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EBS/93/166
Correction 1

CONFIDENTIAL

October 13, 1993

To: Members of the Executive Board

From: The Secretary

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

The following correction has been made in EBS/93/166 (10/8/93):

Page 13, lines 2-3: for "A financing gap...public borrowing."
read "On the basis...emerge in 1994."

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

the program period, or at about the same level as in the first half of 1993. On the basis of these projections, no financing gap is envisaged to emerge in 1994.

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

7. Structural reforms and the transition to a market economy

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

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

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

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

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

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

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

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

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