ATTACHMENT

November 2, 1995

Dear Mr. Camdessus:

1. The Government and the Bank of Estonia have been implementing the economic reform program described in the Memorandum of Economic Policy and cover letter dated February 28, 1995, which is being supported by a stand-by arrangement from the IMF. The commitment of the new government that took office in April 1995 to the pursuit of those policies was re-affirmed in our letter to you of May 3, 1995. The program has met so far with broad success, in terms both of achieving its macroeconomic objectives, and implementing supportive financial and structural policies. In particular, all performance criteria for end-June and end-September have been observed. As we stated in our letter of February 28, 1995, we do not currently expect to make purchases under this stand-by arrangement.

2. During the first half of the year, annual inflation was contained to below 30 percent, economic growth is estimated to have reached 4 percent, and export growth remained vigorous. Fiscal revenues broadly in line with initial budgetary projections allowed achievement of a small financial surplus, and the overall general government was approximately in balance after net lending operations. We expect the general government to be at least in balance for the year as a whole. Both imports and bank credit to enterprises grew significantly more than projected, as commercial banks decreased their holdings of foreign assets. As a result, the deficit of the external current account in the first half of the year was significantly larger than expected. These developments appear to have mainly reflected investment opportunities in the domestic economy. The net international reserves of the Bank of Estonia were, however, on track. We do not expect fundamental changes to the above trends in the second half of the year. We will continue to closely monitor the developments in the balance of payments as well as in monetary aggregates and market interest rates to assess their sustainability.

The measures that are detailed below further specify our adjustment efforts for the remainder of the program period into 1996, and aim at addressing certain difficulties which, if left unattended, could delay or undermine the success of our reforms.

3. Fiscal policy. The 1996 Budget for the State Government and the main extrabudgetary funds submitted to Parliament is consistent with financial balance and an overall deficit of the general government (after net lending) of less than l/2 percent of GDP. It limits the growth in expenditures and revenues of the general government to around 16 l/2 percent, or somewhat less than the projected rate of inflation of 20 percent for the year. Revenues have been projected cautiously, with the impact of an increase in the income threshold for the individual income tax expected to be more than offset by increases in excises on petroleum products, spirits, and beer. On the expenditure side, the 1996 Budget aims at strictly containing growth in the wage bill to no more than 13-14 percent, partly by reducing employment. General government investment and net lending expenditures are expected to increase by more than 50 percent (from a low base), in line with our objective of addressing the needs for repairing and further developing public infrastructure. These outlays are part of a multi-year Public Investment Program which has been developed with assistance from the World Bank in the context of a medium term budget framework. The 1996 Budget also addresses growing disparities in development between urban and rural areas through a program for enterprise and regional development, including in agriculture, infrastructure, and support of new entrepreneurs.

4. Important changes in the Social Tax Law will be submitted to Parliament before end-1995, consistent with parallel changes in the Law on Pensions, in the direction of a contribution-based funded pension system. These changes progressively transfer part of the overall social security contribution from employers to employees.

5. During 1996, we aim at further improving tax administration through continued implementation of technical assistance recommendations, including from the Fund. We intend to make, effective March 1, 1996, the National Tax Board responsible for the collection of all national taxes (with the exception of taxes currently collected by the Customs Department). Our intention is to include responsibility for the collection of the social tax, with a view to improving overall tax administration and reducing

avoidance. Mechanisms would, however, be implemented to ensure the immediate transfer of the appropriate proceeds to the Social and Medical Insurance Funds, which will remain responsible for managing their balances.

6. Amendments to the Budget Law establishing the Estonian Treasury will be approved before the end of 1995, and Treasury operations should commence in early 1996. A main objective is to bring government accounts directly under the control of a single agency with a view to reaching greater efficiency in the management of government cash resources, and improving expenditure control. As a result, the volume of transaction balances held by government in the banking system is expected to fall over time. Because functioning of the currency board does not provide for the Bank of Estonia directly managing liquidity in the economy, we intend to maintain the Treasury accounts with commercial banks rather than at the central bank. Management of these accounts will be increasingly on a market basis.

7. However, there is a need to ensure that Treasury operations do not disturb the stability of the banking system, in particular, that the liquidity position of commercial banks is not undermined by sudden shifts in the location of Treasury deposits. To that end, a joint "Banking Relations Board" will be established under the leadership of the Ministry of Finance by November 1, 1995. The Board will serve purely in an advisory role and include representatives from both the Ministry of Finance and the Bank of Estonia. It will initially meet to establish operational guidelines for the Treasury that will be used in choosing which commercial banks will be eligible for Treasury deposits and the limits of such deposits. It will also monitor operations to ensure that such guidelines are observed. Early on, the Board will need to take into account the inherited structure of government deposits in the banking system. The Extrabudgetary Funds will also coordinate with the Banking Relations Board decisions regarding their investments.

8. We have been concerned by the poor record of debt servicing by enterprises on the on-lending of external borrowing by Government, which also raises questions on the profitability of projects it finances. We are conscious of the potential burden persistence of such a situation could exert on the Government's finances. Accordingly, the State Audit Office will be made responsible for assessing and monitoring performance of state investment projects financed through government net lending to ensure that resources are invested prudently and that adequate rates of return are being realized. In addition, we will strengthen the monitoring of domestic flows and payments associated with this lending.

9. Monetarv and banking issues. We remain committed to the currency board arrangement and to the prudent financial policies which have underpinned its success and continued credibility. The latter should be further strengthened by our decision to maintain at EEK 100 million the maximum margin provided under the Fund program for emergency lending by the Bank of Estonia in case of systemic risk to the banking system, in line with ensuring an adequate cushion for net international reserves above the currency board cover requirement.

10. We remain strongly committed to further strengthening the enforcement of existing prudential regulations and have already implemented all reform measures listed in our Memorandum of Economic Policy. We intend to stand firm on the deadline of January 1, 1996 for banks to reach the minimum capital requirement of EEK 50 million. With a view to encouraging necessary mergers or additional capital issues, the Bank of Estonia will announce well before January 1, 1996 the measures it intends to take in the case of banks not meeting that minimum capital requirement, bearing in mind the special situation of the North Estonian Bank (see below). This will include immediate withdrawal of the banking license if there is no realistic prospect of achieving the necessary minimum, or the imposition of a temporary moratorium on further lending pending compliance, if it is judged that the requirement could be met within a three month period, or reorganization (e.g., into a credit union or as a loan recovery agency).

11. As envisaged in the program, the Government has reduced to less than 10 percent its share of capital in all banks where it had a minority interest, with the exception of one bank, for which this target will be reached before the end of the year. In addition, the Bank of Estonia's share of ownership in the Savings Bank has been reduced from 66 to about 25 percent.

12. The financial position of the fourth largest bank in the country, the North Estonian Bank (NEB), is a matter of great importance. The purchase by the Union Bank of part of the Bank of Estonia's equity in the NEB, for EEK 10 million, and its takeover of management responsibilities at the NEB effective October 20, 1995 represents a plan with a reasonable chance of restoring the bank's financial health. The Union Bank's objective is to reestablish solvency of the NEB within a three year period. As joint owners of the NEB, and to protect the banking system and depositors from any further risk, the Government and the Bank of Estonia need to closely monitor progress in that direction. To that end, we will initiate an audit of the NEB which follows international standards before end-December 1995, to be completed within the following two months. This will be followed by a similar audit for end-June 1996. On the basis of these audits, the Government and the Bank of Estonia may consider other approaches to resolve the situation of the NEB. In the meantime, the Government and the Bank of Estonia will, if necessary, jointly consider plans to restructure and possibly recapitalize the NEB. However, any such recapitalization would not involve any Bank of Estonia resources. Our objective is to privatize the NEB as soon as possible.

13. Any deposit insurance scheme that may be introduced in 1996 will be financed by contributions of commercial banks. We remain committed not to make such a scheme effective until sufficient capital for its funding has been raised, which is not expected to occur within the program period.

14. <u>External policies</u>. We intend to continue with the open trade system that has served Estonia so well in recent years. With the replacement of import duties on furs, motor vehicles and pleasure boats by equivalent excises applicable to both domestic and imported productions of such goods, the already minimal level of distortions introduced by our import duty system has been eliminated. The unification of all excises irrespective of the goods' origin --with the exception of excises on beer--has also removed the implicit protection of domestic production that was built into the system of excises. While the draft 1996 Budget submitted to Parliament envisages only a modest narrowing of the excise differential for imported beer, it is our intention to unify excises for beer in the near future as well. We remain firm in our commitment not to introduce import duties or other broad-based protection in the remainder of the program period, including for agricultural products. The concerns we have about the dumping of low quality imported meat and milk products on the Estonian market will be met by (i) pursuing dumping cases through the competent international bodies or the courts; and (ii) enforcing quality standards for food products whether imported or domestically produced. In this context, if a reference pricing system for import valuation is introduced, we will consult with the WTO to ensure that it is consistent with WTO rules.

15. <u>Structural reforms</u>. Small-scale privatization is essentially completed, and more than 75 percent of medium- and large-scale enterprises are now in the hands of private owners. Remaining state enterprises are largely in the portfolio of state ministries. With a view to completing enterprise privatization within the next six-month period, we intend to implement the following: no later than November 30, 1995, the Government will compile a list of all state enterprises currently under the control of each government ministry, and within a two-month period thereafter ministries will place them on the privatization list and at the same time put them under the supervision of the Privatization Agency. Monopolies in the energy, transportation, and infrastructure areas will be privatized under special programs.

16. At the same time, we have not been satisfied with the pace of land reform. The slow pace has hampered restructuring of the agricultural sector and attached unnecessary uncertainties to private business activities. The inability of enterprises to offer their land as collateral has made it more difficult to secure business loans from banks and has deterred investors. In part this reflects the great care with which we have pursued our restitution policy and proceeded with the registration of titles and properties. We intend, however, to accelerate the land privatization process by streamlining those requirements. Specifically, legislation will be introduced to Parliament no later than November 30, 1995 (i) limiting to no more than one year the time for restitutees to formally register their properties, (ii) simplifying the cadastral requirements to allow use of 1940 maps in identifying property boundaries, and (iii) giving to the Estonian Privatization Agency the exclusive right to sell land associated with both past and future enterprise sales to domestic and foreign investors. The legislation will also authorize private owners and buyers to finance on their own professional land surveys to help establish clear title to land without putting pressure on limited public resources. We will provide sufficient budget resources to make the land registration process as short as possible.

17. Analysis of real sector developments, in particular assessment of GDP growth and its composition, remains hampered by inadequate national accounts statistics. The problem reflects largely insufficient coverage of data on enterprise accounts. To begin addressing the situation, we will submit to Parliament before the end of 1995 a Statistical Law which is to define and enforce reporting requirements on enterprises.

18. Performance criteria. Performance under our program is being assessed on the basis, inter alia, of quarterly quantitative performance criteria, as defined in the Annexes to the Memorandum of Economic Policy of February 1995. The quantifications of these performance criteria for December 31, 1995 and March 31, 1996 are listed in the Table in the Annex to this letter. The limit on the financial deficit of the general government for end-December 1995 has been tightened slightly. The limits on external borrowing by the Government and the Bank of Estonia for end-December 1995 and end-March 1996, as well as net lending of the general government as of the same dates, have been adjusted downward to take into account the developments in the first three quarters of the year, and our intention to proceed very cautiously in borrowing from abroad.

19. We believe that in conjunction with the continued implementation of other policies detailed in the Memorandum of Economic Policy of end-February, the above measures reinforce the prospects for full achievement of the stabilization and structural reform objectives set under the program. We remain ready to take any additional measures that might be necessary to address unexpected difficulties in order to ensure that those objectives remain attainable.

Signed:

Tiit Vähi Prime Minister Republic of Estonia	Vahur Kraft Governor Bank of Estonia

ANNEX I

Estonia: Quantitative Performance Criteria 1/

	Performance Criteria	Actual
	(in millions of Estonian kroon)	
I. Limits on the financial deficit of the general government		
Period January 1, 1995 to:		
March 31, 1995	100	6
June 30, 1995	120	-130
September 30, 1995	160	-176
December 31, 1995	160 2/	
Period January 1, 1996 to:		
March 31, 1996	115	

II. Limits on net lending by the general government		
Period January 1, 1995 to:		
March 31, 1995	200	95
June 30, 1995	400	135
September 30, 1995	600	166
December 31, 1995	400 2/	
Period January 1, 1996 to:		
March 31, 1996	50	
	(in millions of deutsche mark)	
III. Minimum levels for net international reserves of the Bank of Estonia		
March 31, 1995	46	48.4
June 30, 1995	51	57.8
September 30, 1995	57	73.6
December 31, 1995 3/	62 2/	
March 31, 1996 3/	65	
	(in percent)	
IV. Minimum levels for total reserve holdings of deposit money banks expressed as a percent of eligible deposit bank liabilities at the end of the preceding calendar month		
Minimum levels for:		
March 31, 1995	9.0	14.7
June 30, 1995	9.0	13.7
September 30, 1995	9.0	14.0
December 31, 1995	9.0	

March 31, 1996	9.0		
V. Ceilings on external short-, medium-, and long-term government and Bank of Estonia debt 4/5/	Maturity of 1-5 years	Maturity of 1-12 years	Maturity of 0-1 years 6/
		(In millions of U.S. dollars)	
Period January 1, 1995 to:			
Period January 1, 1995 to:			
March 31, 1995	40 (--)	80 (--)	-- (--)
June 30, 1995	40 (--)	80 (--)	-- (--)
September 30, 1995	70 (--)	150 (--)	-- (--)
Period October 1, 1995 to:			
December 31, 1995	40 2/	80 2/	--
March 31, 1996	40	80	--
VI. The Government will not accumulate external payments arrears during the period of the arrangement.			
VII. The currency board is to be fully backed with foreign exchange at all times.			

Sources : EBS/95/25 (March 1, 1995); information provided by Estonian authorities; and Fund staff estimates.

1/ Definitions of the concepts to be measured are included in the Annexes to the Letter of Intent (EBS/95/25, 3/l/95), as modified by footnote 3 below.

2/ Revised limit.

3/ The definition of net international reserves under the program for end-December 1995 and end-March 1996 is modified to include loans guaranteed by tbe Bank of Estonia among the net liabilities of the Bank of Estonia.

4/ Includes debt contracted or guaranteed by the Government or the Bank of Estonia.

5/ Actual performance indicated in parenthesis.

6/ Except for normal import financing.