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

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

- The staff report, prepared by a staff team of the IMF, following discussions that ended on April 19, 2011, 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 May 10, 2011. 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 report.

- A Press Release.

- A statement by the Executive Director for the Republic of Latvia.

The document(s) listed below will be separately released.

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

Fourth Review Under the Stand-By Arrangement and Financing Assurances Review, Request for Rephasing of Purchases Under the Arrangement and Request for Waiver of Nonobservance of a Performance Criterion

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

Approved by Anne-Marie Gulde-Wolf and James Roaf

May 10, 2011

Stand-By Arrangement. A 27-month SDR 1.52 billion exceptional access SBA (1,071 percent of quota, including the March 2011 quota increase) was approved by the Executive Board on December 23, 2008 (Country Report No. 09/3), and extended to December 22, 2011 in February 2010 at the Second Review. SDR 982 million has been purchased thus far. A further SDR 108 million (approximately €120 million) becomes available on completion of this Fourth Review, although the authorities intend to treat this and potential future purchases as precautionary.

Economic Developments and Program Status. The economy has been growing moderately for the past year, rebounding from the deep crisis of 2008–09, although unemployment remains high and inflation has picked up due largely to food and energy prices. The authorities met all September and December 2010 quantitative performance criteria and most structural benchmarks, although the Mortgage and Land Bank (MLB) restructuring plan was submitted late and the fiscal responsibility law and strategy for state-owned enterprises require more work. Staff supports the authorities' request for a waiver of a continuous performance criterion due to an unapproved exchange restriction, and a rephasing of purchases due to delays completing this Fourth Review. Discussions focused on the 2011 budget, commitments and measures to achieve a 2012 fiscal deficit consistent with euro adoption in 2014, MLB restructuring, and implementation of the Parex and Citadele restructuring and sales plans.

Discussions were held in Riga April 5–19. The mission met with Prime Minister Dombrovskis; Finance Minister Vilks; Bank of Latvia (BoL) Governor Rimšēvičs; Head of the Financial and Capital Market Commission Krūmane; senior officials in these institutions; coalition and opposition political parties; mayors; social partners including the trade unions, the employer's confederation and the chamber of commerce; the foreign investors council; Delna (Transparency International); foreign ambassadors; media; and financial institution representatives.

Staff. The staff team comprised Mark Griffiths (head), James John, Emilia Jurzyk, Magnus Saxegaard (all EUR), Alvar Kangur (FAD), David Parker (MCM), and Sergi Lanau (SPR). David Moore (Resident Representative) assisted the mission. The team worked closely with staff of the European Commission (EC), European Central Bank (ECB), World Bank, and the Swedish authorities. Gundars Davidsons (OED) attended some meetings.

Contents Page

EXECUTIVE SUMMARY

Latvia's economy is recovering after the sharp contraction in 2008–09. Real GDP started to increase in late 2009, with annual growth forecast at 3.3 percent in 2011 and 4 percent in the medium term. Net exports supported the initial recovery, but domestic demand is expected to drive growth from 2011 onwards as improving confidence and investment outweigh continued fiscal consolidation, the weak labor market, and contracting credit. Rising food and energy prices have led to an increase in inflation. Unemployment, while falling, is still high (17 percent), underscoring the continuing need for an effective social safety net.

Financial indicators underscore growing confidence. The 5-year CDS for Latvia has fallen to around 200 basis points, and in March Fitch raised Latvia's credit rating to investment grade status. T-bill rates remain close to historic lows, 10-year lats bonds were issued in February, and bank deposits are above pre-crisis levels. Though repayment of banks' foreign liabilities has led to some decline in international reserves, they remain at comfortable levels.

Fiscal performance has been better than expected. Strong spending discipline enabled Latvia to lower its 2010 deficit (ESA basis, including one-off banking costs) to 7.7 percent of GDP, well below the 8.5 percent target. The authorities believe the December budget and April supplementary budget should cut the 2011 deficit to below 4.5 percent of GDP (ESA terms, excluding bank restructuring costs). Although some measures are not high quality or may not be sustained, much less adjustment than previously expected is needed to reduce the 2012 deficit below the 3 percent Maastricht value.

The authorities met all September and December 2010 quantitative performance criteria and continue to perform well in 2011. They met most structural benchmarks, although some with delay, and intend to make progress on a fiscal responsibility law, a strategy for state-owned enterprises (SOE), and the divestment of state-owned banks in 2011. Staff supports a waiver of nonobservance of a continuous performance criterion due to an unapproved exchange restriction, as well as a rephasing of purchases.

Talks focused on fiscal policies through 2012 and restructuring state-owned banks. The authorities agreed to aim at a 2012 deficit of 2.5 percent of GDP to try and meet the Maastricht criterion convincingly, consistent with their strategy for euro adoption in 2014. After long delays, they have also submitted a restructuring plan for Mortgage and Land Bank (MLB) to the EC, and are moving ahead with plans to divest Parex and Citadele banks.

Overall risks are much lower, but the program's exit strategy of euro adoption could be affected by: politics and reform fatigue complicating 2012 deficit reduction; further global commodity price increases that could raise inflation above the Maastricht reference value; and intensified scrutiny of euro entry candidates in the current environment. A delay in euro adoption, after massive adjustment and when Latvia is so close to meeting the Maastricht criteria, would be a tremendous lost opportunity.

I. Recent Developments

1. **Latvia's economy continues to recover.** After a sharp contraction in 2008–09, real GDP started to increase at the end of 2009. However, because of base effects, year-average growth for 2010 remained slightly negative at -0.3 percent (Figure 1). Recovery was led by restocking and strong export growth, which benefited from competitiveness gains and improving macroeconomic conditions in Latvia's main trading partners. Domestic demand lagged behind but only because of base effects: during the year retail sales increased 9 percent and new car registrations more than 40 percent. Industrial production grew 15 percent in 2010, before slowing at the end of the year.

2. **After falling in the first year of the program, prices started to rise in 2010 due to world supply shocks (Figure 2).** Like other Baltic countries (which have high shares of food and energy in the CPI basket), headline inflation jumped to 4.1 percent in March, with food and energy prices growing 9 and 15 percent. However, core inflation has remained flat due to weak domestic demand and high unemployment. VAT and excise tax increases, introduced at the beginning of 2011, have also raised prices. Wages have started to pick up, but only moderately, and remain 9 percent below their pre-crisis peak.

3. **Though the current account remains in surplus, much of the sharp improvement in 2009 has proved transitory as the investment income account has worsened with the recovery in bank profits (Figure 3).**[1] The current account slipped briefly into deficit at the end of 2010 for the first time since the crisis, with imports and exports both rising rapidly. Exports grew by around 19 percent after falling 16 percent in 2009, led by wood and steel exports which grew 140 and 48 percent respectively.

4. **Domestic and external market conditions have improved significantly (Figures 5 and 7).** Five-year CDS spreads have declined to around 200 basis points (from more than 1100 in early 2009), well below most other Central European countries which have had programs and crisis countries in the euro area, and in line with those of neighboring Lithuania which managed to maintain access to international capital markets. In March, Fitch raised Latvia's credit rating to investment grade (in line with Moody's). Treasury rates remain close to all-time lows due to low domestic issuance and increased confidence in the fiscal outlook (Figure 4), and 10-year lats bonds were issued in February. Domestic interbank rates have recently fallen below those in the euro area due to continued excess liquidity and higher interest rates in the euro area. The exchange rate appreciated in January as the Treasury started selling program foreign exchange directly to the market. Once the sales stopped, the exchange rate fell back to the weaker end of the band. Reserves have declined gradually (13 percent since end-October 2010), consistent with the use of program funds for

[1] The balance in the income account in early 2009 is artificially high due to the treatment of bank losses. Debt write-downs and other valuation effects were booked as a credit in the income account.

budget support. The financial and corporate sectors have repaid foreign liabilities, although reserves remain at relatively comfortable levels (6 months import coverage in 2011).

5. **The financial sector returned to profitability in early-2011.** Improving credit conditions have allowed banks to start releasing provisions built up in 2009 and 2010, and non-performing loans have stabilized (but at high levels) (Figure 6). Tax increases and high food and fuel prices have reduced incomes, leading to an increase in overdue loans in recent months, but most banks have excess capital to deal with any resulting credit losses. Banks have resumed lending, but credit growth remains negative due to amortizations and loan write-offs. Future profitability will depend on banks' ability to convert deposits into new lending rather than low-yielding deposits at the BoL (which exceed €1 billion or 5 percent of GDP). Despite low interest rates, resident and non-resident deposits increased more than 16 percent in 2010 reflecting increased confidence in the financial system, and are now above pre-crisis levels.

6. **October's elections returned Prime Minister Dombrovskis to office.** A coalition government of the Prime Minister's Unity bloc and the various parties within the Greens and Farmers grouping holds 55 of the 100 seats in Parliament. Despite having a parliamentary majority and fewer coalition partners, garnering political support for further fiscal adjustment (even though much smaller than in previous years) has become increasingly challenging.

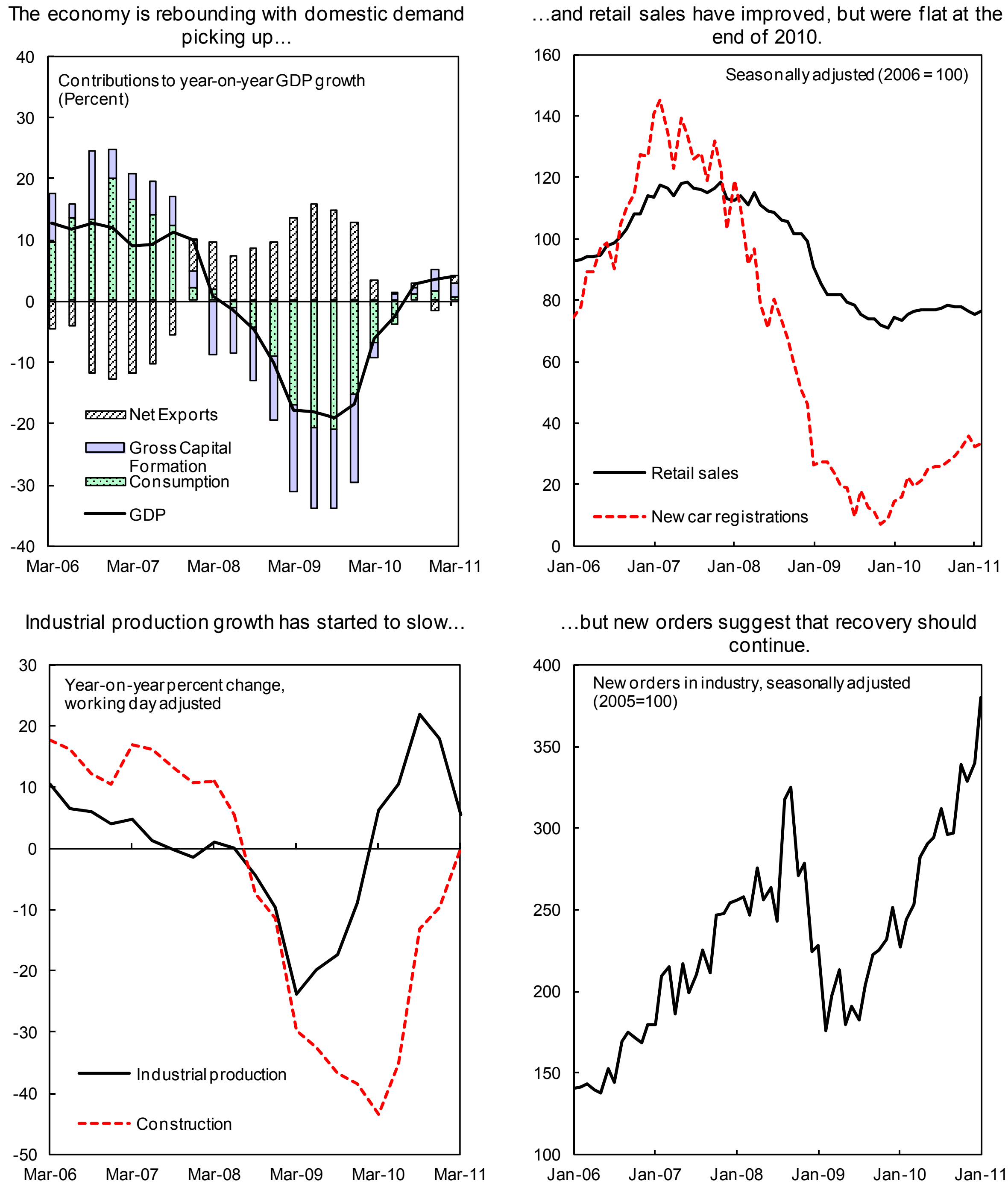
II. Policy Discussions

7. **With the economy now recovering, discussions focused on fiscal policies that would help Latvia move toward euro adoption, and implementing long-delayed state bank reforms:**

- **Fiscal** discussions focused on securing a strong 2011 budget so that in 2012 the Maastricht criterion can be met convincingly and the program's exit strategy of euro adoption in 2014 might be realized.

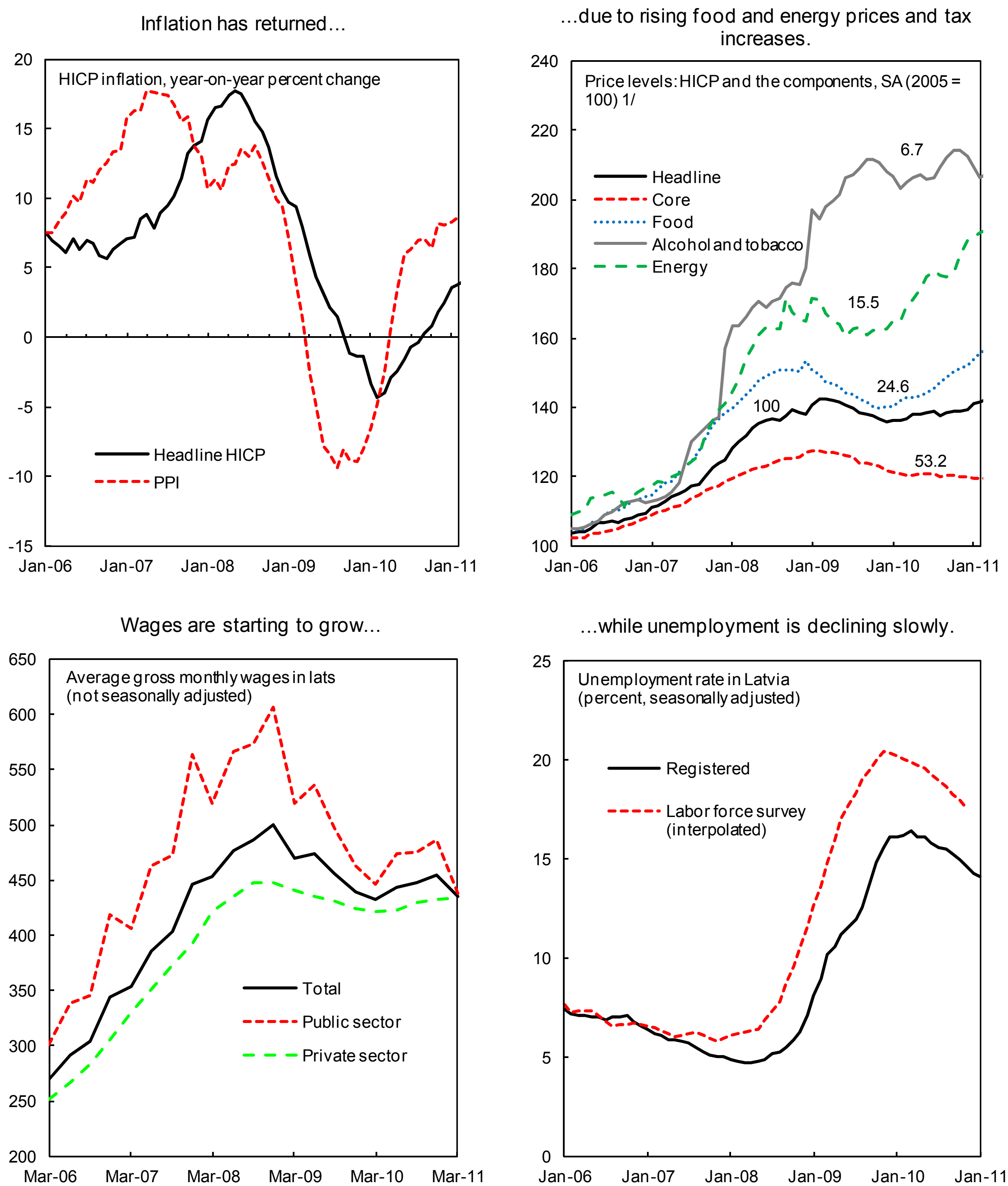
- **Financial sector** talks centered on restarting long stalled efforts to restructure MLB (including to stem losses in the bank) and implementation of the Parex/Citadele restructuring and sales plans.

Figure 1. Latvia: Real Sector, 2006–11



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

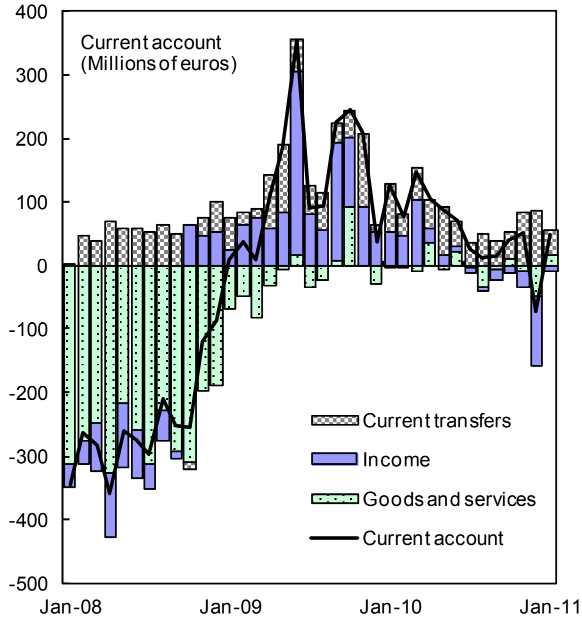
Figure 2. Latvia: Inflation and the Labor Market, 2006-11



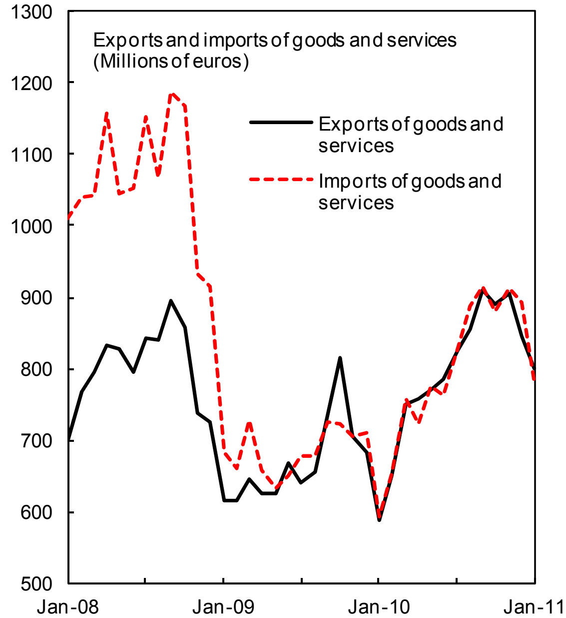
Sources: Eurostat; Haver; Latvian Central Statistical Bureau; and IMF staff calculations.
1/Weight of each component in 2011 HICP as percentage is indicated on the graph.

Figure 3. Latvia: Balance of Payments, 2006-11

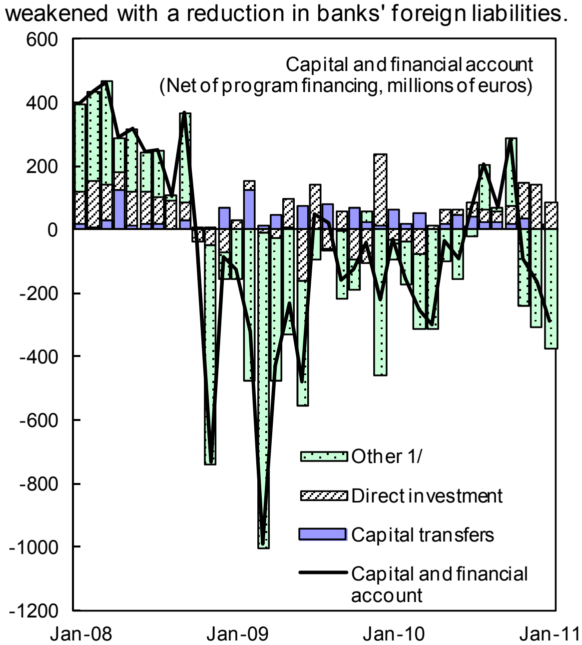
Current account surpluses are declining due to a falling income account.



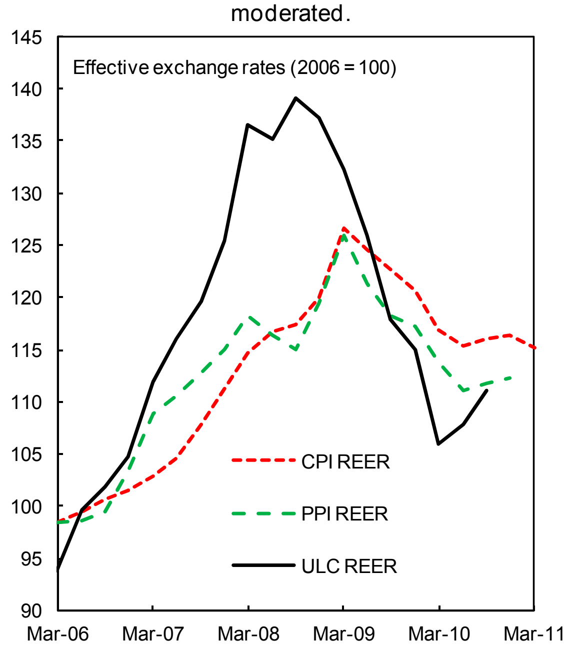
Exports are rising, but so are imports due to recovering domestic demand and inputs for exports.



Despite stabilization, the capital account has weakened with a reduction in banks' foreign liabilities.

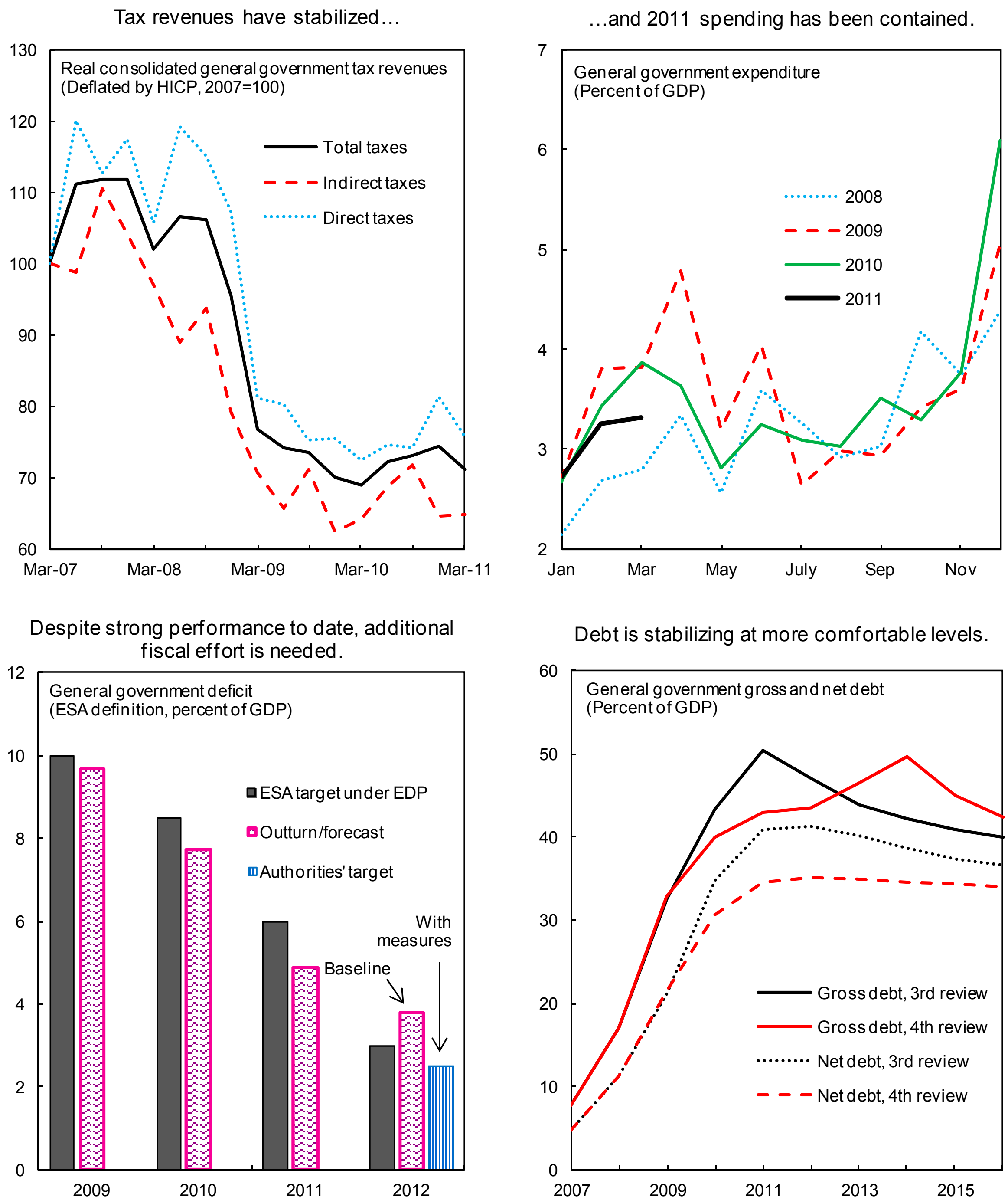


The sharp improvement in competitiveness has moderated.



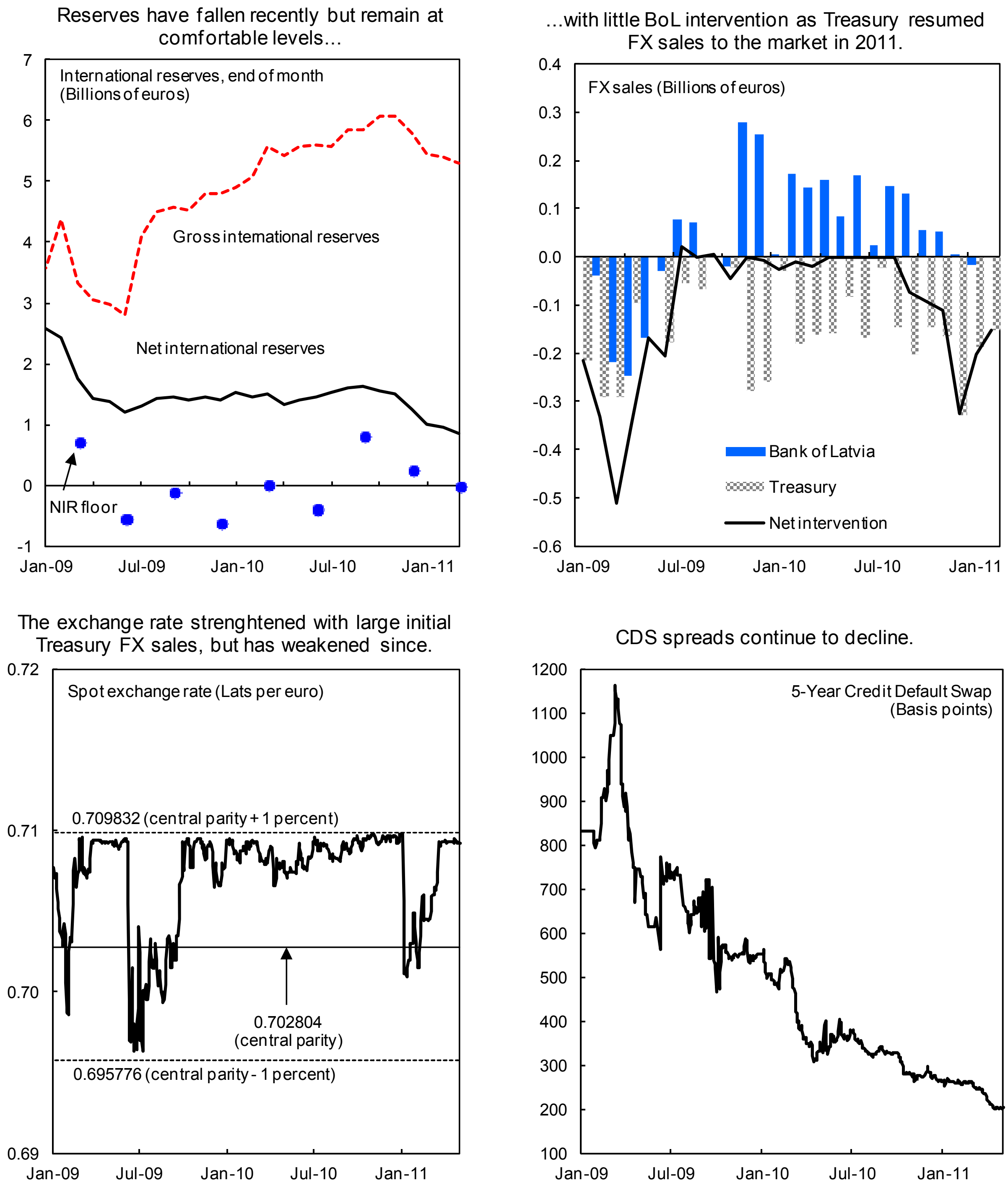
Sources: Bank of Latvia; and IMF staff calculations.
1/ Other is the sum of other investment and portfolio investment and derivatives.

Figure 4. Latvia: Fiscal Sector, 2007-16



Sources: Ministry of Finance; and IMF staff calculations.

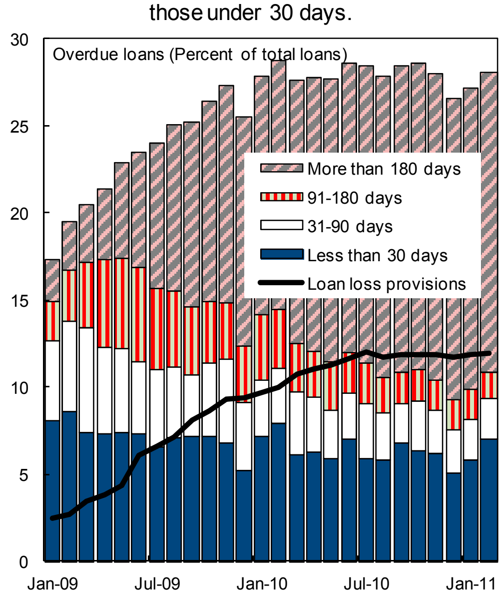
Figure 5. Latvia: International Reserves and FX Market Developments, 2009-11



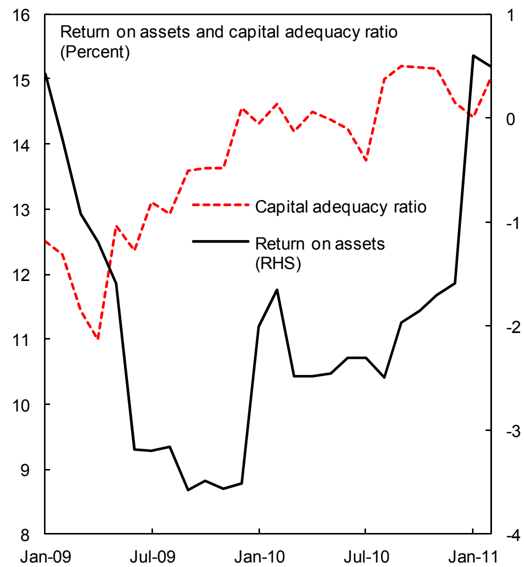
Sources: Bank of Latvia; Bloomberg; and IMF staff calculations.

Figure 6. Latvia: Banking Sector Developments, 2007-11

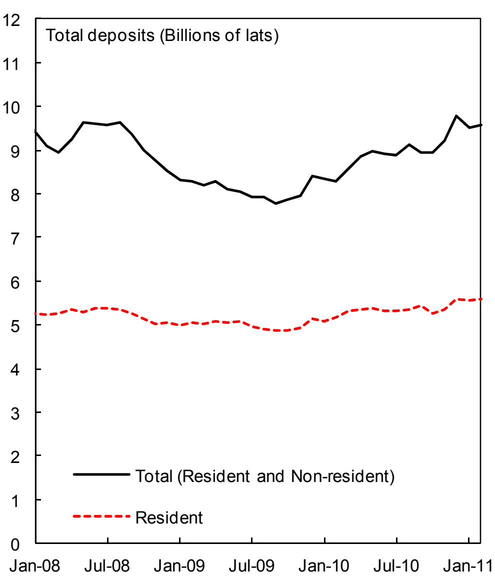
Overdue loans remain high, with a recent uptick in those under 30 days.



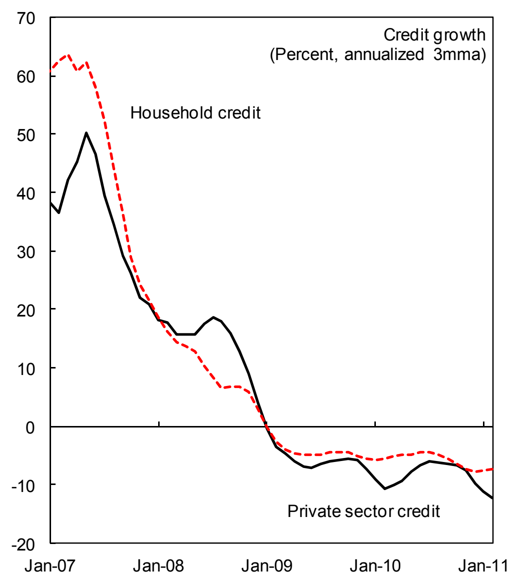
Banks have returned to profitability, and capital ratios remain strong.



Deposits have risen above pre-crisis levels.

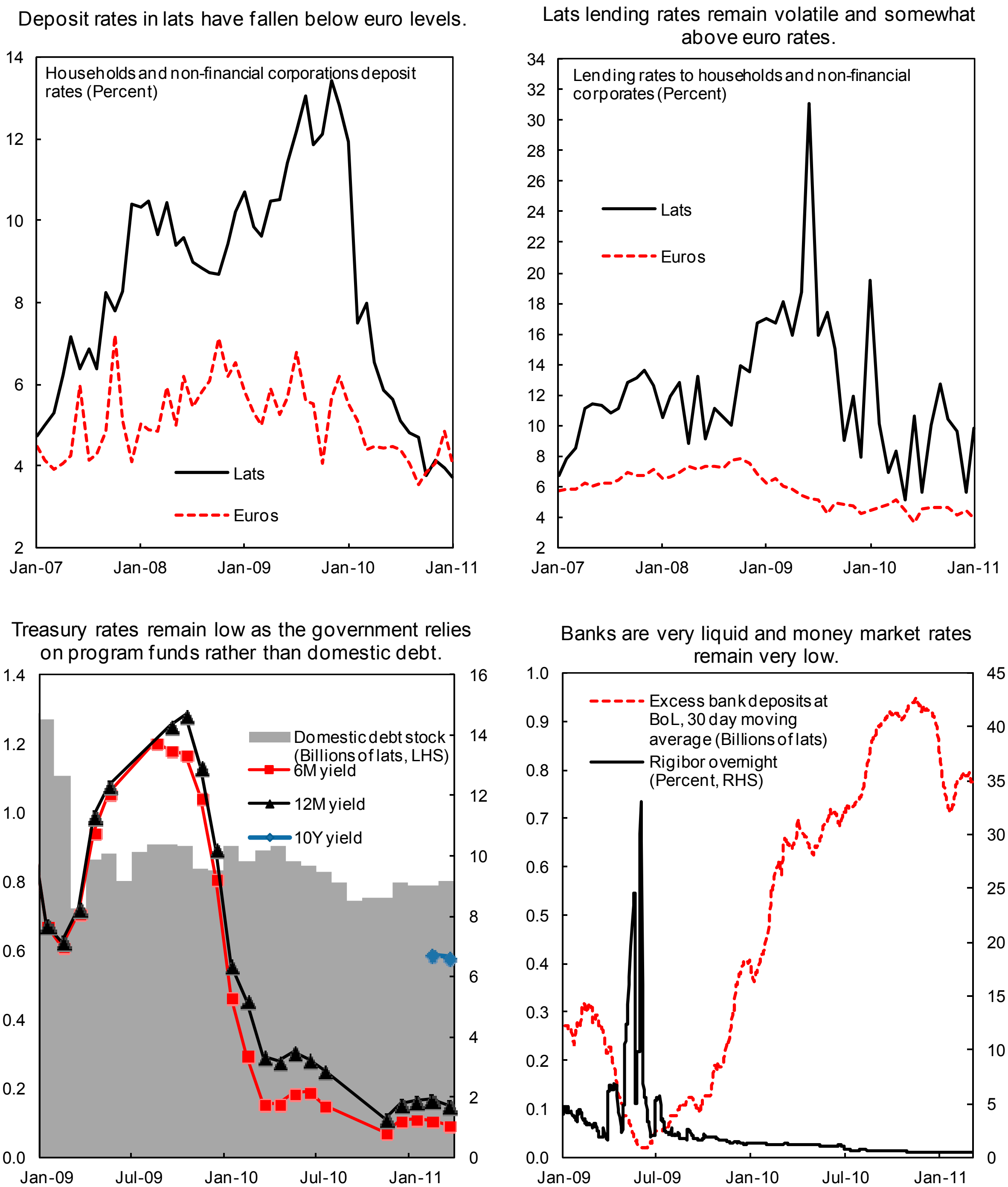


Credit growth remains negative.



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

Figure 7. Latvia: Interest Rates and Euroization, 2007-11



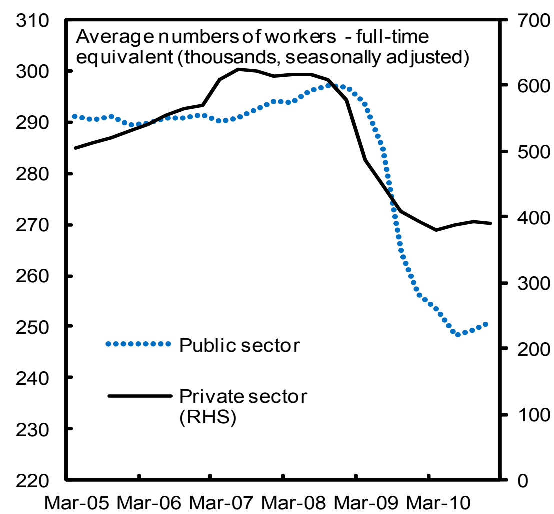
Source: Bank of Latvia.

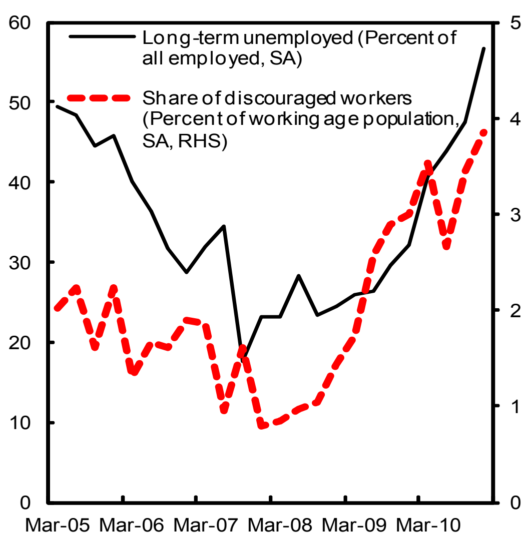
A. Macroeconomic Framework

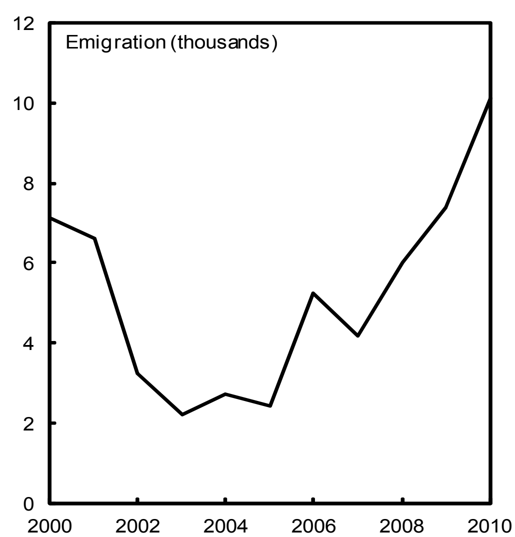
8. **The macroeconomic framework agreed with the authorities assumes modest and steady recovery.** Real GDP is expected to grow 3.3 percent in 2011, and 4 percent from 2012 onwards. Higher food and energy prices and the authorities' reliance on higher taxes (instead of expenditure cuts) for this year's fiscal consolidation will hold back private consumption. However, improving confidence and the need for investment (especially in the export sector which is recovering strongly but is becoming capacity-constrained) should support domestic demand. Unemployment is projected to average around 17 percent in 2011 and has fallen somewhat more quickly than staff previously anticipated, but due primarily to emigration and declining labor force participation rather than new jobs. Unemployment will likely take time to return to pre-crisis levels, since re-orienting construction workers to the traded-sector and re-hiring the long-term unemployed or those close to retirement age will be difficult (Box 1).

Box 1: Labor Market Trends in Latvia, 2005–10

Despite a decline in the official unemployment rate from 20 to 18 percent between Q1 and Q4 2010, the labor market remains a cause for concern. Job creation has been sluggish: At the current rate it will take around 9 years for employment to return to pre-crisis levels, and around 6 years to return to pre-boom 2005 levels. As a result, long-term unemployment, and the number of discouraged workers, is increasing rapidly. At the same time, the opening up of the German labor market in May to the new EU member states is likely to further increase migration.

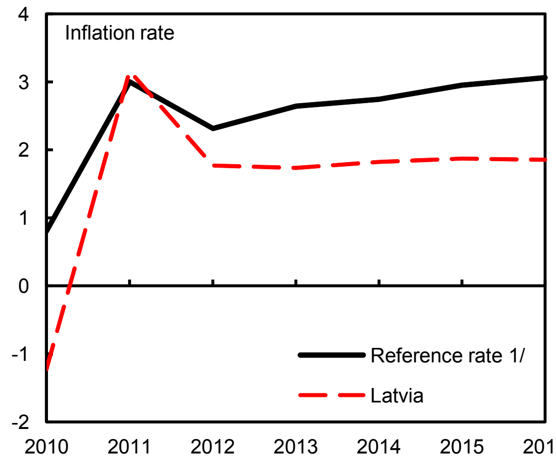






Source: Latvian Central Statistical Bureau and IMF staff estimates.

9. **Higher food and energy prices and tax increases are expected to raise inflation this year, but temporarily.** Inflation is expected to average 3.2 percent in 2011, as Latvia's HICP has a higher weight of food and fuel prices than other EU countries. However, these same factors could push Latvia's inflation rate back down in 2012, provided world food and energy prices do not increase again. With the continuing negative output gap holding down domestic inflation, the Maastricht inflation criterion should be attainable, although the margin is small. Staff noted that while the fixed exchange rate should help anchor medium-term inflation, it makes short-term inflation (and thus meeting the Maastricht reference value) hard to control. The BoL acknowledged the importance of controlling inflation: under the fixed exchange rate this needs to be a joint responsibility with the Ministry of Finance (MoF), for example in avoiding increases in excises and indirect taxes, and in ensuring continued fiscal consolidation. The MoF is considering options for limiting price inflation, including wage restraint. However, Latvia's success with such arrangements has been limited; promotion of more competitive product markets (strengthening the Competition Authority, opening up public procurement contracts, improving state enterprise cost reduction, and price regulation) might prove more effective, though harder to implement.



1/ Reference rate is calculated as the average inflation rate of the three EU countries with the lowest projected inflation, plus 1.5 percentage points.

Sources: Eurostat and IMF staff estimates

10. **Recovering domestic demand and normalization of the banking sector will lead to a moderate deterioration in the current account over the medium term**. Imports are expected to continue rising due to the large import content of exports. However, in the short-term, higher commodity prices will worsen the terms of trade and the trade balance. With wood exports in particular running into capacity constraints, export growth may fall. The income account is projected to turn more negative as banks return to health and reinvested earnings and repatriation of profits to foreign parent banks resume.

11. **Continued competitiveness improvements will be essential for the medium-term success of Latvia's euro adoption strategy.** While internal devaluation and higher productivity have produced significant competitiveness gains (the CPI-based real effective exchange rate has depreciated by around 10 percent, ULC-based by 15 percent), improvements have leveled off recently. As discussed in the 2010 Article IV consultation, quantitative assessment of the real exchange rate is complicated by the rapid pace of structural change but, most likely, a moderate competitiveness gap remains. With its nominal exchange rate fixed to most of its main trading partners, Latvia needs to control labor costs and implement structural reforms (Box 2).

Box 2. Structural Reforms to Improve Competitiveness

Structural reforms and wage restraint will be essential to ensure medium-term competitiveness under the fixed exchange rate regime. Although internal devaluation and productivity improvements have led to significant competitiveness gains, these slowed significantly in 2010 as unit labor costs and nominal wages stabilized. As a result, the moderate competitiveness gap that staff estimated in the 2010 Article IV consultation most likely remains.

The authorities pointed to a substantial improvement in exports as evidence of improving competitiveness. After falling 16 percent in 2009, exports have rebounded strongly, growing by around 19 percent in 2010. Latvia's market share in countries such as Finland, Poland, and Russia has been increasing steadily. Rising hourly productivity in key sectors suggests much of the competitiveness improvement has come from higher productivity rather than deflation. In the boom, unit labor costs rose exceptionally fast by regional standards, but they have since fallen faster than costs in both Lithuania and Estonia. Productivity measured as output per person fell sharply in the run-up to the crisis, but is up 9 percent from its early 2009 trough (compared to 8 percent in Estonia, 5 percent in Lithuania, and 3½ percent in the euro area).

The authorities are considering steps that could limit price and wage growth, and boost productivity. Fiscal consolidation in the 2012 budget will focus primarily on spending cuts and tax increases that do not affect inflation, coupled with continued public wage restraint. Building on efforts early in the program, the authorities will also encourage the private sector to keep wage increases in line with productivity.

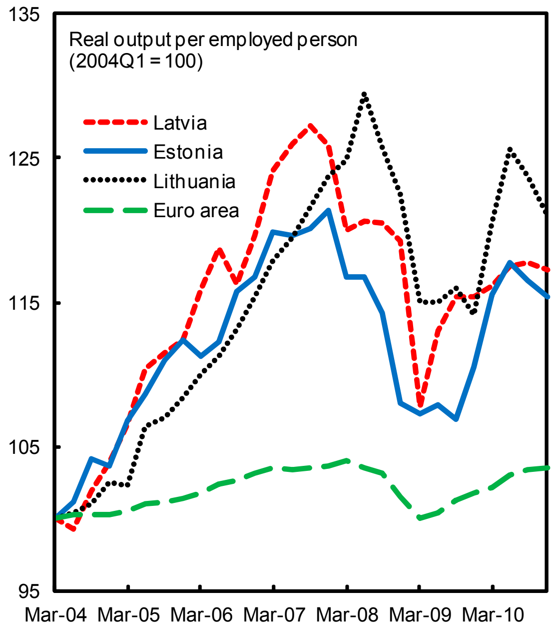
Under the EC and Fund-supported program, the authorities are implementing structural reforms to boost productivity and competitiveness. These include preparing a strategy to improve management and efficiency of SOEs (end-October structural benchmark). The authorities are working with the EC on amendments to sector-specific legislation to improve competition in service sectors such as tourism, construction, retail, and private education (see EC SMoU).

Consistent with the Europe 2020 growth strategy, the authorities recognize the need to strengthen the quality of education and to promote R&D. The authorities intend to develop plans for education system reform (in particular vocational training), and are considering ways to boost private investment to raise the capital-labor ratio, and to facilitate technology transfer from more advanced EU economies.

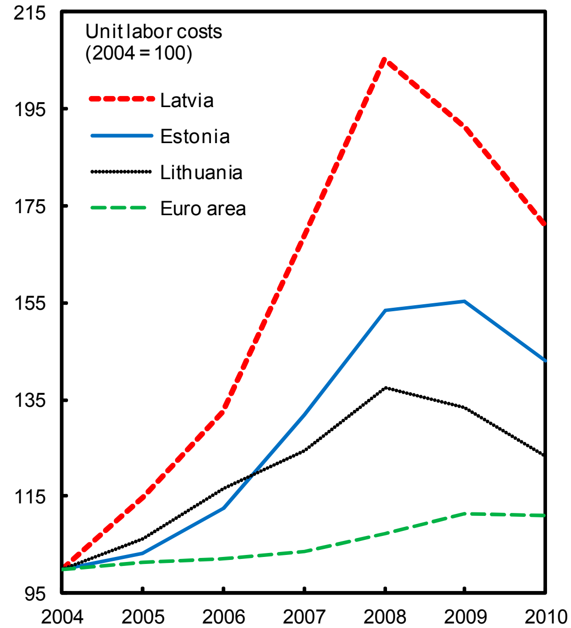
Box 2. Structural Reforms to Improve Competitiveness (Continued)

Latvia: Productivity, Wages, and Export Market Shares, 2004-10

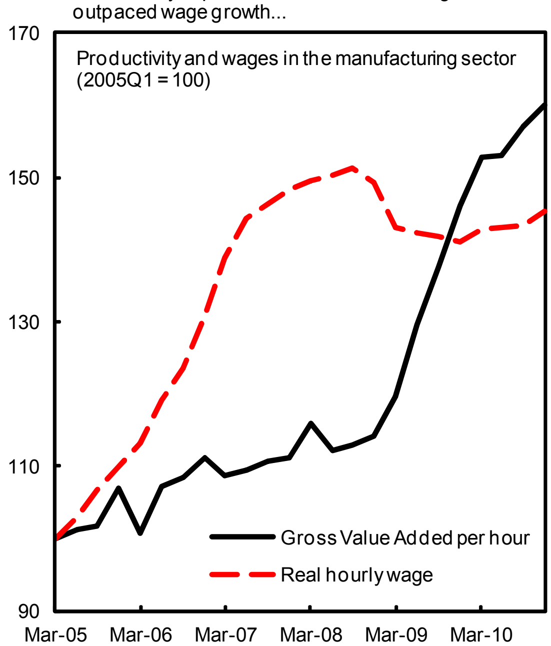
After a drop before the crisis, productivity is improving rapidly...



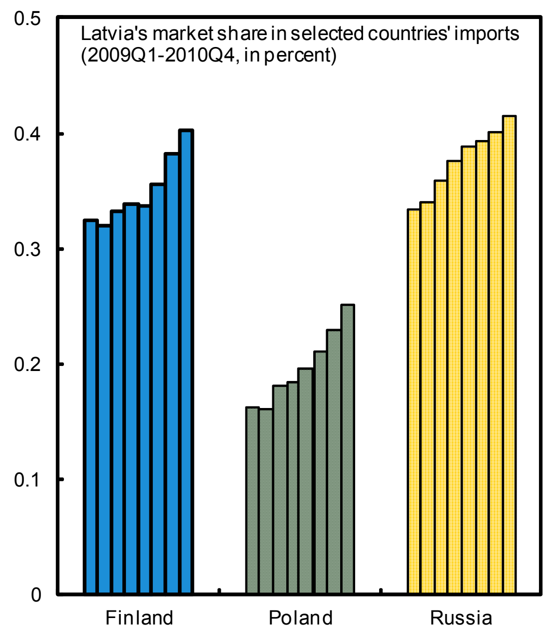
...and unit labor costs have been declining faster than in neighboring countries.



Productivity improvements in manufacturing have outpaced wage growth...



...leading to growth in export market shares.



Sources: Bank of Latvia; ECB; and Haver.

12. **Though the projected recovery is modest, unlike in the pre-crisis years it should be largely self-sustaining.** Upside risks include higher partner country growth (which has proven stronger than anticipated) and improved investor confidence and foreign direct investment if, as seems likely, Latvia were to win investment grade ratings from all three major ratings agencies. Against this, financial stability risks or fiscal consolidation in the euro area could weaken Latvia's exports, and high unemployment, a private debt overhang, and negative or weak credit growth could weigh on domestic demand. High inflation could lead to increasing wage demands, reducing recent competitiveness gains and putting the Maastricht criteria at risk. For the medium-term, challenges include the need to sustain structural reform to boost medium-term growth, and securing euro adoption (which would likely yield significant payoffs to growth and employment).

B. Fiscal Policy

13. **For 2010, strong spending discipline enabled Latvia to comfortably meet its fiscal targets.** Wage restraint coupled with controls on subsidies and transfers, and tight investment financing rules more than offset the need for additional spending in areas such as health, where structural reforms yield savings only slowly. Tax revenues improved mildly across the board with the better macroeconomic environment. The ESA deficit is estimated at 7.7 percent of GDP, well below the 8.5 percent program target. Excluding bank restructuring costs (which have been largely front-loaded and should be much smaller from now on), the deficit is considerably lower, only 5.5 percent of GDP—within striking distance of the Maastricht 3 percent reference value.

14. **The authorities estimate that last December's and this April's supplementary budget combined include about L370 million in adjustment measures (full-year effect) (LOI ¶13).** Both the original and supplementary budgets rely mainly on tax increases, abolition of tax exemptions, and introduction of new fees. Expenditure measures are few and some may not be sustainable, and there is greater emphasis on fighting the grey economy (though the revenue gains are difficult to quantify). The supplementary budget keeps the MoF's discretionary power to increase spending without parliamentary approval, but reduces it from 0.4 to 0.2 percent of GDP (LOI ¶17).

15. **In staff's view, while this year's fiscal effort is significant, some of the budget measures appear likely to be either temporary, difficult to sustain, or have adverse economic side-effects:**

- **Temporary measures (L60 million, 0.4 percent of GDP).** The authorities' decision not to gradually restore second pillar pension contributions to pre-crisis levels, but to leave them at 2 percent, will provide a temporary revenue flow, but these do not really represent fiscal adjustment. Long-term sustainability is not improved, as the higher first pillar contributions will increase the build-up of notional defined-contribution accounts, but without any corresponding savings to pay for them. Also, while staff strongly supports the authorities' efforts to fight the grey economy, the expected yields are either temporary (tax amnesty) or highly uncertain.

- **Measures that may be difficult to sustain (L62 million, 0.5 percent of GDP).** Planned health cuts may be optimistic, given end-year spending increases in previous years, hospital arrears, the slow pace of structural reform, and need for increased out-patient spending to compensate for reduced hospital beds. Higher energy prices, as well as increases in VAT, excises, and the minimum wage will increase spending pressures, while the potential unwinding of emergency safety net measures will increase demands for other social assistance such as guaranteed minimum income (which is 50 percent paid by municipalities). Though included in the 2011 budget with L11 million in savings, a reform of family state benefits still has not been agreed upon, and some of the proposals risk hurting the poor. Some of the 2011 spending cuts have been made possible by prepayments and increased spending at the end of 2010, and so do not constitute a permanent adjustment. Raising the SOE dividend payout ratio to 90 percent also does not seem sustainable.

- **Problematic policies (L18 million, 0.1 percent of GDP).** The 10 percent minimum wage increase runs counter to the strategy of internal devaluation, and may prove binding in poorer areas, thus raising unemployment or promoting the grey economy. Introduction of an investment tax credit (with fiscal effect starting from 2013) will erode the tax base even further and is unnecessary given Latvia's already attractive corporate income tax system (low rates but accelerated depreciation). Demand for public works jobs and related programs is likely to be higher than the authorities have budgeted, potentially increasing social hardship.

Fiscal Adjustment in 2011 Original and Supplementary Budgets (in millions of lats)

		Full-year impact
A. Revenue Measures		
Value added tax	Raise statutory rate from 21 to 22 percent	38
	Raise reduced rates from 10 to 12 percent	15
	Abolish reduced rates on electricity, natural gas and medical equipment	21
	New mechanism for taxation of foreclosures	7
Excise duties	Raise rates on soft drinks, fuel, alcoholic beverages and tobacco	23
	Abolish reduced rates on ethanol fuel, natural gas and diesel fuel for agricultural farming	22
Car tax	Flat tax on privately used company cars	12
	Increase in annual car tax, introduce differentiated rates	5
Real estate tax	Double rates (previously 0.1-0.3 percent of cadastral value)	6
Personal income tax	Cut statutory rate by 1 percentage point; increase personal and dependents' allowances	-54
Social contributions (incl. for pensions)	Leave second pillar pension contributions at 2 percent, instead of increasing to 4 percent	45
	Increase social contributions rate by 2 percentage points	70
Non-tax revenue	Increase SOE payout ratio to 90 percent and apply to consolidated profits, increase payments for the use of state capital	17
	Introduce financial stability duty and license fee for providing consumer loan services	7
Minimum wage	Raise minimum wage from L180 to L200 (net impact)	11
Grey economy	Various measures to reduce grey economy	15
Other	Increases in natural resource tax, state duties, lottery and gambling tax	6
Total (revenue)		**265**
B. Expenditure measures		
Remuneration	Cuts in judges' salaries, reduction of staff in public administration	10
Goods and services	Various cuts across line ministries	37
Subsidies and grants	Cuts in grants for public railway services	3
	Reduce general education subsidies and financing for study places	3
Social benefits	Reform of family state benefits	22
	Cuts in public works jobs program 1/	12
	Additional appropriation for guaranteed minimum income	-5
Health spending	Cut in health spending	12
Local governments	Local government spending cuts (net effect from a reduction in PIT rate, increase in the local governments' share and an introduction of a new transfer rule for the poorest municipalities)	10
Prepaid expenditure	Various expenditures prepaid at the end of 2010	14
Other	Infrastructure maintenance, redirection of sworn bailiffs accounts etc.	1
Total (expenditure)		**107**
Total adjustment		**372**

1/ Financed from European Social Fund (ESF), not counted as a consolidation measure. 4.9 million lats extra financing is expected to be reallocated from other ESF programs towards public works.
Source: IMF staff calculations based on data provided by the Ministry of Finance.

16. **The authorities believe their measures will reduce the 2011 deficit to below 4.5 percent of GDP (ESA terms, excluding bank restructuring costs).** However, given the risks to spending highlighted above, plus the uncertain yield of measures to combat the grey economy, staff believes the outturn could be slightly higher (4.9 percent of GDP), unless strong spending controls are maintained. Even this would be considerably better than the initial program path of 6 percent of GDP.

17. **For 2012, the authorities agreed to aim for a 2.5 percent deficit, well below the 3 percent of GDP Maastricht criterion, so as not to take chances with euro adoption.** Provided that the government keeps the 2011 deficit to 4.5 percent of GDP, preliminary estimates suggest a 2012 adjustment need of L150 to 180 million (1.1 to 1.3 percent of GDP) (LOI ¶18). Although still sizable, the full-year effect of 2011 measures, improving macroeconomic projections and lower expected future bank restructuring costs mean the adjustment amount is much lower than estimated at previous reviews. The authorities are optimistic that economic recovery and their fight against the grey economy (LOI ¶15) will lower this adjustment amount further, which they will reassess together with staff in August.

18. **However, difficulties finding measures for the 2011 budget hinted at challenges for the 2012 adjustment.** While the authorities had prepared a broad menu of options for 2011 fiscal adjustment, this was mainly a listing of ideas from outside (in particular from Fund and Bank TA suggestions, or from Latvia's Reform Management Group), with little political ownership. For 2012, the government's preliminary plans foresee further local government adjustment and lower social safety net spending, with further cuts in civil service remuneration and subsidies and grants also under consideration. Staff encouraged the authorities to keep all options on the table, including sensitive areas such as pensions (so far ruled out politically) where spending rose rapidly during the boom years from 6 to 10 percent of GDP (LOI ¶18).

19. **Reflecting their commitment to fiscal discipline, the authorities are also taking measures that will yield savings in 2013 and beyond.** Pension indexation has been suspended through 2013, supplementary pensions (which were unfunded) will be suspended for new retirees starting 2012, and the Ministry of Welfare is proposing to raise the retirement age and qualification period starting 2016. The government has attempted to extend caps on benefits for high-earners (for those receiving above L11.51 per day, benefits increase 50 percent with income rather than one for one), though this has been suspended while opposition parties seek to overturn this by referendum. The negative effect on revenue of a new VAT repayment system designed to resolve unpaid refunds inherited from the past should gradually peter out.

20. **Although recovery is under way, the authorities should extend the emergency social safety net or integrate it into the welfare system**. The government plans to phase out the public works program by end-2011 and to cut emergency social safety net spending from L65 million this year to L12.5 million in 2012 (though they may raise this to L47.5 million if

needs are higher). The current unemployment insurance system fails to protect the long-term unemployed (benefits taper off quickly and expire after 9 months; the authorities plan to cut this to 6 months), with only 25 percent of the registered unemployed receiving unemployment benefits. Staff encouraged the authorities to ensure adequate safety net spending, to maintain (or even increase) their co-financing of guaranteed minimum income payments (municipalities administer and pay 50 percent of these), and, in line with World Bank recommendations, to support spending on outpatient health care (LOI ¶14).

21. **The authorities are developing a framework to anchor fiscal policy once the Maastricht criteria are met and the program expires.** Guided by staff advice, they are refining a draft fiscal responsibility law that should limit deficits while providing scope for counter-cyclical policy. To give this law greater legal standing over the budget law and other laws, the authorities believe a constitutional amendment is necessary. Working with opposition parties in parliamentary committee, they hope to build support for this and submit a draft amendment to Parliament by end-November. This would be complemented by a medium-term budget framework law to guide multi-year budgeting by setting binding spending ceilings, in keeping with the proposed strengthening of EU economic governance (LOI ¶17).

C. Financial Sector Policies

22. **The health of the financial sector should continue to improve in line with the economic recovery, although a number of challenges remain.** To that end, discussions focused on restructuring state-owned banks and measures to strengthen market-based debt restructuring.

23. **Restructuring of the state-owned Mortgage and Land Bank (MLB) is long overdue.** Despite repeated commitments under the program (most recently an end-September 2010 structural benchmark, itself deferred), progress in restructuring MLB (a hybrid commercial and development bank) has been slow due to lack of political will. In 2010, the bank lost L63 million (0.5 percent of GDP). Although the bank successfully repaid a syndicated loan in March 2011, it did so in part by raising interest rates above average market rates to increase deposits. Staff argued that MLB needed to be restructured without delay.

24. **The authorities finally submitted their MLB restructuring plan to the EC on April 15.** The plan—developed by an independent consultant and which (despite some technical concerns) drew support from both the EC and IMF—envisages the sale of most of the commercial assets and liabilities of MLB later this year. Non-performing assets and other assets in which there is little market interest could possibly be transferred to Parex Bank for a more gradual workout. The development part of the bank would be merged with other development institutions in Latvia. Staff cautiously applauded the plan's adoption, but noted that the lack of political consensus on the need to recognize possible losses in MLB meant

implementation would be a challenge. Staff also stressed the need to maintain depositor confidence. The authorities agreed on an ambitious set of targets (LOI ¶6, 27) to monitor implementation, linked to disbursements from blocked program funds (mostly EC) for financial restructuring. They will quickly hire a qualified and independent sales consultant to assist with the sales strategy, and recruit a head of restructuring for MLB with international experience from similar restructurings. This should facilitate sale of the bank's commercial part by mid-December 2011.

25. **The authorities are committed to implementing Citadele's sales and Parex's resolution strategies (LOI ¶24).** Repayment of the final tranche of Parex's syndicated loan on May 3 closes a chapter for a bank that helped cause Latvia's financial crisis. To maximize recoveries for the state, the sales strategy for Citadele envisages sale of the whole bank in a public auction later this year, while Parex's resolution strategy recommends a combination of quick sale and gradual asset realization depending on the expected future return of individual assets. Staff welcomed the authorities' commitment to keep the sales processes for Parex assets and for Citadele separate, and to exclude insiders and related parties. Staff commended the authorities' commitment to pursue Parex's former majority shareholders and senior managers in the courts to recover losses they caused to Parex Bank and the state.

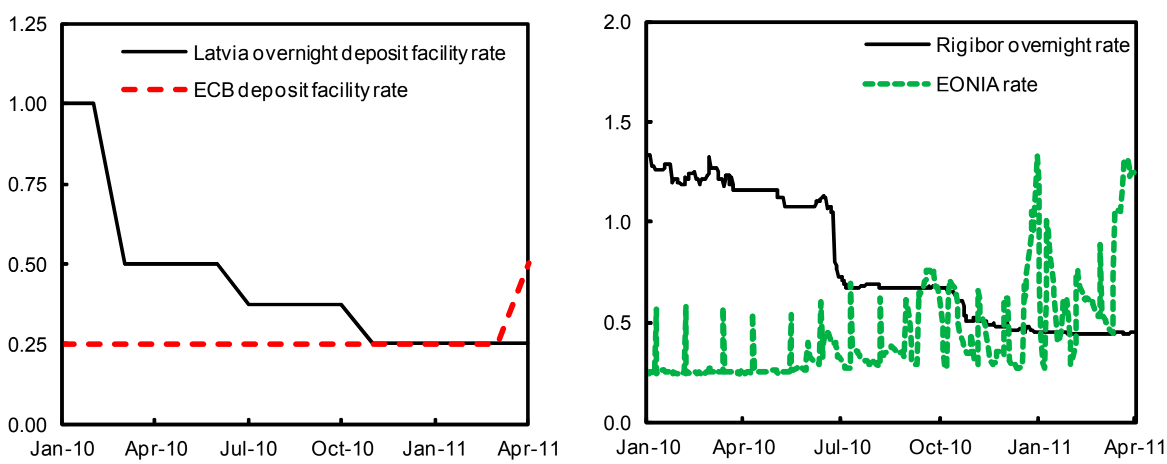
26. **The authorities have made progress toward strengthening private debt restructuring.** They have introduced regulations to reduce tax disincentives for debt write-downs, streamlined foreclosure auction requirements, and introduced a new personal insolvency law. To address mounting debts to utility companies (which may be too small to be worthwhile pursuing in court and difficult to enforce in multi-unit dwellings), the authorities have submitted amendments to the Civil Procedures Law. These amendments would retroactively grant priority status to unsecured claims of utility companies in foreclosure proceedings. Staff voiced concern that the amendments would undermine secured creditors—possibly inhibiting future lending and legal predictability—and were not the best way to address the problem of unpaid utility bills. The authorities agreed to consult with staff on ways to address the problem more directly (improved small claims procedures, a more comprehensive credit registry, better metering, heating assistance for the poor) and to submit amendments to the original proposal by end-July (structural benchmark).

27. **The authorities have strengthened financial sector supervision of large exposures, remuneration and stress-testing, in accordance with EU practice.** Consistent with current EU regulations, a recent amendment to the Law on Credit Institutions allows the Financial and Capital Market Commission (FCMC) to waive minimum capital adequacy and large exposure requirements in certain limited cases. Staff agreed that the safeguards in the amendment (limitations on new lending and deposit taking on potential beneficiaries) meant that they were likely to be used only in exceptional circumstances, but cautioned against the risk of any regulatory forbearance.

D. Monetary Policy

28. **Latvia's fixed (narrow band) exchange rate regime continues to anchor monetary policy.** Since mid-2010, the BoL reduced its official overnight deposit rate from 0.5 to 0.25 percent (currently 25 bps below the ECB's deposit rate). Staff expressed concern that banks' holdings of excess lats deposits at the BoL (around €1.1 billion) and tighter liquidity in the euro area (evidenced by the ECB's recent decision to raise policy rates and the increase in euro area interbank rates) could put pressure on reserves. Since October, the 10 percent decline in reserves coupled with the depreciation of the exchange rate back toward the weaker end of the band, suggest these pressures may already be building. Given strict limits on banks' net foreign exchange open positions, the authorities saw little risk of banks converting their excess liquidity into foreign currency, although they accepted that demand for foreign exchange from corporates in Latvia had increased. Staff expressed concern at the cuts in official interest rates, especially now that the ECB seems to have started a tightening cycle. To guard against any further build-up of risks, the BoL committed to adjust its policy stance if necessary to ensure that liquidity conditions remained consistent with the fixed exchange rate regime.

Latvian and Euro Area Interest Rates, 2010-11



Sources: Bank of Latvia and European Central Bank.

29. **In January 2011, Treasury began converting foreign exchange program funds directly on-market, rather than off-market at the BoL.** The authorities argued that such sales would help contain the build-up of banks' excess deposits at the BoL and facilitate liquidity management. To address staff concerns that such sales would be perceived as foreign exchange market intervention, Treasury agreed to conduct the sales in pre-announced auctions for fiscal financing needs. Sales in early January far exceeded financing needs, prompting the exchange rate to appreciate toward the middle of the band. The private sector took advantage of this (temporary) lats appreciation to repay foreign debt, causing reserves to

decline and the exchange rate to fall back to the depreciated end of the band. Treasury argued that these large sales were necessary to build an initial lats deposit buffer to deal with intra-month spending needs; from now on sales would be more closely linked to financing needs.

III. Program Issues

30. **Latvia met all quantitative performance criteria for end-September and end-December 2010 and most structural benchmarks.** Fiscal targets were met by comfortable margins in September and December 2010, as were NIR and NDA targets, although by a smaller margin than at previous reviews (LOI Table 1). March 2011 indicative targets for NIR and NDA were also met. Most 2010 structural benchmarks were met although some were delayed (LOI Table 3). Staff encouraged the authorities to take more time to improve the draft fiscal responsibility law before submission, and new benchmarks have been set accordingly (LOI Table 4). The SOE strategy has also been delayed and the structural benchmark reset. Staff support the authorities' request for a waiver of nonobservance of a continuous performance criterion due to their decision at end-2010 to keep an exchange restriction related to deposits in Parex Bank, which was approved by the Board in 2011.

31. **The authorities have requested a rephasing of remaining amounts under the arrangement, making them available subject to one final review, which will focus on the 2012 budget (Table 13).** Given delays completing this Fourth Review—due to the October 2010 elections and time needed to identify 2011 fiscal measures—performance criteria would be set for end-August, with indicative targets for end-June and end-September, so that the Fifth and final review can be completed before the program ends on December 22, 2011. The additional amount associated with the Fifth Review (SDR 432 million) would become available only subject to understandings on a strong 2012 budget aimed at bringing the deficit safely below the Maastricht criterion. Given the improving financial position, the authorities intend to treat IMF, EU, and bilateral funds as precautionary, and will only draw EUR 100 million from the World Bank which is expected to be approved shortly (Table 14).

32. **Staff encouraged the authorities to increase market borrowing to help prepare for full reliance on private financing after the program period:**

- The authorities intend to lengthen maturities—2- and 5-year bonds are being considered after the recent issuance of 10-year bonds—but have generally limited issuance given that they used program funds instead and wished to keep interest rates very low. While program funds originally intended for budget support have been used up, funds set aside for the financial sector (about €650 million) are being released gradually for budgetary use as banking reforms progress and risks fall (LOI ¶6). Even so, staff encouraged more ambitious domestic issuance, noting that banks' substantial excess liquidity means there is little risk of crowding out.

- Building on their strong budget performance, lower CDS, and improved credit ratings, the authorities intend to return to international markets soon. Completion of the review may lead to investment grade status from all three major credit rating agencies, and thus more favorable terms.

- While domestic and international issuances are now expected to push public debt to around 50 percent of GDP in 2014, this includes a build-up in government deposits in preparation for large amortizations (including program funds) coming due in 2014 and 2015, so that net debt will be much lower (Tables 3–5 and Figure 8).

33. **Latvia is expected to be in a comfortable position to repay the Fund (Table 15).** Outstanding Fund credit is projected to reach about 22 percent of gross reserves in 2011 with repayments peaking in 2013 at 2.4 percent of GDP and 8.9 percent of gross reserves. Gross external debt is projected to fall steadily from its 2010 peak of 165 percent of GDP while net external debt is substantially lower (54 percent of GDP in 2010) and falls over the medium term (Tables 7-8 and Figure 9). Latvia's capacity to repay would be further enhanced by continued progress toward euro adoption and the resulting ability to tap international markets at lower cost and to be able to economize on the need for international reserves.

34. **Staff encouraged the authorities to begin considering how the Fund might best support Latvia's efforts beyond program expiration in December.** While the program has at times been demanding, the authorities appreciated that the financial and policy support from the IMF, EC, and bilateral partners under the program had contributed to the successful adjustment effort. While post-program monitoring (required since exceptional resources remain outstanding) is the most likely scenario, the authorities will consider whether a short-term precautionary arrangement to support strong policies until the Maastricht criteria are met could be helpful. However, they will not request an arrangement if this would jeopardize euro adoption chances and would consult with the EC beforehand; for example, the ECB has suggested that even a precautionary arrangement could signal that Latvia is not converging sustainably. An ex-post evaluation is expected in 2012.

IV. Risks

35. **Overall risks have fallen substantially, with the recovery taking hold and further adjustment having been achieved.** The chances of Latvia tipping back into recession or experiencing serious financial pressures are much less at this stage, but risks remain:

- **External environment.** Commodity price increases could raise inflation and accelerate the current account deterioration, making it harder to maintain reserves. Uncertainties around Europe's growth outlook could weigh on external demand and, in an extreme scenario, reduce external liability rollover rates.

- **Politics.** Although Prime Minister Dombrovskis' electoral grouping gained seats in October, the coalition has at times lacked cohesion, though now seems more committed to fiscal discipline. The coming presidential election (elected by members of Parliament) could prove a challenge. However, alternative governments would likely be much less committed to economic reform.

- **Reform fatigue/fiscal slippages.** Securing further adjustment in 2012 after 3 years in which 15 percent of GDP in adjustment measures have been taken will not be simple technically (easier savings have already been taken) or politically.

- **Delay in euro adoption** would lower confidence, perpetuate exchange rate risk, and make it harder for Latvia to refinance external amortizations at low interest rates. In addition to 2012 fiscal challenges, inflation could also be a risk. Euro area problems might also lead to stricter application of the more subjective elements in the convergence assessment.

- **Financial sector.** While risks are greatly diminished, careful handling of the MLB restructuring and the next steps on Citadele/Parex is needed. Bank restructuring costs associated with Citadele/Parex have been recognized in ESA terms upfront. Any possible costs associated with MLB should be recognized in 2011 so as not to complicate attainment of the Maastricht fiscal criterion.

- **Longer-term competitiveness and stability.** Challenges in the euro area highlight the need in a currency union for a flexible economy and fiscal discipline to maintain competitiveness and provide scope for counter-cyclical policy. Latvia has demonstrated its ability to execute internal devaluation, but will need to continually enhance productivity and efficiency in the future.

- **That said, compared to previous reviews, the risks are considerably lower and increasingly within the hands of the Latvian authorities to solve.**

V. Staff Appraisal

36. **The economic recovery is strengthening.** Improving confidence and a recovery in private investment are expected to more than offset factors dragging down domestic demand (unemployment, fiscal consolidation, and difficulties accessing credit) and should support a return to growth. Inflation has picked up due to world food and energy prices and tax increases, although core inflation remains contained. However, job creation is still weak and shifting workers formerly employed in construction will be difficult so that, save for migration or declining labor market participation, unemployment could remain in double digits for some time. The authorities may need to augment their active labor market policies with more creative reforms targeted toward the long-term unemployed or other disadvantaged groups.

37. **Program performance has been good in terms of macroeconomic targets, less so in terms of structural reform.** Despite some spending increases before October's elections,

the authorities met their 2010 fiscal performance criteria and indicative targets by comfortable margins. NIR and NDA performance criteria were also met, and performance remains strong so far in 2011. Although some structural benchmarks were delayed or not completed, the authorities have finally submitted their MLB restructuring plan to the EC, and intend to submit a fiscal responsibility law to Parliament and complete development of their strategy to reform SOEs this year.

38. **With the program almost complete, the next key target is to fulfill the euro adoption criteria in a convincing and sustainable way**. This means lowering the deficit to well below the 3 percent reference value and demonstrating further deficit reductions in the out years to show EU institutions and member states that the target has been met in a sustainable way. It also means taking steps to improve price competition and to ensure that next year's fiscal consolidation focuses on expenditure cuts, rather than tax increases, so as to contain domestic inflation. Euro adoption would mark a successful exit from Latvia's ambitious and difficult program. Conversely, a delay in euro adoption when Latvia is so close would be a tremendous lost opportunity to eliminate exchange rate risk and lower borrowing costs.

39. **Though substantial progress has been made in reducing the budget deficit, the authorities should make a final push to reduce the deficit well below 3 percent of GDP in 2012.** The authorities' phenomenal 2009–11 adjustment effort has put the Maastricht deficit criterion solidly within reach although continued strong implementation in 2011 will be necessary. Any revenue over-performance or other savings should be used to achieve a lower deficit (apart from social safety net needs or greater absorption of EU funds). The authorities' decision to aim at a 2012 deficit of 2.5 percent of GDP should help demonstrate their commitment to meeting the Maastricht criteria in a sustainable way, while not taking risks with meeting the target.

40. **To achieve this target, it will be important to keep all options on the table and identify high-quality measures early in the budget cycle**. Unfortunately, political considerations complicate a serious discussion of ways to find savings from pensions (which increased massively during the boom and are absorbing an increasing share of GDP, thus forcing higher taxes or spending cuts elsewhere) in a way that guarantees the poorest pensioners are protected. The authorities' targets for the grey economy are ambitious, but need to be monitored carefully to ensure they are met. With unemployment likely to persist, and few registered unemployed actually receiving benefits, the authorities should be wary of phasing out emergency social safety net programs to find fiscal savings. Instead, they should work closely with the World Bank to integrate these emergency schemes into a robust permanent safety net.

41. **Institutional reform could help ensure fiscal sustainability once the program has ended.** The authorities already have a draft fiscal responsibility law, but should revise it to ensure it is sufficiently countercyclical and not so tight as to be unrealistic (and overridden)

in downturns. Once a reasonable law has been designed, the authorities are aiming for broad political support for the constitutional reform that will likely be needed to make sure it takes precedence over other laws so that it is respected during the budgetary process. Constitutional reform may also be necessary to make the proposed medium-term budget framework law effective.

42. **The authorities should prepare reforms to promote price flexibility and price stability.** Latvia's successful adherence to its fixed exchange rate demonstrates its underlying commitment to price stability. However, to minimize the risk that Latvia might miss the Maastricht numerical criterion for price stability, fiscal adjustment in 2012 needs to be based on sustainable measures, such as structural spending cuts and tax increases that would not affect inflation (e.g., real estate taxes). This underlines the importance of reforming the cadastre, implementing structural reforms, introducing greater competition into product markets by enhancing the powers of the Competition Authority, and improving management of SOEs. These reforms should also help sustain competitiveness, including if Latvia were to be admitted to the euro area.

43. **Adjustment of official interest rates may be needed to support the fixed exchange rate, especially now that the ECB appears to be entering a tightening cycle.** Should international reserves continue to decline, there would be a prima facie case for raising interest rates, particularly as interbank rates are now below those in the euro area. Given its decision to peg the exchange rate, the BoL should as far as possible mimic the behavior of the ECB to maintain the credibility of the peg and to show preparedness for monetary policy being determined by the ECB.

44. **The authorities need to implement their long delayed plans for reforming state-owned banks and continue their efforts to promote market-based debt restructuring.** Though long overdue, the authorities' decision to submit their MLB restructuring plan is welcome, but they now need to hire an independent, well-qualified, and experienced sales consultant, and limit further fiscal losses. Similarly, successful implementation of the Parex and Citadele restructuring and sales strategies should maximize the recovery of state-aid while reducing state involvement in the banking sector. The authorities also need to avoid undermining the status of secured creditors and the important progress that has been made in promoting market-based debt restructuring.

45. **While the situation in Latvia is much improved, risks to the program and the authorities' goal of euro adoption remain.** These include the possibility that politics and reform fatigue complicate achievement of additional deficit reduction, and that global commodity price increases slow domestic demand and raise inflation. Variability in the Maastricht reference value for price stability introduces additional uncertainty. Efforts should focus on meeting all Maastricht criteria in a sustainable way.

46. **Latvia's program implementation has underpinned the economic recovery now underway.** Latvia's intention to return to international markets and to treat this and potential future purchases as precautionary reflects the marked improvement in external financing conditions. Staff supports the authorities' request for completing the Fourth Review and financing assurances review on the basis of Latvia's performance under the arrangement, and the policy commitments specified in the Letter of Intent. Staff also recommends granting a waiver of nonobservance of the continuous performance criterion on imposing or intensifying restrictions on the making of payments and transfers for current international transactions, and approval of the authorities' request to rephase the remaining purchases under the arrangement.

Table 1. Latvia: Selected Economic Indicators, 2008–12

	2008	2009	2010		2011	2012
			Third Rev.	Actual	Proj.	Proj.
National accounts	(percentage change, unless otherwise indicated)					
Real GDP	-4.2	-18.0	-3.5	-0.3	3.3	4.0
Private consumption	-5.2	-24.1	-9.0	-0.1	3.0	3.7
Public consumption	1.5	-9.2	-10.0	-11.0	-2.0	0.0
Gross fixed investment	-13.6	-37.3	-10.0	-19.5	8.0	8.5
Stockbuilding (contribution to growth)	-4.1	-1.5	1.5	5.8	0.0	0.0
Exports of goods and services	2.0	-14.1	5.0	10.3	9.5	7.5
Imports of goods and services	-11.2	-33.5	-6.2	8.6	9.0	7.6
Nominal GDP (billions of lats)	16.2	13.1	12.2	12.7	13.4	14.2
Nominal GDP (billions of euros)	23.0	18.6	17.4	18.1	19.1	20.1
GDP per capita (thousands of euros)	10.1	8.2	7.7	8.1	8.5	9.0
Savings and Investment						
Gross national savings (percent of GDP)	18.1	28.9	30.2	24.2	24.0	23.6
Gross capital formation (percent of GDP)	31.2	20.3	18.9	20.7	22.2	23.1
Private investment (percent of GDP)	26.4	16.0	14.4	16.8	16.0	17.6
HICP inflation						
Period average	15.3	3.3	-2.0	-1.2	3.2	1.8
End-period	10.4	-1.4	-0.5	2.4	2.0	2.3
Labor market						
Unemployment rate (LFS definition; period average, percent)	7.8	17.3	21.0	19.0	17.2	15.5
Real gross wages	4.4	-6.8	-7.9	-2.3	-1.6	0.5
Consolidated general government 1/	(percent of GDP, unless otherwise indicated)					
Revenue	35.4	36.2	39.6	36.2	38.1	36.3
Expenditure and net lending	38.7	43.3	47.8	42.6	42.6	38.6
Basic fiscal balance	-3.3	-7.1	-8.1	-6.4	-4.4	-2.3
ESA balance less bank restructuring	-4.2	-8.6	-8.5	-5.5	-4.5	-2.5
General government gross debt	17.1	32.8	43.4	39.9	43.0	43.5
Money and credit						
Credit to private sector (percentage change)	11.0	-6.9	-5.5	-8.4	-1.7	0.2
Broad money (percentage change)	-3.9	-1.9	21.2	9.8	5.4	8.1
Residents' FX deposits (percent of total deposits)	48.6	55.6	51.7	50.3	53.8	56.0
Treasury Bill rate (365 days, eop, percent)	11.0	10.3	…	1.8	1.8 2/	…
Money market rate (one month, eop, percent)	13.3	2.7	…	0.6	0.6 2/	…
Balance of payments						
Gross official reserves (billions of euros)	3.7	4.8	5.3	5.8	5.2	5.2
(In months of prospective imports)	5.4	6.0	7.8	6.1	5.0	4.6
(percent of broad money and non-resident deposits)	31.1	41.6	37.4	43.5	37.8	35.4
Current account balance	-13.1	8.6	8.2	3.6	1.7	0.5
Trade balance	-17.7	-7.1	-3.3	-6.4	-7.6	-8.1
Exports of goods and services	41.8	43.2	48.4	52.9	58.8	60.4
Imports of goods and services	55.5	44.2	44.4	53.1	59.3	61.8
Gross external debt	128.7	156.3	161.1	165.2	145.4	135.1
Net external debt 3/	56.8	58.8	43.0	53.8	34.4	28.1
Exchange rates						
Lats per euro (average) /4	0.70	0.70	…	0.70	0.70 2/	…
Lats per U.S. dollar (average)	0.48	0.48	…	0.53	0.49 2/	…
REER (average; CPI based, 2000=100)	104.5	110.3	…	103.6	…	…

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

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

2/ Actual rate as of April 18, 2011.

3/ Gross external debt minus gross external debt assets.

4/ Lat is pegged to the euro at a 1 EUR = 0.702804 LVL rate, with ±1 percent band.

Table 2. Latvia. Macroeconomic Framework, 2008-16

	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Projections					
				(percentage change, unless otherwise indicated)					
National accounts									
Real GDP	-4.2	-18.0	-0.3	3.3	4.0	4.0	4.0	4.0	4.0
Consumption	-4.1	-21.5	-2.2	2.1	3.1	3.5	3.7	3.8	3.9
Private consumption	-5.2	-24.1	-0.1	3.0	3.7	4.0	4.1	4.2	4.3
Public consumption	1.5	-9.2	-11.0	-2.0	0.0	1.0	1.5	2.0	2.0
Gross fixed capital formation	-13.6	-37.3	-19.5	8.0	8.5	7.5	7.0	6.5	6.0
Exports of goods and services	2.0	-14.1	10.3	9.5	7.5	6.9	6.5	6.4	6.2
Imports of goods and services	-11.2	-33.5	8.6	9.0	7.6	7.3	7.0	6.9	6.7
Contributions to growth									
Domestic demand	-12.5	-32.2	-0.9	3.3	4.2	4.4	4.5	4.5	4.5
Net exports	8.2	14.2	0.6	0.0	-0.2	-0.4	-0.5	-0.5	-0.5
HICP inflation									
Period average	15.3	3.3	-1.2	3.2	1.8	1.7	1.8	1.9	1.9
End-period	10.4	-1.4	2.4	2.0	2.3	1.1	2.1	1.9	1.8
Labor market									
Unemployment rate (LFS definition; period average, percent)	7.8	17.3	19.0	17.2	15.5	14.1	13.1	12.0	11.0
Employment (period average, percent change)	0.1	-11.4	-3.6	1.5	1.0	0.7	0.6	0.6	0.6
Real gross wages	4.4	-6.8	-2.3	-1.6	0.5	0.5	0.6	0.5	0.5
				(percent of GDP)					
Consolidated general government									
Revenues	35.4	36.2	36.2	38.1	36.3	34.5	33.6	32.9	32.1
Expenditure	38.7	43.3	42.6	42.6	38.6	36.2	35.0	34.7	33.6
Basic Balance	-3.3	-7.1	-6.4	-4.4	-2.3	-1.8	-1.4	-1.8	-1.5
Balance (including bank restructuring costs)	-7.5	-7.8	-7.8	-5.6	-2.3	-1.8	-1.4	-1.8	-1.5
Gross debt	17.1	32.8	39.9	43.0	43.5	46.5	49.7	45.0	42.4
Saving and investment									
Domestic saving	18.1	28.9	24.2	24.0	23.6	23.0	22.7	22.7	23.0
Private	14.9	30.5	26.2	21.7	19.9	18.2	17.3	17.4	17.2
Public 1/	3.2	-1.6	-2.0	2.3	3.7	4.8	5.4	5.3	5.8
Foreign saving 2/	13.1	-8.6	-3.6	-1.7	-0.5	0.8	1.7	2.1	2.2
Investment	31.2	20.3	20.7	22.2	23.1	23.8	24.4	24.8	25.2
Private	26.4	16.0	16.8	16.0	17.6	18.5	19.1	19.3	19.4
Public	4.7	4.3	3.9	6.2	5.5	5.3	5.2	5.5	5.8
External sector									
Current account balance	-13.1	8.6	3.6	1.7	0.5	-0.8	-1.7	-2.1	-2.2
Net IIP	-78.6	-82.6	-81.4	-72.5	-60.4	-56.6	-53.8	-51.6	-49.7
Gross external debt	128.7	156.3	165.2	145.4	135.1	129.9	125.6	116.1	109.2
Net external debt 3/	56.8	58.8	53.8	34.4	28.1	23.5	19.9	17.0	14.3
Memorandum items:									
Gross official reserves (billions of euros)	3.7	4.8	5.8	5.2	5.2	5.8	6.4	5.8	5.7
Nominal GDP (billions of lats)	16.2	13.1	12.7	13.4	14.2	15.0	15.8	16.7	17.7
Nominal GDP (billions of euros)	23.0	18.6	18.1	19.1	20.1	21.3	22.5	23.8	25.1

Sources: Latvian Authorities and IMF staff estimates.

1/ Includes 2nd pillar contributions and privatization receipts, excludes bank restructuring costs.
2/ Current account deficit (+ indicates a surplus)
3/ Gross external debt minus gross external debt assets.

Table 3. Latvia: General Government Operations, 2009-13

	2009	2010 Third Review	2010 Actual	2011 Third Review	2011 Proj.	2011 Risk scenario	2012 Proj.	2013 Proj.
	(millions of lats)							
Total revenue and grants	4,735	4,842	4,607	4,623	5,119	5,138	5,136	5,153
Tax revenue	3,515	3,335	3,403	3,324	3,714	3,692	3,852	3,912
Direct Taxes	2,166	2,042	2,074	2,002	2,153	2,149	2,228	2,205
Corporate Income Tax	197	98	112	102	121	116	127	139
Personal Income Tax	729	770	779	775	739	737	764	789
Social Security Contributions	1,167	1,086	1,093	1,034	1,193	1,196	1,232	1,166
Real Estate and Property Taxes	73	87	90	91	99	99	105	111
Indirect Taxes	1,349	1,294	1,329	1,322	1,561	1,543	1,624	1,707
VAT	798	795	825	807	972	952	991	1,051
Excises	504	459	458	475	476	480	515	536
Other indirect taxes	46	40	46	40	113	111	118	120
Non Tax, self-earned and other revenue	690	598	604	508	507	496	490	527
EU and miscellaneous funds	530	909	600	791	898	950	794	715
Total expenditure 1/	5,662	5,836	5,424	5,290	5,715	5,788	5,466	5,417
Current expenditure	5,231	5,359	5,034	5,233	5,050	5,184	5,095	5,061
Primary Current Expenditure	5,081	5,149	4,855	4,989	4,824	4,953	4,810	4,736
Remuneration	1,337	1,182	1,087	1,182	1,068	1,074	1,083	1,107
Goods and Services	675	689	691	689	583	587	600	634
Subsidies and Transfers	2,884	3,026	2,937	2,872	2,992	3,110	2,938	2,798
Subsidies to companies and institutions	1,224	1,213	1,178	1,140	1,375	1,466	1,316	1,169
E.U. funds related subsidies	668	777	784	704	790	850	725	578
Social Support	1,646	1,796	1,745	1,716	1,604	1,632	1,608	1,615
Pensions	1,082	1,235	1,252	1,195	1,164	1,164	1,166	1,166
Other	564	561	493	521	440	468	442	449
International cooperation	13	17	15	17	13	13	13	14
Payments to EU budget	148	140	121	145	130	130	137	145
Net lending and other current expenditure	36	112	18	100	51	51	51	51
Interest	151	210	180	244	227	231	285	325
Capital expenditure	430	477	390	477	624	604	551	536
E.U. funds related capital expenditure	135	200	141	200	359	350	293	263
Measures to be identified	0	0	0	-420	0	0	-180	-180
Possible contingencies 2/	0	0	0	0	40	0	0	0
Basic fiscal balance	-927	-994	-817	-667	-596	-650	-330	-263
Bank restructuring costs	99	432	182	217	150	150	0	0
Fiscal balance	-1,026	-1,426	-999	-884	-746	-800	-330	-263
Financing (net)	1,026	1,426	999	884	746	800	330	263
Domestic financing	-976	425	112	-47	156	210	40	-426
Banking system	-1,010	425	29	-47	156	210	40	-426
Central Bank	-654	425	313	-147	56	110	-60	-530
Commercial banks	-356	0	-284	100	100	100	100	104
Nonbanks	34	0	83	0	0	0	0	0
Privatization and other	0	0	0	0	0	0	0	0
External financing	1,970	1,001	827	931	590	590	290	690
Net borrowing (net)	195	70	119	250	520	520	520	1,040
Exceptional financing	1,775	931	708	681	70	70	-230	-350
Errors and omissions	32	0	60	0	0	0	0	0

Table 3. Latvia: General Government Operations, 2009-13 (concluded)

	2009	2010		2011			2012	2013
		Third Review	Actual	Third Review	Proj.	Risk scenario	Proj.	Proj.
	(percent of GDP)							
Total revenue and grants	36.2	39.6	36.2	36.8	38.1	38.3	36.3	34.5
Tax revenue	26.9	27.3	26.7	26.5	27.7	27.5	27.2	26.2
Direct Taxes	16.6	16.7	16.3	15.9	16.0	16.0	15.7	14.7
Corporate Income Tax	1.5	0.8	0.9	0.8	0.9	0.9	0.9	0.9
Personal Income Tax	5.6	6.3	6.1	6.2	5.5	5.5	5.4	5.3
Social Security Contributions	8.9	8.9	8.6	8.2	8.9	8.9	8.7	7.8
Real Estate and Property Taxes	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Indirect Taxes	10.3	10.6	10.4	10.5	11.6	11.5	11.5	11.4
VAT	6.1	6.5	6.5	6.4	7.2	7.1	7.0	7.0
Excises	3.9	3.8	3.6	3.8	3.5	3.6	3.6	3.6
Other indirect taxes	0.4	0.3	0.4	0.3	0.8	0.8	0.8	0.8
Non Tax, self-earned and other revenue	5.3	4.9	4.7	4.0	3.8	3.7	3.5	3.5
EU and miscellaneous funds	4.0	7.4	4.7	6.3	6.7	7.1	5.6	4.8
Total expenditure 1/	43.3	47.8	42.6	42.1	42.6	43.1	38.6	36.2
Current expenditure	40.0	43.9	39.5	41.7	37.6	38.6	36.0	33.8
Primary Current Expenditure	38.8	42.2	38.1	39.7	35.9	36.9	34.0	31.7
Remuneration	10.2	9.7	8.5	9.4	8.0	8.0	7.7	7.4
Goods and Services	5.2	5.6	5.4	5.5	4.3	4.4	4.2	4.2
Subsidies and Transfers	22.0	24.8	23.1	22.9	22.3	23.2	20.7	18.7
Subsidies to companies and institutions	9.4	9.9	9.2	9.1	10.2	10.9	9.3	7.8
E.U. funds related subsidies	5.1	6.4	6.2	5.6	5.9	6.3	5.1	3.9
Social Support	12.6	14.7	13.7	13.7	11.9	12.2	11.4	10.8
Pensions	8.3	10.1	9.8	9.5	8.7	8.7	8.2	7.8
Other	4.3	4.6	3.9	4.2	3.3	3.5	3.1	3.0
International cooperation	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Payments to EU budget	1.1	1.1	1.0	1.2	1.0	1.0	1.0	1.0
Net lending and other current expenditure	0.3	0.9	0.1	0.8	0.4	0.4	0.4	0.3
Interest	1.2	1.7	1.4	1.9	1.7	1.7	2.0	2.2
Capital expenditure	3.3	3.9	3.1	3.8	4.6	4.5	3.9	3.6
E.U. funds related capital expenditure	1.0	1.6	1.1	1.6	2.7	2.6	2.1	1.8
Measures to be identified	0.0	0.0	0.0	-3.3	0.0	0.0	-1.3	-1.2
Possible contingencies 2/	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0
Basic fiscal balance	-7.1	-8.1	-6.4	-5.3	-4.4	-4.8	-2.3	-1.8
Bank restructuring costs	0.8	3.5	1.4	1.7	1.1	1.1	0.0	0.0
Fiscal balance	-7.8	-11.7	-7.8	-7.0	-5.6	-6.0	-2.3	-1.8
Memorandum items								
ESA balance	-9.7	-8.5	-7.7	-6.0	-4.9	-5.3	-2.5	-2.5
ESA balance less bank restructuring 3/	-8.6	-8.5	-5.5	-6.0	-4.5	-4.9	-2.5	-2.4
General government debt	32.8	43.4	39.9	50.4	43.0	43.0	43.5	46.5
Primary basic balance	-5.9	-6.4	-5.0	-3.4	-2.7	-3.1	-0.3	0.4
Nominal GDP (In millions of lats)	13,083	12,213	12,736	12,563	13,428	13,428	14,161	14,955

Sources: Latvian authorities and IMF staff estimates.

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

2/ Includes the budgetary clause to increase spending without parliamentary approval.

3/ The bank restructuring costs are calculated in accordance with ESA 95 definitions.

Table 4. Latvia: Fiscal Balances and Debt, 2006-12

	2006	2007	2008	2009	2010	2011	2012
	(percent of GDP)						
Fiscal balances							
Basic fiscal balance (excl. bank restructuring)	-0.5	0.6	-3.3	-7.1	-6.4	-4.4	-2.3
Alternative fiscal balances							
(i) Authorities' definition							
plus net lending	…	0.0	0.0	0.3	0.1	0.4	0.4
Basic fiscal balance, authorities' definition	…	0.6	-3.3	-6.8	-6.3	-4.1	-2.0
(ii) Adjustment for 2nd pillar contribution diversion							
less gain from 2nd pillar contributions < 8%	0.0	0.0	0.0	1.2	1.6	1.7	1.7
Fiscal balance, adjusted for pension diversion 1/	-0.5	0.6	-3.3	-8.3	-8.1	-6.2	-4.0
(iii) Adjustment for EU-related operations							
less revenues from EU	2.3	3.1	2.7	4.0	4.7	6.7	5.6
plus EU-related spending	4.1	3.6	4.2	6.1	7.3	8.6	7.2
Non-EU basic balance	1.3	1.1	-1.8	-5.0	-3.9	-2.6	-0.8
(iv) Primary balance							
plus interest	0.6	0.3	0.4	1.2	1.4	1.7	2.0
Primary basic balance	0.1	1.0	-2.9	-5.9	-5.0	-2.7	-0.3
(v) Recognition of bank restructuring costs							
less bank restructuring costs	0.0	0.0	4.2	0.8	1.4	1.1	0.0
Overall balance	-0.5	0.6	-7.5	-7.8	-7.8	-5.6	-2.3
(vi) Program-relevant ESA balance							
ESA definition less bank restructuring	-0.5	-0.3	-4.2	-8.6	-5.5	-4.5	-2.5
(v) ESA deficit (relevant for euro adoption)							
plus ESA bank restructuring	0.0	0.0	0.0	1.1	2.3	0.4	0.0
ESA deficit	-0.5	-0.3	-4.2	-9.7	-7.7	-4.9	-2.5
Public debt							
Gross debt	9.9	7.8	17.1	32.8	39.9	43.0	43.5
of which foreign currency-denominated	5.2	4.4	9.8	25.6	32.6	35.2	35.4
Net debt (debt less government deposits)	7.4	4.7	13.1	23.0	32.2	36.1	36.6
Net debt if no more bank restructuring	7.4	4.7	13.1	23.0	32.2	35.0	35.5

Sources: Latvian authorities and IMF staff estimates.
1/ Definition used at First Review.

Table 5. Latvia: Public Sector Debt Sustainability Framework, 2006-16
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	9.9	7.8	17.1	32.8	39.9	**43.0**	**43.5**	**46.5**	**49.7**	**45.0**	**42.4**	**-3.0**
o/w foreign-currency denominated	5.2	4.4	9.8	25.6	32.6	35.2	35.4	38.1	41.3	36.8	34.6	
2 Change in public sector debt	-1.9	-2.1	9.3	15.7	7.1	3.1	0.5	3.0	3.2	-4.7	-2.6	
3 Identified debt-creating flows (4+7+12)	-2.4	-3.5	7.0	11.0	11.6	3.5	0.1	-0.5	-1.1	-0.9	-0.9	
4 Primary deficit	-0.1	-1.0	2.9	5.9	5.0	2.7	0.3	-0.4	-1.1	-1.2	-1.2	
5 Revenue and grants	36.1	36.2	35.4	36.2	36.2	38.1	36.3	34.5	33.6	32.9	32.1	
6 Primary (noninterest) expenditure	36.0	35.2	38.3	42.1	41.2	40.9	36.6	34.0	32.4	31.7	30.9	
7 Automatic debt dynamics 2/	-2.2	-2.5	0.0	4.3	5.2	-0.4	-0.2	-0.1	0.0	0.3	0.3	
8 Contribution from interest rate/growth differential 3/	-1.7	-2.1	-0.3	5.2	2.3	-0.4	-0.2	-0.1	0.0	0.3	0.3	
9 Of which contribution from real interest rate	-0.5	-1.3	-0.6	1.4	2.2	0.9	1.4	1.5	1.8	2.2	2.0	
10 Of which contribution from real GDP growth	-1.2	-0.7	0.3	3.8	0.1	-1.3	-1.6	-1.7	-1.8	-1.9	-1.7	
11 Contribution from exchange rate depreciation 4/	-0.6	-0.4	0.3	-0.9	2.9	...	...	...	...	...	...	
12 Other identified debt-creating flows	-0.1	-0.1	4.1	0.8	1.4	1.1	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	-0.1	-0.1	-0.1	0.0	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 Other (specify, e.g. bank recapitalization)	0.0	0.0	4.2	0.8	1.4	1.1	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	0.5	1.4	2.3	4.8	-4.6	-0.4	0.4	3.5	4.3	-3.8	-1.7	
Public sector debt-to-revenue ratio 1/	27.3	21.4	48.3	90.7	110.3	112.7	120.0	134.9	148.1	136.7	132.0	
Gross financing need 6/	2.2	0.3	8.9	15.9	12.6	9.3	6.8	6.0	9.7	7.3	2.1	
in billions of U.S. dollars	0.4	0.1	3.0	4.3	3.0	2.4	1.9	1.7	2.9	2.3	0.8	
Scenario with key variables at their historical averages 7/						**43.0**	**43.1**	**46.4**	**50.2**	**45.8**	**43.8**	**-5.3**
Scenario with no policy change (constant primary balance) in 2011-2016						**43.0**	**46.0**	**52.1**	**59.2**	**58.6**	**59.0**	**-4.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	12.2	10.0	-4.2	-18.0	-0.3	3.3	4.0	4.0	4.0	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	5.9	4.7	5.6	5.4	4.2	4.5	4.9	5.3	5.8	6.4	6.4	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.0	-15.6	-8.8	6.9	6.5	2.4	3.5	3.8	4.2	4.7	4.7	
Nominal appreciation (increase in US dollar value of local currency, in percent)	11.4	10.3	-6.6	7.3	-9.5	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	9.9	20.3	14.4	-1.5	-2.3	2.0	1.4	1.5	1.6	1.7	1.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	12.2	7.6	4.2	-9.8	-2.6	2.6	-6.9	-3.2	-0.9	1.7	1.4	
Primary deficit	-0.1	-1.0	2.9	5.9	5.0	2.7	0.3	-0.4	-1.1	-1.2	-1.2	

Source: IMF staff estimates

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

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.

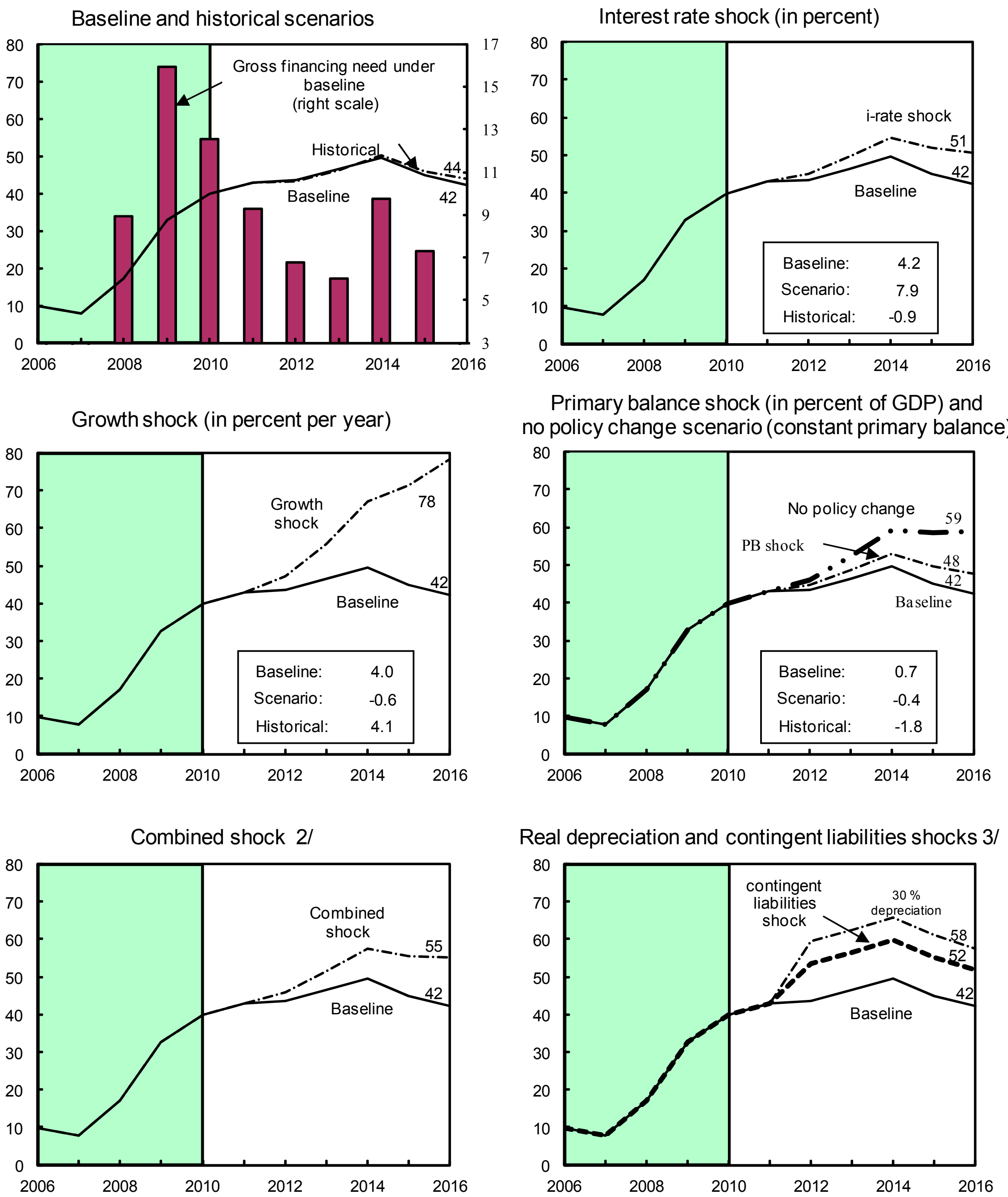
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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.

Figure 8. Latvia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Source: IMF 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).

Table 6. Latvia: Medium Term Balance of Payments, 2008−16

	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Projections					
	(millions of euros)								
Current account	-3,007	1,606	649	333	99	-174	-380	-508	-548
Trade balance (fob)	-4,073	-1,326	-1,168	-1,451	-1,630	-1,825	-2,033	-2,248	-2,487
Exports	6,527	5,276	6,783	8,006	8,664	9,290	9,922	10,661	11,489
Imports	10,600	6,602	7,951	9,457	10,295	11,115	11,955	12,908	13,976
Services	917	1,125	1,121	1,358	1,344	1,425	1,504	1,603	1,714
Credit	3,087	2,757	2,795	3,237	3,503	3,756	4,011	4,310	4,645
Debit	2,171	1,632	1,675	1,879	2,159	2,331	2,507	2,707	2,931
Income	-363	1,176	44	-242	-303	-475	-573	-649	-631
Compensation of employees	372	392	430	439	476	501	524	546	570
Investment income	-735	784	-386	-681	-778	-977	-1,096	-1,195	-1,201
Current transfers	512	631	653	667	688	702	722	786	857
of which: EU (net)	34	176	372	395	302	266	225	225	225
Capital and financial account	2,015	-3,142	-989	-1,042	233	1,279	2,151	1,202	549
Capital account	341	452	353	170	290	307	325	325	326
Financial account	1,674	-3,593	-1,341	-1,212	-57	972	1,826	876	222
Direct investment	697	112	251	495	509	528	557	603	653
of which: equity capital	286	996	493	419	424	440	466	509	555
Portfolio investment	254	124	-141	678	728	1,468	2,399	738	-12
of which: general government	210	-4	-2	740	740	1,480	2,412	750	0
Financial derivatives	-71	303	-169	0	0	0	0	0	0
Other investment	795	-4,132	-1,283	-2,385	-1,294	-1,024	-1,130	-465	-418
Trade credit	-40	-114	248	-119	15	17	19	18	21
Assets	27	87	-166	-160	-98	-93	-94	-110	-123
Liabilities	-67	-202	414	41	113	111	113	129	144
Loans	2,486	-2,012	-2,527	-1,632	-1,035	-721	-791	-330	-411
Assets	-187	-27	469	1,258	346	259	181	136	102
Liabilities	2,673	-1,986	-2,996	-2,890	-1,381	-980	-972	-466	-513
Currency and deposits	-1,633	-2,008	977	-615	-273	-320	-359	-153	-29
Assets	-130	-763	-1,016	-475	-553	-586	-619	-393	-249
Liabilities	-1,503	-1,245	1,993	-139	279	265	260	239	220
Other	-18	3	19	-19	0	0	0	0	0
Errors and omissions	-414	143	-36	0	0	0	0	0	0
Overall balance	-1,407	-1,393	-375	-709	332	1,105	1,771	694	1
Financing	1,407	1,393	375	709	-332	-1,105	-1,771	-694	-1
Change in reserve assets (+ denotes decline)	456	-922	-725	609	-16	-631	-552	596	42
IMF (net)	591	194	300	0	-316	-474	-219	-61	0
Purchases	…	…	300	0	0	0	0	0	0
Repurchases	…	…	0	0	-316	-474	-219	-61	0
Other official financing (net)	360	2,120	800	100	0	0	-1,000	-1,229	-43
Disbursements	…	…	800	100	0	0	0	0	0
Repayments	…	…	0	0	0	0	-1,000	-1,229	-43

Table 6. Latvia: Medium Term Balance of Payments, 2008−16 (concluded)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Projections					
Memorandum items:			(percent of GDP, unless otherwise indicated)						
Current account 1/	-13.1	8.6	3.6	1.7	0.5	-0.8	-1.7	-2.1	-2.2
Trade balance (fob)	-17.7	-7.1	-6.4	-7.6	-8.1	-8.6	-9.0	-9.5	-9.9
Exports	28.4	28.3	37.4	41.9	43.0	43.7	44.1	44.8	45.7
Imports	46.1	35.5	43.9	49.5	51.1	52.2	53.2	54.3	55.6
Services	4.0	6.0	6.2	7.1	6.7	6.7	6.7	6.7	6.8
Credit	13.4	14.8	15.4	16.9	17.4	17.6	17.8	18.1	18.5
Debit	9.4	8.8	9.2	9.8	10.7	11.0	11.2	11.4	11.7
Income	-1.6	6.3	0.2	-1.3	-1.5	-2.2	-2.5	-2.7	-2.5
Compensation of employees	1.6	2.1	2.4	2.3	2.4	2.4	2.3	2.3	2.3
Investment income	-3.2	4.2	-2.1	-3.6	-3.9	-4.6	-4.9	-5.0	-4.8
Current transfers	2.2	3.4	3.6	3.5	3.4	3.3	3.2	3.3	3.4
of which: EU (net)	0.1	0.9	2.1	2.1	1.5	1.3	1.0	0.9	0.9
Net FDI	3.0	0.6	1.4	2.6	2.5	2.5	2.5	2.5	2.6
Export G&S growth (value, fob, percent change)	10.6	-16.4	19.2	17.4	8.2	7.2	6.8	7.4	7.8
Import G&S growth (value, fob, percent change)	-1.7	-35.5	16.9	18.8	8.9	8.0	7.6	8.0	8.3
Export G&S price increase (percent change)	8.5	-3.6	7.3	7.2	0.7	0.3	0.3	1.0	1.5
Import G&S price increase (percent change)	11.7	-2.4	7.1	9.0	1.2	0.7	0.6	1.0	1.5
Gross reserves (billions of euros)	3.7	4.8	5.8	5.2	5.2	5.8	6.4	5.8	5.7
(in months of prospective imports)	5.4	6.0	6.1	5.0	4.6	4.8	4.9	4.1	4.0
Reserve Cover 2/	23.7	78.6	57.9	51.1	52.1	60.4	58.6	57.3	65.4
Short-term debt (percent of official reserves)	268.5	149.1	168.7	183.8	190.0	167.6	151.4	165.6	165.0
Banks' short term liabilities (billions of euros)	7.6	5.5	7.7	7.6	7.9	7.8	7.7	7.6	7.4
Total short-term debt (billions of euros)	9.9	7.2	9.8	9.5	9.9	9.8	9.7	9.6	9.5
Reserves (percent of short-term external debt)	37.2	67.1	59.3	54.4	52.6	59.7	66.0	60.4	60.6
Gross external debt (billions of euros)	29.6	29.1	29.9	27.8	27.2	27.6	28.2	27.6	27.4
Medium and long term (billions of euros)	19.7	21.9	20.2	18.3	17.4	17.9	18.6	18.0	18.0
Short term (billions of euros)	9.9	7.2	9.8	9.5	9.9	9.8	9.7	9.6	9.5
Net external debt (billions of euros) 3/	13.1	10.9	9.7	6.6	5.7	5.0	4.5	4.0	3.6
Gross external debt	128.7	156.3	165.2	145.4	135.1	129.9	125.6	116.1	109.2
Medium and long term	85.6	117.8	111.3	95.6	86.1	84.0	82.7	75.9	71.5
Short term	43.1	38.5	53.9	49.8	49.0	45.9	43.0	40.3	37.7
Net external debt	56.8	58.8	53.8	34.4	28.1	23.5	19.9	17.0	14.3
Nominal GDP (billions of euros)	23.0	18.6	18.1	19.1	20.1	21.3	22.5	23.8	25.1
U.S. dollar per euro (period average)	1.47	1.46	1.32	…	…	…	…	…	…
Lats per euro	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 the current account would have been 2.8 percent of GDP if provisioning by foreign banks for their non-performing loans were excluded.

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, 2008-16

	2008	2009	2010	2011	2012	2013	2014	2015	2016
					(billions of euros)				
Gross external debt	29.6	29.1	29.9	27.8	27.2	27.6	28.2	27.6	27.4
Public	2.5	4.8	6.0	6.9	7.3	8.3	9.5	8.9	8.9
Short term	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Long term	1.9	4.6	5.9	6.7	7.2	8.2	9.4	8.8	8.8
Private	27.1	24.3	23.9	20.9	20.0	19.4	18.8	18.7	18.5
Banks	18.5	15.5	15.6	13.3	12.4	11.8	11.2	11.1	10.9
Short term	7.6	5.5	7.7	7.6	7.9	7.8	7.7	7.6	7.4
Long term	10.9	10.0	7.8	5.7	4.5	4.0	3.5	3.5	3.5
Corporate	6.1	5.8	5.9	5.1	5.0	5.0	5.0	5.1	5.1
Short term	1.8	1.5	1.9	1.8	1.9	1.9	1.9	1.9	1.9
Long term	4.3	4.3	4.0	3.3	3.1	3.1	3.1	3.1	3.1
Other	2.5	3.1	2.5	2.5	2.5	2.5	2.5	2.6	2.6
					(percent of GDP)				
Gross external debt	128.7	156.3	165.2	145.4	135.1	129.9	125.6	116.1	109.2
Public	10.8	25.7	33.2	35.9	36.1	38.9	42.1	37.6	35.4
Short term	2.4	0.8	0.7	0.6	0.6	0.6	0.5	0.5	0.5
Long term	8.5	25.0	32.5	35.2	35.5	38.3	41.6	37.1	34.9
Private	117.9	130.6	132.0	109.5	99.0	91.0	83.5	78.6	73.8
Banks	80.6	83.2	85.8	69.5	61.6	55.5	49.8	46.6	43.3
Short term	33.1	29.6	42.7	39.8	39.2	36.5	34.1	31.8	29.5
Long term	47.5	53.6	43.1	29.7	22.5	18.9	15.7	14.8	13.8
Corporate	26.4	31.0	32.3	26.9	24.9	23.6	22.4	21.2	20.3
Short term	7.6	8.2	10.5	9.4	9.2	8.8	8.3	8.0	7.8
Long term	18.8	22.9	21.9	17.5	15.6	14.8	14.0	13.2	12.5
Other	10.9	16.4	13.9	13.2	12.5	11.9	11.3	10.8	10.2
					(debt dynamics, change in debt to GDP ratio)				
Total Debt to GDP	1.0	27.6	8.9	-19.8	-10.3	-5.2	-4.3	-9.5	-7.0
Due to change in debt	12.1	-2.8	4.7	-11.3	-2.8	1.9	2.7	-2.6	-0.7
Due to nominal GDP	-11.1	30.4	4.3	-8.5	-7.5	-7.2	-6.9	-6.9	-6.3
Public Debt to GDP	5.7	14.9	7.4	2.7	0.2	2.8	3.2	-4.6	-2.2
Due to change in debt	6.2	12.3	6.7	4.4	2.1	4.7	5.3	-2.3	-0.2
Due to nominal GDP	-0.4	2.6	0.7	-1.7	-1.9	-1.9	-2.1	-2.3	-2.0
Private Debt to GDP	-4.7	12.7	1.5	-22.5	-10.5	-8.0	-7.5	-4.9	-4.8
Due to change in debt	6.0	-15.1	-2.1	-15.7	-4.9	-2.8	-2.6	-0.4	-0.5
Due to nominal GDP	-10.7	27.8	3.6	-6.8	-5.7	-5.3	-4.9	-4.6	-4.3
Memorandum items:									
Nominal GDP (billions of euros)	23.0	18.6	18.1	19.1	20.1	21.3	22.5	23.8	25.1

Sources: Latvian authorities and IMF staff estimates.

Table 8. Latvia: External Debt Sustainability Framework, 2006-16
(In percent of GDP, unless otherwise indicated)

		Actual							Projections						
		2006	2007	2008	2009	2010			2011	2012	2013	2014	2015	2016	**Debt-stabilizing non-interest current account 6/**
1	**Baseline: External debt**	114.2	127.7	128.7	156.3	165.2			**145.4**	**135.1**	**129.9**	**125.6**	**116.1**	**109.2**	**-5.5**
2	Change in external debt	14.7	13.5	1.0	27.6	8.9			-19.8	-10.3	-5.2	-4.3	-9.5	-7.0	
3	Identified external debt-creating flows (4+8+9)	-3.4	-19.5	-7.4	34.4	8.1			-9.5	-8.7	-6.9	-5.9	-5.3	-4.9	
4	Current account deficit, excluding interest paym	17.4	17.8	11.1	-9.9	-4.5			-4.1	-2.6	-1.6	-0.8	-0.2	-0.2	
5	Deficit in balance of goods and services	22.3	20.5	13.7	1.1	0.3			0.5	1.4	1.9	2.4	2.7	3.1	
6	Exports	44.0	41.4	41.8	43.2	52.9			58.8	60.4	61.3	62.0	63.0	64.2	
7	Imports	66.2	61.9	55.5	44.2	53.1			59.3	61.8	63.2	64.3	65.7	67.3	
8	Net non-debt creating capital inflows (negative)	-6.5	-6.7	-1.4	3.6	-1.5			-2.7	-2.6	-2.6	-2.6	-2.6	-2.7	
9	Automatic debt dynamics 1/	-14.4	-30.5	-17.2	40.7	13.8			-2.7	-3.4	-2.7	-2.4	-2.4	-2.0	
10	Contribution from nominal interest rate	5.1	4.6	1.9	1.3	0.9			2.4	2.1	2.5	2.5	2.4	2.4	
11	Contribution from real GDP growth	-9.8	-7.9	4.6	30.2	0.6			-5.1	-5.5	-5.2	-5.0	-4.8	-4.4	
12	Contribution from price and exchange rate cha	-9.7	-27.2	-23.7	9.2	12.3			...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3)	18.1	33.0	8.5	-6.8	0.8			-10.3	-1.6	1.7	1.6	-4.2	-2.1	
	External debt-to-exports ratio (in percent)	259.6	308.6	308.1	362.2	312.6			247.1	223.8	211.9	202.7	184.5	170.1	
	Gross external financing need (in billions of U	23.2	29.8	43.0	30.8	24.1			30.7	30.5	31.4	31.0	30.4	30.1	
	in percent of GDP	116.5	103.3	126.8	118.9	100.6	10-Year	10-Year	117.6	111.6	109.5	103.1	96.2	90.7	
	Scenario with key variables at their historical averages 5/								**145.4**	**136.6**	**131.5**	**126.7**	**118.2**	**111.7**	**-12.1**
	Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
	Real GDP growth (in percent)	12.2	10.0	-4.2	-18.0	-0.3	4.1	9.3	3.3	4.0	4.0	4.0	4.0	4.0	
	GDP deflator in US dollars (change in percent)	10.8	31.3	22.8	-6.7	-7.3	8.5	12.3	5.6	0.6	0.7	0.7	1.2	0.9	
	Nominal external interest rate (in percent)	6.4	5.8	1.8	0.8	0.5	3.6	2.3	1.6	1.5	1.9	2.0	2.0	2.1	
	Growth of exports (US dollar terms, in percent)	16.2	35.9	18.8	-20.9	13.2	15.7	15.7	21.5	7.3	6.4	5.9	7.0	6.9	
	Growth of imports (US dollar terms, in percent)	32.4	34.9	5.5	-39.0	11.0	15.2	22.1	23.0	8.0	7.1	6.7	7.5	7.4	
	Current account balance, excluding interest payme	-17.4	-17.8	-11.1	9.9	4.2	-6.6	8.6	4.1	2.6	1.6	0.8	0.2	0.2	
	Net non-debt creating capital inflows	6.5	6.7	1.4	-3.6	1.5	3.0	2.9	2.7	2.6	2.6	2.6	2.6	2.7	

Source: IMF staff estimates

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).

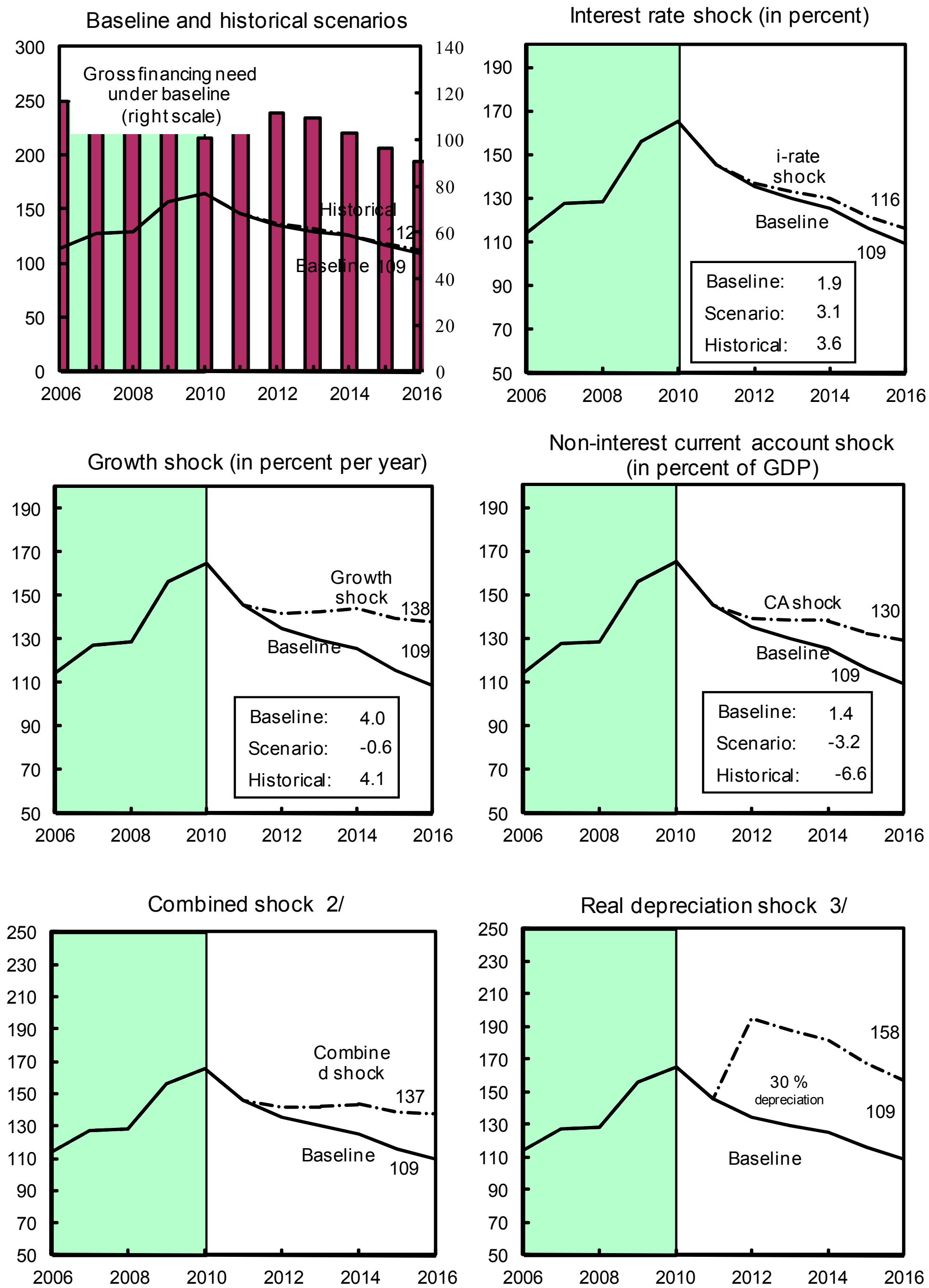
3/ For projection, line includes the impact of price and exchange rate changes.

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.

Figure 9. 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 2011.

Table 9. Latvia: Bank of Latvia Balance Sheet, 2007-12

	2007	2008	2009	2010	2011	2012
	Actuals				Proj.	
	(Billions of Lats, current exchange rate)					
Reserve money	2.5	2.1	1.9	2.6	2.3	2.3
Currency issued	1.0	1.0	0.8	0.9	1.0	1.1
Reserves at the BoL	1.4	1.1	1.1	1.7	1.3	1.2
Required reserves	1.4	1.1	0.9	0.8	0.8	0.8
Deposit facility	0.0	0.0	0.3	0.9	0.5	0.4
Net foreign assets 1/	2.8	2.3	3.3	4.0	3.6	3.6
Foreign assets	2.9	2.7	3.4	4.1	3.6	3.7
Foreign liabilities	0.1	0.4	0.1	0.0	0.0	0.0
Net domestic assets	-0.3	-0.2	-1.4	-1.4	-1.3	-1.4
Net credit to government	-0.2	-0.6	-1.3	-1.1	-0.9	-1.0
Net credit to banks (excluding deposit facility)	0.0	0.6	0.1	0.0	0.0	0.0
Net credit to other sectors	0.0	0.0	0.0	-0.1	-0.1	-0.1
Other items, net	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3
	(Billions of Lats, program exchange rate for actual figures)					
Net foreign assets	…	2.3	3.3	4.0	3.6	…
minus disbursments of program funds	…	0.4	2.3	3.0	3.1	…
minus SDR allocation	…	…	0.1	0.1	0.1	…
Program net international reserves	…	1.9	0.9	0.8	0.4	…
Base money 2/	…	2.1	1.6	1.8	1.9	…
minus program net international reserves	…	1.9	0.9	0.8	0.4	…
Program net domestic assets	…	0.2	0.7	1.0	1.4	…
Memorandum items:						
Base money 2/	2.5	2.1	1.6	1.8	1.8	1.9
Net foreign assets (percent of base money)	112.6	110.5	201.5	229.8	203.5	196.3
Net foreign assets (percent of reserve money)	112.6	110.4	174.3	153.6	155.6	159.4
Net foreign assets (percent of M2)	76.5	67.3	112.2	112.6	101.0	97.1
Net foreign assets (percent of broad money)	45.0	39.3	56.9	63.1	53.9	50.0
Broad money multiplier	2.5	2.8	3.1	2.4	2.9	3.2

Source: Bank of Latvia and IMF staff estimates.

1/ Includes Treasury foreign assets deposited at the BoL
2/ Excludes banks' deposits at deposit facility

Table 10. Latvia: Monetary Survey, 2007-12

	2007	2008	2009	2010	2011	2012
	Actuals				Proj.	
	(Billions of Lats)					
Broad money	6.2	5.9	5.8	6.4	6.7	7.3
Lats broad money (M2)	3.6	3.5	3.0	3.6	3.6	3.7
Currency in circulation	0.9	0.9	0.7	0.8	0.9	1.0
Lats deposits	2.7	2.6	2.3	2.8	2.7	2.8
Resident foreign exchange deposits	2.5	2.5	2.9	2.8	3.1	3.5
Net foreign assets	-4.5	-5.9	-3.0	-1.2	-0.9	-0.5
Bank of Latvia	2.8	2.3	3.3	4.0	3.6	3.6
Domestic money banks	-7.3	-8.2	-6.3	-5.3	-4.6	-4.2
Net domestic assets	10.7	11.8	8.8	7.6	7.7	7.8
Domestic credit	13.0	14.3	12.2	11.2	11.2	11.3
Credit to government, net	-0.1	-0.4	-1.5	-1.4	-1.2	-1.2
Credit to public corporations	0.3	0.4	0.4	0.5	0.5	0.5
Credit to private sector	12.9	14.3	13.3	12.2	12.0	12.0
Other items, net	-2.4	-2.4	-3.4	-3.6	-3.6	-3.4
Sources of funds of deposit money banks	18.0	18.2	16.3	16.4	15.1	14.9
Resident deposits	5.3	5.1	5.2	5.6	5.8	6.3
Non-resident deposits	4.5	3.5	3.3	4.2	4.1	4.3
Liabilities to foreign financial institutions	7.9	9.3	7.4	6.5	5.0	4.2
Other foreign liabilities	0.3	0.4	0.6	0.1	0.1	0.1
Uses of funds of deposit money banks	18.0	18.2	16.3	16.4	15.1	14.9
Reserves	1.6	1.2	1.2	1.8	1.4	1.3
Cash in vault	0.1	0.2	0.1	0.1	0.1	0.1
Required reserves	1.4	1.1	0.9	0.8	0.8	0.8
Deposit facility	0.0	0.0	0.3	0.9	0.5	0.4
Domestic credit	13.2	14.3	13.4	12.3	12.2	12.3
Foreign assets	5.5	4.9	4.9	5.6	4.7	4.4
Other items, net	-2.2	-2.2	-3.1	-3.3	-3.2	-3.1
	(Annual percentage change)					
Broad money	12.6	-3.9	-1.9	9.8	5.4	8.1
Net foreign assets	-70.1	-31.9	48.9	59.6	24.1	40.8
Bank of Latvia	15.0	-16.0	42.1	21.7	-10.0	0.3
Domestic money banks	-43.8	-13.6	23.2	17.1	13.3	8.0
Net domestic assets	31.3	11.2	-25.4	-13.9	0.7	2.2
Domestic credit	31.8	9.7	-14.5	-8.1	0.0	0.4
Credit to government, net	-186.9	-323.3	-298.5	2.9	13.8	0.0
Credit to public corporations	118.3	52.5	3.8	19.9	2.1	4.1
Credit to private sector	33.0	11.0	-6.9	-8.4	-1.7	0.2
	(Percent of GDP, unless otherwise indicated)					
Memorandum items:						
Lats broad money (M2)	24.6	21.4	22.6	28.1	26.8	26.5
Broad money	41.8	36.6	44.5	50.2	50.1	51.4
Currency in circulation	6.1	5.4	5.1	6.3	6.6	6.9
Residents' foreign exchange deposits (percent of total deposits)	48.2	48.6	55.6	50.3	53.8	56.0
Domestic credit	88.1	88.2	93.3	88.1	83.5	79.5
Private sector credit	87.0	88.1	101.5	95.6	89.1	84.6
Nominal GDP (billions of lats)	14.8	16.2	13.1	12.7	13.4	14.2

Source: Bank of Latvia and IMF staff estimates.

Table 11. Latvia: Financial Soundness Indicators, 2007-11
(In percent, unless otherwise indicated)

	Dec-07	Dec-08	Dec-09	Dec-10	Feb-11
Commercial banks					
Capital Adequacy					
Regulatory capital to risk-weighted assets	11.1	11.8	14.6	14.6	15.0
Regulatory Tier I capital to risk-weighted assets 1/	9.8	10.5	11.5	11.5	11.8
Capital and reserves to assets	7.9	7.3	7.4	7.3	7.6
Asset Quality					
Annual growth of bank loans	37.2	11.2	-7.0	-7.2	-8.1
Loans past due over 90 days	0.8	3.6	16.4	19.0	18.7
Loans past due over 90 days net of loan loss provisions to capital	…	13.6	67.6	65.3	58.6
Loan loss provisions to loans past due over 90 days	…	61.3	57.4	61.6	63.6
Loan loss provisions to total loans	…	2.2	9.4	11.7	11.9
Share of loans in total assets, banks dealing with residents 2/	80.4	82.5	76.4	74.7	75.6
Share of loans in total assets, banks dealing with non-residents 2/	48.9	51.7	52.4	46.4	46.3
Earnings and Profitability					
ROA (after tax)	2.0	0.3	-3.5	-1.6	0.5
ROE (after tax)	24.3	4.6	-41.6	-20.4	6.2
Net interest income to total income	32.5	30.1	23.3	19.0	22.0
Noninterest expenses to total income	32.3	47.5	114.5	93.5	61.3
Trading income to total income	7.8	5.6	8.6	5.4	11.1
Personnel expenses to noninterest expenses	31.5	21.3	8.5	11.9	17.9
Income from operations with non-residents to total income					
Banks dealing with residents 2/	13.0	13.7	21.0	25.7	26.7
Banks dealing with non-residents 2/	49.2	48.0	44.8	46.6	55.0
Liquidity					
Liquid assets to total assets	25.0	21.6	21.1	27.3	26.4
Liquid assets to short term liabilities	55.7	52.8	62.8	67.9	66.2
Customers deposits to (non-interbank) loans	68.2	58.8	61.9	77.5	77.0
Sensitivity to Market Risk					
Net open positions in FX to capital 3/	5.4	6.3	4.1*	4.2*	…
Net open positions in EUR to capital	3.2	3.7	3.0*	2.8*	…
FX assets to total assets	79.7	80.5	82.7	80.6	80.7
FX deposits to total deposits	70.7	69.4	74.5	72.6	72.5
FX liabilities to total liabilities 2/	81.7	81.1	83.8	81.6	81.8
FX loans to total loans 2/	81.8	85.0	87.1	88.9	88.2
Nonfinancial Enterprises 4/					
Total debt to equity	202.0	217.6	281.2	226.5**	…
Return on equity	31.1	14.4	1.7	8.4**	…
Earnings to interest expenses	496.7	225.9	24.1	324.1**	…
Households					
Household debt to GDP	42.4	41.1	48.1	46.3	…
Household debt service to GDP 5/	2.5	2.7	2.5	2.0	…
Real Estate Markets					
Real estate prices annual growth rate 6/	-7.3	-37.1	-39.6	7.6	5.8
Residential real estate loans to total loans 7/	31.6	30.5	31.3	32.1	32.1
Commercial real estate loans to total loans 7/	17.8	19.5	19.9	18.0	…
Memorandum Items					
Number of banks dealing with residents 2/	9	14	15	15	15
Number of banks dealing with non-residents 2/	14	13	12	14	14
Assets of banks dealing with residents to total banking system assets 2/	60.8	63.9	78.4	66.6	66.5
Assets of banks dealing with non-residents to total banking system assets 2/	39.2	36.1	21.6	33.4	33.5

Source: Latvian Authorities
* Excluding Parex Bank.
** September 2010.
1/ From 2009, regulatory Tier 1 capital to risk weighted assets is calculated as Tier 1 capital (including deduction) to risk-weighted assets.
2/ Banks dealing with residents (non-residents) are defined as banks in which non-resident non-MFI deposits are below (above) 20 percent of assets.
3/ Including euro-denominated positions.
4/ Data are not annualized and so may not be comparable; From 2010 Q2 the data cover all nonfinancial enterprises.
5/ Interest payments only.
6/ Prices of typical standard apartments in Riga. Source: Real estate company Latio.
7/ Loans to residents as a share of total loans (including loans to non-residents).

Table 12. Latvia: Selected Vulnerability Indicators, 2006–11

	2006	2007	2008	2009	2010	2011 1/	Latest Observation
Key economic and market indicators							
Real GDP growth (y-o-y, percent)	12.2	10.0	-4.2	-18.0	-0.3	…	*Q4, 2010*
HICP inflation (period average, percent)	6.6	10.1	15.3	3.3	-1.2	4.1	*Mar-11*
Short-term (ST) interbank rate, 1-month RIGIBOR (eop, percent)	2.9	6.8	13.3	2.7	0.6	0.6	*May-11*
Eurobond secondary market spread (bps, eop)	23	74	648	505	307	152	*May-11*
Exchange rate (lats per U.S. dollar, eop)	0.53	0.48	0.52	0.48	0.53	0.48	*Apr-11*
Exchange rate (lats per U.S. dollar, period average)	0.56	0.51	0.48	0.48	0.53	0.49	*Apr-11*
External sector							
Exchange rate regime	Pegged to the euro (+/-1% band)						
Current account balance (percent of GDP)	-22.5	-22.3	-13.1	8.6	3.6	…	*Q4, 2010*
Net FDI inflows (percent of GDP)	7.5	6.8	3.0	0.6	1.4	…	*Q4, 2010*
Exports (percentage change of US$ value)	16.2	35.9	18.8	-17.1	8.0	35.0	*Feb-11*
Real effective exchange rate index (2000=100, period average)	89.2	95.1	104.5	110.3	103.6	102.9	*Feb-11*
Gross international reserves (GIR, US$ billion)	4.5	5.8	5.0	7.0	7.7	7.5	*Mar-11*
GIR in percent of ST debt at remaining maturity (RM) excluding non-resident deposits	262.9	215.9	160.7	282.9	311.8	…	*Q4, 2010*
GIR in percent of ST debt at RM including banks' non-resident FX deposits	43.0	34.2	37.2	67.0	83.0	…	*Q4, 2010*
Net international reserves (NIR, US$ billion)	4.4	5.7	3.9	2.0	1.6	1.2	*Mar-11*
Total gross external debt (ED, percent of GDP)	114.0	127.6	129.2	156.3	165.2	…	*Q4, 2010*
ST external debt (original maturity, percent of total ED)	44.1	43.2	33.5	24.6	32.6	…	*Q4, 2010*
ED of domestic private sector (percent of total ED)	94.8	96.0	91.6	83.5	79.9	…	*Q4, 2010*
Total gross external debt (percent of exports)	259.6	308.6	308.1	362.2	312.6	…	*Q4, 2010*
Gross external financing requirement (US$ billion) 2/	6.6	8.8	11.8	6.3	14.4	…	*Q4, 2010*
Public sector (PS) 3/							
Basic balance (excluding bank restructuring costs; percent of GDP)	-0.5	0.6	-3.3	-7.1	-6.4	…	*Q4, 2010*
Primary basic balance (percent of GDP)	0.1	1.0	-2.9	-5.9	-5.0	…	*Q4, 2010*
Gross PS financing requirement (percent of GDP) 4/	2.2	0.3	8.9	15.9	12.6	…	*Q4, 2010*
General government gross debt (percent of GDP)	9.9	7.8	17.1	32.8	39.9	…	*Q4, 2010*
Financial sector (FS) 5/							
Capital adequacy ratio (percent)	10.2	11.1	11.8	14.6	14.6	15.0	*Feb-11*
Overdue loans (percent of total loans) 6/	0.5	0.8	3.6	16.4	19.0	18.7	*Feb-11*
Provisions (percent of overdue loans)	93.3	64.9	61.3	57.4	61.6	63.6	*Feb-11*
Return on average assets (percent)	2.1	2.0	0.3	-3.5	-1.6	0.5	*Feb-11*
Return on equity (percent)	25.6	24.2	4.6	-41.6	-20.4	6.2	*Feb-11*
Residents' FX deposits (percent of total resident deposits)	41.2	48.2	48.6	55.6	50.3	51.6	*Feb-11*
FX loans to residents (percent of total loans to residents)	76.9	86.3	88.4	92.1	92.2	91.8	*Feb-11*
Credit to private sector (percent change, year-on-year) 7/		33.0	11.0	-6.9	-8.4	-8.7	*Feb-11*
Memorandum item:							
Nominal GDP (billions of U.S. dollars)	19.9	28.8	33.9	27.2	24.0	…	*Q4, 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: Proposed Schedule of Reviews and Purchases

	Amount of purchase		
Date 1/	Millions of SDRs	Percent of quota	Conditions
December 29, 2008	535.344	376.7	Approval of arrangement
August 31, 2009	178.448	125.6	First review, end-March 2009 performance criteria
February 19, 2010	178.448	125.6	Second review and end-September 2009 fiscal performance criteria and end-December 2009 monetary performance criteria
August 12, 2010	90.000	63.3	Third review and end-March 2010 fiscal performance criteria and end-June monetary performance criteria
May 15, 2011	107.877	75.9	Fourth review and end-December 2010 performance criteria
November 15, 2011	431.509	303.7	Fifth review and end-August 2011 performance criteria
Total	1521.626	1070.8	

Source: IMF staff estimates.
1/ For past purchases, actual dates are shown. For potential future purchases, the earliest possible dates are shown.

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

	2010				2011				2010Q1 to 2011Q4
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	
						Projections			Proj.
Total financing requirements	1,511	471	457	1,264	1,481	920	582	652	7,338
Amortizing debt	1,201	822	347	76	806	792	541	617	5,202
Other sectors	-42	153	-24	198	104	179	129	208	903
Banks	1,243	669	372	-122	702	614	412	409	4,298
of which:									
Public	313	25	190	23	0	233	0	0	783
Subs	930	644	182	-145	702	381	412	409	3,515
Short term liabilities	490	-281	276	5	392	-30	-13	-64	773
Trade credit (net)	-144	12	-113	-3	162	3	-28	-18	-128
Resident FX accumulation	-36	-82	-53	1,187	121	155	81	118	1,492
Total financing sources	817	471	251	1,064	1,481	920	582	552	6,138
Current account	351	262	53	-16	176	145	47	-35	982
Direct investment (net)	-148	72	109	219	82	94	105	214	746
Portfolio investment and financial derivatives (net)	-30	-88	20	-212	-12	375	-12	358	400
o/w government eurobond	0	0	0	0	0	370	0	370	740
Capital account	138	63	97	55	50	45	40	36	523
Other	1,147	-70	438	869	713	556	183	-233	3,603
Change in gross reserves (+ denotes decline)	-641	232	-465	149	472	-295	220	212	-115
Financing gap	694	0	206	200	0	0	0	100	1,200
Official financing	694	0	206	200	0	0	0	100	1,200
IMF	194	0	106	0	0	0	0	0	300
EU	500	0	0	200	0	0	0	0	700
Nordics	0	0	0	0	0	0	0	0	0
World Bank	0	0	100	0	0	0	0	100	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	750	850	850	1,400	1,400
Nordics	0	0	550	550	550	550	550	1,100	1,100
Czech Republic 1/	0	0	100	100	100	200	200	200	200
Poland 1/	0	0	100	100	100	100	100	100	100

Source: IMF staff estimates.
1/ Loan agreements not yet signed.

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

	2009	2010	2011	2012	2013	2014	2015	2016
Stock, existing 1/	713.8	982.2	982.2	692.3	257.2	56.1	0.0	0.0
Stock, existing and prospective 1/	713.8	982.2	1521.6	1231.6	796.6	568.5	242.7	0.0
Obligations, existing	11.2	6.6	20.2	314.6	448.6	204.2	56.5	0.0
Repurchase	0.0	0.0	0.0	290.0	435.1	201.1	56.1	0.0
Charges	11.2	6.6	20.2	24.6	13.5	3.0	0.4	0.0
Obligations, existing and prospective	11.2	6.6	25.5	333.9	467.7	246.8	334.2	244.8
Repurchase	0.0	0.0	0.0	290.0	435.1	228.1	325.8	242.7
Charges	11.2	6.6	25.5	44.0	32.6	18.7	8.5	2.1
Stock of existing Fund credit								
In percent of quota	502.3	691.2	691.2	487.2	181.0	39.5	0.0	0.0
In percent of GDP	4.2	6.2	5.9	3.9	1.4	0.3	0.0	0.0
In percent of exports of goods and services	9.8	11.8	10.0	6.5	2.3	0.5	0.0	0.0
In percent of gross reserves	16.5	19.5	21.7	15.3	5.1	1.0	0.0	0.0
Stock of existing and prospective Fund credit								
In percent of quota	502.3	691.2	1070.8	866.7	560.6	400.1	170.8	0.0
In percent of GDP	4.2	6.2	9.1	7.0	4.3	2.9	1.2	0.0
In percent of exports of goods and services	9.8	11.8	15.5	11.6	7.0	4.7	1.9	0.0
In percent of gross reserves	16.5	19.5	33.6	27.2	15.8	10.4	4.9	0.0
Obligations to the Fund from existing Fund drawings								
In percent of quota	7.8	4.6	14.2	221.4	315.7	143.7	39.7	0.0
In percent of GDP	0.1	0.0	0.1	1.8	2.4	1.1	0.3	0.0
In percent of exports of goods and services	0.2	0.1	0.2	3.0	4.0	1.7	0.4	0.0
In percent of gross reserves	0.3	0.1	0.4	6.9	8.9	3.7	1.1	0.0
Obligations to the Fund from existing and prospective Fund drawings								
In percent of quota	7.8	4.6	17.9	235.0	329.1	173.7	235.2	193.1
In percent of GDP	0.1	0.0	0.2	1.9	2.5	1.3	1.6	1.1
In percent of exports of goods and services	0.2	0.1	0.3	3.1	4.1	2.1	2.6	1.8
In percent of gross reserves	0.3	0.1	0.6	7.4	9.3	4.5	6.8	0.0

Source: IMF staff estimates.

1/ End-period. The authorities have indicated their intention of treating the purchases associated with the Fourth and Fifth Reviews as precautionary. "Existing and prospective" assumes that these amounts are drawn.

REPUBLIC OF LATVIA: LETTER OF INTENT

Riga, May 9, 2011

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

Dear Mr. Strauss-Kahn:

1. **The Latvian economy is showing clear signs of recovery.** The economy started growing at the end of 2009, and, despite continued turbulence in the global economy, the expectation is for further, more rapid, growth in 2011 and 2012. While rising world food and energy prices have led to an increase in prices, core inflation remains contained. Financial conditions have improved considerably, with much lower CDS spreads, and interest rates in the government securities and interbank market close to all-time lows. A recent upgrade of Latvia's credit rating, coupled with the decision by another rating agency to raise the outlook on Latvia's sovereign debt, is further evidence of the improved economic environment.

2. **The improved economic situation reflects continued implementation of our program.** Since the Third Review we have:

- Lowered our basic fiscal deficit to 6.5 percent of GDP (comfortably meeting the end-December performance criterion on the adjusted primary balance). We have also met the indicative target on the public-sector wage bill (Table 1). In ESA terms our fiscal deficit in 2010 was 7.7 percent of GDP or, excluding bank restructuring costs, 5.5 percent of GDP.

- Comfortably met our net international reserves (NIR) and monetary (NDA) targets.

- Met many of the program's structural benchmarks, including preparation of a strategy on pension reform and a list of all state-owned enterprises in Latvia (Table 3). Other structural benchmarks were met, but with delay. These include changes to our tax regime to strengthen the incentives for debt restructuring, and submission of a transformation plan for Mortgage and Land Bank (MLB) to the EC. However, more work is needed before we can submit a Fiscal Responsibility Law to Parliament, and on options for ensuring that provisions of this law has a greater legal standing than other laws. More time is also needed to develop a strategy for improved management of our state-owned enterprises. Our revised economic program includes structural benchmarks to encourage further progress in these areas (Table 4).

3. **Our policy agenda for 2011 aims to move us toward the goal of euro adoption by January 2014, and sustained growth.** Our 2011 budget and supplementary budget should lower the fiscal deficit to around 4.5 percent of GDP (ESA95 terms). This is consistent with our commitment at the First Review to reduce the 2011 fiscal deficit to no more than 6 percent of GDP (ESA95 terms). For 2012, we will cut our deficit to below 3 percent of GDP (ESA95 terms), consistent with the program target. Aiming for a 2.5 percent of GDP (ESA95) deficit will demonstrate our commitment to fiscal discipline and debt sustainability, and to meeting the Maastricht criterion on a sustainable basis. Provided that we can keep this year's deficit to 4.5 percent of GDP, preliminary estimates suggest that achieving this target will require a further L150 to L180 million in net additional measures, well below previous estimates. We are also committed to strengthening our financial system, including by divesting the commercial part of MLB by end-2011. We believe these policies will further rebuild confidence in our economy.

4. **Against this background and the policies outlined below, we request completion of the Fourth Review and Financing Assurances Review under the Stand-By Arrangement.** We decided in late December to maintain until end-June 2011 the restriction on some deposits in Parex Bank. Since we received Fund approval in 2011 (after the previous approval had lapsed), we request a waiver for nonobservance of the continuous performance criterion against imposing or intensifying restrictions on the making of payments and transfers for current international transactions. Moreover, given the delayed completion of this review, we request the rephasing of Latvia's remaining purchases under the arrangement. 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 for end-August 2011 and structural benchmarks through program expiration on December 22, 2011 are set out in Tables 2 and 4, as well as in the attached Technical Memorandum of Understanding. The Fifth and final review under the Stand-By Arrangement will take place on or after November 15, 2011.

5. **Given our improved economic situation and strong financial position, we do not intend to draw the funds available to us at this review.** Completion of this review by the IMF and EC potentially unlocks around €970 million in additional resources from the Fund, the EU, the Nordic countries, and other EU countries. However, given our much stronger financial situation we only intend to draw the €100 million expected to be approved by the World Bank. Any undrawn funds will remain available to us provided that we sustain our record of satisfactory program performance.

6. **Given the overall stabilization of the financial system that reduces potential banking sector funding needs, money currently in the sub-account for banking sector support at the Bank of Latvia (BoL) can be released** for the purpose of financing general government needs. The funds will be released according to the procedures established in the EC's fourth Supplemental Memorandum of Understanding (SMoU) and according to the following schedule, with progress assessed by the EC and IMF:

- €300 million, on the basis of submission to the EC of the transformation plan for MLB in April 2011, and of the adoption of the sale strategy for Citadele and workout strategy for Parex in May 2011.

- €100 million, on the basis of submission of the sale strategy for MLB to the EC.

- The remaining €249 million, on the basis of progress with the sale of Citadele and of the commercial assets and liabilities of Mortgage and Land Bank (MLB).

I. MACROECONOMIC FRAMEWORK

7. **The economy bottomed out in 2010, and we expect GDP to expand by 3.3 percent in 2011 and 4 percent in 2012.** We expect domestic demand to increase at a modest pace in 2011. In particular, the improvement in consumer confidence suggests that private consumption will increase despite higher taxes, and food and fuel price shocks, while investment is projected to increase even though access to credit remains difficult. The ongoing recovery in Latvia's trading partners should help sustain export growth, although this will largely be offset by rising imports due both to the high import content of Latvia's exports and the increase in domestic demand. The registered unemployment rate was 14.4 percent at end-March 2011, and is projected to decline further during 2011, while the labor force survey measure (ages 15 – 74) is expected to decline from 18.7 to 16.4 percent, as the demand for labor gradually recovers. Strong export performance at the start of the year, suggests that growth this year may exceed our forecast. However, the moderation in industrial production and retail sales at the beginning of 2011, and the uncertain global outlook, also suggest that the recovery remains fragile.

8. **Inflation has increased due to rising food and energy prices, but should remain in the low single digits.** Inflation in 2011 could average around 3.5 percent (CPI measure) as a result of rising food and energy prices, and recent tax increases. However, still weak domestic demand and high unemployment are expected to keep core inflation in check. As a result, we expect inflation in 2012 to decline to around 2 percent (CPI measure), which should ensure that the Maastricht inflation criterion remains within reach. These projections are sensitive, however, to developments in food and energy markets.

9. **We are committed to ensuring that inflation remains contained.** Under our fixed (narrow band) exchange rate regime the responsibility for price stability is shared between the BoL and the Ministry of Finance. While still high unemployment and continued deleveraging by banks should limit inflation pressures, we are considering a range of measures that could help contain inflation (and boost longer-term competitiveness) to maximize the chances of meeting the Maastricht inflation criterion in a sustainable manner.

10. **We expect competitiveness—which has improved significantly as a result of wage and price adjustment—to remain broadly stable.** After two years of decline, unit

labor costs stabilized in 2010 as nominal wages bottomed out. As a result, the improvement in competitiveness observed in recent years has slowed down. The CPI-based real exchange rate has stabilized approximately 10 percent below its peak at end-2008, while the PPI-based exchange rate has declined by 12 percent. Although nominal wages are projected to rise in 2011, inflation differentials with trading partners should remain in Latvia's favor. Competitiveness is therefore projected to improve, albeit at a more modest pace than in recent years.

II. Policies for 2011

A. Fiscal Policy

11. **We comfortably met our program deficit target for 2010.** Significantly lower than programmed government expenditure, coupled with an increase in the share of spending financed by EU transfers, more than offset weaker than projected revenue collection. This allowed us to meet the performance criterion on the primary non-EU cash fiscal balance with a wide margin (see Table 1). As a result, the fiscal deficit (ESA95) declined to an estimated 7.7 percent of GDP compared to the program target of 8.5 percent. Excluding bank restructuring costs, the 2010 deficit was only 5.5 percent of GDP. The downward revision of the 2009 fiscal deficit (ESA95) from 10.2 to 9.7 percent of GDP—to correct the accounting of revenue from the sale of emission quotas—implies that the program target of a fiscal deficit of no more than 10 percent of GDP in 2009 was also met.

12. **Consistent with ESA95 methodology, we have brought forward an estimated L289 million (2.3 percent of GDP) in expected future bank restructuring costs.** These costs, which are reflected in the 2010 ESA deficit, consist mainly of the expected future capitalization of State Treasury deposits in Parex Bank envisaged in the baseline scenario in the EC-approved restructuring plan for Parex, for 2011-2013.

13. **Parliament passed the 2011 budget on December 21, 2010 and a supplementary budget on April 14, 2011.** Together these include measures totaling around L370 million (full year impact, though not all of these will yield permanent savings), which should reduce the ESA95 deficit to below 4.5 percent of GDP. This should ensure that we remain on track to restore fiscal sustainability, and ensures that the Maastricht criterion of a fiscal deficit below 3 percent of GDP (ESA95 terms) in 2012 remains within reach. The two budgets include the following measures:

- **Revenue measures (1.8 percent of GDP).** We have: (i) taken steps to increase the amount of VAT we collect, including by raising both standard and reduced VAT rates, and reducing the categories for which the reduced VAT regime applies; (ii) raised employee's social security contributions; (iii) increased taxation of private vehicles and privately used company cars; (iv) introduced a financial stability duty and a fee for non-bank companies providing consumer loan services; (v) doubled real estate taxes; and (vi) increased excise duties and reduced duty-free allowances on certain products. The budget also incorporates measures which may yield revenue in the short-term, but are unlikely to lead to a permanent reduction in the deficit. These include temporary increases in dividend payout ratios for many state-owned enterprises, and a reduction in pension contributions diverted to the second pillar.

- **Cuts in expenditure and net lending (0.8 percent of GDP).** We have: (i) reduced staff and wage costs in the public administration; (ii) reduced appropriations relative to last year's level in a number of areas, including health spending, social programs, and defense spending; (iii) reduced subsidies for general education and financing for education innovation programs; and (iv) cut railway subsidies.

14. **Although the improving economy is likely to reduce the demand for social safety net spending, we remain committed to protecting the poorest in society.** While spending on the Workplaces with Stipend Emergency Public Works (WWS) program will decline this year, we have kept appropriations for the guaranteed minimum income program broadly unchanged from 2010. Moreover, we are preparing an active labor market policy (ALMP) strategy (end-November structural benchmark) that will replace the WWS program which is set to be wound down by end-2011. This will allow us to transition away from emergency social safety net spending toward more traditional ALMP spending, financed by sufficient European Social Fund resources in 2011 and reallocating EU structural funds if necessary in coming years. Finally, our program includes an adjustor to allow additional social safety net spending of up to ½ percent of GDP if necessary.

15. **We are making a concerted effort to strengthen tax administration and combat the grey economy.** In the 2011 budget and supplementary budget we introduced: (i) measures to speed payment of tax arrears; (ii) an increase in the minimum wage, which should limit the underreporting of wages; (iii) steps to combat smuggling of goods; and (iv) an approach to improve cooperation with sectoral business associations. While battling the grey economy is an important component of our fiscal adjustment strategy, we recognize that the revenue yield is uncertain and hard to quantify. However, we intend to set up a task force comprised of government and program partners by end-June, with a view to assessing the effectiveness of various measures and to report on their expected yield in 2012 and beyond by mid-August. We also intend to revise our tax compliance strategy, taking into account the recommendations of an upcoming technical assistance mission from the IMF (end-August structural benchmark).

16. **Given the need for further adjustment in 2012, we will not increase spending or cut taxes during the year, beyond what is envisaged in the 2011 budget and supplementary budget.** We will use any revenue over performance or other savings to achieve a lower-than-targeted budget deficit or—after consultation with the EC and IMF—to accelerate the absorption of EU funds or increase spending on social safety nets or active

labor market policies. This will limit the amount of adjustment needed in 2012 to meet the Maastricht deficit criterion.

17. **We will take steps to strengthen fiscal discipline and maintain fiscal sustainability over the medium-term.**

- To limit the scope for expenditure overruns and to encourage accurate budgeting, we amended Article 30 of the Law on 2011 State Budget to reduce the maximum state budget appropriation for unforeseen events from 0.4 to 0.2 percent of GDP.

- To limit future commitments and fiscal risk and to meet our fiscal deficit targets, we will launch no new PPPs in 2011 (except concessions in which the government assumes no risk or liability). We also continue to cap public guarantees at L754 million (the level in June 2009, when the 2009 supplementary budget was passed).

- We have completed a concept paper on the long-run sustainability of social security—which benefitted from technical assistance on expenditure policy from the IMF and was prepared with assistance from the World Bank—that will form the basis for a comprehensive pension reform which we intend to introduce in the context of the 2012 budget. In that context, we reiterate our commitment to preserving the sustainability of the three pillars of our pension system and to restoring contributions to the second pillar to 6 percent of gross salaries by 2013, provided that the budgetary situation improves in line with our forecast.

- We have prepared an exhaustive list of all state-owned enterprises in Latvia, including information on their financial situations. However, preparation of a strategy for improving management of these enterprises, including which of these should remain state-owned enterprises, be transformed into government agencies, or privatized, has been delayed. We now intend to engage a consultant by end-June, to help us complete this strategy by end-October 2011 (structural benchmark).

- Following discussions with constitutional experts and members of Parliament, we decided to delay submission of a Fiscal Responsibility Law to Parliament—originally scheduled for end-September 2010—to allow more time to improve the Law and reach agreement on the constitutional amendments necessary to ensure that the provisions of the Fiscal Responsibility Law has greater legal standing than other laws. In particular, we intend to further improve the law, including by incorporating suggestions from the IMF and EC. We intend to agree on the substance of a draft of the Fiscal Responsibility Law with the IMF and the EC by end-August 2011, which we will submit to Parliament by end-November 2011 (structural benchmark). This will help anchor fiscal policy on a credible path following completion of the program, ensure the sustainability of public debt, and allow for counter-cyclical fiscal policy.

- As envisaged in the Fiscal Responsibility Law, we intend to prepare a Medium-Term Budget Framework Law that specifies binding multi-year expenditure ceilings, a prohibition on raising within-year appropriations due to over-performing revenues, and limitations on the introduction of expansionary fiscal measures after adoption of the budget. At a minimum, we will supplement the draft State Budget Law for 2012 with a medium-term macroeconomic development and fiscal policy framework (including a non-binding version of the Medium-Term Budget Framework for 2012).

- We are taking steps to ensure that the provisions in the Fiscal Responsibility Law and the Medium-Term Budget Framework Law—which we intend to submit to Parliament by mid-2012—have greater legal standing than other laws by submitting a constitutional amendment to Parliament by end-November. In addition, we will submit a report to the relevant parliamentary committee by end-May making recommendations on ways to ensure that the Ministry of Finance is given adequate time to evaluate all tax proposals before Parliament votes on these proposals.

18. **For 2012, we will cut our deficit to below 3 percent of GDP (ESA95 terms), consistent with the program target.** Aiming for a 2.5 percent of GDP (ESA95) deficit will demonstrate our commitment to fiscal discipline and debt sustainability, and to meeting the Maastricht criterion on a sustainable basis. Provided that we keep this year's deficit to 4.5 percent of GDP, our current estimates suggest L150 to L180 million (1.1 to 1.3 percent of GDP) in additional net measures will be needed to achieve the necessary fiscal consolidation. To improve revenue collection, we are working on proposals to reform the property tax and to implement a comprehensive strategy to reduce the grey economy. We are also working to reallocate personal income taxes paid to local governments to the state budget. On the expenditure side, we are considering reducing the public sector wage bill and reducing state subsidies (including subsidies to Riga international airport). In order to identify additional options for fiscal consolidation, we intend to prepare a menu of options that we anticipate will focus primarily on expenditure cuts (mid-August structural benchmark). We anticipate that this menu will include elements from the 2011 menu of options—which benefitted from input from the IMF, EC, and the World Bank—that were not incorporated in this year's budget. The menu should include options for rationalizing the system of social benefits and for improving the sustainability of the pension system that is consistent with the long-term stability of the social security system. We will also extend the temporary cap on benefit payments to high earners (set to expire at end-2012) till 2014. We intend to submit a 2012 budget to Parliament by end-September (structural benchmark) consistent with our goal of convincingly meeting the Maastricht deficit target.

19. **We are committed to ensuring a smooth transition back to private market financing during the remainder of the program.** Consistent with our medium-term debt strategy we intend to increase reliance on domestic financing, while working to lengthen the maturity structure of public debt to reduce rollover risk. It is also our intention to access international capital markets once conditions are favorable, to ensure that we are able to meet

our external repayment obligations in the coming years. In order to limit macroeconomic volatility we intend to maintain a smooth domestic borrowing profile, while limiting the amount of overall borrowing to an amount consistent with continued debt sustainability.

III. Monetary and Exchange Rate Policy

20. **The fixed (narrow band) exchange rate will remain the anchor for monetary policy until we adopt the euro.** Should NIR fall by more than EUR 500 million in any given 30-day period, we will consult with IMF and EC staff. We will also consult with IMF staff prior to any changes to official interest rates and minimum reserve requirements. Maintaining monetary and financial stability requires credible policymaking independence. As such, we reaffirm the existing strong institutional and financial independence of the BoL and FCMC as a basis for continued stability.

21. **Our fixed (narrow band) exchange rate regime entails that monetary conditions should be consistent with liquidity conditions in the Euro area.** Overnight interbank rates in the Euro area have increased in recent months due to the tightening of liquidity conditions, and are now above those in Latvia. We will adjust our policy stance if necessary to ensure monetary conditions in Latvia remain consistent with our fixed exchange rate.

22. **Treasury has started exchanging program financing on market, rather than off market at the BoL.** While the sale of foreign exchange on market may increase exchange rate volatility, we believe it will help contain the buildup of excess liquidity and facilitate liquidity management. We recognize the importance of ensuring that Treasury sales of foreign exchange on-market are determined by fiscal financing needs and are not perceived as intervention in the foreign exchange market. To that end, we have designed—in consultation with the IMF—a transparent approach whereby Treasury conducts foreign exchange sales at daily public auctions, with the amount of foreign exchange that Treasury intends to sell preannounced four weeks ahead. After building up a buffer in January and February to cope with intra-monthly spending flows, amounts sold are linked to Treasury's fiscal financing need in the coming month. The amount sold is reported on the Treasury's website the following week, together with historical data. Through April this year, we have sold approximately L350 million in foreign exchange.

IV. Financial Sector

23. **We continue to strengthen our supervision of the financial system in Latvia.** Revised regulations on the management of large exposures and remuneration policies came into effect in December last year, to reflect recent changes to the EU Capital Requirements Directive. We also revised our guidelines on stress-testing in February 2011 to improve banks' internal risk management, and to incorporate the guidelines on stress-testing issued by the Committee of European Banking Supervisors last August. We will strictly enforce these

regulations, while continuing to amend our supervisory framework as needed to keep pace with evolving international best practice. In addition, we will maintain our intensified supervision of banks that have received state aid, and will continue to strictly enforce other prudential rules. Finally, we have improved our cooperation with neighboring countries on cross-border financial stability and crisis management through the establishment of the high-level Nordic-Baltic Cross-Border Stability Group in June 2010—the first meeting of the Group took place in November 2010—and through enhanced cooperation with the relevant foreign supervisors.

24. **We are committed to implementing the sales strategies for Citadele Bank and Parex Bank, which we expect to be approved by Cabinet on May 10.** We intend to carry out the sale of Citadele and Parex separately, and will not bundle any of Parex's assets with those in Citadele, since that could undermine Citadele's attractiveness to potential investors. To achieve adequate burden sharing, we are committed to ensuring that none of Parex's shareholders that were a party to the Investment Agreement at the time of the initial government intervention in Parex, or any investors associated with these shareholders, are allowed to purchase any part of the balance sheet of these banks.

- The sales process for Citadele will be started in the near future to allow us to quickly recover the state aid provided to the bank, free up managerial resources, and ensure compliance with the EC-approved restructuring plan. We intend to market the bank as a whole, but, in order to maximize the potential recovery of state aid, we will also allow investors to bid for individual parts of the balance sheet in a public auction.

- The sales strategy for Parex—which will be implemented by Parex management — envisages a gradual but aggressive asset realization (i.e. collections, workouts, and sales) for assets that are less likely to decrease in value, coupled with the short-term sale of the remainder of the portfolio. In particular, our intention is to avoid the fire-sale of assets while maximizing the recovery of state aid.

- We will ensure that all state-owned banks have sufficient liquidity to meet their external obligations without resorting to liquidity assistance from other state-owned banks.

25. **We intend to pursue Parex's former shareholders and senior managers for losses they caused to Parex bank and to the state.** In particular, we intend to seek compensation from the two former majority shareholders and senior managers in the courts in order to—at a minimum—recover amounts the state originally expended in stabilizing the bank. To that end, we will swiftly determine the amount of losses caused to the bank and to the state, and intend to file suit expeditiously.

26. **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 was relaxed at end-2010, and will only be removed when there is no risk that the withdrawal of deposits will threaten successful implementation of the restructuring plan of Parex Bank.

27. **We submitted a transformation plan for MLB to the EC on April 15:**

- The plan, which has been delayed due to difficulties in reaching a consensus among all stakeholders on the best way forward, envisages the sale of the assets and liabilities of the commercial part of the bank in an open and transparent process. We intend, to the extent possible, to transfer deposits to acquiring bank(s). After divesting the assets and liabilities of the commercial part of the bank we intend to merge the development part of the bank with other state development institutions (see ¶28).

- We have already started preparing for the sale of the commercial segment of MLB later this year. To facilitate this, we have appointed a senior government official to take charge of the restructuring process. We will also hire a qualified, experienced, and independent sales consultant mobilizing a team of internationally reputable experts to prepare and run the sales strategy (end-May structural benchmark). We will consult with the EC and IMF on both appointments and their terms of reference.

- The sales consultant will be tasked with preparing a sales strategy for the commercial segment of MLB, on which we intend to consult with the Fund and the EC. We will submit this strategy to the EC by end-June, in order to allow the actual sales process to start in July, and will appoint a qualified and independent head of restructuring with international experience—who will report to MLB's supervisory council—to oversee the restructuring and sales process (end-June structural benchmark). This should allow us to achieve our goal of selling the commercial part of the bank by mid-December 2011 (structural benchmark).

- Because of potential conflicts of interest, as well as restrictions imposed by the EC-approved restructuring plan, Citadele Bank will not be allowed to purchase any part of MLB's balance sheet. Given the ban on any new economic activities in the EC-approved restructuring plan, any purchase by Parex of MLB assets will be limited.

28. **We will approve a plan to optimize the system of development lending in Latvia by end-October.** The plan envisages creating a single development institution to realize synergies across existing institutions and allow more effective use of EU funds, including by on-lending concessional funds using commercial banks as intermediaries. There will be no direct lending to clients by the development institutions except already approved concessional programs (we estimate this at L245 million), and special programs as described

below. Looking ahead, direct lending will be limited to instances where the lending is: (i) associated with the delivery of products not offered by the commercial banking sector; (ii) dependent on highly specialized knowledge that commercial banks do not possess: or (iii) of too small volume or too risky to be of interest to commercial banks. We will cap new direct lending in line with our consultant's findings. We intend to work closely with the EC on implementation of this plan, as set out in the EC SMoU.

29. **We intend to request technical assistance from the IMF to improve our decision making during the resolution of a credit institution.** The Law on Credit Institutions and the Law on Bank Takeovers provides legal indemnity for the FCMC and its agents—including private individuals authorized by the FCMC—while carrying out their duties. We are working with the IMF to ensure that our legal framework also allows for effective decision making among other government officials, including employees of the Ministry of Finance and the Latvian Privatization Agency, involved in the resolution or restructuring of a credit institution.

V. PRIVATE DEBT RESTRUCTURING

30. **We are working with the IMF to strengthen the incentives for market-based debt restructuring.**

- Regulations were issued in late-2010 to clarify the tax implications of debt write-downs. In addition, we have amended our legislation to ensure that the transfer of a distressed loan to a third party is a tax neutral event, and to waive personal income tax liabilities from debt write-downs for a period of two years, to increase incentives for faster debt resolution. We also intend to reduce the current two percent stamp duty once the economic situation improves. Finally, by end-July, we intend to take steps to clarify the method for collecting VAT on the sale of foreclosed assets.

- A new law regulating inter alia personal insolvency—which allows financially responsible individual debtors a fresh start at the end of the insolvency proceedings—became effective on November 1, 2010. The new law is expected to significantly decrease the cost and time needed for personal insolvency procedures, thus facilitating debt resolution and rehabilitation of such debtors.

- We have submitted amendments to the Civil Procedure Law to Parliament to grant priority status to unsecured claims relating to administration charges for apartment buildings and charges for heating and natural gas supplied to an apartment owner. We intend to work with the IMF to address a number of concerns with the initial proposal—especially the fact that it applies retroactively—and will submit amendments to the initial proposal to Parliament by end-July (structural benchmark).

- Amendments to the Civil Procedure Law that allow the winning bidder at a foreclosure auction to obtain a bank guarantee letter—instead of a bank loan which would require the buyer to pledge the asset auctioned as collateral—to facilitate the simultaneous payment of the auctioned property, transfer of title, and vesting of the first priority security interest in the bank, became effective last year. We believe this will increase the number of successful auctions and facilitate price-discovery. In addition, we are working with the IMF to identify ways to accelerate and reduce the costs of post-auction approval procedures.

- We have submitted amendments to the Civil Procedure Law to Parliament to simplify and accelerate the resolution of small claims.

VI. Other Issues

31. **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. Treasury will also continue to keep its deposits (except daily working balances) with the BoL.

32. **The Latvian government will work closely with the EC to pursue reforms as specified in our SMoU with the EC**, in particular to improve the business environment and to make more efficient use of EU-cofinanced financial instruments and R&D support programs.

VII. IMF Arrangement

33. **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.

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

Sincerely yours,

/s/

Valdis Dombrovskis
Prime Minister

/s/

Andris Vilks
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, Third Review

(In millions of lats unless otherwise indicated)

	2010												2011		
	Performance Criteria												Indicative Target		
	end-March			end-June			end-Sept			end-Dec			end-March		
	Program	Adjusted	Outcome	Program	Adjusted	Outcome	Program	Adjusted	Outcome	Program	Adjusted	Outcome	Program	Adjusted	Prel. Outcome
I. Quantitative performance criteria															
Floor on net international reserves of the Bank of Latvia (millions of euros) 1/	1	29	1,451	-506	-361	1,415	694	839	1,586	141	286	1,200	-281	-136	978
Ceiling on net domestic assets of the Bank of Latvia 1/	1,707	1,679	445	2,056	1,911	708	1,344	1,199	696	1,741	1,596	968	1,960	1,815	1,302
Floor on primary non-EU cash fiscal balance 2/ 3/	-124	-116	-94	-353	-338	-100	-401	-401	-135	-782	-782	-319	-123		
Ceiling on public guarantees	836		379	836		389	754		416	754		426	754		
II. Continuous performance criteria															
Ceiling on accumulation of general government domestic arrears	40		12	40		15	40		12	40		5	40		
Ceiling on accumulation of general government external arrears (millions of euros)	0		0	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		423	654		604	948		846	197		

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

2/ 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 (Third Review TMU ¶14) and excess EU funds-related spending (TMU ¶14).

Table 2: Latvia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, Fourth Review

(In millions of lats unless otherwise indicated)

	2011			
	Indicative Target	Performance Criteria	Indicative Targets	
	end-June	end-Aug	end-Sept	end-Dec
	Program	Program	Program	Program
I. Quantitative performance criteria				
Floor on net international reserves of the Bank of Latvia (millions of euros) 1/	222	76	3	-580
Ceiling on net domestic assets of the Bank of Latvia 1/	1,648	1,754	1,808	2,262
Floor on primary non-EU cash fiscal balance 2/ 3/	-52	-33	-23	-69
Ceiling on public guarantees	754	754	754	754
II. Continuous performance criteria				
Ceiling on accumulation of general government domestic arrears	40	40	40	40
Ceiling on accumulation of general government external arrears (millions of euros)	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				
IV. Indicative target				
Ceiling on the general government wage bill 2/	505	635	700	929

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

2/ Cumulative from the beginning of the fiscal year.

3/ Adjusted downwards for additional social safety net spending (TMU ¶13), and adjusted upwards for excess EU funds-related spending (TMU ¶14) and excess net lending (TMU ¶16).

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

Structural Benchmarks	Motivation	Status
By end-June:		
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.	Partially done. A separate report was not produced, although a proposal to make permanent the reduction in parental benefits was included in the pension strategy paper.
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.	Done. A strategy paper was produced on schedule that offers a number of possible approaches to reform the pension system and improve the system's sustainability.
Prepare a draft fiscal responsibility law	Fiscal sustability: Anchor fiscal policy on a credible and sustainable path	Done. A draft fiscal responsibility law was produced on schedule but staff are encoruaging the authorities to make revisions before the law is submitted to Parliament.
By end-July:		
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.	Done with delay. A report was produced which lays out the regulations and laws which need to be amended to allow credit institutions to deduct losses from debt write-downs against corporate income tax.
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.	Done with delay. The authorities have hired SEB Enskilda to assist in the formulation of a transformation plan.
By end-September:		
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.	Done.
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.	Done with delay. A transformation plan was submitted to the EC on April 15.

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

By end-September (continued):		
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.	Done with delay.
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.	Done with delay.
Submit a Fiscal Responsibilty Law to Parliament	Fiscal sustainability: Anchor fiscal policy on a credible and sustainable path	Not done. Staff encouraged the authorities to delay submission to improve the draft law.
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.	Partially done. The Finance Ministry made a presentation to the Parliament's budget and finance committee. A draft constitutional amendment to be submitted with the FRL is being prepared.
Produce list of state-owned enterprises	Fiscal transparency and sustainability.	Done.
By end-October:		
Prepare menu of potential structural reforms.	Fiscal sustainabiltity: Preparation of a menu of possible structural reforms in key sectors will help achieve sustainable savings in the 2011 budget.	Done
By end-December:		
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.	Not done. The government is working to strengthen SOE management under the current structure while engaging a consultant to develop a strategy by end-October 2011.

Table 4. Latvia: Structural Benchmarks for 2011

Structural Benchmark	Motivation	Target date
Fiscal Policy:		
Prepare a menu of options to achieve the 2012 deficit target.	Fiscal sustainability: A menu of options developed early in the budget cycle will facilitate preparation of the 2012 budget based on high-quality measures.	Mid-August
Revise the tax compliance strategy, taking into account recommendations of an upcoming technical assistance mission from the IMF.	Fiscal sustainability: Improved tax compliance will increase revenue and facilitate the achievement of fiscal deficit objectives. Governance: reduce the gray economy.	End-August
Submission of a 2012 budget to Parliament consistent with the goal of convincingly meeting the Maastricht deficit criterion.	Fiscal sustainability: A strong 2012 budget will be needed to convincingly meet the Maastricht deficit criterion and move Latvia toward the goal of euro adoption in 2014.	End-September
Complete a strategy to improve management of state-owned enterprises.	Fiscal sustainability: Improve fiscal transparency, reduce fiscal risks, and potentially raise government revenues.Growth: Increase economic efficiency by reducing state involvement in areas that could be served by the private sector.	End-October
Submission to Parliament of a draft Fiscal Responsibility Law in consultation with the IMF and the EC.	Fiscal sustainability: This will help anchor fiscal policy on a credible path following completion of the program, ensure the sustainability of public debt, and allow for counter-cyclical fiscal policy.	End-November
Prepare an active labour market policy (ALMP) strategy that will replace the WWS program.	Fiscal sustainability: The new policy will allow a transition away from emergency social safety net spending towards more traditional ALMP spending.	End-November
Financial Sector:		
Hire a qualified, experienced, and independent sales consultant mobilizing a team of internationally reputable experts to prepare and run the MLB sales strategy.	Financial stability: Stem further erosion in the bank's value and maintain depositor confidence. Fiscal sustainability: Limit the need for continued public recapitalization.	End-May
Submit a MLB sales strategy to the EC and appoint a qualified and independent head of restructuring with international experience to oversee the restructuring and sales process.	Financial stability: Stem further erosion in the bank's value and maintain depositor confidence. Fiscal sustainability: Limit the need for continued public recapitalization.	End-June
Submit amendments to the initial proposal to amend the Civil Procedure Law to Parliament.	Financial stability: The amendments will address a number of concerns with the initial proposal to address unpaid debts to utility companies, including its retroactive character.	End-July
Sell the commercial part of MLB.	Financial stability: Stem further erosion in the bank's value and maintain depositor confidence. Fiscal sustainability: Limit the need for continued public recapitalization.	Mid-December

REPUBLIC OF LATVIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

May 9, 2011

1. This Technical Memorandum of Understanding (TMU) defines the variables subject to quantitative targets (performance criteria and indicative targets) established in the Letter of Intent dated May 9, 2011 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, for the purposes of the program, the exchange rate 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
June 30, 2011 (indicative target)	222
August 31, 2011 (performance criterion)	76
September 30, 2011 (indicative target)	3
December 31, 2011 (indicative target)	-580

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 December 31, 2010, foreign reserve assets thus defined amounted to 5,753 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 December 31, 2010, reserve liabilities thus defined amounted to 78.6 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 December 31, 2010, base money amounted to 1,811 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 December 31, 2010, net domestic assets of the BoL amounted to 968 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 December 31, 2010, net foreign assets of the BoL amounted to 3,988 million lats (5,674 million euro).

4. As of December 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 4,335 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 extended 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
June 30, 2011 (indicative target)	1,648
August 31, 2011 (performance criterion)	1,754
September 30, 2011 (indicative target)	1,808
December 31, 2011 (indicative target)	2,262

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 March 31, 2011, provided that net foreign assets of the BoL remain above base money. The outstanding amount on March 31, 2011 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:	
June 30, 2011 (indicative target)	-52
August 31, 2011 (performance criterion)	-33
September 30, 2011 (indicative target)	-23
December 31, 2011 (indicative target)	-69

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.

Excess EU-related spending (adjustor)

14. Should spending on EU-related items exceed 1,200 million lats (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

15. 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):	
June 30, 2011, (indicative target)	505
August 31, 2011 (indicative target)	635
September 30, 2011 (indicative target)	700
December 31, 2011 (indicative target)	929

16. General government net lending will be excluded from calculation of the floor for the non-EU cash primary fiscal balance of the general government up to 115 million lats. Should actual cumulative net lending exceed 115 million lats, the floor will be adjusted upwards by the difference.

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 40 million lats for the duration of the program. As of December 31, 2010, the stock of arrears stood at 5 million lats. 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 Market Commission, and the Ministry of Finance as outlined in Table 1. The authorities will transmit promptly to 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 and within four weeks of test dates for quantitative performance criteria
Data on general government net lending.	Quarterly, within four weeks of the end of each quarter and within four weeks of test dates for quantitative performance criteria.
Public sector guarantees, with a detailed breakdown by issuing institution or agency and purpose.	Quarterly, within four weeks of the end of each quarter and within four weeks of test dates for quantitative performance criteria
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 (at 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	Weekly, within three working days after the end of each week
Daily detailed deposit monitoring in Parex Bank and Citadele Bank in the agreed format	Weekly, within three working days after the end of each week
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

Fourth Review Under the Stand-By Arrangement and Financing Assurances Review, Request for Rephasing of Purchases Under the Arrangement and Request for Waiver of Nonobservance of a Performance Criterion—Informational Annex

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

Approved by Anne-Marie Gulde-Wolf and James Roaf

May 10, 2011

Contents

APPENDIX I. LATVIA: FUND RELATIONS
(As of March 31, 2011)

I. **Membership Status:** Joined May 19, 1992; Article VIII.

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	142.10	100.0
Fund holdings of currency	1,124.30	791.20
Reserve position in Fund	0.06	0.04

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	120.82	100.00
Holdings	114.44	94.72

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Standby Arrangement	982.24	691.23

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR million)**	**Amount Drawn (SDR million)**
Stand-by	12/23/08	12/22/11	1,521.63	982.24
Stand-by	04/20/01	12/19/02	33.0	0.00
Stand-by	12/10/99	4/9/01	33.0	0.00
Stand-by	10/10/97	4/9/99	33.0	0.00

VI. **Projected Obligations to the Fund:**

	2011	2012	2013	2014	2015
Principal	0.0	290.0	435.1	201.1	56.1
Charges/interest	20.2	24.6	13.5	3.0	0.4
Total	20.2	314.6	448.6	204.2	56.5

Exchange Arrangements:

The currency of Latvia is the lats, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate was pegged to the SDR from February 1994 to December 2004, within a ±1 percent band. On January 1, 2005, the lats was repegged to the euro at the rate €1 = 0.702804 lats, and on April 29, 2005, Latvia entered ERM II, maintaining the previous band width. On April 28, 2011 the lats was equal to US$ 2.09. Latvia's exchange system is free of restrictions on the making of payments and transfers for current international transactions. Latvia maintains security-related exchange restrictions pursuant to UN Security Council resolutions and EC Council regulations, which have been notified to the Fund under Decision No. 144-(52/51), adopted August 14, 1952. Latvia also maintains a partial deposit freeze on Parex Bank, which gives rise to an exchange restriction. However, since it has been imposed for balance of payments reasons, is temporary and is nondiscriminatory, the Board has approved its retention until end-June 2011.

Article IV Consultation:

Latvia is on the 24-month consultation cycle.

The 2010 Article IV staff report was issued on December 9, 2010 (Country Report No. 10/356). The last Article IV Board discussion took place on July 21, 2010. The Public Information Notice No. 10/104 was released on August 12, 2010.

Safeguards Assessment:

The safeguards assessment completed on July 8, 2009 concluded that the Bank of Latvia (BoL) operates robust internal audit and control systems. The assessment recommended clarifying the BoL and Treasury's respective roles in holding, managing, and reporting to the Fund audited international reserves data. It also recommended amendments to the mandate of the BoL's audit committee and improvements to the financial statements' disclosures. The authorities have already taken steps to implement these recommendations, notably by establishing a formal arrangement between the BoL and Treasury, revising the audit committee charter and expanding the existing accounting framework.

FSAP Participation and ROSCs:

A joint World Bank-International Monetary Fund mission conducted an assessment of Latvia's financial sector as part of the Financial Sector Assessment Program (FSAP) during February 14–28, 2001. The Financial Sector Stability Assessment (FSSA) report was discussed at the Board on January 18, 2002, together with the 2001 Article IV staff report (Country Report No. 02/10). An AML/CFT assessment mission took place during March 8-24, 2006, and the report was sent to the Board on May 23, 2007. A joint IMF-World Bank mission conducted an FSAP Update during February 27–March 9, 2007.

ROSC Modules

Standard/Code assessed	Issue date
Code of Good Practices on Fiscal Transparency	March 29, 2001
Code of Good Practices on Transparency in Monetary and Financial Policies	January 2, 2002
Basel Core Principles for Effective Banking Supervision	January 2, 2002
CPSS Core Principles for Systemically Important Payment Systems	January 2, 2002
IOSCO Objectives and Principles of Securities Regulation	January 2, 2002
IAIS Core Principles	January 2, 2002
OECD Corporate Governance Principles	January 2, 2002
Data Module	June 23, 2004

Technical Assistance (2007–11):

Dept.	Project	Action	Timing	Counterpart
FAD	Expenditure Policy	Mission	June 2007	Ministry of Finance
FAD	Tax Policy	Mission	March 2008	Ministry of Finance
FAD	Revenue Administration	Mission	January 2009	Ministry of Finance
MCM	Bank Resolution	Mission	January 2009	FCMC, Bank of Latvia
FAD	Public Financial Management	Mission	March 2009	Ministry of Finance
MCM/ LEG	Debt Restructuring	Mission	March 2009	Ministry of Finance, FCMC
LEG	Legal Aspects of P&A Transactions	Mission	Feb-March 2009	FCMC
MCM	Bank Intervention Procedures and P&A	Mission	March 2009	FCMC
FAD	Public Financial Management	Mission	April-May 2009	Ministry of Finance
FAD	Revenue Administration	Mission	July 2009	Ministry of Finance
FAD	Public Financial Management	Resident Advisor	July 2009-June 2010	Ministry of Finance
FAD	Cash Management	Mission	July-August 2009	Ministry of Finance
MCM	Mortgage and Land Bank	Mission	September 2009	Ministry of Finance
MCM	Deposit Insurance	Mission	September 2009	FCMC
MCM	Liquidity Management	Mission	November 2009	Bank of Latvia
LEG	Bank Resolution Legal Framework	Mission	January 2010	FCMC
FAD	Tax Policy	Mission	February 2010	Ministry of Finance
LEG	Bank Resolution Legal Framework	Mission	February 2010	FCMC
LEG	Corporate and Personal Insolvency Law	Mission	March 2010	Ministry of Justice
FAD	Public Financial Management	Mission	April 2010	Ministry of Finance
LEG	Corporate and Personal Insolvency Law	Mission	April 2010	Ministry of Justice
MCM	Stress Testing	Mission	June 2010	Bank of Latvia
FAD	Expenditure Policy	Mission	August 2010	Ministry of Finance
FAD	Revenue Administration	Mission	September 2010	Ministry of Finance
LEG	Legal Framework for Foreclosure Procedures	Missions	November 2010	Ministry of Justice
FAD	Public Financial Management	Mission	Feb-March 2011	Ministry of Finance

Resident Representative:

Mr. David Moore was appointed Resident Representative effective from June 11, 2009.

Fourth Amendment:

Latvia accepted the Fourth Amendment of the Articles of Agreement on February 16, 2001.

APPENDIX II. LATVIA: STATISTICAL ISSUES

LATVIA—STATISTICAL ISSUES APPENDIX As of May 5, 2011	
I. Assessment of Data Adequacy for Surveillance	
General: Data provision to the Fund is adequate for surveillance purposes. The shortcomings for each statistical area are presented below.	
National Accounts: The CSB compiles and publishes quarterly national accounts using the production and expenditure approaches on a regular and timely basis, largely following the *1993 System of National Accounts (SNA 1993)* and the *1995 European System of Accounts (ESA 95)*. However, there are significant discrepancies between the GDP estimates based on production and those based on expenditure. The statistical discrepancy is included in the estimate of changes in inventories on the expenditure side, and appears to have been growing in recent periods. The underlying data for the production approach are obtained primarily through a comprehensive survey of businesses and individuals, and are supplemented by data from labor force surveys and administrative sources. The CSB believes that the basic data understate economic activity, particularly in the private sector, and there is an ongoing effort to increase coverage. Meanwhile, official national accounts include an adjustment for under-recording. Additional data for the expenditure-based accounts are obtained from household budget surveys and other surveys from the State Treasury and ministries.	
Government Finance Statistics: Fund staff are provided with monthly information on revenues, expenditures, and financing of the central and local governments and special budgets. With some limitations, the available information permits the compilation of consolidated accounts of the general government. The 2010 *Government Finance Statistics Yearbook* contains cash data in the *GFSM 2001* format up to 2009. Quarterly general government data on an accrual basis are provided through Eurostat for *International Financial Statistics* on a timely basis.	
Monetary Statistics: Monetary statistics should provide for greater detail in the classification of the liabilities of depository corporations by subsectors of the general government in line with international standards.	
Balance of Payments: The BoL assumed responsibility for compiling the balance of payments statistics from the CSB in early 2000. The data collection program is a mixed system, with surveys supplemented by monthly information from the international transactions reporting system (ITRS), and administrative sources. Contrary to international standards—but similar to a number of other EU countries—the BoL includes provisions for expected losses of foreign-owned banks. Between Q4 2008–Q2 2010, this treatment led to the recording of negative reinvested earnings (i.e., losses) of foreign-owned banks as negative outflows. These “inflows” in the income account of the balance of payments thus gave a positive contribution to the current account.	
II. Data Standards and Quality	
Participant in the IMF’s Special Data Dissemination Standard since November 1, 1996.	Data ROSC published in June 2004
III. Reporting to STA (Optional)	
The authorities are reporting data for the Fund’s *International Financial Statistics, Government Finance Statistics Yearbook*, the *Direction of Trade Statistics,* and the *Balance of Payments Statistics Yearbook*.	

LATVIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(AS OF APRIL 30, 2011)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	4/28/2011	4/28/2011	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	4/27/2011	4/28/2011	D	D	D		
Reserve/Base Money	3/31/2011	4/14/2011	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	3/31/2011	4/14/2011	M	M	M		
Central Bank Balance Sheet	4/27/2011	4/28/2011	D	D	D		
Consolidated Balance Sheet of the Banking System	3/31/2011	4/15/2011	M	M	M		
Interest Rates[2]	3/31/2011	4/18/2011	M	M	M		
Consumer Price Index	3/31/2011	4/8/2011	M	M	M	O, LO, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2/28/2011	3/22/2011	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2/28/2011	3/22/2011	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/31/2011	4/18/2011	M	M	M		
External Current Account Balance	2/28/2011	4/11/2011	M	M	M	O, O, O, O	O, O, O, O, O
Exports and Imports of Goods and Services	2/28/2011	4/11/2011	M	M	M		
GDP/GNP	Q4 2010	4/11/2011	Q	Q	Q	O, O, O, O	O, LO, LO, LO, LO
Gross External Debt	Q4 2010	3/4/2011	Q	Q	Q		
International Investment Position[6]	Q4 2010	3/4/2011	Q	Q	Q		

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means

[2] Both market-based and officially-determined, including deposit and lending rates, discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability position vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC published in July 2004, the findings of the mission that took place during September 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

APPENDIX III. LATVIA: WORLD BANK RELATIONS
(As of May 5, 2011)

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank Work Program	Public Expenditure Review	May 2010	September 2010 (Final Version)
	Second Special Development Policy Loan for Safety Net and Social Sector Reform Program	April 2011	May 2011
	FSAP Development Module	3rd Quarter 2011	4th Quarter 2011
2. Fund Work Program	TA on revenue administration	May 2011	July 2011
	FSAP Development Module	3rd Quarter 2011	4th Quarter 2011
	Staff Visit	August 2011	
	5th Review	October 2011	December 2011

Press Release No. 11/198
FOR IMMEDIATE RELEASE
May 25, 2011

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Fourth Review Under Stand-By Arrangement with Latvia and Approves €121.3 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) yesterday completed the fourth 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 107.877 million (about €121.3 million or US$170.7 million), but the authorities do not intend to draw this amount. The availability of Fund resources will help to provide insurance against the impact of any unforeseen deterioration in external financing conditions. The total amount disbursed under the SBA remains SDR 982.24 million (about €1.10 billion or US$1.55 billion). The Executive Board also approved a request for a waiver of nonobservance of a continuous performance criterion resulting from an unapproved exchange restriction.

Strong policy actions under the SBA have helped restore confidence, contributed to economic recovery, and enabled significant progress toward Latvia's goal of euro adoption. The government has continued to achieve substantial fiscal savings while also protecting the poorest through social safety net spending and a temporary public works jobs program, and is strengthening its active labor market policy efforts. Looking ahead, the government has committed to meet the Maastricht criteria for euro adoption and strengthen the financial sector, which should further enhance confidence and support a rebound in growth. Steps include:

- Implementing a strong 2011 budget, reducing the 2012 deficit safely below the Maastricht reference value, and completing work on a fiscal responsibility law that will ensure future fiscal sustainability; and

- Completing the restructuring of Mortgage and Land Bank, and implementing the sales strategies for Parex and Citadele Banks.

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 €1.71 billion, or US$2.41 billion), entails exceptional access to IMF resources, amounting to 1,071 percent of Latvia's quota in the IMF (reflecting Latvia's quota increase in March 2011). 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:

"Strong policy implementation of the economic program has contributed to Latvia's economic recovery and put attainment of the Maastricht criteria for euro adoption within reach. Unemployment is still high, however, arguing for greater use of active labor market policies and a robust permanent safety net.

"Euro adoption would mark a successful exit from Latvia's difficult and ambitious program, but will require a focus on fulfilling the criteria in a convincing and sustainable way. The substantial fiscal adjustment to date and the decision to aim at a 2012 deficit of 2.5 percent of GDP demonstrates the authorities' commitment. It will be important to maintain strong budget implementation in 2011 while working to identify high-quality and sustainable fiscal measures early in the budget cycle.

"Inflation is rising due to higher world food and energy prices, as well as tax increases. The authorities' should focus on spending cuts rather than tax increases in the 2012 budget and on enhancing efficiency in product markets and state-owned enterprises to help keep inflation under control.

"Development of a restructuring plan for Mortgage and Land Bank after delays marks an important step to strengthen the financial system in the wake of the crisis, and should be followed up by timely implementation. Similarly, progress on the restructuring and sales strategies for Parex and Citadele Banks should help maximize recovery of state aid and reduce state involvement in the banking sector. To promote future lending, it will be important to protect the rights of secured creditors and continue facilitating market-based debt restructuring."

Statement by Benny Andersen, Executive Director for the Republic of Latvia and Gundars Davidsons, Advisor to the Executive Director May 25, 2011

On behalf of the Latvian authorities, we wish to commend staff for a well written report and thank them for fruitful and friendly cooperation during the review mission.

The program has been successful in stabilizing the Latvian economy, despite the criticism and doubts expressed on its viability at the initial stages of the program implementation. While the authorities have always firmly believed in the success of the internal adjustment strategy, this was not the case among many experts and partly so within the Fund itself, as the risks seemed high and grounds untested. The continued implementation of the program has started bearing fruit and the Latvian economy is showing a robust recovery.

Economic recovery is underway supported by regained competitiveness…

The Latvian authorities are pleased to note that the staff report explicitly recognizes that "internal devaluation and higher productivity have produced significant competitiveness gains". As a result of the adjustment, the Latvian economy has clearly shifted from non-traded to traded sector led growth, with a corresponding shift in production factors. Labor has been moving from the previously overheated construction and trade sectors to the largest export sectors, namely, manufacturing and transport. The present investment activities are concentrated in setting up new production sites and upgrading infrastructure, a notable change from the boom years when investment in residential and office buildings took the lead. Manufacturing has become a key driver of growth. Outperformed only by the other two Baltic countries and Bulgaria, Latvia was among the EU's best performers in terms of merchandise export expansion in 2010. Gains in competitiveness have also been manifested in steadily rising export market shares in most export markets and increasing profit margins in the tradable sector, particularly in manufacturing.

Latvia's external position has strengthened. While the current account surplus narrowed last year, this largely represents a return to profitability by foreign investors, the banking sector in particular, as trade in goods and services has been hovering around balance already since early 2009. A saving-investment representation of the current account suggests a pick-up in the investment rate and stabilization of the savings rate, which shot up during the crisis and has now returned to levels observed before the boom. Financial markets pressures have subsided and the remaining moderate outflows are the result of gradual deleveraging of the heavily leveraged sectors of the economy. Staff voiced concern that the recent low lats interest rates, which had slipped slightly below the corresponding euro rates, could put pressure on reserves. The authorities are well aware of the lats interest rates differential with the euro rates and their possible implications on foreign reserves; and are committed, if deemed necessary, to take steps to prevent any unsustainable developments.

<u>Reforms have moved Latvia closer to its goal of euro adoption in 2014…</u>

Consistent implementation of fiscal consolidation measures has allowed the Latvian authorities to meet program fiscal deficit targets comfortably. The fiscal deficit declined to 7.7 percent of GDP on accrual basis in 2010 compared to the program target of 8.5 percent. Excluding bank restructuring costs, the 2010 deficit was only 5.5 percent of GDP, building a solid foundation for reaching the deficit target of well below 3 percent of GDP in 2012. With the adoption of the 2011 supplementary budget, the authorities expect the budget deficit to be 4.5 percent of GDP in 2011, considerably below the initial program target of 6 percent.

Confidence has returned to financial markets and Latvia's credit ratings have started to improve. The Latvian government has been able to successfully issue 10-year lats bonds and plans to return to international financial markets in the first half of 2011. Given the improving economic and financial situation, Latvia intends to treat IMF, EU, and bilateral funds as precautionary, and will only draw EUR 100 million from the World Bank.

Inflation has increased recently raising some concerns over the prospects of compliance with the Maastricht inflation criterion in the coming years. As price setting in Latvia is highly flexible, the global surge in raw materials prices was promptly reflected in the overall consumer price level. In addition, a higher share of food and energy items in consumer basket, if compared to the EU15 countries, ensured that global developments were transmitted rapidly to the headline inflation figure. However, the most significant domestic driver of inflation was the ongoing fiscal consolidation, which included a rise in indirect tax rates, thereby pushing up consumer prices as well. At the same time, the underlying inflation rate, excluding the contribution of food and energy prices, remained negative, since weak labor market conditions and still sluggish credit growth exert downward pressures on prices.

A return to low inflation over the medium term is expected as world commodity prices ease. Significantly lower inflation is expected already in 2012, putting compliance with the Maastricht inflation criterion within reach already in early 2013. Moreover, the commodity price surge is having a similar effect on inflation rates in other countries, including the European Union member states. As a result, along with rising inflation in Latvia, the reference value of the Maastricht criterion moves in the same direction. The Latvian authorities also expect that weak domestic demand and loose labor market conditions are likely to exert downward pressure on inflation in Latvia over the medium term.

Commitment to future reforms is strong and unaltered….

The authorities are committed to the agreed policy targets aimed at euro adoption in 2014. Aspiring to achieve the 2.5 percent of GDP deficit goal in 2012 will demonstrate the Latvian authorities' commitment to fiscal discipline and debt sustainability, and to meeting the Maastricht fiscal criteria on a sustainable basis. Reaching this goal would require further consolidation measures, assessed to be in the range between 150-180 million lats or 1.1 to 1.3 percent of GDP. A menu of potential consolidation measures has already been prepared and the Latvian authorities are committed to incorporate these and any additional measures in the 2012 draft budget by mid-August 2011. The above-mentioned plans, as well as keeping the fiscal deficit below 1.9 percent of GDP in 2013 and 1.1 percent of GDP in 2014 are essential elements of the authorities' strategy to adopt the euro on January 1, 2014.

The Latvian authorities are strongly committed to pursuing counter-cyclical fiscal policy in the future. The government has prepared a draft Fiscal Discipline Law, establishing binding fiscal rules for the annual state budget and setting out a medium-term budget framework. The law will define basic principles of Latvia's fiscal policy, namely, counter-cyclicality and sustainability of public debt. The authorities expect that the draft Fiscal Discipline Law, along with the associated amendments to the Constitution, will be submitted to the Parliament by the end of November 2010.

The authorities are making efforts to strengthen tax administration and to combat the gray economy. They have made steps to combat smuggling of goods and improved cooperation with business associations that is instrumental to this end. As explained in the Letter of Intent, the authorities also intend to set up a task force comprised of government representatives and program partners with a view to assessing the effectiveness of various measures and to report on their expected yield in 2012. While combating the gray economy is an important component of the authorities' fiscal strategy, they recognize that the revenue gains from those activities are uncertain and hard to quantify.

While the improving economy is likely to reduce the demand for social safety net spending, the Latvian authorities remain committed to protecting the most vulnerable. Though the appropriations for the guaranteed minimum income program will remain broadly unchanged, the spending on the Workplaces with Stipend Emergency Public Works program will be gradually replaced with more traditional active labor market policy spending, financed by European Social Fund resources in 2011 and reallocating EU structural funds if necessary in the following years.

The Latvian authorities are taking steps to restructure state-owned banks. On April 15, the authorities submitted the Transformation plan of the Mortgage and Land Bank to the European Commission. With the aim to sell the commercial part of the bank by mid-December 2011 they intend to prepare a sales strategy to be submitted to the European

Commission by end-June. The authorities have successfully implemented the Restructuring plan of Parex Bank. Since August 1, 2010, Parex Bank is split into two banks—performing assets have been transferred to the newly established Citadele Banka and non-performing assets were left in the Parex Bank. On May 17, 2010, the Cabinet of Ministers approved sales strategies for both Citadele Banka and Parex Bank, according to which the sales process of the two banks will be carried out separately.

Closing remarks

With more than two years of the program experience behind, the Latvian authorities would like to thank staff for the close cooperation and the support that has been of great value**. Also, the authorities wish to share some general comments based on the program experience which might be of interest for a broader audience.**

First, the so called 'reform fatigue' and political risks, discussed in this and the previous reports, have not materialized. Of course, in any country there are always possible political risks ahead. But the facts are that in October 2010, after 13 percent of GDP of fiscal consolidation, the coalition members forming the government were re-elected, and even managed to increase their number of seats in the parliament. An equally convincing victory of the parties responsible for a likewise sizable fiscal consolidation in Estonia indicates that it is more a rule than an exception, at least, for the region.

Second, it seems that there are some lessons to learn about the process of adjustment under a fixed exchange rate regime. For the time being, it seems that the mid-2009 worries of various 'market experts', also in the Fund, about competitiveness and slow recovery have not materialized. Manufacturing exports have rebounded strongly by regional standards. A similar rebound was observable in all emerging fixed exchange rate countries of the EU (Bulgaria and the other two Baltic states), indicating that the case of Latvia was not an exception. We hope that the experience of those countries will be sufficiently widely used as a source for learning, and will shape policies and adjustment strategies in the future.