

## International Monetary Fund

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**Republic of Latvia:** Letter of Intent and Technical Memorandum of Understanding

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## LATVIA: LETTER OF INTENT

Riga, July 27, 2009

Mr. Dominique Strauss-Kahn  
Managing Director  
International Monetary Fund  
Washington, DC, 20431  
USA

Dear Mr. Strauss-Kahn:

1. **We are responding to the economic challenge facing Latvia with difficult but strong policy measures.** Since the announcement of Latvia's macroeconomic program—supported by the EU, the IMF, and regional partners—the economic environment has deteriorated sharply. While policy implementation is hugely challenging, we are committed to containing external and fiscal imbalances, and preserving the long-standing exchange rate peg until our goal of euro adoption by 2014. Building on progress towards stabilizing the financial sector, our most urgent focus is on structural reforms needed to restore the public finances to health.
2. **Since December, we have taken key steps to safeguard the financial system.**
  - **Intervention capacity has been strengthened.** A new Law on Bank Takeovers, amendments to the Law on Credit Institutions, Deposit Guarantee Law and the Financial and Capital Market Commission (FCMC) Law, as well as to the Bank of Latvia's regulations on emergency liquidity support have enhanced our capacity for bank intervention.
  - **We have improved supervision and monitoring.** A targeted examination of all banks completed in March 2009 revealed no immediate solvency issues. The FCMC has enacted new regulations on asset quality assessment and provisioning, and issued supervisory guidance on banks' internal capital adequacy assessment processes—shoring up capital buffers. The FCMC has also stepped up its monitoring of individual banks and enacted new reporting requirements.
  - **Stabilizing Parex.** We have made progress towards stabilizing the second-largest bank, Parex. An agreement reached in March rescheduled the bank's syndicated loans. The government and the EBRD agreed in April on EBRD's investment of 25 percent of Parex equity and a subordinated loan. The state recapitalized Parex in May.

3. **We have also made considerable progress towards improving the legal framework to facilitate orderly and efficient debt restructuring.** Recent amendments to the Insolvency Law, which entered into force on July 1, 2009, will facilitate out-of-court workouts by providing the incentive to restructure corporate debt and support rehabilitation of household debtors where needed. We have also developed a strategy to raise public awareness of the refined insolvency framework and to train government and private stakeholders to optimize out-of-court restructurings. Finally, we streamlined foreclosure procedures in March 2009 to speed up the debt resolution process. We have also developed a comprehensive private sector debt restructuring strategy, although without fiscal space a planned household debt restructuring scheme has been put on hold.

4. **The Bank of Latvia (BoL) comfortably met foreign currency reserve and monetary targets under the program.** After falling sharply in the first quarter—a fall that culminated in consultation with staff on the basis of the program’s consultation clause— net international reserves stabilized somewhat. The current account is now in surplus. But balance of payments pressures resulted from non-resident deposit outflows and the lower-than-expected rollover of external debt. Meanwhile, residents switched from local- to foreign-currency deposits. Uncertainty about the exchange rate peg ahead of June’s local elections renewed pressure on reserves. We addressed this in June through the adoption of a supplementary budget—a measure that helped boost confidence and allowed the central bank to start purchasing foreign exchange.

5. **However the depth of the economic contraction has sharply reduced government revenues.** This has made it impossible to fulfill fiscal targets without exacerbating already painful dislocations. On the basis of the 2009 corrective measures detailed below (¶13-15) and our plans for the future (¶20-24), we request waivers for the non-observance of the end-March 2009 performance criterion on the fiscal deficit, and the continuous performance criterion on nonaccumulation of domestic arrears by the general government. And in light of the change of government in March, additional time was needed to prepare the supplementary budget. We are therefore also requesting a waiver for the end-March 2009 structural performance criterion on its submission to the Saeima.

6. **Against this background and given the commitments we make below, we request completion of the First Review and Financing Assurances Review under the Stand-by Arrangement.**

- **Rephasing.** We also request rephasing of the remaining purchases under the program—and smoothing of missed purchases over the program period owing to the slippage of reviews—with quantitative performance criteria for the Second Review to be assessed against end-September data and for the Third Review to be assessed against end-December data, with a return to quarterly reviews in 2010. As such, the second and third reviews are expected to be completed on or after November 15, 2009 and February 15, 2010, respectively.

- **Monitoring.** The program will continue to be monitored through quantitative performance criteria and indicative targets, as well as a continuous performance criterion on the non-accumulation of domestic and external debt arrears of general government. Performance criteria and benchmarks through end-December 2009 are set out in Tables 2 and 3, as well as in the attached Technical Memorandum of Understanding.

## I. MACROECONOMIC FRAMEWORK FOR 2009–10

7. **The recession is much deeper than envisaged when the program was first agreed.** With the bursting of the earlier bubble, there appears to have been a permanent negative shift in the level of potential output; domestic demand has collapsed; construction and consumer durables spending are particularly weak. Latvia's main trading partners are projected to contract by 5 percent in 2009, compared with previously envisaged modest growth. As a result, in the first quarter of 2009 real GDP fell 18 percent year-on-year. Registered unemployment has increased to 11 percent, but labor force survey estimates are higher at 14 percent.
8. **However, internal wage and price adjustment has begun, providing the beginnings of a much-needed competitiveness boost.** Headline inflation has fallen from 18 percent year-on-year mid-2008 to 3 percent in June 2009. Excluding VAT and excise increases, monthly inflation has been close to zero or negative for at least six months. Costs are falling. Gross wages per worker—after several years of rapid increases—fell 2 percent (seasonally adjusted) on end-2008 in the first quarter of 2009, compared with a 20 percent increase in 2008.
9. **We project that recovery will begin late 2010, albeit with further output losses before then.** Of course, there is considerable uncertainty around this. Real GDP is now projected to decline by 18 percent in 2009, compared with 5 percent in the original program. For 2010, in forming our economic program, we project a further (year-average) contraction of 4 percent. However, we hope that economic conditions will improve faster than this. We also project falling wages through this period, though they remain unchanged as a share of national income. Falling domestic demand and wages will bring modestly falling prices: we expect the headline 12-month inflation rate to turn negative end-2009, and to average - 3½ percent in 2010.

## II. POLICIES FOR 2009–11

10. **Our macroeconomic strategy reflects our goal of euro adoption in 2014.** This strategy helps address risks to households, enterprises, and banks from high levels of financial euroization. We recognize that meeting the Maastricht criteria for euro adoption requires difficult policy choices: double-digit fiscal consolidation to close a large structural

general government deficit; tight monetary policy, consistent with the exchange rate peg; stronger financial sector supervision; and structural reforms to sustain economic recovery.

### A. Fiscal Policy

11. **The 2009 supplementary budget was a critical first step towards sustainable public finances.** On June 16, Parliament adopted a supplementary budget, based on consultations with our social partners, intended to keep the 2009 fiscal deficit to 10 percent of GDP (ESA basis), or around 12 percent (general government net borrowing, GGNB; including net lending, but without bank restructuring costs). We remain committed to bringing the general government deficit down to 3 percent of GDP in 2012—satisfying the Maastricht criterion for euro adoption. Given the deterioration in macroeconomic conditions which will likely cause further increases in the deficit, this will require an additional fiscal measures beyond 2009 of about 12-15 percent of GDP over 3 years. However, we recognize that this adjustment path is ambitious and, depending on events, may need to be revisited.

#### 2009 Supplementary Budget

12. **The 2009 supplementary budget is ambitious and includes a wide range of measures:**

- **Revenue increases (about ½ percent of GDP).** We have increased dividends from state-owned companies; raised excise taxes on beer and alcohol; reduced the non-taxable personal allowance from 90 to 35 lats per month; and increased the gambling tax.
- **Net cuts in expenditure and net lending (about 3 percent of GDP).** We have significantly reduced the budgets of ministries and state agencies where we are implementing structural reforms which draw in part on earlier World Bank recommendations. However, given the size of the necessary adjustment, we have also had to introduce additional across the board cuts, beyond these recommended structural reforms, which seek to increase the efficiency and quality of education, strengthen efficiency and targeting of healthcare services, make limited and targeted pension reductions, and reduce less targeted social spending. At the same time, the budget provides additional spending on unemployment benefits and protects EU-related spending.

13. **Safeguarding local government resources, social safety nets, EU-related expenditure and other financial assistance is crucial.** We will monitor local government budgets closely, especially those more resource-constrained municipalities outside larger cities, to ensure they can provide social assistance. To prevent undue social hardships, and in light of possible overruns from the implementation of 2009 budget, the fiscal deficit performance criterion includes a 1 percent of GDP cushion and is set at 13 percent of GDP.

**14. We will provide funding of some 1½ percent of GDP in 2009 to expand social safety nets and accelerate the absorption of EU funds and other foreign financial assistance:**

- **Additional social safety net.** We are working closely with the World Bank to design a comprehensive social safety net strategy. We will ensure appropriate funding of the measures by setting aside 1 percent of GDP of budget resources before mid-September. In this context, as necessary, we will increase budget appropriations for unforeseen events, with the approval of the Parliamentary budget and finance (taxation) committee. Our plan includes:
  - Safeguarding appropriate financing of the guaranteed minimum income (GMI). We intend to increase the levels of GMI payments from LVL 37 to LVL 40 per adult and from LVL 37 to LVL 45 per child;
  - Covering patient copayments for healthcare services and pharmaceuticals in full for the most vulnerable, and partially for households earning less than half of the minimum wage;
  - Increasing funds for emergency housing support;
  - Ensuring the successful implementation of the new curriculum for 5 and 6 year olds;
  - Arranging temporary transportation solutions for children in communities affected by the education reform, pending permanent adjustments to our transport network in 2010;
  - Implementing active labor market policies and temporary public employment programs. We will organize public works programs for between 50,000 and 100,000 people for up to two years starting in the last quarter of 2009. In this context, we will reallocate 20 million lats from the European Social Fund (ESF).
- **EU-financed expenditure and other foreign financial assistance:**
  - **We have ringfenced cash resources of some 6½ percent of GDP to ensure implementation by central and local governments of EU-funded projects in 2009.** Net lending to local governments will be increased by LVL 51 million in 2009 as compared with 2008 to pre-finance EU and other foreign financed projects, and by LVL 10 million for near completed investment. In addition, LVL 5 million will be provided for heating subsidies. We intend to make full use of a new provision in the supplementary budget that allows local governments to enter multi-year commitments for EU projects subject to the approval of the Ministry of Finance.

- **We are developing a comprehensive plan to strengthen safeguards and increase efficiency in the use of EU funds.**

**15. We will take immediate actions to reduce our level of commitments to help minimize risks to medium-term fiscal sustainability:**

- We have closed down the privatization fund and suspended the long term stabilization reserve for the duration of program; no extra-budgetary fund remains;
- We will not launch any new PPPs in 2009, except for four kindergarten building projects representing a total cost of LVL 10 million for their duration;
- We will not provide any net lending outside local governments, except for implementing EU- and other foreign financed projects or in the context of bank restructuring operations carried out in close consultation with EC and IMF staff;
- Similarly, with the exception of one-off guarantees currently committed or planned in the budget to Mortgage and Land Bank and Parex-related operations, we will permanently cap outstanding public guarantees at the level of the June supplementary budget (performance benchmark). Additional guarantees will only be issued if required for bank restructuring operations, and would then be issued after consultation with EC and IMF staff. Under this ceiling we will: (i) limit the liabilities of the Rural Development Fund below LVL 44 million and 3.5 times its capital level, and carefully control its guarantee policy; and (ii) tighten control over the Latvian guarantee agency. In addition, before September 1, 2009, we will review our risk assessment policy of guarantees to determine the size of appropriations required to cover these risks in time for the 2010 budget.

**16. We will take all legal amendments and administrative measures necessary to implement the above decisions before end-September.**

**17. We will considerably strengthen the powers of the Minister of Finance and improve the capacity of the Finance Ministry; in addition, we will seek international assistance to strengthen implementation of our program.** This includes:

- **Technical assistance.** We will set a medium-term TA plan in conjunction with EC, IMF, World Bank and other bilaterals covering: social safety nets, tax policy and administration, macroeconomic forecasting, public financial management, pension reform, liquidity management, debt and banking sector restructuring, deposit insurance, and civil service reform.
- **Revenue administration.** We are expanding the large taxpayer unit operations to cover about 1,100 taxpayers representing 60-70 percent of domestic revenues collected by the State Revenue Service before September 30, 2009. We have also

developed a plan to anticipate emerging risks to the tax system, assist distressed businesses to meet their tax obligations, and contain the rise in noncompliance.

- **Public financial management** will be strengthened through the following steps:
  - **Commitment controls systems.** We have already taken steps to strengthen the powers of the Minister of Finance to control budget execution. Before end-December 2009, we will also: (i) amend the Law on Budget and Financial Management to allow the Ministry of Finance to exercise ex ante control of commitments on central government expenditure; (ii) take a cabinet decision that will help us to standardize commitment control systems across line ministries and institutions; and (iii) streamline the work of the Fiscal Discipline Management Committee to focus on commitments as well as cash. We will also work with local authorities to set standards on commitment control and budget execution procedures at the local government level.
  - **Cash management.** We will take steps to improve cash management, including for EU funds.
  - **Other.** Effective sanction procedures—besides those established by the Penal Code—will be introduced in law for any individual misuse of public money. The analytical capacity of the budget department of the Ministry of Finance will be significantly strengthened. Finally, we have granted veto powers to the Minister of Finance on any government decisions with a fiscal effect.

18. **We acknowledge that the 2009 deficit will require significant domestic financing.** We will also design new instruments in response to investor demand. We will not allow arrears to emerge, and our program includes a performance criterion to reflect this.

19. **We also recognize that the 2009 budget is subject to implementation risks.** We believe our across-the-board cuts are feasible, and our comprehensive social safety net strategy will mitigate the social risks associated with large scale reforms. In addition, we will consider reallocations or, as a last resort, providing additional funding where undue hardship emerges. Our resolve to continue fiscal adjustment next year and beyond will keep us on track even should we need to make small adjustments this year. This approach underlies the margins that we have built into the fiscal performance criteria for 2009.

## **2010 Budget**

20. **We will implement measures to ensure a lower fiscal deficit in 2010 compared to this year.** We are working closely with social partners to prepare whatever measures are necessary for this purpose. As explained in greater detail below, we will present to Parliament a 2010 budget consistent with this goal, along with any necessary legislation to implement the measures required (end-October structural benchmark). Our commitment is to



limit the general government deficit to 8.5 percent of GDP (ESA basis) in line with the recommendation of the ECOFIN Council.

21. **We have already committed ourselves to introducing LVL 500 million (4 percent of GDP) in targeted expenditure cuts and tax measures.** To this end, we will implement the following measures and identify any further measures necessary to meet this objective as part of the 2010 budget process:

- A comprehensive plan to broaden the tax base of the personal income tax as of 2010, to include all capital income (including capital gains from real estate transactions), is under preparation. We will significantly reduce or remove most exemptions, including to farmers. We will reduce disparities in allowances across all sources of income, including pensions and wages. Together, these measures will yield 1 percent of GDP in revenues in 2010;
- We will abolish the special self-employed income tax regime, and bring the self-employed into the standard personal income tax system from 2010. This will support tax compliance;
- We will design a comprehensive reform, allowing means-tested exemptions, to expand the base of the real estate tax to include all residential properties, on the basis of updated cadastral values. We believe that this could yield significantly more revenue (about  $\frac{3}{4}$ -1 percent in GDP from 2011 onwards) than previously envisaged, be less distortionary, and more socially just. A transitory regime is required in 2010, as no means-tested exemptions will be available, but a flat tax will yield about  $\frac{1}{2}$  percent of GDP in revenues. We will request international assistance to prepare this reform before December 31, 2009;
- We will carry out a broad public service reform. We will harmonize remunerations across ministries and institutions, significantly reducing wage inequalities by reviewing employment classifications (job families) and significantly tightening the wage grid. This reform should allow us to generate savings of at least  $\frac{1}{2}$  percent of GDP in 2010 while retaining and appropriately compensating the most skilled public employees. We will also work with local governments to extend this reform to their own employees, creating a special law for remuneration system in local governments;
- We will not index pensions in 2010, pending the pension reform described below;
- We will carry out a number of structural reforms prepared by a series of functional audits to generate sustainable savings of about 2 percent of GDP including in the following areas:

- further consolidating agencies and line ministries' subordinated institutions, including in the economy (Public Utility Commission and the Competition Council), justice, and vocational and higher education sectors.
- agriculture, environment and regional development: consolidating institutions and reducing state support, agricultural subsidies, and other miscellaneous subsidies including excise tax repayments to farmers;
- culture: renegotiating the contract for the National Library project;
- defense: cutting procurement and real estate costs, and reducing the size of the National Armed Forces; this will reduce the defense budget from 1.4 to about 1 percent of GDP;
- foreign affairs: optimizing our network of embassies;
- reducing Parliament's discretionary expenditure, for example the NATO Parliamentary Assembly in 2010;
- social benefits: reduce the levels of social benefits while expanding social safety nets;
- transport: reducing road maintenance and better targeting of public transport subsidies.

22. **We have broadly identified additional measures totaling 2½ percent of GDP, and will implement measures of this scale as necessary as part of the 2010 budget to meet our objectives as laid out in paragraph 20.** To this end, to the extent that the measures described in paragraph 21 above are insufficient, as part of the 2010 budget process we will identify and implement measures—including the following—which would be effective January 1, 2010, and estimated to yield 2½ percent of GDP:

- Increase the headline VAT rate from 21 to 23 percent effective January 1, 2010 (estimated to yield about ½ percent GDP);
- Make the **personal income tax** system more progressive effective January 1, 2010, by raising the average effective tax rate to around 25 percent for people earning more than LVL 500 per month, through a graduated increase in the marginal rate (yielding ½ percent of GDP);
- **Secure an additional 1½ percent of GDP of expenditure cuts** during the budget process, including fundamental revisions in line ministries' budget bases.

23. **We are prepared to take further measures to meet our fiscal objectives,** in particular those objectives specified in paragraph 20.

## 2011 and Beyond

24. **We intend to further reduce the deficit in 2011 and beyond, mostly through expenditure restraint.** Our goal is to reach a deficit of 3 percent of GDP in 2012 (ESA basis), although we recognize that a more gradual adjustment path may be necessary. We will avoid further increases in the taxation of labor income so as not to undermine competitiveness. We have identified two areas where substantial further spending cuts are needed:

- Building on the public service reform in 2010, we will keep the public sector wages and salaries below 7 percent of GDP through further targeted wage cuts.
- In order to preserve the sustainability of the three pillars of our pension system, we will also prepare a pension reform with international assistance and in close cooperation with social partners before July 1, 2010. In this context, we will review all special pension regimes. It will be implemented from January 1, 2011.

### B. Monetary and Exchange Rate Policy

25. **The fixed (narrow band) exchange rate of the lats will remain the anchor for monetary policy until we adopt the euro.** The credibility of the quasi currency board necessitates a conservative approach to monetary policy, and we will maintain existing limits to market operations and ensure that the BoL's liquid liabilities remain fully backed by its net international reserves. Further changes in official interest rates and minimum reserve requirements will be undertaken after prior consultation with IMF staff.

26. **Monetary policy will respond to the Treasury's new policy of exchanging program financing exclusively off market at the BoL.** To ensure this does not lead to excessive volatility in liquidity and interest rates, we will activate our available instruments, including deposit auctions, where necessary. In cooperation with international experts, we will continue to enhance our approach to liquidity management, adding new instruments where necessary and if consistent with the constraints posed by the quasi currency board. Finally, the Bank of Latvia intends to lower wages in line with market developments.

### C. Financial Sector

27. **The FCMC will complete forward-looking assessments to ensure banks maintain adequate liquidity and solvency buffers throughout the program period.** These assessments will build on the recent focused examination, and involve both top-down (performed by BoL and FCMC) and bottom-up (performed by banks after half-year financial results audits) stress tests. These stress tests will be based on extreme but realistic macroeconomic scenarios, agreed with IMF and World Bank staff. Results will be used to

assess potential increases in own funds to build banks' solvency and liquidity buffers. Moreover, given the significant presence of foreign subsidiaries in Latvia, we recognize the need for close cooperation with the home authorities of these banks.

28. **We will accelerate our development of a comprehensive bank resolution strategy** (end-August 2009 structural benchmark). The strategy will set out: (i) responsibilities of various government agencies; (ii) the decision-making process, including options and methods for intervening in various sub-groups of banks; and (iii) plans for individual state-owned and private banks based on the forward-looking assessments noted above. We will discuss drafts with IMF and EC staff.

29. **In the event that capital increases are necessary, we will seek private solutions for banks where possible—especially in view of fiscal constraints.** Bank owners should be the primary providers of resources to cover losses. But we will encourage them to explore opportunities for co-financing capital increases through funding offered by the February 2009 joint EBRD, EIB and World Bank Group Joint Action Plan for CEE banks. We will also develop contingency plans for dealing with bank failures where shareholders cannot recapitalize banks.

30. **The FCMC will introduce a more risk-oriented approach to supervision and regulation,** including by:

- **Strengthening off-site monitoring and analytical capacity** (end-August 2009 structural benchmark). We will seek international assistance to refine our stress testing methodology. The BoL will share regular stress-test results, including methodologies with the FCMC; while these scenarios will be developed jointly between the BoL and FCMC. The FCMC will be given adequate resources to effectively carry out these tasks, and will incorporate stress testing results into off-site supervision and analytical activities.
- **Addressing vulnerabilities.** We will rigorously enforce newly enacted regulations. By revising liquidity regulations in line with best international practice, we will revisit our tolerance of liability concentrations and banks' reliance on short-term external funding. We will enforce best international practice for loan review systems and provisioning in banks, as well as prudential treatment of special entities set up by banks for the management of seized property and other problem assets.

31. **We will continue our efforts to resolve Parex's problems.** Priority will be given to ensuring adequate capitalization and stable management. To this end, the government has selected an international investment bank as its transaction advisor. The FCMC will continue monitoring Parex's liquidity, ensuring that management's restructuring plans do not entail undue risks. The government will engage the EBRD on assistance for bank restructuring.

32. **We remain committed to a fair and equitable treatment of depositors and creditors in the Latvian banking system.** Under our deposit insurance system, we are committed to respect the rights of all depositors, both resident and non-resident. We will remove the partial freeze limiting withdrawal amounts from deposits in Parex as conditions stabilize. We continue good-faith efforts to facilitate the settlement of affected depositors' claims arising from this exchange measure.

33. **We will refocus the Mortgage and Land Bank on core activities.** Commercial banking operations will be minimized as we focus the bank on activities crucial for the economy at this time—financing SMEs, business start-ups, infrastructure, and other national development projects. By end-September we will devise an appropriate strategy to maximize the bank's effectiveness in this task, we will establish an inter-institutional task force as well as seek international assistance. Until the strategy is finalized, the bank will refrain from assuming new foreign borrowing.

34. **We will refine our contingency planning and crisis management capacity:**

- **Contingency planning.** Meetings will discuss financial sector vulnerabilities with particular attention to contingency plans for specific institutions.
- **Liquidity triggers.** Internal FCMC guidelines will establish explicit liquidity triggers for supervisory actions in banks receiving emergency liquidity assistance as envisaged by the BoL ELA framework. The guidelines will include a range of actions with specific triggers, from close monitoring of liquidity, through restrictions on bank's business activities, to appointing the FCMC official to oversee bank's activities.
- **Bank resolution.** A comprehensive review of our bank resolution framework will guide legislative changes needed to bring the framework in line with best international practice. We will focus on ensuring that FCMC regulations and procedures are in line with recently enacted legislation.
- **Deposit guarantee.** International assistance will be sought to improve operational aspects of the Deposit Guarantee Fund; e.g., by setting up an autonomous department and designating trained staff to perform its functions.

#### **D. Private Debt Restructuring**

35. **We recognize the need for a debt restructuring strategy compatible with fiscal constraints.** Our strategy for resolving and recapitalizing banks will increase their capacity to restructure debts and provision and recapitalize accordingly. We thus intend to base our strategy on restructuring corporate and household debt on a market-based approach. We are considering offering subsidized loans to qualifying household borrowers for their restructured mortgage loans in order to help them cope with economic distress, prevent

foreclosures and create incentives for banks to provide debt relief when necessary. However, we are acutely aware of the lack of fiscal space, and will study further, in consultation with EC and Fund staff, how such a scheme could be financed, the degree to which its costs could be accommodated within the envelope of unavoidable bank restructuring costs, and how to ensure the scheme is optimally targeted.

**36. We will further improve the legal framework to help address widespread debt distress in the corporate and household sectors.** With limited prior debt restructuring experience in Latvia, we will issue by mid-August 2009 a set of guidelines on out-of-court corporate debt restructuring to set out general principles and process in line with international best practice. In addition, a further review of the Insolvency Law and other credit enforcement laws is underway with international assistance. Revisions will, *inter alia*, streamline liquidation procedures to facilitate rapid exit of non-viable firms, and further improve the foreclosure process by addressing remaining inefficiencies that hinder debt resolution. We will submit to Parliament the relevant amendments to these laws by end-October 2009 (structural benchmark).

#### **E. Other issues**

**37. Reforming the wage-setting mechanism is a priority.** We will review the new public-sector wage grid to minimize discrepancies in pay between similar positions and skill levels across institutions by narrowing salary ranges for specific grades. In addition, we will monitor public-sector wage cuts to encourage an equitable burden of adjustment across all public sector institutions. A comprehensive report on proposed revisions to the public-sector wage grid and the relative wage adjustment across public institutions since end-December will be published by end-October 2009 (structural benchmark). We will also reform the Committee to Promote Wage Restraint by involving the social partners and outside labor market experts by end-August (structural benchmark). Its mandate will be amended to: (i) monitor private-sector wage developments, as well as the implementation of public sector wage cuts; and (ii) issue recommendations to ensure future compensation evolves in line with productivity. The committee will be subordinated to the National Tripartite Co-operation Council. Its monthly reports will be presented to the Prime Minister and Parliament, and published.

**38. We will implement in full the conclusions of the recent Safeguards Report.** We recently adopted a memorandum of understanding between the Treasury and BoL requiring the Treasury to deposit all major foreign exchange holdings with the BoL. Henceforth, as noted earlier, the Treasury will exchange all international support from the Fund and other program partners off-market. In addition, to increase transparency, all long-term funds under the program will be disbursed to special sub-accounts of the Treasury's euro-account at the BoL, with one account ring-fenced for banking sector support and the other for budget support. We will report daily on the balances in these accounts, and the accounts of other

program partners. Should the program accounts intended for budget support fall by more than EUR 250 million in any 30-day period, the Ministry of Finance will consult with IMF staff.

### III. IMF ARRANGEMENT

39. **We believe the policies described above will achieve the goals of our economic program:** maintenance of the exchange rate peg; macroeconomic stability; and staying the course for euro adoption. Nevertheless, we stand ready to take additional measures needed to keep the program on track. We will consult with the IMF (and other program partners) on the adoption of these measures and in advance of any revisions to the policies contained in this Letter in accordance with the IMF's policies on such consultation. In addition, we will supply such information as the IMF requests on policy implementation and achievement of program objectives.

40. **We authorize the IMF to publish this Letter of Intent and its attachments (including the Technical Memorandum of Understanding), and the related staff report.**

Sincerely Yours,

**Valdis Dombrovskis /s/  
Prime Minister**

**Einars Repše /s/  
Minister of Finance**

**Ilmārs Rimšēvičs /s/  
Governor of the Bank of  
Latvia**

**Irēna Krūmane /s/  
Chairwoman  
Financial and Capital Market Commission**

**Ģirts Valdis Kristovskis /s/  
Civic Union**

**Roberts Zīle /s/  
For Fatherland and Freedom**

**Solvita Āboltiņa /s/  
New Era**

**Mareks Segliņš /s/  
People's Party**

**Mārtiņš Roze /s/  
Union of Greens and Farmers**

Table 1. Latvia: Structural Conditionality under the Stand-By Arrangement, 2008–09

<b>Structural Performance Criterion</b>	<b>Status</b>
1 Submission to Parliament of a second supplementary budget for 2009 to define spending allocations across ministries and spending agencies, and to identify clear programs that should be rationalized (March 31, 2009).	Second supplementary budget submitted to Parliament, and approved, in June 2009.
<b>Structural Benchmarks</b>	
1 Cabinet of Ministers to adopt decision that reforms controls over budget execution (December 31, 2008).	Done.
2 Adopt operational guidelines clarifying procedures for provision of emergency liquidity assistance (December 31, 2008).	Done.
3 National Tripartite Co-operation Council to establish a Committee to Promote Wage Restraint (January 31, 2009).	Done.
4 Review and, if necessary, revise regulations on emergency liquidity support (January 31, 2009)	Done.
5 Complete focused examination of the banking system (March 31, 2009).	Done.
6 Develop comprehensive debt restructuring strategy (April 30, 2009).	Done in June 2009.
7 Amend banking laws to give FCMC, BoL and Government powers to restore financial stability in case of systemic crisis (June 30, 2009).	Done.
8 Adopt an amendment to the Budget and Financial Management law to strengthen financial responsibility, transparency and accountability (June 30, 2009).	In progress. Some amendments to strengthen powers of Minister of Finance adopted.
9 Amend insolvency law to facilitate orderly and efficient debt restructurings (June 30, 2009).	Done.



Table 2: Latvia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2008–09  
(In millions of lats unless otherwise indicated)

	2008				2009				Proposed	
	end-Nov	end-Dec		end-March		end-June		End-Sept	End-Dec	
	Actual	Program	Outcome	Program	Outcome	Program	Outcome			
<b>I. Quantitative performance criteria</b>										
1 Floor on net international reserves of the Bank of Latvia (millions of euros)	3,368	2,103	2,700	737	1,733	-507	1,163	-81	-586	
2 Ceiling on net domestic assets of the Bank of Latvia	-99	951	423	1,434	419	2,501	768	1,719	2,103	
3 Floor on adjusted cash fiscal balance	...	-894	-957	-305	-328	-649	-794	...	...	
4 Floor on adjusted primary cash fiscal balance	...	...	...	...	...	...	-388	-828	-1,289	
5 Ceiling on public guarantees (millions of lats)	...	...	...	...	...	...	...	754	754	
<b>II. Continuous performance criteria</b>										
6 Non-accumulation of general government domestic arrears	...	0	0	0	6	0	11	40	40	
7 Non-accumulation of external debt arrears (millions of euros)	...	0	0	0	0	0	0	0	0	
<b>III. Staff consultation clause</b>										
8 If sub-accounts for program budget support fall by more than €250 million in any 30-day period	...	...	...	...	...	...	...	...	...	
<b>IV. Indicative target</b>										
9 Ceiling on the general government wage bill	...	1,248	1,267	214	263	490	598	840	1,067	

Table 3. Latvia: Structural Benchmarks through end-December 2009

Structural Benchmarks	Target date
1 Wages: reform the Committee to Promote Wage Restraint by involving the social partners and outside labor market experts.	End-Aug 2009
2 Wages: prepare a comprehensive report on proposed revisions to the public-sector wage grid and the relative wage adjustment across public institutions since end-December.	End-Oct 2009
3 Prepare a strategy for bank recapitalization and resolution.	End-Aug 2009
4 Financial sector monitoring: (i) seek international assistance to improve stress-testing capacity; strengthen co-operation between the BoL and FCMC in this area; and (ii) increase resources available to FCMC to perform off-site monitoring incorporating results of stress-tests.	End-Aug 2009
5 Design a strategy to strengthen the social safety net.	End-Aug 2009
6 Submission to Parliament of amendments to the Insolvency Law and other credit enforcement laws.	End-Oct 2009
7 Adopt an amendment on fiscal responsibility to the current Budget and Financial Management Law that will aim to reduce public debt, set expenditure ceilings, avoid procyclicality in fiscal policy and ultimately allow automatic stabilizers to operate fully.	End-Dec 2009

## ATTACHMENT II. LATVIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

July 27, 2009

1. This Technical Memorandum of Understanding (TMU) defines the variables subject to quantitative targets (performance criteria and indicative targets) established in the Letter of Intent dated July 27, 2009 signed by the Prime Minister, the Minister of Finance, the chairwoman of the Financial and Capital Market Commission, the Governor of the Bank of Latvia, and coalition partners. It describes the methods to be used in assessing program performance with respect to these targets.

For program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at “program exchange rates” as defined below, with the exception of the government fiscal balances, which will be measured at current exchange rates. The program exchange rates are those prevailing on November 28, 2008. In particular, the exchange rates for the purposes of the program of the Latvian Lat (LVL) to the euro is set at LVL 0.702804 = €1, to the U.S. dollar at LVL 0.544 = \$1, and to the Japanese yen at LVL 0.00571 = 1 JPY, as shown on the Bank of Latvia (BoL) website.

### A. Floor on Net International Reserves of the BoL

	(in million euros)
Outstanding stock:	
June 30, 2009	1,163
Floors on level of NIR:	
September 30, 2009 (performance criterion)	-81
December 31, 2009 (performance criterion)	-586

### Definitions

2. For program purposes, the following definitions apply:

- *Net international reserves* (NIR) of the BoL are the difference between the BoL’s foreign reserve assets and the BoL’s foreign reserve liabilities, minus Treasury liabilities to the IMF, the European Union, other official creditors participating in the program. If not otherwise captured under this definition, assets associated with SDR allocations will be added to NIR assets, and liabilities associated with SDR allocations will be added to NIR liabilities.

- **Foreign reserve assets** of the BoL are claims on nonresidents denominated in convertible currencies. They include the BoL's holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, participating interests in the European Central Bank and the Bank for International Settlements, and other foreign assets. Excluded from foreign reserve assets are any assets that are frozen, pledged, used as collateral, or otherwise encumbered, except if already included as foreign liabilities, precious metals other than gold, assets in nonconvertible currencies, and illiquid assets. As of June 30, 2009, foreign reserve assets thus defined amounted to 2,913 million euro.
- **Foreign reserve liabilities** of the BoL comprise all liabilities to nonresidents, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options) and banks foreign currency deposits against reserve requirements. Government foreign exchange deposits with the BoL are not treated as a foreign reserve liability. As of June 30, 2009, reserve liabilities thus defined amounted to 132 million euro.
- **Base money** is defined as lats in circulation (both outside banks and vault cash), required and excess reserve deposits of financial institutions in lats and in foreign currency held at the BoL (excluding financial sector funds deposited in the BoL's deposit facility and in term deposits in the BoL). As of June 30, 2009, base money equaled 1,585 million lats.
- **Net domestic assets** (NDA) of the BoL are defined as base money minus the net foreign assets (NFA) of the BoL, plus Treasury liabilities to the IMF, the European Union and other official creditors participating in the program, expressed in local currency, at program exchange rates. If not otherwise captured under this definition, assets associated with SDR allocations will be subtracted from NDA, and liabilities associated with SDR allocations will be added to NDA.
- **Net foreign assets** of the BoL are the difference between the BoL's foreign reserve assets and the BoL's foreign reserve liabilities defined above, plus those foreign reserve assets of the BoL that were excluded from the above definition. As of June 30, 2009, net foreign assets of the BoL amounted to 1,955 million lats.

As of June 30, 2009 the sum of Treasury liabilities to the IMF, the European Union, other official creditors participating in the program, and other external borrowing by the Treasury over the program period, amounted to 1,619 million euros.

The ceilings set out below are based on the assumption that all program related financing will be given to the Latvian government and will be deposited in a special sub-account of the Treasury euro-account at the BoL.

If the reserve requirement ratio and/or the definition of liabilities subject to reserve requirements is changed during the program period, the BoL will consult with the IMF staff to modify the above limits appropriately

### **B. Ceiling on Net Domestic Assets of the BoL**

	(in million lats)
Outstanding stock:	
June 30, 2009	768
Ceiling on level of NDA:	
September 30, 2009 (performance criterion)	1,719
December 31, 2009 (performance criterion)	2,103

### **Adjustor**

So as to not constrain legitimate provision of emergency liquidity assistance (ELA)—subject to the limits implied by Latvia’s quasi currency board arrangement—the NDA ceiling will be adjusted upwards (and correspondingly the NIR target will be revised down) by the amount of any new ELA (beyond that currently outstanding), provided that net foreign assets of the BoL remain above base money.

### **C. Floor on the Adjusted Primary Cash Fiscal Balance of the General Government**

	(in million of lats)
Cumulative adjusted primary cash fiscal balance from	
January 1, 2009:	
June 30, 2009 (preliminary estimate)	-357
September 30, 2009 (performance criterion)	-828
December 31, 2009 (performance criterion)	-1,289

The general government includes: (i) the central government, including all ministries, agencies and institutions attached thereto, as defined in the basic budget; (ii) derived public persons, including universities; (iii) the social security fund (first pillar), as described in the special budget; (iv) municipalities, provincial, regional governments including their basic and special budgets, including all agencies and institutions attached thereto, which are classified as part of

general government according to the budget documents and which are included by the BoL in its monthly submissions to the IMF of balance sheets of the central bank and the consolidated accounts of the commercial banks. No off-budgetary funds will be maintained or created. This definition of general government also includes any new funds, or other special budgetary and extra-budgetary programs that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's *Manual on Government Finance Statistics 2001*. The authorities will inform IMF staff of the creation of any such new funds or programs immediately.

The adjusted cash primary fiscal balance of the general government is defined as **general government net lending/borrowing**, in cash:

- excluding bank restructuring costs (¶12) and any shortfall in contributions to the second pillar below the level of 8 percent of wages, applicable at the start of the program;
- plus interest expenditure;
- minus revenues from EU funds (reimbursements and advances) at the general government level (central and local governments);
- plus EU-related spending by the central government (including national co-financing and pre-financing), including transfers from the central budget to local governments for EU-related spending (excluding net lending).

Foreign financial assistance not managed by the European Commission is excluded from the revenues from EU-funds and from the associated spending.

The net government lending/borrowing includes all recognitions of liabilities by the general government unit. This includes in particular the following debt-related transactions: debt assumption (i.e. when the general government assumes responsibility for the debt as the primary obligor, or debtor), debt payments on behalf of others, debt forgiveness, debt restructuring and rescheduling, debt write-offs and write-downs, debt-for-equity swaps, and defeasance. For example, if a loan guarantee is called, the general government records a transfer to the defaulter and an incurrence of a liability to the creditor.

### **Bank Restructuring Costs**

For program purposes, the cash fiscal balance of the general government excludes the restructuring costs of troubled banks, when carried out under the program's banking sector restructuring strategy. Costs that may be excluded from the cash balance include loans to financial institutions and investments in equity of financial institutions (required recapitalization); unrequited recapitalization; and purchase of troubled assets. However, any financial operation from the general government to support banks, including the emission of guarantees or the provision of liquidities, will be immediately reported to IMF staff.

### **Interest Revenues and Payments (Adjustor)**

The quarterly floor for the adjusted cash fiscal balance of the general government will be adjusted upwards starting in 2009 for interest receipts, dividends or capital gains from government deposits or investments in the banking system, including all revenues from the BoL, in excess of 15 million lats each quarter, cumulated from January 1.

Interest payments are recorded on a gross basis, net of interest payments within the general government.

### **Social Spending (Adjustor)**

The end-December floor for the adjusted cash primary fiscal balance of the general government will be adjusted upward for any shortfall in spending on additional social safety nets, as defined under the World Bank strategy, cumulated from January 1, 2009, below 104 million lats.

### **Financing**

Consistent with the NDA ceilings in section B, the government will deposit all program related financing in a special sub-accounts of the Treasury euro-account at the BoL. Furthermore, three-quarters of IMF program financing (about 150 million euros for the second tranche) will be placed in an account at the Bank of Latvia for budget support, with the remaining financing reserved for banking sector support. The accounts will be distinct from those receiving financing from other program partners, including the European Commission, which will be reported separately.

### **Reporting**

The adjusted cash primary fiscal balance of the general government will be monitored and reported based on financing information (below-the-line) on a monthly basis, and reconciled with revenue and expenditure reports as soon as those become available, at the latest 30 days after the end of each month.

Revenues from EU funds at the general government level, EU-related spending by the central government, including transfers to local governments for EU-related spending, will be reported in details on a monthly basis, at the latest 30 days after the end of each month, distinguishing, for expenditure, between subsidies and transfers and capital expenditure.

## **D. Ceiling on the General Government Wage Bill**

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	(in million of lats)
Wages and salaries in 2008	1267
Wages and salaries (Cumulated from January 1, 2009):	

March 31, 2009 (actuals)	264
June 30, 2009 (preliminary estimate)	598
September 30, 2009 (indicative target)	840
December 31, 2009 (indicative target)	1,067

The ceiling on the general government wage bill includes general government (as defined above) wages and salaries, including allowances (including separation allowances) and bonuses. No in kind benefits will be increased or created during the program period.

The end-September and end-December targets are based on a more conservative scenario on the pace of the wage adjustment than IMF staff's central estimates (1,036 million lats by end-December).

### **E. Ceiling on Public Guarantees**

The stock of outstanding guarantees issued by the general government and by all public agencies and enterprises, excluding public banks and their subsidiaries, will not exceed 754 million lats (about 5.5 percent of GDP in 2009) for the duration of the program:

- This ceiling includes all guarantees that can be issued or committed by the Latvian Guarantee Agency, the Rural Development Fund, or any other public agency or enterprise, excluding public banks;
- It does not include up to 313 million lats of one-off guarantees already issued, committed or planned in the June 2009 supplementary budget to Mortgage and Land Bank; however, further guarantees to Mortgage and Land Bank, except for bank restructuring operations (€123), will be counted under the ceiling on public guarantees;
- It does not include 541 million lats of guarantees already issued, committed or planned, at the date of June 2009 supplementary budget, to Parex or to the privatization agency for Parex-related operations;
- It does not include guarantees extended within the general government.

Consistent with the Law on budget and financial management, the estimated fiscal costs of guarantees will be covered by budget appropriations in the contingency reserve. The ceiling on public guarantees will only be raised if required for bank restructuring operations and after consultation with EC and IMF staff.

All public guarantees, excluding from public banks, will be reported in details on a monthly basis, distinguishing between central and local governments and their attached agencies and public enterprises, and identifying all amounts and beneficiaries.

### **F. Continuous Ceiling on Domestic Arrears by the General Government**

General government domestic arrears are defined as amounts that have not been paid by the date specified in a contract or within a normal commercial period for similar transactions by



the general government. This applies in particular to (i) all employment contracts and arrears thereby captured delayed wage payments to employees of the public sector and to (ii) mandatory contributions to the social insurance funds. The ceiling for arrears will be set at LVL 40 million for the duration of the program. As of end-June, the stock of arrears stood at LVL 11 million. This performance criterion will apply on a continuous basis.

#### **G. Continuous Performance Criterion on Non-accumulation of External Debt Payments Arrears by the General Government**

The general government will accumulate no new external debt payments arrears during the program period. For the purposes of this performance criterion, an external debt payment arrear will be defined as a payment due to nonresidents by the general government, which has not been made within seven days after falling due. This performance criterion does not cover trade credits, or nonresident deposits in state-owned banks. This performance criterion will apply on a continuous basis.

The stock of external debt payments arrears of the general government will be calculated based on the reported schedule of external payments obligations. Data on external debt payments arrears will be reconciled with the relevant creditors, and any necessary adjustments will be incorporated in these targets as they occur.

#### **H. Monitoring and Reporting Requirements**

Performance under the program will be monitored from data supplied to the IMF by the BoL, the Financial and Capital Markets Commission, and the Ministry of Finance as outlined in Table 1. The authorities will transmit promptly to the IMF staff any data revisions.

**Table 1. Republic of Latvia: Data to be Reported to the IMF**

Item	Periodicity
<b>To be provided by the Ministry of Finance</b>	
Consolidated central (basic and special budgets), local and general government operations based on the IMF fiscal template	Monthly, within four weeks of the end of each month
Detailed information on revenues from EU funds at the general government level, and EU-related spending by the central government, including transfers to local governments for EU-related spending	Monthly, within three weeks of the end of each month
Consolidated central and general government bank restructuring operations	Daily, by end of next working day
Privatization receipts received by the general government budget (in lats and foreign exchange, and payments in governments bonds)	Monthly, within four weeks of the end of each month
Information on debt stocks and flows, domestic and external (concessional and non concessional), by currency, and guarantees issued by the (i) consolidated central, local and general governments and (ii) public enterprises (including the Latvian guarantee agency and the Rural guarantee fund), including amounts and beneficiaries	Monthly, within four weeks of the end of each month
Information on new contingent liabilities, domestic and external, of the consolidated central, local and general governments	Monthly, within four weeks of the end of each month
Data on general government arrears, including to suppliers	Monthly, within four weeks of the end of each month
Data on operations of extrabudgetary funds	Monthly, within four weeks of the end of each month
Data on the stock of the general government system external arrears	Daily, with a seven days lag
<b>To be provided by the Bank of Latvia</b>	
Balance sheet of the BoL, including (at actual exchange rate) (i) data on components of program NIR; (ii) government balances at the BoL, broken into foreign exchange balances—distinguishing various program partner sub-accounts for program financing—and balances in lats.	Daily, within one working day
Balance sheet of the BoL (in program and actual exchange rates) (i) data on components of program NIR; (ii) government balances at the BoL, broken into foreign exchange balances—distinguishing various program partner sub-accounts for program financing—and balances in lats.	Weekly, within one week of the end of each week
Consolidated accounts of the commercial banks	Monthly, within two weeks of the end of each month
Monetary survey	Monthly, within two weeks of the end of each month

Currency operations, including government foreign receipts and payments and breakdown of interbank market operations by currencies (interventions)	Daily, by end of next working day
Aggregated data on free collateral—available, unpledged collateral held at the Bank of Latvia	Weekly, within one week of the end of each week
Daily data with banks' current accounts, minimum reserve requirements, stock of repos and fx swaps	Monthly, capturing data over the preceding month, within one week of the end of the month
Foreign exchange rate data	Daily, by end of next working day
Volume of foreign exchange lats trades	Monthly (weekly for a sample of large banks), within one week of the end of each week
Projections for external payments of the banking sector falling due in the next four quarters, interest and amortization (for medium and long-term loans)	Quarterly, within four weeks of the beginning of the year
Projections for external payments of the corporate sector falling due in the next four quarters interest and amortization (for medium and long-term loans)	Annually, within three months after the end of the second quarter
The stock of external debt for both public and private sector	Monthly, within four weeks of the end of each month for the public and the banking sector; quarterly, within three months of the end of each quarter for total external debt
The BoL will continue to provide balance of payments data in electronic format.	Monthly, within six weeks of the end of each month

**To be provided by the Financial and Capital Market Commission**

Daily deposit monitoring bank by bank in the agreed format	Daily, by end of next working day
Daily detailed deposit monitoring in Parex Bank in the agreed format	Daily, by end of next working day
Banking system monitoring indicators in the agreed format (liquidity, credit quality, summary capital adequacy, simplified balance sheet and income statements)	Monthly, within four weeks of the end of each month
Detailed capital adequacy reporting in the agreed format	Quarterly, within four weeks of the end of each quarter
Commercial banks' balance sheets (bank-by-bank)	Quarterly, within four weeks of the end of each quarter
Commercial banks' income statements (bank-by bank)	Quarterly, within four weeks of the end of each quarter

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