

## LETTER OF INTENT

Riga, December 18, 2008

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

Dear Mr. Strauss-Kahn:

1. Financial market strains in Latvia have intensified in past weeks as events in global markets have accentuated the existing challenges facing our economy. In response, the Government and the Bank of Latvia (BoL) have developed a comprehensive strategy to counter financing pressures in the near term, and put the economy on a sustainable footing in the long term. The support of the EU, under the balance of payment financing facility, together with bilateral and multilateral commitments demonstrates the international community's backing for our reform strategy. In this context, we request that the IMF support our program through a 27-month Stand-By Arrangement (SBA) in the amount equivalent to SDR1.521626 billion (1,200.02 percent of quota or €1.7 billion) covering the period December 2008 to March 2011.

2. **We have discussed with IMF Staff our economic program, which is outlined below.** Our main objectives are to (i) stem immediate liquidity pressures, (ii) restore long-term stability by strengthening the banking sector, correcting fiscal imbalances and adopting domestic policies that will improve competitiveness while maintaining our fixed (narrow-band) exchange rate, and (iii) strengthen the long-term structural performance of our economy. If successful, these measures would lay the groundwork for our ultimate economic policy goal of entry to the euro-area as soon as possible. We strongly believe that these goals can best be achieved by maintaining the current exchange rate peg and recognize that this calls for extraordinarily strong domestic policies supported by broad political and social consensus.

3. **We have already taken a number of measures that demonstrate our commitment to this program.** We have taken control of the second largest bank, Parex, and replaced its management. On December 11, the Saeima (parliament) approved a supplementary budget for 2009, which will cap the underlying general government fiscal deficit (excluding possible financial system support measures) at below 5 percent of GDP.

4. **The program will be monitored through quantitative performance criteria and indicative targets, structural performance criteria and structural benchmarks, and quarterly reviews (Table 1).** The attached Technical Memorandum of Understanding sets out specific quarterly targets that are to be observed under the SBA for net international reserves of the Bank of Latvia, net

domestic assets of the Bank of Latvia, the cash fiscal balance of the general government, and also the general government wage bill, as well as a requirement of non-accumulation of domestic and external debt arrears of general government (continuous performance criteria). The first review will take place on or after February 15, 2009, and the second review on or after May 15, 2009.

## **Recent economic performance and macroeconomic FRAMEWORK FOR 2008–09**

5. **Years of strong growth led to a sharp improvement in living standards, but have been accompanied by rising vulnerabilities.** Growth, which averaged 9 percent between 2000-07, the fastest in the EU, was driven by private consumption and investment in real estate and other non-tradable sectors. Rapid public expenditure growth added to demand and overheating during this period, while wage growth above productivity improvements exerted upward pressure on consumer price inflation and eroded competitiveness. The strength of import demand also led to current account deficits in excess of 20 percent of GDP in both 2006 and 2007, driving the gross external debt ratio to 135 percent of GDP. Meanwhile, the high level of short-term external debt has exposed Latvia to the risk of a sudden capital stop, and the indebtedness of the private sector (both domestic and external) is approaching levels that could be detrimental to long-term growth.

6. **The anti-inflation plan that we introduced in early 2007 represented a first step towards addressing the risks facing our country.** The taxation of real estate activity was broadened and new regulations compelled banks to be more circumspect in lending decisions. In 2007, for the first time in recent years, the budget recorded a surplus. Despite a welcome narrowing of the current account since then, competitiveness has deteriorated further and the stock of external liabilities has grown.

7. **Recent international financial market turmoil has magnified these risks, prompting the need for a further significant strengthening in policies.** The availability of external finance has fallen very sharply, due to global developments and downgrades to Latvia's sovereign credit rating. Parex Bank has suffered a significant outflow of deposits since September, compelling us to partially nationalize the institution last month and provide liquidity support. Other domestic banks and companies have found it difficult to rollover their international liabilities. While reductions in reserve requirements and associated intervention by the BoL have helped satisfy demand for foreign exchange, we still see a significant financing requirement emerging in the short term.

8. **In view of these uncertainties, our macroeconomic framework for 2009–2011 has been anchored on cautious assumptions.** A severe slowdown in output is already underway, and we expect weakness in the global economy, financial market deleveraging, and liquidity strains in neighboring countries to lead to a 5 percent contraction in output in 2009. Consumer spending is likely to fall sharply in response

to decelerating real wages, tighter credit conditions and rising unemployment, while investment activity is expected to contract. In 2010, we expect a further, more moderate decline in output. As demand slackens, there will be a very sharp fall in core inflation. Notwithstanding the rises in VAT rates discussed below, we expect headline inflation to fall to 2 percent by end-2010, which will help improve competitiveness.

9. **Gross external financing needs, which will be substantial in the coming two years, will be partially met by external assistance from multilateral and bilateral creditors.** Although the current account deficit will narrow to 5 percent by 2010 as imports subside, there will also be a sharp reduction in available capital inflows. Latvian banks and corporates are likely to have difficulties rolling over their borrowings. Relatively higher rollover rates on loans from foreign banks to their local subsidiaries, as well as substantial continued inflows of EU structural and cohesion funds should partially offset this. Nevertheless, we expect an external financing gap of €7.5 billion through 2011, which will be filled by the IMF, EU, World Bank and bilateral contributions.

10. **A gradual economic recovery will emerge over the medium term.** Once global deleveraging pressures have eased and Latvian banks have recapitalized, private external financing and domestic lending will resume. Rising inflows of EU grants will increase investment. The sharp slowdown in wage and price inflation will deliver a gradual improvement in competitiveness and eventually, taken together with global economic recovery, raise net exports. Weakness in disposable incomes and continued fiscal restraint will depress consumption, but moderate positive output growth should nonetheless resume from 2011.

## **Policies for 2009–2011**

11. **Our goals are ambitious, and we recognize that a very strong policy package will be required to deliver them.** As the objective of monetary policy must be to support the exchange rate, the burden of adjustment will fall primarily on fiscal and incomes policies. We are convinced that the medium-term fiscal consolidation outlined below will improve competitiveness and restore stability. It will be backed by complementary strategies in areas such as structural reform and debt restructuring. In the near term, however, there will be a significant focus on measures to restore confidence to the banking sector, including the stabilization of Parex.

### **Financial Sector Policies**

12. **Partially nationalizing and taking control of Parex represent the first steps towards effectively resolving the bank.** We have already installed a credible and competent new management, and suspended the previous owners from any executive role, and will ensure that the remaining minority shareholders do not benefit from the resolution of the bank. We also will introduce new legislation with a view to providing the legal means of ensuring full government control of the bank to enhance financial stability. The situation warrants close supervision. The new management

will promptly develop a resolution plan, consistent with minimizing losses to the state and depositors, considering all options and submit it to the FCMC (prior action). This is necessary to minimize contagion, disruption to the payment system, and to prevent further losses in deposits and international reserves. An international auditing firm will be hired to undertake a comprehensive audit (including an appraisal of past liquidity support) and due diligence assessment, paving the way to recapitalizing the bank to a level that would be sufficient to restore confidence. The rehabilitation process will include a clear exit strategy so that as large a share as possible of the bank's activities are returned swiftly to the private sector. The new management will seek firm commitments from external parties to renew Parex's syndicated funding in the near future.

**13. To restore confidence to the remainder of the banking system, we will develop a comprehensive bank resolution strategy, comprising the following elements:**

- To avert a recurrence of the unexpected recent developments in Parex, we will complete a focused examination of the banking system (structural benchmark for end-March 2009), to assess whether all banks are solvent and have sufficient liquidity. The work will be conducted by international audit firms (but paid for by the bank undergoing the assessment) and submitted to the FCMC.
- On the basis of this analysis, we will require viable banks that need capital increases to seek private restructuring via outside investors or mergers, or capital support from parent banks. We will also take any necessary measures to provide conditional financial support to these viable banks, in accordance with EU state aid rules. Public support terms and eligibility criteria should be set out in legislation and based on international best practice. We will also take all necessary measures to stabilize deposits in the banking system. We will publish details of this program, and put the recapitalization plan into effect by end-April 2009. We will consult with IMF Staff prior to equity injections.
- Foreign parent banks have recently pledged to maintain credit lines to their Latvian subsidiaries. The FCMC will enhance its existing daily liquidity monitoring by closely tracking foreign banks' exposure in Latvia. In this context, we will strengthen our existing contacts with home supervisors of foreign banks, and share information regarding foreign banks under their supervision.
- We stand ready to take full advantage of our existing supervisory powers under Pillar II of Basel II to require additional capital and enhanced liquidity positions where warranted by banks' risk profile.
- We are committed to a fair and equitable treatment of depositors and creditors in the Latvian banking system. Under our deposit insurance system, we are committed to respect the rights of all depositors – both resident and non-

resident. In particular, we will remove the partial freeze limiting withdrawal amounts from large non-commercial private deposits in Parex as conditions stabilize. The new management we have installed in Parex is actively engaging the affected depositors to settle their limited arrears arising from this measure and we will maintain good faith efforts to facilitate the settlement of such depositors claims. In the meanwhile, we request temporary Fund approval of the exchange restriction in line with Fund policy, on the basis that it has been imposed for balance of payments reasons, it is temporary and is non-discriminatory.

14. **We will also strengthen our crisis management capacity.**

- The FCMC will enhance its capacity to monitor the financial system by monitoring (bank by bank) assets and liability maturity profiles, including the level of deposits, liquid assets, group exposures, interbank transactions, foreign credit lines, debt rollovers, asset quality and bank capital. The BoL will share information on liquidity support to banks with the FCMC. If financial conditions in any bank appear to deteriorate, the FCMC will stand ready to initiate on-site inspections. The BoL and FCMC will cooperate closely in a situation of financial stress and share all necessary information including the items mentioned above.
- Support from the international community will enable us to provide emergency liquidity assistance (ELA) to solvent banks. This will be facilitated by adopting operational guidelines to clarify procedures for inter-agency coordination, cross-border arrangements and the treatment of collateral by end-December 2008 (structural benchmark). We will consult with IMF Staff prior to further provisions of ELA.
- By the time of the first review, we will review the regulations on emergency liquidity support, and if necessary adopt revised regulations, with the aim of ensuring they are (i) consistent with international practice and (ii) provide for adequate safeguards including, for example, appropriate triggers for supervisory intervention and internal control procedures (structural benchmark for end-January 2009). Fund staff will support the authorities in completing this task and in reviewing the early experience of liquidity support provision.
- To promote inter-agency communication, the Domestic Standing group will meet regularly to establish and maintain a common understanding of financial stability responsibilities among the government, BoL and the FCMC. We commit to a regular exchange of information and discussion of financial stability issues.
- The FCMC will be given adequate additional resources to effectively carry out its tasks.

**15. The banking laws will be amended to allow the FCMC, BoL and the Ministry of Finance to take timely and effective actions to restore financial stability in systemic crises and to enhance the special bank insolvency regime by end-June 2009 (structural benchmark).**

- The amended law will include an authority to empower emergency liquidity assistance against a wide range of appropriate collateral, implement full takeovers of insolvent banks (preferably through bridge banks), and guarantee interbank liabilities.
- The special bank insolvency regime will be enhanced to allow timely bank intervention (before capital falls below the regulatory minimum). The law will authorize the FCMC to appoint a temporary administrator replacing the bank's management board without court approval, and at an earlier stage of a bank's decline. The law will authorize tools to make troubled bank resolution more effective such as: purchase and assumption transactions, sale of part or the whole bank, bridge banks, and reduction in the value of existing shareholders' equity to absorb losses incurred in the resolution process.
- We will put in place mechanisms to ensure that reimbursements under the deposit guarantee fund (DGF) are fast and automatic (through an agent bank). We will also give the DGF temporary powers to increase insurance premia after a payout.

#### **Private Debt Restructuring**

**16. We recognize the need for a comprehensive strategy to help ensure sustainability of the private-sector's domestic and external debt burden.** A large share of the external debt has been contracted by banks which have lent to local corporates and households, whose debt service capacity is likely to suffer in the coming slowdown. While voluntary restructurings will be facilitated to the extent possible, insolvency law tools could also play a role in ensuring effective burden-sharing between the banks and private-sector debtors. With technical assistance from the IMF, we will develop a comprehensive private debt restructuring strategy by end-April 2009 (structural benchmark).

**17. The banking sector will play a central role in our strategy.** Capital injections, including from foreign parent banks, will be a primary measure to maintain the solvency of the Latvia banking system. We will align tax treatment to facilitate bank creditors maintaining longer-term support of viable banks, for instance through debt-for-equity swaps. We will seek international assistance to assess by end-March 2009 the merits of establishing an independent asset management entity to take over bad assets from banks and restructure nonperforming loans to maximize recovery over time in a manner that provides initial relief to corporate and household debtors (recognizing the complexities of funding, selection and pricing of assets).

**18. We will amend the Insolvency Law in order to facilitate orderly and efficient debt restructurings by end-June 2009 (structural benchmark).** The

corporate insolvency regime will be refined to facilitate workouts between viable enterprises and their creditors. This will include according priority status to new financing by creditors, clarifying class voting by creditors and expedited court approval of rehabilitation plans. We will also assess the effectiveness of the personal bankruptcy framework with a view to rehabilitating household debtors, including by lowering administrative costs and involving participation of creditors in the proceedings. Furthermore, we will continue to encourage loan modifications to avoid unwarranted foreclosures, while addressing inefficiencies in foreclosure procedures that hinder debt resolution.

### **Monetary and Exchange Rate Policy**

19. **The fixed (narrow band) exchange rate of the lats will remain the anchor for monetary policy until we adopt the euro.** We believe that a pegged exchange rate has served us well over the past 15 years, and that it continues to underpin stability in our increasingly open and euroized economy. It also provides a bridge towards membership of the Eurozone, which will lower risks for banks and the private-sector, as well as promoting long-term growth. Latvia already meets some of the Maastricht criteria. However, determined efforts and a clear strategy will be required to achieve our ambitious goal of meeting the Maastricht criteria as soon as possible, if feasible by 2012.

20. **Maintaining the credibility of the peg necessitates a conservative approach to monetary policy.** We will maintain existing quantitative limits on foreign currency swaps and main refinancing operations, and ensure that base money remains adequately backed by the Bank of Latvia's net international reserves. Further changes in minimum reserve requirements will be undertaken only after consultation with IMF Staff.

### **Fiscal Policy**

21. **An immediate and sustained fiscal consolidation will send a strong signal of our commitment to restore stability and prepare for euro adoption.** Our strategy is anchored in a medium-term fiscal framework that will lower the deficit to the Maastricht level of 3 percent of GDP by 2011. This will require a structural adjustment of 6 percentage points GDP from 2008 to 2011, to be achieved through comprehensive structural reforms implemented simultaneously at all levels of government. However, social safety nets will be preserved to protect the poor from adverse economic conditions, while investment spending will be maintained at high levels so as not to impair long-term growth prospects; EU-financed projects will be ringfenced. Our new approach thus represents a sustainable fiscal consolidation with clearly articulated long-term objectives, which should ensure strong public support, enhance confidence at home and abroad, and spur private-sector growth.

22. **We have already taken a number of measures in support of these goals:**

- In recent months we have controlled budget execution without creating arrears, prioritized essential expenditures, secured tax collection, and pooled available cash. This will allow us to cap the general government deficit (excluding bank restructuring costs) at around 3 percent of GDP in 2008.
- We are also acting to prevent budget imbalances from emerging. On December 11 Parliament adopted a supplementary budget for 2009 that takes into account the recent deterioration in the economic outlook and will cap next year's general government fiscal deficit at below 5 percent of GDP (Prior action), implying an adjustment of around 7 percentage points of GDP compared with the budget passed in November.

23. **The projected decline in government revenue as a share of GDP will be partially offset by tax increases.** The main measures, which were included in the supplementary budget law and should raise approximately 2½ percent of GDP, are as follows:

- From 2009, increase the standard VAT rate by 3 percentage points, to 21 percent, and the reduced rate from 5 percent to 10 percent. The list of items eligible for the reduced rate will be significantly reduced;
- From 2009, increase excise on fuel, alcohol, non-alcoholic beverages, and coffee;
- Also from 2009, partially reverse the recently adopted increases in non-taxable allowances under the personal income tax (PIT) law, but reduce the PIT rate by 2 percentage points to 23 percent;
- From 2010, introduce a 10 percent tax rate on all capital income (interest, dividends, royalties, rental income, realized nominal capital gains on shares, realized nominal capital gains on immovable property). This will be applicable to all capital gains on real estate transactions unless minimum times of continuous ownership (five years) and residence (one year) are fulfilled; and
- From 2010, increase real estate and property taxes, which are currently significantly below the OECD average; this will be achieved by removing exemptions in order to broaden the tax base;
- Increase non-tax revenues. User fees will be increased. Dividend pay-out rates by state owned companies will rise from 27-35 percent at present to 50 percent;
- We will seek to improve tax administration with international assistance, although we have not factored significant improvements in collection rates into our projections before 2010.

24. **In 2009 we will cap expenditures at just below 40 percent of GDP.** We estimate that this will necessitate cuts of 4½ percent of GDP over and above what was already factored into the originally adopted central government budget as well as envisaged local government budgets. This will be achieved by (i) approximately 15 percent cuts in compensation of all public sector employees with effect from January 1, 2009; (ii) a pension freeze, (iii) rationalizing subsidies (excluding social support), and outlays on goods and services. There will be no reductions in social support beyond the impact of the wage reduction (which will lower indexed benefits). Moreover, we will seek to improve the targeting of all social safety nets within a social spending budget that increases by 1 percentage point of GDP relative to 2008. However, measures to restructure the banking sector including recapitalizing banks, covering the liabilities of the deposit guarantee fund and providing various liquidity instruments, may entail significant additional fiscal costs.

25. **The 2009 budget has been revised to reflect this lower level of spending.** The supplementary budget determines total spending appropriations for the consolidated central government that are consistent with the targeted fiscal deficit of 4.9 percent of GDP, and sets aside 10 percent of state basic budget appropriations (excluding those relating to EU-financed projects, debt service and payments to the EU budget) in a contingency reserve held by central government. We will submit to Parliament a second supplementary budget law for 2009 to define further the allocation of spending appropriations among spending agencies and ministries and identify clearly programs that should be rationalized by March 31, 2009 (structural performance criterion). The contingency reserve will be reduced to 5 percent of appropriations once the second supplementary budget has been passed.

26. **Equivalent measures will be taken to ensure that local governments match the central government's belt-tightening measures.** We will sign a protocol (prior action) that stipulates a 15 percent reduction in local government employees' compensation. Local governments will be barred from borrowing except for EU-financed projects and intra-year liquidity needs, and will not receive any central government guarantees for the duration of the program. We will implement fully and without delay the State Audit Office recommendations of September 2008 regarding the assessment of implementation of the 2007 budget and budgets of local governments.

27. **To ensure that fiscal targets are met, we will adopt a decision of the cabinet of ministers to reform controls on budget execution by end-December 2008 (structural benchmark).** The decision will stipulate that appropriations from the central basic budget contingency reserve will be released progressively over the year subject to the objective of meeting the performance criteria and benchmarks set out in the Technical Memorandum of Understanding. The cabinet decision will require all spending ministries and institutions to submit weekly cash-flow projections and proposals for new commitments. Local governments will be required to submit similar reports every fortnight. A committee of finance ministry and Treasury officials will meet weekly to review a consolidated report and propose recommendations to the

Prime Minister, who will decide on the level of new commitments to be authorized in the following week. If there are revenue shortfalls, commitments will be immediately reduced to cover only obligatory expenditures. To ensure that expenditure appropriations represent hard ceilings, privatization receipts and other revenues from asset disposals will be treated as financing items.

**28. We are planning further comprehensive structural reforms to achieve a sustainable fiscal position:**

- We will seek assistance from the IMF, EU and bilateral donors to strengthen public financial management in the first quarter of 2009. The goals will be (i) to strengthen the budget formulation process, (ii) improve the Ministry of Finance's spending controls (especially over the wage bill at the general government level), (iii) make the medium-term budget framework operational, (iv) to increase transparency and external oversight in the budget, improve fiscal decentralization, and (v) to adopt a PPP law in accordance with international standards.
- We will put fiscal discipline on a permanent sustainable path, with assistance from IMF and EU staff, by amending the current Budget and Financial Management law to strengthen provisions on financial responsibility, transparency and accountability. These amendments will aim to keep public debt at an appropriate level, set expenditure ceilings, avoid procyclicality in fiscal policy and ultimately allow automatic stabilizers to operate fully by end-June 2009 (Structural benchmark).
- We have approached the World Bank to seek technical assistance on the comprehensive reforms of the education, civil service, state administration and the healthcare systems that we will launch in 2009. Once completed, these could eventually deliver annual savings of about 2 percent of GDP, including due to staff savings that will commence in 2010.

**29. Additional consolidation measures will be needed to attain the deficit target of 3 percent of GDP by 2011.** This will include further increasing the VAT rate, additional reductions in public employment and wages, and (from 2010) indexing pensions only to inflation. Attaining the deficit target could be challenging given the considerable uncertainties about the medium-term outlook, and therefore all policy options will be kept under review.

### **Income Policies and Structural Reform**

**30. We are strongly committed to wage restraint, which we see as the most effective instrument for restoring competitiveness and correcting external vulnerabilities.** We recognize that wages grew too rapidly during the past boom, and as noted above, intend to cut average compensation (wages and bonuses) in the entire public sector by an additional 15 percent in 2009 (relative to the originally adopted budget), with further reductions in 2010-2011. We will also secure commitments from

the boards of all publicly owned enterprises to deliver the same levels of reduction in compensation. Working with our partners in the National Tripartite Co-operation Council, we will also endeavor to ensure that the private sector follows the strong example that has now been set by budgetary institutions.

31. **We will reform wage-setting mechanisms to ensure that employee compensation evolves in line with the constraints imposed by a fixed exchange rate.** The National Tripartite Co-operation Council will establish a Committee to Promote Wage Restraint by end-January 2009 (Structural Benchmark). Its mandate will be to (i) monitor the implementation of measures to reduce nominal wages (and bonuses) in the public and private sectors, and (ii) issue recommendations to ensure that the deterioration in competitiveness is corrected and that compensation evolves in the future in line with the constraints imposed by the fixed exchange rate. The committee will prepare a monthly report that will be discussed by the full National Tripartite Co-operation Council, presented to the Prime Minister and Parliament, and published.

32. **We will support the rebalancing of the economy through vigorous structural reforms.** To this effect we will form a national committee to examine Latvia's long-term strategic options. In any event, we will press ahead with objectives set out in the National Lisbon Program, including measures to promote the development of new products and technologies, increase labor market flexibility, and facilitate regional mobility, in general aiming for a substantial strengthening of the business environment, thereby also ensuring that Latvia's ability to attract inward investment is enhanced. Administrative burdens on the private sector will be reduced significantly, particularly those hampering small and medium-sized enterprises. We will also take a number of measures to promote exports, including streamlining reimbursements of overpaid VAT, and increasing the availability of risk capital and guarantees by launching a holding fund financed by the European Investment Fund (EIF).

## IMF Arrangement

33. **We believe that the policies described in this letter will achieve the goals of our economic program:** maintenance of the exchange rate peg; macroeconomic stability; and euro adoption. Nevertheless, we stand ready to take additional measures to keep the program on track if required. We will consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in this Letter, in accordance with the IMF's policies on such consultation, and supply such information as the IMF requests on policy implementation and achievement of program objectives.

34. **We recognize the importance of completing a safeguards assessment by the first review of the SBA.** In this regard, the Bank of Latvia will provide the information required to complete the assessment by the first review and receive a safeguards mission from the IMF as necessary. All long-term funds provided under

the program will be disbursed to the government of Latvia and held in an account at the Bank of Latvia.

**35. 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,

Ivars Godmanis  
Prime Minister

Atis Slakteris  
Minister of Finance  
Latvia

Ilmārs Rimšēvičs  
Governor of the Bank of

Irēna Krūmane  
Chairwoman  
Financial and Capital Market Commission

Table 1. Latvia: Prior Actions, Performance Criteria, and Structural Benchmarks for 2008-09

**Prior actions**

1. The management of Parex bank to develop a resolution plan considering all options for the bank, and submit it to the FCMC. Attachment, Para. 12
2. Parliament to adopt a supplementary budget for 2009 with a general government deficit at below 5 percent of GDP. Attachment, Para. 22
3. The government will sign a protocol that stipulates a 15 percent reduction in local government employees' compensation. Attachment, Para. 26

**Quantitative performance criteria and indicative targets**

	Performance criteria		Indicative targets		
	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
1. Floors on the net international reserves of the Bank of Latvia. (net of government foreign liabilities resulting from program financing; in million euros)	2,103	737	-507	-1,128	-1,531
2. Ceilings on the net domestic assets of the Bank of Latvia. (including government foreign liabilities resulting from program financing; in million lats)	951	1,434	2,501	2,656	2,928
3. Floors on the adjusted cash fiscal balance of the general government (in million lats).	-894	-305	-649	-893	-1,282
4. Ceiling on the general government wage bill (in million lats).	1,248		Indicative targets		
		214	490	660	884

**Continuous performance criteria**

- Non-accumulation of domestic arrears by the general government.  
Non-accumulation of external debt payments arrears by the general government.

**Structural performance criterion**

- Submit a second supplementary budget law for 2009 to Parliament to define the allocation of total spending appropriations among spending agencies and ministries, by end-March 2009. Attachment, Para. 25

**Structural benchmarks**

1. Initiate a focused examination of the banking system by international audit firms, to ensure that banks are solvent and have sufficient liquidity; by end-March 2009. Attachment, Para. 13
2. Adopt operational guidelines for the provision of emergency liquidity assistance (ELA) to clarify procedures for inter-agency coordination, cross-border arrangements and the treatment of collateral; by end-December 2008. Attachment, Para. 14
3. Review regulations on emergency liquidity support, and if necessary adopt revised regulations, with the aim of ensuring they are (i) consistent with international practice and (ii) provide for adequate safeguards by end-January 2009. Attachment, Para. 14
4. Amend the banking laws to allow the FCMC, BoL and the Ministry of Finance to take timely and effective actions to restore financial stability in systemic crises and enhance the special bank insolvency regime; by end-June 2009. Attachment, Para. 15
5. Develop a comprehensive debt restructuring strategy; by end-April 2009. Attachment, Para. 16
6. Amend the Insolvency Law in order to facilitate orderly and efficient debt restructurings; by end-June 2009. Attachment, Para. 18
7. Adopt a decision of the cabinet of ministers to reform controls on budget execution; by end-December 2008. Attachment, Para. 27
8. 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; by end-June 2009. Attachment, Para. 28
9. Establish a committee to promote wage restraint; by end-January 2009. Attachment, Para. 31

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

December 17, 2008

1. This Technical Memorandum of Understanding (TMU) defines the variables subject to quantitative targets (performance criteria and indicative targets) established in the letter dated December 17, 2008 from the Prime Minister, the Minister of Finance and the Governor of the Bank of Latvia, and 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 that prevailed on November 28, 2008. In particular, the exchange rates for the purposes of the program of the Latvian Lat (LVL) to the euro is set at LVL 0.702804 = €1, to the U.S. dollar at LVL 0.544 = \$1, and to the Japanese yen at LVL 0.00571 = 1 JPY, as shown on the website of the Bank of Latvia (BoL).

### Floor on Net International Reserves of the BoL

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	(in million euros)
Outstanding stock:	
November 30, 2008	3,368
Floors on level of NIR:	
December 31, 2008 (performance criterion)	2,103
March 31, 2009 (performance criterion)	737
June 30, 2009 (indicative target)	-507
September 30, 2009 (indicative target)	-1128
December 31, 2009 (indicative target)	-1,531

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3. For the purpose of the program, net international reserves (NIR) of the BoL are defined as 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.
4. Foreign reserve assets of the BoL are defined as all 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 November 30, 2008, foreign reserve assets thus defined amounted to 3,618 million euro.

5. Foreign reserve liabilities of the BoL are defined as 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 November 30, 2008, reserve liabilities thus defined amounted to 250 million euro.

6. As of November 30, 2008 the sum of Treasury liabilities to the IMF, the European Union and other official creditors participating in the program amounted to 0 billion euro.

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

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	(in million lats)
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Outstanding stock:	
November 30, 2008	-99
Ceiling on level of NDA:	
December 31, 2008 (performance criterion)	951
March 31, 2009 (performance criterion)	1434
June 30, 2009 (indicative target)	2,501
September 30, 2009 (indicative target)	2,656
December 31, 2009 (indicative target)	2,928

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7. For the purpose of the program, 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.

8. Base money is defined as currency in circulation (outside banks), vault cash of banks, and required and excess reserve deposits of financial institutions in lats and in foreign currency held at the BoL, or at the BoL accounts abroad (excluding financial sector funds deposited in the BoL's deposit facility and in term deposits in the BoL). As of November 30, 2008, base money thus defined amounted to 2,268 million lats.

9. Net foreign assets of the BoL are defined as the difference between the BoL's foreign reserve assets and the BoL's foreign reserve liabilities as defined in paragraphs 2 and 3 respectively, plus those foreign reserve assets of the BoL that were excluded from the definition in paragraph 2. As of November 30, 2008, net foreign assets of the BoL amounted to 2,367 million lats.

10. The above ceilings are based on the assumption that all program related financing will be given to the Latvian government and will be deposited in the government's account in the BoL.

11. 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.

### Adjustor

12. The NDA ceiling for end-December 2008 will be adjusted downwards by 200 million lats, if the BoL's recent foreign exchange swaps with foreign central banks are not closed by the end of 2008.

### Floor on the Adjusted Cash Fiscal Balance of the General Government

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	(in million of lats)
Adjusted cash fiscal balance in 2007	-362
Cumulative adjusted cash fiscal balance from January 1, 2008:	
December 31, 2008 (performance criterion)	-894
Cumulative adjusted cash fiscal balance from January 1, 2009:	
March 31, 2009 (performance criterion)	-305
June 30, 2009 (indicative target)	-649
September 30, 2009 (indicative target)	-893
December 31, 2009 (indicative target)	-1,282

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13. The general government includes: (i) the central government, including all ministries, agencies and institutions attached thereto, as defined in the basic budget; (ii) the social security fund (first pillar), as described in the special budget; (iii) the municipalities, regional governments and their special budgets, 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.

14. The adjusted cash fiscal balance of the general government is defined as net government lending/borrowing, in cash and excluding bank restructuring costs (¶13), plus E.U. project grants (reimbursements and advances). This criterion will be monitored and reported based on financing information on a monthly basis, and reconciled with revenue and expenditure reports as soon as those become available, at the latest 30 days after the end of each month.

15. E.U. financed expenditure will be reported on a monthly basis, distinguishing between subsidies and transfers and capital expenditure, and between central and local

government. Some E.U. financed expenditure may be reallocated from subsidies (excluding social support) to capital expenditure over the course of the fiscal year.

16. For the purpose of the program, the cash fiscal balance of the general government excludes bank restructuring costs, including inter alia: loans to financial institutions and investments in equity of financial institutions (required recapitalization); unrequited recapitalization; and purchase of troubled assets. However, any financial operation from the general government to support banks, including the emission of guarantees or the provision of liquidities, will be immediately reported to IMF staff.

17. Consistent with the NDA ceilings in section B, the government will deposit all program related financing in its account in the BoL.

### **Adjustor**

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

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

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	(in million of lats)
Wages and salaries in 2007	1,060
Wages and salaries (ceiling):	
Cumulated from January 1, 2008	
December 31, 2008 (indicative target)	1,248
Cumulated from January 1, 2009	
March 31, 2009 (indicative target)	214
June 30, 2009 (indicative target)	490
September 30, 2009 (indicative target)	660
December 31, 2009 (indicative target)	884

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

### **Continuous Performance Criterion on Non-accumulation of Domestic Arrears by the general government**

20. General government domestic arrears, 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, will be kept at zero for the duration of the program. This performance criterion will apply on a continuous basis.

### **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.

### **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
<b>To be provided by the Ministry of Finance</b>	
Consolidated central (basic and special budgets), local and general government operations based on the IMF fiscal template	Monthly, within four weeks of the end of each month
Data on E.U. project grants (reimbursements and advances), capital expenditures and subsidies covered by E.U. advances or eligible for E.U. reimbursement on E.U.-supported projects specifically agreed with the E.U.	Monthly, within three weeks of the end of each month
Consolidated central and general government bank restructuring operations	Daily, by end of next working day
Privatization receipts received by the general government budget (in lats and foreign exchange, and payments in governments bonds)	Monthly, within four weeks of the end of each month
Information on debt stocks and flows, domestic and external (concessional and non concessional), by currency, and guarantees given on new debt, contracted by the (i) consolidated central, local and general governments and (ii) public enterprises	Monthly, within four weeks of the end of each month
Information on new contingent liabilities, domestic and external, of the consolidated central, local and general governments	Monthly, within four weeks of the end of each month
Data on general government arrears, including to suppliers	Monthly, within four weeks of the end of each month
Data on operations of extrabudgetary funds	Monthly, within four weeks of the end of each month
Data on the stock of the general government system external arrears	Daily, with a seven days lag
<b>To be provided by the Bank of Latvia</b>	
Balance sheet of the BoL (in both program and actual exchange rates)	Monthly, within three working days of the end of each month
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
Data on components of the NIR of the BoL (in both program and actual exchange rates)	Weekly, within one week of the end of each week
Currency operations, including government foreign receipts and payments and breakdown of interbank market operations by currencies (interventions)	Daily, by end of next working day
Foreign exchange rate data	Daily, by end of next working day
Volume of foreign exchange lats trades	Monthly (weekly for a sample of large banks), within one week of the end of each week
Projections for external payments of the banking sector falling due in the next four quarters, interest and amortization (for medium and long-term loans)	Quarterly, within four weeks of the beginning of the year
Projections for external payments of the corporate sector falling due in the next four quarters interest and amortization (for medium and long-term loans)	Annually, within three months after the end of the second quarter
The stock of external debt for both public and private sector	Monthly, within four weeks of the end of each month for the public and the banking sector; quarterly, within three months of the end of each quarter for total external debt

The BoL will continue to provide balance of payments data in electronic format.	Monthly, within six weeks of the end of each month
<b>To be provided by the Financial and Capital Markets Commission</b>	
Daily deposit monitoring bank by bank in the agreed format	Daily, by end of next working day
Daily detailed deposit monitoring in Parex Bank in the agreed format	Daily, by end of next working day
Banking system monitoring indicators in the agreed format (liquidity, credit quality, summary capital adequacy, simplified balance sheet and income statements)	Monthly, within four weeks of the end of each month
Detailed capital adequacy reporting in the agreed format	Quarterly, within four weeks of the end of each quarter
Commercial banks' balance sheets (bank-by-bank)	Quarterly, within four weeks of the end of each quarter
Commercial banks' income statements (bank-by bank)	Quarterly, within four weeks of the end of each quarter

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