ATTACHMENT

March 11, 1994

Dear Mr. Camdessus:

In a letter to you dated October 6, 1993, the Government and the Bank of Estonia committed themselves to implementing the stabilization and reform program--as set forth in the Memorandum of Economic Policies (MEP) attached to that letter --which is supported by the second stand-by arrangement from the Fund approved by its Executive Board on October 27, 1993. We have since made the first purchase under the Systemic Transformation Facility (STF) equivalent to SDR 11.625 million, and also intend to request the second STF purchase, also equivalent to SDR 11.625 million, to be made upon completion of this first review under the stand-by arrangement.

The Government and the Bank of Estonia continue to be fully committed to implementing the policies outlined in the MEP. Moreover, we stand ready to take any additional measures that may become necessary to achieve the objectives set forth in the MEP. The MEP calls for two reviews of the program. Discussions on the first review, carried out together with policy discussions in the context of the Article IV and XIV consultations, were initiated in Tallinn with the Fund staff on February 3, 1994. We are pleased to be able to confirm that all quantitative performance criteria under the stand-by arrangement have been met for December 31, 1993.

We continue to be encouraged by the results of our stabilization and reform program. Real output appears to be recovering, unemployment has remained relatively low and structural reforms are proceeding. Inflation, however, has been higher than we had anticipated, which underlines the need to persist with appropriately tight financial policies. The pursuit of a prudent fiscal policy continues to be a cornerstone of the Government's economic policy. The general government's overall budget was in balance in 1993, and a balanced central government budget has been approved by the Parliament for 1994. The Government is in the process of finalizing, in collaboration with the World Bank, a Public Investment Program (PIP), which would be financed mainly by externally borrowed resources together with domestically generated budgetary resources. In light of the large number of public infrastructure projects likely to take place under the PIP, we request a modification in the performance criteria for the financial deficit and net lending for end-March 1994, as set forth in Annex I, to allow a greater amount of general government investment and a lesser amount of net lending than previously anticipated.

The recently established External Financing Board (EFB) is serving as the principal mechanism for securing, monitoring, and channelling external loans received under the EU/G-24 process as well as the STF purchases. As provided for in the Memorandum of Economic Policies, the EFB will seek to set the interest rate on Government loans to commercial banks such that the margin in excess of its own borrowing costs reflects the risks associated with these loans. If the Government decides to request the Bank of Estonia (BOE) to serve as fiscal agent in channelling these loans, the Government will retain the default risk, and the BOE will not assume any claims or liabilities related to the Government's foreign loans. The Government and the Bank of Estonia will continue to refrain from directing commercial banks to lend or to provide loan guarantees to specific enterprises.

Taking account of seasonal fluctuations in government revenues and expenditures, the general government's cumulative financial balance from January 1, 1994 shall not be in deficit by more than EEK 150 million as of March 31, 1994, EEK 340 million as of June 30, 1994 nor more than EEK 540 million as of September 30, 1994. Cumulative net lending by the Government from January 1, 1994 shall not be more than EEK 150 million as of March 31, 1994, EEK 340 million as of June 30, 1994, nor more than EEK 540 million as of September 30, 1994. The indicative target for 1994 as a whole is set at EEK 740 million for both the financial deficit and net lending. As a separate performance criterion under the stand-by arrangement, domestic financing of the general government's financial deficit and net lending will also be limited as specified in Annex I.

The Government and the Bank of Estonia continue to be committed to maintaining the integrity of the currency board. In this connection, the Bank of Estonia will not absorb any losses in the event of any possible future bank rescue operations, it will not extend credit to the Government in any form, nor will it acquire new claims on commercial banks except in well considered emergency lending situations. Emergency lending operations to commercial banks for liquidity support will be limited to amounts consistent with meeting the program's targets for net international reserves (as defined in Annex II)-- i.e. DM 43 million at March 31, 1994, DM 48 million at June 30, 1994, DM 53 million at September 30, 1994, and DM 58 million at December 31, 1994 (indicative target). The Bank of Estonia will continue to ensure maintenance of (i) full foreign currency backing for the currency board's liabilities, and (ii) reserve requirements for commercial banks as defined in the MEP. As provided by the MEP, the Savings Bank's reserve requirement ratio will continue to be reduced gradually. The Bank of Estonia intends to increase the issue of CDs in order to offset the liquidity effect of lowering the reserve requirement for the Savings Bank. As regards external trade and payments arrangements, the Government's intention is to maintain a liberal trade and payments environment. In this connection, the Government intends to accept the obligations of Article VIII during the current program period.

In the six-month period ending December 31, 1993, Estonia had contracted public and publicly guaranteed foreign debt with maturities of 1-12 years amounting to US$1.3 million. Taking account of the Government's balance of payments projections and the adjustment program, it is proposed that ceilings on external debt contracted or guaranteed by the Government and the Bank of Estonia be set cumulatively from June 30, 1993 at US$lSO million with a maturity of 1-12 years and US$70 million with a maturity of l-5 years, respectively, as of end-March, 1994 and end-June 1994, and at US$200 million and US$l00 million, respectively, as of end-September, 1994 and, indicatively, as of December 31, 1994 (Annex III).

We regard Estonia's stabilization and reform program to be proceeding as planned. The Government and the Bank of Estonia are determined to continue pursuing the program as detailed in the MEP and further elaborated above. We would ask for the continued support in this effort by the Fund and the international community.

Sincerely yours,

/s/
Prime Minister Mart Laar

/s/
Governor Siim Kallas

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C.
U.S.A.

ANNEX I

General Government Financial Balance

Performance Criteria on Financial Deficit and Net Lending

Financial Deficit Ceilings	(In millions of kroons)
January 1, 1994 - March 31, 1994	150
January 1, 1994 - June 30, 1994	340
January 1, 1994 - September 30, 1994	540
January 1, 1994 - December 31, 1994 (indicative target)	740
Net Lending Ceilings	(In millions of kroons)

January 1, 1994 - March 31, 1994	150
January 1, 1994 - June 30, 1994	340
January 1, 1994 - September 30, 1994	540
January 1, 1994 - December 31, 1994 (indicative target)	740

The general government financial deficit is defined as the sum of net credit to general government from the domestic and foreign banking systems, credit from other financial and nonfinancial institutions or households, and net foreign loans disbursed to general government, less net lending operations undertaken by general government. The financial deficit will be measured excluding valuation gains and losses on all foreign currency denominated assets and liabilities arising from exchange rate fluctuations.

The general government encompasses the central government (comprising the state budget and budgets of extra-budgetary funds) and local governments. The central government extra-budgetary funds include, but are not limited to the Social Security, Medical Insurance, Environment, and Forestry funds.

Net credit to general government from domestic and foreign banks is defined as the change in total claims of domestic and foreign banks on the general government less the change in deposits of the general government with domestic and foreign banks. Claims of domestic and foreign banks on the general government include (a) domestic and foreign bank loans to general government, (b) securities or bills issued by the general government held by domestic and foreign banks with the exception of those issued in relation to bank rescue operations, and (c) overdrafts on the current accounts of the general government with domestic and foreign banks. Deposits of the general government with domestic and foreign banks include, but are not limited to: (a) money deposits of the general government with domestic and foreign banks, and (b) securities issued by domestic or foreign banks held by the general government.

Credit to general povernment from other financial and nonfinancial institutions or households is defined as all increases in domestic claims on general government outside the banking system. In particular, it includes changes in holdings of government securities, debt, and bonds by nonfinancial enterprises and households, but excludes government debt issued in relation to bank rescue operations.

Net foreign loans disbursed to general government comprise total disbursements of all government and government-guaranteed nonbank loans, including drawings from the IMF under the STF, less repayments of such loans (but excluding drawings under stand-by arrangements). This definition excludes government-guaranteed foreign loans disbursed directly to entities outside general government.

Net lending by the general government consists of lending operations by the general government to the nongovernment nonbank sector, less repayments on these loans. Lending operations include direct loans, purchases of debt or equity, transactions in financial assets, and government payments of interest or amortization on debt of nongovernment which generate equivalent claims by the Government on the original debtors. They do not include deposits of general government with the domestic and foreign banking systems. Domestic credit to finance the general government financial deficit and net lending by the general government shall not exceed a combined total of EEK 50 million during the period January 1 to March 30, EEK 30 million during the period January 1 to June 30, EEK 20 million during the period January 1 to September 30, and for the year as a whole such credit shall not exceed EEK 20 million.

As a performance criterion, domestic financing of the general government financial deficit and of net lending by the general government, cumulative from January 1, 1994, shall not exceed a combined total of EEK 50 million as of March 31, 1994, EEK 30 million as of June 30, 1994, and EEK 20 million as of September 30, 1994, and for the year as a whole, as an indicative target, such credit shall not exceed EEK 20 million. The Ministry of Finance and the Bank of Estonia shall report monthly data on general government net deposits held with the foreign banking system, disbursements of foreign loans to the general government, blocked accounts held with the domestic and foreign banking systems, net lending operations, and any other data regarding the general government financial balance. Data on net claims of the domestic banking system on general government, in the agreed format, will be reported to the Fund within thirty days of the end of each month by the Bank of Estonia. The Ministry of Finance shall confirm these data.

ANNEX II

Net International Reserves in Convertible Currencies

Performance criteria on Net International Reserves	Minimum Limits 1/ (in millions of deutsche mark)
Actual stock at December 31, 1993	70
March 31, 1994	43
June 30, 1994	48
September 30, 1994	53
December 31, 1994 (indicative floor)	58

1/ Adjusted downward by DM 27 million for the first purchase under the Systemic Transformation Facility.

Net international reserves consist of gross reserves of the Bank of Estonia, foreign exchange balances corresponding to purchases from the Fund held abroad, net of reserve liabilities (including government obligations associated with Fund purchases) and net of currency board cover. These assets and liabilities will be converted to deutsche marks at current exchange rates defined as the Bank of Estonia's official rates prevailing at each test date.

For the purposes of the program, gross reserves of the Bank of Estonia shall be defined as monetary gold, holdings of SDRs, any reserve position in the IMF, and holdings of foreign exchange in convertible currencies by the Bank of Estonia. Excluded from reserve assets are capital subscriptions to foreign financial institutions, long-term nonfinancial assets of the Bank of Estonia, assets held abroad by the general government and enterprises (other than those corresponding to purchases from the Fund), and any assets in nonconvertible currencies. For the period of the program, monetary gold will be valued at DM 497.4 per ounce. Fund staff will be informed of details of any gold sales, purchases or swap operations during the program period, so that adjustments can be made to exclude changes in the measurement of gross reserves that arise merely from a different valuation of gold. On December 31, 1993, gross reserves, as defined above, amounted to DM 653.7 million, including gold holdings valued at DM 4.1 million.

For the purposes of the program, reserve liabilities shall be defined as the Bank of Estonia's convertible foreign currency liabilities to nonresidents, with an original maturity of up to and including one year and the use of Fund credit. Excluded from reserve liabilities are any liabilities arising from balance of payments support loans of maturity longer than one year, including such loans from the EU, the BIS and other international financial institutions, foreign governments and foreign banks. On December 31, 1993, international reserve liabilities of the Bank of Estonia as defined above, amounted to DM 99.2 million.

Currency board liabilities will comprise kroon notes and coins in circulation, total reserve deposits of banks (including the Savings Bank) with the Bank of Estonia, certificates of deposit issued by the Bank of Estonia and kroon liabilities of the Bank of Estonia in its correspondent accounts. Currency board cover will equal currency board liabilities, expressed in terms of foreign exchange using the official exchange rate of 8 kroons per deutsche mark. On December 31, 1993, currency board liabilities amounted to he equivalent of DM 484.7 million. As a performance criterion, the Bank of Estonia will ensure the maintenance of full foreign reserve backing for the currency board's liabilities at the end of each monthly reporting period.

At the time the authorities make the second purchase under the Systemic Transformation Facility, the performance criteria will be adjusted downward by the deutsche mark equivalent of the purchase.

The performance will be monitored from information supplied monthly by the Bank of Estonia in the agreed format. The monthly data will be provided to the Fund within seven days of the end of each month throughout the program period.

ANNEX III

Limits for External Debt of the
Estonian Government and the Bank of Estonia

(Includes debts contracted or guaranteed)

Performance criteria on cumulative net contracting of external debt	Maximum limits (In millions of U. S. dollars)		
	1-12 year maturity	1-5 year maturity	less than one year
During the period from June 30, 1993 to:			
March 31, 1994	150	70	--
June 30, 1994	150	70	--
September 30, 1994	200	100	--
December 30, 1994 (indicative ceiling)	200	100	--

External debt limits apply to the net contracting (contracting or guaranteeing less repayments) by the Government and the Bank of Estonia of all external debt of original maturities of 12 years or less. These limits differ, as shown above, according to the original maturity of the debt--of one year or less; of more than 1 year up to and including 5 years; and of more than 1 year up to and including 12 years. Neither the Government nor the Bank of Estonia shall contract or guarantee debt of an original maturity of one year or less, other than normal import financing. (Liabilities on interrepublican correspondent accounts shall be considered normal import financing.) The Government is defined as comprising the state and local authorities, and all extrabudgetary funds. Excluded from the limits are use of Fund resources; but other balance of payments support of maturity of 12 years or less is covered by these limits, including loans from official creditors and foreign banks. The amount of debt contracted or guaranteed shall be valued at the relevant currencies of denomination and converted into U.S. dollars using the Bank of Estonia's official exchange rates prevailing at the time the debt is contracted or guaranteed. Repayments shall be valued at the currencies of transactions and converted into U.S. dollars at the time of repayment at the average exchange rate for the month.

In the event that negotiations with any FSU state result in the acceptance by the Estonian authorities of any liability that would require repayment within a 12-year period, this performance criterion would be redefined to include such liabilities and the relevant debt ceilings would be adjusted upward by an equivalent amount.

Compliance with the limits shall be verified for the dates shown above. Information on net contracting, guaranteeing, and disbursements of external debt, in the agreed format, will be reported monthly to, the Fund within thirty days of the end of each month by the Ministry of Finance.

ANNEX IV

Reserves of the Banking Svstem

Required reserves will be calculated as equal to 10 percent of the banking system's domestic and foreign currency deposit liabilities (excluding the Savings Bank) and 10 percent of the Savings Bank's deposit liabilities excluding individual demand deposits, as presented in the monetary survey. Required reserves on individual demand deposits of the Savings Bank--set at 70 percent of such deposit liabilities as at December 31, 1993--shall not be lowered below 60 percent of such deposit liabilities as at June 30, 1994. The deposit aggregates against which required reserves of the banking system (including the Savings Bank) shall be calculated will be referred to as "eligible liabilities". Required reserves for March 31, 1994 will be calculated in this manner from the February 28 monetary survey, for June 30, 1994 from the May 31 monetary survey, for September 30, 1994 from the August 31 monetary survey, and for December 31, 1994 (an indicative limit) from the November 30 monetary survey.

Reserves of the banking system (including the Savings Bank) will not be permitted to be below required reserves of the banking system, as defined in the above paragraph, by more than 1 percent of eligible liabilities, as defined above, at end-March 1994, end-June 1994, end-September 1994, and end-December 1994 (an indicative limit).

The Bank of Estonia will not extend any new credits to commercial banks, except in emergency situations and in amounts that do not violate (i) the performance criterion requiring full foreign currency backing for the currency board liabilities or (ii) the performance criterion specifying the minimum targets for net international reserves.