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Latvia: Letter of Intent and Technical Memorandum of Understanding

January 22, 2010

The following item is a Letter of Intent of the government of Latvia, which describes the policies that Latvia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Latvia, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

LATVIA: LETTER OF INTENT

Riga, January 22, 2010

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

Dear Mr. Strauss-Kahn:

1. **Over the past year we have taken the difficult measures needed to stabilize the Latvian economy, restore public finances to health, and lay the foundations for recovery.** In particular, since the First Review we have:

- ***Kept the budget deficit under control***, comfortably attaining the end-September performance criterion for the adjusted primary balance, as well as the indicative target for the public-sector wage bill (Table 1). With the deficit reaching only L500 million (4 percent of GDP) through October, we are also confident we will outperform the deficit target for the year as a whole;
- ***Taken further steps to safeguard the financial system*** (Box 1);
- ***Comfortably met our net international reserves (NIR) and monetary (NDA) targets.*** Substantial current account surpluses coupled with much more moderate capital outflows have allowed us to build a sizeable NIR buffer;
- ***Met most of the program's structural benchmarks*** (Table 2), though one has been partially met and a second is being reset in the Second Review; and
- ***Are working to resolve small external payments arrears*** that emerged in September and resulted in non-observance of the continuous performance criterion.

2. **As a result, financial market and balance of payments strains have eased, and the economy is showing signs of stabilizing**:

- ***Financial market strains have eased*** and lats interest rates have fallen to more normal levels. Latvia's CDS spread has halved since its peak;
- ***Trade in goods and services is in surplus*** for the first time, contributing to the current account turnaround;
- ***Foreign exchange market intervention has been limited*** since end-September;
- ***Wage and price adjustment is progressing***, helping restore competitiveness.

3. Building on these achievements, our ambitious policy agenda for 2010 aims to lock in fiscal adjustment and set the basis for sustained growth:

- Despite difficult economic conditions, in December Parliament passed a 2010 budget with L500m (4.2 percent of GDP) in net measures. We estimate that implementation of this budget would have reduced the deficit from 8.1 percent of GDP in 2009 to 7.1 percent in 2010 (program definition of deficit: general government net borrowing including net lending, but without bank restructuring costs).

- However, the Constitutional Court's subsequent ruling that pension cuts made in 2009 were unconstitutional and needed to be reversed will increase the deficit by 1 percent of GDP annually (and by 1½ percent of GDP in 2010, since the 2009 cuts also have to be repaid). Given this additional spending requirement, in 2010 we seek to achieve a deficit of no more than 8.6 percent of GDP (program definition). This target is an upper bound: should the 2009 deficit turn out lower than the 8.1 percent of GDP we currently project, then we will ensure that the 2010 deficit is lower than the 8.6 percent target by a similar amount.

- We are confident our 2010 policies will represent a further significant step towards our objective of euro adoption by 2014.

4. **Looking beyond 2010, we also recognize that significant additional measures will be needed** to meet the Maastricht criteria by 2012, and achieve euro entry by 2014. We have demonstrated our resolve by implementing a cumulative fiscal adjustment in 2009–10 of around 10 percent of GDP. For subsequent years, we aim at fiscal deficit targets of no more than 6 percent of GDP in 2011 and 3 percent of GDP in 2012 (ESA methodology), to achieve euro adoption. Maintaining our prudent approach to policies, preliminary estimates suggest that further adjustment of around L800-900 million spread over two years, with some frontloading, will be needed to deliver these deficit targets. This figure has had to be increased in light of the recent Constitutional Court ruling. Even so, this projected adjustment is slightly lower than the L500 million per year adjustment we had earlier envisaged, reflecting the success of our policies in reducing the deficit.

5. In view of reduced near-term pressures and the strength of our international reserve position, we request extension of the Stand-by Arrangement until December 22, 2011. Reduced financial market and balance of payments pressures imply that international assistance under the program can be provided over a longer time span to provide confidence over the adjustment period. Extension will also help support medium-term fiscal adjustment, including through preparation of the 2012 budget. We therefore request extension of the Stand-by Arrangement until December 22, 2011 and rephasing of Latvia's remaining purchases under the arrangement alongside other disbursements under the macroeconomic program—supported by the EU, the IMF, and regional partners—until December 22, 2011.

6. As such, on the basis of the policies outlined below, we request completion of the Second Review and Financing Assurances Review under the Stand-by Arrangement. We request a waiver for the non-observance of the continuous performance criterion on non-accumulation of external payments arrears due to a small amount of arrears related to differences over a procurement contract that are in the process of being cleared. We also request a waiver of applicability of end-December 2009 quantitative performance criteria for the fiscal balance and public guarantees since relevant data are not yet available and we expect these targets to be met. The program will continue to be monitored through quantitative performance criteria and indicative targets, as well as continuous performance criteria on domestic and external debt arrears of general government. Performance criteria and structural benchmarks through end-June 2010 are set out in Tables 3 and 4, as well as in the attached Technical Memorandum of Understanding. The Third and Fourth Reviews are scheduled to be completed on or after May 15, 2010 and August 15, 2010, respectively.

I. Macroeconomic Framework for 2010–11

7. Our macroeconomic framework remains broadly unchanged from the First Review.

- ***While the severe output collapse has bottomed out, we expect that recovery may be gradual***. Retail sales continue to fall, but exports—notably of wood and chemicals—are increasing, as is industrial production. While GDP fell an estimated 19 percent year-on-year in the third quarter, the pace of decline has slowed markedly. With domestic demand expected to remain stagnant, we continue to project that recovery will likely begin in the second half of 2010, though we are also hopeful that recovery may come earlier. Unemployment is therefore expected to average 20 percent in 2010, before coming down slightly in 2011.

- ***Internal wage and price adjustment has begun***. Year-on-year, gross wages per worker fell 10 percent in September; public-sector wages were down 20 percent over the same period. Prices have fallen on a month-on-month basis since early 2009; and in November 2009, 12-month consumer price inflation was negative, at -1.2 percent. This marks a considerable turnaround from the near 18 percent inflation rate recorded in May 2008. As a result, competitiveness has started to improve. Since its March peak, the CPI-based real effective exchange rate has depreciated by around 6 percent, about one-quarter of which is due to nominal trading partner appreciation. Meanwhile, producer price and unit labor cost deflated real effective exchange rates have depreciated by around 7 and 11 percent from their peaks. For 2010 we project inflation of -3.7 percent, with further price and cost declines expected to help restore competitiveness and, as a result, contribute to economic recovery.

II. Policies for 2010–11

A. Fiscal Policy

2010 Budget

8. **Our 2010 budget, which Parliament passed on December 1, includes L500 million (4.2 percent of GDP) of new measures**. Despite the strong headwinds of a contracting economy, our 2010 budget should achieve a fiscal deficit of 8.6 percent of GDP (program definition), which in ESA terms would be below the 8.5 percent of GDP ceiling we had earlier targeted. This will help place Latvia's public finances securely on a sustainable medium-term path. Key measures include:

- ***Revenue increases (2.3 percent of GDP)***. We have broadened the base for personal income tax and social security by reducing or eliminating many exemptions. We have also removed the special tax system for the self-employed and brought capital income into the taxable base. We have raised the personal income tax rate and increased some excises and taxes on wealth such as car tax and real estate tax, which we have expanded by including industrial structures in the base and by introducing a new higher rate on unused agricultural land. We have also introduced a new real estate tax on residential buildings (including a first step towards progressivity) and a new excise tax on natural gas.

- ***Net cuts in expenditure and net lending (1.9 percent of GDP)***. We will derive significant savings from the first stage of our broad public service reform. We have begun harmonizing remuneration across ministries and institutions, reducing wage inequalities by reviewing employment classifications (job families) and tightening the wage grid. We have further reduced the budgets of ministries and state agencies where we are implementing structural reforms which draw in part on earlier World Bank recommendations. To ensure that these measures are sustainable, our Letter of Intent includes a number of safeguards that will become structural benchmarks in the program (Box 2).

9. **We are taking further steps to protect the poorest in society.** Building on measures introduced in 2009, our program includes scope in 2010 for additional social safety net spending. The program's deficit targets will be adjusted by ½ percent of GDP to allow this. We will work closely with the EC and World Bank to explore the need for additional social safety net measures in 2010. Should additional measures be needed, their design will be elaborated in more detail at the next review.

10. **We will continue to implement key measures from the 2009 supplementary budget to reduce commitments and minimize medium-term risks**, including: (i) launching no new PPPs in 2010 (except concessions, in which the general government sector assumes no risk or liability); (ii) implementing our medium-term technical assistance plan, after seeking feedback from program partners; (iii) limiting general government net

lending to L145 million; and (iv) permanently capping outstanding public guarantees at L836 million (the level in June, when the supplementary budget was passed, plus an additional L82 million for the new private debt restructuring strategy, performance criterion). In addition, to reduce the deficit we will avoid tax cuts in 2010, while any revenue overperformance or savings relative to budget plans will be used to achieve a lower-than-targeted budget deficit or—after consultation with the EC and IMF—to accelerate EU funds expenditure or increase social safety net spending or active labor market policies, within deficit targets.

Medium-Term Fiscal Policy and Debt Management

11. **We remain committed to lowering the general government deficit to less than 3 percent of GDP in 2012, in line with EU recommendations, to satisfy the Maastricht criterion for euro adoption**. We realize that this may be an ambitious target. Further contraction in domestic demand will likely cause increases in the deficit, and additional fiscal measures will be required. We have identified areas where substantial further spending cuts are needed, including those outlined in the Letter of Intent for the First Review. However, we recognize that further tax increases may prove necessary, including through further real estate tax reform (on which we have requested IMF technical assistance) and car tax reform. In particular, we will design a comprehensive reform, allowing means-tested exemptions, and improving the quality of cadastral values. We believe that this could yield significantly more revenue than currently, be less distortionary, and more socially acceptable. If necessary we may also need to increase VAT further.

12. **We will work with the EC and World Bank on a new public expenditure review, to improve the efficiency of government spending**. Because of the crisis, government spending as a share of GDP has increased to around 45 percent, in large part because of the fall in output. The public expenditure review will help us find areas for expenditure savings that can be sustained over the medium term. Continuing our in-depth technical engagement with program partners, by mid-year we will consider options for future fiscal adjustment. Building on this exercise, we will prepare a menu of possible structural reforms significantly larger than the needed fiscal consolidation (structural benchmark, end-October 2010).

13. We will continue work on developing a fiscal framework, to anchor fiscal policy on a credible and sustainable path. To this end by end-June 2010 we will prepare a draft fiscal responsibility law (structural benchmark). This law will aim at maintaining prudent policies—to limit public debt and deficits, and reduce pro-cyclicality in fiscal policy.

14. **We will review our medium-term debt management strategy, to help ensure a smooth transition back to private market financing over the course of the program.** We will seek international assistance to identify ways of strengthening the current Central Government Debt Management Strategy to help manage risks related to increased government borrowing, including those related to debt structure and composition.

B. Monetary and Exchange Rate Policy

15. The fixed (narrow band) exchange rate of the lats remains the anchor for monetary policy until we adopt the euro. Further changes in official interest rates and minimum reserve requirements will be undertaken after prior consultation with IMF staff. The Treasury will continue to exchange all international support from the Fund and other program partners off-market with the Bank of Latvia (BoL). Maintaining monetary and financial stability requires credible policymaking independence, as such we reaffirm the existing strong institutional and financial independence of the BoL and Financial and Capital Markets Commission (FCMC) as a basis for continued stability.

16. **Within the framework of our quasi-currency board arrangement, and consistent with coverage requirements, we are committed to enhancing our liquidity management framework to strengthen exchange rate stability**. A recent visit by international experts concluded that the BoL's liquidity forecasting is of a high standard, and instruments for liquidity management are already in place. The BoL has concluded that more active use of these existing instruments will allow for better management of commercial banks' liquidity. Presently, the overnight deposit facility is the only actively used option for excess liquidity that might result in somewhat higher volatility in times of stress. As such, the BoL will examine options for new absorption instruments, to better control commercial bank excess liquidity.

C. Financial Sector

17. **The Latvian banking system has so far weathered the shock generated by the deeper than anticipated contraction in economic activity relatively well.** Although non-performing loans (overdue for more than 90 days) reached 15 percent of total loans by end-October 2009, and the system registered deep losses as a result of a sharp increase in loan loss provisions, the average capital adequacy ratio improved and stood at 13.6 percent for the system with relatively little variation. The coverage of non-performing loans with loan loss provisions has been steadily increasing since May 2009. Following the top down and bottom-up stress-tests and supervisory follow-up, banks with expected future capital needs made good progress toward increases in own funds that will enable them to maintain capital cushions to deal with credit losses ahead. The capital base of banks increased by 720 million lats so far in 2009 and a further 332 million lats are forthcoming by January 2010.

18. **The FCMC will maintain a risk-oriented approach to supervision**, supporting this through the revision of two regulations. First, we will revise liquidity regulations to take account of the developments in best international practice by putting more emphasis on management of funding liquidity risk; i.e. on management of liability concentrations and banks' reliance on short-term external funding (end-March 2010 structural benchmark). We intend to continue revising our regulations in the future in line with the evolving best international practice. Second, we will continue to 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. We will enhance our existing regulatory framework with comprehensive credit risk regulations (end-June 2010 structural benchmark).

19. **Foreign banks play an important role in the stability of Latvia's banking system**. As such, the FCMC will continue to ensure close monitoring and coordinate supervisory actions concerning cross-border institutions. In addition, the Latvian authorities, together with the other participants in the European Banking Co-ordination Initiative, will make progress towards requesting more specific individual commitments from banks, as agreed at an initial meeting in Stockholm in September 2009. The FCMC, with the BoL, will ensure monitoring of foreign banks' exposure and share information with foreign supervisors and central banks.

20. **We will accelerate our efforts to resolve Parex**. In consultation with the EBRD, which took a 25 percent stake in Parex in September 2009, we will devise a comprehensive plan to deal with the bank's non-performing and non-core assets (for example, without prejudice, we are considering setting up a specialized asset management company in line with best international practice on governance, funding and functions of such institutions). This plan will be submitted to the European Commission by end-March 2010 (structural benchmark). Priority will be given to ensuring adequate capitalization and stable management of the restructured bank and to maintaining financial stability and depositor confidence. Meanwhile, we will ensure that shareholders at the time of the initial state intervention do not benefit from the banks' resolution or from state aid.

21. **We remain committed to fair and equitable treatment of depositors and creditors in the Latvian banking system.** Under our deposit insurance system, we are committed to respecting the rights of all depositors, both resident and non-resident. We will continue to relax the partial freeze limiting withdrawal amounts from deposits in Parex, if conditions allow, and will remove the restrictions fully once conditions stabilize. In October 2009 we relaxed the withdrawal ceilings for certain types of clients based on their credit turnover and removed administrative requirements for corporate depositors. And we continue good-faith efforts to facilitate the settlement of affected depositors' claims arising from this exchange measure.

22. **We will transform the Mortgage and Land Bank of Latvia (MLB)**. Drawing on the recommendations of the recent IMF mission and consistent with the strategy adopted by the Latvian Cabinet of Ministers on November 25, 2009, we will prepare a time-bound action plan. We will consult with the IMF and EC staffs on the action plan, which we will adopt by May 2010 (end-May 2010 structural benchmark). We intend to concentrate the core development activities—financing SMEs, business start-ups, infrastructure, and other national development projects—into a specialized development institution subject to strict supervision by the FCMC (which may require a legal change). In co-operation with MLB management, we will define a plan to address non-performing assets and formulate a medium-term funding program for MLB. Until the plan is finalized, the bank will refrain from assuming new foreign borrowing (beyond already signed loan agreements).

23. **Finally, we will continue to improve our contingency planning and crisis management capacity**:

- ***Liquidity triggers***. FCMC will seek international assistance to establish guidelines for 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 business activities, to appointing an FCMC official to oversee bank activities.

- ***Deposit guarantee***. FCMC will designate and train staff to operate the Deposit Guarantee Fund, which will be established as a separate unit with separate financial statements for the fund within the FCMC (end-March 2010 structural benchmark). We will analyze the adequacy of the present DGF investment policy with a view to better meet the requirements for fast payout of insured deposits.

D. Private Debt Restructuring

24. **We are considering launching a debt restructuring strategy compatible with fiscal constraints, while continuing to work on market-based approaches to restructuring.** We would offer to guarantee loan payments to targeted qualifying household borrowers for up to two years in exchange for loan restructuring, including reduction in loan principal amounts, by banks (in accordance with conditions outlined in the debt restructuring strategy) in order to help borrowers cope with economic distress (while avoiding moral hazard), prevent foreclosures and create incentives for banks to provide debt relief. The scheme would be limited to mortgage amounts of L100,000 or less on primary residences. To ensure public money is well spent, access to the debt restructuring scheme would be strictly capped at L82 million of issued guarantees for the whole period, with an estimated fiscal cost of up to L31 million per year. If implemented, the Ministry of Finance (MoF) will review this scheme by end-December 2010 to determine if adjustments are needed to enhance its effectiveness or ensure that costs are contained (structural benchmark).

25. **We will continue to improve the legal framework to help address widespread debt distress in the corporate sector as well also for individuals.** We submitted amendments to the Insolvency Law in early November to streamline liquidation procedures to facilitate rapid exit of non-viable firms and to establish a new personal insolvency framework to support rehabilitation of individual debtors. In addition, we submitted amendments to the Civil Procedure Law to Parliament in September 2009 to further improve the efficiency of the foreclosure procedures and create incentives for debt workouts. These amendments are expected to take effect in early February 2010. Finally, we have launched an information campaign to ensure the new instruments are widely used. In particular, we have held a series of workshops on out-of-court debt restructuring for stakeholders and will continue training judges and insolvency administrators to improve institutional capacity.

E. Other Issues

26. **We will continue to place all long-term funds under the program in special sub-accounts of the Treasury's euro-account at the BoL**. Should these program accounts intended for budget support fall by more than EUR 250 million in any 30-day period, the MoF will consult with EC and IMF staff.

III. IMF ARRANGEMENT

27. On top of previous commitments under the program, we believe the policies described above represent another significant step towards our goal of euro-entry. Nevertheless, we stand ready to take additional measures needed to keep the program on track. We will consult with the EC, 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 information the IMF requests on policy implementation and achievement of program objectives in a timely manner.

28. **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,

/s/
Valdis Dombrovskis
Prime Minister

/s/
Einars Repše
Minister of Finance

/s/
Ilmārs Rimšēvičs
Governor of the Bank of Latvia

/s/
Irēna Krūmane
Chairwoman
Financial and Capital Market Commission

Box 1: Further Steps to Strengthen the Financial Sector

Since July, we have made further progress towards strengthening the financial sector:

- ***Supervision and monitoring***. The FCMC stepped up its monitoring of individual banks and enacted new reporting requirements. A half-year financial results audit of all banks revealed no immediate solvency issues. The FCMC and the BOL have continued regular stress tests to assess risks facing individual institutions. In addition, all banks have completed their own bottom-up tests on the basis of a uniform macroeconomic scenario. FCMC discussed the outcome of the tests with banks' managements. A number of banks strengthened their capital to cope with credit losses ahead. We have improved information exchange between the BOL and FCMC on stress-testing, and we have increased the number of FCMC staff dealing with offsite monitoring.

- ***Prompt Remedial Action Guidelines***. Guidelines have been introduced by the FCMC to ensure, where necessary, timely supervisory action is taken, including outlining decision-making procedures that promote prompt and expedient decisions and consistent application of corrective actions and sanctions.

- ***Contingency planning.*** In August, the FCMC in cooperation with the BoL and MoF completed work on a bank resolution strategy. The strategy defines responsibilities of government agencies, the decision-making process, and options and methods applicable to various sub-groups of banks.

- ***Foreign banks' exposure***. In September, foreign banks committed to maintain the level of their exposure to Latvia. Through a public statement, parent banks also committed to meeting capital and liquidity needs of subsidiaries and branches in conformity with the respective legal and regulatory frameworks.

- ***Stabilizing Parex***. The EBRD acquired 25 percent of Parex equity in September and provided a subordinated loan to the bank. The state recapitalized Parex in October to maintain its capital adequacy safely above the regulatory limits.

- ***Insolvency procedures.*** Amendments to the Insolvency Law and Civil Procedural Law have been submitted to Parliament to streamline liquidation procedures, support rehabilitation of individual debtors and facilitate speedy debt resolution.

- ***Debt workouts.*** Principles and guidelines for out-of-court consumer mortgage workouts were issued in August by the FCMC to promote awareness on general principles for out-of-court mortgage workouts among lenders and customers. Guidelines for out-of-court corporate restructuring in line with international best practice have also been issued.

Box 2: Benchmarks to Assure Budget Sustainability

We are introducing reforms to ensure that the expenditure measures in the 2010 budget are sustainable as well as looking beyond 2010. We will support these through structural benchmarks in the program:

- ***Target welfare benefits.*** In the 2010 budget, unemployment, maternity and paternity benefits have been reduced for high income recipients (yielding L26 million). However, this measure expires in 2012. We will therefore conduct a review to identify permanent (perhaps different) measures to replace reduced welfare benefits that expire in 2012 (structural benchmark, end-June 2010).

- ***Delayed investment projects***. A number of postponed investment projects (including National Library and Ministry of Defense contracts) yield savings in 2010 (L24 million), but spending will be pushed out to future years. We will therefore identify other areas where nationally-financed (that is, non-EU) investment in future years can be reduced.

- ***Ministry of Defense***. Further to the large cuts in 2009, additional reductions (L21 million) will reduce defense expenditures to 1.14 percent of GDP in 2010. We believe this is a feasible medium-term appropriation for the sector. However, to ensure our defense capabilities under the reduced budgetary envelope are sufficient, we will complete a medium-term strategy paper for the sector (structural benchmark, end-September 2010).

- ***Pension reform***. The recent Constitutional Court ruling has implications for future pension reforms, but does not preclude structural reforms to achieve savings. In light of this ruling, by end-June 2010 (structural benchmark), with technical assistance from international organizations and in cooperation with social partners, we will prepare changes in order to ensure future sustainability of the three pillars of the pension system, while making sure that the burden on contributors does not rise further and more generally that the burden of fiscal adjustment is shared fairly, with a view to introducing these changes by January 2011.

Table 1: Latvia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2008–09

(In millions of lats unless otherwise indicated)

	2008			2009							
	end-Nov	end-Dec		end-March		end-June		end-Sept		end-Dec	
	Actual	Program	Outcome	Program	Outcome	Program	Outcome	Program	Outcome	Program	Outcome
I. Quantitative performance criteria											
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	1,402	-586	1,347
Ceiling on net domestic assets of the Bank of Latvia	-99	951	423	1,434	419	2,501	768	1,719	619	2,103	699
Floor on adjusted cash fiscal balance	…	-894	-957	-305	-328	-649	-794	…		…	
Floor on adjusted primary cash fiscal balance	…	…	…	…	…	…	-388	-828	-467	-1,289	-746
Ceiling on public guarantees (millions of lats)	…	…	…	…	…	…	…	754	312	754	328
II. Continuous performance criteria											
Ceiling on general government domestic arrears	…	0	0	0	6	0	11	40	12	40	12
Non-accumulation of external debt arrears (millions of euros)	…	0	0	0	0	0	0	0	8	0	8
III. Staff consultation clause											
If sub-accounts for program budget support fall by more than €250 million in any 30-day period	…	…	…	…	…	…	…				
IV. Indicative target											
Ceiling on the general government wage bill	…	1,248	1,267	214	263	490	598	840	805	1,067	1,028

Table 2. Latvia: Structural Benchmarks under the Stand-by Arrangement, through end-2009

Structural Benchmarks	Target date	Status
Wages: reform the Committee to Promote Wage Restraint by involving the social partners and outside labor market experts.	End-August 2009	Done.
Prepare a strategy for bank recapitalization and resolution.	End-August 2009	Done.
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 re	End-August 2009	Done.
Design a strategy to strengthen the social safety net.	End-August 2009	Done.
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-October 2009	Partially done. Wage grid revised, some analysis undertaken, but no report completed.
Submission to Parliament of amendments to the Insolvency Law and other credit enforcement laws.	End-October 2009	Done with a delay. Submitted to Parliament in November.
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-December 2009	Not met. Reset in Second Review.

Table 3: Latvia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2010

(In millions of lats unless otherwise indicated)

	2010			
	Performance Criteria		Indicative Targets	
	end-March	end-June	end-Sept	end-Dec
	Program	Program	Program	Program
I. Quantitative performance criteria				
Floor on net international reserves of the Bank of Latvia (millions of euros) 1/	-169	-565	-982	-1,740
Ceiling on net domestic assets of the Bank of Latvia 1/	1,820	2,070	2,323	2,853
Floor on primary non-EU cash fiscal balance 2/	-66	-180	-217	-628
Ceiling on public guarantees (millions of lats)	836	836	836	836
II. Continuous performance criteria				
Ceiling on general government domestic arrears	40	40	40	40
Non-accumulation of external debt arrears (millions of euros)	0	0	0	0
III. Staff consultation clause				
If sub-accounts for program budget support fall by more than €250 million in any 30-day period				
IV. Indicative target				
Ceiling on the general government wage bill	194	457	654	948

1/ NIR targets will be adjusted downwards/upwards and NDA targets will be adjusted upwards/downwards by the net change in emergency liquidity assistance (TMU ¶6). NIR targets will be adjusted upwards (and NDA targets adjusted downwards) for any non-concessional external debt issued by the government (TMU ¶7).

2/ Adjusted downwards for additional social safety net spending (TMU ¶13), and adjusted upward for shortfalls on private debt restructuring costs (TMU ¶14) and excess EU funds-related spending (TMU ¶15).

Table 4. Latvia: Structural Benchmarks through end-December 2010

Structural Benchmarks	Motivation	Target date
Revise liquidity regulations.	Bring up to date with changing best international practice by putting more emphasis on management of funding liquidity risk; i.e. on management of liability concentrations and banks' reliance on short-term external funding	end-March
Submit Parex restructuring plan to European Commission.	Crucial to launch bank's resolution.	end-March
Establish Deposit Guarantee Fund as separate unit with separate financial statements.	Needed to operationalize changes to legal framework made in 2009, and strengthen crisis management capacity.	end-March
Complete action plan for Mortgage and Land Bank.	Need to ensure timely implementation of government strategy in view of fiscal implications.	end-May
Conduct thorough review of welfare benefits.	Fiscal sustainability. Some measures in the 2010 budget are due to expire in 2012. Permanent (perhaps different) measures are needed to ensure welfare benefits remain at a sustainable level which this review should identify.	end-June
Pension reform.	Fiscal sustainability: Prepare changes in pension system in order to ensure future sustainability of three pillars of pension system and share the burden of fiscal adjustment fairly, with a view to introducing these changes by January 2011, with international assistance and in close cooperation with social partners.	end-June
Prepare a draft fiscal responsibility law.	Fiscal sustainability: needed to anchor fiscal policy on a credible and sustainable path.	end-June
Revise credit risk management regulation.	Enforce best international practice for credit risk management, 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.	end-June
Complete strategy paper for defence sector.	Fiscal sustainability: Budget cuts have reduced defence expenditures to 1.14 percent of GDP in 2010. To ensure this lower appropriation is feasible over the medium-term, this medium-term strategy will set out priorities for the sector within this reduced budget envelope.	end-September
Prepare menu of potential structural reforms.	To aid the 2011 budget process, we will prepare a menu of possible structural reforms in key sectors.	end-October
Review debt restructuring scheme.	Review performance of the debt restructuring scheme, in particular to ensure costs are contained.	end-December

LATVIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

January 22, 2010

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 January 22, 2010 signed by the Prime Minister, the Minister of Finance, the Governor of the Bank of Latvia, and the Chairwoman of the Financial and Capital Market Commission. It describes the methods to be used in assessing program performance with respect to these targets.

2. 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 Lats (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 millions of euros)
Floors on level of NIR:	
March 31, 2010 (performance criterion)	1
June 30, 2010 (performance criterion)	-506
September 30, 2010 (indicative target)	-926
December 31, 2010 (indicative target)	-1,648

Definitions

3. **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, and 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 September 30, 2009, foreign reserve assets thus defined amounted to 4,770 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 September 30, 2009, reserve liabilities thus defined amounted to 204 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 September 30, 2009, base money equaled 1,606 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 September 30, 2009, net foreign assets of the BoL amounted to 3,111 million lats.

4. As of September 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 3,025 million euros.

5. 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 millions of lats)
Ceiling on level of NDA:	
March 31, 2010 (performance criterion)	1,707
June 30, 2010 (performance criterion)	2,056
September 30, 2010 (indicative target)	2,344
December 31, 2010 (indicative target)	2,882

Adjustors

6. 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/downwards (and correspondingly the NIR target will be revised down/up) by the net change in ELA relative to the outstanding amount on November 30, 2009, provided that net foreign assets of the BoL remain above base money. The outstanding amount on November 30, 2009 was 145 million lats.

7. The NIR targets will be revised up (and NDA targets revised down) for the full amount of any non-concessional external debt issued by the government. For this adjustor, non-concessional external debt does not include Treasury liabilities to the IMF, the European Union, or other official creditors participating in the program.

C. Floor on the primary Non-EU Cash Fiscal Balance of the General Government

	(in millions of lats)
Cumulative adjusted primary cash fiscal balance from January 1, 2010:	
March 31, 2010 (performance criterion)	-124
June 30, 2010 (performance criterion)	-353
Sept.30, 2010 (indicative target)	-424
Dec. 31, 2010 (indicative target)	-813

8. 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.

9. The non-EU cash primary fiscal balance of the general government is defined as **general government net lending/borrowing**, in cash:

- excluding bank restructuring costs (¶12);
- 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).

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

11. 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

12. 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 (requited 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.

Social spending (adjustor)

13. The end-December floor for the non-EU cash primary fiscal balance of the general government will be adjusted downward for any additional spending on social safety nets, as defined under the World Bank strategy, cumulated from January 1, 2010, above 17.5 million lats and up to 35 million lats per quarter.

Private debt restructuring (adjustor)

14. The floor on the non-EU primary cash fiscal balance will be adjusted upwards for any shortfall in net lending to private mortgage holders under the scheme described in paragraph 24 of the Letter of Intent (to which this memorandum is attached) below L7.75 million per quarter, cumulated from January 1, 2010.

Excess EU-related spending (adjustor)

15. Should spending on EU-related items exceed L1,000 million (remaining funds divided by remaining number of years), the floor on the non-EU primary cash fiscal balance will be adjusted upwards by the excess.

Financing

16. Consistent with the NDA ceilings in section B, the government will deposit all program related financing in special sub-accounts of the Treasury euro-account at the BoL. The accounts will be distinct from those receiving financing from other program partners, including the European Commission, which will be reported separately.

D. Ceiling on the General Government Wage Bill

	(in millions of lats)
Wages and salaries (Cumulated from January 1, 2010):	
March 31, 2010 (indicative target)	194
June 30, 2010 (indicative target)	457
September 30, 2010 (indicative target)	654
December 31, 2010 (indicative target)	948

17. 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.

E. Ceiling on Public Guarantees

18. 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 836 million lats 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, 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.

19. 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.

F. Continuous Ceiling on Domestic Arrears by the General Government

20. 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 capture delayed wage payments to employees of the public sector and (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-September, the stock of arrears stood at LVL 12 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

21. 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.

22. 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

23. 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
To be provided by the Ministry of Finance	
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
Social safety net spending	Quarterly, within four weeks of the end of each quarter.
Data on general government net lending showing separately any net lending under the private mortgage restructuring strategy.	Monthly, within four weeks of the end of each quarter.
Public sector guarantees, detailed breakdown by issuing institution or agency and purpose.	Quarterly, within four weeks of the end of each quarter.
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 extra budgetary 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
To be provided by the Bank of Latvia	
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 ,foreign exchange swaps, use of standing facilities, and use of emergency liquidity assistance	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 quarter
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