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Republic of Latvia Third Review Under the Stand-By Arrangement and Financing Assurances Review, Request for Rephasing of Purchases Under the Arrangement, and Request for Waiver of Applicability of a Performance Criterion

The following documents have been released and are included in this package:

- The Third Review Under the Stand-By Arrangement and Financing Assurances Review, Request for Rephasing of Purchases Under the Arrangement, and Request for Waiver of Applicability of a Performance Criterion staff report, prepared by a staff team of the IMF, following discussions that ended on June 4, 2010, with the officials of the Republic of Latvia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 6, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A supplement to the staff reports

- A Press Release.

The document(s) listed below were separately released on July 5, 2010.

Letter of Intent sent to the IMF by the authorities of the Republic of Latvia*
Technical Memorandum of Understanding*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Third Review Under the Stand-By Arrangement and Financing Assurances Review, Request for Rephasing of Purchases Under the Arrangement and Request for Waiver of Applicability of Performance Criteria

Prepared by the European Department
(In Consultation with Other Departments)

Approved by Anne-Marie Gulde-Wolf and James Roaf

July 6, 2010

- **Stand-By Arrangement.** A 27-month SDR 1.52 billion exceptional access SBA (1,200 percent of quota) was approved by the Executive Board on December 23, 2008 (Country Report No. 09/3). The Second Review was completed February 17, 2010 (Country Report No. 10/65) and the arrangement extended until December 22, 2011. SDR 892 million has been purchased thus far and a further SDR 90 million (€107 million) becomes available on completion of this Third Review.
- **Economic Developments and Program Status.** The economy is showing signs of stabilizing and should start growing later this year, although unemployment remains high. The authorities met the end-March performance criterion on the adjusted primary fiscal balance and the end-year deficit target is within reach following a decision to cut net lending to compensate for recent slippages. The end-March performance criteria on net international reserves and net domestic assets were met by wide margins. Staff supports the authorities' request for a waiver of applicability of the end-June performance criteria as these are likely to be met, as well as a rephasing of purchases because of delays in completing the Third Review. The authorities are preparing a menu of measures for next year's budget—which will be issued after the October elections—although more work is needed. The long overdue restructuring of Parex bank is being implemented, but more work is needed to prepare a restructuring plan for Mortgage and Land Bank and to facilitate market-based debt restructuring.
- **Discussions** were held in Riga during May 19–June 4, 2010. The mission met with Prime Minister Dombrovskis; Finance Minister Repše; Bank of Latvia Governor Rimšēvičs; Head of the Financial and Capital Market Commission Krūmane; senior officials in these institutions; social partners; and financial institution and private sector representatives.
- **Staff:** The staff team comprised Mark Griffiths (head), James John, Emilia Jurzyk, Magnus Saxegaard (all EUR), Alexander Klemm (FAD), Michaela Erbenova (MCM), and Irena Asmundson (SPR). David Moore (Resident Representative) and Lone Christiansen (EUR) assisted the mission. The team worked closely with staff of the European Commission, European Central Bank, World Bank, and the Swedish authorities. Gundars Davidson (OED) attended some meetings.

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I. Background and Recent Developments

1. **There are signs the economy is stabilizing, although the labor market remains weak (Figure 1–2, Table 1–2).** Real GDP appears to have leveled off in the first quarter of 2010, although it was 6 percent lower than a year ago. High frequency indicators also suggest the economy may be bottoming out: industrial production is 12 percent higher than a year ago, and retail sales have increased almost 6 percent since the beginning of the year after declining almost continuously since April 2008. Unemployment remains above 20 percent (Labor Force Survey), but is increasing less rapidly.

2. **Disinflation has slowed, but falling wages are improving competitiveness (Figure 3).** Unit labor costs in manufacturing have declined by 21 percent since end-2008 following a 10 percent (seasonally adjusted) decline in nominal wages. Through the first quarter, the CPI- and ULC-based real effective exchange rates have depreciated about 10 percent since early 2009 peaks. The recent depreciation of the euro—the nominal effective exchange rate has depreciated by about 5 percent since the beginning of the year—is also improving competitiveness. Producer prices fell 5 percent year-on-year in 2009, but have increased by around 5 percent on a seasonally adjusted basis since December 2009, while consumer prices have increased by 0.8 percent on a seasonally adjusted basis since February after 12 months of decline. However, price increases have been concentrated in tradable sectors, while non-tradable prices are expected to decline further, suggesting that competitiveness is likely to continue to improve.

3. **After ending 2009 with a large surplus, the current account has started to narrow (Figure 4, Table 6).** While the trade balance continues to grow as exports—which increased 7 percent year-on-year in the first quarter of 2010—rebound, this is being offset by a narrowing of the income account as loan-loss provisioning needs by foreign banks decline. Nevertheless, the current account is likely to remain in surplus in the near term as the still-weak economy dampens import growth, and transfers—including from the European Union (EU)—remain sizable.

4. **The weak economic environment is putting pressure on the banking sector (Figure 7).** Although deposits have recovered to pre-crisis levels, loans are still falling. New overdue loans are stabilizing, but loans more than 180 days overdue continue to increase mainly due to lengthy bankruptcy procedures. Provisioning needs remain high and banking sector losses continue. Banks have responded by pre-emptive recapitalization. This—together with continued deleveraging—has kept the system-wide capital adequacy ratio at around 14 percent, close to historic highs.

5. **Financial conditions have improved steadily since mid-2009, but have deteriorated recently because of international financial market tensions (Figure 6).** CDS spreads have declined significantly since last year but have risen by nearly 80 bps since mid-April, while treasury rates—which earlier this year declined to historic lows allowing

the government to issue two- and three-year bonds—have recently edged up as market interest in long-term government securities has declined. However, the fact that neither the financial system nor the government is reliant on external market financing should limit any spillovers, while the EU's positive assessment of Estonia's bid to join the euro in 2011 makes the program's exit strategy more realistic. Foreign exchange market intervention has been minimal since last fall, while interbank rates remain close to the lower end of Bank of Latvia's (BoL) interest rate corridor reflecting significant excess liquidity.

6. **The BoL has strengthened its liquidity management framework.** A 7-day deposit facility was introduced in March at the existing overnight rate of 1 percent to lock up excess liquidity for longer. Thus far the BoL's actions, coupled with limits on banks' net open foreign exchange positions, precautionary behavior, and confidence in the program strategy have prevented this considerable excess liquidity (€950 million or 17 percent of reserves) from becoming a drain on reserves.

7. **Program implementation remains broadly on-track**. The end-March fiscal targets were met despite payment of pension refunds in March stemming from the December 2009 Constitutional Court ruling, while the NIR and NDA targets were comfortably met due to lower than expected capital outflows and increasing short-term bank deposits at the BoL. NIR and NDA targets have been reset to lock in much of this overperformance. While final data are not yet available, the end-June performance criteria are also likely to have been met. Most structural benchmarks were met, including submission of a restructuring plan for Parex Bank to the European Commission (EC) and completion of regulations to strengthen the financial system. The consultation clause on the use of program budget support was triggered in March—consistent with program projections—due to the provision of liquidity for Parex Bank to repay syndicated loans guaranteed by the government.

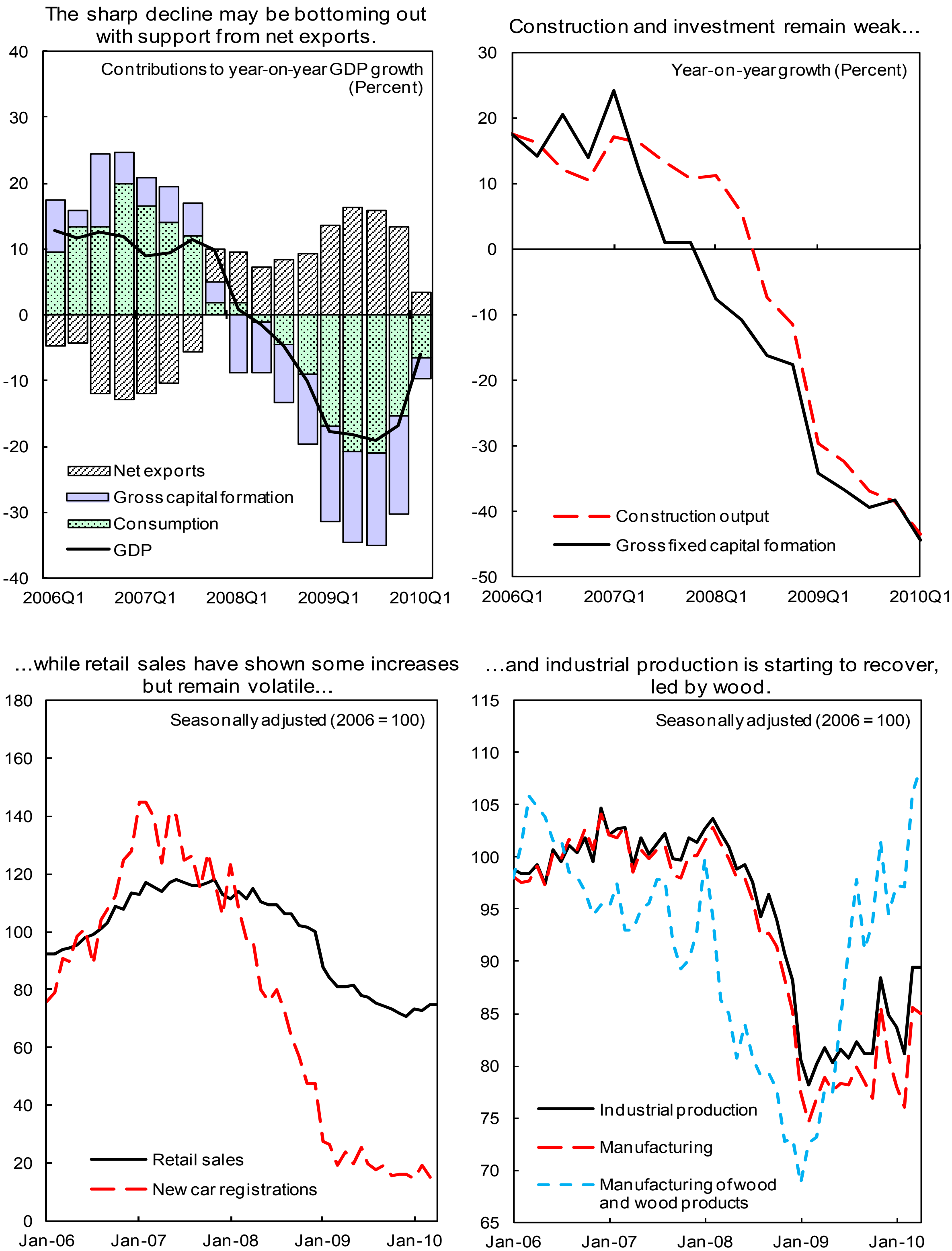
8. **Implementation risks are growing ahead of October's Parliamentary elections:**

- The government has been in minority since March when one of the coalition partners—which had repeatedly expressed dissatisfaction with the program—left the governing coalition. As a result, the government does not have complete control over the legislative agenda. Finance Minister Repše—one of the architects of the fiscal consolidation effort—has decided not to stand for re-election.

- There have been some fiscal slippages. Parliament voted for lower VAT for hotels despite a Letter of Intent (LOI) commitment to avoid tax cuts this year. Other tax cuts and spending increases—although relatively minor—have also been approved or are under consideration. Fiscal pressures could intensify further ahead of the elections.

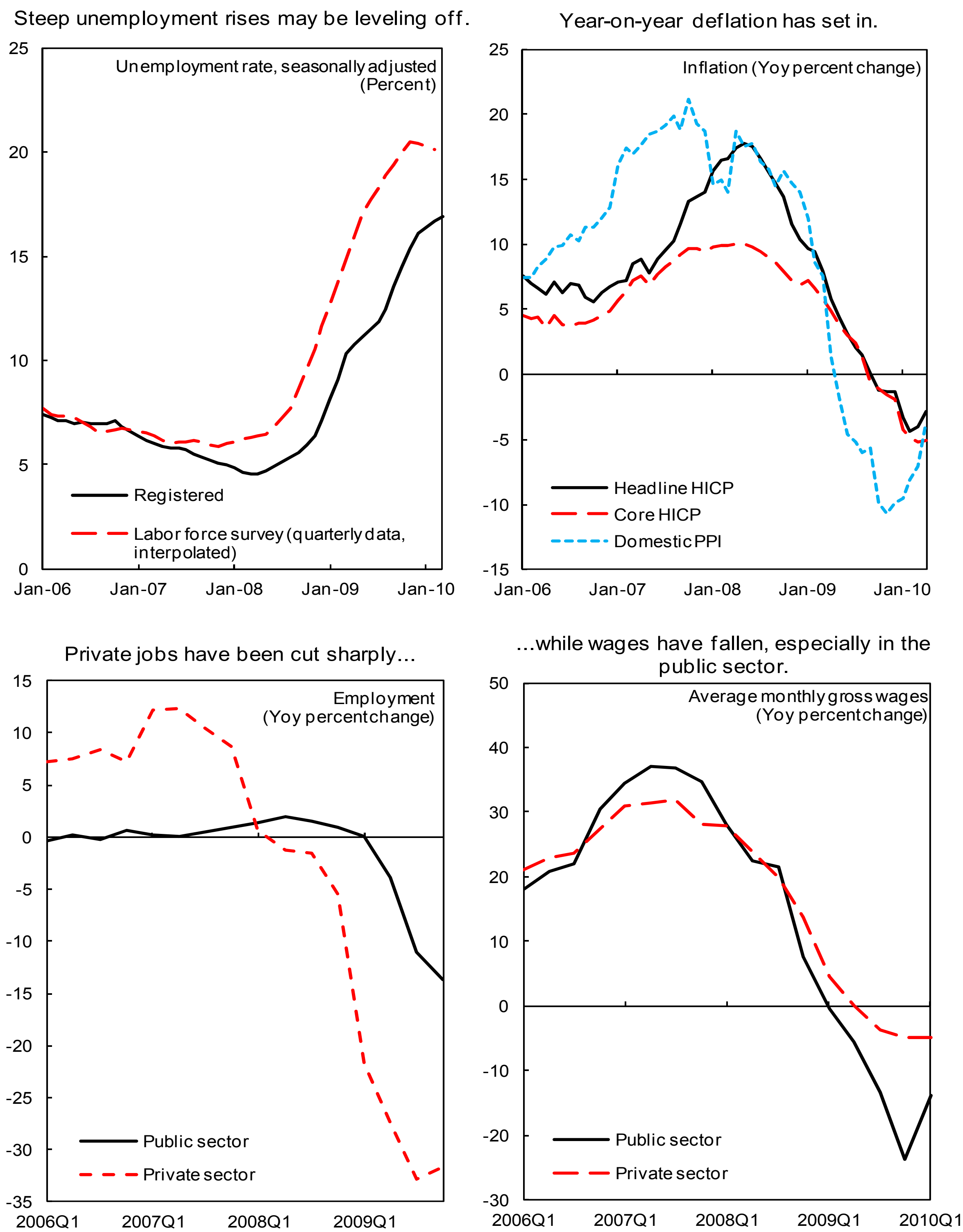
- There have been attempts to delay the restructuring of Parex Bank, but so far these have been unsuccessful.

Figure 1. Latvia: Real Sector, 2006-10



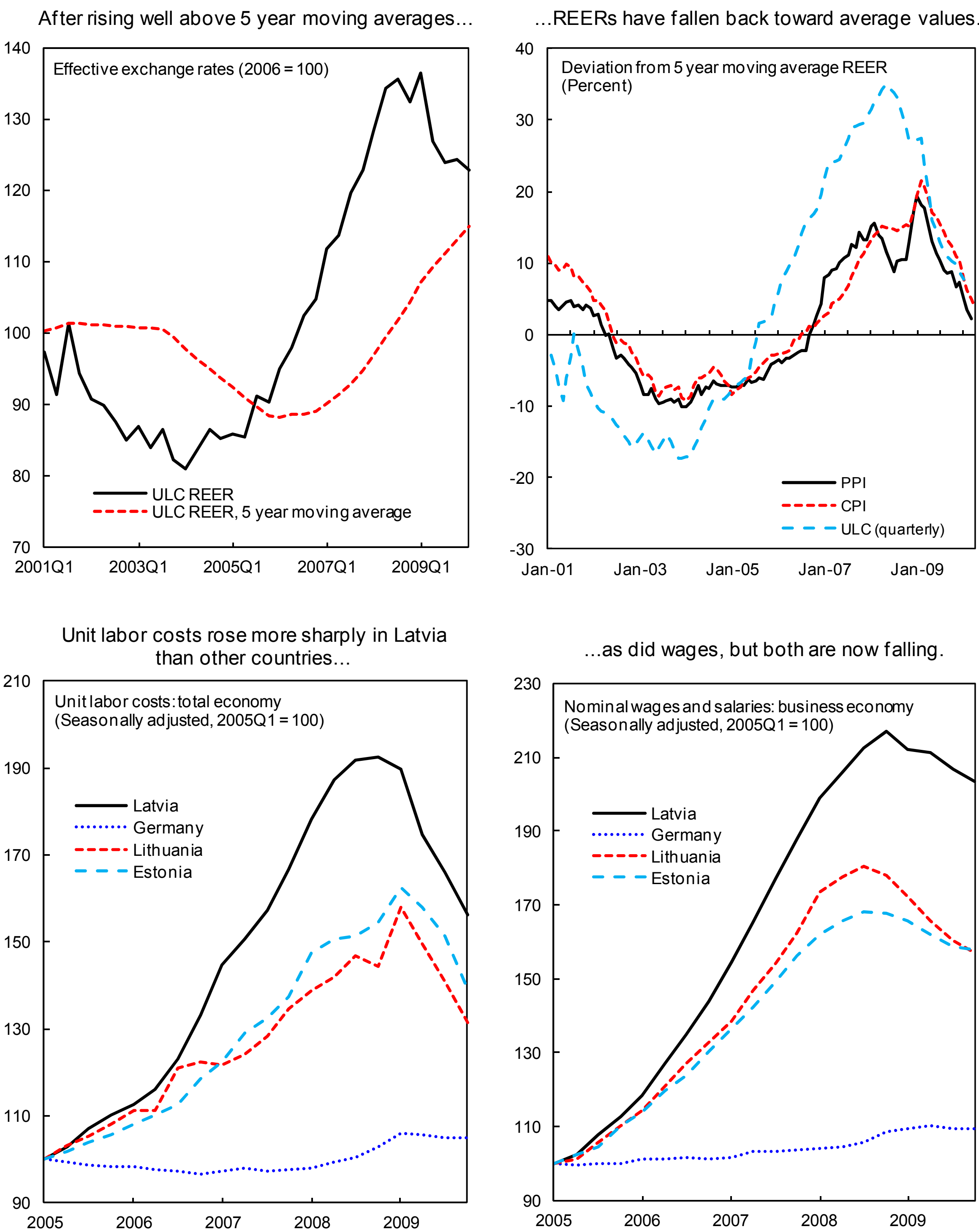
Sources: Latvian Central Statistical Bureau; Haver; and IMF staff calculations.

Figure 2. Latvia: Labor Markets and Inflation, 2006-10



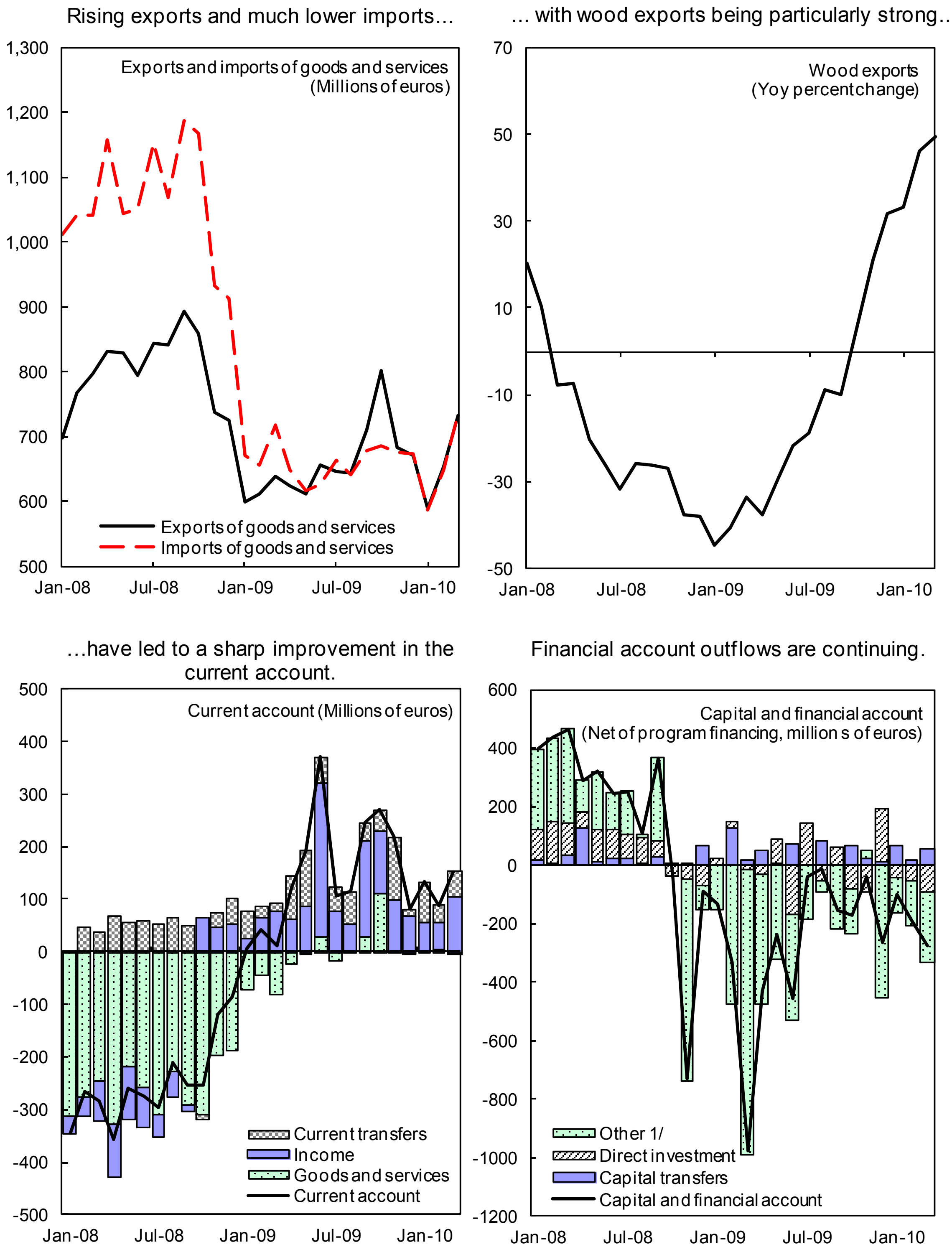
Sources: Eurostat; Haver; Latvian Central Statistical Bureau; and IMF staff calculations.

Figure 3. Latvia: Competitiveness, 2001-10



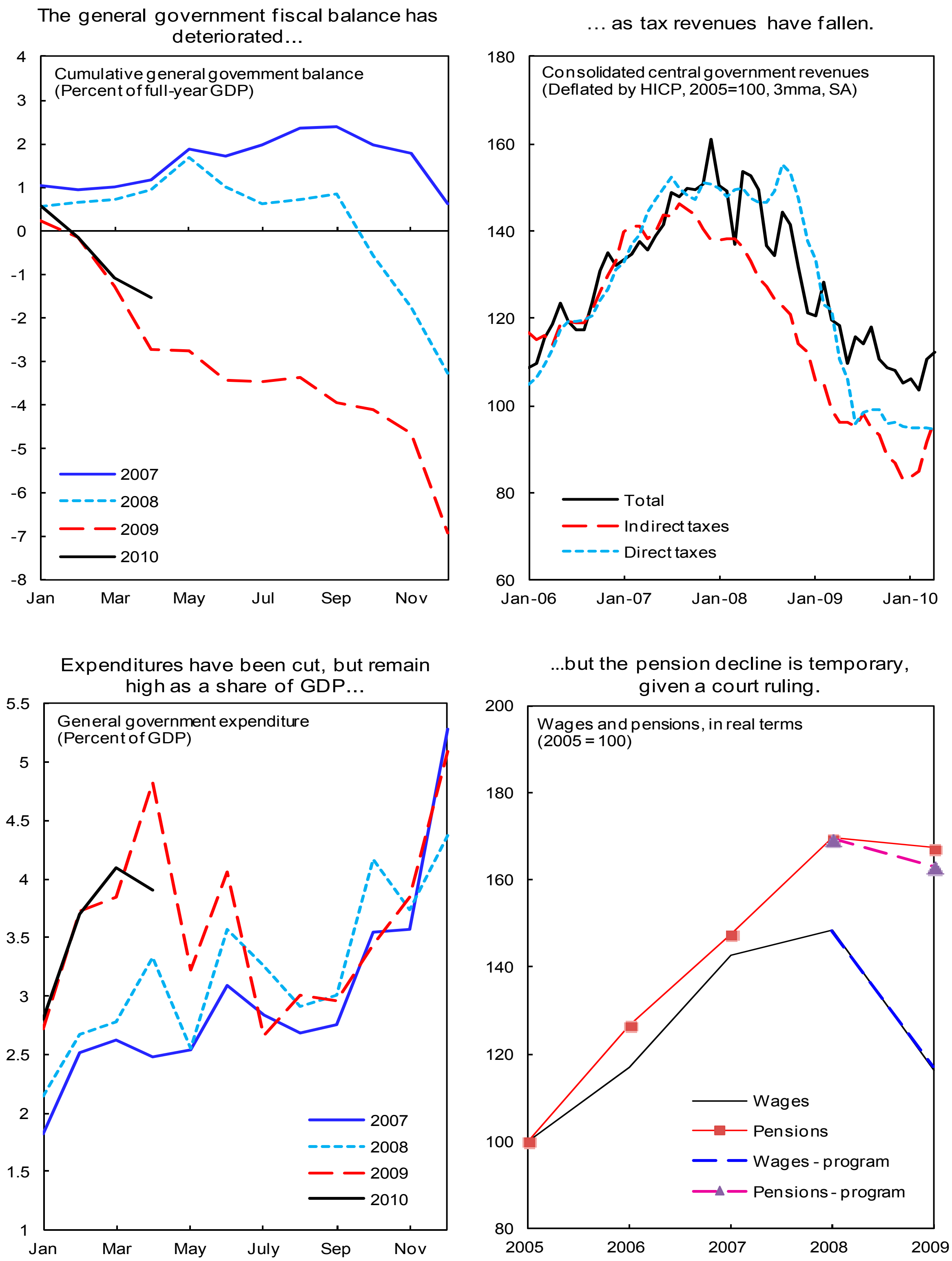
Sources: Bank of Latvia; Eurostat; and Fund staff calculations.

Figure 4. Latvia: Balance of Payments, 2008-10



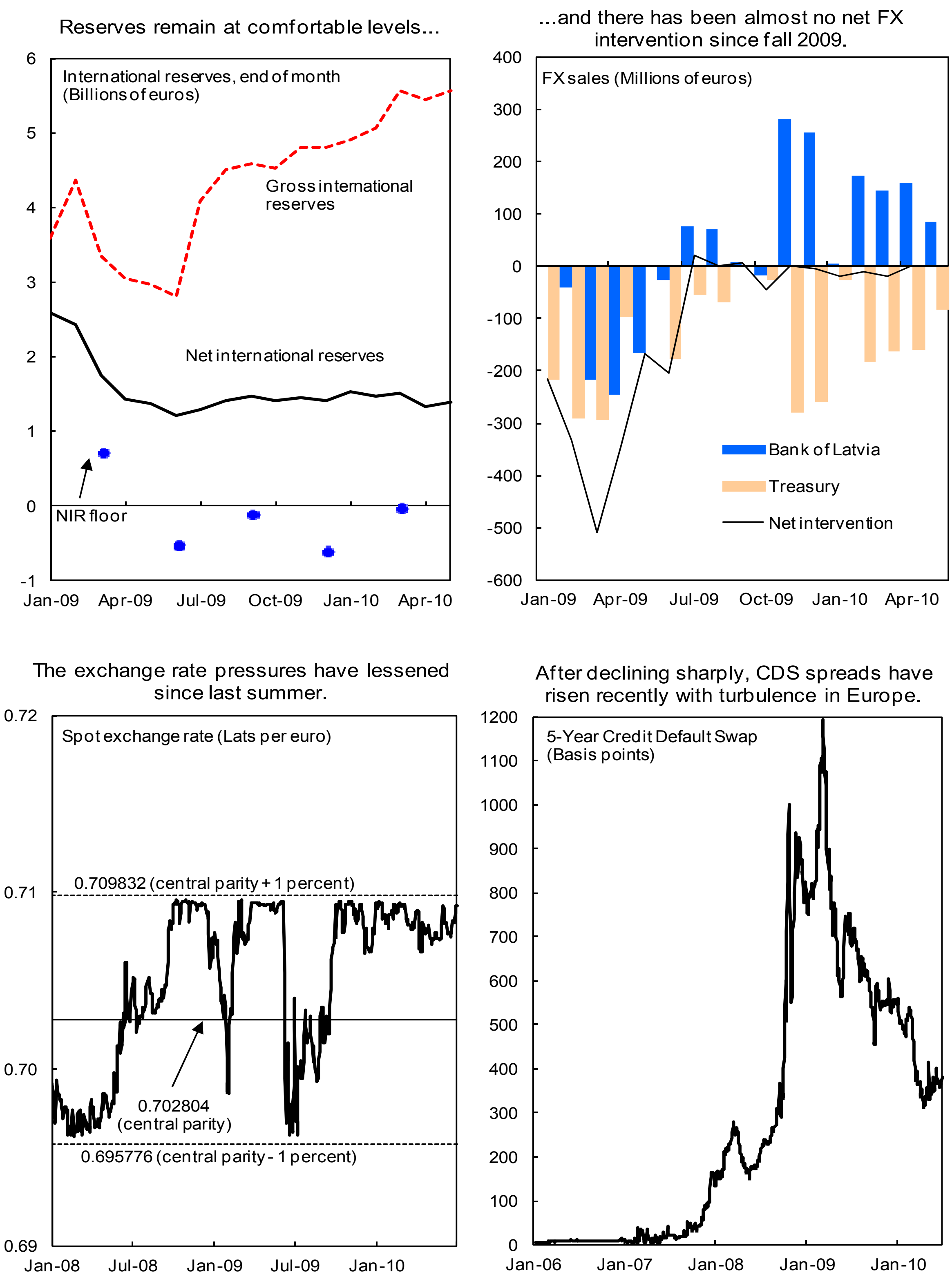
Sources: Bank of Latvia; and IMF staff calculations.
1/ Other is the sum of other investment and portfolio investment and derivatives.

Figure 5. Latvia: Fiscal Sector, 2005-10



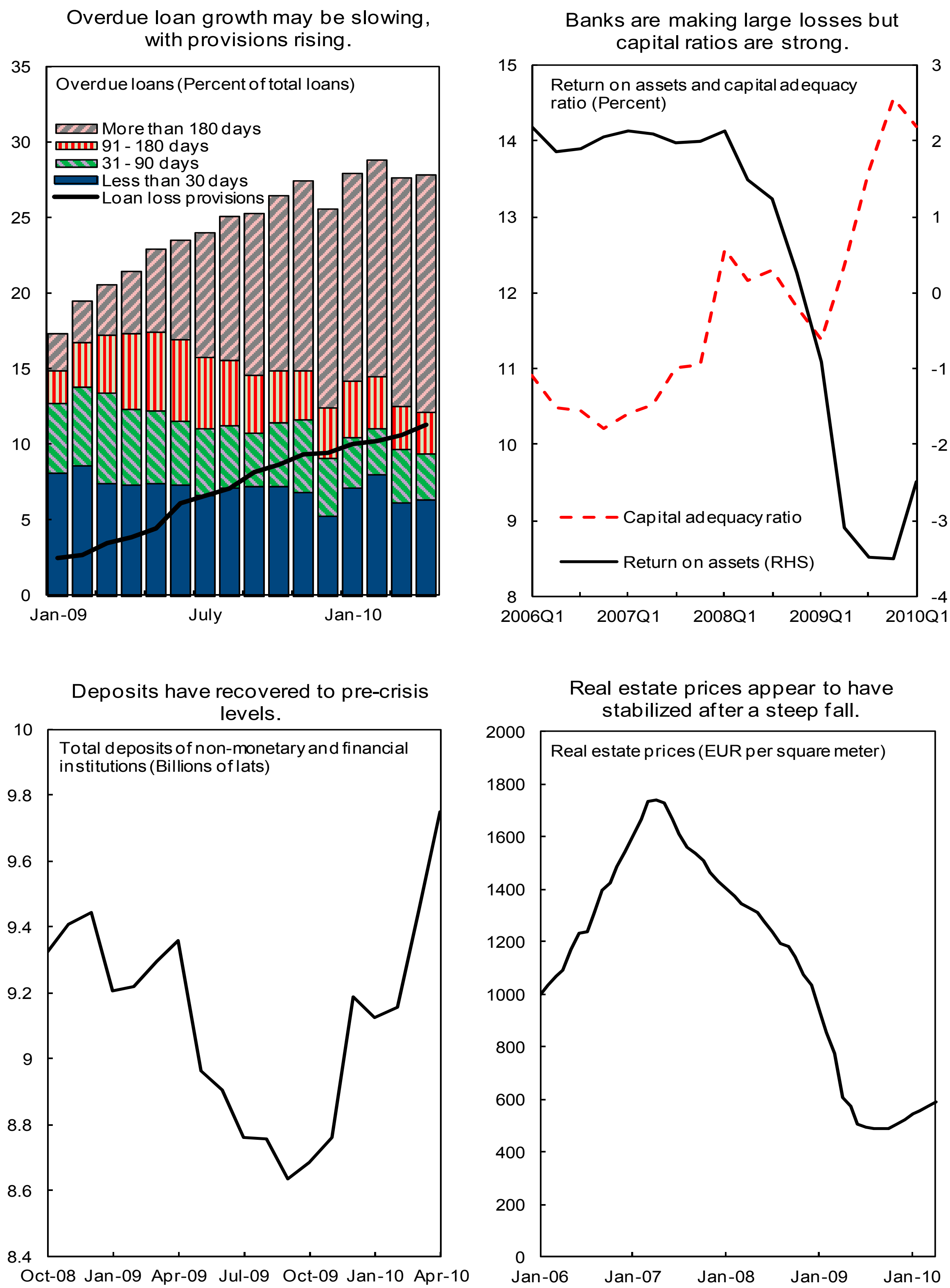
Source: IMF staff estimates and calculations.

Figure 6. Latvia: International Reserves and FX Market Developments, 2006-10



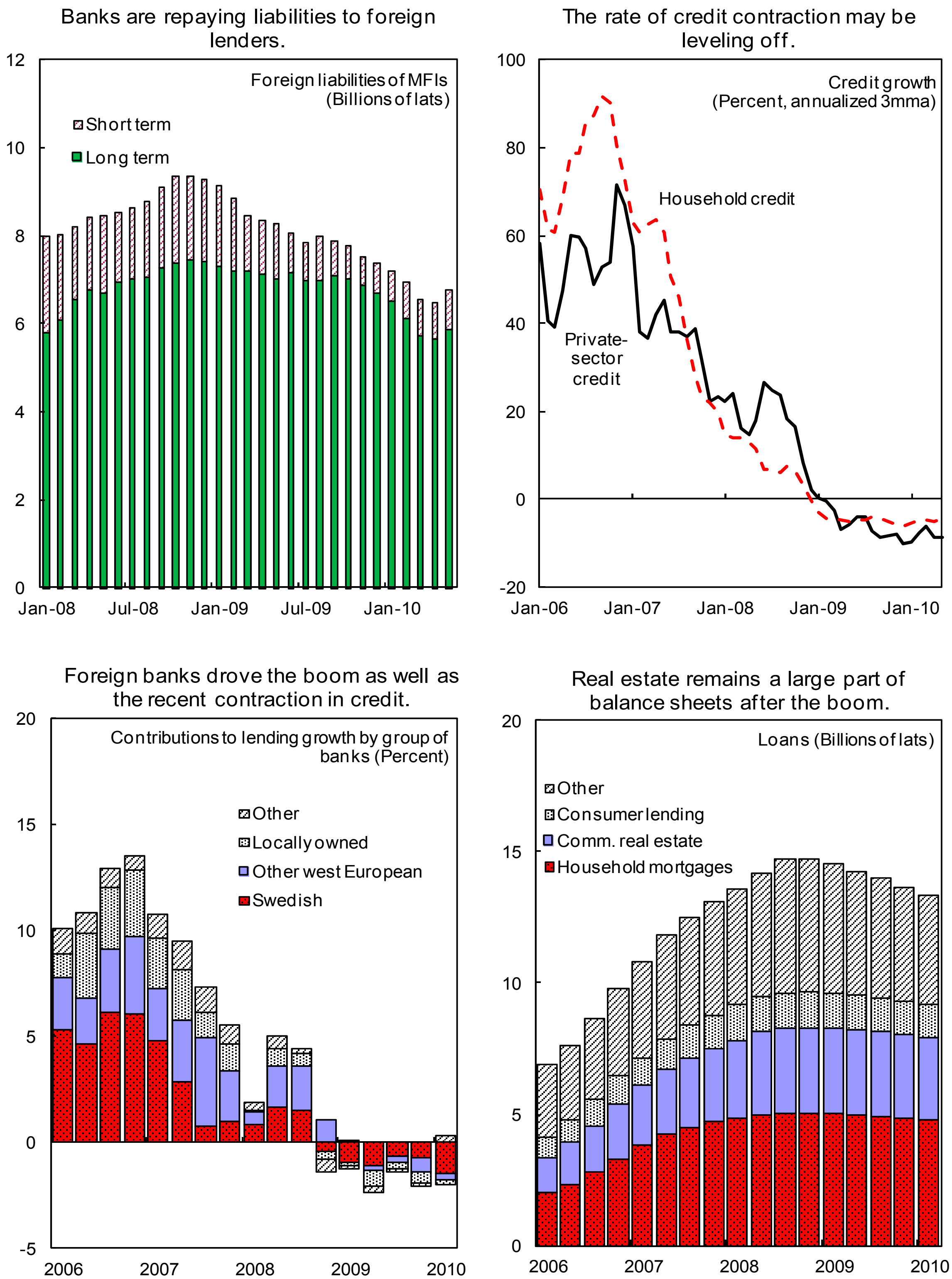
Sources: Bank of Latvia; and Bloomberg.

Figure 7. Latvia: Banking Sector Developments, 2006-10



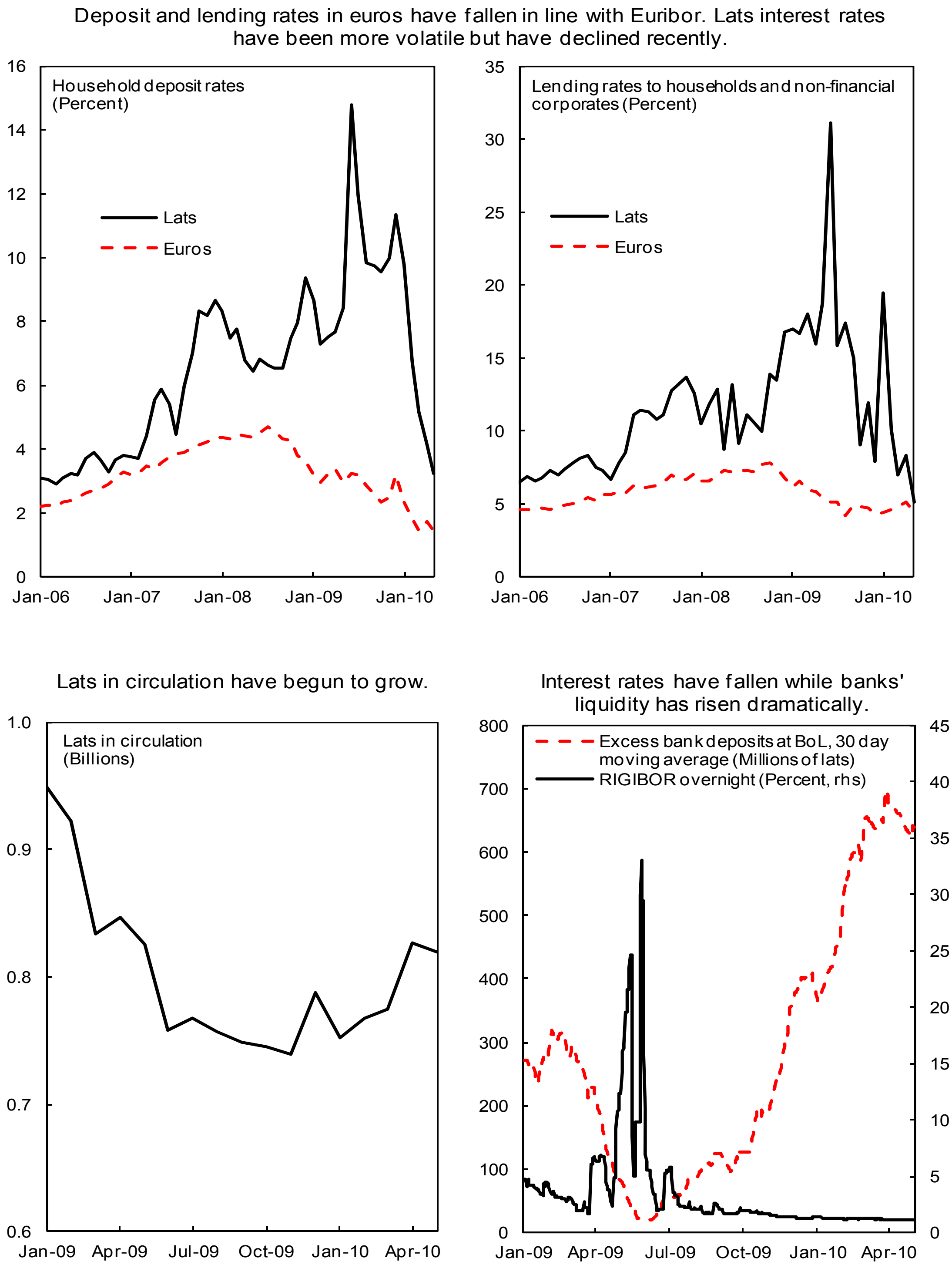
Sources: FCMC; Bank of Latvia; Latvian Central Statistical Bureau; and IMF staff calculations.

Figure 8. Latvia: Bank Credit, 2006-10



Sources: Latvian Authorities; and IMF staff calculations.

Figure 9. Latvia: Interest Rates and Euroization, 2006-10



Source: Bank of Latvia.

II. Policy Discussions

A. Macroeconomic Framework

9. **The authorities have revised their macroeconomic framework to reflect the recent economic stabilization (Table 2, LOI ¶6-7).** While the economy should start expanding this year, real GDP is expected to fall 3½ percent from last year due to the carryover effect of the contraction in late 2009. Domestic demand is expected to remain depressed because of fiscal consolidation, high unemployment, and falling credit, but export growth continues as the global economy recovers and competitiveness improves. Unemployment increases slightly to 21 percent in 2010 before declining in 2011.

10. **Deflation continues, but at a slower pace.** Domestic prices are expected to fall in 2010 due to high unemployment, declining wages, and fiscal consolidation. But higher food and energy prices limit the overall CPI decline to 2 percent.

11. **Competitiveness is improving with internal devaluation**. Although significant uncertainty due to the rapidly changing economic environment complicates assessments, a small competitiveness gap of around 10 percent likely remains (based on end-2009 data):

- Model-based estimates (CGER) are mixed. The equilibrium real exchange rate (ERER) approach—which relates the real exchange rate to medium-term fundamentals—suggests a sizable competitiveness gap, but a little lower than at the start of the program. However, because of the large current account surplus, macro-balance and external sustainability approach estimates range from -3 percent undervaluation to a significant competitiveness gap, depending on the size of the output gap and the natural rate of unemployment. Both these are difficult to estimate after such a deep recession.

- More qualitative indicators also provide a mixed assessment. The real exchange rate continues to depreciate and export market shares are improving. However, the depreciation has not yet reversed past appreciation, while cross-country comparisons suggests Latvia's price level is still high given its per capita income level. While the BoL's assessment of the remaining competitiveness gap was at the lower end of staff's range, both sides agreed that some further improvements were likely needed to rebalance towards tradables.

B. Fiscal Policy

12. **Fiscal developments have been slightly better than projected, with the authorities on track to meet the 8.5 percent of GDP (ESA) deficit target (Figure 5, Table 3).** Moreover, to keep the IMF cash deficit target within reach, the authorities have decided to cut net lending to compensate for recent policy slippages (LOI ¶8):

- Strong indirect, corporate, and nontax revenues have more than offset relatively weak personal income taxes. Spending was slightly below expectations, due to lower net lending, carbon emission-related investment, and interest costs.

- Despite staff and EC opposition, the authorities have broken their LOI commitment not to cut taxes by: (i) lowering the hotel VAT rate from 21 to 10 percent; (ii) extending low VAT rates for books and print media; (iii) exempting some unused infrastructure from real estate taxation; and (iv) exempting gifts for education and medicine from personal income tax. The authorities have also introduced new loans for agricultural producers and accelerated construction of the controversial national library project. These will increase the 2010 deficit by 0.3 percent of GDP. The authorities agreed to cut central government net lending to compensate.

- Fund staff argued strongly against further fiscal loosening ahead of the election, and stressed the need for proper assessment of the revenue implications of tax changes and prior consultation with the Fund and EC.

13. **The authorities have taken advantage of the flexibility in the budget to increase social spending to protect the poorest (LOI ¶9).** They have increased financing for active labor market policies and temporary public employment programs (0.1 percent of GDP to employ 35,000 more people under the successful Workplaces with Stipend (WWS) program) and are considering increasing financial support for transportation needs of the disabled in the coming weeks. The program includes an adjustor allowing this additional safety net spending.

14. **Staff and the authorities agreed the 2011 budget—to be introduced after October's elections—needed to include sufficient measures to reduce the fiscal deficit to no more than 6 percent of GDP (LOI ¶3).** The government believes reaching this target will require L395 to L440 million in net new measures, with staff estimates centered on L420 million (3.3 percent of GDP). This would keep Latvia on track to achieve the Maastricht deficit criterion by 2012, and help convince financial markets of Latvia's commitment to fiscal discipline.

15. **The authorities have committed to identify by end-October 2010 a menu of options significantly larger than this consolidation need (LOI ¶12).** This should speed adoption of the 2011 budget by giving the incoming government a choice of measures, avoiding delays that would increase the adjustment needed during the remainder of the year and improving the chances of a quality 2011 budget. Potential measures of 3 percent of GDP have already been identified:

- On expenditure, subsidy cuts could yield up to 1.2 percent of GDP. The authorities are also considering further streamlining public agencies and ministries, reducing the public enterprise wage bill, and cutting local government expenditure. A World Bank public expenditure review and an August FAD expenditure mission should help identify further measures. These could include: (i) reducing overlapping parental benefits; (ii) pension cuts (particularly the supplementary pension for pre-1996 working years, initially targeted to poor pensioners but expanded to all from 2009); and (iii) addressing possible disability benefit abuses.

- Significant progress has been made on revenue measures. The authorities have published a draft tax strategy which suggests aligning VAT rates at the standard 21 percent rate (yielding up to ¾ percent of GDP, but compensation for the poor may be needed), and increasing real estate taxes (½ percent of GDP). In staff's view, higher car taxation, pensions taxation (where the tax-free allowance is five times that for wages), and higher VAT or progressive personal income tax could also help.

16. **Staff urged the authorities to strengthen the Ministry of Finance (MoF)'s control over fiscal decisions (LOI ¶13).** Recent slippages—largely proposed by other ministries or parliament—have exposed the MoF's weakness in maintaining fiscal discipline. The draft Fiscal Responsibility Law—which the authorities intend to submit to Parliament by end-September (structural benchmark) together with a report on how to give this law greater legal standing than other laws—will impose multi-year spending ceilings and limit appropriations increases after budget adoption. The authorities also intend to propose changes to parliamentary rules to give the MoF time to study any tax proposals before consideration by parliament.

17. **The authorities are working on reforms to maintain fiscal sustainability (LOI ¶13).** These include: (i) ensuring pensions sustainability, including raising the retirement age (end-June structural benchmark); (ii) replacing temporary cuts to social benefits with more permanent measures but with safeguards to protect the poorest (end-June structural benchmark); and (iii) a strategy outlining which state-owned enterprises should be transformed into government agencies, privatized, or remain as state-owned enterprises, building on recent Fund technical assistance (end-December structural benchmark). Finally, staff advised the authorities to include a fiscal rule within the Fiscal Responsibility Law consistent with the EU's Stability and Growth Pact that ensures a balanced budget while allowing for counter-cyclical fiscal policy.

C. Financial Sector Policies

18. **Staff welcomed adoption of a restructuring plan for Parex Bank and urged its rapid implementation (LOI ¶20).** The long overdue plan—submitted March 31 to the EC—envisages transferring performing assets and most junior liabilities into a new "good" bank. Remaining assets and liabilities would stay in a resolution bank. EBRD will be a shareholder in both. The strategy could allow relatively quick and transparent sale of the viable parts of Parex, while protecting depositors and giving the government a chance to recover part of its investment. Such a plan should have been adopted in early 2009, before the erosion of the

bank's value, but the political will and legal underpinnings were then lacking. Cabinet approved creation of the new bank on June 1 and, subject to DG Competition approval, the split should take place late summer.

19. **Progress on MLB has been much slower and the authorities will only submit a transformation plan by end-September (LOI ¶22–23).**

- The bank recently required a L70 million (0.7 percent of GDP) share capital increase from the government, after two capital increases in 2009.

- Staff repeated their concern that the distinction between development and commercial lending has not always been clear, and that EU and other concessional funds have not, at times, been properly on-lent. Instead, funds may have helped cover past credit losses and repayment of, syndicated loans. This may have distorted competition and delayed proper restructuring.

- The authorities agreed to submit a full transformation plan to the EC by September (structural benchmark) for implementation after the elections, helped by a reputable independent advisor to be appointed by end-July. Until the plan is submitted to the EC, 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). The authorities also intend to work with the EC to improve the framework for development lending in Latvia, including by making MLB rely to a greater extent on commercial banks as intermediaries.

20. **The authorities are strengthening financial supervision and improving their crisis management capacity (LOI ¶18).** Revised liquidity risk (liability concentration, funding risk, and liquidity buffer requirements) and credit risk (management of concentration risk and stress testing requirements) regulations came into effect in April and July, while guidelines on the prudential treatment of special entities set up to manage problem assets were issued in February. The deposit guarantee fund was transformed into an autonomous unit with dedicated staff and new investment guidelines issued in early 2010, building on staff recommendations.

21. **Large foreign banks' commitment to remain involved in Latvia should contribute to financial stability (LOI ¶19).** Letters sent by parent banks in February reiterate commitments to maintain a presence in Latvia and to comply with all regulatory requirements. However, the letters do not include specific commitments to maintain exposure because banks want to preserve flexibility: some need to reduce historically high loan to deposit ratios, others are considering expanding. The banks' pledge should reduce the risk of disorderly deleveraging and capital outflows.

D. Monetary Policy

22. **Although external market borrowing conditions have turned unfavorable, staff encouraged the authorities to gradually increase the amount of domestic borrowing when feasible.** Although recent market turbulence has contributed to an increase in yields on lats paper, rates are still low and banks have significant excess liquidity. Increased domestic issuance would help absorb this liquidity and reduce the risk of potentially sharp liquidity movements affecting international reserves and confidence. It would also ensure a smooth transition toward greater reliance on market financing post program.

E. Private Debt Restructuring

23. **The authorities have made efforts to strengthen market-based debt resolution.**

- Amendments to the Civil Procedure Law that inter alia make the seizure of collateral a credible threat—thereby strengthening incentives for debtors to participate in workouts—became effective in February.

- Amendments to the Insolvency Law aimed at speeding the exit of non-viable firms and supporting rehabilitation of individual debtors were approved by parliament in June. However, the president has chosen to send the amendments back to parliament over concerns that a last minute change to the personal insolvency regime unduly favored debtors. Parliament is expected to consider ways to address the president's concerns in July, allowing implementation of the amendments in November as originally planned. Staff will continue to work with the authorities to improve the insolvency regime.

- The amount of loans reported as restructured by banks have more than doubled since end-2008, while the amount of loans where the bank has initiated credit enforcement proceedings has nearly tripled.

24. **Notwithstanding the above, the authorities and staff agreed further steps are needed to improve incentives for market-based debt resolution (LOI ¶26).**

- The authorities will seek technical assistance from the Fund to improve foreclosure procedures, including allowing buyers at foreclosure auctions to pledge the asset auctioned as collateral for a loan, and to accelerate post-auction proceedings.

- The government intends to investigate whether changes to the tax code are necessary to encourage debt restructuring and write-offs, in particular allowing credit institutions to deduct losses from debt write-downs against corporate income tax (end-July 2010 structural benchmark), temporarily suspending personal tax liability for write-offs, and, once fiscal space allows, reducing stamp duty on real estate sold because of insolvency.

III. PROGRAM ISSUES

25. **The authorities intend to treat part of future program financing as lines of credit (LOI ¶5).** With stronger fiscal performance than allowed at the First Review, lower than expected bank restructuring costs, better than expected capital account developments (non-resident deposits are above pre-crisis levels), and significant government deposits at the BoL, the balance of payments has improved considerably. Excessive government deposits could also increase political pressure for higher spending. To lower interest costs and limit public debt, the authorities therefore intend to draw only the approximately €300 million available from the EC and IMF following this review, as well as €100 million previously approved by the World Bank, and to make decisions on future drawings on a review-by-review basis. While choosing not to draw from the Nordics and other bilateral donors limits burden-sharing, these funds will remain available as lines of credit provided the authorities sustain satisfactory program performance.

26. **Risks remain significant and tilted to the downside:**

- **Continued support for the program strategy is uncertain.** Opinion polls suggest the October election is wide open, and a new government including parties which previously have opposed the program cannot be ruled out. High unemployment and unevenness of the adjustment burden could undermine public support for further adjustment and encourage populist policies.

- **Further fiscal adjustment will be challenging.** Recent slippages suggest political support for fiscal consolidation may be waning, and there is a risk of backtracking ahead of the elections. Identifying further savings in the 2011 budget which can withstand legal challenges will be difficult, as the easiest areas may have been tapped already.

- **Competitiveness is improving, but the authorities' strategy of rebuilding competitiveness remains challenging.** Further factor price adjustment and structural reforms will be crucial for ensuring Latvia's competitiveness in the near term and once part of the euro area, but could be difficult given reform fatigue and social hardship.

- **High excess liquidity presents a potential drain on reserves**, but the threat of this could discipline government post-election.

- **Delays to much-needed financial sector reforms would increase vulnerabilities.** If Parex or MLB restructuring is delayed, further recapitalizations using public funds could be necessary. Failure to enact legislation facilitating debt restructuring could inhibit lending and slow growth.

- **Further spillovers from the sovereign debt crisis in the euro area are possible.** While Latvia is not reliant on external market financing in the short-run, heightened risk aversion could raise yields on longer-term government securities and increase scrutiny of the government's strategy. Continued turmoil in financial markets could make foreign banks and non-resident depositors rethink their exposure to Latvia, while a double-dip recession in Europe could hamper Latvia's export-led recovery.

- **Upside risks include a faster than expected rebound in economic activity** as the recovery in Latvia's export markets and euro depreciation contribute to export growth. Increased economic activity would boost revenue collection and job creation.

27. **Staff believes the program leaves Latvia in a position to repay its Fund obligations in a timely manner (Table 15).** Exposure to the Fund is expected to peak at 9.4 percent of GDP in 2011 or around 32.5 percent of reserves. Payments are expected to peak in 2013 at 2.6 percent of GDP. However, the authorities' decision to treat some program disbursements as lines of credit means that gross external debt is expected to peak at 161 percent of GDP in 2010—significantly below the 183 percent of GDP projected at the Second Review—and is expected to fall with successive current account surpluses (Table 7).

IV. Staff Appraisal

28. **The economy is showing signs of stabilizing.** Domestic demand will likely remain depressed due to fiscal consolidation, high unemployment, and declining credit, but this should be partially offset by exports, and the economy should start expanding this year. However, despite new public works programs, unemployment is expected to remain above 20 percent.

29. **Program performance has been satisfactory.** Implementation of the 2010 budget coupled with somewhat stronger than anticipated revenues allowed the authorities to meet their end-March deficit target, and the end-June NIR and NDA targets are also expected to be met. While end-June fiscal PC data are not yet available, these seem likely to be met. Reduced net lending to compensate for recent policy slippages means this year's 8.5 percent deficit target remains within reach.

30. **The priority now is to avoid further fiscal slippages ahead of the elections, and to prepare for the 2011 budget.** Staff urged the authorities to ensure that recent tax cuts and spending increases are not followed by further slippages that would increase the future adjustment need and undermine the program's credibility. Progress needs to continue on preparing a menu of options significantly larger than the estimated 3.3 percent of GDP in measures needed to reach next year's deficit target. This would give the new government options for quickly passing a quality budget.

31. **Strengthening the MoF's control over fiscal decisions will be crucial for the adjustment to be sustained.** Staff urged the authorities to implement a strong Fiscal

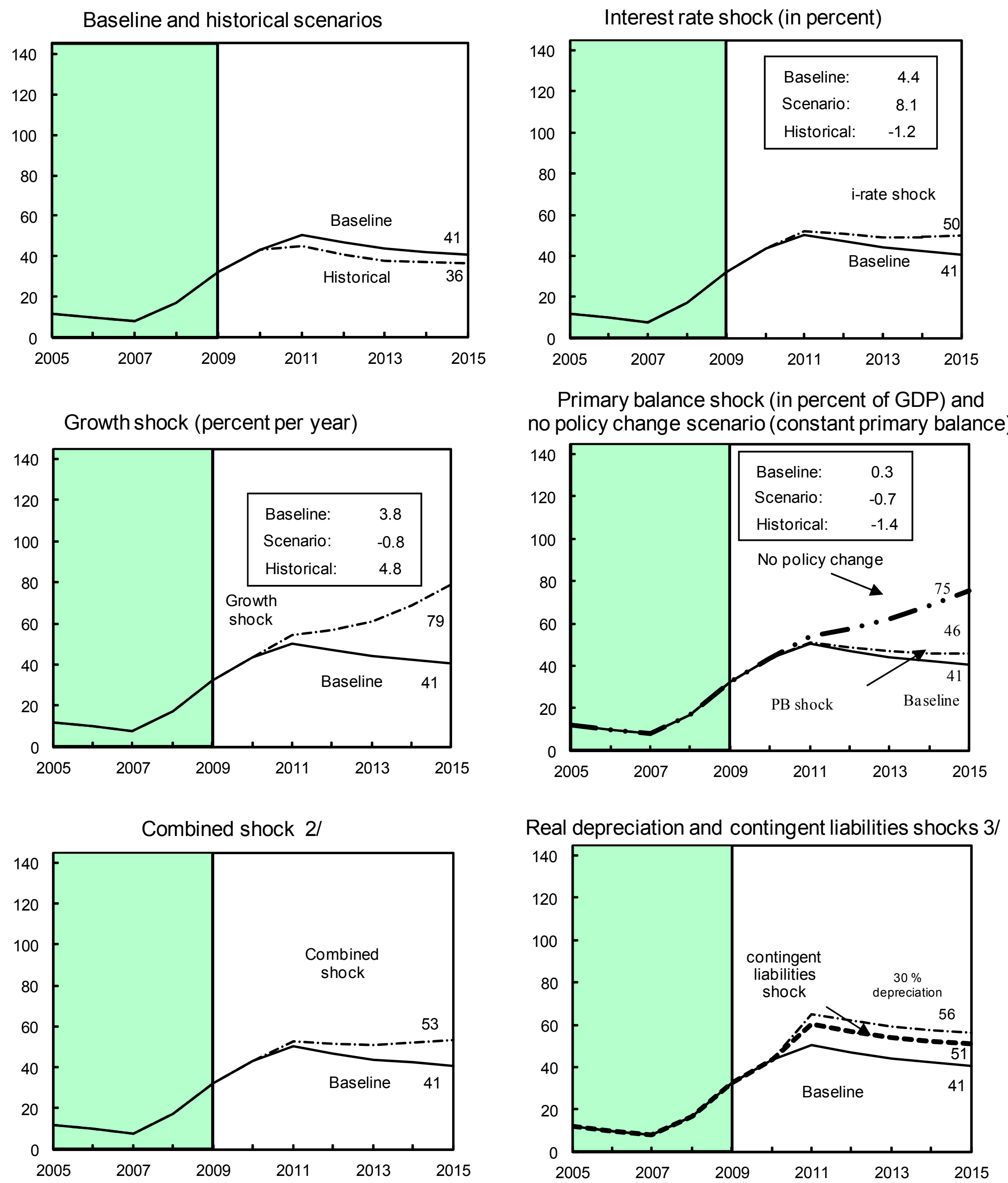
Responsibility Law that imposes fiscal discipline on both government and parliament—including through multi-year spending ceilings and a binding fiscal rule that entails a balanced budget over the cycle—and to investigate options to ensure this law takes precedence over others. This needs to be combined with basic fiscal structural reforms, such as improving control over state-owned enterprises, publishing clear tax rulings, and fighting the gray economy through strengthened tax administration.

32. **The authorities need to accelerate MLB's restructuring and facilitate market-based debt resolution.** Despite legal challenges, Parex Bank's restructuring appears likely to move ahead. For MLB, the authorities need to quickly engage an independent advisor to help prepare a restructuring plan that stems further erosion in the bank's value, given past public recapitalizations. The authorities need to remove tax and legal impediments if their market-based debt restructuring strategy is to work.

33. **Program risks remain significant.** Fiscal slippages before the elections could threaten the program's fiscal targets, increase the adjustment needed for euro adoption, and intensify financial market scrutiny. Further ahead, the new government needs to continue fiscal adjustment for the program strategy to succeed. This could be difficult during the election campaign and given the high unemployment rate. But given the size of the deficit and the time it will take to regain private market financing, there are no easy alternatives.

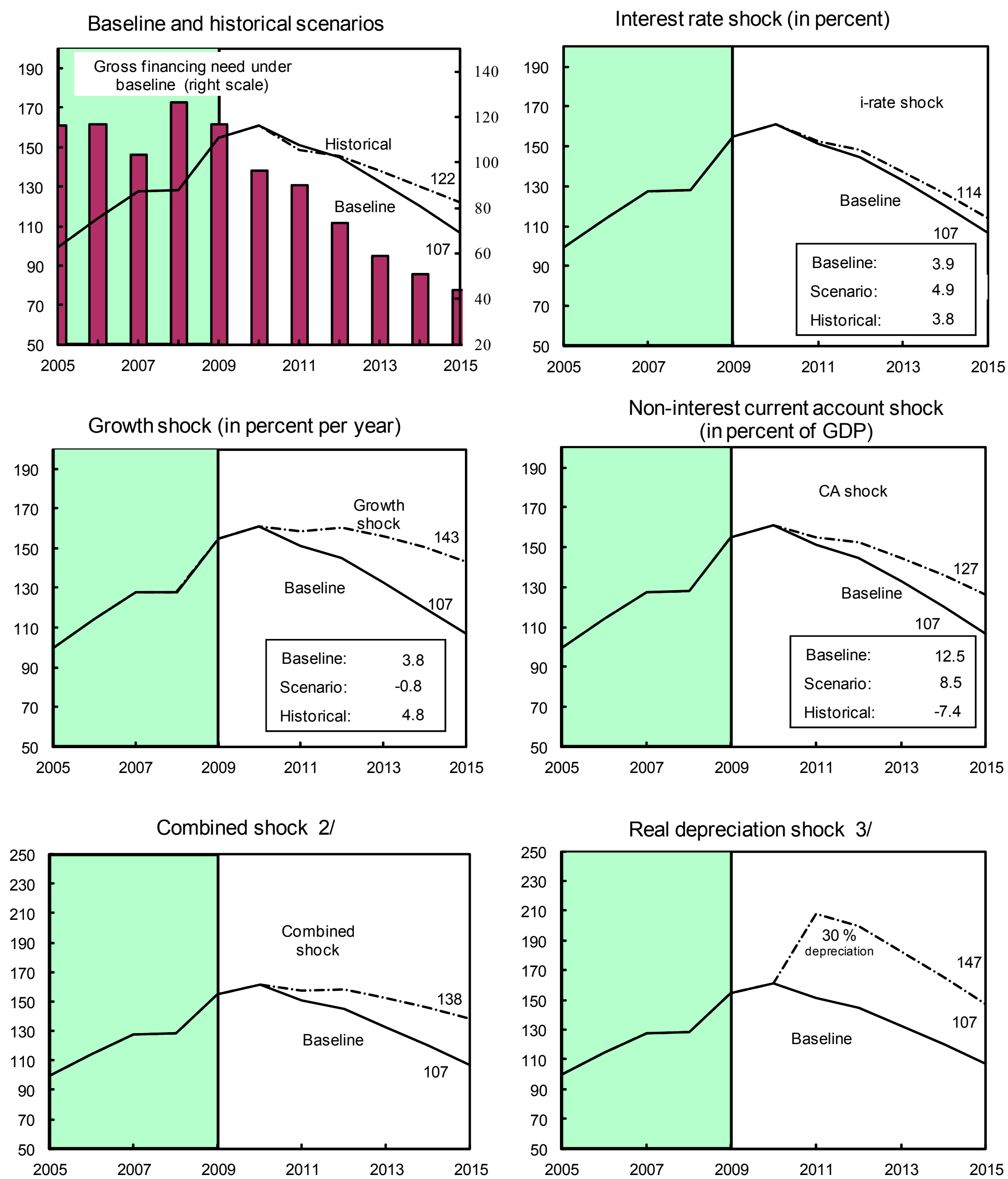
34. **Nevertheless, program implementation to-date has helped insulate Latvia from the worst of the recent international financial market turmoil.** Staff supports the authorities' request for completing the Third Review and financing assurances review on the basis of Latvia's performance under the arrangement, and the policy commitments specified in the LOI. Staff also recommends granting a waiver of applicability of the end-June performance criteria, and approval of the authorities' request to rephase the remaining purchases under the arrangement.

Figure 10. Latvia: Public Debt Sustainability: Bound Tests 1/
(Staff projections; Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 11. Latvia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2010.

Table 1. Latvia: Selected Economic Indicators, 2007–10

	2007	2008	2009		2010	
			Second Rev.	Actual	Second Rev.	Proj.
National accounts			(percentage change, unless otherwise indicated)			
Real GDP	10.0	-4.6	-18.0	-18.0	-4.0	-3.5
Private consumption	14.8	-5.5	-22.0	-22.4	-10.0	-9.0
Public consumption	3.7	1.5	-9.0	-9.2	-9.0	-10.0
Gross fixed investment	7.5	-15.6	-34.0	-37.7	-10.0	-10.0
Stockbuilding (contribution to growth)	1.6	-3.7	-3.5	-3.1	1.5	1.5
Exports of goods and services	10.0	-1.3	-17.5	-13.9	1.5	5.0
Imports of goods and services	14.7	-13.6	-35.0	-34.2	-9.9	-6.2
Nominal GDP (billions of lats)	14.8	16.3	13.1	13.2	11.9	12.2
Nominal GDP (billions of euros)	21.0	23.1	18.6	18.8	17.0	17.4
GDP per capita (euros)	9,209	10,187	8,224	8,334	7,526	7,712
Savings and Investment						
Gross national savings (percent of GDP)	20.0	20.0	28.7	30.8	30.5	30.2
Gross capital formation (percent of GDP)	40.4	31.5	18.7	19.0	18.9	18.9
Private investment (percent of GDP)	34.9	26.4	14.9	15.2	14.9	14.4
HICP inflation						
Period average	10.1	15.3	3.3	3.3	-3.7	-2.0
End-period	14.0	10.4	-1.4	-1.4	-3.3	-0.5
Labor market						
Unemployment rate (LFS definition; period average, percent)	6.2	7.8	17.5	17.3	20.0	21.0
Real gross wages	19.7	4.4	-8.0	-6.8	-6.3	-7.9
Consolidated general government 1/			(percent of GDP, unless otherwise indicated)			
Revenue	36.2	35.2	36.7	35.7	39.6	39.6
Expenditure and net lending	35.6	38.5	44.8	42.7	48.2	47.8
Basic fiscal balance	0.6	-3.3	-8.1	-7.0	-8.6	-8.1
General government gross debt	7.8	17.0	34.9	32.4	58.9	43.4
Money and credit						
Credit to private sector (percentage change)	34.0	11.8	-5.3	-6.6	...	...
Residents' FX deposits (billions of euros)	3.6	3.5	4.1	4.1	...	...
Residents' FX deposits (percent of broad money)	41.2	41.5	48.4	49.3	...	...
BoL refinancing rate (eop, percent, annualized)	6.0	6.0	4.0	4.0	...	...
Money market rate (one month, eop, percent, annualized)	6.8	13.3	2.7	2.7	...	...
Balance of payments						
Gross official reserves (billions of euros)	3.966	3.697	4.500	4.805	4.976	5.319
(In months of prospective imports)	3.7	5.6	7.6	7.5	8.1	7.8
(percent of broad money and non-resident deposits)	26.1	27.7	34.0	37.2	39.9	37.4
Current account balance	-22.3	-13.0	7.7	9.4	8.4	8.2
Trade balance	-23.9	-17.6	-6.7	-6.5	-3.4	-3.3
Exports of goods and services	41.4	41.6	41.6	41.9	46.3	48.4
Imports of goods and services	-61.9	-55.2	-41.7	-42.3	41.6	-44.4
Gross external debt	127.7	128.0	159.9	154.7	180.0	161.1
Net external debt 2/	49.4	56.5	58.2	56.6	44.1	43.0
Exchange rates						
Lats per U.S. dollar (average)	0.513	0.478	0.5	0.505	...	...
(percent change, + denotes appreciation)	9.2	7.4	-5.4	-5.3	...	...
REER (average; CPI based, 2000=100)	100.1	111.4		117.9	...	...
(percent change, + denotes appreciation)	8.0	11.2		5.9	...	...

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

1/ National definition. Includes economy-wide EU grants in revenue and expenditure.

2/ Gross external debt minus gross external debt assets.

Table 2. Latvia. Macroeconomic Framework, 2008-15

	2008	2009	2010	2011	2012	2013	2014	2015
			Projections					
			(percentage change, unless otherwise indicated)					
National accounts								
Real GDP	-4.6	-18.0	-3.5	3.3	4.0	4.0	4.0	4.0
Consumption	-4.4	-20.1	-9.2	0.8	2.3	3.7	4.1	4.2
Private consumption	-5.5	-22.4	-9.0	2.0	3.0	4.0	4.5	4.5
Public consumption	1.5	-9.2	-10.0	-4.0	-1.0	2.5	2.5	2.5
Gross fixed capital formation	-15.6	-37.7	-10.0	4.9	5.7	6.7	5.5	5.5
Exports of goods and services	-1.3	-13.9	5.0	6.0	5.5	5.5	5.5	5.5
Imports of goods and services	-13.6	-34.2	-6.2	3.0	4.0	7.0	7.0	7.0
Contributions to growth								
Domestic demand	-13.0	-32.4	-8.7	1.8	3.1	4.4	4.5	4.5
Net exports	8.5	14.4	5.2	1.6	0.9	-0.4	-0.5	-0.5
HICP inflation								
Period average	15.3	3.3	-2.0	0.0	0.5	1.0	1.2	1.4
End-period	10.4	-1.4	-0.5	0.3	0.7	1.1	1.3	1.4
Labor market								
Unemployment rate (LFS definition; period average, percen	7.8	17.3	21.0	19.2	17.9	16.5	15.5	14.5
Employment (period average, percent change)	0.1	-11.4	-5.7	0.5	0.5	0.5	0.6	0.6
Real gross wages	4.4	-6.8	-7.9	-0.2	1.3	0.7	1.2	1.0
				(percent of GDP)				
Consolidated general government								
Revenues	35.2	35.7	39.6	36.8	35.7	34.1	34.2	33.9
Expenditure	38.5	42.7	47.8	42.1	38.1	35.1	34.7	34.5
Basic Balance	-3.3	-7.0	-8.1	-5.3	-2.3	-1.0	-0.5	-0.7
Balance (including bank restructuring costs)	-7.5	-7.7	-11.7	-7.0	-2.3	-1.0	-0.5	-0.7
Gross debt	17.0	32.4	43.4	50.4	47.0	43.9	42.2	40.8
Saving and investment								
Domestic saving	20.0	30.8	30.2	30.3	30.9	32.0	32.4	32.4
Private	16.5	32.8	33.3	30.7	28.1	28.3	28.2	28.4
Public 1/	3.5	-2.0	-3.1	-0.4	2.8	3.8	4.2	4.0
Foreign saving 2/	11.5	-11.8	-11.3	-10.3	-10.2	-10.4	-10.3	-9.9
Investment	31.5	19.0	18.9	20.0	20.7	21.6	22.1	22.6
Private	26.4	15.2	14.4	15.8	16.7	18.1	18.7	19.2
Public	5.1	3.8	4.5	4.2	4.0	3.4	3.4	3.4
External sector								
Current account balance	-13.0	9.4	8.2	7.3	7.2	7.3	7.2	6.9
Net IIP	-78.2	-81.3	-76.7	-64.2	-51.1	-38.2	-26.0	-14.8
Gross external debt	128.0	154.7	161.1	151.1	144.8	132.7	120.1	106.8
Net external debt 3/	56.5	56.6	43.0	27.8	19.5	6.6	-5.5	-16.5
Memorandum items:								
Gross official reserves (billions of euros)	3.7	4.8	5.3	5.2	4.9	4.7	4.5	4.0
Nominal GDP (billions of lats)	16.3	13.2	12.2	12.6	13.2	13.8	14.5	15.3
Nominal GDP (billions of euros)	23.1	18.8	17.4	17.9	18.7	19.7	20.7	21.8

Sources: Latvian Authorities and IMF staff estimates.

1/ Includes 2nd pillar contributions.

2/ Defined as the sum of the current account deficit and capital transfers.

3/ Gross external debt minus gross external debt assets.

Table 3. Latvia: General Government Operations, 2009-12

	2009	2010 Second Rev.	2010 Proj.	2011 Proj.	2012 Proj.
	(millions of lats)				
Total revenue and grants	4,735	4,717	4,842	4,623	4,698
Tax revenue	3,515	3,308	3,335	3,324	3,363
Direct Taxes	2,166	2,098	2,042	2,002	1,994
Corporate Income Tax	197	77	98	102	102
Personal Income Tax	729	831	770	775	792
Social Security Contributions	1,167	1,100	1,086	1,034	1,004
Real Estate and Property Taxes	73	91	87	91	95
Indirect Taxes	1,349	1,209	1,294	1,322	1,370
VAT	798	687	795	807	836
Excises	504	483	459	475	493
Other indirect taxes	46	40	40	40	40
Non Tax, self-earned and other revenue	690	584	598	508	544
EU and miscellaneous funds	530	825	909	791	791
Total expenditure 1/	5,662	5,743	5,836	5,290	5,007
Current expenditure	5,231	5,335	5,359	5,233	5,330
Primary Current Expenditure	5,081	5,068	5,149	4,989	5,023
Remuneration	1,337	1,170	1,182	1,182	1,182
Goods and Services	675	652	689	689	689
Subsidies and Transfers	2,884	2,931	3,026	2,872	2,900
Subsidies to companies and institutions	1,224	1,141	1,213	1,140	1,167
E.U. funds related subsidies	668	642	777	704	731
Social Support	1,646	1,775	1,796	1,716	1,716
Pensions	1,082	1,230	1,235	1,195	1,195
Other	564	546	561	521	521
International cooperation	13	14	17	17	17
Payments to EU budget	148	140	140	145	152
Net lending and other current expenditure	36	175	112	100	100
Interest	151	267	210	244	307
Capital expenditure	430	409	477	477	477
E.U. funds related capital expenditure	135	200	200	200	200
Measures to be identified	0	0	0	-420	-800
Basic fiscal balance	-927	-1,026	-994	-667	-309
Bank restructuring costs	99	932	432	217	0
Fiscal balance	-1,026	-1,958	-1,426	-884	-309
Financing (net)	1,026	1,958	1,426	884	309
Domestic financing	-976	-185	425	-47	644
Banking system	-1,010	-185	425	-47	644
Central Bank	-654	-505	425	-147	450
Commercial banks	-356	320	0	100	194
Nonbanks	34	0	0	0	0
Privatization and other	0	0	0	0	0
External financing	1,970	2,143	1,001	931	-336
Net borrowing (net)	195	253	70	250	375
Exceptional financing	1,775	1,890	931	681	-711
Errors and omissions	32	0	0	0	0
Memorandum items					
General government debt	4,295	7,019	5,296	6,328	6,186
Primary basic balance	-776	-760	-784	-423	-2
EU spending	803	842	977	904	…
Primary non-EU spending	4,708	4,635	4,649	4,142	…

Table 3. Latvia: General Government Operations, 2009-12 (concluded)

	2009	2010 Second Rev.	2010 Proj.	2011 Proj.	2012 Proj.
	(percent of GDP)				
Total revenue and grants	35.7	39.6	39.6	36.8	35.7
Tax revenue	26.5	27.8	27.3	26.5	25.6
Direct Taxes	16.4	17.6	16.7	15.9	15.2
Corporate Income Tax	1.5	0.6	0.8	0.8	0.8
Personal Income Tax	5.5	7.0	6.3	6.2	6.0
Social Security Contributions	8.8	9.2	8.9	8.2	7.6
Real Estate and Property Taxes	0.6	0.8	0.7	0.7	0.7
Indirect Taxes	10.2	10.1	10.6	10.5	10.4
VAT	6.0	5.8	6.5	6.4	6.4
Excises	3.8	4.1	3.8	3.8	3.8
Other indirect taxes	0.3	0.3	0.3	0.3	0.3
Non Tax, self-earned and other revenue	5.2	4.9	4.9	4.0	4.1
EU and miscellaneous funds	4.0	6.9	7.4	6.3	6.0
Total expenditure 1/	42.7	48.2	47.8	42.1	38.1
Current expenditure	39.5	44.8	43.9	41.7	40.5
Primary Current Expenditure	38.4	42.5	42.2	39.7	38.2
Remuneration	10.1	9.8	9.7	9.4	9.0
Goods and Services	5.1	5.5	5.6	5.5	5.2
Subsidies and Transfers	21.8	24.6	24.8	22.9	22.0
Subsidies to companies and institutions	9.2	9.6	9.9	9.1	8.9
E.U. funds related subsidies	5.0	5.4	6.4	5.6	5.6
Social Support	12.4	14.9	14.7	13.7	13.0
Pensions	8.2	10.3	10.1	9.5	9.1
Other	4.3	4.6	4.6	4.2	4.0
International cooperation	0.1	0.1	0.1	0.1	0.1
Payments to EU budget	1.1	1.2	1.1	1.2	1.2
Net lending and other current expenditure	0.3	1.5	0.9	0.8	0.8
Interest	1.1	2.2	1.7	1.9	2.3
Capital expenditure	3.2	3.4	3.9	3.8	3.6
E.U. funds related capital expenditure	1.0	1.7	1.6	1.6	1.5
Measures to be identified	0.0	0.0	0.0	-3.3	-6.1
Basic fiscal balance 2/	-7.0	-8.6	-8.1	-5.3	-2.3
Bank restructuring costs	0.7	7.8	3.5	1.7	0.0
Fiscal balance	-7.7	-16.4	-11.7	-7.0	-2.3
Financing (net)	7.5	16.4	11.7	7.0	2.3
Domestic financing	-7.4	-1.5	3.5	-0.4	4.9
Banking system	-7.6	-1.5	3.5	-0.4	4.9
Central Bank	-4.9	-4.2	3.5	-1.2	3.4
Commercial banks	-2.7	2.7	0.0	0.8	1.5
Nonbanks	0.3	0.0	0.0	0.0	0.0
Privatization and other	0.0	0.0	0.0	0.0	0.0
External financing	14.9	18.0	8.2	7.4	-2.6
Net borrowing (net)	1.5	2.1	0.6	2.0	2.9
Exceptional financing	13.4	15.9	7.6	5.4	-5.4
Errors and omissions	0.2	0.0	0.0	0.0	0.0
Memorandum items					
General government debt	32.4	58.9	43.4	50.4	47.0
Primary basic balance	-5.9	-6.4	-6.4	-3.4	0.0
Nominal GDP (In millions of lats)	13,244	11,918	12,213	12,563	13,156
EU spending	6.1	7.1	8.0	7.2	…
Primary non EU spending	35.5	38.9	38.1	33.0	…

Sources: Latvian authorities and IMF staff estimates.

1/ Total expenditure excludes net acquisition of financial assets and other bank restructuring costs

2/ The ESA 95 deficit for 2009 is 9.0 percent of GDP due to: (i) unspent greenhouse gas trading revenues (0.7 percent of GDP), (ii) PPPs (0.6 percent of GDP), (iii) broader definition of general government (0.2 percent of GDP), and (iv) accrual adjustments.

Table 4. Latvia: Fiscal balances and Debt, 2006-15

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	(percent of GDP)									
Fiscal balances										
Basic fiscal balance (excl. bank restructuring)	-0.5	0.6	-3.3	-7.0	-8.1	-5.3	-2.3	-1.0	-0.5	-0.7
Alternative fiscal balances										
(i) plus net lending	…	0.0	0.0	0.3	0.9	0.8	0.8	0.8	0.8	0.8
Basic fiscal balance, authorities' definition	…	0.6	-3.3	-6.7	-7.2	-4.5	-1.6	-0.2	0.3	0.1
(ii) less gain from 2nd pillar contributions < 8%	0.0	0.0	0.0	1.2	1.7	1.5	1.0	0.4	0.4	0.4
Fiscal balance, adjusted for pension diversion 1/	-0.5	0.6	-3.3	-8.2	-9.8	-6.8	-3.3	-1.4	-0.9	-1.1
(iii) less revenues from EU	2.3	3.1	2.6	4.0	7.4	6.3	6.0	4.3	4.2	3.8
plus EU-related spending	4.1	3.6	4.2	6.1	8.0	7.2	7.1	5.1	5.0	4.5
Non-EU basic balance	1.3	1.1	-1.8	-4.9	-7.6	-4.4	-1.3	-0.2	0.2	0.0
(iv) plus interest	0.6	0.3	0.4	1.1	1.7	1.9	2.3	2.3	2.2	2.3
Primary basic balance	0.1	1.0	-2.9	-5.9	-6.4	-3.4	0.0	1.4	1.7	1.6
(v) less bank restructuring costs	0.0	0.0	4.1	0.7	3.5	1.7	0.0	0.0	0.0	0.0
Overall balance	-0.5	0.6	-7.5	-7.7	-11.7	-7.0	-2.3	-1.0	-0.5	-0.7
(vi) ESA definition 2/	-0.5	-0.3	-4.1	-9.0	-8.5	-6.0	-3.0	-1.6	-1.1	-1.3
Public debt										
Gross debt	9.9	7.8	17.0	32.4	43.4	50.4	47.0	43.9	42.2	40.8
of which foreign currency-denominated	5.2	4.4	9.8	25.3	35.4	41.8	37.4	33.7	27.9	19.8
Net debt (debt less government deposits)	7.4	4.7	13.1	22.7	36.3	42.3	42.7	41.6	40.1	38.8
Net debt if no more bank restructuring	7.4	4.7	13.1	22.7	34.1	38.5	39.1	38.2	36.8	35.6

Sources: Latvian authorities and IMF staff estimates.

1/ Definition used at First Review.

2/ Statistically adjusted from cash to accrual, less net lending, plus other liabilities (e.g., PPPs).

Table 5. Latvia: Public Sector Debt Sustainability Framework, 2005-2015
(Staff projections; In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing primary balance 9/**
1	**Baseline: Public sector debt 1/**	11.8	9.9	7.8	17.0	32.4	**43.4**	**50.4**	**47.0**	**43.9**	**42.2**	**40.8**	**0.3**
	o/w foreign-currency denominated	6.0	5.2	4.4	9.8	25.3	35.4	41.8	37.4	33.7	27.9	19.8	
2	Change in public sector debt	-2.6	-1.9	-2.1	9.2	15.4	10.9	7.0	-3.3	-3.1	-1.7	-1.4	
3	Identified debt-creating flows (4+7+12)	-0.9	-1.9	-3.5	6.3	12.4	14.4	5.8	0.1	-1.3	-1.7	-1.4	
4	Primary deficit	0.7	-0.1	-1.0	2.9	5.9	6.4	3.3	0.0	-1.4	-1.7	-1.6	
5	Revenue and grants	35.3	36.1	36.2	35.2	35.7	39.6	36.8	35.7	34.1	34.2	33.9	
6	Primary (noninterest) expenditure	36.0	36.0	35.2	38.1	41.6	46.1	40.1	35.7	32.8	32.5	32.2	
7	Automatic debt dynamics 2/	-1.7	-1.7	-2.4	-0.6	5.8	4.5	0.8	0.1	0.1	0.1	0.2	
8	Contribution from interest rate/growth differential 3/	-2.0	-1.7	-2.1	-0.3	5.0	4.5	0.8	0.1	0.1	0.1	0.2	
9	Of which contribution from real interest rate	-0.7	-0.5	-1.3	-0.6	1.3	3.2	2.2	2.0	1.8	1.7	1.8	
10	Of which contribution from real GDP growth	-1.3	-1.2	-0.7	0.3	3.8	1.2	-1.4	-1.9	-1.8	-1.7	-1.6	
11	Contribution from exchange rate depreciation 4/	0.3	0.0	-0.4	-0.3	0.7	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.1	-0.1	-0.1	4.0	0.7	3.5	1.7	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Bank restructuring	0.0	0.0	0.0	4.1	0.7	3.5	1.7	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	-1.7	0.0	1.4	2.9	3.1	-3.5	1.2	-3.4	-1.8	0.0	0.0	
	Public sector debt-to-revenue ratio 1/	33.3	27.3	21.4	48.3	90.7	109.4	136.9	131.7	128.7	123.5	120.5	
	Gross financing need 6/	3.3	2.2	0.3	8.9	15.7	16.6	12.9	8.6	9.4	10.7	16.9	
	in billions of U.S. dollars	0.5	0.4	0.1	2.9	4.2	4.0	3.2	2.2	2.5	3.0	5.0	
	Scenario with key variables at their historical averages 7/						**43.4**	**45.1**	**40.6**	**37.9**	**37.1**	**36.4**	**-2.0**
	Scenario with no policy change (constant primary balance) in 2010-2015						**43.4**	**54.1**	**57.2**	**62.0**	**68.6**	**75.4**	**0.6**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	10.6	12.2	10.0	-4.6	-18.0	-3.5	3.3	4.0	4.0	4.0	4.0	
	Average nominal interest rate on public debt (in percent) 8/	4.9	5.9	4.7	5.6	5.4	4.9	4.7	4.8	5.2	5.4	5.8	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.2	-4.0	-15.6	-9.8	6.2	9.4	5.1	4.1	4.2	4.2	4.5	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-4.3	0.8	9.2	7.4	-5.3	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	10.2	9.9	20.3	15.4	-0.7	-4.5	-0.5	0.7	1.1	1.2	1.3	
	Growth of real primary spending (deflated by GDP deflator, in percent)	15.6	12.2	7.6	3.3	-10.5	6.9	-10.0	-7.5	-4.7	3.1	3.2	
	Primary deficit	0.7	-0.1	-1.0	2.9	5.9	6.4	3.3	0.0	-1.4	-1.7	-1.6	
	Net debt	11.0	9.4	6.6	13.1	22.7	36.3	42.3	42.7	41.6	40.1	38.8	
	Deposits in central bank	0.8	0.4	1.2	3.9	9.8	7.1	8.1	4.3	2.3	2.2	2.0	
	Deposits as a share of average montly financing need	2.8	2.4	54.8	5.3	7.4	5.1	7.5	6.0	2.9	2.4	1.5	

1/ General government.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 6. Latvia: Medium Term Balance of Payments, 2007−15

	2007	2008	2009		2010	2011	2012	2013	2014	2015
			2nd Rev.	Actual	Projections					
	(millions of euros)									
Current account	-4,691	-3,007	1,431	1,778	1,420	1,307	1,355	1,437	1,485	1,498
Trade balance (fob)	-5,031	-4,073	-1,243	-1,230	-567	-519	-607	-538	-493	-479
Exports	5,997	6,527	4,970	5,160	5,691	6,097	6,410	6,798	7,174	7,536
Imports	11,028	10,600	6,212	6,390	6,258	6,616	7,017	7,335	7,668	8,015
Services	730	917	1,221	1,165	1,260	1,370	1,424	1,536	1,638	1,730
Credit	2,696	3,087	2,770	2,739	2,723	2,934	3,086	3,273	3,454	3,628
Debit	1,966	2,171	1,548	1,574	1,463	1,565	1,662	1,737	1,816	1,898
Income	-663	-363	851	1,213	81	-351	-398	-447	-488	-581
Compensation of employees	373	372	395	398	406	362	362	362	362	362
Investment income	-1,037	-735	456	815	-326	-713	-761	-809	-850	-943
Current transfers	274	512	602	630	647	807	936	885	828	828
of which: EU (net)	40	34	40	175	354	354	374	295	310	310
Capital and financial account	5,574	2,015	-3,167	-3,232	-2,357	-2,160	-1,300	-1,148	-351	123
Capital account	410	341	419	451	544	542	550	617	650	650
Financial account	5,164	1,674	-3,586	-3,683	-2,901	-2,701	-1,850	-1,765	-1,001	-527
Direct investment	1,428	697	170	68	364	512	388	414	442	448
of which: equity capital	767	286	670.6	976	468	340	485	500	515	505
Portfolio investment	-494	254	134	287	199	341	534	134	528	600
of which: general government	12	210	-21.4	-3	0	341	534	134	528	600
Financial derivatives	165	-71	313	302	-90	0	0	0	0	0
Other investment	4,065	795	-4,202	-4,340	-3,374	-3,555	-2,772	-2,313	-1,971	-1,575
Trade credit	66	-40	-108	-101	-49	12	-41	26	-31	-25
Assets	-164.7	27	23.4	102	-57	5	-85	-92	-82	-79
Liabilities	230.7	-67	-131.8	-202	8	8	44	117	51	54
Loans	4,148	2,846	-1,998	-2,252	-1,875	-2,159	-1,504	-1,276	-1,004	-763
Assets	-1,612	-187	123.0	16	-500	-854	-789	-711	-639	-576
Liabilities	5,759	3,033	-2120.9	-2,268	-1,375	-1,305	-714	-566	-365	-187
Currency and deposits	-207	-1,993	-2,108	-1,998	-1,450	-1,408	-1,227	-1,062	-936	-787
Assets	-2,566	-130	-1705.5	-1,112	-662	-649	-600	-540	-486	-437
Liabilities	2,359	-1,863	-402.2	-885	-788	-760	-627	-522	-450	-350
Other	59	-18	12	10	0	0	0	0	0	0
Errors and omissions	-168	-414	186	61	126	0	0	0	0	0
Overall balance	715	-1,407	-1,549	-1,393	-810	-853	55	289	1,135	1,621
Financing	-715	1,407	1,549	1,393	810	853	-55	-289	-1,135	-1,621
Change in reserve assets (+ denotes decline)	-715	456	-765	-922	-515	148	261	185	232	463
IMF (net)	…	591	194	194	425	505	-316	-474	-366	-355
Purchases	…	…	…	…	425	505	0	0	0	0
Repurchases	…	…	…	…	0	0	-316	-474	-366	-355
Other official financing (net)	…	360	2,120	2,120	900	200	0	0	-1,000	-1,729
Disbursements	…	…	…	…	900	200	0	0	0	0
Repayments	…	…	…	…	0	0	0	0	-1,000	-1,729

Sources: Latvian authorities and IMF staff estimates.

Table 6. Latvia: Medium Term Balance of Payments, 2007−15 (concluded)

	2007	2008	2009		2010	2011	2012	2013	2014	2015
			2nd Rev.	Actual	Projections					
Memorandum items:			(percent of GDP, unless otherwise indicated)							
Current account 1/	-22.3	-13.0	7.7	9.4	8.2	7.3	7.2	7.3	7.2	6.9
Trade balance (fob)	-23.9	-17.6	-6.7	-6.5	-3.3	-2.9	-3.2	-2.7	-2.4	-2.2
Exports	28.5	28.2	26.7	27.4	32.7	34.1	34.2	34.6	34.7	34.6
Imports	52.5	45.8	33.4	33.9	36.0	37.0	37.5	37.3	37.1	36.8
Services	3.5	4.0	6.6	6.2	7.2	7.7	7.6	7.8	7.9	7.9
Income	-3.2	-1.6	4.6	6.4	0.5	-2.0	-2.1	-2.3	-2.4	-2.7
Compensation of employees	1.8	1.6	2.1	2.1	2.3	2.0	1.9	1.8	1.8	1.7
Investment income	-4.9	-3.2	2.5	4.3	-1.9	-4.0	-4.1	-4.1	-4.1	-4.3
Current transfers	1.3	2.2	3.2	3.3	3.7	4.5	5.0	4.5	4.0	3.8
of which: EU (net)	0.2	0.1	0.2	0.9	2.0	2.0	2.0	1.5	1.5	1.4
Net FDI	6.8	3.0	0.9	0.4	2.1	2.9	2.1	2.1	2.1	2.1
Export G&S growth (value, fob, percent change)	24.5	10.6	-29.6	-17.8	6.5	7.3	5.1	6.1	5.5	5.0
Import G&S growth (value, fob, percent change)	23.5	-1.7	-42.6	-37.6	-3.1	6.0	6.1	4.5	4.5	4.5
Export G&S price increase (percent change)	13.2	10.2	-7.0	-4.5	1.2	1.0	1.0	1.0	1.0	1.0
Import G&S price increase (percent change)	8.4	12.0	-6.5	-2.7	4.5	2.3	1.0	1.0	1.0	1.0
Gross reserves (billions of euros)	4.0	3.7	4.5	4.8	5.3	5.2	4.9	4.7	4.5	4.0
(in months of prospective imports)	3.7	5.6	7.6	7.5	7.8	7.2	6.5	6.0	5.4	4.6
Reserve Cover 2/	23.8	23.7	67.3	80.9	80.7	72.3	72.3	74.4	66.7	56.8
Short-term debt (percent of official reserves)	292.0	268.5	131.2	149.2	127.5	116.6	102.9	98.4	94.6	98.1
Banks' short term liabilities (billions of euros)	9.7	7.6	5.9	5.5	4.7	4.0	3.3	2.8	2.4	2.0
Total short-term debt (billions of euros)	11.6	9.9	7.5	7.2	6.8	6.0	5.1	4.6	4.3	4.0
Reserves (percent of short-term external debt)	34.2	37.2	59.8	67.0	78.4	85.7	97.2	101.6	105.7	101.9
Gross external debt (billions of euros)	26.8	29.6	29.7	29.2	28.0	27.0	27.1	26.1	24.9	23.3
Medium and long term (billions of euros)	15.2	19.7	22.2	22.0	21.2	21.0	22.0	21.5	20.6	19.3
Short term (billions of euros)	11.6	9.9	7.5	7.2	6.8	6.0	5.1	4.6	4.3	4.0
Net external debt (billions of euros) 3/	10.4	13.1	10.8	10.7	7.5	5.0	3.7	1.3	-1.1	-3.6
Gross external debt	127.7	128.0	159.9	154.7	161.1	151.1	144.8	132.7	120.1	106.8
Medium and long term	72.6	85.1	119.5	116.7	122.0	117.3	117.8	109.1	99.6	88.6
Short term	55.1	42.9	40.4	38.0	39.0	33.7	27.0	23.6	20.5	18.1
Net external debt	49.4	56.5	58.2	56.6	43.0	27.8	19.5	6.6	-5.5	-16.5
Nominal GDP (billions of euros)	21.0	23.1	18.6	18.8	17.4	17.9	18.7	19.7	20.7	21.8
U.S. dollar per euro (period average)	1.37	1.47	1.39	1.39	…	…	…	…	…	…
Lats per euro	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70

Sources: Latvian authorities and IMF staff estimates.

1/ 2009 estimate of 2.8 percent of GDP if excluding provisioning by foreign banks for their non-performing loans.

2/ Gross reserves in percent of banks' short-term liabilities and amortization minus the current account surplus.

3/ Gross external debt minus gross external debt assets.

Table 7. Latvia: External Debt Dynamics, 2007-15

	2007	2008	2009	2010	2011	2012	2013	2014	2015
					(billions of euros)				
Gross external debt	26.8	29.6	29.2	28.0	27.0	27.1	26.1	24.9	23.3
Public	1.1	2.5	4.8	6.1	7.2	7.4	7.0	6.2	4.7
Short term	0.0	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Long term	1.0	1.9	4.6	6.1	7.1	7.2	6.9	6.1	4.6
Private	25.8	27.1	24.4	21.9	19.8	19.7	19.1	18.7	18.5
Banks	18.2	18.5	15.5	12.8	10.6	10.3	9.2	8.4	7.8
Short term	9.7	7.6	5.5	5.2	4.5	3.3	2.8	2.4	2.0
Long term	8.4	10.9	10.0	7.5	6.1	7.0	6.4	6.0	5.8
Corporate	5.6	6.1	5.8	5.7	5.6	5.5	5.6	5.7	5.7
Short term	1.8	1.8	1.5	1.5	1.5	1.6	1.7	1.8	1.8
Long term	3.8	4.3	4.3	4.2	4.0	3.9	3.9	3.9	3.9
Other	2.0	2.5	3.1	3.4	3.7	4.0	4.3	4.6	5.0
					(percent of GDP)				
Gross external debt	127.7	128.0	154.7	161.1	151.1	144.8	132.7	120.1	106.8
Public	5.1	10.8	25.4	35.3	40.2	39.4	35.8	30.0	21.7
Short term	0.2	2.4	0.7	0.3	0.3	0.8	0.7	0.7	0.6
Long term	4.9	8.4	24.7	35.0	39.8	38.7	35.1	29.3	21.0
Private	122.6	117.2	129.3	125.8	110.9	105.4	97.0	90.2	85.1
Banks	86.4	80.2	82.2	73.4	59.1	55.0	46.8	40.4	35.9
Short term	46.4	33.0	29.2	30.0	24.9	17.8	14.3	11.4	9.2
Long term	40.0	47.2	52.9	43.4	34.2	37.2	32.5	29.0	26.6
Corporate	26.7	26.3	30.7	33.0	31.1	29.2	28.4	27.4	26.3
Short term	8.5	7.6	8.1	8.7	8.5	8.4	8.6	8.5	8.3
Long term	18.2	18.7	22.7	24.3	22.7	20.8	19.8	19.0	18.0
Other	9.4	10.8	16.4	19.4	20.7	21.1	21.7	22.4	22.9
					(debt dynamics, change in debt to GDP ratio)				
Total Debt to GDP	13.5	0.3	26.7	6.4	-10.0	-6.3	-12.0	-12.6	-13.4
Due to change in debt	41.4	12.1	-2.4	-6.7	-5.5	0.5	-5.0	-6.0	-7.3
Due to nominal GDP	-27.9	-11.7	29.1	13.1	-4.5	-6.8	-7.0	-6.6	-6.1
Public Debt to GDP	-0.8	5.7	14.6	9.9	4.9	-0.7	-3.6	-5.8	-8.3
Due to change in debt	0.6	6.2	12.2	7.7	5.9	1.1	-1.7	-4.0	-6.8
Due to nominal GDP	-1.4	-0.5	2.5	2.1	-1.0	-1.8	-1.9	-1.8	-1.5
Private Debt to GDP	14.4	-5.3	12.1	-3.5	-14.9	-5.5	-8.4	-6.8	-5.1
Due to change in debt	40.8	5.9	-14.6	-14.4	-11.4	-0.5	-3.3	-2.0	-0.5
Due to nominal GDP	-26.4	-11.3	26.7	10.9	-3.5	-5.0	-5.1	-4.8	-4.5
Memorandum items:									
Nominal GDP (billions of euros)	21.0	23.1	18.8	17.4	17.9	18.7	19.7	20.7	21.8

Source: Latvian authorities and IMF staff estimates.

Table 8. Latvia: External Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

		Actual							Projections						
		2005	2006	2007	2008	2009			2010	2011	2012	2013	2014	2015	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	99.5	114.2	127.7	128.0	154.7			**161.1**	**151.1**	**144.8**	**132.7**	**120.1**	**106.8**	**-1.8**
2	Change in external debt	10.3	14.7	13.5	0.3	26.7			6.4	-10.0	-6.3	-12.0	-12.6	-13.4	
3	Identified external debt-creating flows (4+8+9)	-3.8	-3.4	-19.5	-8.1	32.2			-3.3	-14.2	-14.2	-13.9	-13.3	-12.3	
4	Current account deficit, excluding interest payments	8.5	17.4	17.8	11.1	-10.7			-12.6	-13.1	-13.1	-12.8	-12.2	-11.3	
5	Deficit in balance of goods and services	15.2	22.3	20.5	13.6	0.3			-4.0	-4.8	-4.4	-5.1	-5.5	-5.7	
6	Exports	47.0	44.0	41.4	41.6	41.9			48.4	50.5	50.7	51.2	51.4	51.2	
7	Imports	62.2	66.2	61.9	55.2	42.3			44.4	45.8	46.4	46.1	45.8	45.5	
8	Net non-debt creating capital inflows (negative)	-3.6	-6.5	-6.7	-1.4	3.6			-1.2	-1.5	-1.1	-1.1	-1.0	-0.9	
9	Automatic debt dynamics 1/	-8.6	-14.4	-30.5	-17.8	39.3			10.6	0.4	0.1	0.0	0.0	-0.1	
10	Contribution from nominal interest rate	4.0	5.1	4.6	1.9	1.3			4.5	5.8	5.9	5.5	5.0	4.5	
11	Contribution from real GDP growth	-8.1	-9.8	-7.9	4.9	29.9			6.2	-5.4	-5.8	-5.5	-5.1	-4.5	
12	Contribution from price and exchange rate changes 2/	-4.6	-9.7	-27.2	-24.6	8.1			...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	14.1	18.1	33.0	8.4	-5.5			9.6	4.2	7.9	1.9	0.7	-1.0	
	External debt-to-exports ratio (in percent)	211.5	259.6	308.6	308.1	369.1			332.7	299.0	285.4	259.3	233.9	208.4	
	Gross external financing need (in billions of US dollars) 4/	18.7	23.2	29.8	43.0	30.6			21.9	20.4	17.3	14.6	13.2	11.9	
	in percent of GDP	116.4	116.5	103.3	126.2	116.5	10-Year	10-Year	96.5	89.7	73.2	58.9	50.9	43.8	
	Scenario with key variables at their historical averages 5/								**161.1**	**148.9**	**145.5**	**137.8**	**130.0**	**121.9**	**-14.7**
							Historical	Standard							
	Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
	Real GDP growth (in percent)	10.6	12.2	10.0	-4.6	-18.0	4.8	9.2	-3.5	3.3	4.0	4.0	4.0	4.0	
	GDP deflator in US dollars (change in percent)	5.4	10.8	31.3	23.9	-6.0	9.5	11.5	-10.2	-3.3	0.2	0.5	0.6	0.8	
	Nominal external interest rate (in percent)	5.3	6.4	5.8	1.8	0.8	3.8	2.1	2.5	3.6	4.1	4.0	4.0	3.9	
	Growth of exports (US dollar terms, in percent)	25.7	16.2	35.9	18.8	-22.2	15.4	16.1	0.1	4.3	4.6	5.5	5.0	4.5	
	Growth of imports (US dollar terms, in percent)	21.9	32.4	34.9	5.5	-41.0	14.5	22.7	-8.9	2.9	5.5	4.0	4.0	4.0	
	Current account balance, excluding interest payments	-8.5	-17.4	-17.8	-11.1	10.7	-7.4	8.0	12.6	13.1	13.1	12.8	12.2	11.3	
	Net non-debt creating capital inflows	3.6	6.5	6.7	1.4	-3.6	3.1	2.9	1.2	1.5	1.1	1.1	1.0	0.9	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,
ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 9. Latvia: Bank of Latvia Balance Sheet, 2006-11

(end-period; millions of lats, unless otherwise indicated)

	2006	2007	2008	2009	2010		2011
				Actual	Second Rev.	Proj.	Proj.
Net foreign assets (NFA)	2,414	2,769	2,333	3,311	3,649	3,704	3,601
Net domestic assets (NDA)	-166	-298	-221	-1,666	-1,925	-1,891	-1,732
of which:							
Banks (net, excluding bank reserves with the BoL)	-44	7	637	-120	170	-758	-638
General government (net)	-50	-171	-638	-1,308	-1,797	-855	-806
Capital and reserves	104	164	242	270	314	278	288
Base money = NFA + NDA 1/	2,249	2,471	2,112	1,646	1,724	1,813	1,868
of which, lats in circulation	1,074	1,049	1,018	788	772	917	1,016
	(year-on-year growth rate, percent)						
NFA	74.1	14.7	-15.8	42.0	10.2	11.9	-2.8
Base money	66.5	9.9	-14.6	-22.1	4.7	10.2	3.0
Lats in circulation	22.4	-2.3	-3.0	-22.6	-2.1	16.4	10.8
	(contribution to year-on-year growth in base money, percent)						
Net foreign assets	76.0	15.8	-17.7	46.4	20.5	23.9	-5.7
Net domestic assets	-9.6	-5.9	3.1	-68.4	-15.8	-13.7	8.8
Memorandum items:							
NFA/monetary base	107.4	112.1	110.5	201.2	211.7	204.3	192.7
Reserve money/GDP	20.1	16.7	13.0	12.4	14.5	14.8	14.9
Nominal GDP	11,172	14,780	16,274	13,244	11,918	12,213	12,563

Source: Bank of Latvia and IMF staff estimates.

1/ Excludes banks' deposits at deposit facility

Table 10. Latvia: Monetary Survey, 2006-11
(end-period; billions of lats, unless otherwise indicated)

	2006	2007	2008	2009	2010		2011
				Actual	Second Rev.	Proj.	Proj.
			(at current exchange rates)				
Net foreign assets (NFA)	-2.6	-4.5	-5.9	-3.0	-1.9	-1.1	0.3
Bank of Latvia	2.4	2.8	2.3	3.3	3.6	3.7	3.6
Domestic money banks	-5.0	-7.3	-8.2	-6.3	-5.6	-4.8	-3.3
Net domestic assets (NDA)	8.1	10.7	11.8	8.8	7.8	8.1	8.1
Domestic credit	9.9	13.0	14.3	12.2	11.6	11.8	11.9
Credit to private sector	9.8	13.1	14.6	13.7	13.2	12.9	12.9
Government, net	0.1	-0.1	-0.4	-1.5	-1.6	-1.1	-1.0
Other Items, net	-1.8	-2.4	-2.4	-3.4	-3.8	-3.7	-3.9
Broad money (M2 plus residents' foreign currency deposits)	5.5	6.2	5.9	5.8	5.8	7.0	8.4
Domestic money supply (M2)	3.6	3.6	3.5	3.0	2.9	3.8	4.5
Currency held by public	1.0	0.9	0.9	0.7	0.7	0.8	0.9
Private deposits in lats	2.7	2.7	2.6	2.3	2.2	3.0	3.6
Residents' foreign currency deposits	1.9	2.5	2.5	2.9	2.9	3.2	3.9
			(year-on-year growth rate, percent)				
Credit to private sector	58.3	34.0	11.8	-6.6	-4.7	-5.5	-0.3
Broad money	37.5	12.6	-3.9	-1.9	-2.7	21.1	18.9
Private deposits in lats	39.6	3.0	-4.7	-12.1	-7.3	31.6	19.2
			(percent, unless otherwise indicated)				
Memorandum items:							
Broad money/GDP	49.1	41.8	36.4	43.9	48.8	57.7	66.7
Residents' foreign currency deposits/total domestic deposits	41.2	48.2	48.6	55.6	56.9	51.7	51.9
Broad money multiplier (broad money/reserve money)	2.4	2.5	2.8	3.1	3.4	2.7	3.3
Private credit (percent of GDP)	87.5	88.7	90.0	103.3	111.0	105.9	102.7
Non-resident deposits (billions of lats)	3.0	4.5	3.5	3.3	2.9	2.9	2.5
Nominal GDP (billions of lats)	11.2	14.8	16.3	13.2	11.9	12.2	12.6

Source: Bank of Latvia and IMF staff estimates.

Table 11. Latvia: Financial Soundness Indicators, 2007-2010

(In percent, unless otherwise indicated)

	Dec-07	Dec-08	Mar-09	June-09	Sep-09	Dec-09	Mar-10
Commercial banks							
Capital Adequacy							
Regulatory capital to risk-weighted assets	11.1	11.8	11.4	12.4	13.6	14.6	14.2
Regulatory Tier I capital to risk-weighted assets*	9.8	10.5	10.8	10.2	10.7	11.5	11.1
Capital and reserves to assets	7.9	7.3	7.5	7.2	7.1	7.4	7.3
Asset Quality							
Annual growth of bank loans	37.2	11.2	7.9	0.2	-5.4	-7.0	-7.5
Loans past due over 90 days	0.8	3.6	7.1	12.0	14.5	16.4	17.9
Loans past due over 90 days net of loan loss provisions to capital	…	13.6	36.4	60.6	66.6	67.6	69.9
Loan loss provisions to loans past due over 90 days	…	61.3	48.0	50.8	55.6	57.4	59.8
Loan loss provisions to total loans	…	2.2	3.4	6.1	8.1	9.4	10.7
Share of loans in total assets, banks dealing with residents 1/	80.4	82.5	82.4	77.6	76.9	76.4	79.2
Share of loans in total assets, banks dealing with non-residents 1/	48.9	51.7	58.6	57.4	57.6	52.4	54.5
Earnings and Profitability							
ROA (after tax)	2.0	0.3	-0.9	-3.2	-3.6	-3.5	-2.5
ROE (after tax)	24.3	4.6	-11.2	-38.1	-42.1	-41.6	-29.8
Net interest income to total income	32.5	30.1	24.8	25.3	24.1	23.3	16.1
Noninterest expenses to total income	32.3	47.5	68.2	104.1	112.0	114.5	105.9
Trading income to total income	7.8	5.6	3.9	8.8	9.0	8.6	0.1
Personnel expenses to noninterest expenses	31.5	21.3	13.2	8.8	8.4	8.5	10.0
Income from operations with non-residents to total income							
Banks dealing with residents 1/	13.0	13.7	19.4	24.6	22.2	21.0	10.3
Banks dealing with non-residents 1/	49.2	48.0	44.9	48.9	46.6	44.8	46.3
Liquidity							
Liquid assets to total assets	25.0	21.6	18.6	18.8	19.0	21.1	21.7
Liquid assets to short term liabilities	55.7	52.8	48.0	49.6	54.4	62.8	62.8
Customers deposits to (non-interbank) loans	68.2	58.8	58.9	57.8	57.1	61.9	64.5
Sensitivity to Market Risk							
Net open positions in FX to capital 2/	5.4	6.3	3.1**	3.5**	4.2**	4.1**	3.8**
Net open positions in EUR to capital	3.2	3.7	2.6**	2.2**	3.2**	3.0**	3.1**
FX assets to total assets	79.7	80.5	82.1	83.4	83.4	82.7	81.5
FX deposits to total deposits	70.7	69.4	71.5	74.5	74.9	74.5	72.8
FX liabilities to total liabilities 2/	81.7	81.1	81.8	84.1	84.3	83.8	82.8
FX loans to total loans 2/	81.8	85.0	85.5	87.7	88.0	87.1	85.9
Nonfinancial Enterprises 3/							
Total debt to equity	202.0	217.6	175.6	183.2	191.4	…	…
Return on equity	31.1	14.4	1.6	4.1	6.6	…	…
Earnings to interest expenses	496.7	225.9	117.8	151.6	168.6	155.4	…
Households							
Household debt to GDP	42.4	41.1	41.7	43.1	45.3	47.5	…
Household debt service to GDP 4/	2.5	2.7	2.7	2.7	2.6	2.5	…
Real Estate Markets							
Real estate prices annual growth rate 5/	-7.3	-37.1	-52.0	-59.2	-52.4	-39.6	-10.8
Residential real estate loans to total loans 6/	31.6	30.5	30.5	31.0	31.0	31.3	31.6
Commercial real estate loans to total loans 6/	17.8	19.5	19.4	19.7	20.0	19.9	19.1
Memorandum Items							
Number of banks dealing with residents 1/	9	13	12	15	15	14	14
Number of banks dealing with non-residents 1/	14	13	14	11	11	12	12
Assets of banks dealing with residents/Total banking system assets 1/	60.8	63.9	63.9	80.0	80.1	78.4	65.4
Assets of banks dealing with non-residents/Total banking system assets 1/	39.2	36.1	36.1	20.0	19.9	21.6	34.6

Source: CSB, BoL, FCMC, Latvian Leasing Association, staff calculations

*Regulatory Tier 1 capital to risk weighted assets as from December 2009 is calculated as Tier 1 capital (including deduction)/risk-weighted assets

**Excluding Parex Bank

1/ Banks dealing with residents (non-residents) are defined as banks in which non-resident non-MFI deposits are below (above) 20 percent of their assets.

2/ Including euro-denominated positions.

3/ Data for 2009 is not annualized and not comparable to yearly figures due to different sample (for 3, 6, 9 and 12 months respectively); ROE for 2009 based on quarterly data sample, not annualized

4/ Interest payments only.

5/ Prices of typical apartments in Riga. Source: Real estate company Latio

6/ Loans to residents only to total loans (including loans to non-residents).

Table 12. Latvia: Selected Vulnerability Indicators, 2005–10

	2005	2006	2007	2008	2009	2010 1/	Latest Observation
Key economic and market indicators							
Real GDP growth (y-o-y, percent)	10.6	12.2	10.0	-4.6	-18.0	-6.0	*Q1, 2010*
HICP inflation (period average, percent)	6.9	6.6	10.1	15.3	3.3	1.0	*Apr-10*
Short-term (ST) interbank rate, 1-month RIGIBOR (eop, percent)	4.4	2.9	6.8	13.3	2.7	1.3	*Jun-10*
Eurobond secondary market spread (bps, eop)	20	17	56	558	368	284	*Jun-10*
Exchange rate (lats per U.S. dollar, eop)	0.59	0.53	0.48	0.52	0.48	0.57	*Jun-10*
Exchange rate (lats per U.S. dollar, period average)	0.56	0.56	0.51	0.48	0.50	0.57	*Jun-10*
External sector							
Exchange rate regime		Pegged to the euro (+-1% band)					
Current account balance (percent of GDP)	-12.5	-22.5	-22.3	-13.0	9.4	8.5	*Q1, 2010*
Net FDI inflows (percent of GDP)	3.6	7.5	6.8	3.0	0.4	-1.5	*Q1, 2010*
Exports (percentage change of US$ value)	25.7	16.2	35.9	18.8	-22.2	22.2	*Mar-10*
Real effective exchange rate index (2000=100, period average)	90.1	92.7	100.1	111.4	117.9	107.5	*Mar-10*
Gross international reserves (GIR, US$ billion)	2.4	4.5	5.8	5.0	7.0	6.9	*May-10*
GIR in percent of ST debt at remaining maturity (RM) excluding non-resident deposits	197.8	262.9	215.9	160.7	282.9	311.8	*Q1, 2010*
GIR in percent of ST debt at RM including banks' non-resident FX deposits	31.5	43.0	34.2	37.2	67.0	83.0	*Q1, 2010*
Net international reserves (NIR, US$ billion)	2.3	4.4	5.7	3.8	2.0	1.7	*May-10*
Total gross external debt (ED, percent of GDP)	99.5	114.2	127.7	128.0	154.7	162.1	*Q1, 2010*
ST external debt (original maturity, percent of total ED)	49.3	44.1	43.2	33.5	24.6	22.6	*Q1, 2010*
ED of domestic private sector (percent of total ED)	93.3	94.8	96.0	83.1	73.0	66.3	*Q1, 2010*
Total gross external debt (percent of exports)	211.5	259.6	308.6	308.1	369.1	335.4	*Q1, 2010*
Gross external financing requirement (US$ billion) 2/	3.8	6.6	8.8	11.8	6.3	4.8	*Q1, 2010*
Public sector (PS) 3/							
Basic balance (excluding bank restructuring costs; percent of GDP)	-1.3	-0.5	0.6	-3.3	-7.0	-1.1	*Q1, 2010*
Primary basic balance (percent of GDP)	-0.7	0.1	1.0	-2.9	-5.9	-0.4	*Q1, 2010*
Gross PS financing requirement (percent of GDP) 4/	3.3	2.2	0.3	8.9	15.7	16.6	*Q1, 2010*
General government gross debt (percent of GDP)	11.8	9.9	7.8	17.0	32.4	41.6	*Q1, 2010*
Financial sector (FS) 5/							
Capital adequacy ratio (percent)	10.1	10.2	11.1	11.8	14.6	14.2	*Mar-10*
Overdue loans (percent of total loans) 6/	…	0.5	0.8	3.6	16.4	17.9	*Mar-10*
Provisions (percent of overdue loans)	…	93.3	64.9	61.3	57.4	59.8	*Mar-10*
Return on average assets (percent)	2.1	2.1	2.0	0.3	-3.5	-2.5	*Mar-10*
Return on equity (percent)	27.1	25.6	24.2	4.6	-41.6	-29.8	*Mar-10*
Residents' FX deposits (percent of total resident deposits)	39.9	40.3	46.8	47.1	59.6	57.8	*Mar-10*
FX loans to residents (percent of total loans to residents)	70.0	76.9	86.4	88.2	92.1	92.1	*May-10*
Credit to private sector (percent change, year-on-year) 7/	63.6	58.3	34.0	11.8	-6.6	-7.2	*Apr-10*
Memorandum item:							
Nominal GDP (billions of U.S. dollars)	16.0	19.9	28.8	34.0	26.2	5.6	*Q1, 2010*

Sources: Latvian authorities and IMF staff calculations.

1/ Latest observations as indicated in the last column.

2/ Current account deficit plus amortization of external debt.

3/ Public sector covers general government.

4/ Overall balance plus debt amortization.

5/ Financial sector includes commercial banks.

6/ 90-days overdue.

7/ Total loans less loans to the public sector and transit loans, provided to both residents and non-residents.

Table 13. Latvia: Schedule of Reviews and Purchases

Date	Amount of purchase: Millions of SDRs	Amount of purchase: Percent of quota	Conditions
December 23, 2008	535.344	422.2	Approval of arrangement
August 28, 2009	178.448	140.7	First review, end-March 2009 performance criteria
February 17, 2010	178.448	140.7	Second review and end-September 2009 fiscal performance criteria and end-December 2009 monetary performance criteria
June 15, 2010	90.000	71.0	Third review and end-March 2010 performance criteria
November 15, 2010	107.877	85.1	Fourth review and end-September 2010 performance criteria
February 15, 2011	107.877	85.1	Fifth review and end-December 2010 performance criteria
May 15, 2011	107.877	85.1	Sixth review and end-March 2011 performance criteria
August 15, 2011	107.877	85.1	Seventh review and end-June 2011 performance criteria
November 15, 2011	107.878	85.1	Eighth review and end-September 2011 performance criteria
Total	1521.626	1200.0	

Source: IMF staff estimates.

Table 14. Latvia: Program Financing, 2010-11
(millions of euros)

	2010				2011				2010Q1 to
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	2011Q4
				Projections					Proj.
Total financing requirements	396	573	791	780	883	621	631	566	5,241
Amortizing debt	380	138	345	266	474	241	241	241	2,325
Other sectors	43	43	43	43	43	43	43	43	341
Banks	337	95	302	223	431	198	198	198	1,983
Public	313	25	190	23	233	0	0	0	783
Subs	24	44	109	72	152	152	152	152	858
Other	0	26	3	128	46	46	46	46	342
Short term liabilities	-125	197	182	169	220	207	183	149	1,182
Banks credit from MFIs	43	33	32	171	28	27	27	26	387
Trade credit (net)	-76	31	70	24	-14	-11	22	-10	37
Resident FX accumulation	175	175	162	150	175	156	158	160	1,311
Total financing sources	-298	573	386	554	657	495	505	339	3,210
Current account	339	303	365	413	213	271	377	446	2,727
Direct investment (net)	-191	60	245	250	98	138	138	138	876
Portfolio investment and financial derivatives (net)	-40	52	50	47	341	0	0	0	451
o/w government eurobond	0	0	0	0	341	0	0	0	341
Capital account	138	135	135	135	135	135	135	135	1,086
Other	219	63	-372	-618	13	-91	-242	-534	-1,562
Change in gross reserves (+ denotes decline)	-764	-40	-38	327	-145	42	97	154	-367
Financing gap	694	0	405	226	226	126	126	227	2,031
Official financing	694	0	405	226	226	126	126	227	2,031
IMF	194	0	105	126	126	126	126	127	931
EU	500	0	200	0	100	0	0	100	900
Nordics	0	0	0	0	0	0	0	0	0
World Bank	0	0	100	100	0	0	0	0	200
Czech Republic	0	0	0	0	0	0	0	0	0
EBRD	0	0	0	0	0	0	0	0	0
Poland	0	0	0	0	0	0	0	0	0
Memorandum Item									
Lines of credit (cumulative stocks)	0	0	750	750	1,400	1,400	1,800	2,200	2,200
Nordics	0	0	550	550	1,100	1,100	1,500	1,900	1,900
Czech Republic	0	0	100	100	200	200	200	200	200
Poland	0	0	100	100	100	100	100	100	100

Sources: IMF staff estimates.

Table 15. Latvia: Indicators of Fund Credit, 2009-16
(millions of SDR)

	2009	2010	2011	2012	2013	2014	2015	2016
Stock 1/	713.8	1090.1	1521.6	1231.7	796.6	460.6	134.9	0.0
Obligations	11.2	23.6	35.9	330.6	465.4	352.4	331.1	135.8
Repurchase	0.0	0.0	0.0	290.0	435.1	336.0	325.8	134.9
Charges	11.2	23.6	35.9	40.6	30.3	16.4	5.4	0.9
Stock of existing and prospective Fund credit								
In percent of quota	562.9	859.7	1200.0	971.3	628.2	363.2	106.3	0.0
In percent of GDP	4.2	6.9	9.4	7.3	4.5	2.5	0.7	0.0
In percent of exports of goods and services	10.0	14.3	18.6	14.3	8.7	4.8	1.3	0.0
In percent of gross reserves	16.4	22.6	32.5	27.7	18.6	11.3	3.7	0.0
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	8.8	18.6	28.3	260.7	367.0	277.9	261.1	107.1
In percent of GDP	0.1	0.1	0.2	1.9	2.6	1.9	1.7	0.7
In percent of exports of goods and services	0.2	0.3	0.4	3.8	5.1	3.7	3.3	1.3
In percent of gross reserves	0.3	0.5	0.8	7.4	10.9	8.6	9.1	3.7

Source: IMF staff estimates.

1/ End-period.

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.

V. 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.

VI. 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 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.

VII. 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

ATTACHMENT II. 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 (LOI) 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

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

2010 Article IV Consultation, Third Review Under the Stand-By Arrangement and Financing Assurances Review, Request for Rephasing of Purchases Under the Arrangement, and Request for Waiver of Applicability of a Performance Criterion—Supplementary Information

Prepared by the European Department
(In Consultation with Other Departments)

Approved by Anne-Marie Gulde-Wolf and James Roaf

July 19, 2010

1. **This supplement provides additional information that has become available since circulation of the staff reports (SM/10/180 and EBS/10/138)**. It does not alter the thrust of the staff appraisals.

2. **Recent indicators continue to suggest that the economy is bottoming out.** Industrial production increased 13.3 percent year-on-year in May, while exports grew 35 percent. Imports are picking up too, rising 6 percent month-on-month and 11 percent since December. Registered unemployment fell to 15.7 percent in June, but the labor force survey measure remains at around 20 percent. Although year-on-year inflation still remains negative at -1.6 percent, prices have started to increase, with monthly core and overall HICP inflation of +0.4 percent in June.

3. **The end-June performance criteria on net international reserves net domestic assets, and public guarantees were met by wide margins.** The continuous performance criteria on domestic and external arrears were also met.

Quantitative Performance Criteria for which June Data are now Available
(in millions of lats unless otherwise indicated)

	Program	Adjusted	Outcome
Floor on net international reserves (millions of euros)	-506	-361	1,415
Ceiling on net domestic assets	2,056	1,911	708
Ceiling on public guarantees	836	…	389
Ceiling on accumulation of general government domestic arrears	40	…	15
Ceiling on accumulation of general government external arrears	0	…	0

4. **Preliminary data suggest the end-June fiscal targets are likely to be met.** While final outturns for the general government and for relevant adjustors will not be available until after the Board meeting, the central government fiscal deficit for June (2 percent of GDP versus a program projection of 3.1 percent) is consistent with the target having been met. Revenues have been a little stronger and net lending somewhat lower than assumed in the budget.

5. **Progress has been mixed on structural benchmarks related to fiscal policy:**

- **The authorities met the benchmark on preparing a draft fiscal responsibility law**, but important revisions should be made before the law is submitted. These include using a rolling three-year medium-term budgetary framework for the spending rule (rather than fixing expenditure ceilings four years ahead without scope for revision), and modifying the deficit rule to allow scope for more countercyclical fiscal policies while respecting the Stability and Growth Pact.

- **The authorities have met the benchmark on pension reform** by producing a strategy paper that offers a number of possible reforms to the pension system that would achieve cost savings and ensure the system's sustainability.

- **However, the benchmark on conducting a review of welfare benefits seems only to have been partially met.** While full details are not yet available, the review seems only to identify one possible reform: making permanent the cut in maternity and paternity benefits to 80 percent of wages (from 100 percent in 2009). However, there is no intention to make permanent the other 2010 measures (e.g., reducing by 50 percent benefits that exceed L11.5 per day, including for unemployment and parental benefits (care of the child in her first year)), and no identification of savings to pay for this additional cost.

6. **A parliamentary committee is considering delaying the introduction of a natural gas excise tax from July 2010 to January 2014,** given the likely increase in heating prices next winter. Although the full year cost is limited (just under 0.1 percent of GDP), this would be inconsistent with an LOI commitment to avoid tax cuts in 2010, though this year's deficit target would still be met.

7. **On July 15 the Bank of Latvia announced that it will lower rates on its deposit facility**, cutting the 7-day rate from 1 percent to 0.5 percent and the overnight rate from 0.5 percent to 0.375 percent. The changes will take effect on July 23. The Bank of Latvia believes this cut will help stimulate lending.

8. **The President's veto has prompted improvements to proposed amendments to the insolvency law concerning household debtors (EBS/10/138, ¶23).** The latest proposal would limit the use of an income-based repayment scheme to obtain a discharge from the remaining debt to natural persons with either relatively small debts (of up to L100,000) or

very limited repayment capacity. Those with larger debts or better repayment capacity would not be able to make use of this type of scheme, and would have to pay a proportion of their debt (e.g., 50 percent or 35 percent), after liquidation of their non-exempt assets, before being discharged from the remaining debt. A final vote by Parliament is not expected until after the Board meeting, but it seems that stakeholders broadly accept this compromise proposal, which should allow for other improvements to the insolvency law to go through.

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FOR IMMEDIATE RELEASE
July 21, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Third Review Under Stand-By Arrangement with Latvia and Approves €105.8 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third review of Latvia's performance under an economic program supported by a Stand-By Arrangement (SBA). The Board also completed the financing assurances review under the SBA. The Board decision makes available an amount equivalent to SDR 90 million (about €105.8 million or US$135.6 million), bringing total disbursements under the SBA to SDR 982.24 million (about €1.15 billion or US$1.48 billion). The Executive Board also completed the financing assurances review under the SBA and approved a request to waive the applicability of the end-June 2010 performance criterion on the fiscal balance, as data on this criterion were not yet available.

The Board today concluded the 2010 annual Article IV consultation as well, and a Public Information Notice will be released on this in due course.

Strong policy actions under the SBA have helped stabilize the economy, restore confidence, and limit spillovers from financial market turbulence elsewhere in Europe. While achieving substantial fiscal savings, the government has also sought to protect the poorest, by increasing social safety net spending beyond amounts in the 2010 budget, to finance active labor market policies and temporary jobs programs. Looking ahead, the government has committed to steps to support a recovery in growth and continue progress toward euro adoption, which include:

- adhering to the 2010 budget, identifying a menu of options for the 2011 budget that will put the deficit on a declining path consistent with meeting the Maastricht criteria and adopting the euro in 2014, and developing a new Fiscal Responsibility Law to help maintain budget discipline,

- strengthening the financial sector, including by developing a transformation plan for Mortgage and Land Bank, and

- removing tax and legal impediments to private debt restructuring, so that credit can help support a return to growth.

The SBA, which was approved on December 23, 2008 (see Press Release No. 08/345) for an amount equivalent to SDR 1.52 billion (about €1.79 billion, or US$2.29 billion), entails exceptional access to IMF resources, amounting to 1,200 percent of Latvia's quota in the IMF. The IMF's support is part of a coordinated effort with the European Union, Nordic governments, the World Bank, and other bilateral creditors that are providing the financing necessary to ensure that essential public services, especially support to those most severely hit by the crisis, can be maintained in the face of the sharp drop in government revenues. Following the Executive Board's discussion on Latvia, Mr. Naoyuki Shinohara, Deputy Managing Director and Acting Chair, stated:

"The Latvian authorities' fiscal and financial sector reforms have helped stabilize the economy and insulate it from recent international financial market turmoil. Exports and industrial production are rebounding strongly. To support more rapid growth and to put euro adoption within reach, it will be important to ensure sustained fiscal adjustment, reduce unemployment, improve competitiveness through structural reforms, and restore the financial sector to health.

"Considerable fiscal adjustment is still needed to preserve debt sustainability and lower the deficit in line with the Maastricht criteria. The authorities' program focuses on identifying high-quality fiscal measures and spending cuts that will last, including by re-examining areas where spending increased significantly in the past, and on improving control over state-owned enterprises. Given remaining adjustment needs, the authorities' medium-term tax strategy, which identifies possible revenue measures, is welcome.

"Competitiveness has improved significantly. Additional wage and price adjustment, together with structural reforms, would help close any remaining competitiveness gap, further enhance confidence in the quasi-currency board exchange rate regime, and boost growth by reorienting the economy toward the export sector.

"The authorities have taken steps to strengthen financial sector regulation and supervision, bank resolution procedures, credit and liquidity risk management rules, and emergency liquidity support. Plans to restructure two state-owned banks are also advancing. Given high levels of private sector indebtedness, measures are being taken to streamline insolvency and foreclosure procedures and review tax disincentives. These steps should encourage debt restructuring, stimulate new lending, and restore economic growth."