February 28, 1995

Dear Mr. Camdessus:

1. The attached Memorandum of Economic Policies contains a description of the policies the Government and the Bank of Estonia intend to follow during the period January 1, 1995 to March 31, 1996. These policies aim at consolidating the progress toward sustainable growth through a further reduction in inflation and a continuation of structural reforms. The main elements of the stabilization and reform program for 1995/96 are to maintain tight and prudent fiscal policies aimed at a balanced financial position, with net lending operations financed mainly from external sources; adhering firmly to the principles of the currency board arrangement; maintaining a liberal exchange and trade system; accelerating the reform of the financial sector; and continued structural reforms aimed at strengthening the development of the private sector as well as the operation of the social safety net.

2. In support of these policies, we hereby request a fifteen-month stand-by arrangement in an amount equivalent to SDR 13.95 million (30 percent of quota). While we currently do not intend to make any purchases under this stand-by arrangement, we would do so should circumstances warrant.

3. As part of our economic reform program, before our request is considered by the Executive Board, we will implement a viable plan for the Social Bank which avoids any further Bank of Estonia liquidity support. The Government will share in the financial cost of this operation by accepting not to withdraw its subordinated deposit with the Social Bank.

4. We believe that the policies described in the attached Memorandum are adequate to achieve the objectives of the economic reform program, but are prepared to take additional measures that may be appropriate for this purpose. During the period of the arrangement, we will consult with the Fund on the adoption of any such measures that may be appropriate in accordance with the Fund's policies on such consultations. During the program period, a review with the Fund will be carried out no later than November 15, 1995 covering the implementation of the program described in the attached Memorandum. The program will be evaluated on the basis of a number of quantitative performance criteria. Performance criteria for December 31, 1995 and March 31, 1996 will be established at the time of the review.

Yours sincerely,

/s/	/s/
Andres Tarand Prime Minister	Siim Kallas Governor, Bank of Estonia

Attachment

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

Estonia - Memorandum of Economic Policies

I. Introduction

1. In the period since independence in August 1991, Estonia has made great progress in both the political and economic spheres. The adoption of a new constitution in 1992 and elections under that constitution made possible a return to democracy. On the economic front, the introduction of the kroon in June 1992 and the implementation of a program of stabilization and reform, supported by the International Monetary Fund, laid the foundation for improved economic performance and important

structural changes in the process of transforming Estonia from a centrally-planned to a market economy. We believe it is crucial to continue to implement a strong and consistent stabilization and reform program so as to consolidate the gains already made and to lay the groundwork for sustained growth in the period ahead. We regard continued support by the Fund in this endeavor as vital to enhance the domestic and international credibility of our program. Accordingly, we have asked that the Fund support this program in the form of a stand-by arrangement supporting a program for the period January 1, 1995 - March 31, 1996. The Estonian authorities expect that the continuation of their bold commitment to a market economy will continue to elicit timely and substantive support from the international financial community.

II. Background and Recent Developments

2. Reflecting the Government's commitment to a prudent fiscal policy, general government budgetary operations registered surpluses in both 1992 and 1993, and a further surplus is envisaged for 1994 equivalent to 1 percent of GDP. These surpluses were achieved through both ambitious tax measures and expenditure restraint. This tight fiscal policy, together with the currency board arrangement, have led to a decline in the average monthly inflation rate from more than 20 percent in 1992, to 2 l/2-3 percent in both 1993 and 1994. The price liberalization process has been completed, with the exception of continued administered prices by state entities for rents, water, sewer, electricity, natural gas, public transportation, and communications. After declining in 1992 and 1993, real output in Estonia began to recover during the second quarter of 1993 and year-on-year growth of 6 percent is expected in 1994. Official unemployment decreased slightly from 2-3 percent in mid-1993 to about 1 l/2 percent by late 1994; adjusted for recorded jobseekers, however, the unemployment rate has fallen from about 8-9 percent to 7 percent in the fourth quarter of 1994. After a sharp decline in 1992, real wages have increased broadly in line with productivity.

3. The Bank of Estonia has maintained the integrity of the currency board by ensuring that currency issue plus commercial bank deposits with the Bank of Estonia remain fully backed by international reserves. Confidence in the kroon has been strong and was not materially affected by problems in the banking system in late 1992 and early 1993. Although confidence in the banking system was thereafter largely restored, recent developments related to liquidity and solvency problems of the Social Bank have highlighted the need for strengthened bank supervision and enforcement of bank regulations.

4. Since 1992, Estonia has introduced and maintained liberal exchange and trade arrangements and in August 1994 accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement. External trade performance has exceeded expectations, largely due to the rapid growth of trade with industrialized countries which began in the second half of 1992. The continuing strong growth of exports suggests that Estonia has remained competitive in industrialized markets despite the appreciation in its real exchange rate. Although the current account (excluding official transfers) is estimated to show a deficit of around US$170 million in 1994 (6 percent of GDP), this has been financed largely by inflows of private foreign direct investment. Gross international reserves have declined somewhat in relation to rapidly growing imports since 1992, but they remain at about three months of imports. Estonia progressively removed licensing schemes, quotas, and tariffs, with the result that virtually all trade restrictions have now been eliminated. All restrictions on capital transfers have been removed with the elimination in March 1994 of remaining controls on individuals' foreign exchange accounts.

5. The Government remains committed to completing as quickly as possible the structural transformation of Estonia into a fully fledged market economy. Privatization of enterprises has been rapid, but the restitution process has been delayed by the large volume of claims, conflicts between claimants, and limited administrative capacity at the local level. The Government intends to introduce measures to speed up this process. During the past year, the Estonian Government enacted additional legislation aimed at creating a legal framework in support of a market environment. Of particular importance was the recent approval by Parliament of the Credit Institutions Act.

III. The Government's Program for 1995

Program framework

6. The authorities' main objective for the program period is to ensure the sustainability of the real growth which has characterized the Estonian economy over the past 18 months. The inflation rate is expected to decline in 1995, and the ultimate goal is to reach western European levels of inflation. With expected high productivity growth in the tradable goods sector, and wage growth determined by enterprise-specific productivity gains, Estonia will maintain its competitiveness on world markets while sustaining the fixed exchange rate of the kroon. However, continued structural transformation and the rapid development of the nontradable sector--where wages may grow in line with those in the tradable goods sector but productivity growth is likely to lag--will probably keep Estonia's overall consumer price inflation at a higher level than in western Europe in coming years. The authorities intend to continue to pursue policies that encourage flexibility in wage and price formation. The Government also intends to continue structural and legal reforms to allow the private sector to lead the recovery in growth and to further reduce the role of the state in the economy.

7. The average rate of monthly price inflation, including increases in administered prices for key services, is expected to decline from 3 percent in 1994 to below 2 percent in 1995, while real growth in 1995 is again expected at around 6 percent. The external current account deficit (including transfers) in 1995 is projected to amount to about US$190 million (5 percent of GDP), but this can be financed and is consistent with the economy's longer term debt-servicing capacity. While no balance of payments financing gap is expected to emerge in 1995, we are requesting support from the Fund in the context of a stand-by arrangement in view of a possible need for additional gross international reserves.

8. The main elements of the stabilization and reform program for 1995 are as follows:

(i) maintaining tight fiscal policies aimed at balance in the general government's financial position, with net lending financed predominantly from external sources;

(ii) adhering firmly to the currency board arrangement;

(iii) maintenance of a liberal exchange and trade system;

(iv) accelerated reform of the financial sector, with the Bank of Estonia and the Government reducing their ownership and operational involvement in Estonian commercial banks, while at the same time bank supervision and the enforcement of banking regulations are significantly strengthened; and

(v) the continued pursuit of structural reforms, including further privatization, strengthening of property rights, and fiscal reform, so as to promote investment, financial discipline of enterprises and banks, increased competit,ion in the market place, and to improve the operation of the tax system and the social safety net.

Fiscal policy

9. Estonia has pursued a prudent and tight fiscal policy in the period since independence and this policy remains the cornerstone of the Government's stabilization effort. Parliament has approved a balanced state budget for 1995. The budget includes investment expenditures of about EEK 0.8 billion, which are part of a larger public investment program of about EEK 1.6 billion. Net lending will be limited to 2 percent of GDP and will be financed largely with external borrowing (Annex I). The Government will continue to refrain from directing commercial banks to lend or providing loan guarantees to specific enterprises. In the event that revenues fall short of budget projections, the Government is prepared to take the measures necessary to ensure a balanced financial position.

10. There remains an urgent need for expanded public investment in infrastructure, including repairs and rebuilding of existing facilities as well as new construction. In this connection, the Government is collaborating with the World Bank, to formulate a Public Investment Program (PIP), to be financed mainly by externally borrowed resources, and which will be presented to Parliament by September 30, 1995. The Ministry of Finance established the (inter-ministerial level) Public Investment Program Working Group in early 1993, and supported the group's work by establishing the Public Investment Program Unit. This group has guided the development of the 1995 annual capital budget and the

development of the PIP for 1995-97. Public investment of EEK 4.8 billion is planned for this three- year period, mostly in the form of investment projects by government ministries. The rest will be allocated to onlending to the enterprise sector and municipalities through the banking system. Requests for project financing exceed EEK 22 billion, from which a group of priority programs and projects has been selected which fits the national and sectoral priorities for public investment.

11. The Government is determined to undertake further measures to improve the operational efficiency of the budgetary and tax systems and continue with the modernization of the tax and customs administration along the lines recommended by the Fund technical assistance mission in 1993. To that end the Government will: (i) develop a state treasury to improve cash management by the central government by December 31, 1995 which will become operational with the passing of a new budget law; (ii) formulate a medium- term framework for budget planning by September 30, 1995; (iii) refrain from forming any new budgetary and extrabudgetary funds and constrain budgetary transfers to existing funds; and (iv) decide by April 30, 1995 the system of sharing of revenues and expenditures between the state and local governments so as to stabilize the local governments' sources of revenue. A law to govern the allocation of funds from the state budget to local budgets will be presented to Parliament by September 30, 1995. The fiscal years for the state and local budgets will be unified with effect from January 1, 1996. A proposal for the land tax to accrue to local budgets in its entirety will also be presented to Parliament by September 30, 1995. The Government intends to request technical assistance from the Fund and other agencies as required to accomplish these objectives.

<u>Social safety net</u>

12. Outlays on social programs (education, health, pensions, and family benefits) are significant, amounting to about one-third of general government expenditure or the equivalent of about 10 percent of GDP. The Government intends to continue to strengthen and rationalize the social safety net, with technical assistance from the World Bank, so as to ensure that this assistance will be better targeted toward the most vulnerable groups of the population. There is a need to consider the long-term cost implications of the state pension scheme and introduce some measure of earnings-related contributions. In this connection, amendments to the Social Tax Law will be presented to Parliament by November 30, 1995 to introduce contributions by employees. Encouragement will also be given to the development of private pension schemes. In implementing any new measures, the Government will ensure that they are consistent with the overall budgetary objectives noted above.

<u>Monetary policy and financial sector reforms</u>

13. The Bank of Estonia will maintain the integrity of the currency board by continuing to ensure that the currency issue plus commercial bank deposits with the Bank of Estonia are fully backed by liquid international reserves. It will not extend credit to the Government nor, under normal circumstances, to banks. Commercial banks facing temporary liquidity shortages will be able to address these through the use of their reserve deposits with the Bank of Estonia, subject to increasingly severe penalties in circumstances where the amounts required are large or are outstanding for excessive periods. Bank of Estonia lending to commercial banks, including purchases by the Bank of Estonia of certificates of deposit issued by domestic commercial banks, will be collateralized and will be undertaken only in connection with well-considered emergency lending operations. Such lending will continue to be limited,to amounts consistent with meeting the authorities' targets for net international reserves (Annex II) and will not exceed EEK 100 million during 1995, unless the Government agrees to additional support, in which case the Government will accept financial responsibility for any loss that might be incurred in this connection. The limit for such lending by the Bank of Estonia will be re-examined at the program review. A firm basis for close consultation between the Bank of Estonia and the Government is absolutely essential so that a concerted approach can be taken in the future if problematic situations arise in the banking sector. Regular monthly meetings to that end are now being held and will continue between senior officials of the Ministry of Finance and the Bank of Estonia's Banking Supervision Department.

14. The authorities will continue their policy of allowing commercial banks to set freely interest rates on both deposits and loans. The Bank of Estonia will also refrain from extending any loan guarantees beyond any obligations already assumed prior to the currency reform. Where guarantees are required by foreign official creditors, these guarantees will be given by the Government.

15. It is agreed that the minimum amount of profits to be transferred in any year to the state budget should be at least 35 percent of the Bank of Estonia's remaining gross profits, after transfers to capital and reserve funds as required under the Central Bank Law, but before transfers to special or other funds.

16. In line with our objective to reduce and ultimately eliminate official involvement in the banking system, the Bank of Estonia and the Government have agreed on a fully articulated, viable plan for the Social Bank/Development Bank which avoids any further extension of liquidity support by the Bank of Estonia. Under this plan, the Bank of Estonia will not withdraw the bulk of its support, nor the Government its subordinated deposit, amounting to EEK 35 million, with the Social Bank (initially for a period of one year), after transferring a substantial part of the bank's balance sheet to another bank. Any bank acquiring part of the Social Bank balance sheet is expected to observe all commercial bank prudential regulations without support from the Bank of Estonia. The Bank of Estonia will also continue the privatization of the Savings Bank, and reduce its ownership of the Savings Bank to less than one half by end-1995, with the aim of disposing of its remaining equity claims in 1996. The Bank of Estonia will also remove the additional reserve requirement on deposits of individuals with the Savings Bank, in a manner which will ensure that additional liquidity is released only gradually. By April 30, 1995, the Government will, in preparation for privatization of the NEB, request technical assistande from the World Bank and the EU/PHARE in restructuring the management and operation of the bank, and for its possible recapitalization. In addition, the Government through the Estonian Privatization Agency will develop by July 31, 1995 a program and timetable for the privatization of the bank. The Bank of Estonia will not increase its equity position in commercial banks.

17. In order to limit conflicts of interest, Bank of Estonia and Ministry of Finance officials will no longer serve as board members of any commercial banks in which their institutions do not have an equity position. Government minority shareholdings in any commercial bank will be limited to no more than 10 percent by August 15, 1995, and will be eliminated as soon as banking supervision and Treasury operations are satisfactory.

18. We recognize that high priority must be given to strengthening the banking system. To that end, the Bank of Estonia will ensure that (i) supervisory regulations on asset classification standards, provisions for problem loans, capital adequacy requirements, and asset concentration guidelines are approved and published by end-June 1995, and (ii) commercial bank reporting forms have been amended to include information required for comprehensive off-site monitoring. In this connection, the Bank of Estonia has developed a short-term program for intensified bank supervision during 1995. The Fund staff have reviewed this plan and provided advice on its implementation and on the terms of reference for an advisor in bank supervision. The Credit Institutions Act, inter alia, provides for higher regulatory standards and includes effective sanctions to ensure that these standards are adhered to throughout the banking system. The Bank of Estonia is in the process of implementing (i) the enhanced enforcement powers and sanctions available to it under the Act, and (ii) prudential ratios and accounting regulations consistent with EU directives. The minimum share capital requirement for commercial banks will be increased to EEK 15 million by April 1, 1995.

19. The Bank of Estonia has embarked on a plan to strengthen banking supervision and important improvements are already in evidence. Additional staff are being hired in the Banking Supervision Department, and a training program has been established. The plan also includes a schedule for the on- site inspection of all commercial banks during 1995. Moreover, a number of statistical forms for the collection of information from commercial banks have been introduced for off-site surveillance. The Bank of Estonia intends to further develop and refine its plan to strengthen banking supervision in line with recent Fund technical assistance recommendations. To allow this program of strengthening to take effect and to avoid potentially disruptive institutional changes during a year when substantial structural changes in the banking system will be taking place, the Banking Supervision Department will remain the responsibility of the Bank of Estonia.

20. With the establishment of the Core Advisors Group, which is supported by EU/PHARE, and the governments of Denmark and Sweden, technical assistance is now being provided for commercial banks to (i) improve their credit evaluation capabilities, (ii) improve their credit policymaking, (iii) assist them to develop internal methods and policies to better evaluate and manage credit risks, and (iv) provide and develop training programs in risk management.

21. The Bank of Estonia is contemplating the implementation of a deposit insurance system and, in consultation with Fund staff, will consider alternative approaches. As the consolidation of the banking system is continuing and further bank failures cannot be precluded, the authorities will postpone full implementation of the insurance scheme until adequate reserve funds have been accumulated. It is envisaged that the role of the authorities will be limited to supervision of the insurance fund, which should be financed solely by contributions from commercial banks and be consistent with EU directives. In addition, to contain the costs to the banking system and to minimize moral hazard, coverage of deposits, should be restricted to those of individuals up to 90 percent of their deposits, up to a certain limit per person, per bank.

Prices and wages

22. In the context of Estonia's fixed exchange rate regime, it is vital that relative prices and wages respond quickly to external and domestic shocks so as to avoid potentially destabilizing inflationary pressures or severe declines in real output. Particular attention must be paid to free price and wage formation, as well as to the smooth functioning of labor markets.

23. Bearing in mind the past contribution to, inflation brought about by increases in prices by enterprises with monopoly power--especially in the electricity and oil shale industries--the Government will vigorously implement the relevant provisions of the Competition Law to encourage the greatest possible degree of competition in these industries. As necessary, the Government will strengthen the capabilities of the relevant enforcement institutions.

24. Meanwhile, the Government will continue to refrain from providing subsidies to enterprises or consumers, except for residential expenses--for which the Government reimburses that portion of expenditures that exceeds 30 percent of a household's gross income--and the coverage of a portion of the operating expenses of rail, bus and ferry passenger transport services. The Government will review the scope for reducing, and ultimately eliminating, these subsidies.

25. The Government will continue to avoid intervention in the wage-bargaining process. It believes that wages, set at the level of each enterprise, should be linked to productivity developments, which will serve to enhance mobility in the labor market and increase the efficiency of resource allocation.

26. At the same time, the Government intends to pursue active supply- oriented labor market policies instead of only passively rendering cash support to the unemployed. These policies, which will include relying whenever possible on fostering training and retraining through appropriate incentives, are intended to improve the matching process, and geographical and occupational mobility, as well as rehabilitation of hard-to-place labor. The Government intends to improve employment services by, inter alia, computerizing the employment exchange and encouraging training and retraining. The eligibility rules of the unemployment system and the flat compensation will remain unchanged through 1995. The minimum wage will also remain unchanged during 1995.

External sector policies

27. The Government recognizes that rapid economic growth depends on maintaining Estonia's open trading links with the rest of the world, and we therefore intend to maintain a highly liberal external trade and payments regime which has played a key role in the growth of incomes in Estonia. Barriers to external trade are minimal. Import tariffs apply only to cars, bicycles and recreational boats (all at a rate of 10 percent), and furs (16 percent). To eliminate the discriminatory effects of these tariffs, the Government will replace them with excise taxes applying to each of these categories, yielding at least equal, revenue, by September 30, 1995. In addition, the Government intends to equalize excise taxes on alcoholic beverages and tobacco during 1995, so that all excise taxes will apply equally to domestic and foreign production. Export taxes apply only to art and antiques. The Government eliminated all remaining export quotas (on specialized clay, gravel, and quartz sand) on October 18, 1994. Estonia's free-trade agreement with the European Union became fully effective January 1, 1995. We have begun the process of accession to the World Trade Organization as a developed country, and intend to adopt the necessary legal steps to allow accession by end-1995.

28. There have been growing pressures for protection of the agricultural sector in Estonia, stemming from the decline in the terms of trade between rural and urban areas and increasing income inequality.

Concerns have also been raised regarding dumping or export subsidies applying to agricultural products entering Estonia. However, during the period covered by this arrangement, we will not introduce broad-based agricultural protection, such as tariffs, subsidies, or price supports. Such protection would encourage inefficient agricultural production, raise consumer prices, and reduce overall welfare. During the period of the program, we will not impose or intensify restrictions on payments and transfers for current international transactions, introduce or modify multiple currency practices, conclude bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles, or impose or intensify import restrictions for balance of payments reasons.

29. The External Financing Board (EFB), which was established in 1994, has become the principal mechanism for channeling official external borrowing through the general government and through the commercial banks. Funds on- lent to domestic banks through the EFB will not be directed to specific sectors (except for small amounts already agreed with the EU/G-24), and decisions on loan evaluation and the,direction of credit will continue to be made by the banks receiving funds. The EFB is also responsible for monitoring foreign borrowing, and the Ministry of Finance will strengthen its capability by adding appropriately qualified staff and by developing computerized methods to carefully monitor the Estonian Government's obligations to repay external debt.

<u>Structural policies</u>

30. Privatization of enterprises has largely been completed with the international tender announced on November 9, 1994. Of those enterprises remaining under state ownership, some are being privatized partly for vouchers and others are being restructured. In addition, the Government is now preparing the privatization of the telecommunications company (Eesti Telekom), the oil shale company (Eesti Polevkivi), the Estonian shipping company, and the state insurance company (Eesti Kindlustus), which is expected to be completed by end-1997. The privatization of the state energy company (Eesti Energia), Tallinn Port, the national railway company (Eesti Rautee), and the alcohol distillery (Liviko) is also planned in the medium- term. Meanwhile, the process of land restitution has been slower and geographically more uneven than anticipated. As of December 1994, restitution and compensation claims in respect of 159,105 properties had been received by the Government, of which claims for about 111,000 had been processed. The Government recognizes that the restitution process could be assisted by the use of simplified survey work so as to develop a land register as rapidly as possible, and by the development of streamlined procedures for the transfer and sale of property. In addition, the Government will assess the experience of districts with good records in resolving restitution claims and, in light of this, propose measures to streamline the process elsewhere in Estonia. The deadline for existing occupants of residential property to provide documentation indicating their interest in owning the occupied property is March 1, 1995. Government ministries and local authorities have been instructed to set deadlines for the privatization of residential properties still under their ownership. Overall, the Government hopes that over 50 percent of dwellings will be privatized by December 31, 1995.

31. In addition, the Government recognizes that increasing the ability to register property titles and sales, as well as to collateralize land and housing, will be important for the establishment of a mortgage market and the development of a real estate market more generally. Accordingly, the Government began implementing a new land cadastre system on January 1, 1995 and will ensure that the information flows necessary for the rapid registration of titles and properties will proceed smoothly. World Bank assistance is being provided in this area in the context of its proposed agriculture and forestry project. The Bankruptcy Law, which became effective in September 1992, has been actively implemented with the result that a hard budget constraint has been imposed on both enterprises and banks. The law strongly favors creditors and, in the view of the Government, this is appropriate under present circumstances. Accordingly, there is no need to review this legislation at this time.

32. The Compensation Fund has been established to reimburse restitution and financial claims related to the national privatization voucher scheme; it is funded by 50 percent of the proceeds from the privatization of state and municipal property. On approval from its Council, this fund has begun to issue bonds, the face value of which will be guaranteed by the equity of the fund. The bonds may be exchanged in the first instance for vouchers and will circulate freely in the secondary market as marketable securities. Redemption of the bonds and the process of liquidating the fund will begin inthe year 2000, up to which time bondholders receive interest at a rate determined each financial year by the Council of the fund. The Government has stressed the importance of achieving a balance between

the demand and supply of property that is available for vouchers and has modified its privatization policy in support of this balance. Nevertheless, the Government recognizes that there may be potential problems as a result of the issuance of vouchers whose face value may exceed that of the property that is made available for vouchers. However, neither the Government nor the Bank of Estonia will guarantee the value of any of the vouchers.

IV. Prior Actions on Performance Criteria and Program Review

33. A prior action for discussion of the program by the Fund's Executive Board is the implementation of a viable plan for the Social Bank. Performance under the program will be'assessed on the basis, inter alia, of several quantitative targets. Performance criteria will be quarterly floors on the Bank of Estonia's net international reserves net of currency cover, quarterly ceilings on the general government's financial deficit and net lending, and quarterly ceilings on the contracting or guaranteeing of short- medium- and long-term offidial external debt. In addition, the Bank of Estonia will maintain the reserve requirement on deposits with commercial banks, and the Government will not accumulate external payments arrears. Implementation of the program will be assessed during a review carried out no later than November 15, 1995. Performance criteria for end-December 1995 and end-March 1996 will be set at the time of the review.

ANNEX I

Performance Criteria on General Government Financial Deficit and Net Lending

Financial Deficit Ceilings	(In millions of kroons)
January 1, 1995 - March 31, 1995 (indicative)	100
January 1, 1995 - June 30, 1995	120
January 1, 1995 - September 30, 1995	160
January 1, 1995 - December 31, 1995 (indicative)	225

Net Lending Ceilings	(In millions of kroons)
January 1, 1995 - March 31, 1995 (indicative)	200
January 1, 1995 - June 30, 1995	400
January 1, 1995 - September 30, 1995	600
January 1, 1995 - December 31, 1995 (indicative)	800

The general government financial deficit is defined as the sum of net credit to general government from the domestic and foreign banking systems, net 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 extrabudgetary funds) and Local governments. The central government extrabudgetary funds include, but are not limited to the Social Security, Medical Insurance, and Environment funds.

Net credit to general government from domestic and foreign banking systems 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 government 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 purchases from the IMF under the STF, less repayments of such loans (but excluding purchases from the IMF under policies under the STF). 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 changes in deposits of general government with the domestic and foreign banking systems.

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 30 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 and Currency Board Cover

Performance criterion on net international reserves	Minimum Limits (in millions of deutsche mark)
December 31, 1994 (actual stock)	54.4
March 31, 1995 (indicative)	46.0
June 30, 1995	51.0
September 30, 1995	57.0
December 31, 1995 (indicative)	63.0

Net international reserves consist of gross reserves of the Bank of Estonia, minus net liabilities of the Bank of Estonia including currency board liabilities. These assets and liabilities will be converted to deutsche mark at current exchange rates defined as the official rates of the Bank of Estonia 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 gross reserves of the Bank of Estonia are capital subscriptions to foreign financial institutions, long-term nonfinancial assets of the Bank of Estonia, and any assets in nonconvertible currencies. Also excluded are assets held abroad by the enterprises and general government (including any foreign exchange balances of the Government corresponding to purchases from the Fund). For the period of the program, monetary gold will be valued at DM 592.4 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, 1994, gross reserves, as defined above, amounted to EEK 5,533.8 million (equivalent to DM 691.7 million), including gold holdings valued at EEK 39.1 million (equivalent to DM 4.9 million).

For the purposes of the program, net liabilities of the Bank of Estonia shall be defined as the Bank of Estonia's total liabilities, excluding Estonia's quota in the IMF (and excluding the capital accounts of the Bank of Estonia). Government obligations associated with Fund purchases under the STF will not be included among net liabilities of the Bank of Estonia. On December 31, 1994, net Bank of Estonia liabilities as defined here amounted to EEK 5,098.3 million (equivalent to DM 637.3 million).

Also as a performance criterion, the Bank of Estonia will ensure that gross foreign reserves of the Bank of Estonia are at least equal to the currency board's liabilities at all times. 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. For the purposes of this performance criterion, currency board liabilities will be expressed in terms of foreign exchange using the official exchange rate of 8 kroons per deutsche mark. On December 31, 1994, currency board liabilities amounted to EEK 4,318.8 million (equivalent to DM 539.9 million).

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 December 31, 1994 to:			
March 31, 1995 (indicative)	80	40	--
June 30, 1995	80	40	--
September 30, 1995	150	70	--
December 31, 1995 (indicative)	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 interstate 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.

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 30 days of the end of each month by the Ministry of Finance.

ANNEX IV

Reserves of the Banking System

As a performance criterion, eligible assets of the banking system will not be below required reserves of the banking system by more than 1 percent of eligible liabilities as of the end of June, and September 30, 1995. A similar floor shall apply as an indicative target for March 31, and December 31, 1995.

Eligible assets of the banking system shall include demand deposits held at the Bank of Estonia and the domestic currency component of vault cash. For the purposes of calculating eligible assets of the banking system, the share of the domestic currency component of vault cash in the total eligible assets shall not exceed 50 percent; any amount of vault cash in excess of this limit shall not be included in the calculation of the total eligible assets.

Required reserves of the banking system will be equal to 10 percent of the eligible liabilities of the banking system. Required reserves of the banking system at the end of each quarter will be calculated in this manner from the monetary survey for the end of quarter.

Eligible liabilities of the banking system shall include domestic and foreign currency demand deposits, time deposits, savings deposits, and other deposits of individuals, nonbank financial institutions, nonfinancial institutions, and general government.