International Monetary Fund

Latvia: and the IMF

Press Release:
IMF Completes Third Review Under Stand-By Arrangement with Latvia and Approves €105.8 Million Disbursement
July 21, 2010

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Latvia: Letter of Intent and Technical Memorandum of Understanding

July 5, 2010

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LATVIA: LETTER OF INTENT

Riga, July 5, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

1. **There are signs that the Latvian economy is starting to stabilize.** Real GDP appears to have leveled off in the first quarter of 2010, with hopes for growth in the rest of the year. International reserves have increased to €5.5 billion, strengthening confidence in the exchange rate peg. Wages are continuing to decline, competitiveness is improving, and exports are increasing. Much lower CDS spreads and market interest rates, and the decision of two rating agencies to raise the outlook on Latvia from negative to stable, are further evidence of the improved economic environment. At the same time, increased confidence in our program strategy allowed us to lower policy rates in March while foreign exchange intervention has been limited.

2. **The improving economic environment reflects the strong and difficult policy measures we have taken under the program.** Since the Second Review we have:

- Kept the budget deficit under control, meeting the end-March performance criterion for the adjusted primary balance, as well as the indicative target on the public-sector wage bill (Table 1). Despite recent tax cuts—including a cut in the VAT rate for hotels— we believe that the end-year fiscal deficit target remains within reach.
- Comfortably met our net international reserves (NIR) and monetary (NDA) targets.
- Met most of the program's structural benchmarks, including submission of a restructuring plan for Parex Bank to the European Commission (EC) and completing regulations to strengthen our financial system (Table 2). However, further work is needed on a detailed transformation plan for Mortgage and Land Bank (MLB) and a structural benchmark to this effect has been set for end-September.

3. **For 2010 and 2011 we aim to consolidate the gains made thus far while setting the stage for fulfilling the Maastricht criteria by 2012.** We remain committed to achieving this year's deficit target of no more than 8½ percent of GDP in ESA95 terms and the related performance criterion. For 2011, we are committed to a fiscal deficit of no more than 6 percent of GDP in ESA95 terms. Preliminary estimates suggest that a further L395 to L440 million in net measures will be needed to achieve this target. We are also considering increasing appropriations from the EU Structural Funds and Cohesion Fund by L250 million

next year, which would require an additional L30 million in measures to offset the increased cofinancing needs. For 2012 further significant adjustment will likely be needed to bring the deficit below the 3 percent of GDP target. We believe this adjustment, coupled with our efforts to strengthen the financial system, will help rebuild confidence in our economy and move us towards our goal of euro adoption by 2014.

4. **Against this background and the policies outlined below, we request completion of the Third Review and Financing Assurances Review under the Stand-By Arrangement.** We request a waiver of non-applicability for the end-June 2010 performance criteria on the fiscal balance and the ceiling on public guarantees. Data for these targets are not yet available, but we expect them 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 the general government. Performance criteria and structural benchmarks through end-December 2010 are set out in Tables 1, 2 and 3, as well as in the attached Technical Memorandum of Understanding. The Fourth and Fifth Reviews will take place on or after November 15, 2010 and February 15, 2011.

5. **Given the improved economic environment and our much stronger financial position, we intend not to draw all available funds at this Review but to treat some program disbursements as credit facilities.** Completion of this review by the IMF and EC potentially unlocks around €1 billion in additional funding from the Fund, the EU, the Nordic countries, the Czech Republic, and Poland. However, given our much stronger financial position we only intend to draw the around €300 million available from the Fund and the EU, as well as €100 million previously approved by the World Bank. Any undrawn funds will remain available to us provided that we sustain our record of satisfactory program performance. We will make decisions on future drawings on a review-by-review basis.

I. Macroeconomic Framework for 2010–11

6. **We expect the economy to bottom out in 2010.** Domestic demand will likely remain depressed due to fiscal consolidation, high unemployment and declining credit, but exports—notably of wood products, although other categories are increasing as well—are increasing rapidly, as is industrial production. Although the economy is expected to start expanding this year, we project GDP to decline by 3½ percent for the year as a whole due to the carryover effect of the contraction in late 2009. Growth in 2011 should reach around 3½ percent. Unemployment is expected to increase slightly to an average of 21 percent in 2010 and then fall in 2011.

7. **We expect wage and price adjustment to continue to improve competitiveness.** Unit labor costs in manufacturing have declined by 21 percent since end-2008 on the back of a 10 percent decline in nominal wages. As a result, competitiveness is improving as evidenced by an improvement in our export market shares. Since its peak in February 2009,

the CPI-based real exchange rate has depreciated by around 10 percent, while the unit labor cost deflated real exchange rate has depreciated by around 10 from its peak. We expect that domestic prices will decline further in 2010, improving competitiveness, but that the overall CPI will only decline by 2 percent due to higher energy and import prices.

II. Policies for 2010–11

A. Fiscal Policy

8. **We remain committed to the program's fiscal targets, including a fiscal deficit (ESA95) below 8.5 percent of GDP in 2010:**

- **Since the Second Review we have introduced a number of tax cuts to improve competitiveness, stimulate job creation, and boost socially important sectors**: a cut in the VAT rate for hotels from 21 to 10 percent, extension of the low VAT regime for books and other printed media, exemption of unusable infrastructure from real estate taxation, and exemption of gifts for education and medicine from personal income tax. These measures—which total approximately L13.2million (0.1 percent of GDP)—contravene our Second Review LOI commitment to refrain from cutting taxes. We have also increased spending by introducing a net lending scheme for agricultural producers (0.1 percent of GDP) and by accelerating construction of the national library (0.1 percent of GDP). We understand that these measures will add to the adjustment needed in 2011 to remain on the path towards debt sustainability and meeting the Maastricht criteria.

- To offset the impact of these measures and to ensure that this year's fiscal deficit target remains within reach, we intend to cut general government net lending from L142 million to L112 million (0.3 percent of GDP), on account of lower financing needs in 2010 for some projects administered by the Ministry of Transport, including Riga airport, and the ports of Ventspils and Liepaja.

- In addition, we will avoid any further tax cuts in 2010 and will consult well in advance with the EC and the IMF on the revenue implications of any changes to tax policy, or of proposals to increase spending. Revenue collection above the level envisaged in the program 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.

9. **We have increased social safety net spending** beyond the L73 million (0.6 percent of GDP) in the 2010 budget by providing additional financing for active labor market policies and temporary public employment programs, including L13 million (0.1 percent of GDP) to employ a further 35,000 people under the Workplaces with Stipend Emergency

Public Works (WWS) program. We are also considering allocating L4.3 million (0.03 percent of GDP) to finance the transportation needs of the disabled.

10. **We have increased appropriations for EU Structural Funds and Cohesion Fund** by L100 million above the level in the 2010 budget to foster implementation of EU cofinanced projects. We are also increasing spending on payments for EU agricultural payments by L100.5 million. If the fiscal space is available under the program, we intend to approach the IMF and EC for approval to increase appropriations for EU Structural Funds and Cohesion Fund spending by up to L132 million more this year.

11. **We will continue to reduce commitments and medium-term fiscal risks**, including by: (i) launching no new PPPs in 2010 and 2011 (except concessions, in which the government assumes no risk or liability); (ii) implementing our plan which coordinates and prioritizes our medium-term technical assistance needs; and (iii) permanently capping outstanding public guarantees at L754 million (the level in June 2009, when the supplementary 2009 budget was passed).

12. **For the 2011 budget, preparatory work is well underway to identify a menu of options for the new government to reduce the deficit to no more than 6 percent of GDP.** The 2011 budget will only be finalized after Parliamentary elections in October. However, we believe that preparing a menu of options for expenditure cuts and possible tax increases by end-October (structural benchmark) will enable the new government to quickly submit a budget for Parliamentary approval consistent with keeping Latvia's public finances on a sustainable medium-term path and with our goal of achieving the Maastricht deficit target in 2012.Thus far, we have identified possible measures with an aggregate yield of around 3 percent of GDP. The final menu will include more measures, and will be significantly larger than the consolidation needed, to give the incoming government a meaningful choice of measures.

- **Expenditure cuts**. We are considering options that would enable the new government to rationalize expenditure while protecting the poorest in society, building among other things on the recommendations of a recent World Bank public expenditure review. Areas of possible savings include: (i) reforms to public administration, including the possible elimination or consolidation of government agencies: (ii) reducing direct subsidies to enterprises (including state and local-government owned ones, 0.5-1.2 percent of GDP); (iii) further cuts in the wage bill of state-owned enterprises; and (iv) budgetary consolidation in local governments. We are also considering options for rationalizing the system of social benefits, including by making the system more targeted and by introducing changes to ensure the sustainability of the pension system. The State Chancellery and Ministry of Finance are also undertaking a functional review of our expenditure to identify those functions that can be abolished. We have requested an IMF technical assistance mission to help identify further savings, especially to subsidies and social insurance benefits, while protecting the poor.

- **Revenue increases.** In April this year we published our tax reform strategy, which includes several revenue raising measures which could be introduced as part of the 2011 budget. The strategy proposes increasing consumption taxes—with due consideration of the impact on poorer households—to support fiscal adjustment, and to lower labor taxes when fiscal conditions allow in order to boost job creation and competitiveness, and reduce tax evasion. For example, aligning all VAT rates to the standard 21 percent VAT rate could yield L95 million (0.8 percent of GDP) in revenues, although net savings could be somewhat lower given the need for compensatory measures to protect those with low incomes. Increasing property taxes—consistent with a recent technical assistance report from the Fund—could raise an additional ½ percent of GDP. We are also considering proposals to increase revenue from the annual car tax in a progressive manner, and to remove allowances which prove to be inefficient. We will intensify our efforts to improve tax administration and encourage tax compliance and have prepared a list of actions, some of which are already being approved and implemented.

13. **We have taken steps to achieve and maintain fiscal sustainability over the medium-term:**

- We will soon complete a report on pension reform—prepared with assistance from the World Bank—with a view to introducing these reforms by January 2011. A review of welfare benefits, which will propose changes to ensure that these benefits are targeted at the genuinely poor and are adequately financed and thus sustainable once temporary cuts expire in 2012, is also close to being completed.

- We will prepare an exhaustive list of all state-owned enterprises, including information on their profits, subsidy receipts, dividend payments, employment and wage levels by end-September 2010 (structural benchmark). By end-2010 we will prepare a strategy specifying which of these should remain state-owned enterprises, be transformed into government agencies, or privatized (structural benchmark).

- In the coming weeks we intend to submit a Fiscal Responsibility Law—building on technical assistance from the IMF and comments from the EC—that will include a fiscal rule entailing a balanced budget over the cycle, while ensuring consistency with commitments under the EU's Stability and Growth Pact. The new law—which we intend to submit to Parliament by end-September (structural benchmark)—will also include a requirement that the Government prepare and Parliament adopt binding multi-annual expenditure ceilings, a prohibition on raising within-year appropriations due to overperforming revenues, and limitations on the introduction of expansionary fiscal measures after adoption of the budget. We will also take steps to ensure that these provisions have a greater legal standing than other laws, and will submit a report to Parliament on possible options for achieving this by end-September (structural benchmark). This will anchor fiscal policy on a credible path following completion of the program, ensure public debt remains sustainable, and allow for counter-cyclical fiscal policy. Finally, we will submit amendments to the Rules on Procedures of the Parliament to Parliament to ensure that the Ministry of Finance is given adequate time to evaluate tax proposals—including those that are proposed by Parliament—before Parliament votes on these proposals.

- We will accelerate introduction of a Medium-Term Budgetary Framework and will at a minimum apply a nonbinding test version to the 2012 budget.

14. **We intend to improve our methodology for accurately measuring the ESA95 deficit, starting with the 2011 budget.** We will start distinguishing clearly between government spending on behalf of the EU and spending not recoverable from EU funds. This will allow us to better assess the impact of these projects on the fiscal deficit.

15. **We intend to gradually increase our reliance on private market financing when feasible.** Gradually increasing domestic and external market borrowing when market conditions are favorable will help ensure a smooth transition toward greater reliance on market financing once the IMF and EU-supported program expires. We are also taking advantage of the relatively benign conditions in domestic financial markets to expand the maturity of domestic debt.

B. Monetary and Exchange Rate Policy

16. **The fixed (narrow band) exchange rate will remain the anchor for monetary policy until we adopt the euro.** The Treasury will continue to exchange all international support from the Fund and other program partners off-market with the Bank of Latvia (BoL). Should NIR fall by more than EUR 500 million in any given 30-day period, we will consult with IMF and EC staff.

17. **We have taken steps to fine tune our liquidity management framework.** In March this year we introduced a 7-day deposit facility for commercial banks. The facility has reduced the amount of excess liquidity held by commercial banks in the overnight deposit facility and thus reduced the likelihood of sharp fluctuations in liquidity and interest rates. Further changes in official interest rates and minimum reserve requirements will be undertaken after prior consultation with IMF staff.

C. Financial Sector

18. **We continue to strengthen our risk-oriented approach to supervision and our contingency framework.** Revised regulations on liquidity risk and credit risk management came into effect in April and July this year. Among other things, these put more emphasis on

funding risks arising from liability concentration and short-term wholesale funding (liquidity risk regulations) and clarify the treatment of entities set up by banks to manage seized property or other problem assets (credit risk regulations). We will strictly enforce these regulations, while amending our supervisory framework as needed to keep pace with evolving international best practice. Earlier this year, we also strengthened our contingency framework by transforming the deposit guarantee fund into an autonomous unit with dedicated staff within the Financial and Capital Markets Commission (FCMC).

19. **Foreign banks operating in Latvia have committed to remain involved in Latvia's banking system**. In letters sent to the FCMC in February, several large foreign banks restated their commitment to remain involved in Latvia as a parent to their respective subsidiaries/branches, and to comply with all regulatory requirements. The FCMC has also set up a template for monitoring foreign bank's exposure and will share this information with foreign home supervisors and central banks. At the same time, the FCMC will continue to coordinate closely with the relevant foreign supervisors to prevent a build-up of vulnerabilities in cross-border financial institutions.

20. **We are committed to implement the restructuring plan for Parex Bank once it is approved by the EC.** The plan envisages moving all core performing assets and some non-core assets, as well as most senior liabilities (including all unencumbered customer deposits), into a newly-licensed bank, with the remaining assets and liabilities to stay in the existing entity. No additional cash injection by the government is envisaged to capitalize the new bank. To achieve adequate burden sharing, we will ensure that the shareholders at the time of the initial government intervention in Parex do not benefit from the restructuring or from state aid. We believe that implementation of the restructuring plan will allow us to move quickly toward the divestment of Parex assets in a transparent manner, while protecting depositors and giving the government a chance to maximize recovery of 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. The partial freeze limiting withdrawal amounts from deposits in Parex will be removed fully once conditions stabilize following implementation of the restructuring plan. We continue good-faith efforts to facilitate the settlement of affected depositors' claims arising from this exchange measure.

22. **We intend to submit a transformation plan for MLB to the EC by end-September 2010 (structural benchmark).** An action plan which reaffirmed our commitment to transform MLB into a specialized development institution was completed in May. However, further work is needed on a detailed transformation plan consistent with the recommendations of a recent IMF mission, the EU framework for state aid and structural funds, and the strategy adopted by the Latvian Cabinet of Ministers on November 25, 2009, and we intend to move quickly to engage a reputable and qualified independent advisor

(end-July structural benchmark) to assist with that task. We also intend to form a high-level working group to coordinate the formulation of a transformation plan and subsequent transformation process.

23. **We plan to restrict MLB's operations to core development activities funded by concessional financing**. The bank will refrain from any new foreign borrowing and net lending (beyond already signed loan agreements, committed credit lines, and amounts already earmarked in the state budget) until a transformation plan is submitted to the EC (DG Competition). At the same time, the FCMC and Ministry of Finance will closely monitor MLB's activities to ensure compliance with the EU framework for state aid (in particular EC decision No. NN 60/2009 of November 19, 2009) and structural funds, and to ensure the bank does not extend any new commercial loans, except for funds that have been already committed by the bank and for the restructuring of existing loans of the existing commercial clients with respect to the same client and to the same loan amount. We will work with the EC on improving the framework for development lending in Latvia—specifying that the development bank should preferably on-lend concessional funds using commercial banks as intermediaries, and clarify instances when it should lend to directly to clients—and will propose ways to optimize the system of development financing in Latvia, including by merging numerous institutions operating on behalf of the Government into a single effective development financing institution. We believe these measures will improve the effectiveness of the bank's development activities by ensuring that concessional funds are sufficiently targeted toward development lending, and minimize competition distortions.

24. **We intend to seek technical assistance from the IMF to facilitate effective decision making during the resolution of a credit institution.** In our assessment, the Law on Prevention of Squandering of the Financial Resources and Property of the State and Local Governments creates the risk of legal action against government officials, managers, and key decision makers involved in the resolution or restructuring of a credit institution, thus limiting the scope for effective decision making.

D. Private Debt Restructuring

25. **Our efforts to facilitate market-based debt restructuring are working.** Guidelines for out-of-court household mortgages and corporate debt restructuring—developed with assistance from World Bank and IMF staff—were issued in the second half of 2009, and amendments to the Civil Procedure Law that aimed, inter alia, at making the seizure of collateral a credible threat—thereby strengthening the incentives for debtors to participate in workouts—became effective in February. In addition, amendments to the Insolvency Law—drawing on IMF and World Bank technical assistance—aimed at strengthening the incentives for debt restructuring were approved in June 2009, while amendments to speed the exit of non-viable firms and to support the rehabilitation of individual debtors were approved by Parliament in June 2010, but were sent back to Parliament by the President for further

consideration. Approximately 18 percent of the total amount of outstanding loans are currently reported as restructured, more than double the amount at end-2008.

26. **We intend to further improve the tax treatment of restructured loans and foreclosure proceedings** to provide the incentives for writing down loans, reduce the cost of credit enforcement, and increase the recovery rate**.** In particular, we will:

- We intend to engage all relevant stakeholders—including commercial banks and accountants—to clarify the interpretation of current tax legislation as it applies to debt write-downs and restructuring. We will consult with the IMF, EC, and other stakeholders and prepare a report on whether any legislative changes are necessary to allow credit institutions, their subsidiaries, and separated entities to deduct losses from debt write-downs against corporate income tax (end-July 2010 structural benchmark). If legislative changes are necessary, we plan to submit revisions to our tax legislation that by end-August 2010 and to seek passage of these amendments by end-September 2010. We also intend to reduce stamp duty once we increase the residential real estate tax and when the economic situation improves. We will introduce a temporary one year waiver for personal income tax liabilities resulting from debt write-downs to encourage the restructuring of household debt (end-September 2010 structural benchmark). We will consult with IMF and EC staff before making these changes.

- Seek technical assistance from the IMF and engage all stakeholders to review international best practice in the area of foreclosures with an aim to further improve our foreclosure procedures. In particular, we will evaluate ways to allow buyers to pledge the asset auctioned at a foreclosure auction as collateral for a loan in order to increase the number of participants and facilitate price discovery in these auctions. We will also work to identify ways to accelerate post-auction court approval procedures.

E. Other Issues

27. **We will continue to place all long-term program funds in special sub-accounts at 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 Ministry of Finance will consult with EC and IMF staff.

28. **The Latvian government will work closely with the EC to pursue reforms as specified in our Supplemental Memorandum of Understanding with the EC**, in particular in such areas improving the business environment and making more efficient use of EU-cofinanced financial instruments and R&D support programs.

III. IMF Arrangement

29. **On top of our previous commitments under the program, we believe the policies described above are sufficient to achieve the goals of our economic program.** 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.

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

31. **Signatories support the program outlined in this LOI, but will be responsible for implementation only in their areas of authority.**

Sincerely yours,

/s/
Valdis Dombrovskis
Prime Minister

/s/
Einars Repše
Minister of Finance

/s/
Ilmārs Rimšēvičs
Governor of the
Bank of Latvia
For the responsibilities
of the BoL

/s/
Irēna Krūmane
Chairwoman
Financial and Capital Market Commission

Table 1: Latvia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2010-11
(In millions of lats unless otherwise indicated)

	2010						2011	
	Performance Criteria						Indicative Targets	
	end-March			end-June	end-Sep	end-Dec	end-March	end-June
	Program	Adjusted	Outcome	Program	Program	Program	Program	Program
I. Quantitative performance criteria								
Floor on net international reserves of the Bank of Latvia (millions of euros) 1/	1	29	1,451	-506	694	141	-281	-449
Ceiling on net domestic assets of the Bank of Latvia 1/	1,707	1,679	445	2,056	1,344	1,741	1,960	2,116
Floor on primary non-EU cash fiscal balance 2/ 3/	-124	-116	-94	-353	-401	-782	-18	-92
Ceiling on public guarantees	836		379	836	754	754	754	754
II. Continuous performance criteria								
Ceiling on accumulation of general government domestic arrears	40		12	40	40	40	40	40
Ceiling on accumulation of general government external arrears (millions	0		0	0	0	0	0	0
III. Staff consultation clauses								
If international reserves fall by more than €500 million in any given 30-day period								
If sub-accounts for program budget support fall by more than €250 million in any 30-day period	Consultation held in mid-March							
IV. Indicative target								
Ceiling on the general government wage bill 2/	194		188	457	654	948	197	464

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 external debt issued by the government (TMU ¶7).

2/ Cumulative from the beginning of the fiscal year.

3/ 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 2. Latvia: Structural Benchmarks through end-December 2010 (Second Review)

Structural Benchmarks	Motivation	Target date	Status
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	Done
Submit Parex restructuring plan to European Commission	Crucial to launch bank's resolution.	end-March	Done
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	Done
Complete action plan for Mortgage and Land Bank	Need to ensure timely implementation of government strategy in view of fiscal implications.	end-May	Reset till end-September
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	In progress
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	In progress
Prepare a draft fiscal responsibility law	Fiscal sustainability: needed to anchor fiscal policy on a credible and sustainable path.	end-June	In progress
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	Done
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	In progress
Prepare menu of potential structural reforms	To aid the 2011 budget process, we will prepare a menu of possible structural reforms in key sectors (structural benchmark, end-October 2010).	end-October	In progress
Review debt restructuring scheme	Review performance of the debt restructuring scheme, in particular to assure costs are contained.	end-December	Measure abandoned by the authorities

Table 3. Latvia: Structural Benchmarks through end-December 2010

Structural Benchmarks	Motivation	Target date
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 preserve future sustainability of three pillars of pension system, 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 sustability: Anchor fiscal policy on a credible and sustainable path	end-June
Prepare a report on whether any legislative changes are necessary to allow credit institutions, their subsidiaries, and separated entities to deduct losses from debt write-downs against corporate income tax	Financial stability: Reduce non-performing loans. Growth: Enable new bank lending.	end-July
Engage a reputable and qualified independent advisor to assist with formulation of a transformation plan for MLB	Financial stability: Crucial to stem further erosion in the bank's value. Fiscal sustainability: limit the need for continued public recapitalization.	end-July
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 strategy will set out priorities for the sector within this reduced budget envelope.	end-September
Submit a transformation plan for MLB to the EC	Financial stability: Crucial to stem further erosion in the bank's value. Fiscal sustainability: limit the need for continued public recapitalization.	end-September
Parliamentary approval of revisions to our tax legislation to allow credit institutions to deduct losses from debt-write downs against corporate income tax	Financial stability: Reduce non-performing loans. Growth: Enable new bank lending.	end-September
Introduce a temporary one-year waiver for personal income tax liabilities resulting from debt write-downs	Financial stability: Reduce non-performing loans. Growth: Enable new bank lending.	end-September
Submit a Fiscal Responsibilty Law to Parliament	Fiscal sustainability: Anchor fiscal policy on a credible and sustainable path	end-September
Submit a report to Parliament on options for ensuring that the Fiscal Responsibility Law has a greater legal standing than other laws	Ensure fiscal sustainability.	end-September
Produce list of state-owned enterprises	Fiscal transparency and sustainability.	end-September
Prepare menu of potential structural reforms.	Fiscal sustainabiltiy: Preparation of a menu of possible structural reforms in key sectors will help achieve sustainable savings in the 2011 budget.	end-October
Produce strategy on state-owned enterprises	Improve fiscal transparency, reduce fiscal risks, potentially raise government revenues by spelling out which enterprises will be brought back under the budget, considered for privatization, or maintained as state-owned enterprises.	end-December

LATVIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

July 5, 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 July 5, 2010 signed by the Prime Minister, the Minister of Finance, the Chairwoman of the Financial and Capital Market Commission, and the Governor of the Bank of Latvia. 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:	
June 30, 2010 (performance criterion)	-506
September 30, 2010 (performance criterion)	694
December 31, 2010 (performance criterion)	141
March 31, 2011 (indicative target)	-281
June 30, 2011 (indicative target)	-449

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 March 31, 2010, foreign reserve assets thus defined amounted to 5,630 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 March 31, 2010, reserve liabilities thus defined amounted to 109 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 March 31, 2010, base money amounted to 1,465 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. As of March 31, 2010, net domestic assets of the BoL amounted to 445 million lats.

- ***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 definition of foreign reserve assets above. As of March 31, 2010, net foreign assets of the BoL amounted to 3,881 million lats (5,522 million euro).

4. As of March 31, 2010 the sum of Treasury liabilities to the IMF, the European Union, and other official creditors participating in the program over the program period, amounted to 3,931 million euro. Liabilities associated with the SDR allocation amounted to 140 million euro.

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 special sub-accounts of the Treasury 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:	
June 30, 2010 (performance criterion)	2,056
September 30, 2010 (performance criterion)	1,344
December 31, 2010 (performance criterion)	1,741
March 31, 2011 (indicative target)	1,960
June 30, 2011 (indicative target)	2,116

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 May 31, 2010, provided that net foreign assets of the BoL remain above base money. The outstanding amount on May 31, 2010 was zero.

7. The NIR targets will be revised up (and NDA targets revised down) for the full amount of any non-program external debt contracted by the government. For this adjustor, non-program 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:	
June 30, 2010 (performance criterion)	-353
Sept.30, 2010 (performance criterion)	-401
Dec. 31, 2010 (performance criterion)	-782
Cumulative adjusted primary cash fiscal balance from January 1, 2011:	
March 31, 2011 (indicative target)	-18
June 30, 2011 (indicative target)	-92

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 overall balance**, 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 overall balance 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 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 for the Second Review below L7.75 million per quarter, cumulated from January 1, 2010. This adjustor only applies to performance criteria through June 30, 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 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):	
June 30, 2010 (indicative target)	457
September 30, 2010 (indicative target)	654
December 31, 2010 (indicative target)	948
Wages and salaries (Cumulated from January 1, 2011):	
March 31, 2011 (indicative target)	197
June 30, 2011, (indicative target)	464

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 754 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 capturing 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-March 2010, 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 using 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, overnight and 7-day deposit facility amounts, 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