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Report No: 18984

PERFORMANCE AUDIT REPORT

ESTONIA

REHABILITATION LOAN
(Loan 3522-EE)

February 25, 1999

Operations Evaluation Department

Currency Equivalents
(As of December 31, 1994)

Currency Unit = Kroon
US$ 1.00 = 12.39 Kroons
Kroon 1 = US$ 0.081

Weights And Measures

Metric System

Fiscal Year

January 1 - December 31

Abbreviations and Acronyms

CIS	Confederation of Independent States
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
ECA	Export Credit Agencies
EDI	Economic Development Institute
EFF	Extended Fund Facility
EFSAP	Enterprise and Financial Sector Assistance Project
EFTA	European Free Trade Area
ESA	Estonian Statistical Agency
ESW	Economic and Sector Work
EU	European Union
FIA	Foreign Investment Advisory Service
FSU	Former Soviet Union and Baltic Republics
GAT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
GNP	Gross National Product
G-24	Group of 24
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
ICR	Implementation Completion Report
IDA	International Development Association
IDF	Institutional Development Fund
IMF	International Monetary Fund
JEXIM	Export Import Bank of Japan
MER	Ministry of Economic Reform
MERP	Memorandum of Economic Reform Policies
MIGA	Multilateral Investment Guarantee Agency
MOF	Ministry of Finance
NIB	Nordic Investment Bank
OECD	Organization for Economic Cooperation & Development
OED	Operations Evaluation Department
PER	Public Expenditure Review
PHARE	Economic Assistance Program for the Restructuring of Europe
PIP	Public Investment Program
PIU	Project Implementation Unit
PRL	Power Rehabilitation Loan
PSD	Private Sector Development
SAL	Structural Adjustment Loan
SECAL	Sector Adjustment Loan
SBA	Stand-by Arrangement
SOE	State-owned Enterprise
SSNP	Social Safety Net Project
TA	Technical Assistance
VAT	Value Added Tax
VHK	Valtion Hankintakeskus (Finnish Government Purchasing Center)

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The World Bank
Washington, D.C. 20433
U.S.A.

Office of the Director-General
Operations Evaluation

February 25, 1999

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Performance Audit Report on Estonia: Rehabilitation Loan (Ln. 3522-EE)

Attached is the Performance Audit Report (PAR) on Estonia–Rehabilitation Loan (Ln. 3522-EE for US$30 million, approved in FY93). The Estonia project closed on September 30, 1994, six months after the original closing date, with 4.6% of the principal amount being canceled.

The Rehabilitation Loan was extended in emergency conditions following the break-up of the former Soviet Union. It had the following main objectives: (i) to assist the Borrower in designing and implementing the stabilization and the structural reform programs outlined in Estonia's Memorandum of Economic Reform Policies (MERP); and (ii) to help maintain capacity utilization and output in key sectors during the difficult initial phase of transition to a market economy.

In preparing this project, the Bank faced a complex trade-off: financing critically-needed imports, providing timely support for Estonia's adjustment program, and ensuring accountability for loan resources in a country rebuilding its political and economic institutions.

The loan was approved just after Estonia had regained its independence, after a five-year period of experimentation in economic reform. It provided timely and visible external support for a reform program which has subsequently been deepened and sustained. It also facilitated imports of heating oil and other vital commodities during Estonia's first winter after independence. But flaws in project design, including complex procurement requirements and inadequate on-lending facilities for private sub-borrowers, delayed roughly half of the imports until they were no longer in short supply.

The PAR gives greater weight to the economic reform objective of the Rehabilitation Loan, whose outcome is rated as satisfactory. Sustainability is considered likely, thanks to Estonia's durable economic recovery. Institutional development impact is rated as modest, taking into account evidence that international competitive bidding techniques have taken hold in some parts of the public sector, and that, indirectly, the Rehabilitation Loan provided modest support for a reform program which profoundly changed the economic rules of the game. Bank and Borrower performances are rated satisfactory, despite some shortcomings in how the procurement process was designed and implemented.

A key lesson is that the Rehabilitation Loan design did not lead to timely delivery of critically-needed imports. A better project design would have been a quick-disbursing structural or sector adjustment loan with modest conditionality tied to the liberalizing reforms already underway. Such a loan would have been maximally effective, if it had (i) provided on-lending support for private importers; (ii) supplied direct budgetary support to public purchasing agencies; and (iii) restricted items eligible for financing to a few vitally-needed commodities.

Contents

This report was prepared by John H. Johnson, Task Manager. Eneshi Irene K. Davis and Betty Casely-Hayford provided administrative support.

Ratings and Responsibilities

	Estonia (Loan 3522-EE)
Outcome	Satisfactory
Sustainability	Likely
Institutional Development Impact	Modest
Borrower Performance	Satisfactory
Bank/IDA Performance	Satisfactory

Key Staff Responsible

		Appraisal	*Completion*
Estonia (Ln. 3522-EE)	*Task Manager*	Mr. Jaime Biderman	Mrs. Maha Armaly
	Division Chief	Mr. Adil Kanaan	Mr. James Q. Harrison
	Country Director	Mr.Russell Cheetham	Mr. Basil G. Kavalsky

The ICR was prepared as follows:

Estonia: Rehabilitation Loan	Ln. 3522-EE	Mrs. Maha Armaly

Preface

1. This is the Performance Audit Report (PAR) on the Estonia Rehabilitation Loan (Ln. 3522-EE), approved in September 1992 for US$30 million. The loan was extended to assist Estonia in dealing with critical foreign exchange and import shortages following the break-up of the former Soviet Union, particularly in the energy, transport, agriculture and the social sectors.

2. The PAR focuses on the difficulty of designing loans so that they disburse quickly during the period of greatest shortages, while simultaneously maintaining accountability for the efficient use of the funds. The PAR concludes that the loans were most successful in providing timely and visible Bank support for an adjustment effort which has ultimately been sustained. However, it also finds that the operation was considerably less successful in financing critical import needs. It argues that a larger part of the funds committed after mid-1993 should have been cancelled because the import shortage had by then ceased, thanks to inflows of large-scale financial assistance and the emergence of more flexible and efficient private sector import facilities.

3. The PAR was sent to relevant officials in the Government for comments. However, no comments were received.

1. Introduction

1.1 The Rehabilitation Loan was prepared under intense time pressures. The Bank faced an unappealing trade-off. On the one hand, the Bank was eager to provide timely public support for promising adjustment measures and urgently-needed foreign exchange for imports. On the other hand, the Bank sought to maintain adequate controls over the use of the funds in a country where political and economic institutions were only beginning to function.

1.2 As this audit will demonstrate, the loan was most successful in providing tangible support for Estonia's adjustment efforts. But, as a device for helping finance urgent import needs, particularly during the critical winter and spring of 1992-93, the loan fell well short of expectations. Only about half of the disbursements from the Estonia Rehabilitation Loan for fuel, transport, and agricultural inputs occurred during the period when they were most needed, i.e., before Estonia had established working trade ties with the West on a broad scale. As Estonia's economic situation rapidly improved, the country's vastly improved capacity to finance imports through more efficient private channels obviated the need for further financing from the Rehabilitation Loan.

1.3 Rather than canceling the remainder of the Loan, the Bank and Borrower sought to identify new import needs, leading to new delays. The revised list of imports adopted during the last 15 months of implementation reflected increased attention to vested interest requests for long-term investment and working-capital loans, even though no appraisal or supervision capacity for such programs had been established.

1.4 There were four key reasons for this outcome. First, the Project Implementation Unit (PIU) and the purchasing agencies, lacking practical experience and training for international procurement, floundered during the initial year of learning. A full-time external procurement advisor did not come on board until mid-1993, when the emergency had basically ended. This rapid improvement in Estonia's economic situation was a second key factor which limited the usefulness of the loan. Thirdly, the Bank's procurement controls, designed to promote transparency and accountability, were complex and difficult for new borrowers to master, acting as significant barriers to rapid acquisition of needed goods. Fourthly, the loan design failed to anticipate that importers, both public and private, lacked at the outset sufficient local currency to acquire critically-needed imports. The effort to establish on-lending mechanisms during implementation contributed to delays.

2. Background

Estonia Rehabilitation Loan (L3522-EE)

2.5 Rehabilitation Loan 3522-EE, approved in September 1992, was valued at US$30 million. Grant technical assistance for procurement was provided by the Government of Finland, and parallel financing of US$20 million was provided by JEXIM. Disbursements by sector (Table, Annex B) were distributed as follows: 52 percent for energy; 18 percent for transport; 10 percent for the social sector; and 20 percent for agriculture. As a proportion of total imports, the loan never financed more than 2 percent in any single year, or more than 8 percent in any given sector. Two-thirds of disbursements took place during 1993, nearly a third (30.2

percent) in 1994. Only US$1.1 million (3.8%) was disbursed during 1992, the year of the most critical shortages.

3. The Economic Scenario in Estonia at the Time of Loan Preparation[1]

3.1 Following independence in August 1991, **Estonia** experienced a sharp, but temporary recession, combined with critical shortages of basic consumption commodities and key raw materials and production inputs. After declining in 1992 and 1993, real output began to recover only in late 1993. However, one advantage that Estonia enjoyed was the fact that its efforts to undertake restructuring had actually begun in 1987, when it served as a laboratory for economic initiatives which were later expected to be applied in the rest of the Former Soviet Union. Still, the Rehabilitation Loan was prepared in great haste, leaving almost no time for training the PIU in international procurement procedures, a factor which would weigh heavily on subsequent implementation problems.

4. Design of the Loan

4.1 The Estonia Rehabilitation Loan had dual objectives, and it is critical to assess the importance to be ascribed to each of these objectives. First, they were to provide emergency assistance at a critical juncture of a vast, anticipated transformation from command to market economies. The concern was to avoid a total collapse in production before this transformation could be completed. Finance was directed to the purchase of imported spare parts and equipment in sectors such as petroleum and gas, power, transportation, pharmaceuticals, and agriculture. These sectors had been identified during preparation and appraisal as likely to prevent further deterioration in the existing capital stock of economically-viable sectors; as essential to maintain public services such as power, heating, and health; and to generate a short-term supply response to the new incentives expected to emerge as a result of the transformation to a market economy. It was mutually agreed between Bank and Borrower that disbursement should be largely concluded in no more than nine months, taking account that, at the time of approval, Estonia faced a harsh winter with a shortage of energy supplies, and an uncertain spring due to the lack of adequate seeds, fertilizers, and agricultural machinery spare parts.

4.2 Secondly, the loan supported the design and implementation of a stabilization and structural reform program which had been only partially elaborated in public documents prior to loan approval. However, rather than doing a SALs or a SECAL, the Bank opted in favor of quick-disbursing program lending as a first step in building a partnership with the Borrower. SALs and SECALs were regarded as too cumbersome and time-consuming, given the emergency economic situation, and impractical, given the borrowers' unfamiliarity with the prescriptions of a market economy and the distractions of nation-building. The Bank, too, required additional time to identify key development issues and fashion appropriate remedies.

[1] See, also, the Implementation Completion Report: **Estonia Rehabilitation Loan** (Report No. SecM95-395, dated April 25, 1995).

4.3 Therefore, the loan contained no specific conditionality governing the release of funds. Rather, the Government of Estonia (GOE) pledged to: (a) implement the policy measures outlined in a Letter of Development Policy submitted prior to approval; (b) establish and maintain an adequately-staffed PIU; and (c) procure critically-needed imports under standard Bank procurement procedures.

4.4 The adjustment measures identified in the Letter of Development Policy included: (a) deepening trade liberalization through reductions in maximum tariffs, the elimination of all quantitative import restrictions and export tariffs, the maintenance of flexible exchange rate policies, and the introduction of a revised export incentive scheme; (b) strengthening public sector performance through increased government saving, improved tax administration, a shift from taxation of external trade to taxation of domestic income and consumption, increased public utility tariffs, review of the 1992-93 public investment program for its relevance to emerging market forces, and steps to strengthen public enterprise management; (c) lowering or restricting the coverage of guaranteed crop prices, agricultural import quotas, and food and production subsidies; (d) easing interest rate controls, consolidating public sector lines of credit, redefining the role of state agricultural banks, and strengthening bank supervision; and (e) targeting public assistance to the poor.

4.5 During implementation, it became apparent thatthe Rehabilitation Loan suffered from a number of design flaws, which blunted achievement of the emergency import objective. The most critical period for receiving these imports was during the first nine months of loan implementation, roughly from September 1992 until June 1993. The Bank established a target of fully disbursing this loan within one year, and preferably within the first nine months. In fact, the loan took two full years to disburse, and resulted in cancellation of roughly 5 percent of the proceeds at closing. After June 1993, disbursement slowed markedly, as the state-controlled procurement channels were rapidly displaced by more flexible and efficient private channels, and a flood of outside financial assistance and private capital greatly eased domestic illiquidity. Thus, the funds from the Rehabilitation Loans became largely redundant.

4.6 There were a number of factors which slowed disbursement. First, the critical import components were complex, requiring frequent Bank missions, an extensive exchange of correspondence, and endless revision of the eligible list of imports. Secondly, the PIU was inexperienced, and did not receive full time expert procurement advice until mid-1993, too late to be effective. Thirdly, a primary obstacle to rapid acquisition of imports was not recognized during the design phase, namely the inability of most Estonian importers to come up with sufficient local currency to pay for the critical imports. Indeed, it was the local currency shortages, rather than foreign exchange, which provided one of the largest bottlenecks to procurement. By omitting a local-currency on-lending facility from the outset, the Rehabilitation Loan ran into immediate difficulties.

5. Implementation of the Loan

Critical Import Components

5.1 Overcoming the lack of capacity among importers to acquire local currency for foreign exchange purchase required establishment of an on-lending facility during the implementation phase, adding to the delays. Moreover, by providing extended, multi-year repayment terms at subsidized interest rates instead of short-term sale/purchase financing, the on-lending facility served at times as working capital for financially-shaky state purchasing agencies. Adding to the delays were complex Bank procurement procedures, a lack of borrower experience with international competitive bidding, and inadequate provisions for bringing in prompt outside technical assistance.

5.2 The Rehabilitation Loan did make **some** contribution to filling critical import requirements. For example, energy imports contributed modestly to averting shortages of heating fuel and natural gas during the winter of 1992. And some non-energy imports, such as the spare parts for urban bus and trolley fleets, proved vital in maintaining vital transport equipment in continuous operation. Also, there was evidence that the Loan transferred useful technology about conducting international competitive bidding to a large number of public and private sector borrowers.

5.3 But, at least half of financed imports arrived too late to be of any real help, as illustrated by a large fuel oil shipment which arrived too late for the 1993 winter heating season, and had to be held in inventory for nearly a year, at some expense to the Borrower. By the time the next heating season rolled around, the fuel oil was no longer in short supply. Excerpts from a written statement submitted to OED by the Estonian Power Company, Eesti Energia, evaluating its procurement experience with L3522-EE, are all-too-representative of the sort of complaints registered by many sub-borrowers about the complications and delays associated with drawing down the rehabilitation loans:

> *"The Government...allocated US$5.0 million to the energy sector for the purchase of chemicals and materials. The Ministry of Economy allocated US$4.5 million...to the state-owned enterprise, Eesti Energia, and US$500,000 to the company "Termest" for small heating stations. Eesti Energia was appointed to carry out the purchase competition and conclude the procurement agreement...In the second half of 1992, material supplies from Russia stopped. There was no convertible currency to buy it from abroad. As a result of the bids presented [from] international...competitions, it turned out that the prices for necessary compressors and trafos were much higher than in Ukraine. That is why they were not purchased. There were no offers of flouorescine. Because of the high prices, less water purification chemicals and pipes than previously planned were bought...There was an initial plan to use the materials to be bought ...during the winter of 1992/93. In reality, the supplies were postponed, mainly to the second half of 1993. By that time,...the improved supply conditions in Russia enabled us to get some materials cheaper from there...The basic influence of the loan is that the relatively low-[interest]-rate loan enabled us to improve...turnover and increase the company's liquidity...On account of the loan, the supplies of some important [repair] materials were restored...although delays in its realization for almost a year decreased its effectiveness...Participation in...the loan enabled us to become familiar with the procedure and various stages of [lending] by the World Bank, which helps us to be more effective in the future when using World Bank loans. A number of employees were introduced to technical terms and [the standards] for materials used worldwide."*[2]

5.4 By late 1993, with competition from private importers bringing in a wider selection of higher quality, often cheaper goods, state purchasing agencies found it increasingly difficult to

[2] Statement of Ants Pauls, Deputy Chief Engineer, Eesti Energia, submitted to OED, June 1996.

liquidate inventories of pharmaceuticals, agricultural inputs, etc. financed under the loan, except at a loss. The release of parallel financing from JEXIM during 1993-94 only compounded the problem of finding worthy uses for the rehabilitation funds.

5.5 Rather than cancel the remaining funds – about half the original amount – the Bank and the Borrower embarked on a search for additional items in short supply. More often than not, however, the new items more closely resembled capital investments, for which neither the Bank nor the Borrower had conducted adequate appraisals. Examples were railroad engines and gearboxes, spare parts for buses for urban transport, and medical equipment. As the Bank and Borrower became increasingly frustrated at the inordinate amount of time and staff resources needed to negotiate and contract for comparatively modest packages of imports, vested interests began viewing the on-line credit facility as a vehicle, however modest, for boosting working capital and starting the renovation of their outmoded and worn-out equipment. The Bank, to its credit, turned down many proposals of doubtful eligibility. Still, some requests slipped through, as the passage of time and the urgency of closing out the loans led to a relaxation of import criteria. In the end, state purchasing agencies/enterprises were able to negotiate generous financing terms from the on-lending facility, which afforded them an opportunity to convert the sub-loans into longer-term working capital finance, as noted in the Eesti Energia statement.

5.6 In fairness, it must be stated that, in 1992, when this loan was being prepared and appraised, state purchasing agencies and enterprises were virtually the only institutions with any capacity for, or experience with, importing, and even they had done virtually all their procurement through central ministries in Moscow until that time. While they were the only agencies available, these state-run enterprises were the least suitable channel for importing efficiently into economies that were undergoing rapid privatization of the retail and commercial sectors.

5.7 Herein lay the dilemma for the Bank. For there is little question that, in the early days of independence, the only conceivable importers lacked familiarity with international standards of procurement and were only beginning to come to grips with the challenge of managing economies in transition to market-based systems. Logically, the Bank facilitated intensified technical assistance from the Finnish Government on procurement, while designing into the loan mechanisms, such as a positive import list and international competitive bidding, which seemed to lessen the risks of squandering the loan resources.

5.8 Unfortunately, the end result was to overwhelm the borrowers with a multitude of complex, bureaucratic procurement requirements which produced frequent delays and, not infrequently, supplied goods which were costlier and not as well-adapted to Estonia's needs as alternative products from the FSU.

Economic Reforms

5.9 By far the most successful of the two major lending objectives was the support for the incipient stabilization and structural reform programs. Estonia has achieved significant macroeconomic stabilization and structural adjustment since early 1992, with the pace of reform having been accelerated significantly during the last five years. During loan implementation, the Government implemented a tight fiscal policy, registering surpluses in the general Government's budgetary operations throughout the period 1992 to 1995. Fiscal discipline helped assure the success of the currency board scheme under which the *Kroon* was introduced, and contributed to the reduction of average monthly inflation from more than 20 percent in 1992 to 1.5 to 2 percent in 1995.

5.10 Moreover, Estonia gained increased access to Western markets, as indicated by a more than four-fold increase in exports to these markets between 1991 and 1992, and a further five-fold growth in dollar terms in 1995 relative to 1992 levels. As a result, exports to the West now constitute almost two-thirds of Estonia's total exports, compared to less than 5 percent at Independence. In addition, the sharp decline in trade with Russia and the CIS has been partially reversed, with a three-fold increase in dollar terms over the very low levels of 1992.

5.11 Although the current account slipped into deficit in 1994, this was largely financed by inflows of private foreign direct investment. Long-term capital flows also helped finance the growth in gross international reserves. Estonia sharply lowered both tariff and non-tariff barriers, and today enjoys one of the most liberal external trade regimes in the world. With these policies and a competitive exchange rate, Estonia's has established a framework for rapid export development, supported by actions to improve financial services, market information services, domestic supplier information, trading and shipping services, customs facilities, and legislation.

5.12 Enterprise and housing privatization progressed swiftly, and, by late-1995, virtually all state-owned small businesses, and three-quarters of all medium and large state enterprises, had been sold. However, land privatization, including industrial land, has lagged somewhat, deterring domestic and foreign investment, particularly in agriculture.

5.13 Estonia established an affordable social safety net during the transition period, and maintained basic health and education services. Spending on the social safety net currently represents almost 30 percent of the Government's general expenditure, and provides benefits to over 50 percent of the population.

5.14 Implementing reforms was facilitated by the high caliber of Estonia's civil service. During loan implementation, the Government significantly improved administration of the regulatory framework covering competition, contracts, and financial institutions.

Table 5.1: Key Macroeconomic Indicators, 1991-97

	Real GDP Output % Growth	*Inflation Consumer Prices (annual %)*	*Fiscal Balance (% GDP)*
Year	*Estonia*	*Estonia*	*Estonia*
1991	-8.9	..	0.4
1992	-19.6	1,075.9	-0.2
1993	-8.5	89.8	-0.7
1994	-1.8	47.7	1.3
1995	4.3	28.9	-1.2
1996	4.0	23.1	-1.5
1997	12.5	11.2	0.4

	Current Account Balance (% GDP)	*Gross Domestic Savings (% GDP)*	*Total Debt Service (% Exports GFS)*
Year	*Estonia*	*Estonia*	*Estonia*
1991		..	..
1992	3.5	29.0	0.6
1993	1.3	22.2	1.6
1994	-7.4	18.2	1.4
1995	-5.1	18.2	0.8
1996	-9.7	14.6	1.4
1997	-13.0	14.5	1.3

Source: World Development Indicators (WDI); ECA Regional Data

6. Outcome and Sustainability

Outcome

6.1 The outcome of the Rehabilitation Loan is adjudged to be satisfactory. While achievement of the emergency critical imports objective was partial and inefficient, the Loan played a useful part in mobilizing external financial support for what has turned out to be a substantial, and sustainable program of stabilization and adjustment, which has led to a remarkable recovery in Estonia.

Sustainability

6.2 The sustainability of the Loan is judged as likely. This judgment is based largely upon the ongoing success of the Borrower's adjustment efforts, which are considered the principal benefit of these loans. The mixed results from the critical-import component weigh less heavily in judging sustainability, since, by intention, these were designed to have only a short-term impact.

7. Bank and Borrower Performance

7.1 Quality at entry of the Rehabilitation Loans was marginally satisfactory. Project design was overly complex, the procurement methods were not well suited to deliver imports promptly to alleviate shortages of critical goods, and the Bank overlooked the problem of a lack of capacity to pay for critical imports in domestic currency. The haste of preparation led to crucial misunderstandings between the Bank and the Borrower. The Borrower assumed, not unreasonably, that the concept of "rehabilitation" would permit financing of imports to refurbish and modernize capital equipment. The Bank, on the other hand, never conceived of the loan as permitting more than short-term purchases of commodity imports and basic supplies. This misunderstanding gave rise to friction between the two, as the balance of uncommitted funds remained high. The Bank gradually relaxed its restrictions, but was placed in the uncomfortable position of approving capital re-equipment programs for state enterprises which might not have been considered economically viable, if subjected to a full cost-benefit analysis. On the other hand, the Bank deserves praise for having moved with alacrity to support Estonia's reforms at a time when the entire political and economic system was under considerable stress. On balance, Bank performance is rated as satisfactory.

7.2 Supervision of the Rehabilitation Loan can be considered marginally satisfactory. Major commitments of high quality staff resources could not compensate fully for the burdensome requirements of Bank procurement, nor for the impact of rapid structural changes in Estonia's economy on the composition of import demand. During implementation, the Bank allowed imports to stray too far from their original purpose. After the first year of implementation, the Bank should have strongly encouraged the GOE to request cancellation of the undisbursed balance (roughly one-third of the Loan).

7.3 For the Borrower, preparation and implementation of the Rehabilitation loans posed undeniable difficulties, including the challenges of nation-building, coping with acute macroeconomic imbalances, and coordinating large amounts of new foreign aid initiatives from a dozen external donors. Preparation of the first wave of aid projects had to be compressed into a short time period, when the public sector was experiencing heavy losses of experienced staff to the private sector. In retrospect, the Borrower was remiss in not requesting cancellation of unneeded loan balances. Nevertheless, the GOE did accomplish what was most important, namely the stabilization and structural reforms which the Rehabilitation Loan was intended to support. On balance, Borrower performance is rated as satisfactory.

8. Institutional Development

8.1 The Rehabilitation Loan indirectly supported a profound change in the economic rules of the game in Estonia. A command economy was replaced with a market-based system (at least outside of agriculture) in a remarkably short period of time. In the process, the philosophy of public sector involvement in the economy has been transformed, to the benefit of Estonia's long-term growth prospects. Some of the benefits from improving international procurement procedures were dissipated by the high turnover of staff in public agencies, but, ironically, this may have speeded their adoption in the private sector. However, since the Rehabilitation Loan focused principally on procurement, and played only a minor role in supporting wider institutional reforms, institutional development is rated as modest.

9. Lessons Learned

9.1 There are several lessons which emerge from Estonia's experience:

(a) The design of the Rehabilitation Loan was flawed in that it sought to achieve laudable, but contradictory, objectives, i.e., (a) mobilizing donor funds to support ambitious reforms; (b) providing emergency financing for imports urgently needed to restart production; and (c) maintaining detailed control over the allocation and disbursement of the funds.

(b) A better project design might have involved negotiation of a quick-disbursing structural or sector adjustment loan with modest conditionality, given the liberalizing reforms already underway and the urgency of getting the economy restarted. The loan would have needed to address three issues: (i) the need for an on-lending facility to provide short-term sale/purchase financing for private importers, (ii) the need to provide direct budgetary support for the imports of the public purchasing agencies, and (iii) a simplified method of pre-identifying a few vital commodity imports to minimize the drag of international procurement procedures. The conditionality of the SAL or SECAL could then have included a commitment for the GOE to reduce the budgetary subsidies required initially to move vital commodities into the hands of end-users. An alternative design would have been to auction off the foreign exchange from the Loan exclusively to private-sector bidders, supported by a short-term on-lending facility to overcome the domestic illiquidity problem. This would have encouraged the emergence of a market-based solution to the question of which imports were most urgently required. However, it would have posed a new problem, namely public sector biasing of the outcome of the auction, since, in most cases, only private bidders with access to domestic financing would have been in a position to win. In any case, either of these recommended approaches would likely have been more effective than the one the Bank actually chose, avoiding some of the bottlenecks the Rehabilitation Loan encountered.

(c) Reliance upon state enterprises and purchasing agencies, many of them in dire financial and institutional straits, to act as lead importers proved to be a flawed choice, however much the decision was dictated by the shortage of competent private sector importers at appraisal. State importers were sometimes more interested in altering the composition of the sub-loans to meet their own modernization needs, rather than those of the public, particularly after the summer of 1993;

(d) The Bank should have encouraged the Borrower to cancel some portion of the Loan, once it became apparent the import emergency had ceased;

(e) Intensive efforts to pre-identify critical import needs, even when supported by ample technical assistance, are usually inadequate to equip a new borrower with the means to administer standard Bank-mandated procurement regulations. Either the Bank must simplify its procurement requirements, or it must postpone the start of new lending until the borrower's procurement institutions are fully-functioning;

(f) Project Implementation Units suffer high turnover when pay and incentives are inadequate to prevent skilled managers from defecting to an emerging private sector; and

(g) Good Borrower performance in meeting a key operational objective (stabilization and adjustment) can sometimes produce a satisfactory outcome, even when a loan suffers from design flaws.

ANNEXES

Basic Data Sheet

ESTONIA - REHABILITATION LOAN (LOAN 3522-EE)

Key Project Data *(Amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	50.0	48.63	97.3
Loan amount	30.0	28.63	95.4
Cancellation	-	1.37	-
Date physical components completed	03/31/94	09/30/94	-

Cumulative Estimated and Actual Disbursements

	FY93	*FY94*	*FY95*
Appraisal estimate (US$M)	25.0	30.0	
Actual (US$M)	13.7	26.2	28.6
Actual as % of appraisal	55%	87%	N/A

Date of final disbursement: December 14, 1994

Project Dates

	Original	*Actual*
Initiating memorandum		
Negotiations	07/92	09/03/93
Letters of Development Policy	08/92	09/92
Board approval	09/29/92	10/01/92
Signing	-	10/02/92
Effectiveness	10/92	10/06/92
Closing date	03/30/94	09/30/94

Staff Inputs (*Staff Weeks*)

	Planned		*Revised*		*Actual*	
	Weeks	*US$*	*Weeks*	*US$*	*Weeks*	*US$*
Preappraisal	0	0	3.3	8.2	3.5	8.7
Appraisal	13	32.2	27.5	68.4	41.3	110.4
Negotiations	10	24.8	13.7	34.0	13.4	37.8
Supervision	49	113.6	68.7	168.8	70.8	160.7
Other	10	24.0	10.0	20.8	6.0	13.4

Mission Data

	Date (month/year)	*No. of persons*	*Staff days in field*	*Specializations represented*[1]	*Performance Rating*[2]	*Types of problems*[3]
Through Appraisal	01/92-04/92	9	10	E, F, A, O*		
Appraisal	06/92	5	10	E, F, O		
Supervision I	11/92	5	10	E, O	1	-
Supervision II	02/93	5	10	E, O	2	M
Supervision III	06/93	4	8	E, O	2	M
Supervison IV	11/93	3	10	O	2	M
Supervison V	04/94	2	5	O	2	M
Completion	11/94	3	9	E, O	1	-

[1]Specialization	[2]Performanance Rating	[3]Types of Problems
A = Agriculturist	1 = Minor problems	F = Financial
E = Economicst	2 = Moderate problems	T = Technical
F = Financial Analyst	3 = Major problems	M = Managerial

*Other includes country officer, operations analyst, sector specialist, procurement and disbursement specialist. Many of these specialists visited the country in combination with other missions.

Table: Estonia Rehabilitation Loan: Imports Financed by Sector and Year, 1992-94 (US$ millions).

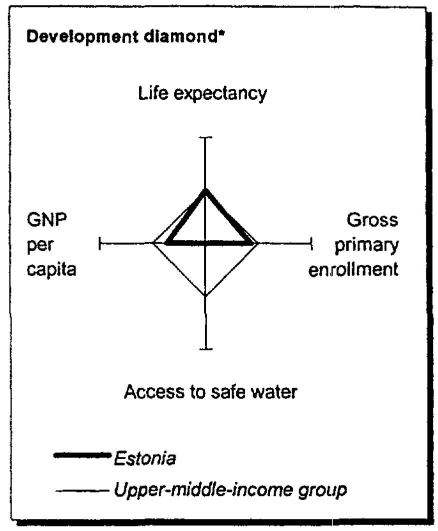
Category[1]	*1992*	*1993*	*1994*
Transport	0.2	3.4	1.5
Energy	0.6	9.8	4.4
Agricultural	0.2	3.8	1.7
Social Sector	0.1	1.9	0.9
Total Imports financed under rehabilitation loan	1.1	18.8	8.5
Total Imports	**519.9**	**968.2**	**1650.0**
Imports financed under rehabilitation loan as % of Total Imports.	0.2%	1.9%	0.5%
Total Imports of Agricultural Products[2]	**34.6**	**127.9**	**276.2**
Imports of Agricultural Products financed under rehabilitation loan as % of Total Imports of Agricultural Products.	0.6%	2.9%	0.6%
Total Imports of Energy Products	**111.0**	**136.1**	**131.8**
Imports of Energy Products financed under rehabilitation loan as % of Total Imports of Energy.	0.5%	7.2%	3.4%

[1] Loan Disbursements by category and year are distributed as follows: 18% of the total imports financed for transport; 52% for energy; 10% for social sector; 20% for agriculture.
[2] Imports of agricultural products comprise: live animals, animal products, vegetable products, animal products, animal and vegetable fats and oils, food, drink and tobacco.
Sources: Recent Economic Developments - Estonia: IMF; November 13, 1996; OIS Disbursements Database; ICR - Rehabilitation Loan 3522, Estonia.
Note: Import amounts are in f.o.b. terms.

Estonia at a glance

9/30/98

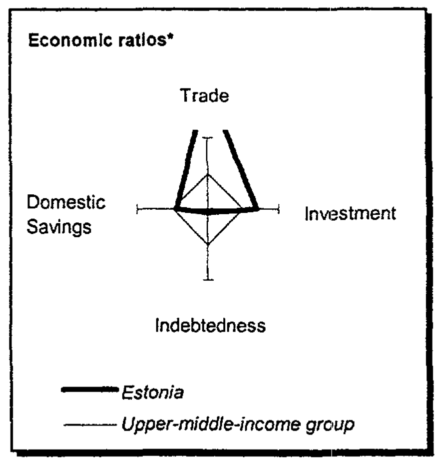
POVERTY and SOCIAL	Estonia	Europe & Central Asia	Upper-middle-income
1997			
Population, mid-year *(millions)*	1.4	476	571
GNP per capita *(Atlas method, US$)*	3,330	2,320	4,520
GNP *(Atlas method, US$ billions)*	4.8	1,106	2,584
Average annual growth, 1991-97			
Population *(%)*	-1.3	0.2	1.5
Labor force *(%)*	-1.1	0.5	1.9
Most recent estimate (latest year available, 1991-97)			
Poverty *(% of population below national poverty line)*	9	..	..
Urban population *(% of total population)*	74	67	73
Life expectancy at birth *(years)*	70	69	70
Infant mortality *(per 1,000 live births)*	12	25	30
Child malnutrition *(% of children under 5)*	..	..	..
Access to safe water *(% of population)*	..	..	79
Illiteracy *(% of population age 15+)*	..	..	15
Gross primary enrollment *(% of school-age population)*	92	92	107
Male	..	..	..
Female	..	..	..



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

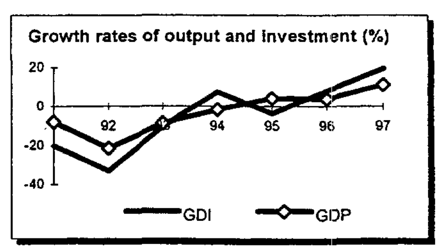
	1976	1986	1996	1997
GDP *(US$ billions)*	..	..	4.4	4.7
Gross domestic investment/GDP	..	..	27.8	29.8
Exports of goods and services/GDP	..	..	67.1	77.2
Gross domestic savings/GDP	..	..	16.3	18.4
Gross national savings/GDP	..	..	18.6	17.8
Current account balance/GDP	..	..	-9.1	-12.0
Interest payments/GDP	..	..	0.2	0.3
Total debt/GDP	..	..	9.3	14.0
Total debt service/exports	..	..	1.4	1.4
Present value of debt/GDP	..	..	8.8	..
Present value of debt/exports	..	..	12.6	..

	1976-86	1987-97	1996	1997	1998-02
(average annual growth)					
GDP	2.8	-4.8	4.0	11.4	..
GNP per capita	..	-4.1	5.2	9.2	..
Exports of goods and services	..	..	..	28.2	..



STRUCTURE of the ECONOMY

	1976	1986	1996	1997
(% of GDP)				
Agriculture	..	..	7.7	7.2
Industry	..	..	28.7	27.9
Manufacturing	..	..	17.0	17.4
Services	..	..	63.6	64.8
Private consumption	..	..	59.6	58.7
General government consumption	..	..	24.1	22.9
Imports of goods and services	..	..	78.6	88.6



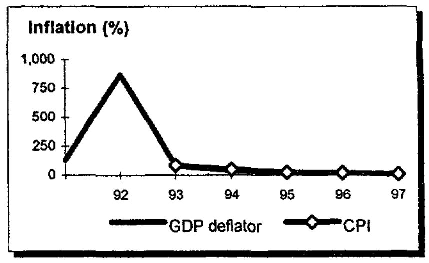
	1976-86	1987-97	1996	1997
(average annual growth)				
Agriculture	..	-6.5	-2.2	4.4
Industry	..	-8.8	4.7	13.9
Manufacturing	..	-1.5	2.7	19.6
Services	..	-1.4	4.8	9.6
Private consumption	..	-2.0	7.9	9.6
General government consumption	..	2.2	3.9	5.7
Gross domestic investment	..	-8.3	8.1	19.6
Imports of goods and services	..	..	..	25.5
Gross national product	..	-5.0	3.9	7.9

Note: 1997 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

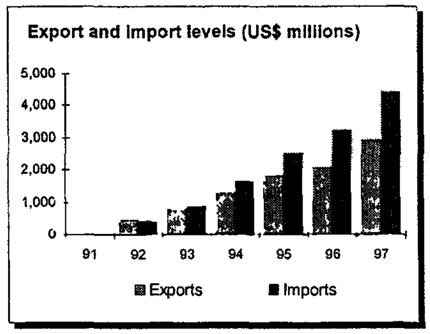
Estonia

PRICES and GOVERNMENT FINANCE	1976	1986	1996	1997
Domestic prices				
(% change)				
Consumer prices	..	..	23.1	11.2
Implicit GDP deflator	..	3.1	23.9	11.4
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	..	39.0	39.3
Current budget balance	..	..	3.4	5.8
Overall surplus/deficit	..	..	-1.5	2.0



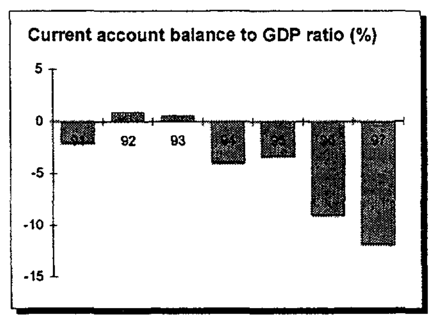
Inflation (%)

TRADE	1976	1986	1996	1997
(US$ millions)				
Total exports (fob)	..	..	2,079	2,929
Food	..	..	323	480
Minerals	..	..	150	214
Manufactures	..	..	1,607	2,235
Total imports (cif)	..	..	3,231	4,438
Food	..	..	501	732
Fuel and energy	..	..	320	373
Capital goods	..	..	950	1,513
Export price index *(1995=100)*	..	..	111	123
Import price index *(1995=100)*	..	..	96	90
Terms of trade *(1995=100)*	..	..	117	136



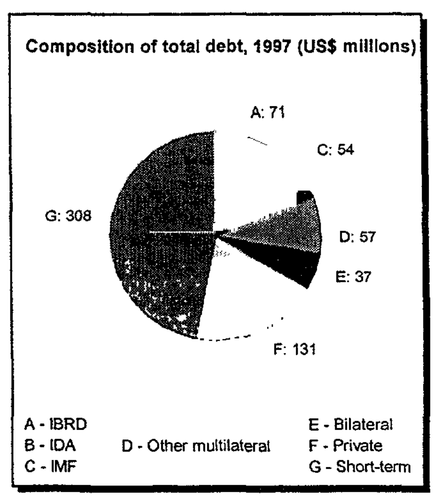
Export and import levels (US$ millions)

BALANCE of PAYMENTS	1976	1986	1996	1997
(US$ millions)				
Exports of goods and services	..	..	2,921	3,614
Imports of goods and services	..	..	3,422	4,147
Resource balance	..	..	-501	-533
Net income	..	..	2	-146
Net current transfers	..	..	101	117
Current account balance	..	..	-399	-563
Financing items (net)	..	..	500	759
Changes in net reserves	..	..	-101	-197
Memo:				
Reserves including gold *(US$ millions)*	..	..	..	..
Conversion rate *(DEC, local/US$)*	..	..	12.0	13.9



Current account balance to GDP ratio (%)

EXTERNAL DEBT and RESOURCE FLOWS	1976	1986	1996	1997
(US$ millions)				
Total debt outstanding and disbursed	..	..	405	658
IBRD	..	..	62	71
IDA	..	..	0	0
Total debt service	..	..	43	52
IBRD	..	..	4	4
IDA	..	..	0	0
Composition of net resource flows				
Official grants	..	..	36	17
Official creditors	..	..	52	12
Private creditors	..	..	36	79
Foreign direct investment	..	..	110	130
Portfolio equity	..	..	157	40
World Bank program				
Commitments	..	..	15	0
Disbursements	..	..	16	11
Principal repayments	..	..	0	0
Net flows	..	..	16	11
Interest payments	..	..	4	4
Net transfers	..	..	13	7



Composition of total debt, 1997 (US$ millions)