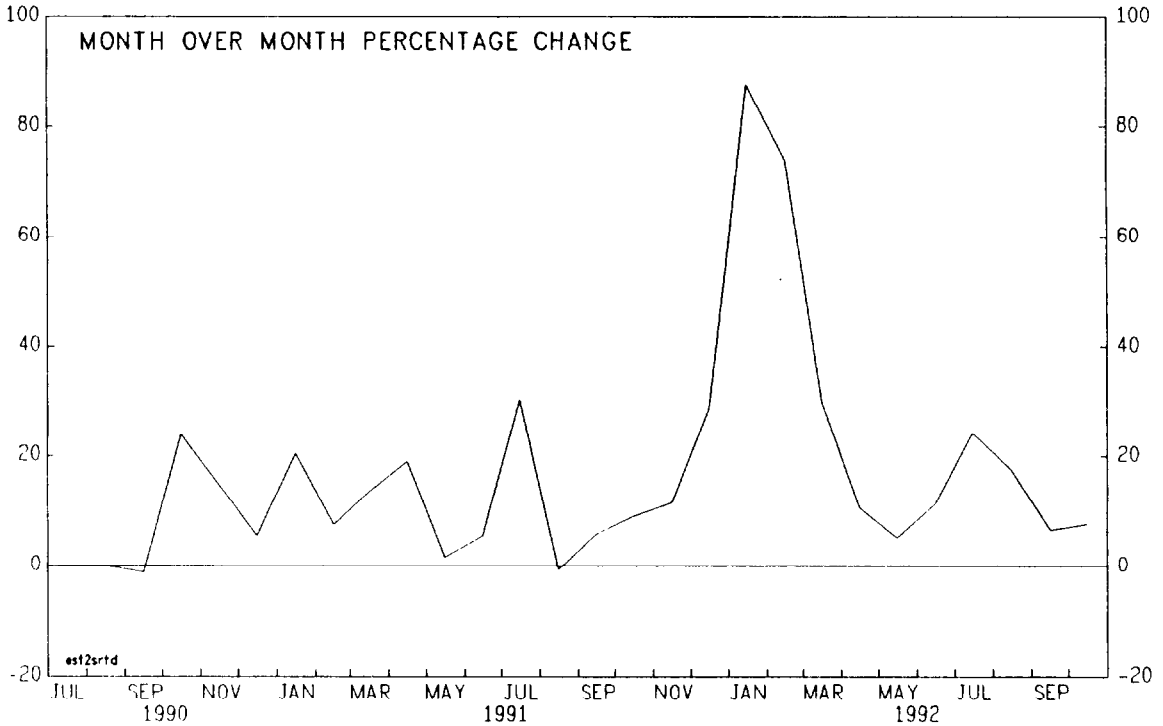
2/ The average ratio for major European countries is in the order of about 7.5 percent.

3/ Of this, EEK 540 million represented the return of pre-war gold to Estonia (most of which was immediately sold by the Bank), which was also reflected in the large increase in other items (net) in the monetary survey.

4/ The Bank of Estonia raised its reserve requirement on commercial bank liabilities from 10 percent at the time of the currency reform, to 11 percent on August 1 and 12 percent on September 1.

CHART 2
ESTONIA
CONSUMER PRICE INDEX

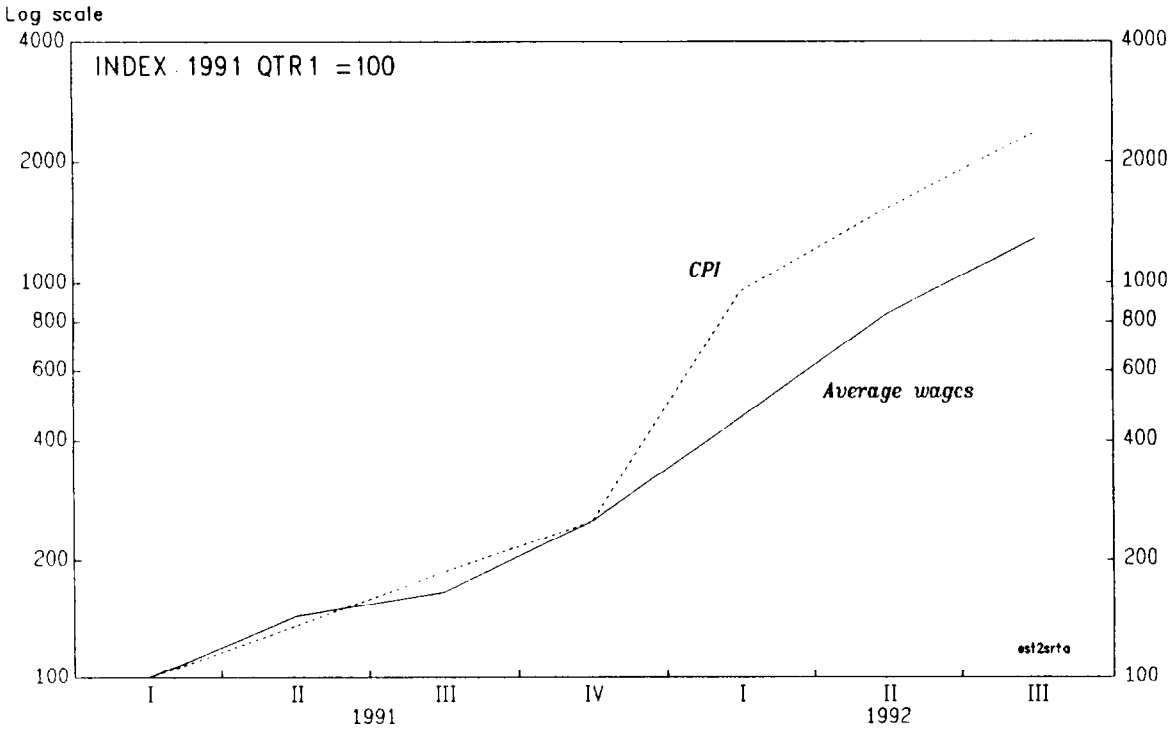


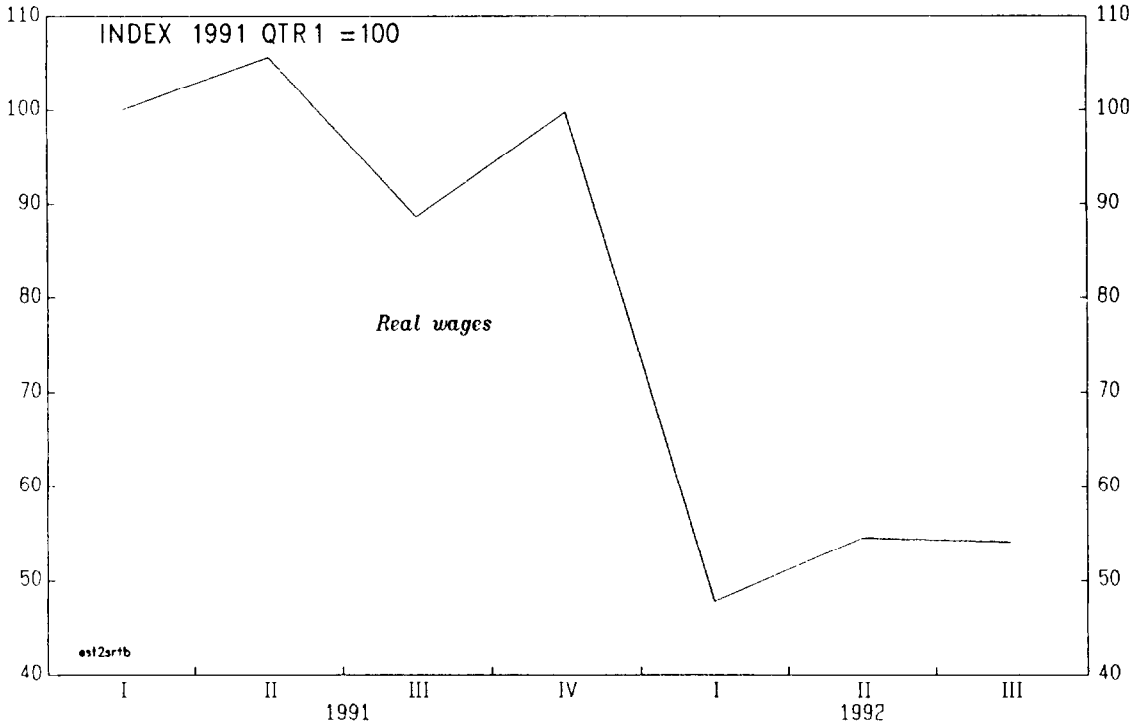


Sources: Data provided by the Estonian authorities; and staff estimates.

CHART 3
ESTONIA

AVERAGE WAGES AND COST OF LIVING





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

Interest rates on large time deposits and six-month loans by private commercial banks were at levels of about 20-30 percent and 50-60 percent, respectively, or somewhat lower than before the currency reform. The substantial proportion of nonperforming assets held by a number of commercial banks contributed to this wide spread between lending and deposit rates.

The serious strains in the banking sector, already evident in the summer and early fall, culminated on November 17 with the closure by the Bank of Estonia of three major commercial banks--Union Baltic Bank (UBB), Northern Estonian Bank (NEB) and Tartu Commercial Bank--and the freezing of deposits with them. The combined deposit liabilities accounted for almost 40 percent of M2 at end-September 1992. In the case of UBB and NEB, the difficulties stemmed mainly from the freezing of their deposits in early 1992--amounting to US$76 million--at the old Vneshekonombank (Moscow). These banks managed to continue operating through 1992 by using new deposits to pay off maturing liabilities, but at the expense of a growing lag between the maturity date and the final payment of these liabilities--a lag which had stretched to three weeks by early November. Tartu Commercial Bank experienced severe problems due primarily to a weak loan portfolio. The Bank of Estonia's response was initially to extend emergency credit to the NEB--formerly its wholly owned commercial banking arm--amounting to EEK 75 million in late September/October. 1/ When this failed to improve matters, the Bank formed a special commission in mid-November to make recommendations on early remedial measures.

As regards structural reforms associated with the financial sector, the Bank of Estonia successfully implemented the two measures set out in paragraph 53 of the MEP: the balance sheet of the central bank was separated into the Issue Department (the currency board) and the Banking Department (other operations) in August and substantial improvements were effected to the operation of the clearing system, so that as of end-September the overwhelming majority of payments were cleared within a 48 hour period. The Bank of Estonia continues to examine the question of how to reorganize the Savings Bank (which remains the main depository for personal savings).

4. Incomes policy

The MEP envisaged that average nominal wages for workers in state enterprises and government would be raised twice during the second half of 1992, first in September (by up to 12 percent) and then in November (by up

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1/ This sum brought gross lending by the Bank of Estonia since end-June to EEK 175 million. In July and August the Bank of Estonia had also lent, by means of an overdraft to the Savings Bank, EEK 75 million to the National Grain Board and EEK 25 million to a commercial bank in Narva. Furthermore, some EEK 136 million was advanced to banks in the form of cash at the time of the currency reform, only a part of which had been repaid by end-September.

to 13 percent). Consistent with these increases, the minimum wage was to be raised to EEK 224 in September and to EEK 253 in November. Excess wage increases were to be penalized by a punitive tax on enterprises beginning in January 1993 (with respect to wage increases granted in the second half of 1992).

The implementation of this policy was briefly delayed, but the main quantitative recommendations were followed. The Government announced the wage guidelines for state enterprises in September. The average wage was to be raised as of October 1 by 12 percent--or in line with the agreed wage guidelines. However, for government workers, the increase was limited to about 4 percent (concentrated mainly in the lower paid groups) due to the desire to contain expenditures. Wage guidelines for the second part of the incomes policy period were announced on November 4. These guidelines provided for a maximum average wage increase for state enterprises of 13 percent as of December 1. For government workers, no pay increases were announced, again due to fiscal stringencies.

Although the announced pay increases appear to have remained within the limits set in the MEP, slippages occurred on the minimum wage front. The minimum wage was raised by 50 percent to EEK 300 per month on October 1, which was almost twice the increase provided under the guidelines through end-1992. The budgetary implications were mitigated by scaling back associated increases in social transfers (see section III, paragraph 2(b) below).

5. External sector

a. Balance of payments developments in the program period

Trade with the states of the FSU has shown little sign of recovery, reflecting mainly continuing economic dislocation in the former U.S.S.R., problems with payments arrangements, and possibly also the strengthening of the real exchange rate of the kroon with adverse effects on the competitiveness of Estonia's exports to the FSU. Trade with industrialized countries, on the other hand, appears to have grown dramatically since the currency reform, and as of the third quarter of 1992 is estimated to have accounted for about half of Estonia's external trade (Table 5). The reorientation of Estonia's trading relationships in favor of trade with industrial countries thus seems to be proceeding much more rapidly than envisaged earlier. It appears that the initial surge of imports from industrial countries was concentrated on consumer goods, which became readily available through the convertibility of the kroon. In this connection, imports of certain agricultural products, especially subsidized butter from Finland, have started to threaten domestic producers and consideration was being given to introducing compensating measures. Through end-October 1992, Estonia had not received any external financial assistance under the G-24 process.

Estonia's reserves were augmented on September 30 by the return of pre-war gold from the BIS amounting to the equivalent of US$28 million. By end-October 1992, Estonia's gross international reserves had reached US$176 million, of which US$122 million represented cover for the currency board.

b. Trade and payments system

Estonia continues to maintain a relatively liberal trade environment. 1/ Although Estonia concluded a free trade agreement with Russia on September 7, 1992, discussions continue on annexes to this agreement relating to trade taxes and licenses and on re-exports through Estonia. 2/

The special correspondent accounts established by the Bank of Estonia and the Central Bank of Russia (CBR) to facilitate trade have recently been used more actively. 3/ Russia has virtually exhausted its initial credit balance of EEK 50 million through financing the expenses of its army in Estonia. Meanwhile, the parallel ruble account of the Bank of Estonia with the CBR has fluctuated around its initial balance of rub 500 million. In addition to the payments agreement with Russia, as of November 10, 1992, Estonia had concluded arrangements with Belarus, Ukraine, Latvia and Lithuania. Under these arrangements, the balances of accounts can be settled without deadline in freely convertible currencies at the market exchange rate.

Since early October 1992, Estonia has tried to promote the decentralization of payments arrangements so that the bulk of transactions are handled through the accounts of commercial banks, mainly to facilitate payments but also to relieve the central bank of the burden of processing the large volume of payments involved. To facilitate this process, restrictions on trading in rubles were largely lifted on November 24, 1992. 4/ Specifically, commercial banks were explicitly permitted to open accounts with commercial banks in Russia and to trade rubles (in the form of

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1/ See EBS/92/132, Supplement 1, dated August 25, 1992 (pages 16-17) and Supplement 2, dated September 15, 1992 (pages 2-3) for details of trade arrangements, including trade agreements with the states of the FSU, the status of which have remained broadly as already described.

2/ Estonia has become a major channel for the export of scrap metal originating from the FSU.

3/ In the case of Russia, ruble payments are effected through a branch of the Central Bank of Russia (CBR) located near Tallinn. This branch maintains separate accounts with each of the 82 regional clearing centers of the CBR thereby facilitating the processing of payment orders (which avoids the need to clear through the congested Moscow branch).

4/ Parallel liberalization applied to the Latvian ruble, Lithuanian talonas and the Ukrainian karbovanets.

both deposit accounts and banknotes) for kroons and vice-versa. 1/ 2/ Direct trading of kroons against rubles has continued on the Tallinn Stock Exchange. However, the indications are that the bulk of payments still takes place through official correspondent accounts, where substantial processing delays remain a major problem for trading firms and banks.

c. Exchange system

The exchange system has remained broadly as described in EBS/92/132, Supplement 1. The Bank of Estonia has continued to make minor modifications in its exchange system in the direction of liberalizing arrangements, particularly as regards ruble payments (as mentioned above). In addition, whereas exchange bureaus had since July 2, 1992 been permitted only to buy foreign exchange, as of November 5 they were permitted to both buy and sell foreign exchange. Although the surrender requirement continues to apply to exports, as regards payments through domestic accounts, enterprises no longer need to surrender foreign exchange if they demonstrate a need for equivalent balances of foreign exchange within a period of 2 days. As regards payments through foreign accounts, the Bank of Estonia is now issuing licenses completely exempting enterprises from the surrender requirement (based on the need for holding working balances abroad); as of November 10, 140 enterprises had applied for exemption and 130 licenses had been granted.

6. Structural reforms and the transition to a market economy

Progress in the area of structural reforms continues. The return of property through the restitution process started in late August and the privatization of housing and land is expected to begin shortly. The government initiated the process of the privatization of large-scale enterprises through the establishment of the Estonian Privatization Agency (EPA) in October 1992 (modeled on the German Treuhand). The EPA commenced its operations by advertising internationally on November 17 the sale of 38 large- and medium-sized enterprises (employing about 27,000 workers in total, or about 3 1/2 percent of the labor force) in their entirety. Bids are to be submitted by December 22 and the EPA will decide upon the successful bids within three months. The selection process will use modified Treuhand principles, mainly to take into account, in addition to price, new investment plans and a commitment to maintain or create jobs.

1/ Under Russian regulations, (i) balances of rubles held by Estonian commercial banks can only be used to acquire goods and services (but not make investments) or be sold against other currencies and (ii) Russian commercial banks are not permitted to open kroon accounts in Estonia.

2/ In the case of nonconvertible currency banknotes, transactions are limited to the equivalent of rub 8,000, but with no restrictions on the number of transactions. Exchange of such banknotes is restricted to border checkpoints, airports and railway stations.

Meanwhile, the creation of a legal framework consistent with a market economy has been delayed by the change of government. In particular, the presentation to Parliament of the competition and anti-monopoly law by October 1, 1992, which was identified as a structural reform in paragraph 53 of the MEP, is being reviewed by the new government and its intention is to submit this law--modified to conform with EC standards--to Parliament by December 1992.

III. Policy Issues for the Remainder of the Program Period

1. Inflation

The crucial element in the success of the economic program is to contain inflationary pressures in the coming months and in this way preserve the competitiveness of the Estonian economy and maintain the credibility of the currency board with the fixed peg to the deutsche mark. Progress toward low inflation has started and is likely to continue. Inflation is expected to rise temporarily in November because of further price liberalization measures--including the freeing of bread and flour prices on October 15 and telephone fees on November 1, which together are expected to add 6-7 percentage points to the measured inflation rate in November. However, beyond November, prospects for a decline of inflation appear promising. First, given the currency board arrangement, credit policy will remain nonaccommodating. Second, the deutsche mark peg should ensure that the prices of traded goods rise very little. Finally, low profitability and rising unemployment in the state enterprise sector, together with the Government's incomes policy, should help keep wage inflation under control.

2. Fiscal policies and the social safety net

a. Fiscal policy

The Estonian authorities agree that a sound fiscal policy--reflected in their commitment to a balanced budget for the remainder of 1992 and for 1993--is at the core of their stabilization effort and a key prerequisite in maintaining the credibility of the currency board. However, balancing the general government budget is becoming increasingly difficult.

Although the performance criterion for fiscal policy was comfortably met at end-September, some disquieting developments were expected in the last quarter of 1992. On the revenue side, the main uncertainty is the development of corporate tax receipts. The authorities expect only a meager increase in these receipts, mainly reflecting the weak profitability of the enterprise sector. Recent experience with enterprise tax arrears suggests that even this cautious forecast may be optimistic. The authorities are also finding that tax avoidance by individuals and enterprises is becoming an increasing problem. On the expenditure side, additional appropriations are needed to cover rising heating costs in public buildings and establishments, and to finance the Government's recently introduced program

to help support heating costs for low-income households (in cases where the heating bill exceeds 25 percent of gross family income). 1/ It was estimated that these factors could increase general government expenditures by 10 percent in real terms in the last quarter of 1992, thereby threatening budgetary balance (and the observation of the performance criterion on the Government's net position with the banking sector for December 31, 1992). However, the authorities are committed to implementing further expenditure reductions, as necessary, to comply with the end-1992 performance criteria.

The staff cooperated closely with the Ministry of Finance to elaborate a preliminary 1993 general government budget in accordance with the targets in the MEP. These early discussions suggest that achieving a balanced budget in 1993 would require additional policy action. Mainly reflecting stagnant real domestic demand, declining employment, and only a modest improvement in enterprise profitability, total revenues were expected to increase by 53 percent in 1993 as compared to a projected annual inflation rate of 63 percent. Meanwhile, total expenditures were expected to remain unchanged in real terms. The Government's intention to increase certain social transfers (pensions, family, and unemployment benefits) in real terms will thus require cuts elsewhere. As a result, the underlying general government budget deficit was estimated at about 2 1/4 percent of GDP. To balance the 1993 budget the mission recommended the adoption of a program of additional permanent savings in expenditures. The mission stressed expenditure restraint rather than further tax increases as the gross tax burden in Estonia--at 42 percent of GDP--is already high by international standards, and further increases could distort work, savings, and investment incentives. Notwithstanding the already high tax burden, the authorities were investigating the possibility of implementing a land use fee, mainly to help finance intended increases in social benefits.

b. The social safety net

Social security programs finance pensions, family benefits, unemployment benefits (funded through the extrabudgetary Social Security Fund), and medical expenses (funded through the extrabudgetary Medical Insurance Fund). While in principle all benefit payments are explicitly linked to the minimum wage, when the Government raised the minimum wage by 50 percent on October 1, benefit payments were raised by a smaller percentage to mitigate the impact on the budget: pensions (all flat rate) and family benefits from EEK 200 to EEK 260, and after-tax unemployment benefits from EEK 160 to EEK 180. The Government was considering reforming the pension system by, inter alia, raising the level of benefits; this would imply a sizable increase in outlays. It was also evaluating a switch in its

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1/ As a result of the increases in heating and hot water rates introduced in October, the average household bill for these services is expected to rise by about 200 percent.

labor market policies from passive income support to more active measures (such as public works). The authorities recognize that any increase in social security benefits must be consistent with budgetary constraints.

3. Monetary policy

Under Estonia's currency board, relatively little scope is left for an autonomous monetary policy. 1/ The Bank of Estonia may not lend to the Government 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 does take place, it is limited by the excess reserves of the Bank of Estonia (i.e., foreign exchange reserves in excess of the currency board's requirements), and therefore will not be allowed to undermine the commitment to a full backing of the currency board. As noted above, the Bank of Estonia has already provided financial assistance to two banks, and in so doing--taking account of the end-1992 performance criterion--has virtually exhausted its capacity for further lending for the remainder of the year under the program. 2/ However, substantial pressure is being brought to bear on the Bank of Estonia to use what is perceived as its excess liquidity to assist in the bank rescue operation. The mission cautioned that any financial involvement of the Bank should take into account the lending limits implicit in the need to meet the end-1992 performance criterion, and stressed the need to address concurrently the issues of liquidity and solvency. This would involve, inter alia, the recapitalization of those banks deemed viable. Financial sector reforms, including rapid improvements in banking supervision, are also needed to prevent the recurrence of similar problems. 3/

In addition to dealing with the immediate problems associated with the closure of the three commercial banks, the Bank of Estonia is also engaged in a more general bank restructuring exercise, the aim of which is to strengthen domestic commercial banks. To that end, the Bank of Estonia is actively promoting mergers among smaller banks through implementing a phased increase in the minimum capital requirement, starting with an increase from the present minimum of EEK 500,000 to EEK 6 million on

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1/ See "Operations of the Estonian Currency Board", by Adam Bennett, (forthcoming in the PPAA series).

2/ As foreign exchange reserves, surplus to the requirements of the currency board, amounted to about US$41.5 million (or over EEK 500 million) at end-September 1992, in absolute terms the Bank of Estonia retained the ability for substantial further lending without directly undermining the currency board. However, under the program limit, the scope for further lending was only US$1.5 million at end-September.

3/ Discussions are continuing between staff and the authorities on the problems in the banking system and a detailed supplement to the staff report will be issued closer to the Board meeting.

January 1, 1993. 1/ It was hoped that this measure would cut the number of licensed commercial banks from about 40 at present to about 20-25, mainly through mergers. Foreign banks are also permitted to operate in Estonia, although to date only one foreign bank license has been issued--to Baltic-American Bank which commenced operations in November 1992.

4. Incomes policy

The Government agreed that an effective incomes policy was an important element of the overall policy mix to achieve price stability and prevent wage inflation, thereby helping protect Estonia's competitive position vis-à-vis its trading partners. As expected, Estonia's real effective exchange rate appreciated in July-October, partly due to domestic inflation, but also because of the strengthening of the kroon--via its deutsche mark peg--vis-à-vis the currencies of Scandinavian countries (Estonia's main trading partners outside the FSU) and the Russian ruble. Although the competitive position of the kroon can still be regarded as strong--as illustrated by an average monthly wage equivalent to about US$55 per month in October 1992--a further material erosion can only be avoided by the rapid convergence of Estonia's inflation rate with that of its main trading partners.

With price liberalization virtually completed, the evolution of inflation will be closely linked to wage developments. In the authorities' view, the budget constraint faced by the government sector and the low profitability of state enterprises are likely to limit pay increases to below the norms provided under the program's wage guidelines. However, trade unions' claims for wage increases continue to reflect high inflationary expectations. For example, after the 50 percent rise in the monthly minimum wage to EEK 300 in October, an additional increase of 22 percent was proposed by the unions in November. The Government intends to stand firmly against these demands and freeze the minimum wage at its present level until its previous relationship with average wages is re-established. According to the MEP, the wage guidelines for the period through June 30, 1993 would be set in connection with the mid-term review of the program, due in February 1993, and will be structured to achieve a rapid deceleration of annualized inflation to single digits by mid-1993.

5. External policies

The Estonian authorities have underscored their general intention to introduce further measures to liberalize and decentralize trade and payments arrangements. To that end, all export quotas will be removed on January 1, 1993 except where deemed necessary for reasons of security or health. However, in the case of imports, pressure is building to impose import duties to offset the impact of foreign subsidies on a few agricultural items (butter, meat, cheese and potatoes). As regards payments arrangements,

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1/ The intention is to implement an annual increase in the minimum capital requirement until it reaches EEK 80 million in 1997.

under current regulations, all foreign currency accounts held by both individuals and enterprises must be closed by December 31, 1992. The Bank of Estonia is currently debating how these regulations should be modified. Although the belief is that it is too early to move to full capital account convertibility, there is a strong sentiment for continued "pragmatic" liberalization based on the principle that foreign exchange accounts should be permitted provided that there is a demonstrated need.

6. Structural policies

The Government is committed to accelerating the process of privatization, restitution and the implementation of a legal framework consistent with a market economy. The Government hopes largely to complete the privatization process within a two-year period. However, the restitution process has slowed due to the indefinite extension of the deadline for filing restitution claims by nonresidents and certain other individuals; the Government is considering setting a final deadline for all claims in early 1993 to complete this process, which has created a degree of ambiguity regarding the ownership of property. Claimants have the choice of receiving their property or a compensation voucher which can be used in the privatization process. The privatization of housing is also proceeding using a voucher system (based on the length of employment in Estonia); housing vouchers not used to purchase residential property for housing will be available to acquire enterprises being privatized.

In addition to the submission to parliament of the competition law by December 1992 (as noted above), the Government also intends to submit to parliament by end-1992 a new enterprise law and a real estate law. The latter law would make possible the ownership and sale of land, which to-date has remained largely in the hands of the Government (the exception being selected rural property already returned through restitution).

7. External assistance and the balance of payments

The staff's balance of payments projections changed materially from those set out in EBS/92/132, Supplement 1. The effects of the drought proved less severe than feared, but the EC and the United States are nonetheless likely to provide significant assistance (grants) in the form of grain during the course of the program year. 1/ Disbursements under the World Bank rehabilitation loan of US$30 million are expected to begin by end-1992. Total financing through the G-24 process during the program period is expected to be in the order of US$105 million. Of this, the EC Commission approved on November 23 a loan to Estonia of ECU 40 million (or about US$50 million) and disbursements under this loan are expected to start in early 1993. Negotiations with other contributors had not been finalized by early December although there were indications that some disbursements

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1/ The shipment of grain associated with a US$10 million soft loan from the United States was expected in November.

could take place already before the end of 1992. Meanwhile, the EBRD, with co-financing from the Nordic Investment Bank, have approved a loan for upgrading the energy sector, for a total of US$45 million; this is now expected to be disbursed over a two-year period (rather than over one year as envisaged earlier). 1/

To ensure the successful implementation of the economic program, it is crucial that the remainder of the committed external assistance is made available soon to Estonia.

The staff's medium-term balance of payments outlook and assessment of Estonia's capacity to repay the Fund have not been revised.

IV. Staff Appraisal

The Estonian authorities have pursued their economic stabilization and reform program with vigor, and all the quantitative performance criteria set for September have been met under increasingly demanding circumstances. Moreover, the new Government that took office in October, has declared its strong commitment to the policies initiated by its predecessor as detailed in the MEP. These policies are aimed at adjusting the Estonian economy simultaneously to world market prices for much of its trade, and to the transition to a market economy.

Some gains have already been made in the brief period since the program has been adopted. In particular, the availability of consumer goods has improved greatly, queues have almost disappeared, new enterprises are springing up daily, exports to industrial countries have started to grow strongly, and, importantly, the Estonian kroon has gained recognition as a strong and convertible currency. However, the economic and social dislocations associated with the adjustment process are also very real and likely to intensify over the next several months as unemployment increases. In particular, the banking crisis, if not resolved quickly, may well have serious repercussions on the economy.

The most urgent economic issue now facing the Estonian authorities is the situation in the banking sector. The problem has surfaced mainly as a result of the freezing of foreign currency deposits of Estonian commercial banks at the former Vneshekonombank in Moscow, but it also reflected the granting of loans that have not been repaid. To address the problems in the banking sector the Bank of Estonia is currently assessing the extent of the present difficulties, and the magnitude and character of measures required to address them.

1/ To reflect this change in disbursement plans, import and current account projections have been revised downward commensurately.

However, the authorities have also used the resources of the Bank of Estonia to shore up the liquidity of selected banks without addressing their solvency problems. These measures have not been successful, and the staff stresses that, in evolving an appropriate strategy, it is vital that the problems of solvency and liquidity be tackled simultaneously. Early recapitalization of those banks deemed viable, combined with management changes are essential. Rapid improvements in banking supervision are also necessary to ensure the orderly and healthy evolution of other banks. Meanwhile, continued lending by the Bank of Estonia to support the liquidity of troubled banks can only lead to an undermining of confidence in the Bank and the kroon.

So far, the Government has been successful in implementing a prudent budgetary policy in the face of falling output and rising social demands. In the period ahead, the principal challenge for the Government will be to maintain a balanced budget to support the credibility of the kroon and prevent crowding out of the emerging private sector. This task is becoming increasingly difficult in the face of the banking crisis and the demands arising from the groups hardest hit by the economic transition, especially the unemployed, retired and disabled. The banking crisis is already starting to undermine the ability of enterprises with frozen deposits to meet their tax obligations in a timely fashion. As regards strengthening the social safety net, the staff fully endorses the Government's intention to ensure the livelihood of these groups, although any increases in benefits should be accompanied by an effort to target benefits to the hardest hit groups. However, to the extent that other expenditures cannot be cut to secure the finance for this effort, rapid progress in this area will be difficult.

Preliminary calculations suggest that a budget deficit is very likely to emerge in 1993, even without any reforms to the benefits system. As the gross tax ratio is already high, raising taxes much further could cause serious distortions to savings and investment, work incentives and the efficient allocation of resources in the economy. Thus, emphasis should be placed on the containment of expenditures to levels consistent with budgetary balance. Meanwhile, improvements should be made in tax administration to ensure compliance with the existing tax code and reduce tax arrears.

Provided the Government continues to implement its firm financial and incomes policies, a rapid decline in the inflation rate, which is essential to limit the erosion of competitiveness and preserve the credibility of the deutsche mark peg, is deemed achievable following the recent surge. In this respect, the 50 percent increase in the minimum wage in September was inconsistent with the incomes policy, but the key elements of this policy were preserved through the adjustment of social benefits by a reduced factor and by limiting the increase in average wages to the ceilings agreed in the MEP. As regards the December increase in average wages, the staff supports the Government's decision to limit this increase to a maximum of 13 percent

as provided in the MEP. Meanwhile, further increases in the minimum wage should be delayed until previous relationships with average wages are restored.

The staff endorses the Government's intention to accelerate the pace of privatization and restitution. It can be expected that most of the recovery of growth and employment will come from the private sector. Accordingly, the transfer of state assets should be undertaken as quickly as is prudently possible. In addition, all possible steps should be taken to ensure that the growth of this sector is not impeded by artificial constraints. Among these constraints, ambiguities relating to the ownership of land should be speedily removed. To ensure that enterprises compete fairly, the Government should also aim for the early passage of the competition law and create the institutional apparatus to enforce its provisions.

The staff supports the Bank of Estonia's recent measures liberalizing the exchange system, particularly as it applies to the trading of rubles and other currencies of the states of the FSU. However, the need for clear and simple rules is apparent to increase transparency and predictability of the exchange system. The responsibility for transactions with the ruble area should also be shifted from the Bank of Estonia to commercial banks as quickly as possible.

The approval of the stand-by arrangement between Estonia and the Fund has opened the door to external assistance to Estonia through the G-24 process. The rapid mobilization and use of these resources will be crucial in facilitating an early recovery of growth and employment. In this respect, the staff is concerned that none of the balance of payments assistance pledged has yet been disbursed, and urges foreign donors to conclude agreements as quickly as possible. Immediate steps should also be taken to ensure that delays on the Estonian side are not responsible for stalling the negotiation and disbursement of loans provided from external sources.

The Estonian authorities are committed to pursue a strong stabilization and economic reform effort, and considerable progress has already been achieved. Therefore, the staff recommends that the proposed decision be adopted.

V. Proposed Decision

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

The Fund decides that the review contemplated in paragraph 4(c) of the stand-by arrangement is completed and Estonia may proceed to make a purchase of SDR 5.0375 million under the stand-by arrangement.

Table 1. Estonia: Quantitive Performance Criteria
at end-September 1992

Variable and periods	Program	Actual
	(in millions of Estonia kroon)	
I. Limits on net credit of the banking system to the general government		
Position on June 30, 1992 1/	-174	...
Limits for:		
September 30, 1992 1/	-129	-178
	(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:		
Position on June 20, 1992	-5.5	...
Targets for:		
September 30, 1992	12.0	13.5
	(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	17.3
IV. The currency board remained fully backed with foreign exchange throughout the third quarter of 1992		
V. The Government has not contracted or guaranteed loans of less than one year's maturity, with the exception of normal import financing, or accumulated any external arrears. 2/		

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

1/ The Government's net position for June 30, 1992 has been revised upward by EEK 23 million, as provided in Appendix I of the Memorandum of Economic Policies. An equivalent upward adjustment has been made to the target for net claims at September 30, 1992.

2/ Compliance with the limits of the external medium- and long-term debt of the Government and the Central Bank for July 1-December 3, 1992 shall be verified during the Second Review. So far, the cumulative net disbursements of external debt amounts to US$10 million compared to the maximum limit of US$80 million for 1-5 year maturity and of US$130 million for 1-12 year maturity.

Table 2. Estonia: Selected Economic Indicators

	1990	1991 1/	1992 2/	1993 2/	1992 Q1	1992 Q2	1992 Q3	1992 Q4 Program
	(Percentage Change Over Same Period In Previous Year)							
Output and employment								
Real GDP	−3.6	−12.6	−26	0	−28	−29	−28	−22
Industrial Production, Volume	−5.6	−9.0	−32	...	−34	−37	−39	...
Total Employment	−2.0	−1.0	−4	−5	...	...	...	...
Prices and costs								
Consumer price index	23.1	210.0	1,055	63	854	1,029	1,168	902
Average wage	24.5	98.3	529	61	356	483	664	492
Real wage	1.1	−36.0	−46	2	−52	−48	−39	−42
	(Percentage Change Over Previous Period)							
External sector								
Export volume								
CIS and Baltics, goods	...	...	−47	9	...	71	−10	15
Other countries, goods	...	...	87	57	...	28	155	4
Import volume								
CIS and Baltics, goods	...	...	−57	7	...	21	48	45
Other countries, goods	...	...	10	56	...	43	106	62
Current account deficit,(US$ millions) 3/	...	546	−116	−170	...	33	−11	−82
In percent of GDP	...	...	−14	−13	...	...	...	...
Net international reserves in convertible currencies, (US$ millions) 4/	...	...	12	...	...	−5.5	13.5	12
Public finance								
Total revenue	10.6	136.2	538	53	...	...	...	...
Total expenditure	6.7	122.3	570	63	...	...	...	...
Balance, in percent of GDP	...	4.9	1.5	−2.2	...	1.4 5/	...	1.6 5/
Net claims on the general government (EEK million, end of period)	...	−95	−174	...	−83	−174	−178	−174
Financial market								
Domestic credit	48.9	429.2	...	...	−13	51	3	...
Broad money	...	...	...	...	−16	66	5	...
Interest rates (loans, percent)	...	...	...	...	...	...	...	...
State banks	2−5	6−11	...	...	...	...	...	...
Private commercial banks		20−30			...	80−100	50−60	...
Interest rates (deposits,percent)	...	...	...	...	...	20−40	20−30	...

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

1/ Preliminary estimates.

2/ Staff forecasts.

3/ Including official transfers.

4/ Based on definitions agreed in the Letter of Intent for the performance criteria on net international reserves.

5/ First and second half of 1992, respectively.

Table 3. Estonia: Summary of Consolidated General Government Operations 1991-92 1/

(In millions of kroons)

	1991	1992		
	Actual 2/	Total	1st half (Act.)2/	2nd half (Prov.)3/
Total general government revenue	667	4,690	1,572	3,118
Tax revenue	619	4,336	1,355	2,981
Taxes on income and profits	257	1,645	540	1,105
Taxes on goods and services	181	1,111	373	738
Taxes on property	17	--	--	--
Taxes on international trade	4	61	19	42
Payroll taxes	143	1,473	404	1,069
Other taxes	17	47	20	27
Nontax revenue	48	354	217	137
Total general government expenditure	582	4,538	1,520	3,018
Current expenditure	520	4,387	1,446	2,941
Wages and salaries	74	965	315	650
Other goods and services	234	2,016	647	1,369
Interest payments	2	...	...	...
Subsidies/current transfers	210	1,408	484	924
Capital expenditure	62	151	74	77
General government budget balance	85	152	52	100
Of which: (- = deficit)				
State budget	17	583	271	312
Local budget	30	-384	-136	-248
Extrabudgetary funds	38	-47	-83	-36
Memorandum items:				
Ratios to GDP (in percent)				
Overall budget surplus	4.9	1.5	1.4	1.6
Total general government revenue	38.6	45.4	40.2	48.6
Of which: tax revenue	35.9	42.0	34.6	46.5
Total general government expenditure	33.7	43.9	38.8	47.1
Of which: current expenditure	30.1	42.5	36.9	45.7
Intergovernmental transfers (gross)	143	882	323	559
To state budget	14	100	...	100
To local budgets	44	325	189	136
To extrabudgetary fund budgets	85	457	134	323

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

1/ Excluding intergovernmental transfers. Rounding errors.
2/ Converted from rubles into kroons at a conversion rate of EEK 1 = rub 10, to facilitate comparison.
3/ Based on actual data through October.

Table 4. Estonia: Monetary survey

(In millions of kroons; end of period)

	1991	1992		
	Qtr.IV	Qtr.I	Qtr.II	Qtr. III
Net foreign assets	2,087.5	1,290.4	1,727.0	3,116.1
Foreign assets	2,551.6	1,841.1	2,822.1	3,837.5
In convertible currency	2,069.8	1,315.1	2,338.8	3,267.8
Of which: BoE's gold holdings	--	662.3	114.0	352.2
In nonconvertible currency 1/	481.8	526.0	483.3	569.6
Foreign liabilities	-464.1	-550.7	-1,095.1	-721.3
In convertible currency	-208.1	-238.1	-791.7	-369.2
In nonconvertible currency 1/	-256.0	-312.6	-303.4	-352.2
Net domestic assets	199.5	635.8	1,466.2	229.8
Claims on general government (net)	-94.7	-83.3	-174.1	-177.8
Central government (net)	-65.6	-49.6	-106.6	-127.7
Of which: claims on	1.8	7.4	17.3	32.4
Local government (net)	-29.1	-33.7	-68.1	-50.1
Of which: claims on	--	14.6	40.6	62.5
Claims on state enterprises	854.4	518.8	472.7	589.4
Claims on private sector	344.7	520.3	1,145.0	1,076.6
Other items (net)	-904.9	-320.0	22.6	-1,258.4
Liquid Liabilities (M2)	2,286.9	1,926.1	3,193.2	3,345.9
Currency outside banks	212.4	267.9	237.0	723.4
Demand deposits	478.4	532.1	766.6	1,765.5
Time and savings deposits	305.2	298.8	278.4	144.8
Foreign currency deposits	1,290.9	827.3	1,911.2	712.2

Source: Data provided by the Estonian authorities.

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

Table 5. Estonia: Balance of Payments 1991-93

	1991 1/	1992	1992				1993	1993	
			Q1	Q2	Q3	Q4		Q1	Q2
			(In millions of U.S. dollars)						
Current account balance	546	-116	-38	3	-11	-70	-170	-58	-43
Trade balance	534	-131	-39	--	-15	-77	-200	-64	-48
CIS and Baltics	686	-52	-3	19	-12	-57	-87	-29	-17
Other countries	-152	-79	-36	-19	-4	-20	-113	-35	-31
Exports	2,866	377	42	82	126	127	581	134	142
CIS and Baltics	2,814	214	24	59	65	65	318	71	77
Other countries	52	163	18	22	61	62	263	63	65
Imports	2,332	507	81	81	141	204	781	198	190
CIS and Baltics	2,128	266	27	40	77	122	406	100	94
Other countries	204	241	53	42	64	82	375	98	96
Services (net)	12	9	--	3	3	3	18	3	3
Interest (net)	...	2	--	--	--	2	1	1	--
Private transfers	...	3	--	--	2	2	10	2	2
Clearing arrangements	...	-17	3	-20	--	--	--	--	--
Reserves (increase -)	...	-183	-55	-6	-108	-13	-26	-7	-7
Financing	...	262	91	23	120	28	116	28	38
Claims on gold	...	125	55	--	70	--	--	--	--
Short-term credits	...	--	--	3	-3	--	--	--	--
Private flows	...	25	--	--	23	2	--	--	--
Direct investment	...	18	--	5	10	3	16	3	4
Trade credit (official)	...	23	20	--	10	-7	-4	-7	3
Official transfers	...	31	16	15	--	--	35	13	12
Medium and long term (net) 2/	...	23	--	--	--	23	48	12	12
IMF purchases (net)	...	18	...	...	11	7	21	7	7
Financing gap	...	54	--	--	-1	55	80	37	12
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	45	34	58	52	52	49	49	52
Other countries	163	305	137	176	448	460	479	469	477
Import volume (1990=100)									
CIS and Baltics	70	30	19	23	34	52	32	32	31
Excl. energy	69	21	16	20	23	23	23	23	23
Other countries	111	122	115	66	136	172	190	200	194
Reserves (gross)	...	183	55	62	170	183	209	190	197
Reserves (mths of imp)	...	4.3	2.1	2.3	3.6	2.7	3.2	2.9	3.1
Reserves (net)	...	165	55	62	159	165	170	165	165
			(In percent)						
Debt/GDP (Incl IMF)	...	8.2	--	--	--	8.2	16.3	9.3	11.6
Debt service/Total exports	...	--	--	--	--	--	1.9	2.5	1.5
Debt service/Non FSU exports	...	--	--	--	--	--	4.3	5.3	3.2
Current account/GDP	...	-13.7	-18.1	1.5	-5.0	-33.2	-12.6	-17.2	-12.7

Sources: Estonian authorities and staff estimates

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

Table 6. Estonia: Schedule of Purchases Under Stand-By Arrangement

Amount	Scheduled Availability Date	Conditions Necessary for Purchase
SDR 7.7500 million	Purchased September 21, 1992	
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

Source: International Monetary Fund.

Table 7. Estonia: Projected Payments to the Fund
(In millions of SDRs; as of November 30, 1992)

	1992	1993	1994	1995	1996	1997	1998	Total
Obligations from existing drawings								
1. Principal repurchases	--	--	--	1.0	3.9	2.9	--	7.8
2. Charges and interest 1/	0.1	0.5	0.5	0.5	0.4	0.1	--	2.0
Total obligations	0.1	0.5	0.5	1.5	4.2	3.0	--	9.8
(percent of quota)	0.1	1.1	1.1	3.2	9.0	6.5	--	21.1
Obligations from prospective drawings								
1. Principal repurchases	--	--	--	--	4.4	10.1	5.7	20.2
2. Charges and interests 1/	--	0.6	1.3	1.3	1.2	0.7	0.2	5.2
Total obligations	--	0.6	1.3	1.3	5.6	10.8	5.8	25.3
(percent of quota)	--	1.3	2.8	2.8	12.0	23.2	12.5	54.4
Cumulative (outstanding and prospective)								
1. Principal repurchases	--	--	--	1.0	8.3	13.0	5.7	27.9
2. Charges and interest 1/	0.1	1.1	1.8	1.7	1.5	0.8	0.2	7.2
Total obligations	0.1	1.1	1.8	2.7	9.8	13.8	5.8	35.1
(percent of quota)	0.1	2.4	3.9	5.8	21.1	29.7	12.5	75.5

Source: International Monetary Fund.

1/ Projections are based on current rates of charge, including burden-sharing charges where applicable.
2/ Based on post-Ninth Review of Quota of SDR 46.5 million.

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

Table 8. Estonia: Projection of IMF Position
During Period of Proposed Stand-By Arrangement

	1992		1993		
	July-Sept.	Oct.-Dec.	Jan.-Mar.	April-June	July-Sept.
	(In thousands of SDRs)				
Purchases	7,750.0	--	5,037.5	5,037.5	10,075.0
Tranche policies	7,750.0	--	5,037.5	5,037.5	10,075.0
Ordinary resources	7,750.0	--	5,037.5	5,037.5	10,075.0
Total Fund credit outstanding (end of period)	7,750.0	7,750.0	12,787.5	17,825.0	27,900.0
Tranche policies	7,750.0	7,750.0	12,787.5	17,825.0	27,900.0
	(In percent of quota) 1/				
Total Fund credit outstanding (end of period)	16.67	16.67	27.50	38.33	60.00
Tranche policies	16.67	16.67	27.50	38.33	60.00

Source: International Monetary Fund.

1/ Estonia's quota is SDR 46.5 million.

November 9, 1992

Dear Mr. Camdessus,

I have the honor to inform you that the new Government of Estonia, which was formed on October 22, 1992, has undertaken to complete the transformation of Estonia into a market economy as rapidly as possible and believes that this can only be accomplished by the implementation of a strong stabilization program.

Consistent with these objectives, the Government of Estonia is fully committed to executing the policies set out in the Memorandum of Economic Policies agreed to by Mr. Vähi's Government on August 14, 1992 and by the International Monetary Fund's Executive Board on September 16, 1992 in the context of Estonia's request for a stand-by arrangement. The successful implementation of these policies will make a key contribution to maintaining confidence in the kroon and creating the preconditions for sustained economic growth in the medium term. The Government also fully supports the independent status of the Bank of Estonia and the currency board system, which it believes remain fully appropriate to Estonia's present circumstances.

In addition, the Government of Estonia also agrees to fulfill the undertakings described in the letter signed by Messrs. Vähi and Kallas on August 14, 1992, including taking whatever additional measures may become necessary to achieve the aims of the program and the completion with the Fund of three reviews of economic developments and policies under the program.

As you will have been informed by Mr. Knöbl, Estonia has successively met all its quantitative performance criteria for end-September 1992 and has also reviewed the appropriate increase in average wages in November 1992 under its incomes policy, which it was decided to limit to 13 percent. Accordingly, the Government looks forward to the successful completion by the Fund of the first review under Estonia's stand-by arrangement.

Sincerely,

Mart Laar - Prime Minister

Received in the Fund on November 19, 1992

Estonia -- Fund Relations

(as of November 30, 1992)

I. Membership Status

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

II. General Department (General Resources Account)

	(In millions of SDRs)	(In percent of quota)
(a) Quota	46.5	100.0
(b) Total Fund holdings of currency	54.25	116.7
(c) Fund credit	--	--
Credit tranche	7.75	16.7
CCFF	--	--
(d) Reserve tranche position	--	--
(e) Operational budget transfers (net)	--	--

III. SDR Department

		(In percent of allocation)
(a) Net cumulative allocation	--	...
(b) Holdings	7.72	...
(c) Designated plan amount	--	--

IV. Outstanding Purchases and Loans:

		(In percent of quota)
Stand-by arrangement	7.75	16.7

V. Financial Arrangements:

Type	Approval date	Expiration date	Amount approved (SDR millions)	Amount drawn (SDR millions)
Stand-by	Sept.16, 1992	Sept.15, 1993	27.90	7.75

VI. Projected Obligations to Fund (SDR millions):

	Overdue	1992	1993	1994	1995	1996	1997	1998	Total
Principal	--	--	--	--	1.0	8.3	13.0	5.7	27.9
Charges/Interest	--	0.1	1.1	1.8	1.2	1.5	0.8	0.2	7.2
Total obligations	--	0.1	1.1	1.8	2.7	9.8	13.8	5.8	35.1
(in percent of quota)	--	0.1	2.4	3.9	5.8	21.1	29.7	12.5	75.5

VII. Exchange Rate Arrangement

The currency of Estonia is the kroon. The kroon replaced the ruble on June 20, 1992. Since that day, the Bank of Estonia (the Bank) has offered a fixed rate of exchange of EEK 8 per DM for kroon bank notes, coins, and reserve deposits of commercial banks. This conversion is guaranteed for all valid current account transactions. A 100 percent surrender requirement for export receipts is in effect, except for enterprises granted a special license by the Bank of Estonia. Capital account transactions require the authorization of the Bank. The Bank deals only in 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, plus the Russian ruble, at rates of their own choosing, with the proviso that the rate of exchange including commission should not diverge from their central rate, or rates derived from cross rates, by more than plus or minus 3 1/2 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 1/

Department	Subject/Identified Need	Action	Timing	Counterpart 2/
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, foreign exchange operations and monetary policy	Mission	Feb. 92	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
INS	Course on Financial Programming	Visit	Sep. 92	BOE/MOF
STA	Balance of Payments Statistics	Visit	Nov. 92	BOE
MAE	Foreign operations, payments, accounting & banking supervision	Mission	Oct. 92	BOE
STA	Government Finance	Mission	Dec. 92	MOF

Source: International Monetary Fund.

1/ Through December 15, 1992.
2/ 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) has now been discussed with the Government in the final published form.

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--amounting to US$30 million--was presented to the Board of Directors on October 1, 1992, signed on October 2 and became effective on October 6, 1992. It is expected to be disbursed over a period of about 12-18 months.

A Bank mission visited Estonia in October 1992 to prepare a detailed assessment of enterprise and financial sector reform issues and initiate the preparation of a possible lending operation focusing on enterprise reform, private sector development and banking restructuring. A Bank mission will visit Estonia in December 1992 to prepare a possible energy operation which would focus, in particular, on investments promoting energy conservation and efficiency.