# REPUBLIC OF ESTONIA
## Memorandum of Economic Policies

### I. Introduction

1. The performance of the Estonian economy has continued to improve steadily in 1996 and 1997. Output growth reached 4 percent in 1996 and, based on developments in the first half of 1997, is expected to accelerate to 7 percent this year, led by a vibrant and dynamic private sector and strong export growth. Inflation has declined faster than expected, reaching 15 percent at end-1996 and dropping to under 12 percent in the year to September 1997. Real per capita income increased by 4.6 percent in 1996, leading to a further improvement in the living standards of the population.

2. These achievements were made possible by the sound macroeconomic policies that the government and the Bank of Estonia have continued to pursue in the context of Estonia's currency board arrangement, as well as the ongoing structural reform efforts that have already largely transformed Estonia into a modern, market-based economy. These policies were supported by a stand-by arrangement with the IMF that expired on August 28, 1997.

3. Estonia met all the performance criteria under the stand-by arrangement except the end-September and end-December 1996 criteria on the overall deficit of the general government, which were exceeded by a small margin. In addition, we made significant progress in meeting the structural benchmarks of the program, although there were delays in certain areas.

4. The deficit of the general government in 1996 was contained to EEK 811 million (1.5 percent of GDP). This deficit was larger than in 1995, reflecting difficulties early in the year in mobilizing revenue, as well as higher infrastructure investment; at the same time, the general government continued to generate public savings of the order of 3 1/2 percent of GDP. Fiscal performance in the first half of 1997 has been better than anticipated, as a result of stronger-than-expected economic growth and improved revenue collection; there are indications that this good performance has continued during the third quarter. These developments, together with the one-off transfer to the government in July 1997 of accumulated profits of the Shipping Company (in anticipation of its privatization), will result in the general government registering a surplus of about EEK 280 million (0.4 percent of GDP) this year, considerably better than initially projected. Excluding this profit transfer, the overall deficit is projected to be about EEK 120 million (0.2 percent of GDP). The Bank of Estonia adhered to its commitment under the currency board. Although monetary aggregates developed broadly in line with program projections for most of 1996, the rapid growth of domestic bank credit to the private sector in 1996 and 1997, combined with continued balance of payments surpluses, resulted in broad money growth exceeding program projections (broad money grew by 39 percent in the year to June 1997, compared with a program target of 29 percent). In order to limit the risks associated with rapid credit growth, the Bank of Estonia extended the coverage of the reserve requirement to include banks' net liabilities to foreign financial institutions from July 1, and raised the capital adequacy ratio from 8 percent to 10 percent as of October 1, 1997.

5. Market reforms have continued. We have taken steps towards the privatization of the large public utilities, notably by restructuring the state oil shale company (Eesti Põlevkivi) and by preparing the electricity company (Eesti Energia) for privatization. We have amended the Land Reform Law and introduced new procedures for local authorities aimed at accelerating land privatization. In cooperation with the World Bank, we have completed a review of public expenditures, which is the first step towards a comprehensive public sector reform. We have initiated a study to overhaul the pension system, and are now preparing legislation for a pension reform. We have passed a new Statistical Law, which establishes a firm legal basis for systematic collection and compilation of national statistics. Finally, we have maintained an open and tariff-free trade regime. At the same time, however, there have been delays in civil service reform, monopoly regulation, and competition legislation. These delays are regrettable and we intend to address them in the immediate future.

6. We are aware that the recent spectacular acceleration of economic growth in Estonia has created a new set of risks. The deficit of the current account of the balance of payments in 1996 jumped to over 10 percent of GDP, and could rise to over 12 percent in 1997 (although the latter figure could overstate the underlying deficit since it includes the impact of a change in accounting procedures regarding transit trade, which took effect in October 1996). This deficit reflects excessive aggregate demand growth which, given the small size and openness of our economy, does not manifest itself in inflationary pressures but in a widening external imbalance that is becoming unsustainable. The fact that this current account deficit has been so far more-than-fully financed by private capital inflows and that Estonia has had little difficulty in attracting foreign financing is a sign of confidence in our economy. At the same time, it creates an economy increasingly dependent on foreign capital and vulnerable to shifts of confidence in the international capital markets. Moreover, a large part of the external financing reflects borrowing abroad by Estonian commercial banks to finance rapid domestic credit expansion, and we are aware that the pace of this expansion and the intense competitive pressures in the banking sector may pose a serious challenge to the health and soundness of our banking system.

7. These macroeconomic risks have emerged at a time when Estonia's inflation rate is still high relative to our trading partners, and our economy is still fragile. Although the first round of economic reforms is now virtually completed, and Estonia is undeniably a market economy, we need to embark on a second generation of reforms in order to expand the productive capacity of the economy and improve the efficiency of both the private and the public sectors. In addition to completing the process of privatization of the remaining state enterprises (mostly public utilities), these include reforming public administration, overhauling the pension system, continuing the process of land reform, and strengthening supervision and regulation of the financial system.

8. Accession to the European Union (EU) remains a major strategic objective. Following the recommendation of the European Commission to include Estonia in the first group of applicants with whom accession negotiations can begin in 1998, the attainment of this objective is now in sight. We recognize that the pre-accession preparation and eventual accession will create additional challenges and impose new constraints, increasing the competitive pressures on our economy, straining the resources of our public administration, raising demands for public investment, and necessitating a rapid harmonization of our economic policies to those in the EU in a number of key areas.

9. To meet these challenges, the government and the Bank of Estonia have jointly formulated an economic program for the rest of 1997 and through December 1998, which is described below, and for which we request the support of the IMF under a new stand-by arrangement. This support would be helpful in mobilizing domestic consensus for our policies and in enhancing their credibility.

## II. Objectives and Strategy for 1997--98

10. The joint objectives of the Estonian Government and the Bank of Estonia for 1997--98 are the following: (1) to limit the macroeconomic risks arising from the rapid growth of domestic aggregate demand and the attendant widening of the external current account deficit; (2) to enhance productivity further and broaden the base of economic growth; and (3) to accelerate the process of preparation for EU accession. These objectives will be pursued within the context of the present currency board arrangement, which has been one of the cornerstones of Estonia's economic success during the last five years, and remains an appropriate policy framework in the present circumstances. The stability of the kroon's peg to the deutsche mark and the currency board underpin the credibility of and impose discipline on our financial policies. Estonia's impressive success in rapidly re-orienting its trade from countries in the Commonwealth of Independent States to the west and the continuing increase in the market share of its exports indicate that our tradeable goods sector can still compete successfully in international markets. Under these conditions, we do not envisage any change in the present peg and currency board, except with the advent of the European Monetary Union, when the kroon's link with the deutsche mark will be replaced by a link to the euro according to the conversion rate at which the value of the deutsche mark will be fixed to the euro.

11. Achieving these objectives in the present economic conditions will require more aggressive macroeconomic policies than those we have followed until now. The constraint imposed by the currency board leaves fiscal policy as the main instrument available for managing aggregate demand. Although the present institutional structure in Estonia places some constraints on the conduct of a national fiscal policy (in particular, the local authorities have considerable budgetary autonomy), we intend to use this instrument forcefully to ensure a continued deceleration of inflation and a sustainable external position. In addition, we believe that the current growth performance provides an opportunity, which we intend to exploit, to save in order to cover contingencies and facilitate Estonia's future development.

12. Estonia's financial system, and more specifically, the commercial banks and their financial subsidiaries, has been one of the fastest-growing sectors of our economy, contributing directly and indirectly (through increasing financial intermediation) to economic growth. Estonian banks, which are now entirely in private hands, are subject to prudential standards that correspond to or exceed the recommendations of the Basle Committee on Banking Supervision (and in some cases also exceed EU directives), are profitable, and have recently started expanding into neighboring countries. The Tallinn Stock Exchange has been one of the most successful in transition economies, and is mobilizing increasing amounts of domestic and foreign savings. To improve quality, the capital requirement for quoted companies on the stock exchange's main list was raised recently from EEK 100 million to EEK 300 million. Financial statements of these companies must be audited by an auditor approved by the Stock Exchange Quotation Commission. Nevertheless, our financial sector is still very young, and its extremely rapid expansion may make it vulnerable to sudden shifts of market confidence, especially given its increasing dependence on external capital inflows. Therefore, ensuring the soundness of our financial system in the current highly competitive environment is a key component of our program for 1997--98.

13. Given the present momentum of economic growth, we envisage that the policies in this program will result in real GDP rising by 7 percent this year and, reflecting tighter financial policies, decelerating slightly to 5.4 percent in 1998. Inflation will slow down to just under 12 percent by end-1997, and we aim to reduce it to 8 percent by the end of 1998. The centerpiece of our financial policies will be an increase of public savings to 4 percent of GDP in 1997 and 5.7 percent of GDP in 1998. This will contribute to closing the savings-investment gap directly, as well as indirectly through its impact on private sector investment, which is expected to decline slightly from almost 24.8 percent of GDP in 1997 to 24.5 percent in 1998. Because we conservatively expect private savings to rise only slightly in the short run, our reliance on foreign savings will continue to be high in 1997--98: the current account deficit could be just over 12 percent of GDP in 1997, but is targeted to decline to under 10 percent in 1998. We believe that this strategy, combined with continued structural reforms, will set the foundation for rapid growth on a more sustainable basis over the medium term, as well as a more balanced external position.

## III. Policies

**Fiscal policy and public sector reform**

14. The fiscal target for 1997 has been to contain the general government deficit to no more than EEK 325 million (0.5 percent of GDP), less than half its size in 1996. However, improvements in tax administration, and expenditure restraint at the level of the central government in the areas of administrative expenses and domestically-financed capital expenditure (notwithstanding the higher spending appropriations in two supplementary budgets in June and October 1997), together with stronger-than-expected economic growth, will lead to an overall deficit smaller than that targeted under the program. Moreover, the transfer of EEK 400 million of accumulated profits from the recently

privatized Estonian Shipping Company, which is a one-time operation, will result in the general government registering a surplus of about EEK 280 million (0.4 percent of GDP) in 1997 as a whole. Accumulated financial savings of the general government amounting to EEK 150 million will be placed in the Stabilization Reserve Fund (described below) by November 7 and invested abroad; a further

EEK 350 million will be placed in the Fund by November 30 and an additional EEK 200 million before end-1997.

15. Although the fiscal adjustment undertaken in 1997 will send a clear message to the financial and capital markets, we believe that economic and financial developments this year call for a more ambitious target for 1998. We are therefore adopting a fiscal stance designed to generate savings of at least EEK 1.3 billion (1.8 percent of GDP) for 1998. During the course of 1998, we will undertake durable measures to improve the underlying fiscal position over the medium term.

16. Given the present relatively high level of taxation in Estonia, we do not intend to raise the tax burden significantly. We intend to maintain the present flat rate income tax system. At the same time, we are taking a number of measures to widen the tax base and to harmonize indirect taxes in Estonia with those in the EU. In September, parliament approved legislation that will allow the taxation (up to a rate of 26 percent) of dividends paid to nonresidents by foreign-owned companies operating in Estonia; in addition, by end-January 1998 the government will propose to parliament that the sale of services to offshore companies be taxed at a rate of 15 percent. Starting on January 1, 1998, we will raise the excise taxes on gasoline and tobacco by 39 percent and 50 percent, respectively; extend to the whole country the current car tax applied in Tallinn City; apply the 16 percent stumpage tax to all timber sales by the Forestry Fund; and implement a fuel coloring scheme so as to discourage evasion of the excise on diesel for transport. In addition, the government will continue its divestiture of state assets by selling up to 49 percent of its shares in Estonian Telecom; we estimate that total receipts from these sales will be at least EEK 1.1 billion, of which at least EEK 500 million will be saved through the Stabilization Reserve Fund during 1998. A significant part of the fiscal adjustment in 1998, however, will fall on expenditure, notably current expenditure. We intend to reduce the current spending of the general government by just over 1 percentage point of GDP in 1998 to a little more than 34 percent of GDP. We will freeze selected administrative expenditures at their 1997 budget levels (excluding those for education, regional development, agriculture, defense, public order, and EU integration); in particular, the wage bill for central government will be frozen in real terms, with the average wage increase being limited to 11 percent. In addition, the increase in pensions will not exceed the rate of inflation and health costs will be contained, thereby generating savings of at least EEK 194 million in the Social Insurance Fund and at least EEK 104 million in the Medical Insurance Fund.

17. The measures to contain public spending in 1998 are taken in the context of a wider medium-term effort to reform public expenditure. On the basis of the recent Public Expenditure Review by the World Bank, we have identified a number of areas in which the efficiency of expenditure can be improved, the level of service can be raised and, over time, savings can be generated. In particular, we plan to introduce a review of employment in the education sector by September 1998 and in state agencies and local governments by December 1998; this will serve as a basis for reducing the size of the public administration. In the area of health care, the number of regional sickness funds will be reduced from 17 to a maximum of 4 by September 1998, with a view to limiting transactions costs and increasing the negotiating power of the funds with respect to providers of medical services. Furthermore, as of September 1998, sickness benefits will be paid out as of the fourth rather than the second day of illness, and the responsibility for paying for the first two weeks of sick leave will be transferred from the government to employers; this measure is expected to yield annual savings of EEK 250 million which will be paid into insurance funds and frozen for a minimum of two years.

18. In Estonia, local authorities have a significant degree of autonomy in setting, implementing, and financing their annual budgets; this somewhat limits the flexibility of the central government in conducting fiscal policy. While we are committed to a decentralized fiscal system, which is also safeguarded by our constitution, we recognize the need to improve coordination of the borrowing activity of the various levels of government. To this end, in May 1997, we amended the local authority financing law so as to limit borrowing by local governments and oblige them to register their borrowing with the central government. To limit further domestic financing to local governments, effective December 1, 1997, as part of its prudential responsibilities over the banking system, the Bank of Estonia will require commercial bank groups to obtain, in advance, a letter of no-objection from the

Ministry of Finance for each acquisition of financial claims on local governments. The no-objection will be based on the credit history of the local authority concerned vis-?-vis the central government as well as on general fiscal policy considerations; the letter will not represent either an implicit or explicit guarantee by the central government.

19. On the basis of the policies described above, in 1998, consolidated general government expenditures will be limited to no more than EEK 27.7 billion (38.3 percent of GDP), of which those of the central government will be limited to EEK 14.3 billion (19.7 percent of GDP), including those financed by foreign borrowing. The recent rapid economic growth and far-reaching structural changes taking place in Estonia, although having a positive effect on fiscal revenue, make it difficult to be precise with regard to the probable level of receipts in 1998. To be prudent, we have targeted general government revenue to be EEK 29 billion (40 percent of GDP), of which central government receipts will be EEK 15.5 billion (21.4 percent of GDP). We will save this excess of revenue over expenditure by transferring at least EEK 1.2 billion into the Stabilization Reserve Fund; this amount will be invested abroad, by the Bank of Estonia acting as an agent of the government in close cooperation with the Treasury, to reinforce the contractionary effect of the fiscal adjustment. The quarterly general government balance as well as the amounts transferred to the Stabilization Reserve Fund will be performance criteria under the proposed stand-by arrangement, as indicated in the Annex to this Memorandum. Moreover, to the extent possible, we will continue with the policy started in 1997 of early repayment of Estonia's government debt. Finally, the policy of asset sales could result in additional savings during 1998 and beyond.

20. We have initiated a thorough reform of the public pension system, with the assistance of the World Bank. Our intention is to move from the current pay-as-you-go system to a three-tier partially-funded system: a first tier will provide a minimum pension financed by the social tax; a second tier will offer additional pension coverage financed by mandatory individual contributions; and a third tier will consist of voluntary contributions administered by private pension funds and insurance companies. A working group with representatives from the various agencies concerned has been set up and, as a first step, a detailed study of the long-term finances of the pension system will be completed in December 1997. The legislation for the new system is under preparation. The Social Tax Law, which provides for the registration of individual contributions, and the law establishing pension funds will be submitted to parliament by January 1, 1998. The Pension Law, prepared in consultation with the World Bank, and which spells out the modalities of the first tier will be presented to parliament by April 1, 1998. Our plan calls for gradual implementation of the new pension system as follows: both the registration of individual contributions will be established and the system of voluntary contributions (third tier) will be introduced by July 1, 1998; the minimum pension scheme (first tier) will be operational by January 1, 1999; and the system of mandatory contributions (second tier) will be introduced by January 1, 2001. Moreover, as of July 1, 1998, responsibility for collecting the social tax will be transferred from the Social Insurance Fund to the National Tax Board.

21. Finally, the government will introduce during 1998 two significant reforms of the budgetary process. First, with effect from January 1, 1998, all foreign and domestic debt service payments of the central government will be handled by the state Treasury; the latter will also be responsible for monitoring all foreign loan disbursements to the general government as well as repayments of foreign loans onlent by the central government. Second, legislative changes will be made for the 1999 budget to be presented on the basis of the consolidated central government, including all the extrabudgetary funds, and to take account of the utilization of foreign loans.

**Monetary arrangements, financial sector policies, and the capital market**

22. Although the currency board arrangement precludes the use of monetary policy instruments to curb aggregate demand growth, the Bank of Estonia will play an important role in limiting the macroeconomic risks in the period ahead. The Bank of Estonia does not intend to introduce any administrative non-market constraints on bank credit, and therefore cannot control lending activity directly. Nevertheless, the Bank of Estonia views with concern the extremely rapid growth of private sector credit (and corresponding external capital inflows) during the last few months, and will act

decisively to safeguard the health and strength of the commercial banking system. The Bank of Estonia is taking action at three levels: first, it has already begun to implement a series of important measures to restrain credit expansion, strengthen the banks' capital base, and reduce systemic risks; second, it has prepared a number of contingency measures that will be implemented rapidly in case the first round of measures does not have the desired effect; and third, it will place special emphasis on strengthening and improving bank supervision. It will continue to use its supervisory authority as well as moral suasion to ensure that the rapid deepening of financial intermediation and the pressures of competition do not expose banks to unnecessary risk. Finally, the Bank of Estonia will continue its policy not to extend any new guarantees to assist banks in difficulties.

23. The Bank of Estonia believes that banks' capital base should be strengthened and their ability to withstand risks improved. Therefore, the capital adequacy ratio was raised from 8 percent to 10 percent as of October 1, 1997. In addition, banks' minimum capital requirement will be raised to EEK 75 million (equivalent to ECU 5 million) from January 1, 1998. Before end-1997, the Bank of Estonia will notify banks of the introduction of a market risk component to the capital adequacy ratio, in line with the EU directive on capital adequacy (which reflects amendments to the Basle Committee on Banking Supervision Capital Accord), to take effect from April 1, 1998. The Bank of Estonia has already begun to reinforce significantly its ability to assess developments in financial markets and, in a major step forward, will begin to monitor and enforce bank prudential regulations on a consolidated basis (i.e., banks together with their nonbank financial subsidiaries) based on their operations during the first quarter of 1998. During early 1998, the Bank of Estonia will assess the impact of these measures on the banks' capital base, and will raise the capital adequacy ratio further to 12 percent as well as raise some of the weights, if the need arises.

24. Large capital inflows are having a profound impact on our banking system. Although Estonia's commercial banks have thus far been able to avoid a substantial mismatch in the currency and maturity composition of their balance sheets, they are becoming increasingly dependent on foreign financing and, thus, vulnerable to shifts of confidence in international financial markets. The extension in July of the 10 percent reserve requirement to the net liabilities of domestic banks vis-?-vis nonresident financial institutions has reduced the distortions in the structure of the cost of funds for banks. To reinforce the effort to restrain the growth of domestic bank credit, effective November 1, the Bank of Estonia has introduced an additional requirement for banks' reserve holdings at the central bank through the establishment of a temporary compulsory monthly minimum on the banks' balances in excess of required reserves. This requirement was set at 2 percentage points over the reserve requirement base in November, and will be raised at least to 3 percentage points effective December 1. At the same time, the Bank of Estonia has doubled the daily minimum reserve requirement held at the central bank from 20 percent to 40 percent of the general requirement. Combined with the expected withdrawal of at least EEK 700 million of government deposits from the domestic banking system during November-December 1997, these measures will have an immediate and considerable tightening impact on monetary conditions. Nevertheless, if credit growth has not slowed down significantly by late-December, the Bank of Estonia will take additional measures, and, in particular, will consider the introduction of a marginal reserve requirement on gross foreign liabilities in January 1998. In the meantime, the Bank of Estonia is very closely monitoring developments in the financial sector.

25. Although the legal and regulatory standards of bank supervision in Estonia are steadily improving, the recent rapid credit expansion, particularly in the area of consumer credit, might jeopardize the quality of banks' loan portfolios. To address this potential problem, the Bank of Estonia intends to review banks' asset valuation rules, including the loan classification and provisioning practices applied by all commercial banks with a view to improving them where necessary. This review will be completed by December 31, 1997, and the banks will be required to implement the required improvements no later than March 31, 1998. Furthermore, in a major step towards reducing risk, the Bank of Estonia will introduce an additional general risk reserve requirement on commercial bank assets and off-balance sheet items with a view to raising the total amount of general risk reserves in the banking system as a whole to no less than 5 percent of the risk-weighted assets and off-balance

sheet items. This general risk reserve requirement will be announced shortly so as to take effect by December 31, 1997.

26. In addition to the Bank of Estonia's moves to safeguard the health of the banking system, and monitoring and enforcing prudential regulations on a consolidated basis, we intend to take a number of important additional steps to strengthen the financial sector as a whole. First, in view of the rapid expansion of banks' activities in the securities market, the Bank of Estonia will tighten its supervision of banks in this area. In particular, it will review the adequacy of banks' internal rules and controls to minimize the scope for conflict of interest between banking and securities activities. Second, by March 31, 1998, the government will submit to parliament a new draft Securities Law, regulating the primary and secondary markets, setting standards for public offerings, regulating insider trading, and introducing minimum capital and capital adequacy requirements for investment funds. Third, the government and the Bank of Estonia are preparing amendments to the Credit Institutions Law that will strengthen the supervisory authority of the Bank of Estonia, and intend to submit them to parliament by November 30, 1997. The amendments reflect comments by the IMF, the EU, and other international institutions. And finally, in 1998 we will decide on a strategy to bring all financial sector supervision, including credit institutions, investment funds, securities firms, insurance companies, and private pension funds, under one agency. This strategy will specify the legislative and regulatory requirements, as well as the timetable, for the transition to the new supervisory arrangement.

27. A draft law on deposit insurance will be submitted to parliament before December 31, 1997. The draft has benefited from comments by the IMF, the EU, and other international bodies. The law will set up a deposit insurance scheme limited to EEK 20,000 per depositor and financed by banks' annual contributions of 0.5 percent of the deposits covered.

28. Finally, the Bank of Estonia has initiated a three-year program to modernize its payments and settlement system, and to bring it into line with the principles and regulations governing the payments and settlement systems in the EU. Under this program, the Designated Time Net Settlement and the Real Time Gross Settlement Systems for retail payments will be designed and implemented by 1999 and 2000, respectively.

**Other structural policies**

29. Our liberal market-oriented policies since the beginning of transition, particularly in the area of trade, have been a key factor behind Estonia's economic success thus far: they have benefited our economy directly by minimizing distortions, and have contributed to establishing Estonia's international reputation as a bold reformer. These policies have continued during 1996--97. The Baltic Free Trade agreement on agricultural products came into effect on January 1, 1997. Moreover, negotiations with the WTO are proceeding well, and we expect to complete them by end-1997, with accession taking place by March 31, 1998. However, as our accession to the EU is drawing nearer, we will begin the harmonization of our policies to those in the EU, which are much less liberal in some areas, notably agricultural trade. At the same time, we believe that some degree of support for our agriculture is warranted in order to offset the social costs of the extremely rapid economic restructuring of the last five years. A special Commission has studied this issue and produced a number of specific recommendations. We plan to study these recommendations and their economic implications carefully before taking any measures, and will ensure that any measures taken in this area are consistent with our overall fiscal objectives and with our strong commitment to open trade. During the period of this arrangement, the government will not introduce import tariffs except possibly on a highly limited number of agricultural products. In addition, we will refrain from differentiating indirect tax rates between domestic goods and imports.

30. Our program of privatization and divestiture of state assets is entering its final stages. Only a few medium- and large-scale commercial or industrial enterprises remain now in state hands (e.g., the chemical company Kiviter, and the state distillery and alcoholic beverage companies). We intend to complete the privatization of Kiviter, Rakvere and Moe distilleries, and the Liviko alcohol beverage company in 1998. We have also started in 1997 the complex process of restructuring and privatization of the large state monopolies and public utilities, in particular, the Estonian Electricity Company (Eesti

Energia), the oil shale company (Eesti Põlevkivi), and the Estonian Railways (Eesti Raudtee). In particular, the government has decided that, after restructuring, the privatization of Eesti Energia and Eesti Raudtee will begin by mid-1998. Finally, as mentioned earlier, we are proceeding with the divestiture of shares in Estonian Telecom.

31. The privatization of the energy companies is raising complex issues of regulation of the energy sector. The new Energy Law sets up a modern regulatory environment for the energy sector and a supervisory framework for energy companies in the form of the Energy Market Inspectorate. Furthermore, in order to ensure better cost recovery, electricity tariffs were increased by 33 percent on May 1, 1997, and the price of oil shale by 25 percent. Electricity tariffs will be raised by 8 percent for residential consumers on January 1, 1998; at present, these tariffs do not cover operating costs. From 1999 until the energy sector has been fully privatized, tariff adjustments will be decided by the Energy Market Inspectorate.

32. More broadly, we are also moving to ensure effective monopoly regulation and protection of competition. Specifically, (1) amendments to the Competition Law, which is harmonized with EU regulations and sets the conditions for most administered prices, regulations on mergers, and the role of the Competition Board are expected to be approved by early 1998; and (2) the energy pricing provisions of the Energy Law passed in June 1997. In October 1997, we abolished the special licensing requirements for foreign investors that still existed in a number of strategic sectors such as energy and telecommunications, and replaced them by the general licensing requirements that apply to domestic investors.

33. After the April 1996 amendments of the Land Reform Law, the process of land reform has been accelerated as purchasers are now allowed to pay in instalments and municipalities have been required to follow the new, accelerated procedures for the sale of land linked to enterprise privatization. About 14 percent of total land is now in private hands, and the maximum private ownership will ultimately be about 60 percent of total land, because the state will retain ownership of its forests, wetlands, national parks, wildlife reserves, and areas with valuable natural resources. We intend to increase private land ownership to 17 percent of total land by the end of this year, and to at least 35 percent by the end of 1998. By April 30, 1998, in particular, all outstanding land restitution claims will have been settled. Finally, in light of the European Commission's observation that investment in real estate is the only capital transaction for which restrictions still apply in Estonia, we are in the process of ensuring that legislation concerning the sale of land to foreigners is in accordance with EU practices and expect this process to be completed vis-?-vis EU member countries in 1998.

34. Timely and accurate economic statistics are critical to our ability to assess the economic situation and react quickly when required. The new Statistical Law, introduced in July 1997, sets the basis for further improvements of the coverage and integrity of our economic statistics. In preparation for the consolidated budget of the central government in 1999, we intend to substantially improve the timeliness and coverage of fiscal data during 1998. In addition, we continue to work on addressing the shortcomings in our national accounts and labor market statistics with technical assistance from the IMF. We have also established a working group to assess the improvements needed in our statistical system to be in observance of the requirements of the Special Data Dissemination Standard.

## IV. Performance Monitoring, Program Review, and Availability of Purchases

35. Progress in the implementation of the policies under this program will be monitored through quarterly performance criteria, structural benchmarks, indicative targets, and program reviews. The mid-term review will focus particularly on the evolution of Estonia's balance of payments and the implementation and adequacy of the measures taken to reduce the current account deficit, as well as the situation in the domestic financial sector; it will be concluded by June 15, 1998, completion of which will be a performance criterion. Quarterly quantitative performance criteria will apply to (1) net international reserves; (2) the overall balance of the general government; (3) the balance of the Stabilization Reserve Fund; and (4) contracting or guaranteeing by the general government or the Bank of Estonia of nonconcessional external borrowing, with separate sub-ceilings on borrowing of

maturities of one year or less, and from one to five years. In addition, gross foreign reserves of the Bank of Estonia must equal (or be greater than) the currency board's liabilities at all times and the government cannot accumulate any external arrears during the program period. The addition, on schedule, of the market risk component to the calculation of the banks' capital adequacy ratio will constitute a structural performance criterion for March 31, 1998. These performance criteria are defined and clarified in the Annex to this Memorandum; a list of structural bench-marks is also included in the Annex. Indicative targets have been set for September 30, 1998 and December 31, 1998, and these will be reassessed and respecified as performance criteria at the time of the review.

*Tallinn, November 7, 1997*