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Republic of Latvia: Second Review and Financing Assurances Review Under the Stand-By Arrangement, Request for Extension of the Arrangement and Rephasing of Purchases Under the Arrangement and Request for Waiver of Nonobservance and Applicability of Performance Criteria

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 December 14, 2009 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 January 25, 2009. 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.

- Supplements 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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REPUBLIC OF LATVIA

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

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

Approved by Anne-Marie Gulde-Wolf and Tessa van der Willigen

January 25, 2010

Stand-By Arrangement: A 27-month SDR 1.52 billion SBA involving exceptional access (1,200 percent of quota) was approved by the Executive Board on December 23, 2008 (Country Report No. 09/3). A first purchase of SDR 535 million was made following the Board meeting. A Staff Report for the Interim Review under the Emergency Financing Mechanism was issued on February 23, 2009. A second purchase of SDR 178 million was made following the First Review on August 27, 2009 (Country Report No. 09/297) and a third purchase, also of SDR 178 million, becomes available on completion of this Second Review.

Program status: The sharp economic downturn is starting to bottom out, although recovery has not yet begun. The authorities have implemented the June 2009 supplementary budget, and met with a wide margin the end-September performance criterion on the adjusted primary balance (the end-December performance criteria also seem likely to be met, although final data are not yet available). The continuous performance criterion on external payments arrears was missed, but by a small amount which the authorities expect to resolve soon. The authorities adopted a strong budget for 2010 that would likely have lowered the deficit to 7 percent of GDP, well below First Review projections; however, a recent Constitutional Court ruling overturning last June's pension reductions will add around 1½ percent of GDP to the 2010 deficit, increasing the necessary medium-term fiscal adjustment. The Court also held that all significant and essential loan agreements needed Parliamentary approval. As the current account surplus has widened, and capital outflows have been less than expected, the end-December 2009 performance criteria for net international reserves and net domestic assets were met. Further steps are needed to accelerate the restructuring of domestically owned banks.

Discussions were held in Riga during December 2–14, 2009, building on the work of earlier staff visits focused on the budget. The mission met with Prime Minister Dombrovskis; Finance Minister Repše and coalition leaders; Bank of Latvia Governor Rimšēvičs; Head of the Financial and Capital Market Commission Krūmane; senior officials in these institutions; social partners; and representatives of financial institutions.

Staff: The staff team comprised Mark Griffiths (head), Lone Christiansen, James John (all EUR), Alex Klemm (FAD), Michaela Erbenova (MCM), Gavin Gray and Chris Marsh (SPR). David Moore (Resident Representative) assisted the mission. The team worked closely with staff of the European Commission, ECB, World Bank, and the Swedish authorities. Gundars Davidsons (OED) attended some meetings.

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I. INTRODUCTION AND SUMMARY

1. **The authorities have improved their program implementation, especially with respect to fiscal policy.** The authorities have realized substantial savings by implementing the June 2009 supplementary budget almost in full, and in December they adopted a strong budget for 2010 with a further 4.2 percent of GDP fiscal adjustment. However, a recent Constitutional Court ruling has overturned last June's pension reductions, and this will add 1½ percent of GDP to the 2010 deficit. All quantitative performance criteria (PCs) for end-September and end-December 2009 were met by large margins (data for the end-December performance criteria on the fiscal balance and public guarantees are not available but seem likely to be met, and for the fiscal balance by a similarly large margin). For the monetary performance criteria these reflect the substantial buffers that were included earlier, but the fiscal adjustment has been considerably stronger than anticipated or allowed for under the program. The authorities are working to clear small amounts of external payments arrears that resulted in nonobservance of a continuous PC. They have also fulfilled most of the structural benchmarks (though some with slight delay), although one was met only partially (assessment of the wage grid) and one has been reset (fiscal responsibility law).

2. **Strong efforts to implement the program and the global recovery have strengthened confidence and reduced financial market risks.** Since the First Review, pressure on the exchange rate has subsided, reserves have grown, and CDS spreads and domestic interest rates have fallen steadily. This has enabled the State Treasury to extend maturities and lower its borrowing costs in the domestic market.

3. **Even so, the difficult economic situation and coming elections pose considerable risks to future reforms.** Falling output and rising unemployment have increased social strains, raising the risk of a populist backlash to fiscal adjustment and an inability to plan new structural reforms ahead of the fall 2010 parliamentary election. The banking sector also remains vulnerable, as non-performing loans (NPLs) are rising and funding sources—especially from abroad—have come under strain, putting pressure on capital and liquidity and discouraging banks from resuming lending. Progress in restructuring the main state-owned banks has been slow. Tensions within the government persist, with the largest coalition party publicly questioning parts of the current Letter of Intent.

4. **Recognizing the need to sustain fiscal adjustment to achieve the program's exit strategy of euro adoption, the authorities have requested an extension of the program until December 22, 2011.** This extension would include the first full year of the next parliamentary term, including preparation of the 2012 budget, which is expected to aim for a general government deficit below 3 percent of GDP (ESA definition) to meet the Maastricht deficit criterion.

II. Background

5. **The economy is contracting much more slowly (Figure 1, Tables 1–2).** Seasonally adjusted GDP fell by an estimated 4 percent quarter-on-quarter in the third quarter (19 percent year-on-year), down from a more than 11 percent decline in the first quarter:

- **Domestic demand has continued to decline sharply**. Retail sales fell by 30 percent year-on-year in the third quarter, partly due to the contractionary effect of the June 2009 supplementary budget. Depressed confidence (notwithstanding recent improvements) and a withdrawal of credit have also led to massive contractions in construction activity (down 37 percent year-on-year in the third quarter), and sales of consumer durables such as new cars (down 74 percent in the third quarter). Real estate prices seem to have bottomed out, but at 30 percent of their peak.

- **After slowing in summer, job cuts have resumed, particularly in the public sector**. The registered unemployment rate rose to 15 percent in November (despite outward migration), while the labor force survey measure increased above 20 percent in October, far exceeding the 16 percent year-average projection at the First Review.

- **The domestic downturn has been partly offset by some recovery in the tradables sector**. Seasonally adjusted manufacturing output has expanded by more than 10 percent since its February trough, with wood products (one of Latvia's main exports) growing more than 40 percent. The transport sector, which depends heavily on CIS transit trade, has also held up well: the volume of cargo loaded at Latvia's ports in the third quarter was unchanged from a year ago, although cargo unloaded was down close to 30 percent.

6. **The domestic recession and falling wages have led to deflation (Figure 2).** Latvian firms have responded to falling demand by trimming producer prices for goods sold domestically by 11 percent since late 2008. They have also cut wages, which fell 4 percent year-on-year in the third quarter. But the true correction has probably been even greater as these official figures omit sharp cuts in undeclared cash-in-hand wage payments. As a result, consumer prices have fallen for eight consecutive months, and in November were 1¼ percent below their year-earlier level.

7. **Competitiveness is gradually improving and the external economic environment has become more supportive (Figure 3)**. The CPI-based real exchange rate has depreciated by 6 percent since its peak in March, back to its pre-program level, due to domestic deflation and the reversal of partner country depreciations earlier in the year. However, preliminary Bank of Latvia (BoL) data suggest that the ULC-based measure has depreciated by more. The euro area, Latvia's largest single trading partner, finally grew in the third quarter (0.4 percent quarter-on-quarter), after five consecutive quarters of recession.

8. **The fiscal deficit has been well below the First Review's increased program targets as expenditure restraint has offset falling tax revenues (Figure 4, Tables 3–4):**

- **The authorities met the end-September PC on the adjusted fiscal primary balance** by nearly 3 percent of GDP (and are likely to meet the end-December PC too). They also met the indicative target on the public wage bill.

- **For the most part, the authorities have implemented the expenditure cuts in the June supplementary budget although some additional health spending was undertaken late in the year**. They have also refrained from using the space for extra social safety net spending provided under the program to respond to the crisis. However, in late December the Constitutional Court ruled that last June's pension cuts (10 percent across-the-board and 70 percent for working pensioners) were unconstitutional. This will raise the deficit by 1 percent of GDP annually (1½ percent of GDP in 2010, since the 2009 pension cuts have to be reimbursed). While not ruling out the possibility of future pension cuts, the Court held that the government had rushed the pension cuts without considering less harmful alternatives.

- **Tax revenues have been in line with program projections**. Through November, the general government deficit (including net lending) is estimated at 4.7 percent of GDP. Staff project an 8 percent of GDP deficit for the year (9.3 percent of GDP excluding second pillar pension contributions, the previous program definition, compared to a ceiling of 13 percent of GDP). This forecast is uncertain given the scale and unpredictability of spending in December.

9. **Expenditure has been lowered through structural reforms, and cuts in administration, social spending and the public-sector wage bill:**

- **Structural reforms have continued**, mainly in health and education. Drawing partly on World Bank advice, the authorities have derived permanent savings by closing underutilized hospitals, and reducing the number of teachers (given low student-teacher ratios).

- **A number of ministries, including defense, education, interior and agriculture**, have cut administrative costs by merging agencies, such as a four-way merger to create the new Institute for Food and Environment.

- However, many of the savings have come from **reductions in the quality or scope of public services**. These include July's decision to suspend elective surgery unless the patient pays in full, abolition of university grants for poorer students, and cuts in research spending. However, in October health spending was allowed to increase by L25 million to cover emergency care for the remainder of the year.

- **The public sector wage bill has been reduced.** The central government laid off almost 6,000 workers in the third quarter, and applied an 18 percent average wage cut to the remainder. The burden has fallen heavily on teachers, who now earn less than half the public-sector average.

- **The government increased social safety net spending less than the program allowed.** It added only L14 million (0.1 percent of GDP) to cover health copayments for the poor and additional transportation for schoolchildren, not the 1 percent of GDP allowed under the program. This increase was more than offset by cuts in local governments' discretionary benefits, such as free school meals and maternity benefits.

- **Arrears have remained low,** although arrears incurred to a foreign supplier (for a L6 million contract, which the authorities expect soon to clear) meant nonobservance of a continuous PC.

10. **The recession has contributed to a large current account surplus (Figure 5, Table 7).** A collapse in imports coupled with a more modest decline (then stabilization) in exports has led to a very sharp adjustment in the goods and services balance, which recorded a small surplus for the first time in the third quarter (compared with a 3½ percent of GDP deficit last year). The current account surplus reached an annualized 8.7 percent of GDP for the first nine months of 2009, a sizeable reversal compared to deficits of 22 percent of GDP in 2007 and 13 percent in 2008. Excluding foreign banks' provisioning for non-performing loans (which does not create a reserve inflow but reduces the stock of external debt), the surplus for the whole year is projected to be somewhat less, at around 3 percent of GDP. This represents a dramatic turnaround, and a considerable improvement on earlier projections.

11. **Capital outflows have been less than expected at the First Review (Figure 6):**

- The **Nordic banks** have continued to make substantial repayments to their parents (€381 million in the third quarter, close to program estimates). However, the banks have almost fully offset this by increasing subordinated debt and equity in their subsidiaries, consistent with maintaining exposure.

- **Non-resident deposits** have been stable since late May (compared with program assumptions of sizable outflows), reflecting improving liquidity in the CIS, the confidence effect of recent program disbursements, continued restrictions on withdrawals of large deposits from Parex bank, and some stabilization of the banking sector.

- **Trade credits** have held up well, despite the decline in overall trade volumes, while rollover rates on **corporate debt** have remained around the 80 percent assumed at the First Review.

- **Resident accumulation of foreign assets** has been substantial, though slightly below expectations at the First Review. Banks have acquired €410 million of foreign assets since end-March, while the non-bank private sector (including corporates) has acquired €630 million.

- **FDI inflows have been large (€180 million in the third quarter)**, as capital injections by major foreign banks have outweighed accruals adjustments for their losses.

- With the current account in surplus and lower than expected outflows, Latvia **exceeded its end-December NIR floor** (minus €586 million, which included a substantial buffer in view of the risks) by €1.9 billion. Program targets for 2010 have been increased to lock in much of this overperformance.

12. **The weak economic situation has intensified strains on the banking sector (Figures 7–8, Table 10):**

- **By October, more than 15 percent of loans were more than 90 days overdue**, up 10 percentage points since the start of the year; a further 12 percent of loans have been overdue for a shorter period.

- **Banks are restructuring many of these loans** by offering borrowers grace periods on principal payments, capitalization of interest and extending loan maturities. These approaches may ease borrowers' cash-flow constraints. They do not, however, reduce the debt overhang on borrowers with solvency problems, which would require banks to forgive significant amounts of principal payments. Banks may be reluctant to do so as long as they fear more NPLs are to come. For residential loans that cannot be restructured, banks have started to lease back properties to the previous owners, rather than selling collateral in the current environment.

- **The resulting provisioning needs caused banking sector losses of L640 million (5 percent of GDP) in the first 10 months of 2009**. Banks have responded with equity and subordinated capital increases of L700 million through October, with a further L300 million expected by January 2010. During 2009, thirteen banks increased capital, lifting the system-wide capital adequacy ratio above 13 percent.

- **Deleveraging is continuing**. Banking sector assets fell 0.8 percent quarter-on-quarter in the third quarter, and have declined by 7 percent since end-2008. Local banks have repaid most of their pre-crisis stock of syndicated loans, and liabilities to foreign affiliated MFIs have fallen (being partially replaced by paid-up and subordinated capital). The deposit base has stabilized recently after falling more than 6 percent since the beginning of 2009. The stock of credit fell 5½ percent in the first 10 months of the year and banks do not forecast a resumption of lending growth until the second half of 2010.

13. **The authorities have made limited progress in restructuring state-owned banks**. In November the Cabinet approved a framework strategy for the state-owned Mortgage and Land Bank (MLB), with the goals of addressing a growing NPL problem and refocusing the bank on development lending (such as to SMEs) financed by EU funds and loans from international financial institutions. However, implementation of this strategy has not yet started, save for a decision to suspend new commercial lending. The government has yet to finalize a restructuring plan for Parex—majority state-owned since the intervention in late 2008—and the European Commission has yet to formally approve the state aid that the bank has received so far. In October 2009, the FCMC again partially relaxed deposit withdrawal restrictions at Parex.

14. **Nevertheless, financial markets and the demand for lats have stabilized since the First Review**, in part due to the rebound in global financial markets (Figures 9–10; Tables 11–12):

- **CDS spreads have fallen sharply and the State Treasury has succeeded in extending maturities in the domestic debt market.** To reduce rollover risk, it has retired its entire stock of one-month T-bills, and expanded issuance at 6- and 12-month maturities. Yields on 6-month paper fell to 6.7 percent in early January, down by about 700 basis points since the First Review, while 3-month yields fell by about 800 basis points to just over 3 percent.

- **Interest rates in lats have fallen from their peaks in early June.** Greater confidence in the sustainability of the peg, especially following the conclusion of program negotiations on the 2010 budget, have pushed local interest rates lower. Rising expenditure in the final quarter of the year, in line with normal seasonal patterns, has provided a temporary impetus to liquidity.

- The **share of residents' deposits in FX stabilized in June** at around 58 percent of the total (but up from 49 percent in 2008).

- **Base money increased marginally** in the third quarter, but picked up sharply in November as increased commercial bank deposits at the BoL have offset slight declines in cash in circulation. Nevertheless, the BoL met the program **end-December NDA ceiling** (L2.1 billion) by L1.4 billion. Program ceilings for 2010 have been lowered to lock in much of this overperformance.

III. Policy Discussions

15. **Throughout the discussions, the authorities remained firmly committed to their program strategy:** maintaining the fixed exchange rate to the euro, reducing the fiscal

deficit, taking further steps to stabilize the financial system and, in the medium term, qualifying for euro adoption. They felt that the strategy, while challenging, was succeeding. They argued that keeping the fixed exchange rate regime had maintained stability in a difficult environment, while the wage and price adjustments needed to restore competitiveness are taking place. The remaining fiscal adjustment would still be very difficult, but the authorities accepted its necessity in order to meet the Maastricht criteria for entry to the euro zone as soon as possible.

A. Macroeconomic Framework

16. **The authorities' macroeconomic framework remains largely unchanged from the First Review (Table 2),** with the economy expected to bottom out by the middle of 2010 and then to gradually recover (LOI ¶7; number refers to paragraph in Letter of Intent):

- **Domestic demand will likely remain weak.** Though necessary for reducing the deficit, the 2010 budget measures are likely to further dampen domestic demand. Another wave of job and wage cuts is expected in January, in the private sector as well as in public institutions. This will support the strategy of strengthening competitiveness under the fixed exchange rate, but lead in the short run to lower disposable incomes and consumer spending.

- **Banks seem keen to continue shrinking their balance sheets rather than extend new loans**. But trade finance should gradually expand, removing a potential barrier to exports.

- **Growth should finally come from manufacturing**, transit trade, and other sectors that directly benefit from the global upswing. The authorities are also taking steps to accelerate the use of EU funds to support exports and stimulate recovery.

17. **While accepting this baseline scenario, the authorities also held out hope that recovery could come sooner, and that growth in 2010 could be stronger than the negative 4 percent assumed in the program.** Latvia's trading partners are projected to expand by nearly 1 percent in 2010 (versus expectations at the First Review that they would still be in recession), and by 2¼ percent in 2011. The authorities argued that this could lead to a faster recovery in the second half of 2010, although carry-over effects mean that GDP should still contract for the year as a whole. Staff were more cautious, arguing that the impact on stronger exports and investment would show up later, but did raise the 2011 growth projection to 2¾ percent from 1½ percent at the First Review.

18. **Even if the recovery were to come more quickly, a return to pre-crisis growth rates looks unlikely.** Latvia's capital stock remains heavily skewed towards non-tradables such as real estate but future growth needs to come from tradables, and several years of deflation will be needed to restore Latvia's cost competitiveness. Employment is likely to increase only with a lag, and banks will be reluctant to restart consumer lending given the

private sector debt overhang. Continued fiscal adjustment needed to meet the Maastricht criteria and achieve euro adoption would also likely act as a drag on growth, but should over the medium term allow the financial sector to channel more resources toward the private sector. Staff's baseline projection is for real GDP growth rates of around 4 percent in 2012–14, which is somewhat above estimates of potential growth and driven to a large extent by a gradual recovery in domestic demand. Even so, staff do not expect the large output gap to be fully closed by 2014. Improving the potential growth rate will depend on Latvia's success in attracting new investment, especially into the tradable sector, which may prove challenging.

19. **Competitiveness remains a challenge, although there are some signs of improvement as deflation sets in (LOI ¶7)**. Further work will be undertaken for the Article IV consultation in 2010, but preliminary results highlight the need for additional real exchange rate adjustment beyond the small improvement seen since March 2009 when the real exchange rate peaked. However, it should be stressed that estimates are subject to considerable uncertainty given the rapidly changing economic environment:

- Equilibrium real exchange rate analysis (which relates the real exchange rate directly to a broad set of fundamental factors such as productivity levels and government spending) finds overvaluation on a scale similar to that indicated at the outset of the program.

- In contrast, because of the turnaround in the current account, the macro-balance and external sustainability approaches suggest little or no overvaluation, unlike previous assessments. However these approaches are highly sensitive to assumptions on variables such as the underlying current account balance or the output gap, which are especially difficult to predict in Latvia's current circumstances. The low overvaluation estimates generated by these approaches implicitly assume that the unemployment rate will remain high (as closing the output gap would still imply an unemployment rate close to 15 percent). Lowering this high unemployment rate will either require outward migration or real depreciation to boost the tradable sector.

20. **The current account surplus is projected to peak in 2011 (Table 7).** Excluding provisioning by foreign banks for their non-performing loans, the surplus should reach around 3 percent of GDP this year, rising to close to 9 percent in 2011 before falling off as recovery takes hold. The current account is anticipated to remain in surplus over the medium term with continued strong performance in current transfers and services.

21. **Although international financial support has helped boost reserves, the balance of payments still faces significant pressures:**

- **Foreign-owned banks** are estimated to have repaid €0.6 billion to their parents in 2009, though future outflows could be even greater if banks cannot find sufficient investment opportunities, as scheduled amortizations increase from end-2010.

- **Domestic banks** are estimated to have repaid all their maturing debt (mainly syndicated loans), contributing a further €0.7 billion outflow in 2009.

- Private sector **foreign asset accumulation** is projected to continue as a counterpart to external current account surpluses.

- Supporting the balance of payments, **FDI** should pick up in 2010 due to bank recapitalizations as well as some pick-up of investment in tradable sectors. From 2011 onwards, investment in tradables is expected to rise as competitiveness gains take hold. However, over the medium term, FDI as a percent of GDP remains below its 2006 and 2007 peaks.

- Also on the positive side, the better fiscal position and improving international market conditions might allow new eurobond issuance.

22. **The projected current account surpluses should slowly reduce Latvia's external vulnerabilities (Figure 12, Tables 8–9).** While gross external debt remains high (around 160 percent of GDP in 2009 and rising through 2011), staff projects that net external debt should have peaked in 2009 at close to 60 percent of GDP but, following successive current account surpluses, should then fall steadily. The net international investment position will remain negative over the medium term, due to substantial equity liabilities, but should improve over time. The main source of external risk over the medium term will be the banking sector, which will remain a large external debtor, with gross debt projected at 67 percent of GDP in 2014, much of it short-term.

B. Fiscal Policy

23. **Despite much better than expected performance in 2009, Latvia faces major fiscal challenges in 2010 and beyond.** The authorities need to reduce the structural deficit to meet the Maastricht criteria, while ensuring that adjustment does not stifle economic recovery nor cause excessive social hardship. The coming October elections and the high unemployment rate, as well as the recent Constitutional Court ruling invalidating previous pension savings, will make this challenging. Beyond 2010, further measures will be required to counter a deteriorating baseline deficit and to meet the Maastricht criteria and achieve the program goal of euro adoption.

24. **In light of these coming challenges, there were strong arguments for the authorities to deliver on their First Review commitment to take measures of 4 percent of GDP**, even though less would have been sufficient to reach the 2010 deficit target of 8.5 percent of GDP (ESA). Frontloading fiscal adjustment reduces the still very large

adjustment needed in the following years, and makes it more likely the authorities' ambitious adjustment path is feasible. The extra adjustment also gives more room for extra safety net or EU spending in 2010, and provides some insurance against adverse fiscal shocks (such as the legal reversal on pensions (LOI ¶10)). While ambitious, the 4 percent of GDP in measures is still lower than the 6.5 percent of GDP of measures staff had expected in the First Review to be necessary to achieve the 2010 budget target. Finally, the authorities' decision to map out and deliver on a difficult fiscal adjustment strategy has kept Latvia relatively insulated from recent tensions affecting high debt EU countries.

The 2010 budget

25. **Consistent with LOI commitments made at the First Review, the 2010 budget includes L500 million (4.2 percent of GDP) in net new measures (including some structural reforms) relative to a deteriorating baseline (Table 5; LOI ¶8):**

- Increases in personal income tax (raising the rate from 23 to 26 percent, and substantial broadening of the base), real estate tax, car tax and excises are expected to **boost revenue by 2.3 percent of GDP**.

- Substantial cuts in administrative budgets (through closure and merger of agencies), local government wages, and further across-the-board cuts should **reduce expenditure by 1.9 percent of GDP**.

- However, **net lending increases by 0.7 percent of GDP** to allow some delayed projects from 2009 (when the authorities kept net lending below budget by 1.5 percent of GDP) to take place in 2010 (0.4 percent of GDP), and implementation of a private debt restructuring strategy (0.3 percent of GDP).

- **The budget implies a general government deficit of around 8.6 percent of GDP (including net lending)**. Were it not for the reversal of the pension cuts (which will add 1½ percent of GDP to the 2010 deficit), the deficit would have fallen to a highly creditable 7.1 percent of GDP; this would have improved market confidence by putting the Maastricht criteria well within reach**.** However, the projected 8.6 percent deficit is still considerably less than allowed for at the First Review (10.3 percent of GDP on a comparable basis).

26. **While the budget delivers significant adjustment, in the staff's view its composition falls short in a number of areas:**

- Reliance on higher personal income tax raises the labor tax wedge considerably, as compared to making greater use of residential real estate tax or increasing VAT.

- Increased transfers from the BoL and state enterprises may not be sustainable.

- For their effect to be lasting, some of the across-the-board spending cuts still need to be backed up by structural reforms (LOI Box 2).

27. **The ruling that last year's pension cuts are unconstitutional will make the medium-term adjustment needed to achieve the goals of debt sustainability and euro adoption even more challenging.** Pensions make up roughly 20 percent of government spending and rose by about 27 percent in real terms between 2005 and 2008: keeping these off limits, especially at a time of price deflation, would mean that discretionary spending would need to be cut disproportionately. And seeking a rise in contributions to help cover such high pension costs could dampen employment prospects. The ruling in itself does not preclude future pension cuts, although a careful approach would be needed to ensure that pension savings are generated in a way that is constitutional. While it would have been desirable to find offsetting measures upfront, given the difficult and sizeable adjustment already committed to, this was not possible politically, especially in an election year. Staff therefore encouraged the authorities to intensify their efforts to prepare changes that are constitutional and which would ensure the sustainability of the pension system (new structural benchmark for June), so that the new government would have reform options (and potential savings) available to consider and could act quickly.

28. **Staff recognized the extraordinary effort that had gone into this budget.** Together with June's supplementary budget, the authorities had taken steps to introduce around 10 percent of GDP in fiscal adjustment. During negotiations, the government had also worked closely with EC representatives and Fund staff to strengthen the budget: honoring its commitment to the full L500 million in adjustment; finding an additional L68 million in measures when alerted that their original package fell short of the L500 million; dropping earlier plans for regressive cuts in personal income tax exemptions (though recommendations to introduce a progressive personal income tax were rejected); and, in response to technical arguments from the staff, dropping earlier plans to introduce a multiple rate corporate income tax. Though the final budget may have room for improvement, it also reflects the outcome of a difficult political process. The staff recognized that reaching this agreement within a multi-party coalition was a significant achievement.

29. **To lessen the social impact of the recession, the program includes an adjustor on the deficit target to allow additional social safety net measures (LOI ¶9).** The World Bank hopes to work with the authorities on options such as lengthening the duration of unemployment benefits (at the current L45 monthly flat rate), expanding the number of places in the active labor market program, and increasing the number of nurses. Increasing central government co-financing of guaranteed minimum income (GMI) benefits from 50 to 75 percent (perhaps even 100 percent) would ensure that poor people in financially weaker municipalities would still be protected. Staff cautioned against measures that might exacerbate poverty traps, such as too large increases in GMI as opposed to greater use of active labor market policies. However, despite the increase in unemployment, the authorities

regarded the existing social safety net as largely adequate, and did not intend to introduce any new measures before undertaking a thorough review.

30. **The mission stressed the benefits of locking in recent fiscal overperformance and avoiding wasteful expansionary measures ahead of the election.** The authorities recognize that the program does not offer any space for expansionary measures (apart from social safety net and EU funds-related spending). They have committed to save any revenue overperformance and avoid tax cuts (LOI ¶10) as this would add to consolidation needs in 2011.

Medium-term fiscal path

31. **Despite the many measures taken so far, substantial further fiscal adjustment will be required after the October election to meet the Maastricht fiscal criteria (LOI ¶11).** In the coming years deflation and weak domestic demand are likely to slow the growth of tax receipts, while earlier temporary revenue increases are set to expire (1 percent of GDP). Court mandated pension outlays will be about 1 percent of GDP higher unless pension reforms can be implemented. The government will also lose about 1.2 percent of GDP in revenues if, as planned, it restores social security contributions to the second pillar. Higher public debt will increase interest payments. The staff estimates that these factors will lead to a 4 percent of GDP deterioration in the baseline deficit, implying a need for an estimated 7 percent of GDP in measures to meet the 3 percent Maastricht target. The authorities believed that the needed adjustment might be less, pointing to the possibility that interest payments might be lower than staff had projected. However, staff urged the authorities to be prudent in their assessment of the amount of measures likely to be needed, to ensure they have a safety margin.

32. **Well-structured and front-loaded spending reforms need to be identified and carefully designed to ease the adjustment (LOI ¶12).** Following the sizeable adjustment already introduced, further measures will need to be very carefully designed. Given the high share of pensions in public expenditure, and the need to spread the burden of adjustment, the authorities already committed at the First Review to prepare by June 2010 a pension reform that would come into effect at the beginning of 2011. They also intend to work with the EC and World Bank on a public expenditure review to identify further measures. While stressing the political sensitivities in the pre-election period, the authorities recognized the need to continue technical work through 2010 so that the next government will have a menu of options it can work from when it prepares the 2011 budget.

33. **Although less than projected at the First Review, there are still sizeable fiscal risks (Figure 11, Table 6).** The reduction in the deficit path, lower interest rates, revised projections for bank restructuring costs, and new data allaying concerns of a significant mismatch between EU funds received and spent, imply that gross public debt could rise to just under 70 percent of GDP (compared with 90 percent at the First Review). This exceeds

the Maastricht threshold, though the criterion could still be met as long as debt is on a downward path. However, this projection includes sizeable government deposits at the BoL which are needed to cover potential bank restructuring costs (estimates of potential costs have been lowered given limited outlays in 2009 but remain sizeable); excluding these, net debt should still be around 60 percent of GDP. Arguably, the main risk is that the authorities are unable to deliver on their commitment to deficit adjustment, given the enormous consolidation already undertaken and the potentially insuperable practical and political challenge of doing more, or because measures that deliver adjustment now are poorly designed and thus later prove unsustainable or subject to court challenge. The presence of large government deposits may increase the risk of fiscal slippages. Further important risks include deteriorating tax compliance following recent tax increases, a worse than expected macroeconomic environment, or financial weaknesses in state enterprises.

C. Financial Sector Policies

34. **Given the depth of the recession, the banking sector remains under pressure:**

- Banking system CARs are above regulatory limits because of recent capital injections. To avoid exacerbating procyclicality, staff advised that these might be allowed to fall in the cycle, while remaining above the regulatory minimum.

- Liquidity and funding risks remain significant given the continued repayment of syndicated loans with little or no rollover for local and non-EU owned banks, weak deposit growth and repayments by subsidiaries to their foreign parents.

- Staff discussed with the FCMC the need to avoid regulatory forbearance on recognizing credit losses and on creating loan loss provisions, and welcomed their plans to revise regulations on credit risk management and liquidity requirements to ensure that risks are managed and monitored in line with evolving international best practice (LOI ¶18).

35. **Banking stability depends upon the continued involvement of the largest foreign banks.** Building on earlier informal commitment letters, four large foreign banks (accounting for around 55 percent of bank assets) met in Stockholm in September and committed to maintain overall exposure levels, conditional on how nominal GDP evolves and the availability of sound business opportunities. These banks have signaled their willingness to make bilateral commitments in the next stage of the process. However, these commitments will be difficult to enforce, especially in an environment of global deleveraging. In addition, although these plans have been put aside, previous debate within the government of plans to weaken the legal status of mortgages (by limiting recourse to the value of the collateral), which would have hurt foreign banks, may also complicate the task of obtaining effective commitment letters.

36. **The authorities have established a high-level working group to help strengthen Parex Bank.** Options include establishing an independent asset management company (AMC) (in cooperation with the EBRD, which since September 2009 has held a 25 percent stake), and removing non-core and/or non-performing loans from the main bank:

- **Staff urged the authorities to seek professional advice in developing its action plan for the bank, which should be submitted to the European Commission competition authority by end-March (LOI ¶20, structural benchmark)**. If established, an AMC should be structured in line with best international practice for transparency and governance, including with a clear sunset date. Staff cautioned against transferring non-core but performing assets to provide working capital for the AMC, as this could complicate governance and lessen incentives to collect on the bad assets. Assets should also preferably be transferred at fair value, with an agreement in place on how the profit or loss will eventually be distributed. The two major shareholders are discussing all these issues.

- **The authorities have continued to make good-faith efforts to facilitate the settlement of limited arrears arising from the partial deposit freeze at Parex Bank (LOI ¶21).** The Fund Executive Board has recently approved the retention of this exchange restriction until end-June 2010 or Latvia's next Article IV consultation, if completed earlier. Further relaxation of deposit restrictions should only be undertaken after careful analysis, if conditions allow.

37. **Plans to transform the state-owned Mortgage and Land Bank (MLB) have been protracted (LOI ¶22):**

- The authorities plan to refocus MLB on development lending, and scale back its commercial lending. However, the bank lost money and required two capital increases in 2009 (the second of which, a conversion of EU funds into capital, has yet to be approved by the EC's regional directorate).

- To reduce the burden on the state, it would be preferable to devise an action plan for the bank before the bank assumes further liabilities backed by government guarantees. The authorities agreed to adopt the plan by end-May (structural benchmark) though staff argued for an earlier date.

- Staff urged the authorities to divest the commercial banking division, focus on development lending, and separate non-performing assets into an independent asset management company. This would help rid the bank of bad assets, maximize asset recoveries (if problem loans are dealt with quickly), and let the bank focus on development lending. As in the case of Parex, any AMC should follow best international practice and respect EU regulations. The bank's management needs to prepare a medium-term funding plan to sustain the bank's liquidity position and support its strategic goals.

38. **The authorities are working on institutional reforms to mitigate the impact of any future banking-sector distress:**

- **August's bank resolution strategy (LOI Box 1),** developed with assistance from the World Bank, defines the responsibilities of each government agency in the event of a crisis, and sets out how they would take decisions. It also identifies alternative options and methods for resolving problems in various sub-groups of banks. As such, it strikes an appropriate balance between setting out higher-level principles and giving the authorities sufficient flexibility depending upon the specific circumstances.

- **Building on MCM technical assistance, the FCMC intends to transform the deposit guarantee fund** into a separate unit with designated, trained staff to ensure it will have adequate capacity for a fast payout of insured deposits in accordance with the recently amended legal framework.

D. Monetary Policy and Debt Management

39. **Liquidity conditions have improved, but warrant close monitoring.** The improvement in the last few weeks of 2009 was partly due to seasonally strong public spending. Large expected disbursements of international program support in the first quarter may reduce borrowing needs and keep interest rates relatively low. While welcoming greater stability recently, the authorities acknowledged the potential for a return to greater interest rate volatility.

40. **Staff encouraged the BoL to examine new ways of smoothing liquidity and dampening interest rate volatility (LOI ¶16).** The BoL believes that liquidity conditions in Latvia are mainly influenced by external conditions, exogenous shocks and public confidence, with interest rates moving to equilibrate the resulting flows. The existing monetary framework provides scope for smoothing liquidity fluctuations through the active use of monetary instruments, and the BoL stands ready to use them as necessary. However, the BoL stressed that in times of economic strain its adherence to the quasi-currency board could imply accepting greater interest rate fluctuations. Staff encouraged the BoL to explore introduction of longer-term instruments to mop up banks' excess liquidity and to find ways to encourage reactivation of the interbank market (the volumes in which have declined significantly). Staff also stressed the importance of maintaining the operational and financial independence of the BoL, as this would uphold the credibility of the currency board.

41. **Improved domestic liquidity and the stabilization of global markets should allow the State Treasury to lessen its reliance on short-term domestic debt (LOI ¶14).** It has already retired its entire stock of one-month T-bills, expanded issuance of 6-month and 12-month bills, and is considering resuming two- and three-year bond issuance. The

authorities are also considering a return to international debt markets. To prepare for this, they will review their medium-term debt strategy, including the need to repay significant amounts of program funds over the medium term.

E. Private Debt Restructuring

42. **The authorities have continued to strengthen market-based approaches to debt restructuring (LOI ¶24–25).** Guidelines for corporate workouts were established in mid-August. Amendments to the Insolvency Law and other credit enforcement laws, which will streamline liquidation and foreclosure procedures, and establish a new insolvency regime for individuals, were submitted to Parliament in November and are expected to become effective in February 2010. The authorities and the legal profession have arranged seminars to raise awareness of the new framework. In conjunction with earlier reforms, such as increased incentives for out-of-court restructuring, the latest initiatives will help reduce the risk of debt overhang impeding the recovery.

43. **The authorities are considering launching a scheme that uses government guarantees to promote household mortgage debt restructuring.** Under the scheme**,** banks would freeze at least 20 percent of the restructured loan—zero interest rate and no principal repayments—for a period of two years. During this time, the state would guarantee monthly payments of up to 90 percent of the restructured loan (but would obtain a priority claim on the borrower if the guarantee is called). If the borrower pays on time, banks would write off 50-100 percent of the frozen part of the participating loan. To make better use of public resources, the scheme will be limited to homeowners with mortgages up to L100,000; even so, the scheme would do little to benefit the poor, as their debts are mostly consumer credit. The program gives the authorities room to cover the cash costs of the scheme (estimated L31 million in 2010 in the worst case, but the government should be able to claim back much of this later). The authorities are still considering whether or not to implement the current scheme, or to introduce improvements.

IV. Program Issues

44. **The authorities have requested an extension of the arrangement and a rephasing of undisbursed amounts.** Though the program appears over-financed at present (the NIR floor was exceeded by some margin), the balance of payments faces considerable risks over the medium term, which the extension through December 22, 2011 should help address. The extension should also allow the program to support the incoming government following the October 2010 election with a focus on the needed medium-term fiscal adjustment. It would cover preparation of the 2012 budget, which is intended to reduce the general government deficit below 3 percent of GDP, necessary for the program goal of euro adoption. The program's NIR targets have been raised to lock in most of the recent overperformance, while still leaving a buffer of around €400 million in case of shocks. Access under the arrangement will remain unchanged despite the emergence of current account surpluses, given the

considerable risks to the capital account that remain. After the purchase associated with this review, the remaining purchases will be rephased in seven roughly equal disbursements through the remainder of the arrangement (Tables 14–15). Other program partners are likely to extend their involvement and financial support too.

45. **The government has taken steps to address the recent Constitutional Court opinion that international loan agreements were of sufficient importance to Latvian society that they needed the approval of Parliament**. Following Minister Repse's presentation of a report summarizing the Fund arrangement and the LOI (and also the EC loan and its Supplementary Memorandum of Understanding), Parliament voted on January 21 to approve the €7.5 billion international support package and to allow the Government to sign the Letter of Intent for the Second Review. Deciding on procedures that would respond appropriately to the Court's concerns contributed to a slight delay in completing this Review.

46. **Although substantial progress has been made, as described in the First Review, program risks remain:**

- **The authorities' strategy of restoring external competitiveness without a nominal depreciation remains challenging**. Although real exchange rate adjustment is underway, the chosen path is difficult and entails depressed demand and low growth for some time, and external demand is dependent on a still uncertain recovery in the global economy.

- **This strategy and the economic downturn have resulted in a substantial increase in unemployment and intense social hardship**. Considerable fiscal adjustment is unavoidable given the size of the structural deficit and sharp fall in the level of output, and the authorities argue that alternative strategies would have been even worse. However, they could have made more use of the room in the program for increased social safety net spending. Should social unrest develop, it could make the already difficult fiscal and political situations worse.

- **Further fiscal adjustment will likely prove challenging**. Pressures for tax cuts or increased spending will likely intensify ahead of the October 2010 elections. Over the medium term, identifying and implementing the sizeable fiscal measures needed to fulfill the Maastricht criteria will be difficult, especially as the most promising areas for savings have likely already been tapped. The Constitutional Court's ruling against the 2009 pensions cuts has also complicated fiscal adjustment, both in terms of direct fiscal cost and because a high standard must be met to ensure that pension reforms are constitutional. The Constitutional Court is also considering the legality of cuts to parental benefits and to judges' salaries: while there would be little immediate fiscal cost should these be reversed, other spending cuts might then also come into doubt, calling into question the authorities' ability to deliver on their strategy of budget adjustment.

- **The political situation will likely remain difficult at least through the October 2010 parliamentary elections**. One of the key coalition parties has openly expressed dissatisfaction with the contents of the Letter of Intent. Instead it argues that tax cuts and spending increases are needed to boost the economy and reduce the deficit. Rumors of a change in government are commonplace.

- **Although financial volatility has fallen, conditions remain fragile and prospects for the banking system difficult**. Only limited progress has been made in resolving and strengthening Parex and MLB. Low growth and rising unemployment will increase NPLs and risks to the financial sector. Funding and liquidity risks need to be carefully monitored and managed.

- **With the output gap expected to remain negative for several years, deflation may be even deeper than currently projected**. This would support an improvement in competitiveness and growth, but would also exacerbate fiscal and debt sustainability challenges. For example, the government may find it difficult to reduce nominal wages, pensions, and budget allocations further.

- **Finally, having a clear path to euro adoption is key to the success of the program**. If the authorities meet the Maastricht criteria, it will be critical that no obstacles are set up to prevent Latvia from euro entry.

47. **Staff believes that the program leaves Latvia in a position to fulfill its substantial obligations to the Fund in a timely manner (Table 16)**. Fund credit outstanding would peak in 2011 at 10 percent of GDP (which is among the highest levels for Fund borrowers) or about 32 percent of gross reserves. Payments would peak in 2013 at about 2.8 percent of GDP. Gross external debt rises to 183 percent of GDP (also high relative to other Fund borrowers), but is then projected to fall steadily from 2012 onwards; net external debt (at around 60 percent of GDP) is considerably lower and is projected to fall with successive current account surpluses.

V. Staff Appraisal

48. **The sharp economic downturn is starting to bottom out, but recovery has not yet begun and sizable risks remain.** The rebound in the rest of the world is only partially offsetting the drag on output from fiscal consolidation, labor market shedding, and rising private sector savings. The economy looks set to stabilize, but with a structural unemployment rate in double digits and, compared to the previous boom, a much lower rate of potential growth. Despite this, the authorities have been slow to make use of the scope in the program for extra social safety net spending. Successful adjustment will likely entail

falling wages and prices for at least two more years, which will erode tax revenues and undermine loan quality. Thus medium-term challenges remain considerable.

49. **The authorities have adapted their policies to changing circumstances and have improved program implementation.** They have implemented their June 2009 supplementary budget almost in full (some additional amounts for health care were deemed necessary toward the end of the year), despite difficult circumstances, and look likely to achieve a deficit considerably below the First Review ceiling. This has increased their chances of meeting the Maastricht criteria by 2012, and so brought closer the program's exit strategy of euro adoption. Except for the end-December PCs on the fiscal balance and public guarantees—for which data are not available but which seem likely to have been met—all quantitative PCs for end-September and end-December have been met (in part because of the considerable buffers built into the program targets). The end-September indicative ceiling on the wage bill was also met with a sizeable margin. Although the continuous PC on external arrears was missed, given that the amount was minor and the authorities are taking corrective action to resolve this shortly, staff supports their request for a waiver.

50. **The priority now is to implement the 2010 budget and lock in expenditure cuts following progress in 2009 towards limiting the deficit.** The budget's L500 million of tax and expenditure measures represent important progress on still-large adjustment needs. While the budget's composition is not without problems, the adjustment is significant and even impressive given the challenges of reaching agreement within a coalition government with elections less than one year away. In the run-up to the 2010 election, it will be critical to avoid tax cuts or spending increases as this would only increase the need for further measures over the medium term and jeopardize the recent stabilization in financial markets. If the economy and tax revenues recover faster than expected, the authorities should make faster progress on their goals by saving any such windfall revenues.

51. **Attaining the Maastricht criteria will require determined fiscal policy implementation over the medium term.** The next government will inherit a still-difficult fiscal situation, reflecting the impact of deflation and likely slow growth on revenue, and the expiration of temporary measures. It will therefore need to implement another package of fiscal adjustment measures in 2011–12; the prudent approach will be to frontload this adjustment to make sure that the fiscal deficit will be brought safely below 3 percent of GDP by 2012, so as to meet the Maastricht criteria.

52. **Very few countries have managed to implement the adjustment Latvia has already undertaken: doing even more is likely to be extremely politically challenging**. Given the very large adjustment already undertaken and the likelihood that the easiest measures have already been done, it will be increasingly difficult to identify further measures. A planned public review of social spending supported by the World Bank will help identify future structural reforms to deliver these improvements. The authorities should accelerate technical work on reforms that have already been identified, including finding

savings in pensions (as pensions have risen rapidly in recent years and account for a fifth of overall government spending) and further rationalization of public sector wages. While urgent, this work also needs to be done carefully—not only for its own sake, but also so that the authorities can demonstrate that they have considered a wide range of options and have deliberated fairly, to make sure that any future fiscal adjustment respects the Constitution. This work will be critical for the success of the 2011 and 2012 budgets in delivering medium-term fiscal adjustment, debt sustainability, and euro adoption.

53. **Prospects for recovery depend on further stabilization of the banking sector.** Banks have made substantial capital injections. However, with non-performing loans likely to continue rising, the FCMC needs to maintain a cautious approach to bank supervision, rigorously enforcing their revised regulations and further strengthening their supervisory tools. The pending launch of a limited mortgage debt restructuring scheme is appropriate, since this could help encourage needed loan modifications, benefiting both households and the banking system. Any legislative changes affecting the banking sector should be carefully considered to avoid undermining confidence and jeopardizing recovery. Maintaining the existing strong institutional and financial independence of the BoL and the FCMC is crucial for monetary and financial stability.

54. **The authorities need to speed up the restructuring of the domestic state-owned banks.** Early action to devise comprehensive restructuring plans that address banks' non-performing assets will help maximize value while reducing risks to the government and economy. Any specialized asset management companies should adhere to best practice on governance, functions and funding. The authorities' continued good-faith efforts to facilitate the settlement of limited arrears arising from the partial deposit freeze at Parex Bank are welcome.

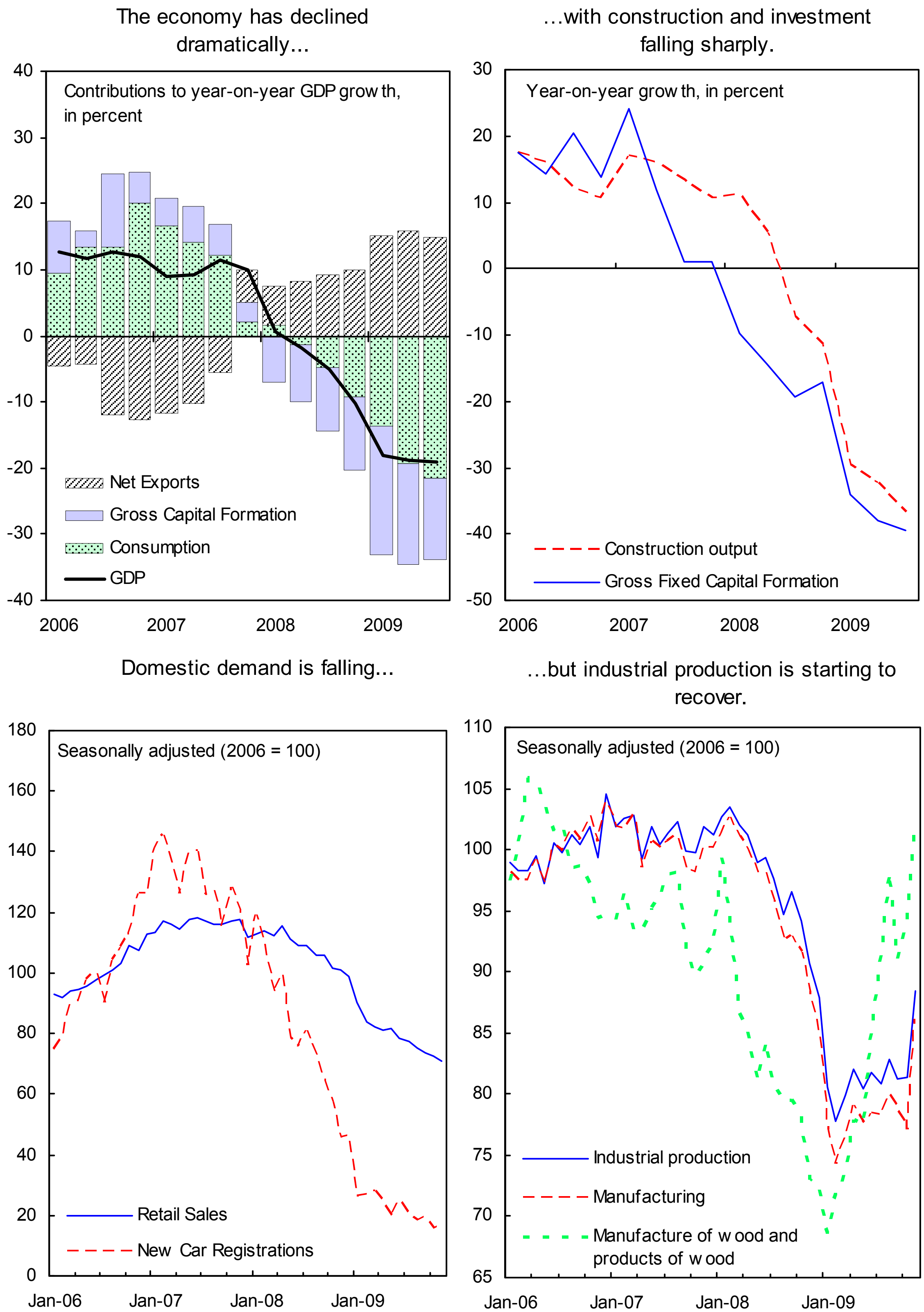
55. **The fixed exchange rate to the euro will continue to anchor monetary policy.** As the economy and financial markets stabilize, liquidity management will remain important. Volatility in interest rates and lats liquidity is inevitable under a quasi-currency board. But refinements to monetary policy to moderate the impact of fiscal policy might dampen some of these swings, and so support confidence and financial stability. Staff encourages the BoL to consider a more active use of its instruments, but consistent with the choice of a quasi-currency board arrangement.

56. **Risks to the program, although still considerable, have diminished**. Staff assesses the program as fully financed for the next 12 months, as the rising current account surplus will likely offset capital outflows, and financial market conditions have calmed considerably in the past six months. Significant contingent drains remain, however, which effective restructuring of domestic state-owned banks could lessen. The main immediate uncertainty is whether the current government will be able to sustain fiscal adjustment in an election year when unemployment is high and rising. There is also a risk that poorly designed adjustment could slow growth or prove unsustainable, either by not being implementable or by later

being ruled unconstitutional. To help mitigate risks, the authorities should, in conjunction with the World Bank, continue to assess the adequacy of the social safety net and, if needed, take steps to strengthen it, using the room provided for this under the program.

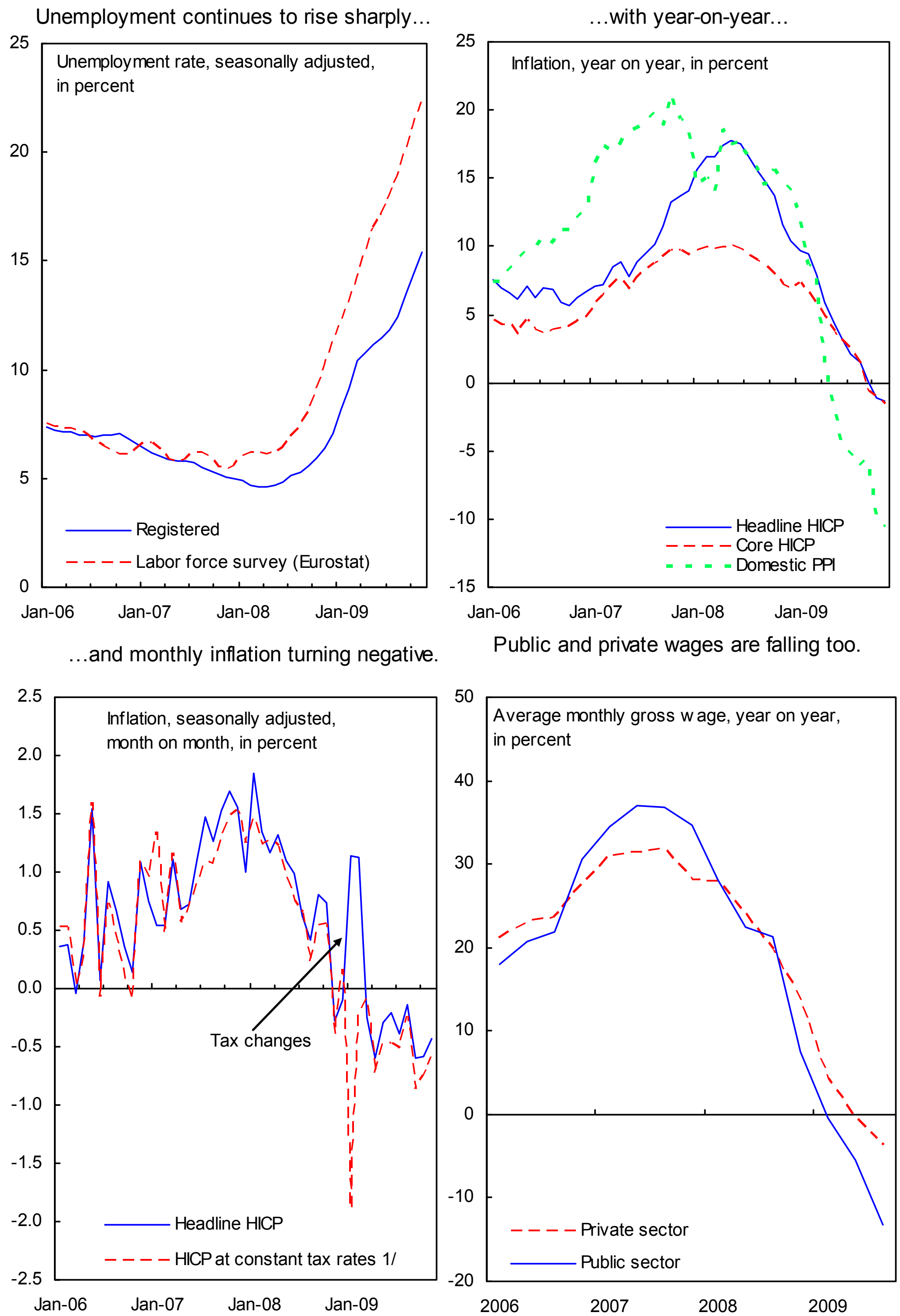
57. **Continued implementation of the economic program supported by the Fund arrangement should help Latvia overcome the current crisis and lay the foundations for recovery.** Staff supports the authorities' request for completing the Second Review and financing assurances review on the basis of Latvia's performance under the arrangement, and the policy commitments specified in the Letter of Intent. Staff also recommends granting a waiver for nonobservance of the performance criterion on external payments arrears and a waiver of applicability of end-December performance criteria on the adjusted fiscal balance and on public guarantees (which are expected to be met, though final data are not available), as well as approval of the authorities' request for extension of the arrangement to December 22, 2011 and a rephasing of remaining purchases under the arrangement.

Figure 1. Latvia: Real Sector, 2006-09



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

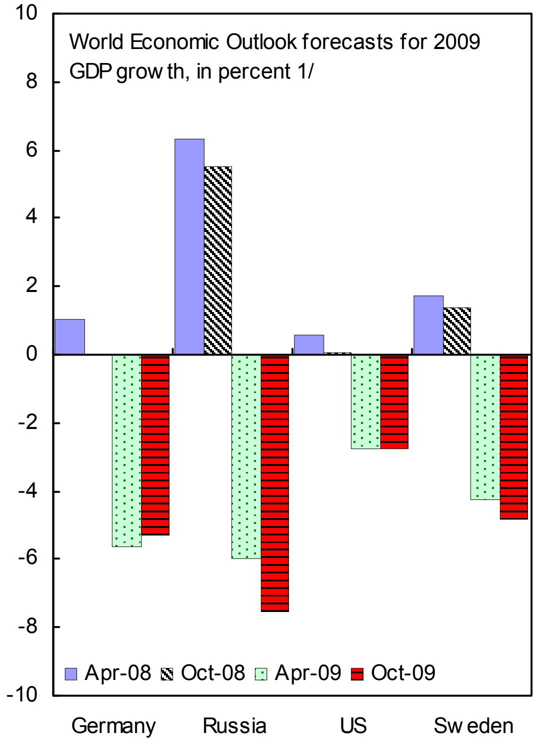
Figure 2. Latvia: Labor Markets and Inflation, 2006-09



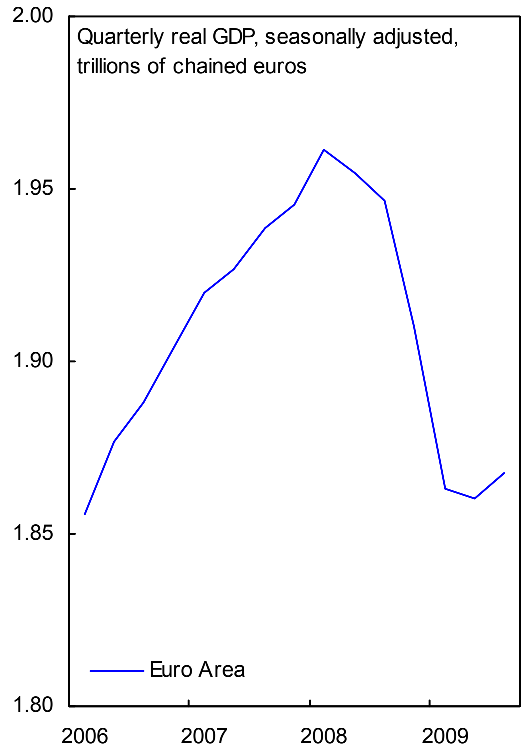
Sources: Eurostat, Haver, Latvian Central Statistical Bureau, Fund Staff Calculations.
1/ HICP at constant tax rates is estimated as HICP, excluding the influence of indirect taxes (excise, VAT and car registration) on consumer prices. It assumes immediate and complete pass-through, and so likely overestimates the effect of taxes on HICP.

Figure 3. Latvia: Competitiveness and the Global Outlook, 2006-09

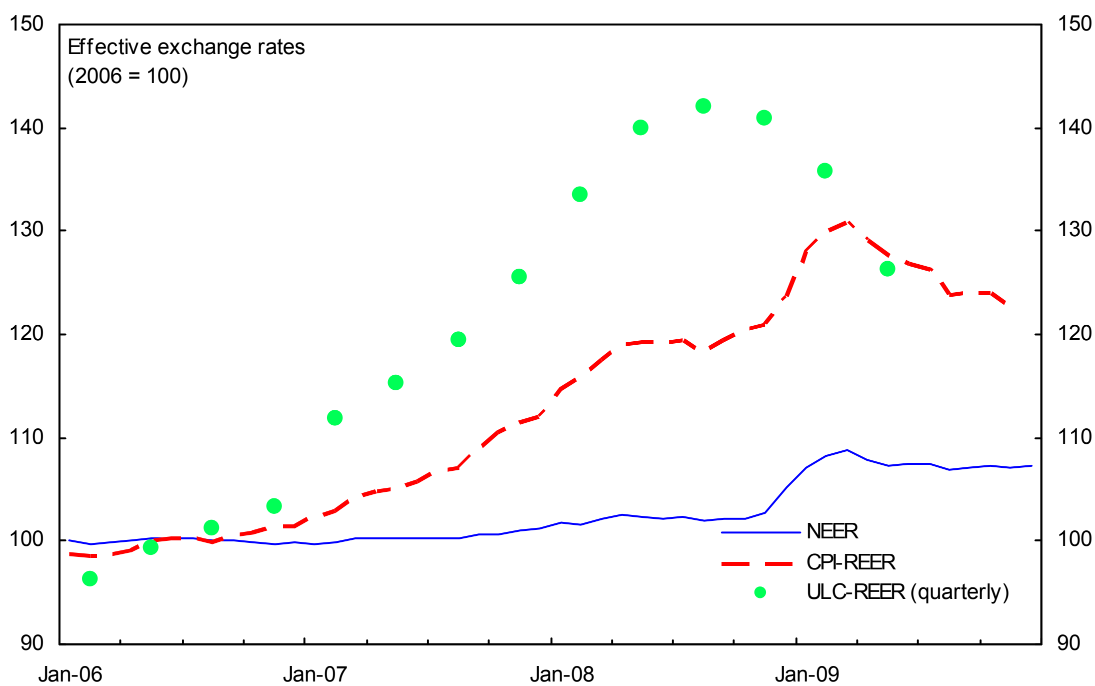
Although the outlook in trading partners has repeatedly been revised downwards...



...Euro Area partners are starting to recover from recession...

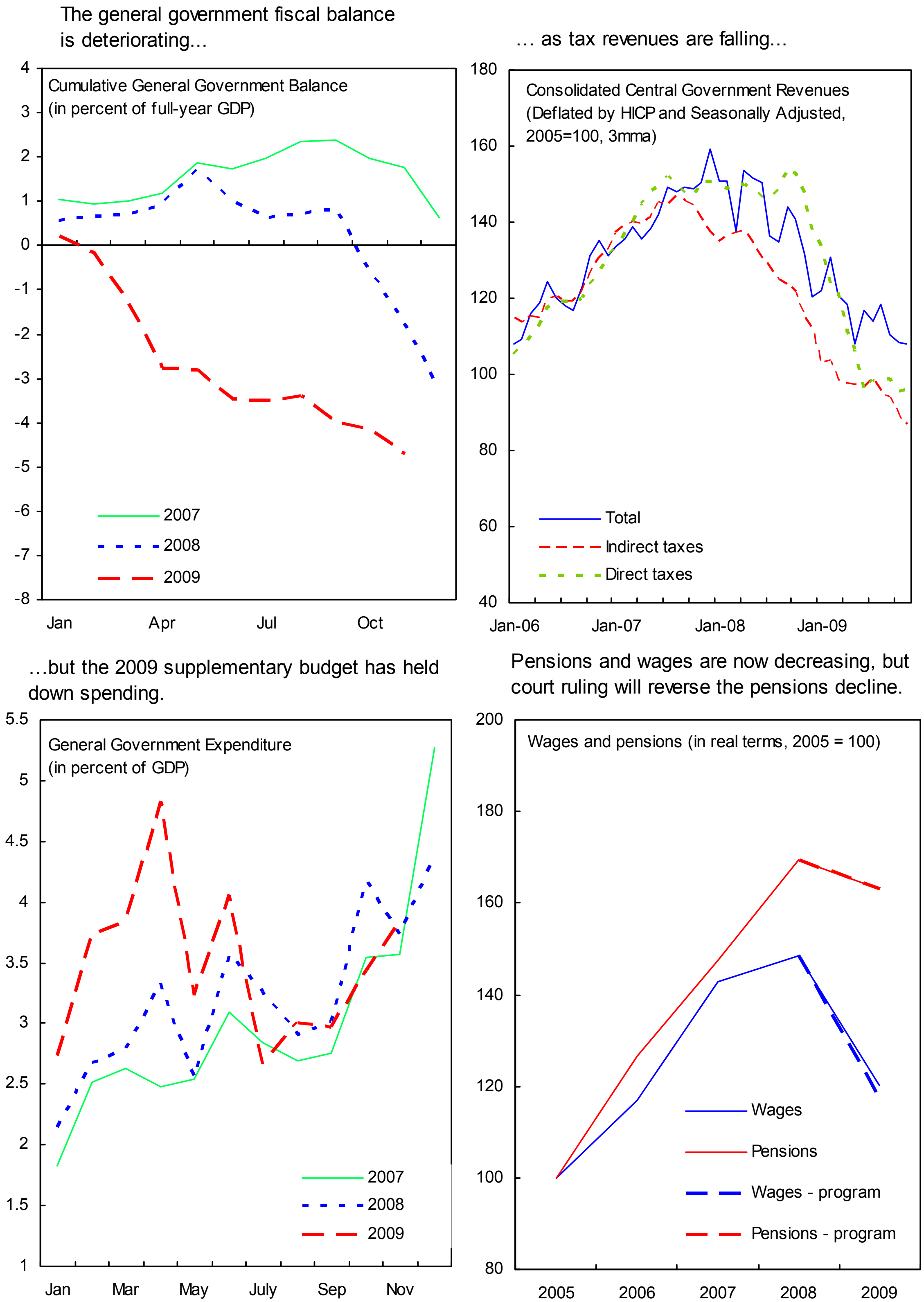


...and the real exchange rate is starting to depreciate.



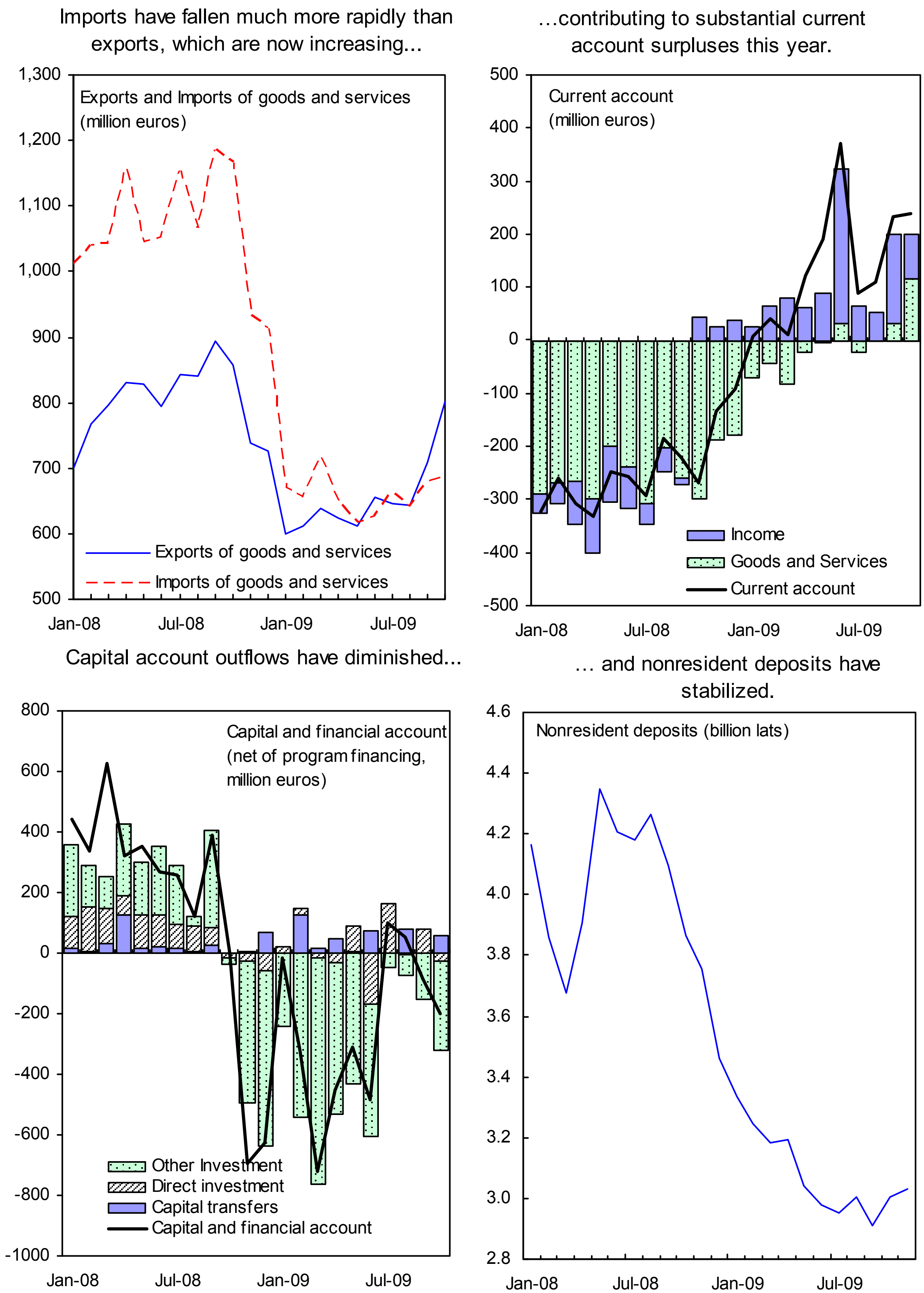
Sources: World Economic Outlook, Eurostat, Bank of Latvia, IMF Staff Calculations.
1/ Dates denote different vintages.

Figure 4. Latvia: Fiscal Sector, 2005-09



Source: Fund Staff estimates and calculations.

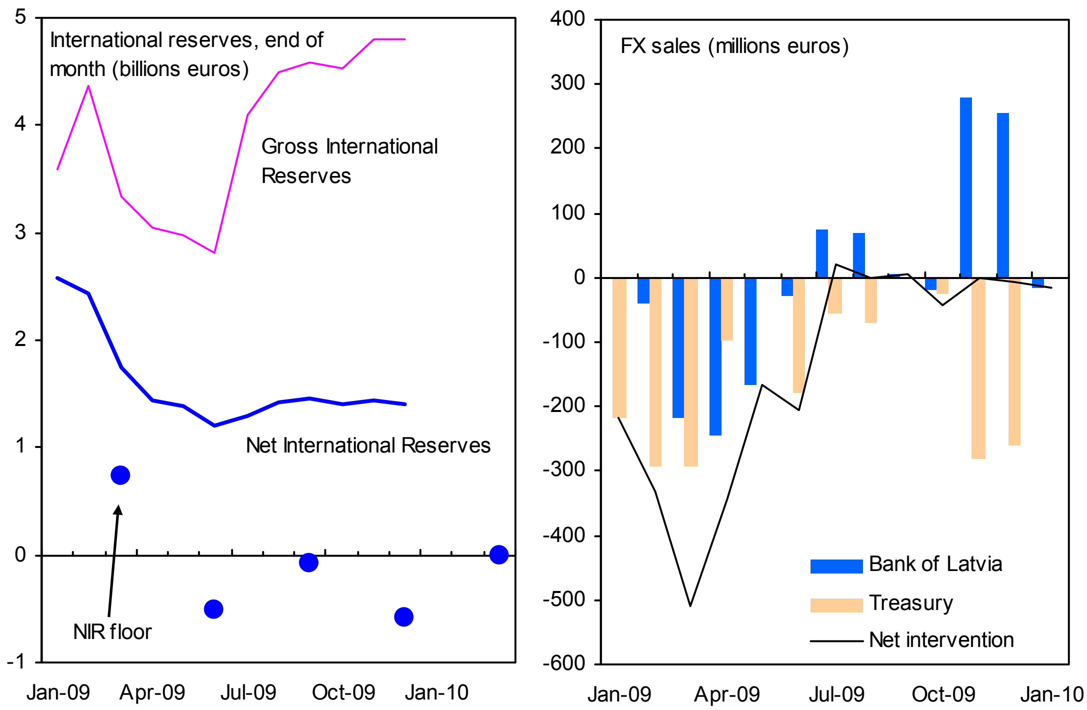
Figure 5. Latvia: Balance of Payments, 2008-09



Source: Bank of Latvia and staff calculations.

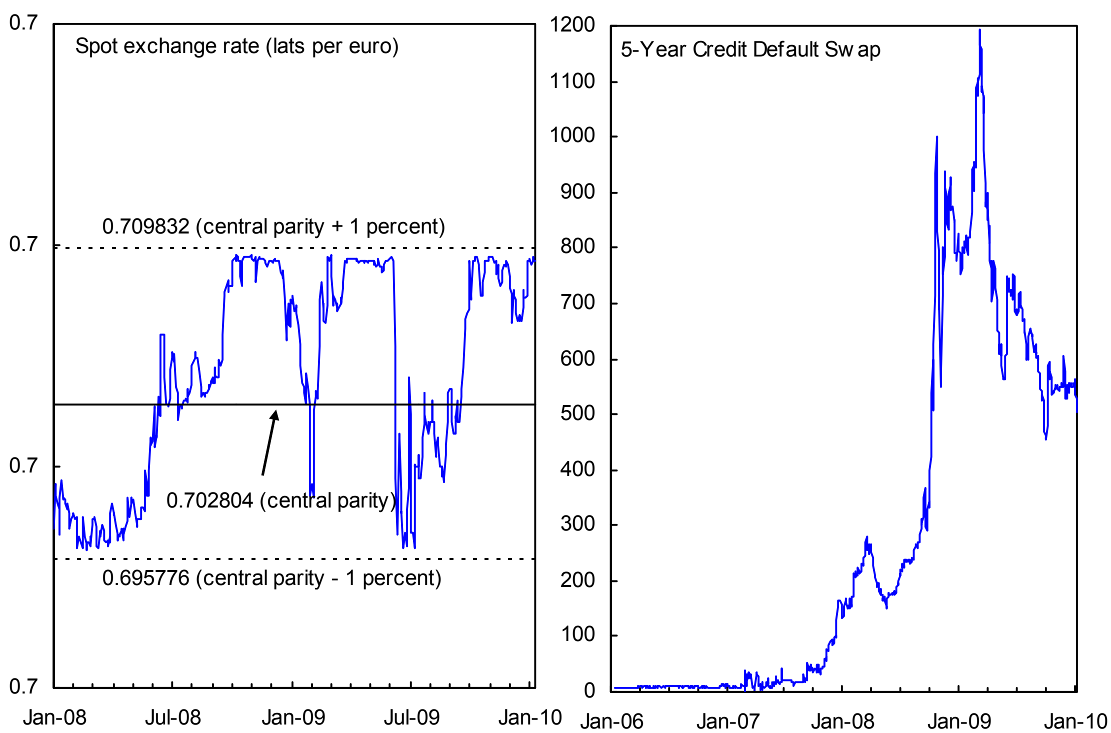
Figure 6. Latvia: Net International Reserves and FX Market Developments, 2006-10

NIR has stabilized recently with limited net interventions given more stable financial conditions after high volatility in the first half of the year.



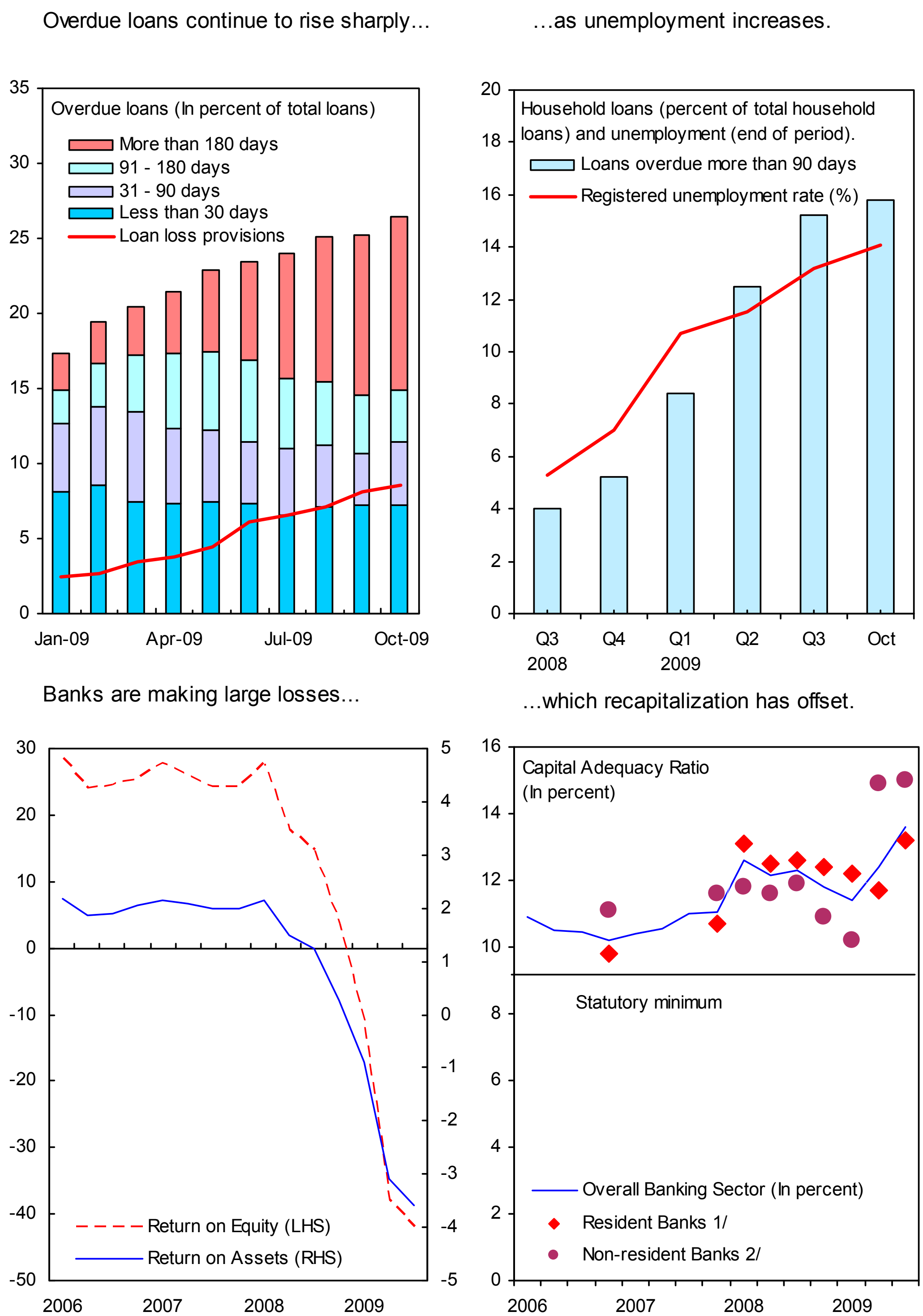
The lats is back in the depreciated end of the band...

...but CDS spreads are declining



Source: Bank of Latvia and Bloomberg

Figure 7. Latvia: Banking Sector Developments, 2006-09

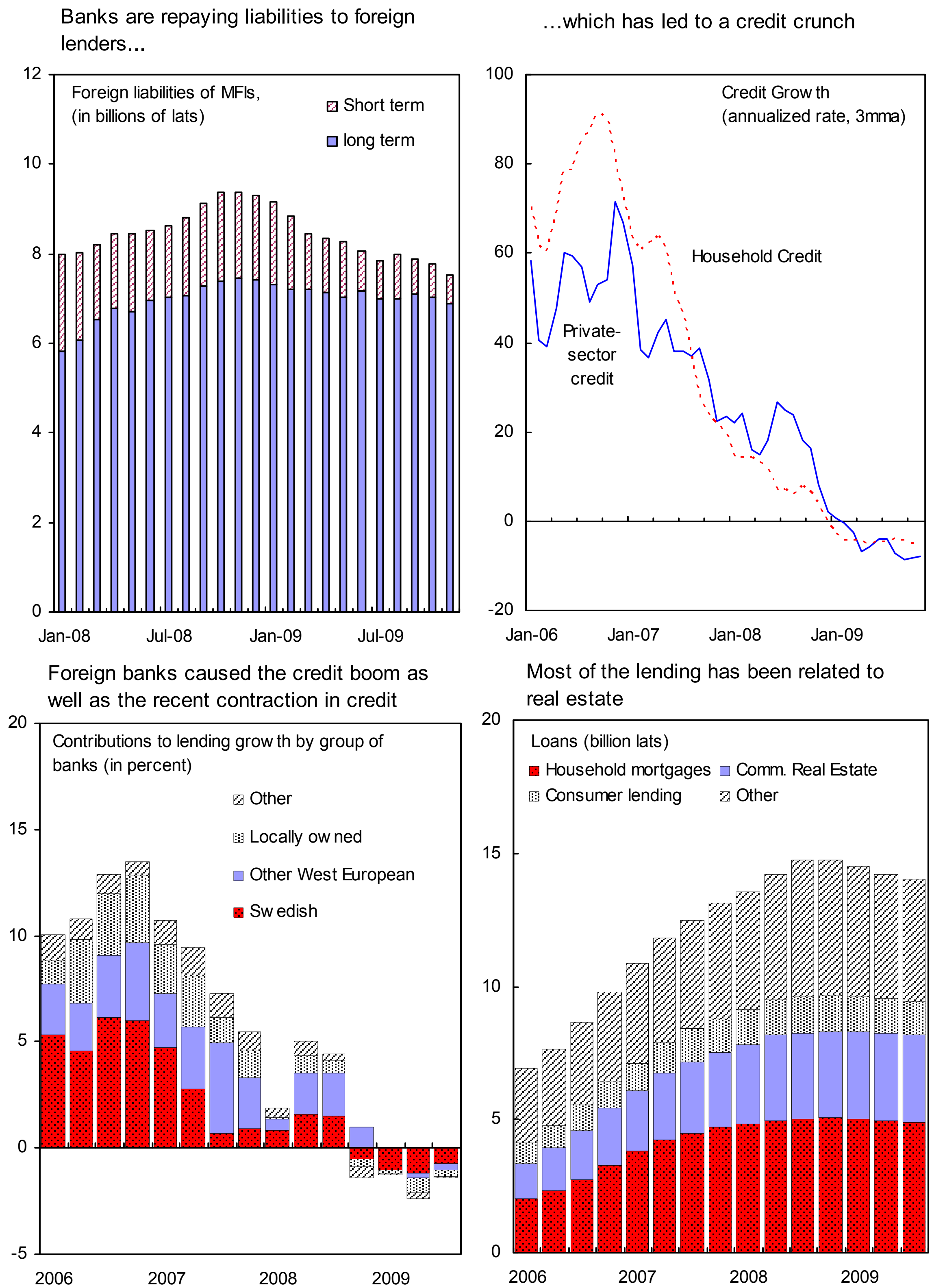


Sources: FCMC, Bank of Latvia, Latvian Central Statistical Bureau, and IMF staff Calculations.

1/ Banks (mainly foreign owned) dealing primarily with Latvian residents.

2/ Banks dealing primarily with non-residents of Latvia.

Figure 8. Latvia: Bank Credit, 2006-09

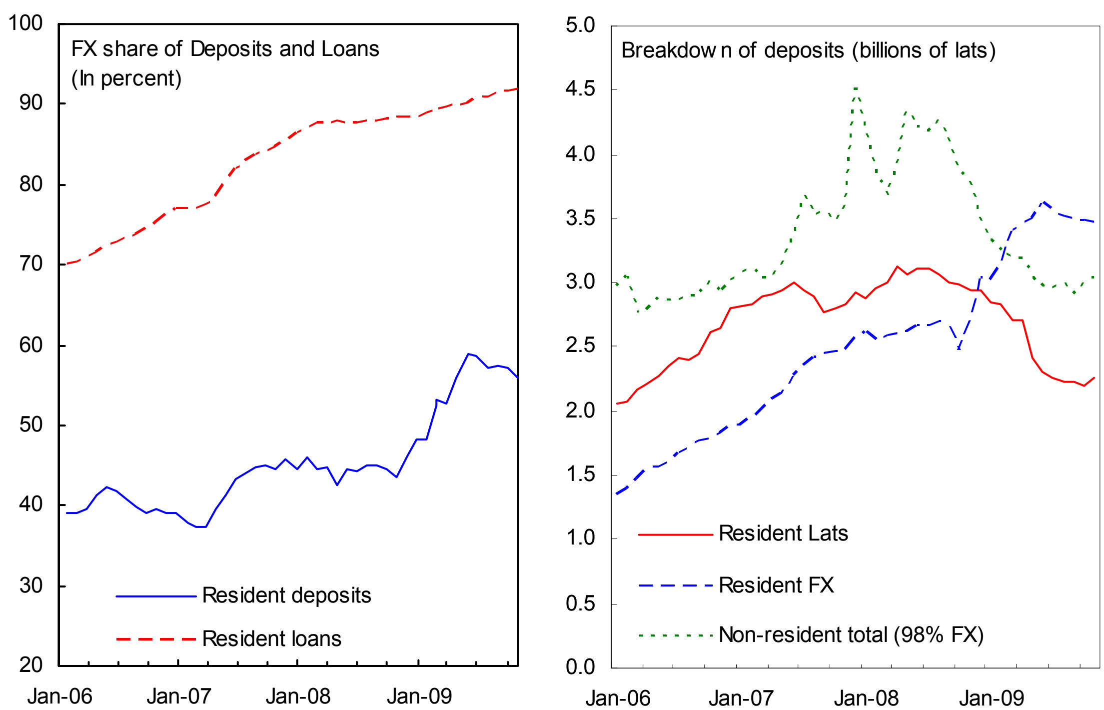


Source: Latvian Authorities, Fund Staff Calculations.

Figure 9. Latvia: Interest Rates and Euroization, 2006-09

Deposit and lending rates in euros have fallen in line with Euribor. Lats interest rates have been more volatile but have started to decline recently.

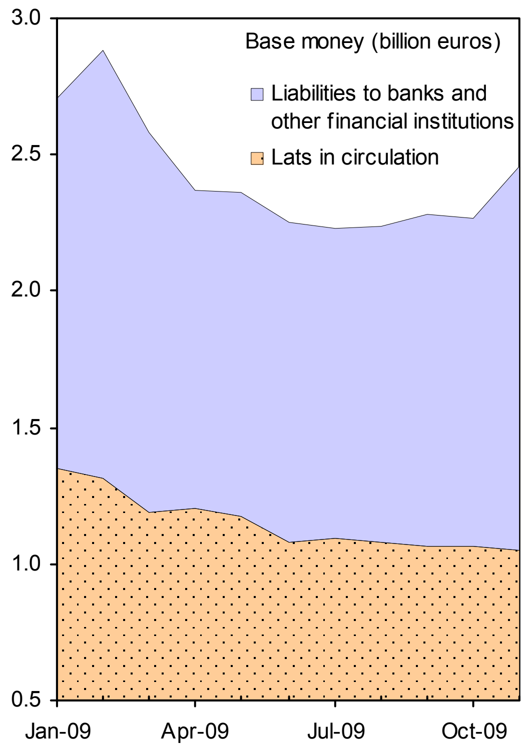
Euroization has increased, especially in the first half of 2009.



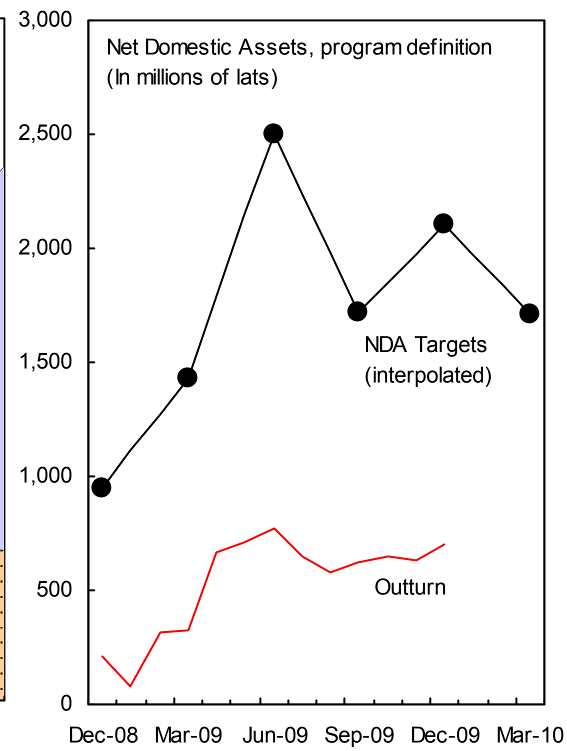
Source: Bank of Latvia

Figure 10. Latvia: Monetary Developments, 2008-09

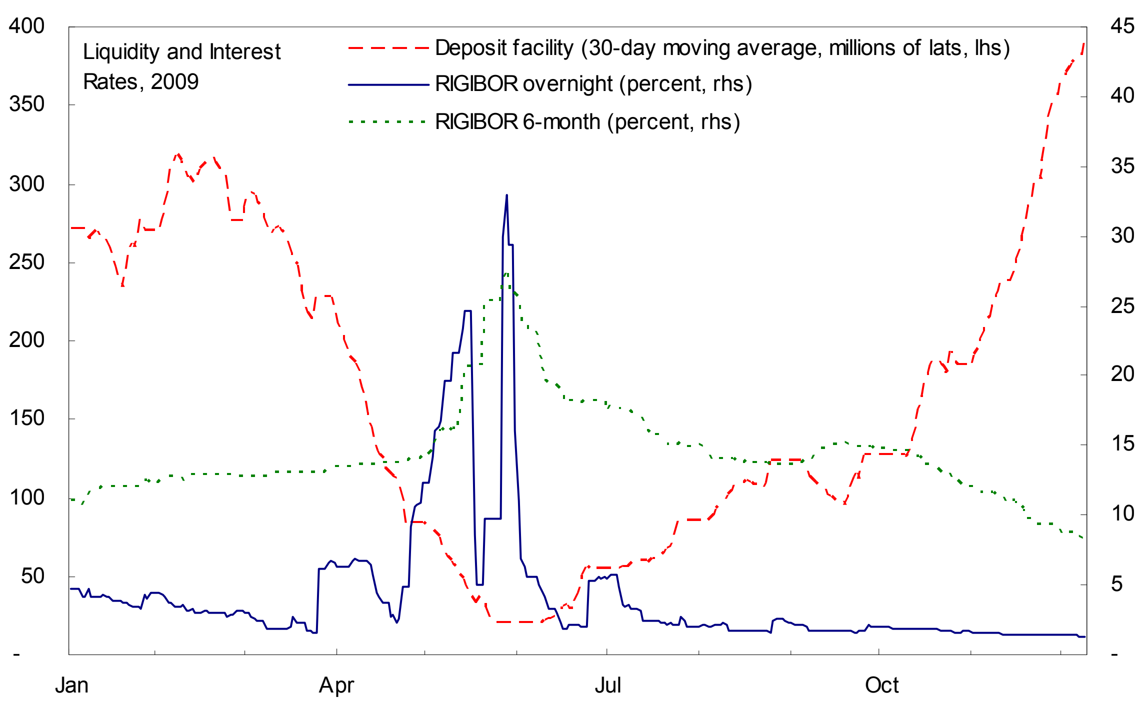
Lats in circulation have fallen more than 20 percent since the beginning of the year



The authorities have easily met their NDA targets

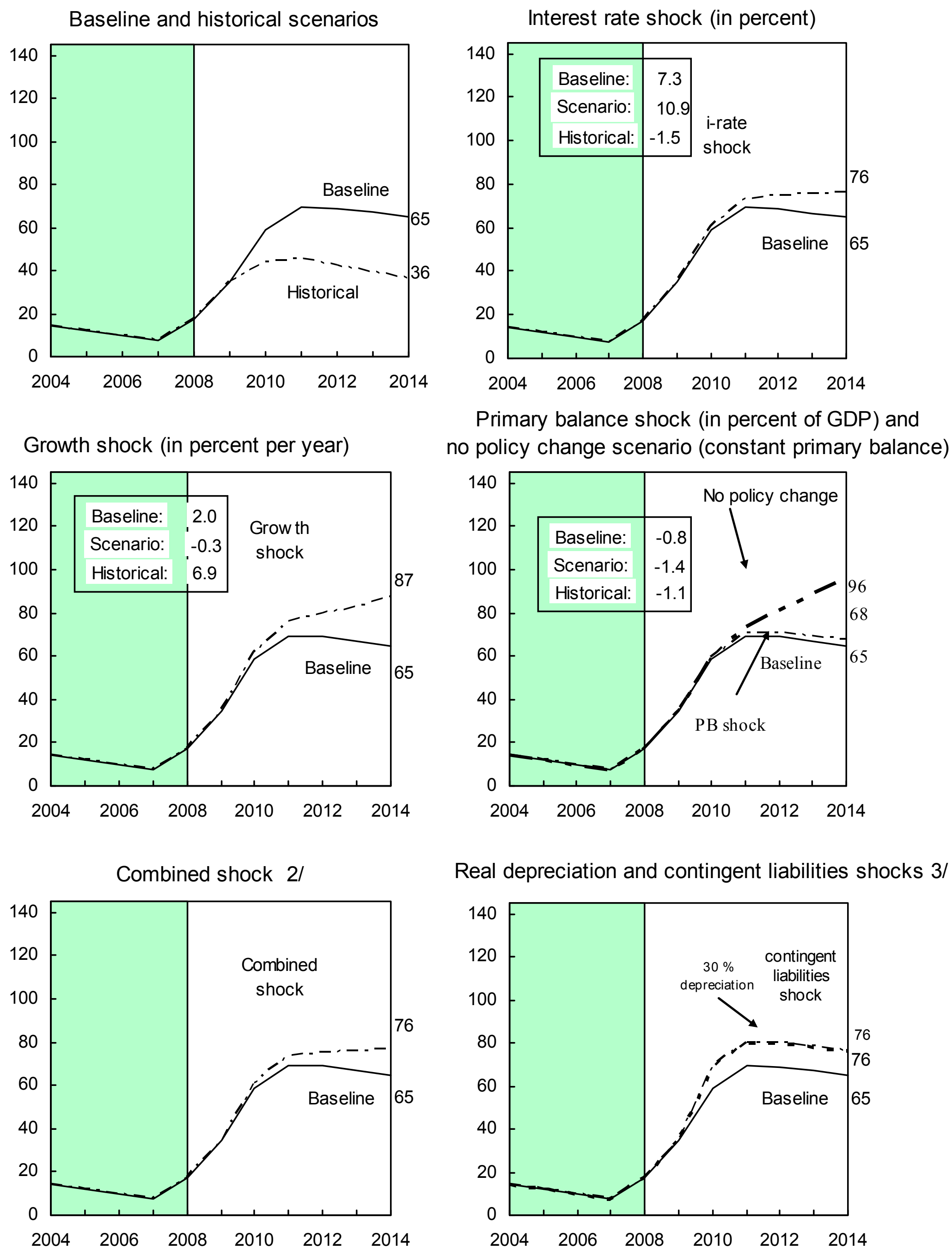


Interest rates have fallen while banks' liquidity has risen.



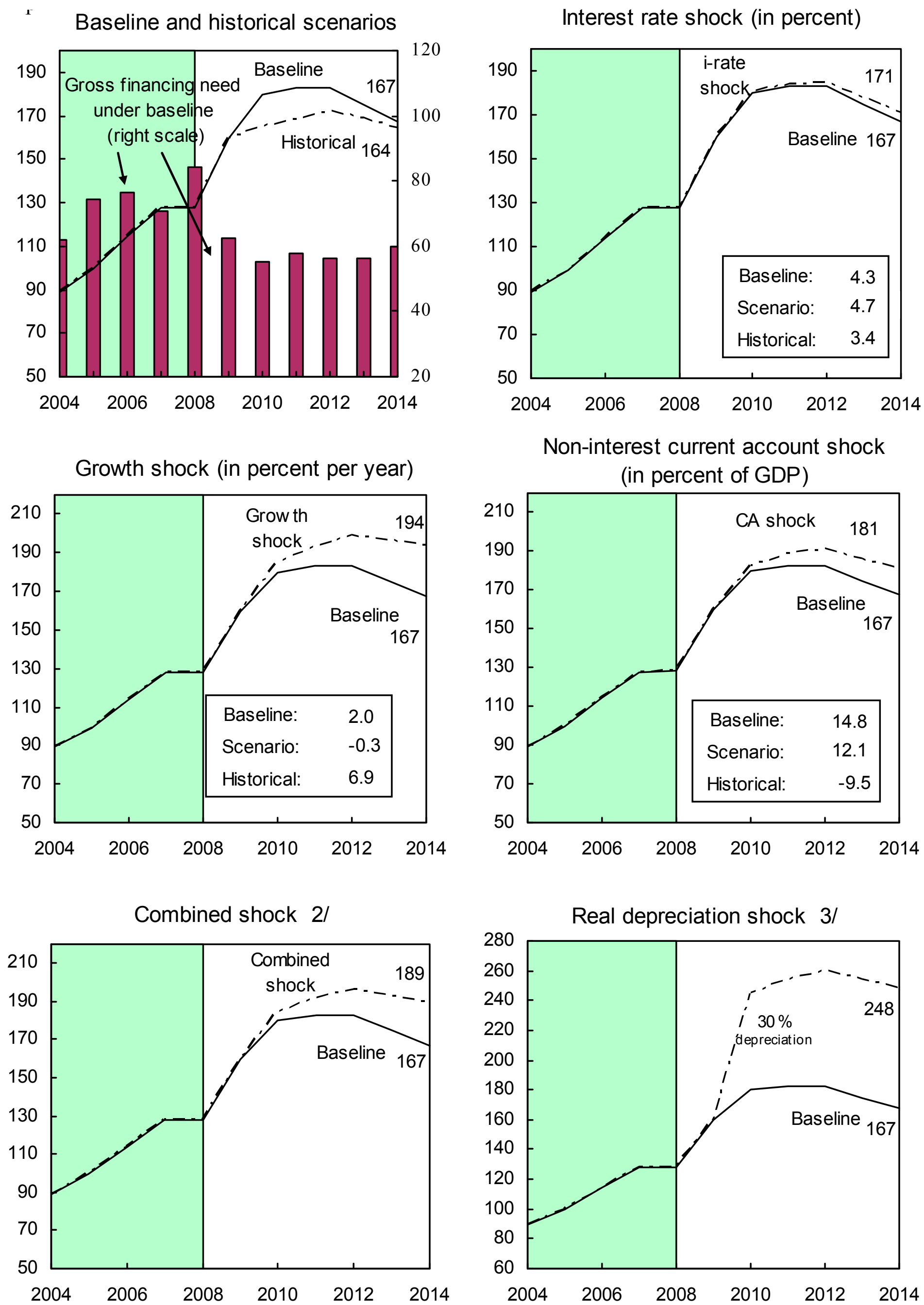
Source: Latvian Authorities, Reuters, and Fund Staff Calculations.

Figure 11. Latvia: Public Debt Sustainability: Bound Tests 1/
(Staff projections; Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also show n.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, grow th rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, w ith real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 12. 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 2009.

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

	2007	2008	2009		2010	
			First Rev.	Proj.	First Rev.	Proj.
National accounts	(percentage change, unless otherwise indicated)					
Real GDP	10.0	-4.6	-18.0	-18.0	-4.0	-4.0
Private consumption	14.8	-5.5	-25.3	-22.0	-8.0	-10.0
Public consumption	3.7	1.5	-12.0	-9.0	-10.0	-9.0
Gross fixed investment	7.5	-15.6	-29.0	-34.0	-11.5	-10.0
Stockbuilding (contribution to growth)	1.6	-3.7	0.0	-3.5	0.0	1.5
Exports of goods and services	10.0	-1.3	-15.5	-17.5	1.3	1.5
Imports of goods and services	14.7	-13.6	-28.5	-35.0	-10.0	-9.9
Nominal GDP (billions of lats)	14.8	16.3	13.0	13.1	11.9	11.9
Nominal GDP (billions of euros)	21.0	23.1	18.5	18.6	17.0	17.0
GDP per capita (euros)	9,209	10,187	8,163	8,224	7,521	7,526
Savings and Investment						
Gross national savings (percent of GDP)	20.0	20.0	35.8	28.7	36.1	30.5
Gross capital formation (percent of GDP)	40.4	31.5	29.2	18.7	27.8	18.9
Private investment (percent of GDP)	34.9	26.4	24.5	14.9	22.6	14.9
HICP inflation						
Period average	10.1	15.3	3.1	3.3	-3.5	-3.7
End-period	14.0	10.4	-1.7	-1.4	-2.6	-3.3
Labor market						
Unemployment rate (LFS definition; period average, percent)	6.2	7.8	15.8	17.5	17.4	20.0
Real gross wages	19.7	4.4	-14.6	-8.0	-4.7	-6.3
Consolidated general government 1/	(percent of GDP, unless otherwise indicated)					
Revenue	36.2	35.2	35.3	36.7	35.6	39.6
Expenditure and net lending	35.6	38.5	48.4	44.8	47.6	48.2
Basic fiscal balance	0.6	-3.3	-11.8	-8.1	-10.3	-8.6
Basic fiscal balance, excl. pension fund diversion	0.6	-3.3	-13.0	-9.3	-12.0	-10.3
General government gross debt	7.8	17.0	43.5	34.9	74.2	58.9
Money and credit						
Credit to private sector (percentage change)	34.0	11.8	-4.8	-5.3	…	…
Residents' FX deposits (billions of euros)	3.6	3.5	…	4.1	…	…
Residents' FX deposits (percent of broad money)	41.2	41.5	…	48.4	…	…
BoL refinancing rate (eop, percent, annualized)	6.0	6.0	…	4.0	…	…
Money market rate (one month, eop, percent, annualized)	6.8	13.3	…	2.7	…	…
Balance of payments						
Gross official reserves (billions of euros)	3.966	3.697	3.392	4.500	4.397	4.976
(In months of prospective imports)	3.7	5.7	6.3	7.6	7.6	8.1
(percent of broad money and non-resident deposits)	26.1	27.7	26.0	34.0	35.5	39.9
Current account balance	-22.3	-13.0	4.5	7.7	6.4	8.4
Trade balance	-23.9	-17.6	-8.3	-6.7	-5.6	-3.4
Exports of goods and services	41.4	41.6	36.6	41.6	32.2	46.3
Imports of goods and services	-61.9	-55.2	-38.0	-41.7	-31.8	-41.6
Gross external debt	127.7	128.0	159.6	159.9	171.3	180.1
Net external debt 2/	49.4	56.5	63.7	58.2	67.0	44.1
Exchange rates						
Lats per U.S. dollar (average)	0.513	0.478	…	0.506	…	…
(percent change, + denotes appreciation)	9.2	7.4	…	-5.4	…	…
REER (average; CPI based, 2000=100)	100.1	111.4	…	…	…	…
(percent change, + denotes appreciation)	8.0	11.2	…	…	…	…

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

1/ National definition. Includes economy-wide EU grants in revenue and expenditure.
2/ Gross external debt minus gross external debt assets.

Table 2. Latvia. Macroeconomic Framework, 2007–14

	2007	2008	2009	2010	2011	2012	2013	2014
			Projections					
			(percentage change, unless otherwise indicated)					
National accounts								
Real GDP	10.0	-4.6	-18.0	-4.0	2.7	3.8	4.0	4.0
Consumption	12.8	-4.4	-19.8	-9.8	0.0	2.3	3.0	3.1
Private consumption	14.8	-5.5	-22.0	-10.0	1.0	3.1	3.3	3.3
Public consumption	3.7	1.5	-9.0	-9.0	-4.0	-1.0	2.0	2.0
Gross fixed capital formation	7.5	-15.6	-34.0	-10.0	6.0	7.5	8.0	8.0
Exports of goods and services	10.0	-1.3	-17.5	1.5	5.0	5.6	5.5	5.5
Imports of goods and services	14.7	-13.6	-35.0	-9.9	2.4	5.6	7.0	7.0
Contributions to growth								
Domestic demand	15.1	-13.0	-31.4	-9.4	1.5	3.7	4.4	4.4
Net exports	-5.1	8.5	13.3	5.3	1.2	0.2	-0.5	-0.6
HICP inflation								
Period average	10.1	15.3	3.3	-3.7	-2.5	0.0	0.2	0.7
End-period	14.0	10.4	-1.4	-3.3	-0.5	0.4	0.2	0.9
Labor market								
Unemployment rate (LFS definition; period average, percent)	6.2	7.8	17.5	20.0	18.8	17.5	15.9	14.9
Employment (period average, percent change)	2.7	0.1	-10.8	-4.7	-0.7	0.5	0.6	0.6
Real gross wages	19.7	4.4	-8.0	-6.3	2.3	1.8	1.5	1.6
			(percent of GDP)					
Consolidated general government								
Revenues	36.2	35.2	36.7	39.6	38.1	36.8	35.6	35.7
Expenditure	35.6	38.5	44.8	48.2	44.6	40.4	37.6	37.4
Basic Balance	0.6	-3.3	-8.1	-8.6	-6.5	-3.6	-2.0	-1.7
Balance (including bank restructuring costs)	0.6	-7.5	-9.4	-16.4	-14.9	-3.6	-2.0	-1.7
Gross debt	7.8	17.0	34.9	58.9	69.3	69.0	66.9	64.8
Saving and investment								
Domestic saving	20.0	20.0	28.7	30.5	32.3	32.6	32.1	31.8
Private	13.0	16.5	31.7	34.5	34.0	31.2	29.4	28.9
Public 1/	7.0	3.5	-3.0	-4.0	-1.7	1.5	2.7	2.9
Foreign saving 2/	20.4	11.5	-9.9	-11.6	-12.0	-11.2	-9.4	-8.0
Investment	40.4	31.5	18.7	18.9	20.3	21.5	22.7	23.9
Private	34.9	26.4	14.9	14.9	16.2	17.6	19.4	20.6
Public	5.5	5.1	3.8	4.0	4.0	3.9	3.3	3.3
External sector								
Current account balance	-22.3	-13.0	7.7	8.4	8.8	8.2	6.3	4.8
Net IIP	-74.5	-78.2	-91.8	-89.1	-76.6	-62.4	-50.3	-40.1
Gross external debt	127.7	128.0	159.9	180.1	182.8	182.8	175.0	167.3
Net external debt 3/	49.4	56.5	58.2	44.1	23.5	14.5	0.0	-12.4
Memorandum items:								
Gross official reserves (billions of euros)	4.0	3.7	4.5	5.0	5.3	6.1	7.1	8.3
Nominal GDP (billions of lats)	14.8	16.3	13.1	11.9	12.0	12.5	13.0	13.7
Nominal GDP (billions of euros)	21.0	23.1	18.6	17.0	17.0	17.8	18.5	19.4

Sources: Latvian Authorities and IMF staff estimates.

1/ Includes 2nd pillar contributions.

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

3/ Gross external debt minus gross external debt assets.

Table 3. Latvia: General Government Operations, 2008-12

	2008	2009		2010			2011	2012
		First Rev.	Proj.	First Rev.	Baseline	Proj. 1/	Proj.	
				(millions of lats)				
Total revenue and grants	5,727	4,589	4,796	4,244	4,436	4,717	4,562	4,586
Tax revenue	4,737	3,352	3,490	3,211	3,074	3,308	3,271	3,262
Direct Taxes	3,005	1,991	2,138	1,945	1,877	2,098	2,081	2,037
Corporate Income Tax	503	185	194	82	77	77	79	80
Personal Income Tax	1,029	721	719	858	676	831	844	863
Social Security Contributions	1,402	1,015	1,154	885	1,063	1,100	1,065	997
Real Estate and Property Taxes	71	71	71	120	61	91	93	97
Indirect Taxes	1,733	1,361	1,351	1,266	1,197	1,209	1,190	1,225
Non Tax, self-earned and other revenue	559	674	678	433	536	584	506	538
EU and miscellaneous funds	431	562	629	600	825	825	786	786
Total expenditure 2/	6,267	6,279	5,849	5,673	5,740	5,743	5,341	5,038
Current expenditure	5,523	5,734	5,419	5,558	5,274	5,335	5,448	5,525
Primary Current Expenditure	5,459	5,512	5,263	5,159	4,993	5,068	5,028	5,004
Remuneration	1,679	1,348	1,378	1,178	1,223	1,170	1,170	1,170
Goods and Services	934	696	725	671	702	652	638	638
Subsidies and Transfers	2,693	3,097	2,955	3,090	2,828	2,931	2,949	2,949
Subsidies to companies and institutions	1,296	1,208	1,284	1,208	1,198	1,141	1,223	1,223
E.U. funds related subsidies	590	656	740	711	642	642	734	734
Social Support	1,385	1,875	1,657	1,870	1,616	1,775	1,712	1,712
Pensions	954	1,055	1,055	1,073	1,056	1,230	1,166	1,166
Other	430	820	602	797	559	546	546	546
International cooperation	12	14	14	12	14	14	14	14
Payments to EU budget	154	153	154	119	140	140	141	147
Net lending and other current expenditure	0	216	51	100	100	175	130	100
Interest	64	222	157	399	281	267	420	521
Capital expenditure	743	544	430	550	465	409	434	434
E.U. funds related capital expenditure	95	122	122	242	200	200	190	190
Measures to be identified	0	0	0	-435	0	0	-540	-920
Basic fiscal balance 3/	-539	-1,528	-1,053	-1,224	-1,304	-1,026	-779	-452
Basic fiscal balance, excl. pension fund diversion	-539	-1,690	-1,215	-1,430	-1,509	-1,232	-965	-580
Bank restructuring costs	674	1,007	173	934	932	932	1,008	0
Fiscal balance	-1,213	-2,697	-1,226	-2,363	-2,236	-1,958	-1,787	-452
Financing (net)	1,213	2,697	1,226	2,363	2,236	1,958	1,787	452
Domestic financing	480	144	-792	54	…	-185	810	264
Banking system	446	…	-792	…	…	-185	810	264
Central Bank	-467	…	-564	…	…	-505	500	150
Commercial banks	913	…	-228	…	…	320	310	114
Nonbanks	16	…	0	…	…	0	0	0
Privatization and other	17	…	0	…	…	0	0	0
External financing	707	2,553	2,018	2,309	…	2,143	977	188
Net borrowing (net)	292	…	48	…	…	253	281	281
Exceptional financing	415	…	1,971	…	…	1,890	696	-93
Errors and omissions	27	…	0	…	…	0	0	0
Memorandum items								
General government debt	2,766	5,645	4,556	6,920	6,792	7,019	8,306	8,608
Primary basic balance	-475	-1,468	-896	399	-1,023	-760	-359	69
EU spending	685	778	862	953	842	842	925	…
Primary non-EU spending	5,518	5,278	4,830	4,321	4,617	4,635	3,997	…

Sources: Latvian authorities and IMF staff estimates.

Table 3. Latvia: General Government Operations, 2008-12 (concluded)

	2008	2009		2010			2011	2012
		First Rev.	Proj.	First Rev.	Baseline	Proj. 1/	Proj.	
	(percent of GDP)							
Total revenue and grants	35.2	35.3	36.7	35.6	37.2	39.6	38.1	36.8
Tax revenue	29.1	25.8	26.7	26.9	25.8	27.8	27.3	26.1
Direct Taxes	18.5	15.3	16.4	16.3	15.7	17.6	17.4	16.3
Corporate Income Tax	3.1	1.4	1.5	0.7	0.6	0.6	0.7	0.6
Personal Income Tax	6.3	5.6	5.5	7.2	5.7	7.0	7.0	6.9
Social Security Contributions	8.6	7.8	8.8	7.4	8.9	9.2	8.9	8.0
Real Estate and Property Taxes	0.4	0.5	0.5	1.0	0.5	0.8	0.8	0.8
Indirect Taxes	10.6	10.5	10.3	10.6	10.0	10.1	9.9	9.8
Non Tax, self-earned and other revenue	3.4	5.2	5.2	3.6	4.5	4.9	4.2	4.3
EU and miscellaneous funds	2.6	4.3	4.8	5.0	6.9	6.9	6.6	6.3
Total expenditure 2/	38.5	48.4	44.8	47.6	48.2	48.2	44.6	40.4
Current expenditure	33.9	44.2	41.5	46.6	44.3	44.8	45.5	44.3
Primary Current Expenditure	33.5	42.5	40.3	43.3	41.9	42.5	42.0	40.1
Remuneration	10.3	10.4	10.5	9.9	10.3	9.8	9.8	9.4
Goods and Services	5.7	5.4	5.5	5.6	5.9	5.5	5.3	5.1
Subsidies and Transfers	16.5	23.9	22.6	25.9	23.7	24.6	24.6	23.6
Subsidies to companies and institutions	8.0	9.3	9.8	10.1	10.0	9.6	10.2	9.8
E.U. funds related subsidies	3.6	5.1	5.7	6.0	5.4	5.4	6.1	5.9
Social Support	8.5	14.4	12.7	15.7	13.6	14.9	14.3	13.7
Pensions	5.9	8.1	8.1	9.0	8.9	10.3	9.7	9.3
Other	2.6	6.3	4.6	6.7	4.7	4.6	4.6	4.4
International cooperation	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Payments to EU budget	0.9	1.2	1.2	1.0	1.2	1.2	1.2	1.2
Net lending and other current expenditure	0.0	1.7	0.4	0.8	0.8	1.5	1.1	0.8
Interest	0.4	1.7	1.2	3.4	2.4	2.2	3.5	4.2
Capital expenditure	4.6	4.2	3.3	4.6	3.9	3.4	3.6	3.5
E.U. funds related capital expenditure	0.6	0.9	0.9	2.0	1.7	1.7	1.6	1.5
Measures to be identified	0.0	0.0	0.0	-3.7	0.0	0.0	-4.5	-7.4
Basic fiscal balance 3/	-3.3	-11.8	-8.1	-10.3	-10.9	-8.6	-6.5	-3.6
Basic fiscal balance, excl. pension fund diversion	-3.3	-13.0	-9.3	-12.0	-12.7	-10.3	-8.1	-4.6
Bank restructuring costs	4.1	7.8	1.3	7.8	7.8	7.8	8.4	0.0
Fiscal balance	-7.5	-20.8	-9.4	-19.8	-18.8	-16.4	-14.9	-3.6
Financing (net)	7.5	20.8	9.4	19.8	18.8	16.4	14.9	3.6
Domestic financing	2.9	1.1	-6.1	0.5	…	-1.5	6.8	2.1
Banking system	2.7	…	-6.1	…	…	-1.5	6.8	2.1
Central Bank	-2.9	…	-4.3	…	…	-4.2	4.2	1.2
Commercial banks	5.6	…	-1.7	…	…	2.7	2.6	0.9
Nonbanks	0.1	…	0.0	…	…	0.0	0.0	0.0
Privatization and other	0.1	…	0.0	…	…	0.0	0.0	0.0
External financing	4.3	19.7	15.4	19.4	…	18.0	8.2	1.5
Net borrowing (net)	1.8	…	0.4	…	…	2.1	2.3	2.3
Exceptional financing	2.6	…	15.1	…	…	15.9	5.8	-0.7
Errors and omissions	0.2	…	0.0	…	…	0.0	0.0	0.0
Memorandum items								
General government debt	17.0	43.5	34.9	74.2	57.0	58.9	69.3	69.0
Primary basic balance	-2.9	-11.3	-6.9	3.4	-8.6	-6.4	-3.0	0.6
Nominal GDP (In millions of lats)	16,274	12,981	13,071	11,918	11,918	11,918	11,979	12,479
EU spending	4.2	6.0	6.6	8.0	7.1	7.1	7.7	…
Primary non EU spending	33.9	40.7	37.0	36.3	38.7	38.9	33.4	…

Sources: Latvian authorities and IMF staff estimates.

1/ Compared to the baseline this includes 4.2 percent of GDP (L500 million) of measures, less 0.7 percent of GDP of additional net lending, 1.5 percent of GDP of additional pension spending, plus 0.3 percent of GDP of temporary cuts, timing effects etc. (see Table 5).

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

3/ Basic fiscal balance, in cash, or net government borrowing/lending.

Table 4. Latvia: Fiscal balances and Debt, 2008-14

	2008	2009	2010	2011	2012	2013	2014
				(percent of GDP)			
Fiscal balances							
Basic fiscal balance (excl. bank restructuring)	-3.3	-8.1	-8.6	-6.5	-3.6	-2.0	-1.7
Alternative fiscal balances							
(i) plus net lending	0.0	0.4	1.5	1.1	0.8	0.8	0.8
Basic fiscal balance, authorities' definition	-3.3	-7.7	-7.1	-5.4	-2.8	-1.2	-0.9
(ii) less gain from 2nd pillar contributions < 8%	0.0	1.2	1.7	1.6	1.0	0.5	0.5
Fiscal balance, adjusted for pension diversion 1/	-3.3	-9.3	-10.3	-8.1	-4.6	-2.5	-2.2
(iii) less revenues from EU	2.6	4.8	6.9	6.6	6.3	4.6	4.5
plus EU-related spending	4.2	6.6	7.1	7.7	7.4	5.4	5.3
Non-EU basic balance	-1.8	-6.3	-8.5	-5.3	-2.5	-1.2	-1.0
(iv) plus interest	0.4	1.2	2.2	3.5	4.2	4.3	4.3
Primary basic balance	-2.9	-6.9	-6.4	-3.0	0.6	2.3	2.6
(v) less bank restructuring costs	4.1	1.3	7.8	8.4	0.0	0.0	0.0
Overall balance	-7.5	-9.4	-16.4	-14.9	-3.6	-2.0	-1.7
(vi) ESA definition 2/	-4.1	-8.5	-7.9	-5.6	-3.0	-1.4	-1.1
Public debt							
Gross debt	17.0	34.9	58.9	69.3	69.0	66.9	64.8
of which foreign currency-denominated	9.8	26.6	47.1	55.0	54.3	50.4	44.1
Net debt (debt less government deposits)	13.1	25.7	44.6	59.3	60.5	59.9	58.9
Net debt if no more bank restructuring	13.1	25.1	40.7	42.5	44.4	44.5	44.2

Sources: Latvian authorities and IMF staff estimates.
1/ Definition used at First Review.
2/ Statistically adjusted from cash to accrual, less net lending, plus other liabilities (e.g., PPPs).

Table 5. Latvia: Estimated Impact of the 2010 Budget
(percent of GDP, cash basis)

Baseline fiscal balance	-10.9
Consolidation measures (L500 million)	+4.2
Revenue increases	+2.3
Capital income taxation	+0.2
PIT and social security base broadening	+0.6
Higher PIT rate	+0.8
Excises and car tax	+0.2
Property tax	+0.2
Other	+0.3
Expenditure cuts	+1.9
Structural reform	+0.6
Underpinned by reform commitment (LOI, Box 2)	+0.6
Other (i.e., across-the-board, reduction of services)	+0.8
Other measures / changes	-1.9
Increase in net lending for private debt restructuring	-0.3
Other increases in net lending	-0.4
Constitutional court decision to undo pension cuts	-1.5
Other (temporary measures, shifted expenditure, timing differences)	+0.3
Fiscal balance 1/	-8.6

Sources: Latvian authorities and IMF staff estimates.

1/ Basic fiscal balance, or general government net borrowing requirement excluding bank restructuring costs.

Table 6. Latvia: Public Sector Debt Sustainability Framework, 2004-2014
(percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing primary balance 9/**
1 **Baseline: Public sector debt 1/**	14.4	11.8	9.9	7.8	17.0	**34.9**	**58.9**	**69.3**	**69.0**	**66.9**	**64.8**	**1.2**
o/w foreign-currency denominated	7.5	6.0	5.2	4.4	9.8	26.6	47.1	55.0	54.3	50.4	44.1	
2 Change in public sector debt	-0.2	-2.6	-1.9	-2.1	9.2	17.9	24.0	10.4	-0.4	-2.1	-2.0	
3 Identified debt-creating flows (4+7+12)	-1.3	-1.1	-1.5	-3.5	6.3	13.5	19.8	14.6	0.8	-1.0	-1.4	
4 Primary deficit	0.3	0.5	0.3	-1.0	2.9	6.9	6.4	3.0	-0.6	-2.3	-2.6	
5 Revenue and grants	33.9	35.3	36.1	36.2	35.2	36.7	39.6	38.1	36.8	35.6	35.7	
6 Primary (noninterest) expenditure	34.2	35.8	36.4	35.2	38.1	43.6	46.0	41.1	36.2	33.4	33.1	
7 Automatic debt dynamics 2/	-1.7	-1.7	-1.7	-2.4	-0.6	5.4	5.6	3.2	1.4	1.2	1.2	
8 Contribution from interest rate/growth differential 3/	-1.3	-2.0	-1.7	-2.1	-0.3	5.4	5.6	3.2	1.4	1.2	1.2	
9 Of which contribution from real interest rate	-0.2	-0.7	-0.5	-1.3	-0.6	1.6	4.1	4.8	3.9	3.9	3.7	
10 Of which contribution from real GDP growth	-1.1	-1.3	-1.2	-0.7	0.3	3.8	1.5	-1.6	-2.5	-2.6	-2.6	
11 Contribution from exchange rate depreciation 4/	-0.4	0.3	0.0	-0.4	-0.3	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.1	0.1	-0.1	-0.1	4.0	1.3	7.8	8.4	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.1	0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Bank restructuring	0.0	0.0	0.0	0.0	4.1	1.3	7.8	8.4	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	1.1	-1.5	-0.4	1.4	2.9	4.3	4.2	-4.2	-1.2	-1.2	-0.7	
Public sector debt-to-revenue ratio 1/	42.5	33.3	27.3	21.4	48.3	95.0	148.8	182.0	187.7	187.7	181.9	
Gross financing need 6/	4.6	3.1	2.6	0.3	7.9	17.1	23.4	23.6	15.8	16.0	18.5	
in billions of U.S. dollars	0.6	0.5	0.5	0.1	2.6	4.4	5.2	5.3	3.7	3.9	4.7	
Scenario with key variables at their historical averages 7/						**34.9**	**44.0**	**45.4**	**42.0**	**38.9**	**36.4**	**-2.8**
Scenario with no policy change (constant primary balance) in 2009-2014						**34.9**	**59.5**	**74.0**	**81.1**	**88.4**	**96.1**	**1.8**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	8.7	10.6	12.2	10.0	-4.6	-18.0	-4.0	2.7	3.8	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	5.9	4.9	5.9	4.7	5.6	5.7	5.8	6.0	6.3	6.4	6.7	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	-5.2	-4.0	-15.6	-9.8	7.7	10.8	8.1	5.9	5.9	5.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	5.8	-4.3	0.8	9.2	7.4	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	7.0	10.2	9.9	20.3	15.4	-2.0	-5.0	-2.1	0.3	0.6	0.9	
Growth of real primary spending (deflated by GDP deflator, in percent)	10.0	15.7	14.0	6.4	3.3	-6.3	1.3	-8.2	-8.5	-4.3	3.1	
Primary deficit	0.3	0.5	0.3	-1.0	2.9	6.9	6.4	3.0	-0.6	-2.3	-2.6	
Net debt	13.0	11.0	9.4	6.6	13.1	25.7	44.6	59.3	60.5	59.9	58.9	
Deposits	1.4	0.8	0.4	1.2	3.9	9.2	14.3	10.1	8.5	7.0	5.9	
Deposits as a share of average monthly amortization	3.8	2.9	2.0	54.8	5.9	6.5	7.3	5.1	6.4	5.2	3.8	

1/ General government.

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

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

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

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

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

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

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

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

Table 7. Latvia: Medium Term Balance of Payments, 2007−14

	2007	2008	2009		2010	2011	2012	2013	2014
			First Rev.	Proj.	Projections				
	(millions of euros)								
Current account	-4,691	-3,007	832	1,431	1,422	1,508	1,460	1,167	938
Trade balance (fob)	-5,031	-4,073	-1,537	-1,243	-577	-469	-505	-640	-795
Exports	5,997	6,527	4,165	4,970	5,057	5,416	5,834	6,278	6,756
Imports	11,028	10,600	5,702	6,212	5,635	5,885	6,339	6,919	7,551
Services	730	917	1,278	1,221	1,375	1,510	1,627	1,726	1,830
Credit	2,696	3,087	2,589	2,770	2,803	3,002	3,233	3,479	3,744
Debit	1,966	2,171	1,312	1,548	1,428	1,491	1,606	1,753	1,914
Income	-663	-363	724	851	-229	-387	-550	-754	-972
Compensation of employees	373	372	368	395	398	398	398	398	398
Investment income	-1,037	-735	356	456	-626	-784	-947	-1,151	-1,369
Current transfers	274	512	367	602	854	854	888	835	874
of which: EU (net)	40	34	80	40	354	354	355	278	291
Capital and financial account	5,574	2,015	-4,230	-3,167	-3,635	-2,654	-337	303	1,652
Capital account	410	341	380	419	542	542	521	581	610
Financial account	5,164	1,674	-4,610	-3,586	-4,177	-3,195	-858	-278	1,042
Direct investment	1,428	697	213	170	970	1,000	1,012	1,063	1,119
of which: equity capital	767	286	…	671	720	720	736	760	786
Portfolio investment	-494	254	218	134	564	400	350	100	450
of which: general government	12	210	…	-21	360	400	400	200	600
Financial derivatives	165	-71	249	313	0	0	0	0	0
Other investment	4,065	795	-5,290	-4,202	-5,711	-4,595	-2,220	-1,441	-527
Trade credit	66	-40	-160	-108	11	-20	-24	-11	-10
Assets	-164.7	27	…	23	98	-59	-95	-101	-109
Liabilities	230.7	-67	…	-132	-87	39	71	91	99
Loans	4,148	2,846	-1,444	-1,998	-2,051	-1,651	-501	-185	283
Assets	-1,612	-187	…	123	-714	-714	0	0	0
Liabilities	5,759	3,033	…	-2,121	-1,337	-937	-501	-185	283
o/w SDR allocation	…	…	…	0					
Currency and deposits	-207	-1,993	-4,013	-2,108	-3,670	-2,925	-1,695	-1,246	-800
Assets	-2,566	-130	…	-1,706	-3,093	-2,775	-1,600	-1,200	-800
Liabilities	2,359	-1,863	…	-402	-577	-150	-95	-46	0
Other	59	-18	-33	12	0	0	0	0	0
Errors and omissions	-168	-414	-41	186	0	0	0	0	0
Overall balance	715	-1,407	-3,438	-1,549	-2,213	-1,145	1,122	1,469	2,590
Financing	-715	1,407	698	1,549	2,213	1,145	-1,122	-1,469	-2,590
Change in reserve assets (+ denotes decline)	-715	456	305	-765	-476	-347	-806	-971	-1,199
IMF (net)	…	591	394	194	489	392	-316	-499	-391
Purchases	…	…	394	…	489	392	0	0	0
Repurchases	…	…	0	…	0	0	-316	-499	-391
Other official financing (net)	…	360	…	2,120	2,200	1,100	0	0	-1,000
Disbursements	…	…	…	…	2,200	1,100	0	0	0
Repayments	…	…	…	…	0	0	0	0	-1,000

Sources: Latvian authorities and IMF staff estimates.

Table 7. Latvia: Medium Term Balance of Payments, 2007−14 (concluded)

	2007	2008	2009 First Rev.	2009 Proj.	2010	2011	2012	2013	2014
					Projections				
Memorandum items:	(percent of GDP, unless otherwise indicated)								
Current account 1/	-22.3	-13.0	4.5	7.7	8.4	8.8	8.2	6.3	4.8
Trade balance (fob)	-23.9	-17.6	-8.3	-6.7	-3.4	-2.8	-2.8	-3.5	-4.1
Exports	28.5	28.2	22.6	26.7	29.8	31.8	32.9	33.9	34.8
Imports	52.5	45.8	30.9	33.4	33.2	34.5	35.7	37.3	38.9
Services	3.5	4.0	6.9	6.6	8.1	8.9	9.2	9.3	9.4
Income	-3.2	-1.6	3.9	4.6	-1.3	-2.3	-3.1	-4.1	-5.0
Compensation of employees	1.8	1.6	…	2.1	2.3	2.3	2.2	2.1	2.0
Investment income	-4.9	-3.2	…	2.5	-3.7	-4.6	-5.3	-6.2	-7.0
Current transfers	1.3	2.2	2.0	3.2	5.0	5.0	5.0	4.5	4.5
of which: EU (net)	0.2	0.1	…	0.2	2.1	2.1	2.0	1.5	1.5
Net FDI	6.8	3.0	1.2	0.9	5.7	5.9	5.7	5.7	5.8
Export volume (goods and services, percent change)	10.0	-1.3	-15.5	-17.5	1.5	5.0	5.6	5.5	5.5
Import volume (goods and services, percent change)	14.7	-13.6	-28.5	-35.0	-9.9	2.4	5.6	7.0	7.0
Terms of trade (percent change)	5.1	-1.8	0.4	-0.5	-1.0	0.0	0.0	0.0	0.0
Gross reserves (billions of euros)	4.0	3.7	3.4	4.5	5.0	5.3	6.1	7.1	8.3
(in months of prospective imports)	3.7	5.7	6.3	7.6	8.1	8.0	8.5	9.0	9.9
Reserve Cover 2/	23.8	23.7	44.5	67.3	69.1	65.2	73.8	81.3	84.2
Short-term debt (percent of official reserves)	245.7	206.3	184.1	131.2	107.0	97.3	82.9	70.9	60.7
Banks' short term liabilities (billions of euros)	9.7	7.6	6.2	5.9	5.3	5.2	5.1	5.0	5.0
Total short-term debt (billions of euros)	11.6	9.9	…	7.5	6.9	6.7	6.7	6.8	6.9
Reserves (percent of short-term external debt)	34.2	37.2	43.5	59.8	72.6	78.9	91.0	104.7	120.7
Gross external debt (billions of euros)	26.8	29.6	…	29.7	30.5	31.2	32.5	32.5	32.5
Medium and long term (billions of euros)	15.2	19.7	…	22.2	23.7	24.4	25.7	25.7	25.6
Short term (billions of euros)	11.6	9.9	…	7.5	6.9	6.7	6.7	6.8	6.9
Net external debt (billions of euros) 3/	10.4	13.1	…	10.8	7.5	4.0	2.6	0.0	-2.4
Gross external debt	127.7	128.0	159.6	159.9	180.1	182.8	182.8	175.0	167.3
Medium and long term	72.6	85.1	112.0	119.5	139.7	143.2	144.9	138.4	131.9
Short term	55.1	42.9	47.6	40.4	40.4	39.6	37.9	36.5	35.4
Net external debt	49.4	56.5	63.7	58.2	44.1	23.5	14.5	0.0	-12.4
Nominal GDP (billions of euros)	21.0	23.1	18.5	18.6	17.0	17.0	17.8	18.5	19.4
Gross financing requirement (billions of euros)	…	8.3	…	5.3	4.7	5.7	5.6	5.8	6.0
U.S. dollar per euro (period average)	1.37	1.47	1.31	1.39	…	…	…	…	…
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 2.8 percent of GDP if excluding provisioning by foreign banks for their non-performing loans.

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

3/ Gross external debt minus gross external debt assets.

Table 8. Latvia: External Debt Dynamics, 2006-14

	2006	2007	2008	2009	2010	2011	2012	2013	2014
					(billions of euros)				
Gross external debt	18.1	26.8	29.6	29.7	30.5	31.2	32.5	32.5	32.5
Public	0.9	1.1	2.5	4.7	7.8	9.7	9.8	9.5	8.7
Short term	0.0	0.0	0.5	0.1	0.1	0.1	0.1	0.1	0.1
Long term	0.9	1.0	1.9	4.7	7.7	9.6	9.7	9.4	8.6
Private	17.2	25.8	27.1	25.0	22.8	21.5	22.7	23.0	23.8
Banks	12.5	18.2	18.5	16.0	13.6	12.1	12.9	12.7	13.0
Short term	6.7	9.7	7.6	5.9	5.3	5.2	5.1	5.0	5.0
Long term	5.8	8.4	10.9	10.1	8.3	7.0	7.9	7.7	7.9
Corporate	3.2	5.6	6.1	5.8	5.6	5.5	5.4	5.5	5.6
Short term	1.3	1.8	1.8	1.6	1.5	1.5	1.6	1.7	1.8
Long term	2.0	3.8	4.3	4.3	4.1	3.9	3.8	3.8	3.9
Other	1.5	2.0	2.5	3.2	3.6	3.9	4.3	4.8	5.2
					(percent of GDP)				
Gross external debt	114.2	127.7	128.0	159.9	180.1	182.8	182.8	175.0	167.3
Public	5.9	5.1	10.8	25.4	45.8	56.7	55.0	51.1	44.7
Short term	0.2	0.2	2.4	0.3	0.4	0.4	0.3	0.3	0.3
Long term	5.7	4.9	8.4	25.0	45.4	56.3	54.7	50.7	44.4
Private	108.2	122.6	117.2	134.5	134.3	126.1	127.8	123.9	122.6
Banks	78.4	86.4	80.2	86.0	80.5	71.2	72.9	68.6	66.7
Short term	42.1	46.4	33.0	31.6	31.3	30.3	28.6	27.2	25.9
Long term	36.4	40.0	47.2	54.3	49.2	40.9	44.3	41.4	40.8
Corporate	20.5	26.7	26.3	31.4	32.9	32.0	30.5	29.7	29.1
Short term	8.0	8.5	7.6	8.5	8.8	9.0	9.0	9.1	9.2
Long term	12.4	18.2	18.7	22.9	24.1	23.0	21.5	20.6	19.9
Other	9.3	9.4	10.8	17.2	20.9	22.9	24.4	25.7	26.8
					(debt dynamics, change in debt to GDP ratio)				
Total Debt to GDP	14.7	13.5	0.3	31.9	20.2	2.6	0.1	-7.9	-7.7
Due to change in debt	33.5	41.4	12.1	0.6	4.8	3.6	7.4	-0.1	0.3
Due to nominal GDP	-18.8	-27.9	-11.7	31.2	15.5	-0.9	-7.3	-7.8	-8.0
Public Debt to GDP	-0.8	-0.8	5.7	14.6	20.4	10.9	-1.6	-4.0	-6.4
Due to change in debt	0.5	0.6	6.2	11.9	18.0	11.1	0.6	-1.6	-4.1
Due to nominal GDP	-1.3	-1.4	-0.5	2.6	2.5	-0.2	-2.3	-2.3	-2.3
Private Debt to GDP	15.5	14.4	-5.3	17.3	-0.2	-8.2	1.7	-3.9	-1.3
Due to change in debt	33.0	40.8	5.9	-11.3	-13.2	-7.5	6.8	1.5	4.3
Due to nominal GDP	-17.5	-26.4	-11.3	28.6	13.0	-0.7	-5.1	-5.4	-5.6
Memorandum items:									
Nominal GDP (billions of euros)	15.9	21.0	23.1	18.6	17.0	17.0	17.8	18.5	19.4

Source: Latvian authorities and IMF staff estimates.

Table 9. Latvia: External Debt Sustainability Framework, 2004-2014
(percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing non-interest current account 6/**
1 **Baseline: External debt**	89.2	99.5	114.2	127.7	128.0	**159.9**	**180.1**	**182.8**	**182.8**	**175.0**	**167.3**	**-4.0**
2 Change in external debt	12.9	10.3	14.7	13.5	0.3	31.9	20.2	2.6	0.1	-7.9	-7.7	
3 Identified external debt-creating flows (4+8+9)	1.1	-3.1	-2.2	-11.3	0.4	22.0	-5.4	-17.9	-18.9	-17.0	-15.2	
4 Current account deficit, excluding interest payments	11.0	10.4	19.3	18.3	7.6	-7.5	-14.9	-15.9	-16.0	-14.3	-12.8	
5 Deficit in balance of goods and services	15.9	15.2	22.3	20.5	13.6	0.1	-4.7	-6.1	-6.3	-5.9	-5.3	
6 Exports	43.6	47.0	44.0	41.4	41.6	41.6	46.3	49.4	51.1	52.6	54.0	
7 Imports	59.5	62.2	66.2	61.9	55.2	41.7	41.6	43.3	44.7	46.8	48.7	
8 Net non-debt creating capital inflows (negative)	-3.8	-3.1	-5.9	-5.7	-0.9	-3.9	-4.1	-4.2	-4.0	-3.9	-3.9	
9 Automatic debt dynamics 1/	-6.2	-10.4	-15.7	-23.8	-6.4	33.4	13.5	2.2	1.1	1.2	1.5	
10 Contribution from nominal interest rate	1.9	2.2	3.1	4.1	5.4	4.7	6.5	7.0	7.8	8.0	8.0	
11 Contribution from real GDP growth	-5.9	-8.1	-9.9	-8.6	5.3	28.7	7.0	-4.8	-6.7	-6.8	-6.5	
12 Contribution from price and exchange rate changes 2/	-2.2	-4.4	-8.9	-19.3	-17.0	…	…	…	…	…	…	
13 Residual, incl. change in gross foreign assets (2-3) 3/	11.9	13.4	16.9	24.8	0.0	9.8	25.6	20.5	18.9	9.1	7.5	
External debt-to-exports ratio (in percent)	204.5	211.5	259.6	308.6	308.1	384.3	388.6	370.1	358.0	332.6	309.5	
Gross external financing need (in billions of euros) 4/	6.8	9.6	12.2	14.9	19.5	11.6	9.4	9.9	10.0	10.4	11.6	
in percent of GDP	61.8	74.2	76.6	71.0	84.3	62.6	55.4	57.8	56.2	56.2	59.5	
Scenario with key variables at their historical averages 5/						**159.9**	**165.4**	**168.3**	**172.0**	**168.6**	**164.4**	**-18.2**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	8.7	10.6	12.2	10.0	-4.6	-18.0	-4.0	2.7	3.8	4.0	4.0	
GDP deflator in euros (change in percent)	3.0	5.2	9.9	20.3	15.4	-1.9	-5.0	-2.1	0.3	0.6	0.9	
Nominal external interest rate (in percent)	2.8	2.8	3.9	4.7	4.6	3.0	3.7	3.9	4.4	4.6	4.8	
Growth of exports (euro terms, in percent)	16.7	25.5	15.3	24.5	10.6	-19.5	1.6	7.1	7.7	7.6	7.6	
Growth of imports (euros, in percent)	22.2	21.6	31.3	23.5	-1.7	-39.2	-9.0	4.4	7.7	9.1	9.1	
Current account balance, excluding interest payments	-11.0	-10.4	-19.3	-18.3	-7.6	7.5	14.9	15.9	16.0	14.3	12.8	
Net non-debt creating capital inflows	3.8	3.1	5.9	5.7	0.9	3.9	4.1	4.2	4.0	3.9	3.9	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

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

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

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

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

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

Table 10. Latvia: Financial Soundness Indicators, 2007-09
(percent, unless otherwise indicated)

	Dec-07	Dec-08	Mar-09	June-09	Sep-09	Oct-09
Commercial banks						
Capital Adequacy						
Regulatory capital to risk-weighted assets	11.1	11.8	11.4	12.4	13.6	13.6
Regulatory Tier I capital to risk-weighted assets	9.8	10.5	10.8	10.2	10.7	10.7
Capital and reserves to assets	7.9	7.3	7.5	7.2	7.1	7.0
Asset Quality						
Annual growth of bank loans	37.2	11.2	7.9	0.2	-5.4	-6.6
Loans past due over 30 days	...	7.8	13.1	16.2	18.0	19.2
Loans past due over 90 days	0.8	3.6	7.1	12.0	14.5	15.0
Loans past due over 90 days net of loan loss provisions to capital	...	13.6	36.4	60.6	66.6	66.9
Loan loss provisions to loans past due over 90 days	...	61.3	48.0	50.8	55.6	57.3
Loan loss provisions to total loans	...	2.2	3.4	6.1	8.1	8.6
Share of loans in total assets, banks dealing with residents 1/	80.4	82.5	82.4	77.6	76.9	77.0
Share of loans in total assets, banks dealing with non-residents 1/	48.9	51.7	58.6	57.4	57.6	56.6
Earnings and Profitability						
ROA (after tax)	2.0	0.3	-0.9	-3.2	-3.6	-3.5
ROE (after tax)	24.3	4.6	-11.2	-38.1	-42.1	-42.1
Net interest income to total income	32.5	30.1	24.8	25.3	24.1	24.0
Noninterest expenses to total income	32.3	47.5	68.2	104.1	112.0	113.1
Trading income to total income	7.8	5.6	3.9	8.8	9.0	9.1
Personnel expenses to noninterest expenses	31.5	21.3	13.2	8.8	8.4	8.4
Income from operations with non-residents to total income						
Banks dealing with residents 1/	13.0	13.7	19.4	24.6	22.2	22.5
Banks dealing with non-residents 1/	49.2	48.0	44.9	48.9	46.6	41.9
Liquidity						
Liquid assets to total assets	25.0	21.6	18.6	18.8	19.0	19.6
Liquid assets to short term liabilities	55.7	52.8	48.0	49.6	54.4	57.4
Customers deposits to (non-interbank) loans	68.2	58.8	58.9	57.8	57.1	57.8
Sensitivity to Market Risk						
Net open positions in FX to capital 2/	5.4	6.3	3.1*	3.5*	4.2*	…
Net open positions in EUR to capital	3.2	3.7	2.6*	2.2*	3.2*	…
FX assets to total assets	79.7	80.5	82.1	83.4	83.4	83.5
FX deposits to total deposits	70.7	69.4	71.5	74.5	74.9	75.4
FX liabilities to total liabilities 2/	81.7	81.1	81.8	84.1	84.3	84.5
FX loans to total loans 2/	81.8	85.0	85.5	87.7	88.0	88.2
Nonfinancial Enterprises 3/						
Total debt to equity	202.0	...	175.6	183.2	…	…
Return on equity	31.1	...	1.6	4.1	…	…
Earnings to interest expenses	496.7	321.3	117.8	151.6	…	…
Households						
Household debt to GDP	42.4	41.2	41.8	43.3	45.3	…
Household debt service to GDP 4/	2.5	2.7	2.7	2.7	2.6	…
Real Estate Markets						
Real estate prices annual growth rate 5/	-7.3	-37.1	-52.0	-59.2	-52.4	-49.3
Residential real estate loans to total loans 6/	31.6	30.5	30.5	31.0	31.0	31.1
Commercial real estate loans to total loans 6/	17.8	19.5	19.4	19.7	20.0	20.0
Memorandum Items						
Number of banks dealing with residents 1/	9	13	12	15	15	14
Number of banks dealing with non-residents 1/	14	13	14	11	11	12
Assets of banks dealing with residents/Total banking system assets 1/	60.8	63.9	63.9	80.0	80.1	78.4
Assets of banks dealing with non-residents/Total banking system assets 1/	39.2	36.1	36.1	20.0	19.9	21.6

Source: Latvian authorities, Latvian Leasing Association, and IMF staff calculations.

*Excluding Parex Bank

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

2/ Including euro-denominated positions.

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

4/ Interest payments only.

5/ Price of typical apartment in Riga. Source: Real estate company Latio.

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

Table 11. Latvia: Bank of Latvia Balance Sheet, 2005-10
(end-period; millions of lats, unless otherwise indicated)

	2005	2006	2007	2008	2009		2010
					First Rev.	Proj.	Proj.
Net foreign assets (NFA)	1,387	2,414	2,769	2,333	2,583	3,311	3,649
Net domestic assets (NDA)	-36	-166	-298	-221	-941	-1,666	-1,925
of which:							
Banks (net, excluding bank reserves with the BoL)	-8	-44	7	637	250	-120	170
General government (net)	33	-50	-171	-638	-906	-1,308	-1,797
Capital and reserves	87	104	164	242	303	270	314
Base money = NFA + NDA 1/	1,351	2,249	2,471	2,112	1,641	1,646	1,724
of which, lats in circulation	877	1,074	1,049	1,018	849	788	772
	(year-on-year growth rate, percent)						
NFA	33.5	74.1	14.7	-15.8	10.7	42.0	10.2
Base money	41.2	66.5	9.9	-14.6	-22.3	-22.1	4.7
Lats in circulation	20.6	22.4	-2.3	-3.0	-16.6	-22.6	-2.1
	(contribution to year-on-year growth in base money, percent)						
Net foreign assets	36.4	76.0	15.8	-17.7	11.9	46.4	20.5
Net domestic assets	4.9	-9.6	-5.9	3.1	-34.1	-68.4	-15.8
Memorandum items:							
NFA/monetary base	102.7	107.4	112.1	110.5	144.8	201.2	211.7
Reserve money/GDP	14.9	20.1	16.7	13.0	12.6	12.6	14.5
Nominal GDP	9,059	11,172	14,780	16,274	12,981	13,071	11,918

Source: Bank of Latvia and IMF staff estimates.
1/ Excludes banks' deposits at deposit facility

Table 12. Latvia: Monetary Survey, 2005-10

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

	2005	2006	2007	2008	2009 First Rev.	2009 Proj.	2010 Proj.
				(at current exchange rates)			
Net foreign assets (NFA)	-1.3	-2.6	-4.5	-5.9	-3.9	-3.3	-1.9
Bank of Latvia	1.4	2.4	2.8	2.3	2.6	3.3	3.6
Domestic money banks	-2.7	-5.0	-7.3	-8.2	-6.4	-6.6	-5.6
Net domestic assets (NDA)	5.3	8.1	10.7	11.8	9.7	9.2	7.8
Domestic credit	6.4	9.9	13.0	14.3	12.9	12.5	11.6
Credit to private sector	6.2	9.8	13.1	14.6	13.9	13.9	13.2
Government, net	0.3	0.1	-0.1	-0.4	-1.0	-1.4	-1.6
Other Items, net	-1.1	-1.8	-2.4	-2.4	-3.3	-3.2	-3.8
Broad money	4.0	5.5	6.2	5.9	5.8	6.0	5.8
Domestic money supply (M2)	2.7	3.6	3.6	3.5	2.8	3.1	2.9
Currency held by public	0.8	1.0	0.9	0.9	0.7	0.7	0.7
Private deposits in lats	1.9	2.7	2.7	2.6	2.1	2.4	2.2
Monetary base	1.4	2.2	2.5	2.1	1.6	1.9	1.7
Total domestic deposits	3.2	4.5	5.3	5.1	5.1	5.3	5.1
of which, residents' foreign currency deposits	1.3	1.9	2.5	2.5	3.0	2.9	2.9
Non resident non-bank deposits	2.9	3.0	4.5	3.5	2.8	3.3	2.9
Total foreign currency deposits	4.2	4.9	7.1	5.9	5.8	6.2	5.9
				(year-on-year growth rate, percent)			
Credit to private sector	63.6	58.3	34.0	11.8	-4.8	-5.3	-4.7
Broad money	38.9	37.5	12.6	-3.9	-2.1	0.8	-2.7
Private deposits in lats	38.4	39.6	3.0	-4.7	-20.7	-8.0	-7.3
Foreign currency deposits	17.4	15.4	44.7	-16.0	-2.8	5.0	-5.8
Memorandum items:							
Broad money/GDP	44.0	49.1	41.8	36.4	44.7	45.7	48.8
Residents' foreign currency deposits/total domestic deposits	40.6	41.2	48.2	48.6	59.2	54.7	56.9
Broad money multiplier (broad money/reserve money)	3.0	2.4	2.5	2.8	3.5	3.1	3.4
Private credit (percent of GDP)	68.2	87.5	88.7	90.0	107.4	106.2	111.0
Nominal GDP	9.1	11.2	14.8	16.3	13.0	13.1	11.9

Source: Bank of Latvia and IMF staff estimates.

Table 13. Latvia: Selected Vulnerability Indicators, 2005–10

	2005	2006	2007	2008	2009 1/	Latest Observation
Key economic and market indicators						
Real GDP growth (percent)	10.6	12.2	10.0	-4.6	-19.0	*Q3, 2009*
HICP inflation (period average, percent)	6.9	6.6	10.1	15.3	-1.4	*Nov-09*
Short-term (ST) interbank rate, 1-month RIGIBOR (eop, percent)	4.4	2.9	6.8	13.3	2.7	*Dec-09*
Eurobond secondary market spread (bps, eop)	20	17	56	558	309	*Jan-10*
Exchange rate (lats per U.S. dollar, eop)	0.59	0.54	0.48	0.48	0.49	*Dec-09*
Exchange rate (lats per U.S. dollar, period average)	0.56	0.56	0.51	0.48	0.51	*Oct-09*
External sector						
Exchange rate regime	Pegged to the euro (+-1% band)					
Current account balance (percent of GDP)	-12.5	-22.5	-22.3	-12.6	8.7	*Q3, 2009*
Net FDI inflows (percent of GDP)	3.6	7.5	6.8	3.0	0.5	*Q3, 2009*
Exports (percentage change of U.S. dollar value)	25.4	16.7	34.8	18.9	-21.3	*Oct-09*
Real effective exchange rate index (2000=100, period average)	90.1	92.7	100.1	111.4	116.2	*Nov-09*
Gross international reserves (GIR, billions of U.S. dollars)	2.4	4.5	5.8	5.2	7.1	*Dec-09*
GIR in percent of ST debt at remaining maturity (RM) excluding non-resident deposits	92.6	66.0	67.5	71.8	90.4	*Q3, 2009*
GIR in percent of ST debt at RM including banks' non-resident FX deposits.	31.5	35.9	33.9	38.0	60.6	*Q3, 2009*
Net international reserves (NIR, billions of U.S. dollars)	2.3	4.4	5.7	4.7	6.8	*Jan-10*
Total gross external debt (ED, percent of GDP)	100.0	114.8	126.8	126.9	157.8	*Q3, 2009*
ST external debt (original maturity, percent of total ED)	49.3	44.1	44.3	32.6	37.3	*Q3, 2009*
ED of domestic private sector (percent of total ED)	93.3	94.8	95.8	91.4	84.6	*Q3, 2009*
Total gross external debt (percent of exports)	212.6	261.0	307.2	305.9	397.2	*Q3, 2009*
Gross external financing requirement (billions of U.S. dollars) 2/	3.8	6.6	9.8	7.8	5.3	*Q3, 2009*
Public sector (PS) 3/						
Basic balance (excluding bank restructuring costs; percent of GDP)	-1.1	-0.9	0.6	-3.3	-4.7	*Nov. 2009*
Primary basic balance (percent of GDP)	-0.5	-0.3	1.0	-2.9	-3.7	*Nov. 2009*
Gross PS financing requirement (percent of GDP) 4/	3.1	2.6	0.3	7.9	17.1	*Nov. 2009*
General government gross debt (percent of GDP)	11.8	9.9	7.8	17.0	32.6	*Nov. 2009*
Financial sector (FS) 5/						
Capital adequacy ratio (percent)	10.1	10.2	11.1	11.8	13.6	*Nov, 2009*
Overdue loans (percent of total loans) 6/	…	0.5	0.8	3.6	15.7	*Nov, 2009*
Provisions (percent of overdue loans)	…	93.3	64.9	61.3	61.7	*Nov, 2009*
Return on average assets (percent)	2.1	2.1	2.0	0.3	-3.5	*Oct, 2009*
Return on equity (percent)	27.1	25.6	24.2	4.6	-42.1	*Oct, 2009*
Residents' FX deposits (percent of total resident deposits)	39.9	40.3	46.8	47.1	61.2	*Sept, 2009*
FX loans to residents (percent of total loans to residents)	70.0	76.9	86.4	88.2	92.3	*Sept, 2009*
Credit to private sector (percent change, year-on-year) 7/	63.6	58.3	34.0	11.8	-7.8	*Nov, 2009*

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 14. Latvia: Schedule of Reviews and Purchases

	Amount of purchase		
Date	Millions of SDRs	Percent of quota	Conditions
December 23, 2008	535.344	422.2	Approval of arrangement
August 28, 2009	178.448	140.7	First review, end-March 2009 performance criteria
January 15, 2010	178.448	140.7	Second review and end-September 2009 fiscal performance criteria and end-December 2009 monetary performance criteria
May 15, 2010	90.000	71.0	Third review and end-March 2010 performance criteria
August 15, 2010	90.000	71.0	Fourth review and end-June 2010 performance criteria
November 15, 2010	90.000	71.0	Fifth review and end-September 2010 performance criteria
February 15, 2011	90.000	71.0	Sixth review and end-December 2010 performance criteria
May 15, 2011	90.000	71.0	Seventh review and end-March 2011 performance criteria
August 15, 2011	90.000	71.0	Eighth review and end-June 2011 performance criteria
November 15, 2011	89.386	70.5	Ninth review and end-September 2011 performance criteria
Total	1521.626	1200.0	

Source: IMF staff estimates.

Table 15. Latvia: Program Financing, 2009-11
(millions of euros)

	2009	2010				2011				2009Q4 to
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	2011Q4
					Projections					Proj.
Total financing requirements	496	1,497	1,101	1,038	1,361	1,071	1,088	878	844	9,373
Amortizing debt	266	388	153	381	290	397	165	165	165	2,369
Other sectors	43	43	43	43	43	43	43	43	43	384
Banks	223	345	110	338	247	355	122	122	122	1,985
Public	167	313	25	190	23	233	0	0	0	951
Subs	40	32	59	146	96	76	76	76	76	677
Other	15	0	26	3	128	46	46	46	46	357
Short term liabilities	-639	186	175	110	105	76	74	0	0	87
Banks credit from MFIs	33	32	32	31	31	22	15	7	0	204
Trade credit (net)	83	-19	74	-39	-27	12	52	-42	-2	92
Resident FX accumulation	754	910	667	555	962	564	783	748	682	6,622
Total financing sources	296	102	1,003	-60	1,263	373	990	379	647	4,993
Current account	323	328	344	367	384	352	368	386	402	3,254
Direct investment (net)	107	235	240	245	250	250	250	250	250	2,077
Portfolio investment and financial derivatives (net)	0	415	52	50	47	200	0	200	0	964
o/w government eurobond	0	360	0	0	0	0	0	0	0	360
Capital account	72	135	135	135	135	135	135	135	135	1,155
Other	-179	-179	-179	-179	-179	-179	-179	-179	-179	-1,607
Change in gross reserves (+ denotes decline)	-26	-832	410	-679	625	-385	415	-413	38	-849
Financing gap	200	1,394	98	1,098	98	698	98	498	197	4,380
Official financing	200	1,394	98	1,098	98	698	98	498	197	4,380
IMF	0	194	98	98	98	98	98	98	97	880
EU	0	500	0	200	0	100	0	0	100	900
Nordics	0	500	0	500	0	500	0	400	0	1,900
World Bank	200	100	0	100	0	0	0	0	0	400
Czech Republic	0	100	0	100	0	0	0	0	0	200
EBRD	0	0	0	0	0	0	0	0	0	0
Poland	0	0	0	100	0	0	0	0	0	100

Sources: IMF staff estimates.

Table 16. Latvia: Indicators of Fund Credit, 2009-16

(millions of SDR)

	2009	2010	2011	2012	2013	2014	2015	2016
Stock 1/	713.8	1162.2	1521.6	1231.7	774.1	415.4	112.2	0.0
Obligations	11.2	25.6	37.1	330.6	487.6	373.8	307.6	113.0
Repurchase	0.0	0.0	0.0	290.0	457.6	358.6	303.3	112.2
Charges	11.2	25.6	37.1	40.7	30.1	15.2	4.4	0.8
Stock of existing and prospective Fund credit								
In percent of quota	562.9	916.6	1200.0	971.3	610.5	327.6	88.5	0.0
In percent of GDP	4.2	7.6	9.8	7.7	4.6	2.4	0.6	0.0
In percent of exports of goods and services	10.2	16.3	19.9	15.0	8.8	4.4	1.1	0.0
In percent of gross reserves	17.5	25.8	31.5	22.2	12.0	5.5	1.5	0.0
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	8.8	20.2	29.2	260.7	384.6	294.8	242.6	89.1
In percent of GDP	0.1	0.2	0.2	2.1	2.9	2.1	1.7	0.6
In percent of exports of goods and services	0.2	0.4	0.5	4.0	5.5	3.9	3.0	1.1
In percent of gross reserves	0.3	0.6	0.8	6.0	7.6	5.0	4.1	1.5

Source: IMF staff estimates.

1/ End-period.

APPENDIX I. LATVIA: LETTER OF INTENT

Riga, January 22, 2010

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

Dear Mr. Strauss-Kahn:

1. **Over the past year we have taken the difficult measures needed to stabilize the Latvian economy, restore public finances to health, and lay the foundations for recovery.** In particular, since the First Review we have:

- ***Kept the budget deficit under control***, comfortably attaining the end-September performance criterion for the adjusted primary balance, as well as the indicative target for the public-sector wage bill (Table 1). With the deficit reaching only L500 million (4 percent of GDP) through October, we are also confident we will outperform the deficit target for the year as a whole;
- ***Taken further steps to safeguard the financial system*** (Box 1);
- ***Comfortably met our net international reserves (NIR) and monetary (NDA) targets.*** Substantial current account surpluses coupled with much more moderate capital outflows have allowed us to build a sizeable NIR buffer;
- ***Met most of the program's structural benchmarks*** (Table 2), though one has been partially met and a second is being reset in the Second Review; and
- ***Are working to resolve small external payments arrears*** that emerged in September and resulted in non-observance of the continuous performance criterion.

2. **As a result, financial market and balance of payments strains have eased, and the economy is showing signs of stabilizing**:

- ***Financial market strains have eased*** and lats interest rates have fallen to more normal levels. Latvia's CDS spread has halved since its peak;
- ***Trade in goods and services is in surplus*** for the first time, contributing to the current account turnaround;
- ***Foreign exchange market intervention has been limited*** since end-September;
- ***Wage and price adjustment is progressing***, helping restore competitiveness.

3. **Building on these achievements, our ambitious policy agenda for 2010 aims to lock in fiscal adjustment and set the basis for sustained growth**:

- Despite difficult economic conditions, in December Parliament passed a 2010 budget with L500m (4.2 percent of GDP) in net measures. We estimate that implementation of this budget would have reduced the deficit from 8.1 percent of GDP in 2009 to 7.1 percent in 2010 (program definition of deficit: general government net borrowing including net lending, but without bank restructuring costs).

- However, the Constitutional Court's subsequent ruling that pension cuts made in 2009 were unconstitutional and needed to be reversed will increase the deficit by 1 percent of GDP annually (and by 1½ percent of GDP in 2010, since the 2009 cuts also have to be repaid). Given this additional spending requirement, in 2010 we seek to achieve a deficit of no more than 8.6 percent of GDP (program definition). This target is an upper bound: should the 2009 deficit turn out lower than the 8.1 percent of GDP we currently project, then we will ensure that the 2010 deficit is lower than the 8.6 percent target by a similar amount.

- We are confident our 2010 policies will represent a further significant step towards our objective of euro adoption by 2014.

4. **Looking beyond 2010, we also recognize that significant additional measures will be needed** to meet the Maastricht criteria by 2012, and achieve euro entry by 2014. We have demonstrated our resolve by implementing a cumulative fiscal adjustment in 2009–10 of around 10 percent of GDP. For subsequent years, we aim at fiscal deficit targets of no more than 6 percent of GDP in 2011 and 3 percent of GDP in 2012 (ESA methodology), to achieve euro adoption. Maintaining our prudent approach to policies, preliminary estimates suggest that further adjustment of around L800-900 million spread over two years, with some frontloading, will be needed to deliver these deficit targets. This figure has had to be increased in light of the recent Constitutional Court ruling. Even so, this projected adjustment is slightly lower than the L500 million per year adjustment we had earlier envisaged, reflecting the success of our policies in reducing the deficit.

5. **In view of reduced near-term pressures and the strength of our international reserve position, we request extension of the Stand-by Arrangement until December 22, 2011.** Reduced financial market and balance of payments pressures imply that international assistance under the program can be provided over a longer time span to provide confidence over the adjustment period. Extension will also help support medium-term fiscal adjustment, including through preparation of the 2012 budget. We therefore request extension of the Stand-by Arrangement until December 22, 2011 and rephasing of Latvia's remaining purchases under the arrangement alongside other disbursements under the macroeconomic program—supported by the EU, the IMF, and regional partners—until December 22, 2011.

6. **As such, on the basis of the policies outlined below, we request completion of the Second Review and Financing Assurances Review under the Stand-by Arrangement.** We request a waiver for the non-observance of the continuous performance criterion on non-accumulation of external payments arrears due to a small amount of arrears related to differences over a procurement contract that are in the process of being cleared. We also request a waiver of applicability of end-December 2009 quantitative performance criteria for the fiscal balance and public guarantees since relevant data are not yet available and we expect these targets to be met. The program will continue to be monitored through quantitative performance criteria and indicative targets, as well as continuous performance criteria on domestic and external debt arrears of general government. Performance criteria and structural benchmarks through end-June 2010 are set out in Tables 3 and 4, as well as in the attached Technical Memorandum of Understanding. The Third and Fourth Reviews are scheduled to be completed on or after May 15, 2010 and August 15, 2010, respectively.

VI. Macroeconomic Framework for 2010–11

7. **Our macroeconomic framework remains broadly unchanged from the First Review.**

- ***While the severe output collapse has bottomed out, we expect that recovery may be gradual***. Retail sales continue to fall, but exports—notably of wood and chemicals—are increasing, as is industrial production. While GDP fell an estimated 19 percent year-on-year in the third quarter, the pace of decline has slowed markedly. With domestic demand expected to remain stagnant, we continue to project that recovery will likely begin in the second half of 2010, though we are also hopeful that recovery may come earlier. Unemployment is therefore expected to average 20 percent in 2010, before coming down slightly in 2011.

- ***Internal wage and price adjustment has begun***. Year-on-year, gross wages per worker fell 10 percent in September; public-sector wages were down 20 percent over the same period. Prices have fallen on a month-on-month basis since early 2009; and in November 2009, 12-month consumer price inflation was negative, at -1.2 percent. This marks a considerable turnaround from the near 18 percent inflation rate recorded in May 2008. As a result, competitiveness has started to improve. Since its March peak, the CPI-based real effective exchange rate has depreciated by around 6 percent, about one-quarter of which is due to nominal trading partner appreciation. Meanwhile, producer price and unit labor cost deflated real effective exchange rates have depreciated by around 7 and 11 percent from their peaks. For 2010 we project inflation of -3.7 percent, with further price and cost declines expected to help restore competitiveness and, as a result, contribute to economic recovery.

VII. Policies for 2010–11

A. Fiscal Policy

2010 Budget

8. **Our 2010 budget, which Parliament passed on December 1, includes L500 million (4.2 percent of GDP) of new measures**. Despite the strong headwinds of a contracting economy, our 2010 budget should achieve a fiscal deficit of 8.6 percent of GDP (program definition), which in ESA terms would be below the 8.5 percent of GDP ceiling we had earlier targeted. This will help place Latvia's public finances securely on a sustainable medium-term path. Key measures include:

- ***Revenue increases (2.3 percent of GDP)***. We have broadened the base for personal income tax and social security by reducing or eliminating many exemptions. We have also removed the special tax system for the self-employed and brought capital income into the taxable base. We have raised the personal income tax rate and increased some excises and taxes on wealth such as car tax and real estate tax, which we have expanded by including industrial structures in the base and by introducing a new higher rate on unused agricultural land. We have also introduced a new real estate tax on residential buildings (including a first step towards progressivity) and a new excise tax on natural gas.

- ***Net cuts in expenditure and net lending (1.9 percent of GDP)***. We will derive significant savings from the first stage of our broad public service reform. We have begun harmonizing remuneration across ministries and institutions, reducing wage inequalities by reviewing employment classifications (job families) and tightening the wage grid. We have further reduced the budgets of ministries and state agencies where we are implementing structural reforms which draw in part on earlier World Bank recommendations. To ensure that these measures are sustainable, our Letter of Intent includes a number of safeguards that will become structural benchmarks in the program (Box 2).

9. **We are taking further steps to protect the poorest in society.** Building on measures introduced in 2009, our program includes scope in 2010 for additional social safety net spending. The program's deficit targets will be adjusted by ½ percent of GDP to allow this. We will work closely with the EC and World Bank to explore the need for additional social safety net measures in 2010. Should additional measures be needed, their design will be elaborated in more detail at the next review.

10. **We will continue to implement key measures from the 2009 supplementary budget to reduce commitments and minimize medium-term risks**, including: (i) launching no new PPPs in 2010 (except concessions, in which the general government sector assumes no risk or liability); (ii) implementing our medium-term technical assistance plan, after seeking feedback from program partners; (iii) limiting general government net

lending to L145 million; and (iv) permanently capping outstanding public guarantees at L836 million (the level in June, when the supplementary budget was passed, plus an additional L82 million for the new private debt restructuring strategy, performance criterion). In addition, to reduce the deficit we will avoid tax cuts in 2010, while any revenue overperformance or savings relative to budget plans will be used to achieve a lower-than-targeted budget deficit or—after consultation with the EC and IMF—to accelerate EU funds expenditure or increase social safety net spending or active labor market policies, within deficit targets.

Medium-Term Fiscal Policy and Debt Management

11. **We remain committed to lowering the general government deficit to less than 3 percent of GDP in 2012, in line with EU recommendations, to satisfy the Maastricht criterion for euro adoption**. We realize that this may be an ambitious target. Further contraction in domestic demand will likely cause increases in the deficit, and additional fiscal measures will be required. We have identified areas where substantial further spending cuts are needed, including those outlined in the Letter of Intent for the First Review. However, we recognize that further tax increases may prove necessary, including through further real estate tax reform (on which we have requested IMF technical assistance) and car tax reform. In particular, we will design a comprehensive reform, allowing means-tested exemptions, and improving the quality of cadastral values. We believe that this could yield significantly more revenue than currently, be less distortionary, and more socially acceptable. If necessary we may also need to increase VAT further.

12. **We will work with the EC and World Bank on a new public expenditure review, to improve the efficiency of government spending**. Because of the crisis, government spending as a share of GDP has increased to around 45 percent, in large part because of the fall in output. The public expenditure review will help us find areas for expenditure savings that can be sustained over the medium term. Continuing our in-depth technical engagement with program partners, by mid-year we will consider options for future fiscal adjustment. Building on this exercise, we will prepare a menu of possible structural reforms significantly larger than the needed fiscal consolidation (structural benchmark, end-October 2010).

13. **We will continue work on developing a fiscal framework, to anchor fiscal policy on a credible and sustainable path**. To this end by end-June 2010 we will prepare a draft fiscal responsibility law (structural benchmark). This law will aim at maintaining prudent policies—to limit public debt and deficits, and reduce pro-cyclicality in fiscal policy.

14. **We will review our medium-term debt management strategy, to help ensure a smooth transition back to private market financing over the course of the program.** We will seek international assistance to identify ways of strengthening the current Central Government Debt Management Strategy to help manage risks related to increased government borrowing, including those related to debt structure and composition.

B. Monetary and Exchange Rate Policy

15. **The fixed (narrow band) exchange rate of the lats remains the anchor for monetary policy until we adopt the euro.** Further changes in official interest rates and minimum reserve requirements will be undertaken after prior consultation with IMF staff. The Treasury will continue to exchange all international support from the Fund and other program partners off-market with the Bank of Latvia (BoL). Maintaining monetary and financial stability requires credible policymaking independence, as such we reaffirm the existing strong institutional and financial independence of the BoL and Financial and Capital Markets Commission (FCMC) as a basis for continued stability.

16. **Within the framework of our quasi-currency board arrangement, and consistent with coverage requirements, we are committed to enhancing our liquidity management framework to strengthen exchange rate stability**. A recent visit by international experts concluded that the BoL's liquidity forecasting is of a high standard, and instruments for liquidity management are already in place. The BoL has concluded that more active use of these existing instruments will allow for better management of commercial banks' liquidity. Presently, the overnight deposit facility is the only actively used option for excess liquidity that might result in somewhat higher volatility in times of stress. As such, the BoL will examine options for new absorption instruments, to better control commercial bank excess liquidity.

C. Financial Sector

17. **The Latvian banking system has so far weathered the shock generated by the deeper than anticipated contraction in economic activity relatively well.** Although non-performing loans (overdue for more than 90 days) reached 15 percent of total loans by end-October 2009, and the system registered deep losses as a result of a sharp increase in loan loss provisions, the average capital adequacy ratio improved and stood at 13.6 percent for the system with relatively little variation. The coverage of non-performing loans with loan loss provisions has been steadily increasing since May 2009. Following the top down and bottom-up stress-tests and supervisory follow-up, banks with expected future capital needs made good progress toward increases in own funds that will enable them to maintain capital cushions to deal with credit losses ahead. The capital base of banks increased by 720 million lats so far in 2009 and a further 332 million lats are forthcoming by January 2010.

18. **The FCMC will maintain a risk-oriented approach to supervision**, supporting this through the revision of two regulations. First, we will revise liquidity regulations to take account of the developments in best international practice by putting more emphasis on management of funding liquidity risk; i.e. on management of liability concentrations and banks' reliance on short-term external funding (end-March 2010 structural benchmark). We intend to continue revising our regulations in the future in line with the evolving best international practice. Second, we will continue to enforce best international practice for loan review systems and provisioning in banks, as well as prudential treatment of special entities

set up by banks for the management of seized property and other problem assets. We will enhance our existing regulatory framework with comprehensive credit risk regulations (end-June 2010 structural benchmark).

19. **Foreign banks play an important role in the stability of Latvia's banking system**. As such, the FCMC will continue to ensure close monitoring and coordinate supervisory actions concerning cross-border institutions. In addition, the Latvian authorities, together with the other participants in the European Banking Co-ordination Initiative, will make progress towards requesting more specific individual commitments from banks, as agreed at an initial meeting in Stockholm in September 2009. The FCMC, with the BoL, will ensure monitoring of foreign banks' exposure and share information with foreign supervisors and central banks.

20. **We will accelerate our efforts to resolve Parex**. In consultation with the EBRD, which took a 25 percent stake in Parex in September 2009, we will devise a comprehensive plan to deal with the bank's non-performing and non-core assets (for example, without prejudice, we are considering setting up a specialized asset management company in line with best international practice on governance, funding and functions of such institutions). This plan will be submitted to the European Commission by end-March 2010 (structural benchmark). Priority will be given to ensuring adequate capitalization and stable management of the restructured bank and to maintaining financial stability and depositor confidence. Meanwhile, we will ensure that shareholders at the time of the initial state intervention do not benefit from the banks' resolution or from state aid.

21. **We remain committed to fair and equitable treatment of depositors and creditors in the Latvian banking system.** Under our deposit insurance system, we are committed to respecting the rights of all depositors, both resident and non-resident. We will continue to relax the partial freeze limiting withdrawal amounts from deposits in Parex, if conditions allow, and will remove the restrictions fully once conditions stabilize. In October 2009 we relaxed the withdrawal ceilings for certain types of clients based on their credit turnover and removed administrative requirements for corporate depositors. And we continue good-faith efforts to facilitate the settlement of affected depositors' claims arising from this exchange measure.

22. **We will transform the Mortgage and Land Bank of Latvia (MLB)**. Drawing on the recommendations of the recent IMF mission and consistent with the strategy adopted by the Latvian Cabinet of Ministers on November 25, 2009, we will prepare a time-bound action plan. We will consult with the IMF and EC staffs on the action plan, which we will adopt by May 2010 (end-May 2010 structural benchmark). We intend to concentrate the core development activities—financing SMEs, business start-ups, infrastructure, and other national development projects—into a specialized development institution subject to strict supervision by the FCMC (which may require a legal change). In co-operation with MLB management, we will define a plan to address non-performing assets and formulate a medium-term funding program for MLB. Until the plan is finalized, the bank will refrain from assuming new foreign borrowing (beyond already signed loan agreements).

23. **Finally, we will continue to improve our contingency planning and crisis management capacity**:

- ***Liquidity triggers***. FCMC will seek international assistance to establish guidelines for explicit liquidity triggers for supervisory actions in banks receiving emergency liquidity assistance as envisaged by the BoL ELA framework. The guidelines will include a range of actions with specific triggers, from close monitoring of liquidity, through restrictions on bank business activities, to appointing an FCMC official to oversee bank activities.

- ***Deposit guarantee***. FCMC will designate and train staff to operate the Deposit Guarantee Fund, which will be established as a separate unit with separate financial statements for the fund within the FCMC (end-March 2010 structural benchmark). We will analyze the adequacy of the present DGF investment policy with a view to better meet the requirements for fast payout of insured deposits.

D. Private Debt Restructuring

24. **We are considering launching a debt restructuring strategy compatible with fiscal constraints, while continuing to work on market-based approaches to restructuring.** We would offer to guarantee loan payments to targeted qualifying household borrowers for up to two years in exchange for loan restructuring, including reduction in loan principal amounts, by banks (in accordance with conditions outlined in the debt restructuring strategy) in order to help borrowers cope with economic distress (while avoiding moral hazard), prevent foreclosures and create incentives for banks to provide debt relief. The scheme would be limited to mortgage amounts of L100,000 or less on primary residences. To ensure public money is well spent, access to the debt restructuring scheme would be strictly capped at L82 million of issued guarantees for the whole period, with an estimated fiscal cost of up to L31 million per year. If implemented, the Ministry of Finance (MoF) will review this scheme by end-December 2010 to determine if adjustments are needed to enhance its effectiveness or ensure that costs are contained (structural benchmark).

25. **We will continue to improve the legal framework to help address widespread debt distress in the corporate sector as well also for individuals.** We submitted amendments to the Insolvency Law in early November to streamline liquidation procedures to facilitate rapid exit of non-viable firms and to establish a new personal insolvency framework to support rehabilitation of individual debtors. In addition, we submitted amendments to the Civil Procedure Law to Parliament in September 2009 to further improve the efficiency of the foreclosure procedures and create incentives for debt workouts. These amendments are expected to take effect in early February 2010. Finally, we have launched an information campaign to ensure the new instruments are widely used. In particular, we have held a series of workshops on out-of-court debt restructuring for stakeholders and will continue training judges and insolvency administrators to improve institutional capacity.

E. Other Issues

26. **We will continue to place all long-term funds under the program in special sub-accounts of 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 MoF will consult with EC and IMF staff.

VIII. IMF Arrangement

27. **On top of previous commitments under the program, we believe the policies described above represent another significant step towards our goal of euro-entry**. 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.

28. **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/
Einars Repše
Minister of Finance

/s/
Ilmārs Rimšēvičs
Governor of the Bank of Latvia

/s/
Irēna Krūmane
Chairwoman
Financial and Capital Market Commission

Box 1: Further Steps to Strengthen the Financial Sector

Since July, we have made further progress towards strengthening the financial sector:

- ***Supervision and monitoring***. The FCMC stepped up its monitoring of individual banks and enacted new reporting requirements. A half-year financial results audit of all banks revealed no immediate solvency issues. The FCMC and the BOL have continued regular stress tests to assess risks facing individual institutions. In addition, all banks have completed their own bottom-up tests on the basis of a uniform macroeconomic scenario. FCMC discussed the outcome of the tests with banks' managements. A number of banks strengthened their capital to cope with credit losses ahead. We have improved information exchange between the BOL and FCMC on stress-testing, and we have increased the number of FCMC staff dealing with offsite monitoring.

- ***Prompt Remedial Action Guidelines***. Guidelines have been introduced by the FCMC to ensure, where necessary, timely supervisory action is taken, including outlining decision-making procedures that promote prompt and expedient decisions and consistent application of corrective actions and sanctions.

- ***Contingency planning.*** In August, the FCMC in cooperation with the BoL and MoF completed work on a bank resolution strategy. The strategy defines responsibilities of government agencies, the decision-making process, and options and methods applicable to various sub-groups of banks.

- ***Foreign banks' exposure***. In September, foreign banks committed to maintain the level of their exposure to Latvia. Through a public statement, parent banks also committed to meeting capital and liquidity needs of subsidiaries and branches in conformity with the respective legal and regulatory frameworks.

- ***Stabilizing Parex***. The EBRD acquired 25 percent of Parex equity in September and provided a subordinated loan to the bank. The state recapitalized Parex in October to maintain its capital adequacy safely above the regulatory limits.

- ***Insolvency procedures.*** Amendments to the Insolvency Law and Civil Procedural Law have been submitted to Parliament to streamline liquidation procedures, support rehabilitation of individual debtors and facilitate speedy debt resolution.

- ***Debt workouts.*** Principles and guidelines for out-of-court consumer mortgage workouts were issued in August by the FCMC to promote awareness on general principles for out-of-court mortgage workouts among lenders and customers. Guidelines for out-of-court corporate restructuring in line with international best practice have also been issued.

Box 2: Benchmarks to Assure Budget Sustainability

We are introducing reforms to ensure that the expenditure measures in the 2010 budget are sustainable as well as looking beyond 2010. We will support these through structural benchmarks in the program:

- ***Target welfare benefits.*** In the 2010 budget, unemployment, maternity and paternity benefits have been reduced for high income recipients (yielding L26 million). However, this measure expires in 2012. We will therefore conduct a review to identify permanent (perhaps different) measures to replace reduced welfare benefits that expire in 2012 (structural benchmark, end-June 2010).

- ***Delayed investment projects***. A number of postponed investment projects (including National Library and Ministry of Defense contracts) yield savings in 2010 (L24 million), but spending will be pushed out to future years. We will therefore identify other areas where nationally-financed (that is, non-EU) investment in future years can be reduced.

- ***Ministry of Defense***. Further to the large cuts in 2009, additional reductions (L21 million) will reduce defense expenditures to 1.14 percent of GDP in 2010. We believe this is a feasible medium-term appropriation for the sector. However, to ensure our defense capabilities under the reduced budgetary envelope are sufficient, we will complete a medium-term strategy paper for the sector (structural benchmark, end-September 2010).

- ***Pension reform***. The recent Constitutional Court ruling has implications for future pension reforms, but does not preclude structural reforms to achieve savings. In light of this ruling, by end-June 2010 (structural benchmark), with technical assistance from international organizations and in cooperation with social partners, we will prepare changes in order to ensure future sustainability of the three pillars of the pension system, while making sure that the burden on contributors does not rise further and more generally that the burden of fiscal adjustment is shared fairly, with a view to introducing these changes by January 2011.

Table 1: Latvia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2008–09
(In millions of lats unless otherwise indicated)

	2008			2009							
	end-Nov	end-Dec		end-March		end-June		end-Sept		end-Dec	
	Actual	Program	Outcome	Program	Outcome	Program	Outcome	Program	Outcome	Program	Outcome
I. Quantitative performance criteria											
Floor on net international reserves of the Bank of Latvia (millions of euros)	3,368	2,103	2,700	737	1,733	-507	1,163	-81	1,402	-586	1,347
Ceiling on net domestic assets of the Bank of Latvia	-99	951	423	1,434	419	2,501	768	1,719	619	2,103	699
Floor on adjusted cash fiscal balance	…	-894	-957	-305	-328	-649	-794	…		…	
Floor on adjusted primary cash fiscal balance	…	…	…	…	…	…	-388	-828	-467	-1,289	-746
Ceiling on public guarantees (millions of lats)	…	…	…	…	…	…	…	754	312	754	328
II. Continuous performance criteria											
Ceiling on general government domestic arrears	…	0	0	0	6	0	11	40	12	40	12
Non-accumulation of external debt arrears (millions of euros)	…	0	0	0	0	0	0	0	8	0	8
III. Staff consultation clause											
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	…	1,248	1,267	214	263	490	598	840	805	1,067	1,028

Table 2. Latvia: Structural Benchmarks under the Stand-by Arrangement, through end-2009

Structural Benchmarks	**Target date**	**Status**
Wages: reform the Committee to Promote Wage Restraint by involving the social partners and outside labor market experts.	End-August 2009	Done.
Prepare a strategy for bank recapitalization and resolution.	End-August 2009	Done.
Financial sector monitoring: (i) seek international assistance to improve stress-testing capacity; strengthen co-operation between the BoL and FCMC in this area; and (ii) increase resources available to FCMC to perform off-site monitoring incorporating re	End-August 2009	Done.
Design a strategy to strengthen the social safety net.	End-August 2009	Done.
Wages: prepare a comprehensive report on proposed revisions to the public-sector wage grid and the relative wage adjustment across public institutions since end-December.	End-October 2009	Partially done. Wage grid revised, some analysis undertaken, but no report completed.
Submission to Parliament of amendments to the Insolvency Law and other credit enforcement laws.	End-October 2009	Done with a delay. Submitted to Parliament in November.
Adopt an amendment on fiscal responsibility to the current Budget and Financial Management Law that will aim to reduce public debt, set expenditure ceilings, avoid procyclicality in fiscal policy and ultimately allow automatic stabilizers to operate fully	End-December 2009	Not met. Reset in Second Review.

Table 3: Latvia: Quantitative Performance Criteria and Indicative Targets under the Stand-By Arrangement, 2010

(In millions of lats unless otherwise indicated)

	2010			
	Performance Criteria		Indicative Targets	
	end-March	end-June	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/	-169	-565	-982	-1,740
Ceiling on net domestic assets of the Bank of Latvia 1/	1,820	2,070	2,323	2,853
Floor on primary non-EU cash fiscal balance 2/	-66	-180	-217	-628
Ceiling on public guarantees (millions of lats)	836	836	836	836
II. Continuous performance criteria				
Ceiling on general government domestic arrears	40	40	40	40
Non-accumulation of external debt arrears (millions of euros)	0	0	0	0
III. Staff consultation clause				
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	194	457	654	948

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/ Adjusted downwards for additional social safety net spending (TMU ¶13), and adjusted upward for shortfalls on private debt restructuring costs (TMU ¶14) and excess EU funds-related spending (TMU ¶15).

Table 4. Latvia: Structural Benchmarks through end-December 2010

Structural Benchmarks	Motivation	Target date
Revise liquidity regulations.	Bring up to date with changing best international practice by putting more emphasis on management of funding liquidity risk; i.e. on management of liability concentrations and banks' reliance on short-term external funding	end-March
Submit Parex restructuring plan to European Commission.	Crucial to launch bank's resolution.	end-March
Establish Deposit Guarantee Fund as separate unit with separate financial statements.	Needed to operationalize changes to legal framework made in 2009, and strengthen crisis management capacity.	end-March
Complete action plan for Mortgage and Land Bank.	Need to ensure timely implementation of government strategy in view of fiscal implications.	end-May
Conduct thorough review of welfare benefits.	Fiscal sustainability. Some measures in the 2010 budget are due to expire in 2012. Permanent (perhaps different) measures are needed to ensure welfare benefits remain at a sustainable level which this review should identify.	end-June
Pension reform.	Fiscal sustainability: Prepare changes in pension system in order to ensure future sustainability of three pillars of pension system and share the burden of fiscal adjustment fairly, with a view to introducing these changes by January 2011, with international assistance and in close cooperation with social partners.	end-June
Prepare a draft fiscal responsibility law.	Fiscal sustainability: needed to anchor fiscal policy on a credible and sustainable path.	end-June
Revise credit risk management regulation.	Enforce best international practice for credit risk management, loan review systems and provisioning in banks, as well as prudential treatment of special entities set up by banks for the management of seized property and other problem assets.	end-June
Complete strategy paper for defence sector.	Fiscal sustainability: Budget cuts have reduced defence expenditures to 1.14 percent of GDP in 2010. To ensure this lower appropriation is feasible over the medium-term, this medium-term strategy will set out priorities for the sector within this reduced budget envelope.	end-September
Prepare menu of potential structural reforms.	To aid the 2011 budget process, we will prepare a menu of possible structural reforms in key sectors.	end-October
Review debt restructuring scheme.	Review performance of the debt restructuring scheme, in particular to ensure costs are contained.	end-December

APPENDIX II. LATVIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

January 22, 2010

29. 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 January 22, 2010 signed by the Prime Minister, the Minister of Finance, the Governor of the Bank of Latvia, and the Chairwoman of the Financial and Capital Market Commission. It describes the methods to be used in assessing program performance with respect to these targets.

30. For program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "program exchange rates" as defined below, with the exception of the government fiscal balances, which will be measured at current exchange rates. The program exchange rates are those prevailing on November 28, 2008. In particular, the exchange rates for the purposes of the program of the Latvian Lats (LVL) to the euro is set at LVL 0.702804 = €1, to the U.S. dollar at LVL 0.544 = $1, and to the Japanese yen at LVL 0.00571 = 1 JPY, as shown on the Bank of Latvia (BoL) website.

A. Floor on Net International Reserves of the BoL

	(in millions of euros)
Floors on level of NIR:	
March 31, 2010 (performance criterion)	1
June 30, 2010 (performance criterion)	-506
September 30, 2010 (indicative target)	-926
December 31, 2010 (indicative target)	-1,648

Definitions

31. **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 September 30, 2009, foreign reserve assets thus defined amounted to 4,770 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 September 30, 2009, reserve liabilities thus defined amounted to 204 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 September 30, 2009, base money equaled 1,606 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.

- ***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 above definition. As of September 30, 2009, net foreign assets of the BoL amounted to 3,111 million lats.

32. As of September 30, 2009 the sum of Treasury liabilities to the IMF, the European Union, other official creditors participating in the program, and other external borrowing by the Treasury over the program period, amounted to 3,025 million euros.

33. The ceilings set out below are based on the assumption that all program related financing will be given to the Latvian government and will be deposited in a special sub-account of the Treasury euro-account 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:	
March 31, 2010 (performance criterion)	1,707
June 30, 2010 (performance criterion)	2,056
September 30, 2010 (indicative target)	2,344
December 31, 2010 (indicative target)	2,882

Adjustors

34. 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 November 30, 2009, provided that net foreign assets of the BoL remain above base money. The outstanding amount on November 30, 2009 was 145 million lats.

35. The NIR targets will be revised up (and NDA targets revised down) for the full amount of any non-concessional external debt issued by the government. For this adjustor, non-concessional 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:	
March 31, 2010 (performance criterion)	-124
June 30, 2010 (performance criterion)	-353
Sept.30, 2010 (indicative target)	-424
Dec. 31, 2010 (indicative target)	-813

36. 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.

37. The non-EU cash primary fiscal balance of the general government is defined as **general government net lending/borrowing**, 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).

38. Foreign financial assistance not managed by the European Commission is excluded from the revenues from EU-funds and from the associated spending.

39. The net government lending/borrowing 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

40. 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)

41. The end-December floor for the non-EU cash primary fiscal balance of the general government will be adjusted downward for any additional spending on social safety nets, as defined under the World Bank strategy, cumulated from January 1, 2010, above 17.5 million lats and up to 35 million lats per quarter.

Private debt restructuring (adjustor)

42. The floor on the non-EU primary cash fiscal balance will be adjusted upwards for any shortfall in net lending to private mortgage holders under the scheme described in paragraph 24 of the Letter of Intent (to which this memorandum is attached) below L7.75 million per quarter, cumulated from January 1, 2010.

Excess EU-related spending (adjustor)

43. Should spending on EU-related items exceed L1,000 million (remaining funds divided by remaining number of years), the floor on the non-EU primary cash fiscal balance will be adjusted upwards by the excess.

Financing

44. Consistent with the NDA ceilings in section B, the government will deposit all program related financing in special sub-accounts of the Treasury euro-account 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):	
March 31, 2010 (indicative target)	194
June 30, 2010 (indicative target)	457
September 30, 2010 (indicative target)	654
December 31, 2010 (indicative target)	948

45. 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

46. 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 836 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.

47. 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

48. 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 capture delayed wage payments to employees of the public sector and (ii) mandatory contributions to the social insurance funds. The ceiling for arrears will be set at LVL 40 million for the duration of the program. As of end-September, the stock of arrears stood at LVL 12 million. This performance criterion will apply on a continuous basis.

G. Continuous Performance Criterion on Non-accumulation of External Debt Payments Arrears by the General Government

49. 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.

50. 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

51. Performance under the program will be monitored from data supplied to the IMF by the BoL, the Financial and Capital Markets Commission, and the Ministry of Finance as outlined in Table 1. The authorities will transmit promptly to the IMF staff any data revisions.

Table 1. Republic of Latvia: Data to be Reported to the IMF

Item	Periodicity
To be provided by the Ministry of Finance	
Consolidated central (basic and special budgets), local and general government operations based on the IMF fiscal template	Monthly, within four weeks of the end of each month
Detailed information on revenues from EU funds at the general government level, and EU-related spending by the central government, including transfers to local governments for EU-related spending	Monthly, within three weeks of the end of each month
Social safety net spending	Quarterly, within four weeks of the end of each quarter.
Data on general government net lending showing separately any net lending under the private mortgage restructuring strategy.	Monthly, within four weeks of the end of each quarter.
Public sector guarantees, detailed breakdown by issuing institution or agency and purpose.	Quarterly, within four weeks of the end of each quarter.
Consolidated central and general government bank restructuring operations	Daily, by end of next working day
Privatization receipts received by the general government budget (in lats and foreign exchange, and payments in governments bonds)	Monthly, within four weeks of the end of each month
Information on debt stocks and flows, domestic and external (concessional and non concessional), by currency, and guarantees issued by the (i) consolidated central, local and general governments and (ii) public enterprises (including the Latvian guarantee agency and the Rural guarantee fund), including amounts and beneficiaries	Monthly, within four weeks of the end of each month
Information on new contingent liabilities, domestic and external, of the consolidated central, local and general governments	Monthly, within four weeks of the end of each month
Data on general government arrears, including to suppliers	Monthly, within four weeks of the end of each month
Data on operations of extra budgetary funds	Monthly, within four weeks of the end of each month
Data on the stock of the general government system external arrears	Daily, with a seven days lag
To be provided by the Bank of Latvia	
Balance sheet of the BoL, including (at actual exchange rate) (i) data on components of program NIR; (ii) government balances at the BoL, broken into foreign exchange balances—distinguishing various program partner sub-accounts for program financing—and balances in lats.	Daily, within one working day

Balance sheet of the BoL (in program and actual exchange rates) (i) data on components of program NIR; (ii) government balances at the BoL, broken into foreign exchange balances—distinguishing various program partner sub-accounts for program financing—and balances in lats.	Weekly, within one week of the end of each week
Consolidated accounts of the commercial banks	Monthly, within two weeks of the end of each month
Monetary survey	Monthly, within two weeks of the end of each month
Currency operations, including government foreign receipts and payments and breakdown of interbank market operations by currencies (interventions)	Daily, by end of next working day
Aggregated data on free collateral—available, unpledged collateral held at the Bank of Latvia	Weekly, within one week of the end of each week
Daily data with banks' current accounts, minimum reserve requirements, stock of repos ,foreign exchange swaps, use of standing facilities, and use of emergency liquidity assistance	Monthly, capturing data over the preceding month, within one week of the end of the month
Foreign exchange rate data	Daily, by end of next working day
Volume of foreign exchange lats trades	Monthly (weekly for a sample of large banks), within one week of the end of each week
Projections for external payments of the banking sector falling due in the next four quarters, interest and amortization (for medium and long-term loans)	Quarterly, within four weeks of the beginning of the quarter
Projections for external payments of the corporate sector falling due in the next four quarters interest and amortization (for medium and long-term loans)	Annually, within three months after the end of the second quarter
The stock of external debt for both public and private sector	Monthly, within four weeks of the end of each month for the public and the banking sector; quarterly, within three months of the end of each quarter for total external debt
The BoL will continue to provide balance of payments data in electronic format.	Monthly, within six weeks of the end of each month
To be provided by the Financial and Capital Market Commission	
Daily deposit monitoring bank by bank in the agreed format	Daily, by end of next working day
Daily detailed deposit monitoring in Parex Bank in the agreed format	Daily, by end of next working day
Banking system monitoring indicators in the agreed format (liquidity, credit quality, summary capital adequacy, simplified balance sheet and income statements)	Monthly, within four weeks of the end of each month
Detailed capital adequacy reporting in the agreed format	Quarterly, within four weeks of the end of each quarter
Commercial banks' balance sheets (bank-by-bank)	Quarterly, within four weeks of the end of each quarter
Commercial banks' income statements (bank-by bank)	Quarterly, within four weeks of the end of each quarter

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Second Review and Financing Assurances Review Under the Stand-By Arrangement, Request for Extension of the Arrangement and Rephasing of Purchases Under the Arrangement and Request for Waiver of Nonobservance and Applicability of Performance Criteria—Informational Annex

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

Approved by Anne-Marie Gulde-Wolf and Tessa van der Willigen

January 25, 2010

Contents

Appendix

APPENDIX I. LATVIA: FUND RELATIONS
(As of December 31, 2009)

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

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	126.80	100.0
Fund holdings of currency	840.55	662.9
Reserve position in Fund	0.06	0.04

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	121.38	100.46

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Standby Arrangement	713.79	562.93

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR million)**	**Amount Drawn (SDR million)**
Stand-by	12/23/08	03/22/11	1,521.63	713.79
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:**

	2009	2010	2011	2012	2013
Principal	0.00	0.00	0.0	290.0	457.6
Charges/interest	11.2	25.6	37.1	40.7	30.1
Total	11.2	25.6	37.1	330.6	487.6

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 ERM2, maintaining the previous band width. On January 12, 2010 the lats was equal to US$ 2.04. 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, as it has been imposed for balance of payments reasons, is temporary and is nondiscriminatory, the Board has approved its retention until end-June 2010 or the conclusion of the next Article IV, whichever comes earlier.

Article IV Consultation:

Latvia is on the 24-month consultation cycle.

The 2006 Article IV staff report was issued on September 13, 2006 (Country Report No. 06/353). The last Article IV Board discussion took place on October 4, 2006. The Public Information Notice No. 06/113 was released on October 12, 2006.

Safeguards Assessment

The safeguards assessment completed on July 8, 2009 concluded that the 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 begun implementing these proposals.

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 (2007–2009):

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	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

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: WORLD BANK RELATIONS
(As of January 14, 2010)

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank Work Program	Social Sector, Public Administration Reform and Emergency Safety Net – Development Policy Loan	In preparation	Board meeting scheduled for Feb 25, 2010
	Public Expenditure Review Update for Social Sectors and Public Administration	In preparation	Implementation throughout FY 2010
	Financial Sector TA (to support DPL; includes strategic contingency plan, deposit insurance, consumer protection, debt restructuring)	Under implementation	To be delivered by end-2010
	Swiss TA funds from SECO (State Secretariat for Economic Affairs)	Swiss Govt. has made resources available	Implementation in FY2010
2. Fund Work Program	TA on real estate taxation	February 2010	April 2010
	TA on public financial management	March 2010	May 2010
	TA on stress testing (financial sector)	April 2010	June 2010
	Review and Article IV mission	May 2010	June 2010

INTERNATIONAL MONETARY FUND
REPUBLIC OF LATVIA

Second Review and Financing Assurances Review Under the Stand-By Arrangement, Request for Extension of the Arrangement and Rephasing of Purchases Under the Arrangement, Request for Waiver of Nonobservance and Applicability of Performance Criteria—Supplementary Information

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

Approved by Anne-Marie Gulde-Wolf and Tessa van der Willigen

February 9, 2010

1. **This supplement provides additional information that has become available since circulation of the staff report.** It does not alter the thrust of the staff appraisal.

2. **Recent indicators confirm that the economy is contracting much more slowly although domestic demand remains weak.** Manufacturing output declined by 5.7 percent in December after a sharp increase in November, but the increase since February remains at around 10 percent. At the same time, retail sales continue to decline on the back of negative real wage growth, high unemployment, and the contractionary effect of reduced government spending.

3. **The authorities met the end-December performance criterion (PC) on the adjusted primary cash fiscal balance** by a comfortable margin (L545 million or 4.2 percent of GDP). They also comfortably met the end-December PC on public guarantees (by L425 million) and met the indicative target on the public wage bill by a small margin (L39 million). Since they have been met, the authorities are no longer requesting a waiver of applicability of the two PCs.

4. **Lower than anticipated expenditure growth resulted in a 2009 fiscal deficit of 7.1 percent of GDP compared to 8.1 percent projected in the staff report.**

- **Total revenues were ½ percent of GDP lower than projected, largely on account of lower than anticipated grant financing.** Total revenue for 2009 is estimated at 36.2 percent of GDP, including 26.9 percent of GDP in tax revenues, 5.3 percent of GDP of nontax revenues, and 4.1 percent of GDP of foreign (mainly EU) assistance.

- **Total expenditure was 1½ percent of GDP lower than projected due to lower than expected current spending.** The overperformance was evident in all spending categories including remuneration, spending on goods and services, transfers, and net lending. It suggests that the authorities were more successful than expected at containing the usual increase in spending in the last quarter, with 28 percent of 2009 expenditure taking place in the last quarter of 2009, compared to 32 and 34 percent in 2007 and 2008. Overall expenditure amounted to 43.3 percent of GDP, including 40.0 percent of GDP in current spending, and 3.3 percent of GDP in capital spending.

- **Bank restructuring costs were ½ percent of GDP lower than projected,** reducing the 2009 fiscal deficit—including bank restructuring costs—to 7.8 percent of GDP compared to 9.4 percent projected in the staff report.

5. **Despite the better than projected fiscal outturn in 2009, staff's projections for the 2010 deficit remain appropriate.** While staff have not had the opportunity to examine the expenditure outturns—and their sustainability—in detail, the overperformance does not warrant lowering the projected deficit for 2010, which is guided by the already-approved 2010 budget. At the same time, continued expenditure restraint is warranted to guard against fiscal risks, including from a pending Constitutional Court decision on reversing cuts to parental benefits. The authorities are also considering increasing EU-funded spending as well as increasing the number of places in their active labor market scheme, which would raise expenditure still further.

6. **The government has reached agreement on rescheduling of €8 million in external arrears to a foreign supplier** that emerged in September and resulted in nonobservance of the continuous PC on external payment arrears.

7. **The authorities intend to provide Parex Bank with L100 million (0.8 percent of GDP) in liquidity support to help it cover payments to syndicated lenders on February 15.** Parex Bank's syndicated loan payments were guaranteed by the government in March 2009 as part of its support package for Parex Bank after its takeover by the state. While the first installment of the loans was paid entirely using government liquidity support, the bank and the authorities have determined that Parex Bank currently has sufficient liquid resources to cover more than half of the L217.9 million due in February. The liquidity support—part of the 7.8 percent of GDP in bank restructuring costs included in the 2010 projection—is not included in the program definition of the fiscal balance. The final installment of the loan—L163.4 million—is due in May 2011.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 10/47
FOR IMMEDIATE RELEASE
February 17, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Second Review Under Stand-By Arrangement with Latvia and Approves €200.3 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Latvia's performance under an economic program supported by a Stand-By Arrangement (SBA). The Board decision enables the immediate disbursement of an amount equivalent to SDR 178.4 million (about €200.3 million or US$274.9 million), bringing total disbursements under the SBA to SDR 892.2 million (about €1.00 billion or US$1.37 billion).

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$2.34 billion), entails exceptional access to IMF resources, amounting to 1,200 percent of Latvia's quota in the IMF. The IMF’s support is part of a coordinated effort with the European Union, Nordic governments, the World Bank, and other bilateral creditors that are providing the financing necessary to ensure that essential public services, especially support to those most severely hit by the crisis, can be maintained in the face of the sharp drop in government revenues.

In response to the sharp downturn following the bursting of credit and real estate bubbles, the authorities have taken a number of steps to restore stability and confidence while cushioning the impact of the crisis on the poorest, including:

- keeping the 2009 fiscal deficit well below the level allowed under the program and passing a strong 2010 budget to make further progress toward fiscal sustainability,
- limiting the cost of adjustment for the most vulnerable in society by eliminating health copayments for the poorest, increasing the guaranteed minimum income, extending unemployment benefits, and launching a temporary jobs program, and
- addressing urgent financial sector strains, and strengthening supervision and monitoring.

While conditions remain quite difficult, there are signs that the Latvian economy is beginning to bottom out with hope for a recovery late this year and into 2011, and financial markets have calmed considerably. The current account has turned positive and previously high inflation is being reversed.

The authorities reaffirmed their commitment to putting the budget deficit on a rapidly declining path from 2010 onward in order to meet the Maastricht criteria for euro adoption as quickly as possible. Measures to achieve additional fiscal savings through the medium term will be considered during the year and will be discussed in subsequent reviews under the Fund arrangement.

Recognizing the need to sustain fiscal adjustment to achieve the program's exit strategy of euro adoption, the authorities have requested, and the Board has approved, an extension of the SBA by nine months to December 22, 2011. This will spread the IMF's financial support over a longer period and means that the program supported by the SBA would still be in place when the government prepares its 2012 budget, which will be critical for meeting the Maastricht criteria for euro adoption.

The Board also granted a waiver of non-observance of the continuous performance criterion on non-accumulation of external payment arrears.

Following the Executive Board's discussion on Latvia, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair stated:

"The Latvian authorities are to be commended for their strengthened program implementation, which yielded better-than-expected fiscal performance in 2009 and helped improve confidence. Adoption of a 2010 budget with substantial savings measures has enhanced the credibility of the authorities' strategy. Nevertheless, Latvia continues to experience extremely challenging economic circumstances. Output has shrunk substantially, more than a fifth of the workforce is unemployed, and the downturn has eroded government revenue. There are, however, signs that the economy is starting to bottom out with exports increasing, and financial market conditions have improved considerably. The current account has moved fast from a very large deficit to a surplus and a correction of wage and price levels has set in.

"Looking ahead, substantial additional fiscal adjustment remains necessary to enable Latvia to meet the Maastricht criteria and realize the program's exit strategy of euro adoption. Rigorous execution of the 2010 budget is the first step, and this entails refraining from tax cuts or spending increases, saving any windfall revenues, and using the spending flexibility allowed under the program to ensure a robust safety net for the most vulnerable. To ensure a rapid decline in the deficit in the 2011 budget and beyond, early action is needed this year to identify sustainable savings measures backed by structural reforms.

"Banks continue to face difficult conditions as non-performing loans and losses increase, and liquidity and funding risks remain. Capital increases as well as enhanced financial supervision and monitoring are helping to address risks. Faster progress in restructuring state-owned banks and addressing non-performing assets would strengthen the economy and lower potential costs for the government.

"The Latvian authorities remain committed to restoring macroeconomic stability and, ultimately, growth. They made good progress during 2009 and have outlined key measures to advance further in 2010. Decisive further efforts are needed, backed by strong international support from the European Union, Nordic countries, and other partners, in addition to the IMF."

Statement by Mr. Per Callesen, Executive Director for Latvia and
Mr. Gundars Davidsons, Advisor to Executive Director
February 19, 2010

The Latvian authorities would like to thank staff and management for their exceptional involvement with the program. The amount of work done is reflected in the staff report, which provides a well-balanced assessment of the program implementation and economic developments in Latvia.

Program implementation is firmly on track

Preliminary data for 2009 confirm that the general government budget deficit was well below the forecasted level. According to the current estimates, the budget deficit in 2009 reached 6.8 percent of GDP– well below the target of 8 percent. This better-than-forecasted performance has been achieved due to the rigid implementation of the June 2009 supplementary budget.

The Latvian authorities have adhered to the fiscal consolidation policy when drafting and adopting the 2010 budget. New fiscal consolidation measures adopted with the 2010 budget amount to more than LVL 500 million (around EUR 700 million or 4.2 percent of GDP), which is fully in line with the government's initial commitments. As a result, the authorities estimate that the agreed consolidation would be sufficient to meet the program's budget deficit target for 2010, even if the effect from the recent Constitutional Court rulings is taken into account. Budget execution is regularly monitored in order to avoid the risk of exceeding the committed fiscal targets. Continuous performance criteria on external payment arrears have also been fulfilled, and we expect a continuous compliance, going forward.

Fiscal consolidation measures for 2010 are aimed at both increasing revenue and decreasing budget expenditure. On the revenue side, my authorities have raised the personal income tax rate from 23 percent to 26 percent, broadened the personal income tax base including capital income, increased tax on cars and introduced taxation of fringe benefits from using employer's car for employee's private needs, and introduced a new real estate tax on residential buildings. On the expenditure side, the functions of the government are continuously and vigorously being optimized, including through reduction of the public sector wages and number of public employees, harmonizing remuneration across ministries and public institutions, and centralization of support functions in the public sector. As a result, the public wage bill is expected to be down by additional 12.7 percent in 2010 on top of the 2009 consolidation.

At the same time, with a view to protect the most vulnerable part of the society, on September 18, 2009 the authorities have adopted the Social Safety Net Strategy. The measures included in this strategy contain, *inter alia*, compensating costs for medication and patient co-payments in hospitals for the most vulnerable, increasing the guaranteed minimum income and housing support, ensuring transportation for pupils in the areas where schools are being closed down, creating emergency social employment in municipalities. Social safety net measures have been designed and implemented in close cooperation with experts from the World Bank.

Latvia has made further **progress towards strengthening the financial sector.**

First, in August, the Financial and Capital Markets Commission (FCMC) in cooperation with the BoL and MoF completed work on the **bank resolution strategy**. The strategy defines responsibilities of government agencies, the decision-making process, and options and methods applicable to various sub-groups of banks.

Second, **guidelines** have been introduced by the FCMC to ensure, where necessary, that timely supervisory action is taken, including outlining decision-making procedures that promote prompt and expedient decisions and consistent application of corrective actions and sanctions. The guidelines will be amended with explicit liquidity triggers for supervisory actions in banks receiving emergency liquidity assistance as envisaged by the BoL ELA framework.

Third, in December 2009 the FCMC revised **Regulation on Liquidity Requirements, Compliance Procedures and Liquidity Risk Management** and **Regulation on the Credit Risk Management** taking into account the developments in best international practice. Enforcement of both regulations will be a priority for 2010.

Undertaken reforms have delivered results

While acknowledging that there are still important challenges ahead, authorities are pleased that despite the various uncertainties, **the program and the associated reforms are delivering results.** As a result, confidence in the Latvian economy and financial sector has gained ground over the course of the past six months.

Market pressures and immediate concerns have been removed and private outflows have moderated, allowing for the performance criteria to be met with a huge margin. Money market interest rates have reached the lowest levels since March 2007. The banking system has so far weathered the storm generated by the deep economic contraction relatively well. In September 2009 four large foreign banks (accounting for around 55 percent of bank assets) committed to maintain overall exposure levels.

Although non-performing loans exceeded 16.4 percent of total loans by end-December 2009, and the system registered sizable losses as a result of a sharp increase in loan loss provisions, the average capital adequacy ratio improved and stood at 14.6 percent system-wide in December 2009, providing a good cushion to deal with credit losses ahead. In 2009 and January 2010, 14 banks have increased the capital base by almost 1 billion lats and a further 140 million lats are forthcoming. With resuming deposit growth, particularly for lats denominated deposits, depositors' confidence has been returning.

Past imbalances are disappearing. Since the inception of the program, Latvia has experienced a dramatic current account turnaround, at a magnitude not very often observable in peacetime world history. Bursting of the sizable real estate bubble caused a rise in unempoyment and associated social costs to the economy. However, it would be wrong to associate the current social difficulties with the chosen adjustment strategy. The burst of the real estate bubble and unwinding of massive imbalances observed at the outset of the crisis could not have been without dramatic consequences for unemployment in any adjustment scenario, as the most recent developments in a number of countries around the globe attest.

In the meantime, the external **competitiveness is improving**. This is suggested both by the traditional exchange rate indicators, and developments in the real economy.

As regards Latvia's **exchange rate assessment,** we note that two of the three CGER approaches show insignificant or no currency overvaluation– similar to our findings, which is a remarkable improvement when compared to past assessments. At the same time, we are surprised that exchange rate assessment was included in the current report at all, since the authorities did not have the opportunity to discuss issues related to the exchange rate during the last staff visit. Nevertheless, we look forward to discussing all exchange rate issues and presenting the authorities' views on this important subject during the next Article IV consultations. We hope that the exchange rate assessment methods applied will be comparable with the methods used both in the previous reports and in the reports of peer countries.

As regards developments in the real economy, **the restructuring towards the tradables sector has begun**. Monthly inflation slipped into negative territory in April 2009. Excluding impact of indirect tax changes, consumer prices posted a decrease in the order of 6.5 percent over a 12 months horizon (in December 2009). Producer prices and export unit values were down by 10.2 percent (in December 2009) and 16.8 percent (in Q3 2009) respectively since their peaks in August 2008 and Q3 2008. Economy wide wages, adjusted to reflect compensation per hour worked, were already down by 10 percent year on year in September, while compensation per employee posted a 16.5 percent year on year drop in Q3 2009. Productivity per hour worked resumed growth, by close to 14 percent year-on-year in the economy as a whole, and by 24 percent in manufacturing. Export market shares are either stable or increasing in most key export markets, with a notable increase in Russia, Germany, Estonia. Real sector activity seems to be gradually resuming, with tradables leading recovery. While domestic demand remains compressed, exports and manufacturing showed positive growth rates in recent quarters, posting an increase of 9.2 percent in Q3 2009 and 6.7 percent in Q4 2009 since their respective troughs (both in Q1 2009).

My authorities appreciate that against the backdrop of restoring confidence and considerably lower uncertainties the **staff assessment has also become more balanced with the risks associated with the main scenario being less pronounced** compared to the First Review. The Latvian authorities believe this is a good step forward in anchoring the attained stability and underpinning future progress with reform implementation.

Policies for 2010 and beyond

Continuous adherence to the program has repeatedly required the implementation of measures which, as rightly pointed out by staff, have been rather difficult at times. However, as stressed in previous reports, the **fiscal deficits accumulated during the previous years have been of structural nature.** Hence, they had to be tackled and the lingering fiscal imbalances corrected irrespectively of the overall adjustment strategy.

Against this background, and looking beyond 2010, we recognize that significant additional measures will be needed to set the basis for sustainable development and growth of the economy. The authorities remain committed to lowering the general government deficit to less than 3 percent of GDP in 2012, while continuing the implementation of the structural reforms. To this end, the authorities will elaborate tax policy guidelines or a long-term policy paper on tax reforms, and will work with the European Commission and the World Bank on a new public expenditure review with the goal of improving the efficiency and effectiveness of government spending. The Latvian authorities will prepare changes in the pension system in order to ensure future sustainability of the three pillars of the pension system, and will continue working on developing a fiscal framework, to anchor fiscal policy on a credible and sustainable path by preparing a fiscal responsibility law.

The EU funds will provide the necessary stimulus to kick-start growth. Notwithstanding the overall fiscal consolidation objectives, my authorities will continue efforts to ensure sufficient budgetary expenditure for projects co-financed by the European Union funds. Speed of the implementation of EU co-financed projects has increased in 2009 and is expected to increase further in 2010. Financing for EU funds in the 2010 budget is enough for reaching the annual spending targets set in the SMoU. It does not, however, allow us to undertake new projects that are in the pipeline and are vital for the revitalization of the national economy. My authorities will continue efforts to find additional expenditure for EU funded projects.

As regards the country's financial system, the FCMC will continue to ensure **close monitoring of foreign banks' exposure to Latvia** and coordinate supervisory actions concerning cross-border institutions, given the important role played by the foreign banks in Latvia.

The government is **taking steps in order to achieve a successful restructuring of state-owned banks (Parex and MLB)**. To resolve Parex a comprehensive plan will be developed in cooperation with EBRD and international consultant "Nomura International Plc" to deal with the bank's non-performing and non-core assets. Priority will be given to ensuring adequate capitalization and stable management of the restructured bank and to maintaining financial stability and depositor confidence. The partial deposit freeze will be removed once conditions stabilize.

A comprehensive action plan for implementation of the medium-term strategy for MLB will be adopted. It is intended to relocate the core development activities—financing SMEs, business start-ups, infrastructure, and other national development projects—into a specialized development institution subject to strict supervision by the FCMC.

My authorities acknowledge the potential risks to program implementation associated with political tensions. Nevertheless, it is worth noting that after a year of difficult and unpopular measures, **the program still enjoys wide political support.** Parliament has sent a clear signal regarding the program ownership and strong political support by authorizing the government to proceed with the program implementation following the Constitutional Court ruling that requires program endorsement by the parliament.

The Latvian authorities remain strongly committed to fulfilling the Maastricht criteria and euro introduction on January 1, 2014. Against this background, the authorities envisage that public debt will be kept below the 60 percent ceiling until 2012, and will be on a downward trajectory afterwards.

Finally, **risks to the program remain, however, we do not view them as insurmountable.** The IMF has been at our side through all difficult challenges and we believe it will remain so also for the years ahead. The Latvian authorities would like to thank Fund staff, management and the Board for their support, and look forward to continuous and fruitful cooperation.