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Republic of Latvia: Stand-By Arrangement—Interim Review Under the Emergency Financing Mechanism

In the context of the Stand-By Arrangement for the Republic of Latvia under the Emergency Financing Mechanism, this paper on the Stand-By Arrangement—Interim Review Under the Emergency Financing Mechanism for the Republic of Latvia was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on February 23, 2009. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Republic of Latvia or the Executive Board of the IMF.

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REPUBLIC OF LATVIA

Stand-By Arrangement—Interim Review Under the Emergency Financing Mechanism

Prepared by the European Department in consultation with other departments

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February 23, 2009

Summary. Financial market pressures have eased somewhat since program approval: deposit outflows have slowed and the exchange rate has moved off the weaker end of its band. However, new risks are emerging. The recession has intensified, facilitating external adjustment but lowering tax revenues. Though sizeable, fiscal policy adjustment has fallen short of commitments in the program, due to weaknesses in implementation and difficulties reducing local government expenditure. Political uncertainty has increased, resulting in the resignation last week of Prime Minister Godmanis.

Discussions. This report draws on a number of missions and contact with the authorities from headquarters, including with President Zatlers; Prime Minister Godmanis; Minister of Finance Slakteris; Governor Rimšēvičs; Chairwoman of the Financial and Capital Market Commission Krūmane; Head of the State Treasury Āboliņš; senior officials; the National Tripartite Commission; and representatives of the financial and business communities.

- The **first review** mission started discussions in Riga February 17.
- **Outreach**. January 12–14, Christoph Rosenberg (EUR, mission chief) and Simonetta Nardin (EXR) conducted outreach focused on explaining the program to a wide variety of stakeholders, and joined the authorities' discussions with the European Commission on a memorandum of understanding for its balance of payments loan.
- **Financial sector**. January 23–27, Michaela Erbenova (MCM, head), David Parker (MCM), Wouter Bossu (LEG) and Carl Lindgren (MCM expert), conducted a technical assistance mission on bank resolution, in cooperation with the Sveriges Riksbank.
- **Revenue administration**. January 26–February 4, Graham Harrison (FAD, head) and François Michel (FAD) conducted a mission to identify immediate actions available to the authorities to secure tax revenues.
- A **safeguards assessment** mission visited Riga from February 9–13.

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I. Introduction

1. **On December 23, 2008 the Executive Board approved a 27-month Stand-By Arrangement for Latvia under the Emergency Financing Mechanism** (EFM) in an amount equivalent to SDR 1.5 billion (about €1.7 billion, 1,200 percent of quota). A first purchase in an amount equivalent to SDR 535 million was made after the Board approval of the arrangement. The EFM calls for a review of the initial policy response and reaction of markets within two months of approval, which is set out in this document.

II. Recent Developments and Reaction to the Program

A. Macroeconomic Developments

2. **The recession intensified in the final quarter of 2008 (Figure 1)**. Retail sales fell by 16 percent year on year, and car sales contracted 60 percent. Unemployment increased to 7½ percent in mid-January, from 5 percent a year earlier. Manufacturing output fell 15 percent year on year, on weak global demand. Consistent with the above, preliminary official data suggest GDP fell 10.5 percent year on year in the fourth quarter.

3. **As a result, inflation is falling faster than expected.** The CPI fell ½ percent in both November and December. Year-on-year inflation fell below 10 percent in January, and core inflation dipped below 2 percent (annualized, 3-month moving average).

4. **Competitiveness gains are underway, but are being somewhat eroded by trading partner depreciation**. The CPI-based real effective exchange rate has depreciated by 4½ percent from July until December, as inflation remained below many partner countries. And a sharp deceleration in wage growth appears underway according to proxies for wages and unit labor costs (e.g., social security receipts and construction costs). This is corroborated by press reports and anecdotal evidence—especially in the export sector. However, since December depreciations by some trading partners have partially offset these gains, resulting in a 3 percent appreciation of the nominal effective exchange rate. A real depreciation is still expected for 2009 as a whole, however, especially in terms of relative unit labor costs.

5. **The trade deficit is narrowing as expected.** Weak global demand—especially from the EU—resulted in a 17 percent year-on-year fall in exports in November. However, imports also fell more sharply than anticipated, by 23 percent. Service receipts continued to grow in November, though are also likely to decline in December.

6. **All end-2008 monetary targets were comfortably met**. Gross international reserves increased as expected in light of external support from the Fund and a bridge loan from Nordic partner countries as well as a degree of financial sector stabilization. On January 20 the European Council supported the Commission's proposal to provide medium-term financial assistance for Latvia (€ 3.1 billion in total; the first € 1.0 billion should be disbursed this week).

7. **However, the end-2008 fiscal deficit performance criterion was almost certainly missed.** Reliable end-December data are not yet available, but preliminary estimates suggest an overrun of about ½ percent of GDP.

- Part of this overrun reflects fiscal underperformance that predates the approval of the arrangement, but that had not yet become apparent in the data then available. In particular, tax revenues fell sharply as the recession intensified in the final weeks of 2008 and net collection weakened (Figure 2).

- However, expenditure restraint in the central government was offset by larger-than-projected outlays in local government, in particular on wages. The general government wage bill overshot its indicative target by 2 percent (and the supplementary budget's estimate by 5 percent).

The authorities' failure to meet the program's end-2008 fiscal performance criterion thus partly reflects some fundamental weaknesses in fiscal institutions. This includes the challenges of accurately projecting local government spending (given that part of it is mandated by central government, and so may be difficult to cut) and controlling it too (as local governments may want to run down bank deposits they have accumulated through past surpluses). Finally, an exemption from wage cuts for government workers with low incomes will make it difficult to achieve the agreed wage adjustment.

B. Financial Sector Developments

8. **The reaction of financial markets and depositors to the program has been broadly positive (Figure 3)**. Non-resident deposits initially stabilized, aided by continuing partial restrictions on deposit withdrawals at Parex, but also due to confidence effects. However, there have since been further outflows due to uncertainty surrounding Parex (see below). There has been only one small intervention by the central bank in the foreign exchange market to date in 2009, and the exchange rate has reached its central parity. However, the Treasury has intervened by selling foreign exchange deposits for domestic currency in the open market. Money market rates have fallen slightly. While CDS and Eurobond spreads initially declined, they rose again on weak global developments and a downgrade of the sovereign by Moody's in January.

9. **However, banks still face difficulties and have begun to tighten credit.** Provisions for non-performing loans increased four-fold through end-2008, to just over 2 percent of total loans; 3½ percent of loans are now more than 90 days overdue (from ¾ percent a year ago). Bank profits fell 80 percent in 2008, though all banks except Parex and three small start-ups made money (excluding Parex, total profits fell by 55 percent). Private-sector credit dropped in absolute terms in November and December, with year-on-year growth falling to 12 percent.

10. **Parex's new management has made progress stabilizing the bank and preparing for its eventual resolution.** Discussions with large non-resident depositors on extending the term of their deposits seem to be making progress. Deposit outflows have slowed, albeit helped by continuing restrictions, improving the bank's liquidity position. A comprehensive, independent due diligence has been completed and is being used to determine the optimal resolution strategy. Meanwhile, the EBRD will complete its own due diligence shortly, and is considering taking an equity stake if their preliminary assessment that the bank is solvent is confirmed.

11. **Dealing with Parex's outstanding syndicated loans presents a key challenge**. Both loans (€ 775 million in total) have been in technical default since November 2008. While lenders have not yet accelerated the loans, the first loan (€ 275 million) matured on February 19, 2009. Parex management tabled an offer to repay 20 percent of the principal upfront, with the balance deferred until 2010–12 (albeit with a government guarantee) for both loans, compared with program projections of a 40 percent rollover rate. Negotiations are continuing. A number of other Latvian banks will find it challenging to roll over maturing syndicated loans.

12. **Other structural reforms in the banking sector are underway:**

- The government, with technical assistance from the Fund, is developing the legal tools to allow the orderly resolution of banks and improve supervisory intervention tools. A package of measures is expected to pass parliament by mid-February

- The Bank of Latvia adopted a new regulation on the provision of emergency liquidity assistance, and should fulfill both the end-December and end-January benchmarks. The regulation has been amended to make access to ELA contingent on supervisory action and remedial measures to restore liquidity.

- Meanwhile, targeted examinations of all banks' liquidity, solvency and internal capital setting procedures under Pillar II of Basel II are underway. Examinations are paying special attention to problem loan portfolios, such as real-estate related loans. Results are expected in time to fulfill the end-March benchmark.

C. Political Developments

13. **Political uncertainty has increased, with the resignation on February 20 of Prime Minister Godmanis.** The governing coalition has been blamed for Latvia's economic difficulties, with mass demonstrations taking place on January 13. President Zatlers is carrying out discussions with the major political parties with the aim of forming a new government shortly. Prime Minister Godmanis stays on as caretaker prime minister in the interim. However, even if a new government is created, municipal elections in June will limit

its immediate room for maneuver, and there remains the possibility of early parliamentary elections.

III. Staff Appraisal

14. **Program implementation is proving challenging, especially in the fiscal area, while sharper-than-expected adjustment presents new risks and challenges**.

- **Internal adjustment to restore competitiveness appears underway**. Private sector wage reductions seem to be taking place. Public sector wage reductions are being implemented, though local governments in particular will need to strengthen implementation.

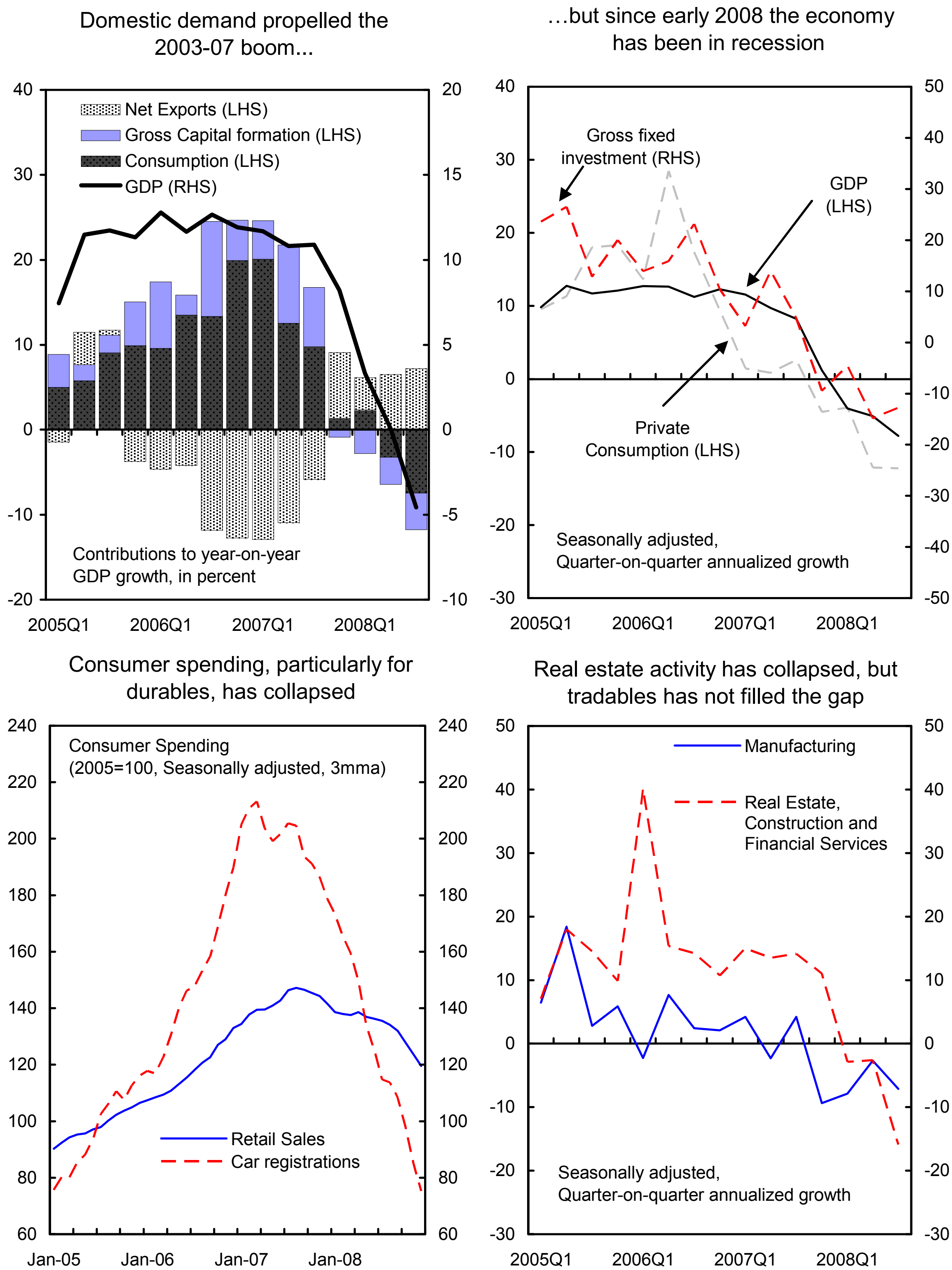
- **However, meeting the fiscal targets will likely prove extremely challenging**. The depth of the contraction is impacting revenues and, despite measures that have been identified to improve revenue administration, significant additional measures and tighter spending controls, especially at the local government level, may be needed to meet the deficit target.

15. **Progress has been made towards resolving Parex, but the situation remains delicate.** Parex's management seems to have made a good faith effort to negotiate a partial rollover of debt falling due this year with external creditors. This approach offers the prospect of Parex management (together with the EBRD) restructuring the bank and returning it to profitability over the medium term. The proposed partial payout to creditors this year would be within the program's NIR targets, though the extension of government guarantees on rolled-over debt is unfortunate, as it implies a potential significant claim on scarce future fiscal resources (and, more generally, the authorities should also guard against broader issuance of government guarantees, to safeguard fiscal sustainability). In addition, Parex's management continues to actively engage the affected depositors to settle their limited arrears arising from the partial deposit freeze and the authorities maintain good faith efforts to facilitate the settlement of such claims.

16. **The political environment will remain highly difficult as the economic downturn continues**. Even after the formation of a new government, popular discontent at the extent of the recession may limit its room for maneuver. As a result, early elections are a possibility.

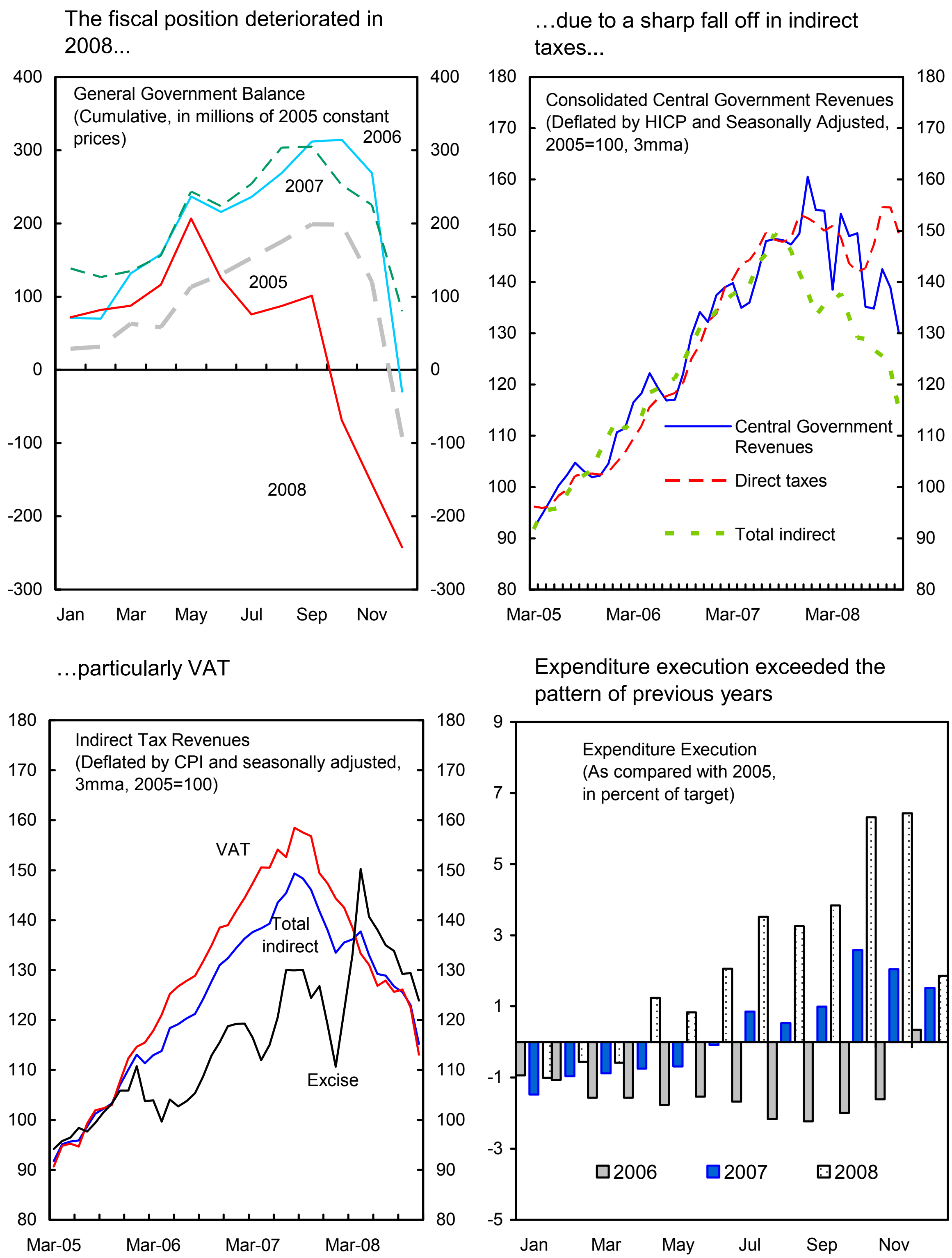
17. **Continued implementation of sound economic policies, despite challenging conditions, is essential to maintain investor confidence and facilitate the adjustment**. The first review mission arrived in Riga February 17 to start discussions under the Stand-By Arrangement.

Figure 1. Latvia: Real Sector, 2005-08



Sources: Latvian Central Statistical Bureau, Haver, Fund Staff Calculations.

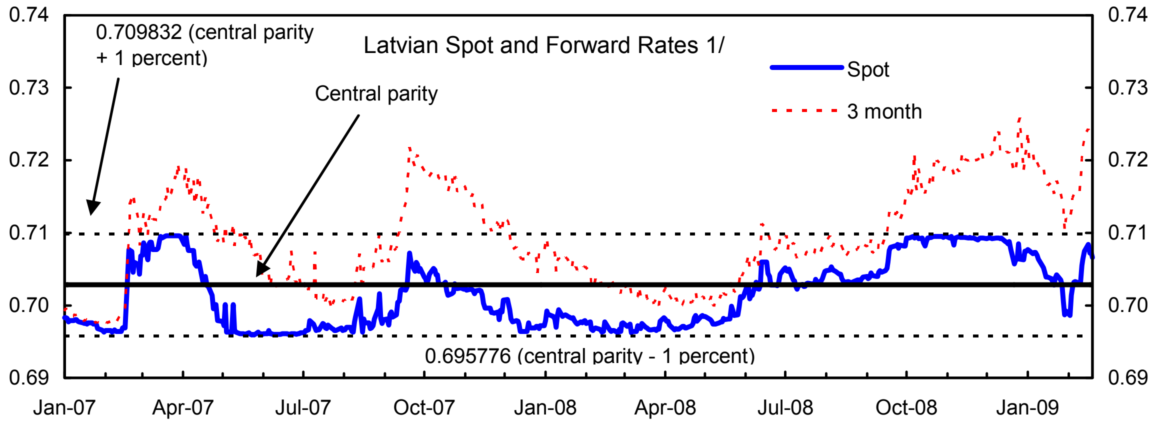
Figure 2. Latvia: Fiscal Sector, 2005-2008



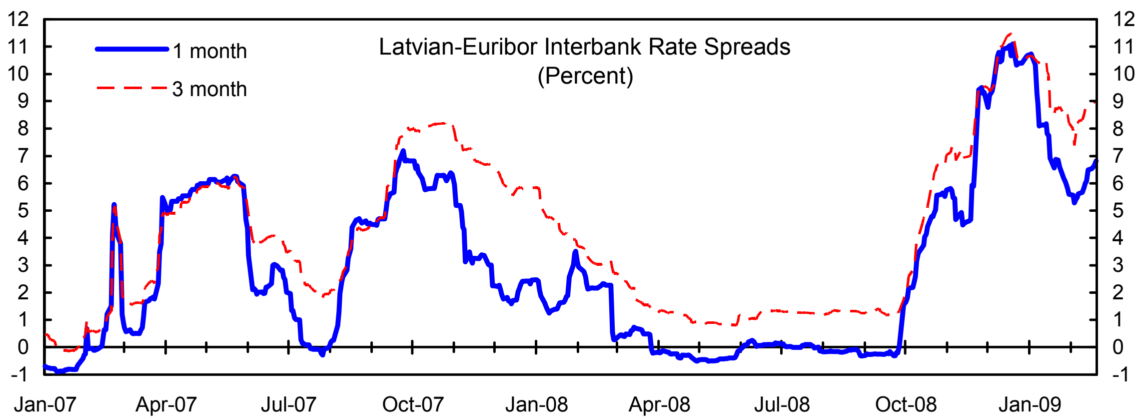
Sources: Latvian Authorities, Fund Staff Estimates and Calculations.

Figure 3. Latvia: Exchange Rate, Interbank Interest Rates, and Intervention

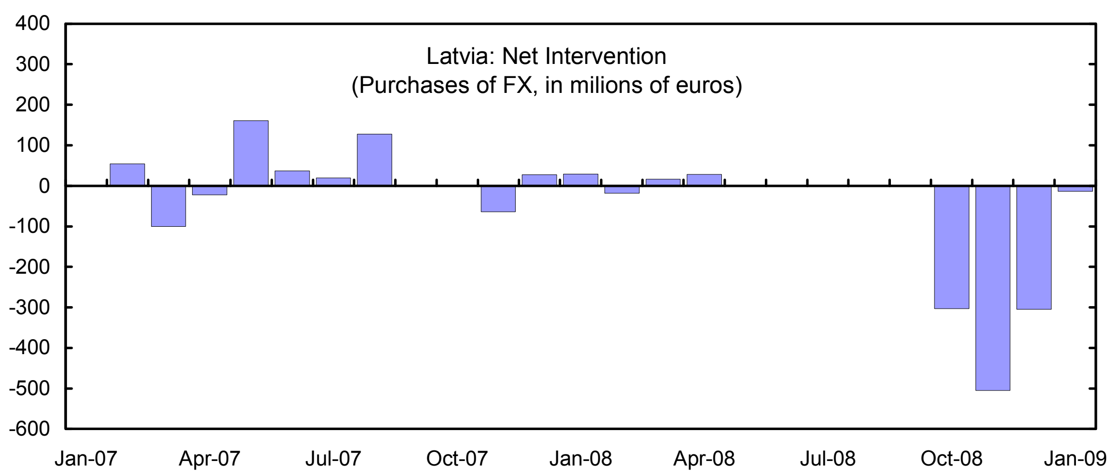
The lats has returned to the depreciated end of its trading band



Interbank interest rates have fallen from their peaks



The Bank of Latvia has stopped intervening in defense of the peg



Source: Bloomberg, Datastream.

1/ Spot: lat-euro rate. Forward rates calculated as the product of the lat-US$ forward rate and US$-euro forward rate.

Table 1. Latvia: Selected Economic Indicators, 2006–09

	2006	2007	2008		2009	
			Prog.	Est.	Prog.	Proj. 1/
Output	(Annual growth rate, in percent)					
Real GDP	12.2	10.3	-2.0	-2.3	-5.0	-9.0
Private consumption	21.2	13.9	-6.3	-6.6	-7.5	-12.5
Public consumption	4.9	4.8	1.0	1.0	-3.0	-5.0
Gross fixed investment	16.3	8.4	-10.0	-10.0	-12.0	-15.0
Stockbuilding (contribution to growth)	0.7	1.8	0.0	0.0	-0.1	0.4
Exports of goods and services	6.5	11.1	4.5	4.5	-3.0	-6.4
Imports of goods and services	19.3	15.0	-6.1	-6.1	-9.5	-12.1
Nominal GDP (in billions of euros)	15.9	19.9	21.7	21.5	21.5	20.4
Savings and Investment						
Gross national savings (in percent of GDP)	18.4	15.4	17.1	17.9	22.2	20.2
Gross capital formation (in percent of GDP)	39.7	37.2	30.5	29.8	27.5	25.5
Private investment (in percent of GDP)	34.5	31.4	25.5	24.7	22.8	21.6
Net exports (in percent of GDP)	-21.5	-20.3	-12.8	-12.2	-8.5	-6.3
Prices, and employment						
HICP (average; in percent)	6.6	10.1	15.5	15.3	5.9	6.2
(End-of-period; in percent)	6.8	14.0	11.9	10.4	3.3	3.1
Unemployment rate (LFS definition; in percent) 2/	6.8	6.2	6.7	6.7	9.0	11.1
Real gross wage 2/	15.2	19.7	5.2	5.4	-4.6	-13.0
Consolidated general government	(In percent of GDP)					
Revenue	36.1	38.4	38.0	37.9	34.8	34.8 3/
Expenditure and net lending	36.9	37.7	41.1	41.5	39.8	39.8 3/
Fiscal balance	-0.9	0.7	-3.0	-3.5	-4.9	-4.9 3/
Gross general government debt	9.9	8.3	14.3	14.5	33.7	33.7 3/
Credit and deposits	(Annual percent change, unless otherwise stated)					
Credit to nongovernment	58.4	34.2	13.0	13.0	-0.5	-5.0
Residents' FX deposits (in millions of euros)	2,689	3,659	...	...	...	...
Residents' FX deposits (percent of M2X)	34.5	41.7	...	...	...	...
Interest rates (annualized)						
BoL refinancing rate	5.0	6.0	...	...	...	...
Money market (one month)	2.9	6.8	...	...	...	...
Balance of payments	(In percent of GDP, unless otherwise stated)					
Gross official reserves (in millions of euros)	3,439	3,966	3,720	3,721	3,386	3,819
(In months of prospective imports of GNFS)	3.2	3.7	4.0	3.8	3.8	3.6
Current account balance	-22.5	-23.8	-14.8	-13.4	-7.3	-7.4
Trade balance	-25.6	-25.3	-18.0	-18.1	-12.5	-12.4
Exports of goods and services	43.9	43.6	45.3	44.1	44.8	38.5
Imports of goods and services	-66.2	-65.4	-59.2	-58.4	-52.0	-46.4
Gross external debt	114.7	134.1	129.2	127.5	138.1	140.7
Net external debt 4/	43.3	51.0	54.6	51.9	65.1	61.1
Exchange rates						
Lats per U.S. dollar (Annual average)	0.560	0.514	...	...	...	...
(yoy percent change, + means appreciation)	0.8	9.1	...	...	...	...
REER (annual average; CPI based, 2000=100)	92.6	100.1	...	...	...	...
(yoy percent change, + means appreciation)	2.9	8.0	...	...	...	...
Nominal GDP						
Nominal GDP (in millions of Latvian lats)	11,172	13,957	15,268	15,081	15,091	14,318
Nominal GDP (in millions of euros)	15,891	19,854	21,719	21,453	21,466	20,373
GDP per capita (in euros)	6,926	8,703	9,565	9,448	9,487	9,004

Sources: Latvian authorities; Eurostat; and IMF staff estimates.

1/ Based on measures to meet original program targets
2/ Year-average.
3/ Existing Program targets (EBS/08/155). Subject to revision at First Review.
4/ Gross external debt liabilities minus gross external debt assets and international reserves.