



Center for Social & Economic Research

ESTONIAN WAY TO LIBERAL ECONOMIC SYSTEM

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1. Starting point of reform and general features of development

Estonia¹ has adopted the one of the most radical programs of stabilization and transformation amongst not only the former Soviet Union countries but among previously centrally planned economies as well.

The commodity and service markets were balanced mainly through the price liberalization and introduction of the internally convertible national currency. This was supplemented with the austerity in public consumption and surplus in the state budget. The changes were also associated with a radical shift in the foreign trade reorientation. The economy that previously was oriented to almost costless resources from the former Soviet Union and work mostly for the Soviet "markets" seems to be very well adjusted to western markets and broad participation in the world economy.

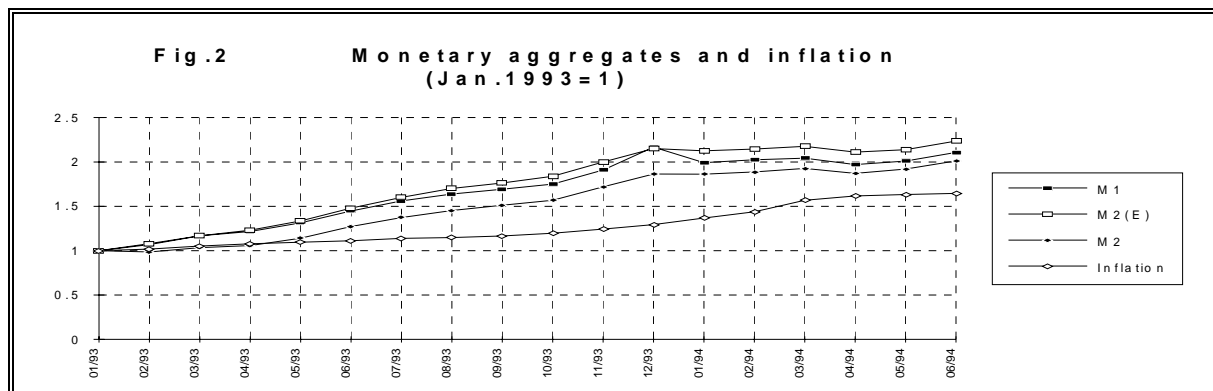
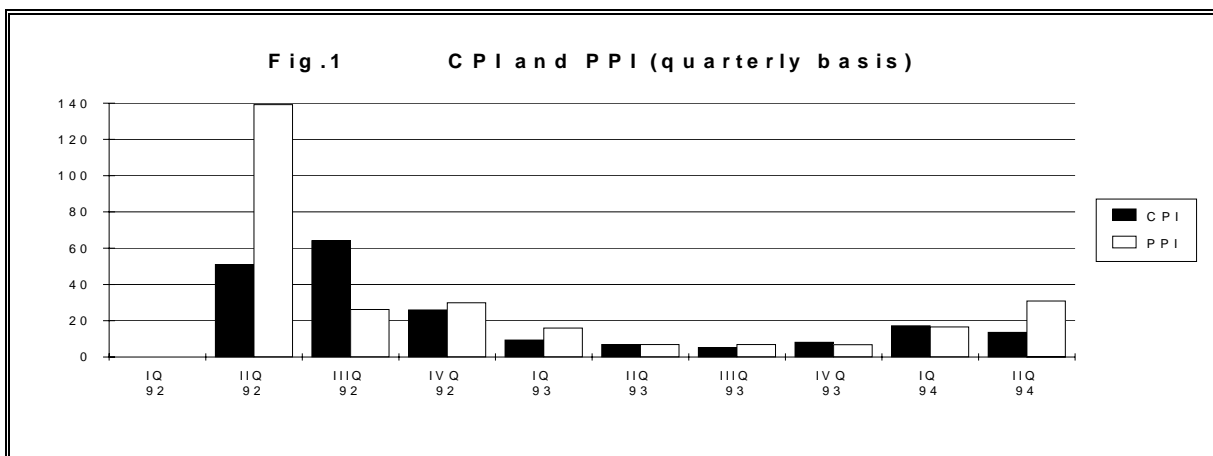
The above mentioned radical changes brought about a serious decline in the economy (Tab.1). The real decline started in 1990 when the growth rate of GDP reached -6.5. In 1991 this magnitude decreased by 13.6%. This was followed by additional drop in 1992 of 18%. Some stabilization was attained in 1993 when the further decline of GDP was equal 2%. The data from the first half of 1994 indicate 5-6% growth rate increase comparing to analogous period of 1993.

Much further crisis touched the industrial production. For the four consecutive years i.e. from 1990 to 1993 the production shranked by consequently 1.3, 9, 39 and 27 per cents.

¹ Basic information about Estonia:

1. Estonians belong to the Baltic-Finnic group of the Finno-Ugric peoples as do the Finns and Hungarians. They arrived on the territory of Estonia in the third millennium BC.
2. Estonia has a population of 1,565,662 (1989), 71.6 % live in urban centres. Ethnic composition:
 - Estonians (61.5%)
 - Russians (30.3%)
 - Ukrainians (3.1%)
 - Byelorussians (1.8%)
3. State language -Estonian
4. Main religious:
 - Lutheran
 - Orthodox
 - Baptist
5. Administratively Estonia is divided into 15 counties and 6 towns. The capital is Tallinn of 481,500 (1991)
6. Currency: Estonian kroon (=100 sents)
7. Political system: The November 16,1988 Declaration on the sovereignty of the Estonian SSR established the Estonian SSR. The November 12 1989 the Supreme Soviet declared the 1940 aggression as a military occupation and annexation. The July 22 1940 resolution on Estonia Joining the USSR was declared null. On May 8, 1990 the official name of the state is Republic of Estonia. The 101 member Supreme Council is the highest continually active legal body of the state authority. The SC is elected for 5 years. The head of the government (prime minister) is nominated by the SC. The Prime Minister presents ministerial candidates to the SC for approval.

The inflation in the second quarter of 1992 (just before introducing the currency reform) was 51%. At the same time production prices grew by 139% (fig.1). In the last two quarters of 1992 inflation (CPI) reached 64% and 25%. After that the stabilization effects appeared lowering inflation considerably. 1993 inflation was equal 32.6%. The inflation is then still high but as one estimates it is pushed ahead mostly by the world market prices. This is due to quite considerable overshooting in the exchange rate at the beginning of the currency reform that caused a supply shock leading to a further inflation. This view is also supported by the fact that during the period of stabilization and transformation PPI has been exceeding a CPI index (Fig.1)



Foreign trade has been totally liberalized. As a result the Estonian economy became very much open. In 1993 the share of exports contributed to 67% of the GDP. There are almost no restrictions or protectionist import barriers. The same extend of liberalization relates to financial markets. Inflow of foreign capital is favoured. There are no restrictions on capital exports. Foreign investors may withdraw their profits anytime or reinvest them in Estonia (Tab.1).

The currency reform of June 20, 1992 gained high degree of credibility. International reserves of the Bank of Estonia have increased significantly (Tab.1). This fact in the framework of a currency board system resulted in fast growth of money supply that was propelled mainly by the influx of foreign capital and

investment. During 1993 both M1 and M2 (also the domestic part of M2 i.e. M2(E)) grew 2 times (Fig.2). This growth was halted in 1994 and was replaced by an almost stable level of monetary aggregates.

The balance of payments was in surplus in 1993 thanks to the net capital inflow which offset the deficit in the current account that appeared in the last quarter of 1993 and also at the beginning of 1994 (Tab.1).

Tab.1 Basic indicators of economic performance

| Indicators | IQ | IIQ | IIIQ | IVQ | IQ | IIQ | IIIQ | IVQ | IQ | IIQ |
|--|------|------|------|------|------|------|------|------|-------|------|
| | 92 | 92 | 92 | 92 | 93 | 93 | 93 | 93 | 94 | 94 |
| Industrial output (Jan. 1993 prices, EEKmill.) | 4348 | 3802 | 4001 | 3499 | 2609 | 2689 | 2844 | 3283 | 2922 | 2604 |
| CPI (IQ 92=1) | 1,00 | 1,51 | 2,48 | 3,12 | 3,41 | 3,65 | 3,84 | 4,15 | 4,86 | 5,52 |
| PPI (IQ 92=1) | 1,00 | 2,39 | 3,02 | 3,92 | 4,55 | 4,86 | 5,20 | 5,55 | 6,47 | 8,47 |
| Current Account (EEK mill, IIQ 92=IQ+IIQ) | | 961 | 591 | 287 | 403 | 193 | 416 | -519 | -1071 | |
| Capital Account (EEK mill, IIQ 92=IQ+IIQ) | | -392 | 178 | -125 | 672 | 412 | 762 | 701 | 934 | |
| Direct investments (EEK mill.) | | 212 | 158 | 335 | 454 | 367 | 608 | 700 | 551 | |
| International reserves (EEK mill.) | | 780 | 1739 | 2502 | 3061 | 3720 | 4507 | 5237 | 5296 | 5266 |

As far as the banking sector is concerned there was a significant crisis in 1993. One of the leading commercial banks run into bankruptcy while two others were merged and eventually bailed out by the government. Interests rates on deposits and loans have been declining and there have been some signs of revitalization of credit market. The share of loans given to private sector has been increasing. The role played by the state owned enterprises declines in this respect.

There has also been significant change in the ownership structure. A decisive majority of enterprises in the fields of trade, public catering and services have been privatized. It is associated with a large amount of new enterprises that have recently been established. By June 1994 there were above 75,000 units registered. Only 7,000 of them belong to the state and 1,780 to municipalities. It is also worth mentioning that the number of enterprises and institutions owned partly by foreigners exceeded that of state owned ones.

2. Stabilization package in Estonia

2.1. Soviet Union's inheritance

The final collapse of Soviet central planning in 1990-1991 brought about widespread disruptions in trade leading to shortages in goods and raw materials, loss of exports markets, disfunctioning of payments and monetary arrangements and a “wait and see” attitude among enterprise managers. At the same time galoping inflation severly cut households’ real balances that together with price liberalization started to eliminate the shortages. In Estonia the 210,6% inflation in 1991 reduced the stock of cash and deposits held by households by about 75% of its real value.

In 1991 Estonia faced also the terms of trade shock after the Soviet Union had collapsed loosing about 10% of GDP. The overall drop in GDP reached in 1991 13% after declining in 1990 by 3.6%.

All these signs of instability and general chaos in the ruble zone did not leave much scope for a gradualist approach to stabilization. Model that was adopted in Estonia seems to have been the baldest not only among the former Soviet Union countries but possibly among the Central and Eastern Europe states as well.

2.2. Currency and exchange rate reforms

2.2.1. First steps of currency reform

An introduction of a new own currency was understood as an indispensable element of independent monetary system. The need to grant economic authomomy in Estonia apeared in August 1987. It stressed the need to introduce a convertible currency and clear accounts with other Soviet Union regions.

The accelerating inflation based on inflationary rouble that discredited itself in every respect as a currency together with an accute cash crisis gave another push to the spread of the idea of national currency. In the spring 1988 the Estonian SSR government formed official work groups to elaborate the concept of economic independence including creation of national monetary system.

There were several ideas all included an accomplishment of three goals²:

- elimination of inflationary impacts from the East,
- guaranteeing an equivalent exchange based on market forces,
- conquering the cash crisis.

² See: Kallas S., Sorg M., Currency reform in Estonia, Estonian Academy of Sciences, Institute of Economics, Reform Round Table Working paper No 9, Tallinn, May 1994.

The first proposal, based on the experience of Soviet Union monetary reform in 1922, stipulated simultaneous circulation of two currencies - inflationary rouble and inflation-free koru. This solution however could not have secured the stability of a national currency. At the end of 1989 a proposition appeared to announce the Finnish mark FIM for the official legal tender. This was to assure stability and also referred to old experiences of 1918 when the Finnish currency was in circulation in the newly independent Estonia. The additional argument concerned the fact that the Finnish money circulated in mass in Estonia at that time.

More realistic concept of regulation of the Estonian monetary system was elaborated by an international group suggesting introducing the currency board principle. It was based on the idea of taking a loan of SEK 600 million from Sweden for the reserve assets of the new Kroon. New currency EEK was to be fully backed with gold and foreign currency reserve. For many political and also practical reasons (unsolved problem of getting the loan etc), this idea was also rejected.

2.2.2. Price liberalization

Implementation of the new currency required former price liberalization. Price reform started in late 1989. In this reform the government allowed changes in prices to be initiated by enterprises. Control over price setting at the wholesale and retail level for a wide range of goods was retained. At first prices of paper product, furniture and vegetables were decontrolled. In October 1990, prices of food were raised administratively and later subsidies on energy, telecommunication and transport were reduced. In July prices of milk, meat and several other consumer goods were deregulated. At the end of 1991 prices of 10% of the consumer basket remained under government price fixing procedure while other 30% were under some administrative regulation. All other prices were more or less free and their movement reflected supply and demand conditions on the market. Further deregulation took place within the framework of the stabilization package. By the end of 1992 the price liberalization process was virtually completed.

2.2.3. Implementation of the currency reform

On the basis of theoretical discussions the Bank of Estonia formed in July 1990 8 work groups for the elaboration of the comprehensive currency reform system accompanied by relevant laws. In order to strengthen the operativeness the Currency Reform Committee was set up in March 1991. It had been delegated great powers like the right to issue decrees concerning preparation and implementing the currency reform that was equal to the resolution of the Parliament. The final version of the reform referred to the mentioned above concept of a currency board. The Estonian version of a currency board boils down to the following elements³:

³ Pure version of the currency board solution requires only for the money in circulation to be fully backed by the international reserve stock.

1. The Estonian kroon i.e. cash in circulation, demand and fixed time deposits have to be completely backed with gold and convertible currency reserves of the Bank of Estonia.
2. The Kroon has a fixed exchange rate for the Deutschmark at the parity 8:1. The Kroon floats against all other currencies.
3. The Bank of Estonia has no right to devalue the Kroon. Devaluation requires a law to be passed by the parliament.
4. The Bank of Estonia has to ensure free convertibility of the Kroons against foreign currencies with respect to both current and capital account transactions.

The reform based on these principles came into existence in June 1992. Estonia was then the first country of the former Soviet Union to introduce its own national currency.

2.2.4. Wood backed reform

The fixed exchange rate system especially in Estonian version requires sufficient stock of gold and foreign exchange. After declaring in 1991 the Bank of Estonia the legal successor of the central bank that existed before Soviet annexation in 1940 11 tons of gold kept in Great Britain, Sweden and Switzerland were restored as gold reserves of Bank of Estonia. In order for the currency be fully backed one estimated the lack required reserves of additional 120 mln USD. The problems regarding obtaining such an amount forced the Estonian Supreme Council to commit into the balance of the Bank of Estonia reserve area from the state forest with the estimated value of \$150 mln. In other words the central bank received at its disposal the total of 150 thousand cubic meters of forests ready for felling which can be sold for supplementing the gold and foreign currency reserves of the Estonian kroon in the event of crisis!

2.2.5. Erhard (German) pattern

From the technical point of view the most decisive stage of the currency reform was the withdrawal of rubles from circulation and replacement with the national currency. Every citizen could exchange up to 1500 rubles for 150 EEK. Above this magnitude the exchange rate was 50 rubles/EEK which effectively restrained the potential flow of inflationary rubles from east across the border. At the exchange rate 10:1 demand and fixed term deposits were exchanged. As a result every resident exchanged on average EEK 100 and average saving after the reform was EEK 220 i.e. DEM 28! per person.

2.3. Credibility assessment of the stabilization program

Following the implementation of the stabilization program inflation in Estonia decelerated rapidly suggesting gaining credibility. Although important the disinflation process itself should be supported by other measures of credibility. The extend to

which the credibility is confirmed allows to derive conclusions about the main directions of transformation process⁴.

Here the attention will be paid to supporting the view of gaining credibility by evaluating the risk involved in the exchange rate and by appreciating the costs of disinflation⁵.

For the economy with a free capital movement the concept of interest parity must hold. The interest rate differential is then justified by expected rate of devaluation. In other words if domestic and foreign interest rates differ that difference is covered by the risk premium the public sets on the exchange rate. It turns out that comparing the Bank of Estonia 28 day certificates of deposits for which the annual interest rate fluctuates closely around 5.5% or Estonia's interbank market interest rate (around 5.6%) to analogues interest rates in Germany to which the Estonian currency is pegged no statistically significant difference appears. That suggests full credibility of the Estonian currency⁶.

The next measure that confirms high credibility of Estonian way of stabilizing the economy concerns the costs of disinflation. As a rule the less credible policy the higher the so called sacrifice ratio indicating a loss in production caused by a given (in our example - 100%) decrease in inflation (Tab.2).

As we can see the sacrifice ratio has been low and relatively stable since the first quarter of 1993 when 100% decline in inflation caused only 3,05% drop in GDP. During second and third quarters it was even subject to reduction which means growing confidence in this kind of policy. In turn in the last quarter of 1993 and during the first half of 1994 one can observe rising level of the sacrifice ratio. This process may indicate that the program is slightly losing its reliability. Despite this fact it seems that further disinflation should not entail any substantial drop in real

⁴ Hansson and Sachs in: Hansson A., Sachs, J., Monetary Institutions and Credible Stabilization: A Comparison of Experiences in the Baltics, University of Chicago Law School, April, 1994 suggest that for small open in terms of current and capital accounts economy with fixed exchange rate regime which well fit to the Estonian case gaining credibility of stabilization implies fulfilling the following list of eight conditions

1. lower nominal interest rates,
2. lower ex post real interest,
3. smaller spreads between deposits and lending rates,
4. less of a buildup of bad debts in the banking system,
5. greater growth of money demand,
6. longer-term maturities of the central bank lending,
7. a faster buildup of foreign exchange reserves,
8. faster recovery in GDP and industrial production.

Examining these hypotheses for Estonian case they "find most of them to be strongly confirmed in data: the currency board arrangements in Estonia seem to have contributed to enhanced credibility of the stabilization program." (p. 13).

⁵ See: Saavalainen T., Stabilization in the Baltic Countries: A Comparative Analysis, Annual meetings of the Allied Social Science Associations, Washington, D.C., January 6, 1995.

⁶ The interesting fact is that much bigger interest rate differentials one can observe in Latvia where the inflation in the first half of 1994 was even lower than in Estonia. That also supports the proposition that Estonia's currency board has contributed importantly to enhanced credibility of macroeconomic stabilization.

GDP⁷. If this cost of disinflation remains an additional 10% reduction in inflation should not cost more than 0,4% of an additional drop in GDP.

Tab.2 The sacrifice ratio

| | % Change in GDP 2Q 92=100 | Cumulative change in GDP | % Change in inflation 2Q 92=100 | SR | Change in SR |
|-------|------------------------------|--------------------------|------------------------------------|--------|--------------|
| 3Q 92 | -4,9 | -4,9 | 139 | -3,53 | |
| 4Q 92 | -9,1 | -14 | 94 | -14,89 | -11,37 |
| 1Q 93 | -8,4 | -22,4 | -735 | 3,05 | 17,94 |
| 2Q 93 | -3,6 | -26 | -893 | 2,91 | -0,14 |
| 3Q 93 | -0,5 | -26,5 | -967 | 2,74 | -0,17 |
| 4Q 93 | -3,7 | -30,2 | -990 | 3,05 | 0,31 |
| 1Q 94 | -8,1 | -38,3 | -984 | 3,89 | 0,84 |
| 2Q 94 | -0,4 | -38,7 | -978 | 3,96 | 0,06 |

3. Foreign trade reorientation

From the socialist period Estonia inherited Soviet market oriented economy. Thus, the share of former Soviet republics was more than 90% of Estonian exports while the share of imports exceeded 80%. In 1980s the foreign trade was in deficit. The restoration of Estonia's independence coincided with the increase in the difficulties in the Soviet economy⁸ Those problems specially touched the trade of fuels and raw materials. There were also many attempts made to blockade both the trade and banking and money transfers as well⁹ The year 1990 was the last year of so called stagnation period characterized by a rigid set of rules covering both with commodity groups and trade partners which had been forced upon Estonian foreign trade for a long period of time.

In 1991 Estonia fulfilled its agreements with the former Soviet Republics in terms of exports. On the other hand the imports from that region dropped dramatically which implied a positive balance of foreign trade. Despite, Russia and former Soviet republics remained main trade partners in 1991. Changes that took place in the year of deepening economic instability 1991 did not in fact exert any noticeable influence on foreign trade. The decisive break occurred in 1992.

⁷ The same procedure applied to remaining Baltic states produces much higher sacrifice ratios.

⁸ See: Gaidar's Program, CASE, Warsaw, May 1993.

⁹ See: T. Rajasalu, Estonian Economy: Spring 1993, Estonian Academy of Science, Institute of Economics Report 1, Tallinn, June 1993.

At the beginning of 1992 the difficulties in Russian economy escalated. It was associated with imposing by Russia exports quotas and licencing. Liberalization of prices for raw materials and fuel in Russia resulted in a big jump of prices in Estonia during the first half of 1992. The terms of trade deteriorated by over 30% or by over 10% of GDP. Due to very high dependency of the former Soviet Union Estonia experienced much higher losses than East European countries after dissolution of CMEA. For instance estimates for Poland, Hungary and Czechoslovakia show the terms of trade shock in 1991 ranged between 3 and 5.5 % of GDP.

Tab.3 The breakdown of the foreign trade in 1992 in Estonia

| Year | Eksports (EEK mill.) | Imports (EEK mill.) | Foreign trade balance | | |
|------|-------------------------|------------------------|-----------------------|----------------------|----------------------|
| | | | Energy (EEK mill.) | Other (EEK mill.) | Total (EEK mill.) |
| 1990 | 262 | 342 | -18 | -61 | -79 |
| 1991 | 510 | 445 | -26 | 91 | 65 |
| 1992 | 5232 | 5134 | -853 | 951 | 98 |

Source: Bank of Estonia, Quarterly Review 1993:1.

The figures in table 3 reflect two important features of Estonian economy before systemic crucial changes and trade reorientation. Firstly, the inflation that made both exports and imports ten times larger in 1992 comparing to 1991 also changed the price structure. The new price system bettered the terms of trade particularly in 1991 significantly. Secondly we can see Estonia's dependence on imported fuel and energy. The negative balance of their (-853 mln kroons) is almost equal to positive balance of all the remaining imports and exports (951 mln kroons).

In the first quarter of 1992 the foreign trade was practically blocked. Missing shipments to Russian fuel were replaced with loans and aid from the West, particularly from Nordic states.

Under such unfavourable circumstances Estonia started to reorient on western markets. It relates both to trade structure and trade partners (tables 4 and 5).

Looking at Estonian foreign trade by commodities one can distinguish three groups.

First, commodities that have given a positive balance during the whole period. Traditionally those were products of animal origin (meat and dairy products). Several types of manufactured goods must be included here as well (group 12, tab.4). It particularly comprises furniture, sports equipment, toys etc. During this period Estonia also earned foreign trade revenues from exporting timber, paper and products

Tab.4 The reorientation of trade by products

| | % of TOTAL | | | | | | BALANCE | | |
|--|------------|------|------|--------|------|------|------------|------|------|
| | Eksport | | | Import | | | mln kroons | | |
| | 1990 | 1991 | 1992 | 1990 | 1991 | 1992 | 1990 | 1991 | 1992 |
| 1. Live animals, products of animal origin | 7.3 | 10.0 | 10.2 | 1.0 | 1.1 | 0.5 | 16 | 46 | 506 |
| 2. Products of vegetable origin | 1.0 | 0.9 | 0.9 | 7.6 | 10.1 | 1.7 | -23 | -40 | -40 |
| 3. Animal and vegetable fats and oils | 12.6 | 7.4 | 5.4 | 6.3 | 6.6 | 6.5 | 12 | 8 | -44 |
| 4. Mineral products | 3.2 | 5.2 | 11.2 | 7.5 | 12.0 | 28.0 | -18 | -27 | -853 |
| 5. Chemical products | 14.0 | 15.7 | 7.5 | 16.8 | 11.5 | 7.6 | -21 | 30 | 13 |
| 6. Wood, paper, paper products | 4.7 | 5.9 | 13.9 | 2.2 | 2.4 | 3.9 | 5 | 20 | 524 |
| 7. Textiles | 24.5 | 26.4 | 13.8 | 23.1 | 19.0 | 7.8 | -14 | 50 | 321 |
| 8. Footwear, headgear | 3.4 | 1.9 | 1.0 | 2.6 | 1.9 | 1.1 | 0 | 1 | -3 |
| 9. Metals | 3.8 | 3.6 | 13.5 | 10.0 | 9.4 | 4.7 | -25 | -24 | 467 |
| 10. Machinery equipment | 10.1 | 11.6 | 5.5 | 12.7 | 14.0 | 18.7 | -17 | -3 | -669 |
| 11. Transport equipment | 1.3 | 1.0 | 6.5 | 3.4 | 3.8 | 13.8 | -8 | -12 | -368 |
| 12. Other manufactured goods | 14.1 | 10.4 | 10.6 | 6.8 | 8.2 | 5.7 | 14 | 16 | 244 |
| TOTAL | 100 | 100 | 100 | 100 | 100 | 100 | -79 | 65 | 98 |

Source: Bank of Estonia, Quarterly Review 1993:1.

Tab.5 Reorientation of trade by partners

| | % of TOTAL | | | | | | BALANCE | | |
|----------------------------------|------------|------|------|--------|------|------|----------|-------|--------|
| | Eksport | | | Import | | | EEK mill | | |
| | 1990 | 1991 | 1992 | 1990 | 1991 | 1992 | 1990 | 1991 | 1992 |
| 1. CIS (inc. Latvia, Lithuania) | 94.0 | 94.8 | 41.8 | 82.0 | 84.7 | 40.9 | -33.6 | 105.9 | 88.9 |
| 2. CIS (excl. Latvia Lithuania) | 85.2 | 83.3 | 30.2 | 74.1 | 73.3 | 37.8 | -29.6 | 98.2 | -360.0 |
| Russia | 55.1 | 56.5 | 17.7 | 51.8 | 45.9 | 32.5 | -32.4 | 83.9 | -742.1 |
| Ukraine | 13.2 | 12.9 | 5.7 | 7.7 | 7.9 | 2.3 | 8.2 | 30.4 | 181.0 |
| Belarus | 4.6 | 4.1 | 1.1 | 4.4 | 4.9 | 1.7 | -3.0 | -0.9 | -30.2 |
| 3. Latvia | 5.7 | 7.7 | 10.3 | 4.7 | 5.1 | 1.4 | -1.2 | 16.6 | 467.8 |
| 4. Lithuania | 3.1 | 3.8 | 1.3 | 3.2 | 6.3 | 1.7 | -2.8 | -8.9 | -18.9 |
| 5. Finland | 1.1 | 2.3 | 24.3 | 1.6 | 2.0 | 29.4 | -2.5 | 3.0 | -240.2 |
| 6. Germany | 0.3 | 0.2 | 4.3 | 2.3 | 0.8 | 7.6 | -6.9 | -2.7 | -163.8 |
| 7. Sweden | 0.4 | 0.5 | 9.0 | 0.1 | 0.8 | 6.6 | 0.6 | -0.8 | 135.0 |
| 8. Other West-European countries | 0.5 | 1.0 | 11.5 | 2.9 | 2.4 | 8.5 | -9.8 | -5.2 | 170.0 |
| 9. USA and Canada | 0.6 | 0.1 | 2.1 | 3.2 | 3.7 | 3.5 | -2.6 | -15.8 | -64.0 |
| 10. Other countries | 3.1 | 1.1 | 7.0 | 7.9 | 5.6 | 3.5 | -24.5 | -19.6 | 172.5 |
| TOTAL | 100 | 100 | 100 | 100 | 100 | 100 | -79.3 | 64.8 | 98.4 |

Source: Bank of Estonia, Quarterly Review 1993:1.

made of wood and paper. This, except timber which became the most important source of foreign trade revenue, did not change in 1992.

The second group includes commodities having traditionally given a negative balance in Estonian foreign trade. It specially relates to fuels (group 5, tab.4) that steeply increased their negative balance during 1990-1992. Similar situation concerns machinery and transport equipment and products of vegetable origin. The difference between export and import increased most notably in the group of transport equipment.

The third group embraces goods that sometimes show positive, sometime negative foreign trade balance. First of all one has to mention metals (metals and metal products) where their import traditionally exceeded export. In 1992 Estonia became metal net exporting country.

Summing up it should be stressed that at the beginning of deep reforms the structure of trade balance started adjusting to new requirements. Anyway it was far from being rational. Commodities that had no direct link to local manufacturing industries played a far too important role (metal trading, timber felling).

Changes affecting Estonian foreign trade partners in 1992 seem to have been much greater than changes with respect to commodities. Estonia started to look for new trade partners in the West in order to avoid the risk connected to the East trade. Enterprises which had oriented to the CIS markets faced deep difficulties. Not all could sell their products on western markets. The substitution of cheap raw materials and fuel imported previously from Russia with those bought from western markets caused an intolerable cost increase and they turned out to be unprofitable. As a result the former Soviet Republics, especially Russia, lost their leading role. That region was mainly replaced by the trade with Finland. Export to other western countries, mostly Germany and Sweden was increasing as well. During 1992 exports to the West have been steadily outstripping exports to the East. The increase accelerated in the second half of 1992 after the monetary reform.

4. Banking system reform

Before World War II Estonia had a well-functioning banking system. Apart the central bank - the Bank of Estonia there were three types of financial establishments operated within the system: commercial banks, which were the biggest and most universal, city banks and loan and saving societies.

The discussions of necessity and possibility of creating Estonian own banking system started in the autumn 1987. A year later the first commercial bank in the Soviet Union was established in Tartu. Thus, the creation of an independent banking system started well before political independence was regained. The initiators of the new banking system were managers of Estonian enterprises and private entrepreneurs, whose activities were the most severely hindered by the existing banking system. The initiative coming from below was supported by local politicians and at the end of 1989 there were six independent commercial banks. A year later this amount doubled.

They were responsible for 20% of loans granted in Estonia at that time. Furthermore, they caused a rise in competition providing alternative opportunities for borrowing, saving and quality of services. Simultaneously five branches of all-Union banks continued operation.

The next step was the struggle to separate the branches of all-Union banks and incorporate them into an independent banking system of Estonia. At the end of 1989 the USSR gave the Baltic states economic autonomy and transferred the branches of the all-Union banks under the administration of the governments of these republics. The process of the banks' gaining independence was however not free of problems and controversies. The problem of parallel central banks was resolved on 31 December 1991 when the Tallinn Branch of the Gosbank stopped its operation. This fact made it possible to emerge a "two-tier" system from previously existed monobank. This system was completed in May 1992 with the transfer of all remaining commercial functions to the new North-Estonian Joint-Stock Bank which was 100% owned by the Bank of Estonia.

In the meantime a financial chaos and galloping inflation in the ruble zone reduced the real value of the obligatory initial capital of banks several times. By the mid-1992, the 5 million ruble threshold was equivalent to less than 40,000 USD. In such an environment banking became a very lucrative business. The possibility of exploiting an arbitrage in foreign exchange trading was the easiest way and main source of banking profits. Therefore in 1992 one could observe a boom of setting up new commercial banks. In the first half of that year 21 banks were issued a licence. At the end of 1992 the total number of commercial banks in Estonia was 42.

4.1. The Bank of Estonia and consolidation of the banking system

The Bank of Estonia was founded at the end of 1989. The main task the bank was obliged to fulfil was to create the banking system, secure economic sovereignty and restore normal functioning of the market economy. The Bank of Estonia started with modest financial resources. As of January 1991 its capital stock was only 10 million roubles while according to the norm it should have had 400 million!. It tried to improve its position by direct crediting and tried to incorporate some commercial banks too. After improving its finance the bank stopped direct crediting except crediting of banks. As it was already mentioned in June 1992 the Board of Foreign Transactions broke off from the Bank of Estonia to form an independent North-Estonian Bank. At the same time with the help of EBRD (25% of shares) The Estonian Investment Bank was formed as a separate unit.

The explosive growth of commercial banks resulted in establishment of banks that were not satisfactory. The average capital stock at the end of 1992 was EEK 5 millions (625,000 DEM). Some of them did not operate professionally and had difficulties in staying liquid. If we add a deep crisis of the whole economy in terms

of a GDP decline we will get the basic roots of banking crisis the economy was facing.

In 1993 prudential ratios and deadlines for reaching them were established. For new banks they are following:

- 8% minimum solvency ratio (bank's own funds to the sum of risk adjusted assets),
- 30% minimum liquidity ratio (liquid assets to current liabilities),
- 800% upper limit on risk concentration (sum of debts of high risk concentration customers to the bank's net assets),
- 50% maximum loan available to any one customer to bank's own funds.

For already functioning banks new capital stock minimum deadline is:

- EEK 15,000,000 by 1 April 1995,
- EEK 25,000,000 by 1 April 1996,
- EEK 35,000,000 by 1 April 1997.

All these steps together with a liquidation of some banks and not issuing new licences to others made some banks to merge. At the beginning of 1994 there were 21 operating commercial banks i.e. a half of the number of banks functioning at the end of 1992. The process of banking sector recovering presents a table 6.

Tab.6 Consolidation of the banking system

| Period | Total balance capacity mill EEK | Total amount of loans mill EEK | Banks' capital mill EEK | Average loan interest rate % | Unpaid loans from loans portfolio % |
|----------|------------------------------------|-----------------------------------|----------------------------|---------------------------------|--|
| 1 Q 1993 | 4152 | 1369 | 366 | 37.2 | 10.1 |
| 2 Q 1993 | 4611 | 1682 | 548 | 34.2 | 11.1 |
| 3 Q 1993 | 5553 | 2586 | 606 | 29.7 | 7.9 |
| 4 Q 1993 | 6396 | 3024 | 680 | 25.4 | 6.8 |

Source: Sort M., Banking reform in Estonia, Estonian Academy of Sciences, Institute of Economics, Reform Round Table Working paper No 10, Tallinn, May 1994.

Since 1992 there is no limits put on allowing foreign capital into Estonian Banks.

4.2. Selected issues in banking reform

4.2.1. The liquidity crisis

One of the negative side effects of the currency reform was worsening the functioning of the payments system. For instance the average transfer by Union Baltic Bank taking 4 days in September 1992 lasted 1 month by November 1992. Attempts of the Bank of Estonia to reduce delays through short term liquidity loans exerted no perceptible impact¹⁰ It turned out that banks with substantial bad assets or mismatched terms of assets and liabilities could remained liquid from profits earned from foreign exchange, or by onlending cheap central bank credits at much higher interest rate¹¹ The currency reform unifying the exchange rates reduced spreads and cut the profits. In addition the adopted model of stabilization prohibiting the Central Bank from financing commercial banks stopped the regular access to soft credits. The monetary reform revealed problems of weak balance sheets stating a combination of loans in arrears, loans contracted at very low interest rates and losses on foreign exchange operations¹². Banks played well known Ponzi scheme in which depositors who placed their money early enough to withdraw it earned quite significant returns while those coming later carried losses. Therefore some banks being aware of its current situation were in a strong opposition regarding introducing the currency reform. This problem particularly touched three banks whose deposit liabilities constituted in that time about 40% of M2. Among others two there was also a sign of a national pride i.e. the first commercial bank in the Soviet Union (Tartu Bank). The authorities exhibited large degree of determination closing the Tartu Bank with no rescue of depositors and merged the other two with only partial bailout. Also two other smaller banks have been forced to go into bankruptcy with no bailout of depositors.

4.2.2. Bad debts

The potencial of bad debt problem was in some sense solved by inflation that erased the existing debt overhang. The CPI level of December 1993 exceeded 86 times the third quater 1990 price level. Debts from the pre-reform period have then negligible real value. Many debtors and especially heavilly indebted firms have benefited more than they have lost due to currency reform shock.

¹⁰ IMF Economic Review: Estonia, Washington 1993.

¹¹ Hanson A., Reforming the Banking System in Estonia, LSE/TEWS conference on "Banking Reform in FSU and Eastern Europe: Lessons from Central Europe", Budapest, 14-15 January 1994.

¹²IMF Economic Review: Estonia, Washington 1993, p. 21.

In fact the situation is not clear because of the accounting shortcomings. On the other hand there is no important evidence for this problem to be a real one. New strict rules of monetary policy exerted an impact on both firms and banks not to restore the size of credits granted recklessly with little if any credit analysis.

5. Budgetary reform

The budget reform is closely associated with the whole package of reforms especially with the tax and the monetary reform. At the same time it seems to deserve an independent treatment.

As the beginning of the budget reform can be regarded the late 80s when Estonia started to prepare for the transition along with the establishment of independence. The law of 1989 provided that every local government has its own independent budget. It also established the sources of revenues and expenditures of the state and local budgets. The most significant sign of determination to change the old budget was the liquidation of subsidies. In 1991 the social fund was subsidized by ca 50% of the actual needs. Later the share of subsidies decreased considerably. Similarly the maintenance of medical system and sickness benefits used to be entirely financed by the budget. But in 1992 the expenditures connected with public health were practically fully financed from the medical insurance contribution into the sick funds.

In 1992 new system of local governments budget was enforced. According to these regulations budgets of communes and towns receive 100% of personal tax income, 35% of enterprise tax income, natural resource tax and other local taxes. This solution brought about significant differences among regions. Now all surpluses are collected by the central budget and reallocated to those of deficit.

The differences in revenue structure of budget, local budgets and and extrabudgetary funds before and after reform shows the table 7.

Tab.7 Budget revenue structure before and after reform

| Items | 1990 % | 1991 % | 1992 % |
|---------------------------------|-----------|-----------|-----------|
| Enterprise income tax | 18.8 | 20.3 | 17.1 |
| Tax on fixed and current assets | 5.2 | | |
| Personal income tax | 11.9 | 13.3 | 20.4 |
| Turnover tax/VAT tax | 36.6 | 15.6 | 21.4 |
| Total excise tax | | 8.2 | 4.3 |
| Social Tax | | 16.7 | 17.4 |
| Medical insurance tax | | | 10.5 |
| Other taxes, duties and incomes | 27.5 | 25.9 | 8.9 |

Source: Tang P., Niglo H., Budget Reform in Estonia, Estonian Academy of Sciences, Institute of Economics, Reform Round Table Working paper No 7, Tallinn, February 1994.

Since 1992 there have been significant changes in the structures of state and local budgets (see tables 8 and 9).

Tab.8 The structure of the state budget before and after reform

| Items | 1992 | 1992 % | 1993 | 1993 % | 1994(I-VI) | 1994(I-VI) % |
|------------------------------------|------|-----------|------|-----------|------------|-----------------|
| State budget revenues | | | | | | |
| Corporate income tax | 472 | 22,65 | 1032 | 24,86 | 584 | 16,45 |
| Personal income tax | | 0,00 | | 0,00 | 513 | 14,45 |
| VAT | 896 | 42,99 | 1994 | 48,04 | 1670 | 47,03 |
| Excise duty | 182 | 8,73 | 403 | 9,71 | 308 | 8,67 |
| Revenue from state property | 230 | 11,04 | 77 | 1,85 | 68 | 1,91 |
| Revenue from local budgets | 177 | 8,49 | 243 | 5,85 | | 0,00 |
| Total revenue | 2084 | 100,00 | 4151 | 100,00 | 3551 | 100,00 |
| State budget expenditures | | | | | | |
| Finance of social sphere | 791 | 39,04 | 1675 | 41,66 | 1285 | 41,48 |
| Finance of national economy | 388 | 19,15 | 606 | 15,07 | 494 | 15,95 |
| Administration expenses | 120 | 5,92 | 260 | 6,47 | 266 | 8,59 |
| Law and order maintenance | 195 | 9,62 | 482 | 11,99 | 365 | 11,78 |
| State defence | 61 | 3,01 | 171 | 4,25 | 157 | 5,07 |
| Other | 147 | 7,26 | 30 | 0,75 | 94 | 3,03 |
| Subsidies to local administrations | 322 | 15,89 | 649 | 16,14 | 294 | 9,49 |
| Total expenditure | 2026 | 100,00 | 4021 | 100,00 | 3098 | 100,00 |
| Surplus/deficit(-) | 58 | | 130 | | 453 | |

Source: Statistical Yearbook 1993, Estonian Statistics Monthly No 7, 1994

Tab.9 The local budget structure before and after reform

| Items | 1992 | 1992 % | 1993 | 1993 % | 1994 (I-VI) % | 1994 (I-VI) % |
|-----------------------------|------|-----------|------|-----------|---------------------|---------------------|
| Local budget revenue | | | | | | |
| Corporate income tax | 247 | 15,66% | 5 | 0,18% | | 0,00% |
| Personal income tax | 857 | 54,34% | 1832 | 65,76% | 505 | 44,81% |
| Subsidies from state budget | 322 | 20,42% | 617 | 22,15% | 295 | 26,18% |
| Total revenue | 1577 | 100,00% | 2786 | 100,00% | 1127 | 100,00% |
| Local budget expenditures | | | | | | |
| Economy | 442 | 30,21% | 806 | 30,92% | 225 | 22,98% |
| Social sphere | 651 | 44,50% | 1192 | 45,72% | 570 | 58,22% |
| Administration | 95 | 6,49% | 223 | 8,55% | 124 | 12,67% |
| Total expenditures | 1463 | 100,00% | 2607 | 100,00% | 979 | 100,00% |
| Surplus | 114 | | 179 | | 148 | |

The currency board model implemented in Estonia with poorly developed capital market has made the both government budget and the local budgets be kept balanced or in surplus.

It is also worth mentioning that pensions and child and family allowances are paid from a special extrabudgetary fund. Similarly the medical insurance expenditures (maintenance of medical institutions and illness compensations, child birth and taking care) is also financed from extrabudgetary health insurance fund.

In general the reallocation of resources made by the budgets (state and local) is surprisingly low and stable. Both in 1992 and 1993 there was about 30% of GDP reallocated through budget.

5.1. Tax system

At the outset of the tax system reform it was assumed that it should fulfill its classical functions

1. The fiscal function i.e. providing the state and local budgets with income needed for fulfilling their economic and social functions.
2. The stimulative function i.e. stimulating of economic activity and business development.
3. The stabilizing function i.e. stabilization of the economy.

At the beginning there was a confusion among enterprises whose budget (Soviet or Estonian) should be paid taxes. In 1991 new tax system was elaborated. It was aimed at creating an independent and save from inflation tax. The tax structure was thought so that the predominant role was played by indirect taxes. This has been achieved by establishing low rates of direct taxes (enterprise and individual income tax). Tax rates were kept low to create a situation where the former all-Union enterprises be interested in paying their taxes into the Estonian budget rather than into the Soviet one.

The structure of state taxes is following (table 10):

Tab.10 State taxes structure before and after reform

| Items | Rate before July 1992 | Rate after July 1992 | Rate after January 1994 | Remarks |
|--------------------------|-----------------------|---------------------------------|-------------------------|---|
| Value added tax | 10% | 18 | 18 | Exemptions: social service, post service, drugs, thermal energy |
| Excises | up to 400% | up to 400% | up to 400% | levied on: alcohol, tobacco, fur and gasoline |
| Enterprise income tax | progressive up to 30% | proportional 35% till Dec.1993. | proportional 26% | Some allowances until Jan 1994 |
| Individual income tax | progressive up to 33% | proportional 26% | proportional 26% | Before Jan 1994 100% to local budgets, after Jan. 1994 52% local and 48% state budget. 1994 tax free income-3600 EEK. |
| Social tax | 20% | 20% | 20% | Paid by employers to extrabudgetary fund |
| Health insurance tax | 13% | 13% | 13% | Paid by employers to extrabudgetary fund |
| Land tax | | from 1993 0.8-1.2% | 0.8-1.2% | 0.5%-state budget, 0.3-0.7%-local budgets. tax base: land price |
| Customs duty | | | | except imported cars-10% and exported rape oil <u>no duties</u> |
| Tax on gambling | | | | insignificant |
| Inheritance and gift tax | | | | insignificant |

The new tax system was introduced in 1991 under conditions of high inflation and significant drop in GDP. Despite this both state and local budgets were kept balanced. It obviously happened at high social price. Since 1992 there have been essential changes in the state budget and the local budgets. The share of local budget in the total budget revenues kept declining from 43% in 1992 to 24% in first half of 1994. However, introduction at the beginning such a decentralized tax system was not

supported by a mechanism reallocating funds among different regions. The government decided then to make a step back by intervening in local activities as reallocation of the state budget resources over particular regions appeared unavoidable. Unlike 1992 and 1993 when part of the corporate tax was allocated to local budgets since the beginning of 1994 all of it has gone to the state budget. At the same time personal income tax that previously was collected by local budgets was subject to split between state (48%) and local governments (52). Those changes in turn created a situation of insufficient local budgets. More than 85% of their income comes from personal income tax. The subsidies from the state budget equal a half of their own incomes and a quarter of their total revenues.

6. Labour market

The economic reforms have caused great changes in the labour market. Besides the economic changes the labour market formation has been influenced by:

- enforcement of new law regulating labour relations,
- changes in institutional structure of the labour market
- shift in the trade unions' role they played in the economy,
- application of tripartite agreements (trade unions, employers and government).

Current processes so far have reflected only the beginning of labour market formation. Large scale privatization has not gone into full swing yet and the ownership and land reforms are in some intermediate stage. Also unemployment as a new social phenomenon has not touched the Estonian labour resource yet.

6.1. Labour market institutions

6.1.1. Government

Within the government the elaboration and execution of social policy, including labour and income policy is regulated by the Estonian Ministry of Social Affairs (MSA). Under its administration the National Social Insurance Office was formed. Main tasks of MSA include planning of the whole social policy and solving social problems in the following principal spheres:

- protection of people's health and medical care,
- employment and income policy,
- social security and social insurance.

The work of unemployment local offices (40) has been passive so far, being limited to the registration of job-seekers and the unemployment and payment of benefits to them. Also training of the unemployed has played a minor role.

6.1.2. Trade Unions

The trade union reform started in 1988-1989 together with the Trade Union Law. Although the law was adopted in the Soviet period it is still in force. The law established most generally recognized principles of international law like independence of the trade unions, freedom of joining the trade unions and so forth. Today there is 25 trade union federations that unite about 50% of the labour force. Despite this fact there is a quite strong resistance among employees to be involved in the trade union work mainly due to their role they played during the socialist period. So far the main achievement is a preparation of the ratification of ILO conventions in the Parliament.

Since the employers (the third part of the institutional arrangement) are practically not organized also the tripartite negotiations are at the very preliminary stage.

6.2. Labour supply

The employment rate of the population has always been relatively high. In 1989 86.1% of working age population were engaged in the economy. This share dropped to 77% in 1994. This decline results from introducing economic reforms and general economic decline in Estonia. This shift comprises pensioners whose share of being economically engaged decreased from 28.4% in 1990 to 18.2% in 1993 and studying young people whose share has risen.

The Estonian labour force is considered to be rather highly qualified. 15% of employees has higher, 30% secondary and 25% specialized secondary education. The certain part of professional structure of employment is not in harmony with the present labour market requirements (engineers in industrial specialties for instance).

Another characteristic feature of the labour market are regional differences. In some regions especially in Tallinn there is no unemployment at all. In others one estimates to be over 20%.

The workforce was ethnically divided between different regions of the country as well as sectors of economy. This is the result of decades of purposeful labor import to certain regions (North-Eastern industrial towns and Tallinn) and into certain branches and companies. The share of Estonians in the total workforce was 58.7% in 1987. in industry the share of Estonians in the workforce was 42.8% (in the oil shale industry 17.1%). In agriculture there was 85.4%. Estonians prevail in education - 71% and in culture - 84%.

More than one third of the total workforce is located in Tallinn. This is first and foremost connected with the concentration of new businesses emerging in the capital.

The territorial and professional mobility of working people is relatively limited. People are stuck to the place they happen to live. This is also connected with the early formative stage of housing market.

6.3. Labour demand

As far as the labour market is concerned the economic reforms essentially affected the labour demand side. In 1989-1994 the total number of employees decreased in manufacturing, agriculture and construction and increased in the service sector. This confirms the GDP structures by kinds of activity where the share of services increased from 34% in 1992 to over 50% in 1994 (table 11).

Tab.11 GDP structure by kinds of activity

| Sectors of the economy | Jan 1992 % | Oct.1993 % |
|--------------------------------|---------------|---------------|
| Agriculture, forestry, fishing | 19 | 11 |
| Manufacturing | 31 | 27 |
| Power engineering | 2 | 3 |
| Constuction | 7 | 7 |
| Trade, catering, hotels | 9 | 12 |
| Transport, communication | 10 | 9 |
| Financial institutions | 4 | 6 |
| Social and personal services | 17 | 25 |
| Other | 1 | 1 |

Source: Venesaar U.I labour Market in Estonia. Estonian Academy of Sciences. Institute of

The labour demand exhibits the following features:

- declining tendency,
- overemployment in the state sector,
- differences in labor demand by kinds of activity, occupations and regions,
- mismatch between labour demand and vacancies.

The first issue will be considered in the section concerning unemployment. The phenomenon of hidden unemployment in the state sector can be detected by

comparison 60% decline in manufacturing and 45% decrease in employment. The enterprises that are facing the problem of privatization are not too much eager to reveal their excessive labour resources just in case of having troubles with hiring fired people again. The second reason is a slight rise in the manufactural production since third quarter of 1993. On the other hand there has been announced over 5000 vacancies where the firms cannot find suitable employees. This is a sign of a natural mismatch phenomenon during so severe reorientation.

6.4. Unemployment

Unemployment or rather the lack of unemployment seems at the first sight not to fit to other results the Estonian economy produces. According to different measures applied to this issue there was 2-6.8% unemployment at the beginning of 1994. Despite some obvious tendencies during the period of recovery like a rise in industry or an acceleration in privatization process some other explanations deserve attention. Fortunately for the economy and statistcs some natural and exogenous factors are at work.

1. Emigration. Regained independence and the withdrawal of Russian troops from Estonian territory made quite large amount of Russians leave or emigrate. Till beginning of 1994 more than 50,000 Russians emigrated. For the economy of 630,000 working people it has had a substancial meaning.
2. Before 1991 there were some 28.4% share of pensioners in the total number of employees. This category of employment dropped by 10% to 18.2%. That means additional 60,000 people out of labour force with no sign of increasing unemployment!
3. It is also wort mentioning keeping, along with other fields of economy, strict liberal attitude towards unemployment benefits. Unemployment compensation and related social benefits have been remaining at levels which do not distort incentives for job search and skill enhacement.
4. Under the condition of high inflation and wage liberalization¹³ wage rigidities generally tend to be small. That makes the labour market quite flexible. Hence, in the absense of strong trade unions there is no room for western European type insider-outsider phenomena.

7. Ownership reform and privatization

7.1. First trials of privatization

¹³ The Estonian government have so far been successful in resisting demands for wage and price indexatian scheme.

By the middle of 1980s Estonian economy was centralized and highly concentrated. In the manufacturing sector 200 large state enterprises dominated, of which the majority were subordinated directly to Moscow. In transport and even in the service sector the share of state enterprises was nearly 100%. In agriculture there were approximately 300 farms of which 50% were state and other 50% cooperative (kolkhoz). 2/3 of dwellings represented state living space at that time.

The privatization in Estonia was not in the agenda until the beginning of 1990. In the privatization process a strategy of reforming that sphere step by step was a basic principle of Edgar Savisaar's government. It was intended to start with commercialization, privatization of dwellings, small-scale units and some experimental privatization. In 1990 the special institution - Department of State Property was founded to carry out small and pilot privatization. First auctions of small units took place in March 1991. Similarly the leasing program and the commercialization process of state enterprises started at that time. This was also the period when the spontaneous privatization started in various forms. After an introduction of the new currency on June 20 1992 and adoption of basic laws (on competition, bankruptcy, etc.) the mass privatization of larger units was planned to start.

7.2. Debate on privatization principles

Passing the Law on the Fundamentals of the Ownership Reform in June 1991 splited the political scene into supporters of predominantly political approach or economic approach to privatization process. The former one represented mainly by National Coalition Party "Fatherland" and National Independence Party placed the restitution of property rights and the general interest of Estonians in the front. They support radical and immediate transfer of state property into private ownership by means of vouchers. This approach negated the role of former "nomenklatura", foreigners of mostly Soviet origin. Also the Rural Center Party and Social Democrats gave priority to vouchers but delivered according to one's work contribution. The supporters of the latter approach wanted the restitution and compensation problems be separated from privatization. Sale was regarded as the main form of privatization while vouchers were basically rejected since they were considered as a mean of diffusion of property.

The economic approach predominated in the E. Savisaar government. It was also followed by T. Vahi government that came into power in January 1992. Controversies concerning the basic way of privatization hampered the process of private ownership restitution. Most government's initiatives were rejected by the parliament which cut and dried among others the following programs:

- partial sale of the shares of state owned joint-stock companies,
- reorganization of state owned small scale enterprises,
- privatization of dwellings.

The last one was finally adopted in April 1992. This envisaged the introduction of the so called national capital vouchers in the process of privatization of dwellings.

7.3. Progress in privatization

After the parliamentary elections had taken place Mart Laar's government was formed (September 1992). The coalition consisted of "Fatherland", Liberal Democrats, National Independence Party, Rural Center Party and Social Democrats. A series of laws and decrees were passed. This solved several important issues that hampered the privatization process previously. It gave some jump in the privatization field but because the coalition members had several different understandings about the ownership reform large privatization still proceeded slower than desired.

7.3.1. Small privatization

Till now the small privatization program has turned out to be the most successful one. There were two stages of this kind of privatization.

The first one lasted from January 1991 to May 1992 embraced objects whose book value did not exceed EEK 50,000 (slightly above DM 6,000). Foreigners were excluded from this sort of privatization.

The existing law granting the possibility for insiders to buy the property at initial price with the pre-emptive right to buy became unexpectedly wide-spread. Approximately 80% of objects were sold in this way while the real auction took place only in the case of about 10% cases. The rest was sold by means of tender (competition of business ideas).

Due to a wide-spread criticism relating mainly to preferences given to insiders second stage of small privatization started with adoption of the new law regulating this way of privatization on 21 May, 1992. First of all the range of objects was extended by rising the ceiling book value to EEK 600,000 and by widening the privatization to all branches. The range of obtainers eligible to purchase the privatized property was also widened. This time all adult residents of Estonia and foreigners as well as joint-stock companies registered in Estonia were granted the right to take part in the privatization process. The lack of mortgage law complicated the possibility to obtain credits from banking sector. To alleviate this shortcoming buying by installments was introduced.

The process of small privatization is practically over. By December, 1993 the total sale price reached EEK 115.5 million and over 1200 objects were sold. Most of the privatized objects have been repaired, re-equipped with modern equipment and made generally much more attractive for customers. As a result all signs of competition emerged.

7.3.2. Experimental privatization

This sort of privatization program was launched in spring/summer 1991. It was aimed at gaining experience and figuring out the suitability of different forms and procedures of privatization before introducing the large scale privatization. Object for this goal (7 enterprises) were chosen so as to function in different branches of industry, to be of various size (book value fixed assets ranged from 170,000 to 20,255,800 rubles, and to be of different form (association, state-owned small enterprise, and large enterprises). Also different methods of privatization were applied.

7.3.3. Large-scale privatization

Formally large-scale privatization started in August 1992 after two fundamental acts had been adopted¹⁴. They were supposed to regulate the privatization of the objects with book value over EEK 600,000. In a charge of running the program Estonian Privatization Enterprise was established in September, 1992. As a rule all enterprises i.e. around 250 industrial and appr. 150 from other spheres of economy have been reorganized into new forms like state-owned joint-stock companies or lease enterprises.

The property to be privatized in this manner was to be sold in exchange for privatization securities (vauchers, EEK or convertible currencies). Both Estonian and foreign citizens, physical and legal persons can participate in the privatization process. Privatization proceeds are allocated in the following way:

1. 50% - into the Compensation Fund,
2. 20% - at the disposal of the Estonian Government reserve fund for covering expenses of ownership reforms,
3. 10% - to supplement the Statutory Fund of the Bank of Estonia,
4. 10% - into the special pension fund,
5. 10% - into the special fund for supporting employment.

During 1993 and 1994 there was quite significant progress in the large scale privatization. In 1993 three international tenders were announced. Almost 400 applications were submitted for 130 selected enterprises. The response from Estonia and from abroad turned out to be unexpectedly large. As it was already mentioned the large scale privatization is one of the most sensitive issues in Estonia. The second round of the program that took place in 1994 was even more successful (Tab. 12).

¹⁴ Those acts are: (1) Resolution on Terms and Procedure of the Privatization of State and Municipal Property and (2) Resolution on the Commencement of the Sale of Shares of the State-Owned Joint-Stock Companies.

Although at the end of 1994 due to the parliamentary election in spring 1995 the privatization process practically stopped the list of great state owned enterprises to be privatized in 1995 was announced. It may be said, that it almost concludes the privatization of usual business enterprises and starts dismantling and sales of some state owned monopolies. It includes enterprises in the field of energy and power production and also in the field of transportation (including merchandise fleet, "Estonian Air" railroad transportation). The state owned North-Estonian Bank is also included into the list of enterprises to be privatized.

Tab.12 Large scale privatization

| Items | 1993 | 1994 |
|-----------------------------------|-------------|-------------|
| Number of contracts made | 54 | 183 |
| Total value of sales (EEK mill.) | 353.2 | 1151.8 |
| Number of jobs guaranteed | 9099 | 20339 |
| Investments guaranteed (EEK mill) | 236.8 | 746.8 |

It is expected that the public sale of shares (and especially for vouchers) should increase in 1995. The problem is that those shares are not much attractive. Most of enterprises is not very profitable and the expected yield is rather low. As part of these enterprises are natural monopolies their activities will remain under some regulation even after privatization. Additionally, quite uncertain results of the parliamentary election make some doubts arise if the further progress in this field will be fast and smooth.

7.3.4. Reprivatization

Problems connected with the extent and form of rehabilitation of the rights of former owners has in principle been treated as one of the fundamental issues in ownership reform. According to the current law in this respect the unlawful expropriation is interpreted rather broadly. It comprises:

- unlawfully nationalized property
- property collectivized within the collectivization and property expropriated in the course of unlawful repressions during the period June 16, 1940 - June 1, 1981.

The objects include illegally expropriated land (with its natural objects as for example forests), buildings, ships, agricultural inventory, factory fittings, shares excluding debts associated with them and the unreceived profit.

Since much of the subjects to restitution (specially dwellings) are actually occupied Estonia has also followed the voucher mechanism of compensation. These vouchers can be bequeathed, donated to close relatives but not traded. They can be used in the process of privatization of shares, land and dwellings. The value of the

alienated property will be compensated for according to value of the property at the time of illegal expropriation. The decline or increase of the value of the property to be restituted will not be compensated for. The restitution and compensation process is arranged and decided by local governments.

By the end of 1993 197,228 claims of which 1 concerning farms and/or land were submitted for restitution or compensation. Comparing to 1.6 mill. population the number of claims seems enormous. In the same time 61,692 assets were reprivatized.

7.4. Effects of privatization

The structure of ownership (table 13) shows that during the first quarters of 1993 and 1994 there was quite significant progress in privatization of the economy in terms of value added. The most important change took place for economic units with participation of foreign trade where the share of value added almost doubled.

Tab.13 Value added ownership structure

| Ownership form | 1993 IQ value added % | 1994 IQ value added % |
|---------------------------------------|-----------------------------|-----------------------------|
| State owned | 55.8 | 43.5 |
| Municipal | 1.5 | 2.2 |
| Private | 25.0 | 29.7 |
| Cooperatives | 4.9 | 3.9 |
| Foreign owned | 0.4 | 1.9 |
| With participation of foreign capital | 8.1 | 15.0 |

Source: Economic survey on 1th half of 1994, Ministry of Economy, 1994, p.7

Tab.14 The share of the private sector

| Sectors | Sales % of total | Fixed capital % of total | Investment % of total |
|--|---------------------|--------------------------------|--------------------------|
| Industry | 37.5 | 34.6 | 21.7 |
| Fuel and energy | 8.0 | 2.8 | 14.2 |
| Construction | 81.2 | 38.5 | 10.3 |
| Agriculture, forestry, hunting, fishing | 89.2 | 88.8 | 8.0 |
| Transport and communication | 37.4 | 32.3 | 0.7 |
| Trade | 83.2 | 78.7 | 21.4 |
| Other | 71.4 | 28.1 | 7.6 |
| Total | 58.8 | 39.6 | 31 - 51.3 |

The growing importance of the private sector can also be evaluated from the viewpoint of other measures. Analysing data from table 8 one can notice that industry and transport and communication are still dominated by state owned enterprises. Other spheres are mostly private. It is also worth stressing that less than 40% of fixed capital produced in 1993 58.8% of sale. This shows much greater efficiency of private sector comparing to the state one.

7.5. The agrarian reform

Agriculture is traditionally one of the most important sector of Estonian Economy. In 1992 it gave 12% of GDP and employed 14% of labour force. The food processing contributed to 31% of industrial output.

The reestablishment of private farms started in late 1980s. Priority was given to the former owner or his or her heirs in case of still existing buildings. Otherwise preferences were given to those who used the land. The farms were exempt from state taxes for five years after establishing the farm.

There were two approaches characterizing the agricultural reform. Supporters of evolutionary development aimed at keeping the stability of agriculture production based on partial preservation of large-scale farms. Others holding the view that agriculture should also be transferred to production based on private property proposed a shock therapy. In reality the second approach was adopted.

8. Challenges in the future

There is no doubt the so far economic transformation in Estonia must be considered to be successful. Very much liberal variant of stabilization and transformation has been adopted and implemented. Main points that were planned and realized are following:

1. Currency board system with fixed exchange rate and no domestic credit expansion,
2. Fiscal squeeze characterized by the balanced budget,
3. Low and proportional tax system (26%)
4. Pensions and medical care financed from extrabudgetary funds,
5. No fiscal and quotas restrictions on foreign trade (insignificant exemptions),
6. Open capital account with no formal restrictions,
7. Important role of local budgets (large degree of decentralization),
8. Large scale of reprivatization and privatization (except big state enterprises),
9. Deep reorientation in foreign trade towards world markets.

Such a system was introduced under some peculiar conditions. First of all the Russian minority boycotting the parliamentary election has had no representatives and practically no influence on systemic changes and current policy. The government responsible for changes consists of right wing politicians that have exhibited determination and consequence in realizing very accute version of systemic reforms.

On the other hand, there has been a kind of social costs to be paid for these radical reforms. The output volume has declined considerably in agriculture, manufacturing and construction. The agrarian lobby demands introducing protectionist measures. The labour force in manufacturing and construction consists to a large extend of Russian workers. Considerable inequalities in incomes have appeared while average purchasing power of wages have declined sharply.

Unemployment that was an unknown phenomenon until the end of 1991 and is still at a moderate rate is likely to increase in the near future as a result of a large scale privatization.

The Estonian population is rather old, fertility is low and mortality high. Per 100 working age persons there are 40 persons under working age and 39 persons over the retirement age. The pensions are close to the edge of survival. Contradictions between aged people and young ones are being deepened

All those problems reflect rather low rating for governing right wing coalition. The favourable background of current reforms may change after new election held in spring 1995. Population expects improvement of the wealth level. It is then quite likely that this dissatisfaction may result in the growing support to left wing parties and eventulally result in changing the way of reforms.

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