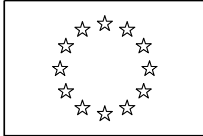

EUROPEAN COMMISSION

DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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COMMUNITY BALANCE OF PAYMENTS ASSISTANCE

LATVIA

1ST REVIEW LINKED TO THE 2ND INSTALMENT

(NOTE FOR THE ECONOMIC AND FINANCIAL COMMITTEE)

1. Introduction

On 20 January 2009 the ECOFIN Council approved Community medium-term financial assistance for Latvia totalling up to €3.1 billions under the Balance of Payments (BoP) facility for Member States. The Community assistance, part of a coordinated package of international financial assistance totalling up to €7.5 billions over the period to 2011 (see Annex 1), underpins the implementation of the "Economic Stabilisation and Growth Revival Programme" adopted by the Latvian authorities on 12 December 2008. Contributions from the EU, either multilaterally under the Community BoP (€3.1 billions) or bilaterally from several EU countries, total €5.3 billions, with the remaining part provided by the IMF (around €1.7 billion), the WB and the EBRD.

A Memorandum of Understanding (MoU) associated with the Community assistance details the precise conditionality that will be applied to successive loan disbursements. It was signed in Riga on 26 January 2009 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 and in Brussels on 28 January by the Commissioner.

The EU loan comprises six instalments. The first instalment of Community assistance of €1 billion was released on 25 February following the entry into force of the Loan Agreement and the Memorandum of Understanding (MoU), after the consultation of the Economic and Financial Committee; it is scheduled to be followed by three other instalments during 2009: €1.2 billion in Q2, €500 million in Q3 and €200 million in Q4, subject to meeting the conditions set in the MoU. The remaining instalments are planned for Q3 2010 and Q1 2011. For the first Community instalment the coupon rate is 3.125% and maturity 3 April 2014.

This assistance was provided in conjunction with loans from the IMF supported by a Stand-by arrangement (SBA). The IMF disbursed the first instalment of 600 million EUR on 26 December 2008. The second instalment by the IMF of 200 million EUR, due in the first quarter of 2009, has not been released, as the joint EC/IMF review mission in February could not be concluded after the fall of PM Godmanis's government. According to original plans, other donors have not made any disbursement for the time being and plan to do so only starting later in the year.

A second instalment by the EU of up to EUR 1.2 billion is foreseen for the second quarter of 2009. In this context, **the Commission services carried out a review mission** from 27 May to 17 June in close cooperation with the IMF staff (which undertook its first full review under their SBA in parallel). The Latvian authorities sent a Compliance Statement to the Commission on XX June 2009, which reports on progress they consider achieved as regards respect of the conditionality. Based on the findings of the above-mentioned review mission and additional available information, the economic policy criteria for the second instalment as laid down in the MoU can be considered to be fulfilled. The full review of compliance is detailed in the remainder of the note, and summarised in Annex 2.

A revision of the Memorandum of Understanding (MoU) is necessary. The revision of the target as well as a number of additional and amended economic policy conditions linked to the savings and structural measures announced by the authorities and to further commitments in the area of financial sector reform are laid down in a Supplemental Memorandum of Understanding (SMoU), see Annex 4. Assent to the SMoU should lock in the commitment of

the Latvian authorities to continue with vigour their macro-financial stabilisation programme. In the view of the Commission services, this revision of the Latvian economic policy programme and in particular a revision of the deficit target for 2009 by around five percentage points of GDP can be justified based on the substantial further deterioration in the economic outlook, the additional fiscal consolidation measures taken by the Government, and the Government's strategy towards ensuring a sustainable long-term correction in view of preparing for entering the euro area. The draft SMoU included in Annex 4, and in particular its Annex, amends the Memorandum of Understanding with respect to the deficit target against which progress will be monitored from now on as well as a number of conditions in the areas of fiscal consolidation, fiscal governance, structural reforms and financial sector policies in line with the strengthened economic programme of the authorities.

The European Council on 19 June 2009 showed a very supportive attitude about the recent steps taken by the government, as stated in its conclusions:

> "13. The European Council supports the adoption of the new budgetary measures in Latvia aiming at sizeable fiscal consolidation this and next year. It stresses that rigorous implementation of the measures adopted together with credible medium-term strategy will deliver a successful outcome of the current adjustment programme. The European Council strongly supports the intention of the Commission to propose the swift disbursement of the next instalment of the Community balance-of-payments assistance in the framework of the adjustment programme."

The purpose of this note is to consult the Committee on the disbursement of the second instalment of EUR 1.2 billion of the Community assistance based on the conclusion that the authorities have complied with the conditionality laid out in the MoU with respect to the second instalment and based on the signature of the attached draft Supplemental Memorandum of Understanding, subject to any comments the Committee may have on it.

2. Deteriorated macroeconomic outlook

The macroeconomic outlook has deteriorated significantly since the December package was approved, leading to a significant worsening of the fiscal balance in spite of some consolidation measures. Latvia is now undergoing one of the sharpest recession of an EU Member State. The sharp contraction in domestic demand and the deteriorating external environment have deepened the recession that started in 2008. The budgetary targets agreed in December are out of reach due to worse-than-expected GDP growth and insufficient fiscal tightening since the adoption of the stabilisation programme. The current contraction of economic activity will lead to a deterioration of the solvency of economic agents, leading to rising non-performing loans and a deterioration of the quality of the balance sheets of banks.

Real GDP fell in 2008 by 4.6%, but contracted by 10.3% y-o-y in the fourth quarter 2008. On the expenditure side, private consumption fell increasingly rapidly in 2008 (by around 20% y-o-y in Q4), as house prices and new credit declined and the general mood turned gloomy. Investments also fell sharply. Moreover, due to the global crisis affecting trade partner economies, exports began to fall sharply towards the end of the year, exacerbating the downturn. While the fall in final demand was accompanied by large drops in imports, to some extent mitigating the negative impact on activity, the fall in output was substantial.

A further and more rapid contraction of the economy than previously expected took place at the beginning of the 2009. Unadjusted data from Statistics Latvia show a y-o-y growth of -18% in Q1 2009, a substantially larger fall in yearly terms than the decrease in the fourth quarter of 2008 (-10.3%). According to preliminary estimate, real GDP fell by 11.2% q-o-q in the first quarter of 2009. Manufacturing value-added decreased by 25.8% in real terms; that of retail trade by 25.8% and of hotels and restaurants services by 39%. The decline in goods exports has accelerated alongside lower demand in trade partner economies. Despite public commitments by the financial institutions and supporting efforts by the authorities, credit extended to the private non-financial system by the banking system continues to fall. House prices – already back to early 2005 levels – continue their downward movement. In addition to the downward pressure on real disposable income and negative wealth effects, fear of unemployment is pervasive, undermining consumer confidence. Within household expenditure, bigger ticket purchases are being withheld, as reflected in the decline in car and consumer durable sales.

The economy is now in a very severe recession. Investment is projected to fall sharply in 2009, as in addition to depressed domestic conditions the tradable sector is suffering from low external demand and cost and price competitiveness problems, *inter alia* because of currency depreciations in some of the neighbouring countries (anecdotal evidence suggests a loss of market share in several product groups). Public investment will provide some cushion, and EU-funded projects are safeguarded in the supplementary budget. While the first quarter GDP data underlines the downside risks, this has to be seen against improving sentiment registered in business and consumer surveys since their trough in March, with some recovery in confidence in April and May in practically all sectors of the economy, more markedly in the industry and retail trade sectors and among consumers.

The macroeconomic outlook has hence deteriorated significantly since the December package was approved. At the time when the MoU and the stabilisation programme was defined last December **GDP was projected to fall by 5% in 2009.** According to the latest baseline projections for growth, used by the EC/IMF and Latvian authorities during the review mission from 27 May to 17 June, **GDP will fall by 18% in 2009**, followed by a further drop of 4% in 2010.

The unadjusted rate of **unemployment increased from 9.9% in Q4 2008 to 13.9% in Q1 2009**. Gross wages were up by 3.5% y-o-y in Q1 2009 with private sector wages up by 5.1% and public sector wages down by 1.4% y-o-y. Inflation has been decreasing rapidly (April y-o-y HICP 5.9%), as demand in the economy is falling and the impact of earlier commodity price decreases is feeding through to consumer prices. Current baseline projections indicate that unemployment would reach 16% in 2009 and increase further by a couple of points in 2010, implying the pressing need to address the social implications of the current recession as they become manifest.

The current account is estimated to have been in a marginal surplus in Q1 2009 (after a deficit of 8.3% of GDP in Q4 2008). As domestic demand is plummeting, imports are also rapidly correcting. Since end-2008, exports have also fallen sharply, but exports of services have held up well. The income account was in surplus due to losses incurred on foreign direct investment. It is expected to remain in surplus over the next years. The bulk of the FDI in Latvia is in real estate and in the financial sector, i.e. in the sectors most exposed to the recession. Overall, the external imbalances are being rapidly corrected. While the adjustment

in wages is mainly reflecting the dramatic economic downturn, there are some signs of improvement in competitiveness. In this regard, delivering the wage adjustment is a critical step in successfully implementing the strategy of internal devaluation.

The table below presents how the **baseline macro-economic projections** used during the above-mentioned review mission compare with the December programme's baseline and with the Commission services' spring forecast[1]. The unavoidable fiscal consolidation is expected to have a negative short-term impact on the domestic economy. The macroeconomic scenario already discounts (to a large extent, given the uncertainty on the packages) the effects of fiscal consolidation under consideration.

		2008	**2009**	**2010**	**2011**	**2012**
Real GDP growth rate	December Programme	-4.6	-5.0	-3.0	1.5	n.a.
	Commission services' spring forecast	-4.6	-13.1	-3.2	n.a.	n.a
	Revised baseline projections	-4.6	-18.0	-4.0	1.5	3.8
HICP inflation	December Programme	15.5	5.9	2.2	1.3	n.a.
	Commission services' spring forecast	15.3	4.6	-0.7	n.a.	n.a
	Revised baseline projections	15.3	3.1	-3.5	-2.5	0.2
Unemployment rate in %	December Programme	6.7	9.0	11.0	11.2	n.a.
	Commission services' spring forecast	7.5	15.7	16.0	n.a.	n.a
	Revised baseline projections	7.8	15.8	17.4	16.9	16.3
Current account balance*	December Programme	-14.8	-7.3	-5.5	-5.5	n.a.
	Commission services' spring forecast	-13.6	-1.5	-1.9	n.a.	n.a.
	Revised baseline projections - EC**	-12.6	+1.7	+3.8	+2.8	+2.6

* % of GDP, ** there are no agreed current account projections yet

3. Budgetary developments

There are three fiscal consolidation conditions set in the MoU related to: the adoption of corrective measures with a supplementary budget for 2009; the achievement of a 5.3% fiscal target for 2009; and a reduction of average public sector remuneration in nominal terms by at least 15% in 2009.

The general government deficit is seriously off-track compared to targets and, after a notified deficit of 4.0% of GDP for 2008, it was forecast by the Commission, last May, to reach more than 11% of GDP in 2009 and 13% of GDP in 2010, assuming no extra consolidation measures.[2] General government debt stood at around 19.5% of GDP at the end of 2008 but is now increasing very rapidly. VAT increases implemented in early 2009 failed to bring the expected results and public spending in the first months of 2009 was well above corresponding 2008 levels. In particular, social transfers increased significantly due to generous pension increases in 2008. Public finances appeared set to deteriorate significantly in 2009, mainly due to the downward revision in the macroeconomic context, but also due to discretionary expenditures. The no-policy change *baseline* scenario, which the EC, IMF and the Latvian Ministry of Finance technical teams used as a basis for discussion during the last review mission, showed that without significant discretionary measures the deficit would

[1] The latter is not directly comparable with the other two, given that it is a no policy change forecast.

[2] The 2009 target for the deficit/GDP ratio set in the December 2008 programme was 5.3%, and the government intended to bring the ratio below 3% by 2011. At the time, the government expected the economy to contract by 5% in 2009 and further moderate decline in output in 2010.

reach 15% of GDP in 2009 and increase further in the following years (international organisations didn't take into account the diversion of second pillar pension schemes contributions, measure taken in April and deemed to improve the revenues by 0.8% of GDP). These levels of deficit would lead to public debt levels above 100% by 2012, jeopardising the sustainability of public finances and the ultimate goal of euro adoption.

The December 2008 Economic and Stabilisation Programme aimed at introducing additional corrective budgetary measures in 2009. However, the approval of a fully-fledged supplementary budget by end-March was delayed, due to the fall of the PM Godmanis' government on 20 February. Given the difficulties by the government in defining the additional measures, discussed also with the IMF and the EC, the process has been delayed.

A supplementary budget has been adopted by the Latvian Parliament on 16 June 2009, as part of a fiscal package which includes also orientations for the 2010 budget. Such package also received prior support by social partners. Continued support to the package is crucial to underline the commitment amongst key stakeholders to undertake bold action in the current difficult economic situation.

The measures adopted by the Latvian Government are intended to produce a sizeable annual fiscal correction. For 2009 and 2010, the budgetary consolidation foreseen amounts to about LVL 500 million, or 4% of GDP per year. The Latvian authorities intend to continue with such sizeable adjustment every year until the budget deficit is below the 3% of GDP Maastricht threshold. The new fiscal strategy, if implemented rigorously and the economy recovers as forecast, is expected to reduce the deficit below 3% in 2012.

The next sections assess the measures envisaged for 2009 and the following years.

I. The 2009 consolidation package (discretionary adjustment)

1) The baseline for the assessment of the 2009 supplementary budget

The table below summarises the budgetary situation of the general government in Latvia (in cash terms) starting from the no-policy-change *baseline* used at the beginning of the review mission. The column entitled "update of the baseline" shows that, given the latest data available from the Latvian authorities (showing previous underestimations for some expenditure items) or the latest news available as regards economic and financial developments or institutional arrangements (e.g. including the possible impact of guarantee schemes or recapitalisations, social costs of a further deterioration of the labour market - for more details see below in paragraph I.4), the reference scenario is a general government deficit of 16.5% of GDP. Both figures (the -15% initial baseline and the -16.5% updated baseline) exclude at this stage the additional revenues due to the diversion of second pillar pension contributions.

It should be noted that, throughout the whole assessment process, as local governments still have to adopt their budgets (after the recent consolidation of municipalities and the elections held on 6 June), the forecasts made by the central government have been used when assessing the public finance situation in 2009 for the whole general government.

While there is an overall deterioration of the starting point by 1.5% of GDP, the 2009 consolidation package is assessed to improve the deficit by 577 million LVL, which represents an improvement of 4.4% of GDP.

General Government ; unit : million LVL	Initial Baseline	Update of the baseline	Assessment of the package (net corrective measures)
Revenue	**4,419.2**	**124.9**	**40.5**
Tax revenue	3,421.9		8.7
Direct taxes	2,025.0		4.7
Corporate income tax	210.0		
Personal income tax	705.2		29.1
Social security contributions	1,035.1		-24.5
Real estate taxe	74.7		
Indirect taxes	1,396.9		4.0
Value added tax	826.1		
Excise tax	520.5		3.8
Other indirect taxes	50.3		0.2
Nature resource tax	7.0		
Taxes on lotteries and gambling	21.9		0.1
Car tax	3.0		
Tax on electricity	0.9		
Custom duty	17.5		
Non tax, self-earned and other revenue	453.3	104.1	31.8
Non tax revenue	280.8	70.0	31.8
Self-earned revenue	172.5	34.1	
Foreign financial assistance	544.0	20.7	
Expenditure	**6,361.3**	**323.6**	**-536.9**
Non-capital expenditure	5,729.3	323.6	-443.9
Primary non-capital expenditure	5,470.3	348.6	-443.9
Current expenditure	2,168.3	35.6	-106.9
Remuneration	1,469.0		-97.9
Goods and services	699.3	35.6	-9.0
Subsidies, grants and social support	3,107.7	159.0	-337.0
Subsidies and grants	1,463.9		-277.0
Social support	1,630.1	158.9	-60.0
Pensions	1,082.0	76.0	-60.0
Other social support	548.1	82.9	
International collaboration	13.7	0.1	
Other non-capital expenditure	35.3	160.0	
Payments to EU budget	159.0	-6.0	
Interest payments	259.0	-25.0	
Capital expenditure	632.0		-93.0
Financial surplus(+)/ deficit(-)	**-1,942.1**	**-198.7**	**577.3**
% GDP	**-15.0%**	**-1.5%**	**4.4%**

While the treatment of some measures in the baseline has been made in view of their potential impact on the cash situation of the general government and taking into account their desirability, moving to an ESA 95 methodology implies further corrections to the deficit figures. For the appropriate deficit figures (for 2009 and until 2012) according to ESA 95 methodology, please refer to section IV (page 18).

2) The expenditure side of the package

In December 2008 the Latvian authorities were asked by international donors to set aside 10 percent of the state basic budget appropriations (excluding those relating to EU-financed projects, debt service and payments to the EU budget) in a **contingency reserve** held

by the central government, as a means to increase pressure on the spending Ministries and to avoid significant overruns by Ministries. The amounts would be allocated by the end of the year following a review of effective needs by a Committee. Such a procedure was dictated by the emergency budgetary situation at the end of 2008. The Letter of Intent indicated that "the contingency reserve will be reduced to 5 percent of appropriations once the second supplementary budget has been passed". With the supplementary budget this contingency reserve has been suppressed altogether. The amount of the reserve initially foreseen in the 2009 budget and now cancelled has been considered as a normal expenditure cut when assessing the consolidation package. In principle, this stringent budgetary choice should exert a certain downward pressure on the remaining expenditure allocations, as ministries will have no hope of getting additional resources later in the year, and would have to compensate slippages with savings elsewhere. Nevertheless there is some uncertainty about the ability of the Latvian authorities to remain within the allocated expenditure ceilings by ministry for the fiscal year 2009, and hence there is a risk of negative surprises by the end of the year. It should be noted that the committee set up for deciding on the allocation of the appropriation reserve remains, and can be expected to have a role in the review of regular budgetary appropriations.

The current package includes **cuts in several areas**: the most sizeable impacts remuneration (which includes both the wage bill and the part of social contributions due by the government as an employer), while a small decrease should also be mentioned as regards goods and services (but only at the State level). Many ministries are affected by very large cuts in subsidies, as well as by cuts in capital expenditure. Finally, cuts in pension benefits represent a sizeable reduction in the social security bill.

a) Remuneration. The State budget includes 87 million LVL remuneration cuts in the budget of ministries, with the biggest individual cuts applied to the Ministries of Defence (17 million), Education (11 million) and Finance (9 million).

Moreover, in the total changes to remuneration brought by the supplementary budget, one should include the part of the cut of 56 million LVL in transfers to local governments, which corresponds to cuts in teachers' remuneration. The latter represent almost the entirety of the cuts in transfers, as they amount to around 50 million LVL. [3]

It should be noted that, even after this sizeable remuneration cut for teachers, compared with December 2008 plans the Ministry of Finance currently forecasts an increase of 90 million LVL in the local remuneration expenditure, for which the original projections were unrealistic (the initial budget allocated 613 million LVL, whereas 230 million LVL have already been spent in 4 months).

Overall, given the savings expected in line ministries but also the uncertainty at the local level, it seems **possible to agree with the Latvian authorities forecast, namely a decrease of remuneration of nearly 98 million LVL compared with the baseline**.

[3] Of this amount, 6 million LVL are linked to the cancellation of a special programme for teaching 5 and 6 year olds. This specific measure may lead to some savings without necessarily harming the education of such children, who would enjoy a pre-schooling experience for a shorter duration (from January to May, rather than from September to May). It should be noted that the IMF has taken this measure as an iconic example of 'harmful cuts', although views expressed in Latvia appear less negative about the reduction in this service.

While cuts in remuneration are quite sizeable, it is still unclear which part of the cuts will be achieved through per capita wage cuts or through staff cuts. Whatever the relative proportion, the implementation of these remuneration cuts may not be easy to achieve:

1) The wage cuts may be easier to achieve given the current situation of the labour market, however, they have to be realistic and fairly calibrated: currently wages are quite different from one ministry to another, which calls for the creation of a unified system in the whole administration sector, which will more generally facilitate policy making and monitoring. Cuts should hence apply in a differentiated manner. Some forms of coefficients are being considered by the Ministry of Finance in order to implement the cuts in a more than proportional way in the ministries which enjoy higher average wages. At the same time, attention should be paid on ensuring that the cuts fall more than proportionally on the higher grades of the administrative careers, for which wages increase almost exponentially. However, the ranges for each grade which are used in the current grid system employed by the Ministry of Finance to assess wage levels across ministries are very large in particular for higher grades and hence there is a risk that even if nominally the high ends of each range are reduced in line with the budgetary cuts, de facto effective wages for the higher grades will not be affected. A revision of the ranges and the introduction of the grid should be pursued as rapidly as possible to ensure appropriate control on public sector wage dynamics. Given the serious understaffing of the relevant department, technical assistance should be provided, funded by the European Social Fund.

2) at the same time, lay-offs are necessary, at least in some areas of public administration, , though they mean additional social expenditure and could have consequences for the social stability of the country in the short run. It is important that these lay-offs are not made in an indiscriminate manner, but are targeted to those individuals and areas of the public sector where productivity is lower. Sufficient funds and administrative resources should be available for the necessary social safety nets and the development of active labour market policies, which will help employees to develop new skills and find a job in more dynamic sectors of the economy;

b) The State budget includes also cuts in goods and services amounting to 9 million LVL. It should be noted that at the local level the Latvian authorities now forecast an increase of 76 million LVL in spending in goods and services. This evolution for local governments reflects an expected increase in expenditure given that the 2009 budget underestimated this item (with an unrealistic decrease of 40.7%). This increase was already included in the baseline and hence is not considered to offset the consolidation package. The current plan for local governments is still ambitious with a 22% decrease compared with the year 2008. Since for the first five months of 2009 the decrease recorded was only 5.5%, this implies a significant contraction in the remaining part of the year, which may be difficult to deliver.

c) The State budget includes also **cuts which are more specific to certain ministries**, like **cuts in subsidies**, whose breakdown is the following:

Ministry	December 2008 amount	Cut (amount in million LVL)	Cut (%)
Finance	205,7	98,6	48
Health	461,5	94,1	20
Education	88,4	63,4	72
Culture	35,7	15,1	42

Others	*512,4*	*5,9*	*1*
Total	**1303,7**	**277,1**	**21**

As regards the ministry of **education**, the cut has the objective to improve the efficiency of spending thanks to a transition to the financial model "money follows the student" (instead of a schools or teachers' financing model), and by preventing duplication of programmes in higher education and decreasing the expenditure on state budget financed study places. 45.4 million LVL out of the 63.4 million decrease are consequently linked with the budgetary programme 03.01.00 "universities", as there is a scope for budget savings in higher education through consolidation of small universities and consolidation of management across programmes within the larger universities (in order to prevent overlapping of programmes). Based upon a provisional assessment of the World Bank, combining duplicative laboratory and library facilities and unifying hiring and assignment of teaching staff can lead to major savings. However there is a concern that universities could charge higher fees to compensate the decrease of subsidies, preventing low-income students from pursuing higher education. A suggestion would be to ring-fence part of the additional self-earned revenues to devote them to the social needs that could arise among the students.

Other reforms should also result in savings, among which:

- as regards the programme 05.02.00 "science's base financing" (cuts in subsidies amounting to 8.7 million LVL), reconsideration of the work load and financing calculation for the existing scientific workers, definition of priority directions of science and financing of fundamental and applied research in 2010-2013 in co-operation with representatives of economic sectors;
- as regards the general programme 09.00.00 "sport", the sport financing system will be re-considered by increasing of the role of sport non-governmental organizations, in cooperation with them (cuts in subsidies amounting to 1 million LVL).

As regards the ministry of **health**, all the savings are linked with the budgetary programme 33.01.00 "medicine" which includes transfers to hospitals. The Latvian authorities intend to rationalise the existing network of hospitals, regarded as inefficient and expensive, and to bring down health care tariffs, which is appropriate. However, it should be stressed that 63% of the 2009 amount allocated to municipalities for subsidising health copayments for the poor had already been spent during the first quarter, implying that there is a risk of an increase in co-payments demanded to users, or of potential overruns.

The structural savings based upon the **improvement of efficiency** of the different involved public bodies will also allow sizeable remuneration cuts. Overall, these savings are directly linked to structural reforms already undertaken or under consideration, that we can assess as globally positive. However, it is not easy to quantify precisely the impact of such structural reforms, and the current budget cuts shifting a part of the consolidation burden to other public bodies could prove overestimated or difficult to achieve, despite the real measures behind the alleged savings.

Therefore, while it is plausible that the cuts in subsidies will translate into real sustainable savings at a general government level, **the amount of 277 million LVL implies downside risks, which have to be contained with a strong focus on implementation and a control by the Ministry of Finance.**

d) As regards cuts in **capital expenditure,** in the state budget they are concentrated on the Ministry of Transport, with a 65 million LVL decrease, The variations for all other ministries are negligible. [4]

At a general government level, **cuts in capital expenditure are deemed to produce 93 million LVL of additional savings,** resulting from the above-mentioned cuts in the ministry of transport but also from the slowdown in the absorption pace that has already taken place at the level of local governments since the beginning of the year.

According to the information provided in the budget, t**he capital expenditure cuts would not jeopardise the overall EU funds related projects**. It should be stressed that cuts in EU funds related expenditure would be unwelcome, as they would represent a significant slowdown of productive spending. Nevertheless, risks exists that cuts are made because of a shortage of funds, notably at local level, which according to information from local authorities could lead to halting not only new projects but also those which have already started. Given that the latter will most likely become productive only once they are completed and may incur higher costs if not pursued in the short run, it appears very important to preserve adequate financing. In addition, it should be noted that for projects which are eligible for EU co-financing, slowing capital spending implies reducing the amount invoiced to the Commission and, in turn, reduce revenues for the General government.

e) The current consolidation package includes a 10% cut in old age and long term pensions, which had increased far more than inflation for several years, representing a rise in pension levels in real terms of 40% over the last four years: this measure affects an area which was considered politically too sensitive to be addressed, and somewhat rebalances the weight of the adjustment across main sectors of the population, as wage earners have already been hit significantly by the consolidation packages since December. This measure should result in 50.5 million LVL savings according to the Latvian authorities. This is likely to face significant resistance, and entails some social risks as it may affect more than proportionally low income pensioners. Several pensioners will now receive an income below what is considered to be the subsistence minimum.

Another measure deemed to bring sizeable savings is the 70% reduction of pensions for working pensioners. However, these cuts seem too high, as when implemented there will be very little incentive for people to go on working. While this would result in a reduction in either pension costs or the wage bill for the public sector, this measure for the private sector

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[4] The breakdown of the cuts planned in the ministry of transport includes:

- 13 million LVL that were included in the contingency reserve;
- 8 million LVL as regards the programme 23.00.00 "state road fund";
- 44 million LVL concerning EU funds programmes (a 80 million LVL decrease on programmes 46.00.00 "ERDF activities implementation", 29.00.00 "implementation of cohesion fund financing projects development of the motor roads" and 33.00.00 "implementation of the cohesion fund financed railway infrastructure development project"; these decrease are partially offset by an increase of 36 million LVL on programme 43.00.00 "projects financed by cohesion fund for 2007-2013"). However, the decrease of EU-funds-related capital expenditure in the ministry of transport is compensated by expenditure increases in other ministries, for instance, mentioning only the largest :
  - the ministry of economy, with an increase of 14 million LVL on programmes 27.06.00 "ERDF projects implementation (2007–2013)" or 38.00.00 "Implementation of the programmes funded by EU";
  - the ministry of education, with an increase of 8 million LVL for the programme 33.07.00 "Repayment and prepayment to local government and others receivers of structural funds financing about implementation of ERDF projects for 2007-2013".

may imply either a fall in activity (and revenues) if people stop working, or an outright fall of revenues if they move to the black economy. In general, this measure can imply a decrease of national workforce, and seems to go against the principle of inducing active ageing; hence its quality seems poor. It could be consequently considered to limit the extent of the cut in the private sector, while maintaining it as such for pensioners of the public sector (where efficiency gains may be larger, and this could push such people to work in the private sector). Overall, there are downside risks as regards the 37 million LVL savings expected from this measure. Consequently 30 million LVL have not been considered as savings in our assessment.

The Latvian authorities also plan a decrease of early retirement pensions from 80% to 50% of the normal amount. This measure should bring 2.2 million LVL additional savings (contrarily to the previous measure, this one will encourage people to go on working).

Overall, the expected savings thanks to the measures on pensions are assessed at around 60 million LVL. This amount could still be increased, given that the 10% decrease is not consistent with the official announcements made as regards the extent of wage cuts (20%, sometimes more). The signals given to the private sector should be very consistent to trigger the internal devaluation loop. However, the implications of lower pensions on those at most risk of poverty need to be addressed, possibly by improving benefits for the lower quintile.

3) The revenue side of the package

a) several measures have been taken to increase revenues:

As regards **the personal income tax**, the Latvian Government has decided to decrease the non taxable threshold from 90 to 35 LVL a month; this measure should bring **43.8 additional million LVL** according to the LV authorities. This assessment seems realistic given the current wage distribution in Latvia.

The Latvian government has also taken the decision to increase **excise taxes on beer and other alcoholic beverages**, which should entail additional revenues amounting to **3.8 million LVL**. However the underlying assumption is that the tax base keeps constant, the amount is consequently on the high side.

Some other measures are one-off, like the increase of payments/dividends from state-owned companies or Bank of Latvia. There is a risk that investment from these companies may suffer, although it cannot be excluded that dividends are currently disproportionate. Overall, additional **payments from state-linked entities amount to 32 million LVL in 2009.**

b) One should take into account the **negative effect of some expenditure cuts** (remuneration) concerning personal income tax and social security contributions. The corresponding amounts are 25% of the remuneration cuts as regards **social security contributions (24.5 million LVL)** and around 20% of the wage bill cuts as regards **PIT (around 15 million LVL)**.

4) Other explanatory elements (mandatory spending or unexpected revenues)

The purpose of this part of the document is to update the baseline that was agreed with the Latvian authorities in the first days of the review mission. The corrections correspond to

elements linked with the latest economic or financial news, or the latest institutional arrangements, which could not been taken into account when the baseline was defined. **The present assessment is therefore carried out against a cautious baseline.**

a) Some rectifications of **previous underestimations** were necessary, which offset a part of the consolidation package, even when compared with the intial baseline.

As regards **goods and services** (cf. analysis of the current package) the increase compared with the initial baseline should be limited and it seems possible to agree with the figure given by the Latvian authorities **(+27 million LVL).**

Pensions were also previously underestimated by 76 million LVL, so despite the 60 million savings there is a 16 million LVL increase in comparison with the baseline.

But the biggest rectification required is due to **social benefits at general and local level** ("other social support").

As regards unemployment allowances, the baseline already included 77 million LVL, assuming an increase of the rate from 10% to 12.7% (under national methodology, i.e. only taking into account people who are entitled to unemployment allowances, hence a lower level than in the Eurostat releases). But increased unemployment calls now for a higher assumption concerning the unemployment rate, which could reach 14%, hence a further **increase of unemployment allowances of 38 million LVL compared with the baseline**.

There are also numerous social safety nets among which the most important is the general minimum income (GMI) to which people become eligible once they cease to be entitled to unemployment allowances. There is therefore a 9 months lag before we can see the impact of the deterioration of the labour market on the corresponding expenditure. The other safety nets managed at local level are: health-care benefit, feeding benefit, extraordinary allowance in emergency situations, social guarantees for orphans and foster families (in goods instead of money), apartment benefit, social care services, social rehabilitation services and the disabled transport services. So far the Latvian Ministry of Finance forecasts a shortage of nearly 50 million LVL at the local level for the financing of these items essential for the cohesion of the country.

Assuming there is a **need to add around 45 million LVL for the local safety nets**, the Commission agrees with the proposal of the Latvian authorities (other social support increased by 83 million LVL in comparison with the initial baseline).

There are also various **other risks on the expenditure side:** state guarantee schemes which could lead to additional expenditure, which the different budget programmes do not provide for, the recapitalisation of the Mortgage and Land Bank (potentially 60 Million LVL, out of which only one half already in the baseline), net lending to other institutions. **All these items would amount to 160 million LVL.**

b) However, some **spontaneous improvements** should also be mentioned. The most sizeable are associated with non-tax revenues, with 91 million LVL **emission quotas** receipts (70 taken into account) or better than expected **self-earned revenues**; the increase by **20 million LVL** of **foreign financial assistance** is due to EU funds. On the expenditure side, lower than expected **interest payments** and **contribution to the EU budget** entail 31 million LVL additional savings compared with the baseline.

5) Overall assessment of the package for 2009

The measures adopted by the Latvian Government would result in a sizeable annual fiscal correction, with a frontloaded adjustment and a medium-term perspective. **Significant reforms underline the fiscal strategy**, for example in local administration, the health care system and education. Other significant reforms are implied by the current package, such as the reform of the public sector administration.

This package **includes several important and durable measures consistent with the internal devaluation strategy**, like pension or remuneration cuts. Part of the remuneration cuts are based upon structural reforms, especially in the fields of education and health, which can be deemed as globally positive although they could entail additional social needs in the short-term. These structural reforms also allow sizeable cuts in subsidies. In addition, it is also positive that the consolidation is more focused on the expenditure than on the revenue side, even if additional tax measures need to be considered in following years given the very tight budgetary situation.

The decision taken to ring-fence the co-financing of EU structural funds is important as it ensures access to EU financing that will be used for productivity-enhancing expenditures thus supporting the necessary shift of production towards tradable sectors.

There are a number of one-off measures within this package. One could consider on the revenue side the policy of increasing dividends from state-owned companies - in proportions which may prove unsustainable – to be a one-off measure. On the expenditure side there are no obvious one-off measures, but it can be questioned whether:

- the cuts in capital expenditure are sustainable if they consist in a simple postponement of investments, which are necessary to long term growth prospects;
- the drastic budgetary cuts concerning other public entities (transfers to local governments, hospitals, universities) will prove sustainable in the longer term, raising to a certain extent the issue of the governance of non-state public bodies.

While the package is sizeable, a number of measures may need to be revisited, given some uncertainty about the desirability of their design and impact.

The package contains some measures not of the desired quality, but overall it is a desirable outcome of a difficult internal process. While the urgency to act in the current situation may warrant to some extent the recourse to one-off measures in 2009, work on permanent measures to sustainably reduce the budget deficit and improve the competitiveness of the economy in 2010 and the following years should start immediately.

The package is likely to have negative distributional consequences that should be corrected by the 2010 budget to the extent possible. The reduction in the personal income tax threshold, as well as the substantial cuts in wage and pensions, may disproportionately affect low income people.

There are some across-the-board cuts (goods and services, and the budget of several Ministries), which imply that Ministries will have to achieve efficiency gains. While this will result in some service cuts and/or translation of costs to customers, this may prove an effective way to force reforms at the Ministry level.

The main risks to the package seem to be related to its implementation, given the weaknesses of the Latvian institutional framework, highlighted by joint EC/IMF technical

missions, for instance the so-far untested new power of the Ministry of Finance towards line ministries, the absence of a commitment follow-up and accounting framework, or the difficulties to improve tax compliance (hence entailing the risk of a possible increase of the black economy).

Social risks should not be neglected, given the size of private indebtedness, which will necessarily grow because of the increase of unemployment and taxes, and the fall of nominal revenues. Local governments need to be financially ready to address the social problems (e.g., GMIs after unemployment benefits run out). Special attention should therefore be paid to the way the Latvian authorities intend to share the fiscal consolidation burden across the population, and to the debt restructuring strategy. The design of the municipal equalisation fund will also have to be fine-tuned, since this fund plays an important redistributive role, ensuring that local governments with a smaller revenue base can meet critical expenditure to maintain the essential social safety nets. Some forms of guarantees may be useful to facilitate planning by poorer municipalities which are exposed to fluctuations in income taxes

III. Assessment of measures and developments for 2010 and 2011

The following sections are based on the information provided by the authorities during the review mission,

a) The revenue measures :

i) measures for 2010

Real estate tax on residential buildings would be introduced along the existing one for commercial property along with a minimum payment of 10 LVL for each property. Local governments will be empowered to increase the rate from the current 1% up to 3%. Combined, these changes should lead to additional revenues by 70 million LVL (this impact has however already been included in the 2010 baseline).

Concerning Personal Income Tax (PIT) the exemption on revenue from growing forest and selling of timber products could be removed, which would mean 10 million LVL additional revenues. The measure already taken in 2009 (the lowering of the non-taxable minimum threshold) would have a total impact of 105 million LVL in 2010.

Concerning Corporate Income Tax (CIT), 5 million additional LVL are forecast thanks to a change in the deduction of charitable donations (which would be only removed from the CIT tax base and not from the tax payment).

A new calibration of the car tax, taking into account the CO2 emissions, which is consistent with the general European policy guidelines, would result in additional revenues amounting to 90 000 LVL.

An interest capital income/gains tax should also be introduced as from 2010, with the first payment in 2011.

Unless other measures are found in order to secure a fiscal correction of 500 million LVL in 2010, the Latvian government has already got the agreement of the Parliament to increase VAT by 2 points from 21% to 23%. This measure is deemed to bring 68.8 million LVL additional revenues. It is plausible that social partners and in particular the business

community will come forward with ides for alternative measures to cover the possible gap, so as to avoid the need for an increase in the VAT rate.

ii) <u>measures for 2011</u>

The PIT rate for the self-employed is planned to be increased from 15% to 23% in order to get a unique rate applying to all work incomes in the country.

The employer part of the social security contributions rate is planned to increase by 4 points from 24.09% to 28.09%. This measures, however should be avoided as it could worsen the competitiveness of the country, and risks offsetting the expected results of the internal devaluation strategy.

iii) <u>several challenges should be pointed out:</u>

The challenges that the Latvian authorities will have to address are threefold: technical, social and political. The technical hurdles have to be solved swiftly to allow a satisfactory implementation, the share of tax increases among citizens has to be socially sustainable to guarantee the efficiency of the strategy in the longer term, and the regional (Baltic) cooperation on the tax issues should be strengthened.

Several of the above-mentioned measures (real estate tax, capital income tax) were already suggested by international organisations 6 months ago. An explanation for the delay in their implementation is the technical problems that have to be solved, like the need to merge personal and property databases for the real estate tax, in order to be able to target and calibrate it in an appropriate way, for instance by taking into account the number of people within the household. These problems have to be addressed as soon as possible, partly by using permanent technical assistance that is proposed by international organisations and especially the European Commission.

Overall, about the revenue side, some measures could be implemented earlier, given both the planned 2009 deficit, which is still very high, and the need to share the burden of the consolidation in a sustainable way: low income earners are hit in particular by the decrease of the non taxable PIT threshold and the sizeable cut of the pensions of working pensioners. This policy choice could still worsen the situation as regards non performing loans and overindebtedness. The authorities should therefore reconsider their decision to refuse the introduction of a progressive PIT, although the long-standing use of a flat tax makes this decision more difficult, or to consider an increase in the common PIT rate, combined with measures on the expenditure side to provide additional benefits to the low earners.

More in general, the lack of cooperation among Baltic countries in the field of taxation is particularly should be addressed as soon as possible, as it hampers the required fiscal consolidations in the three countries. The recent announcements of VAT increases in Estonia and Lithuania indicate that the countries may have a common interest in deciding policies in a regional perspective.

b) The expenditure measures

The government and parliament have formally committed to an overall improvement in the deficit by another LVL 500 million. This has been made through an update of the December 2008 Economic and Stabilisation Programme, which accompanies the budget and includes a list of key measures.

The list of measures to be considered for 2010 includes, apart from the revenue measures already presented:
- introducing a unified public sector wage grid, with measures to apply the 20% public sector wage reduction so as to address the large income differences across ministries;
- allocating additional financing for local government GMI needs;
- reducing further pensions and benefits, possibly targeting higher income beneficiaries;
- it is considered to initiate the pension reform by gradually increasing the retirement age starting from 2010 from the current level (60 years old).

Overall, according to the Latvian government, the amount of measures considered for 2010 overall could reach LVL 1 billion, i.e. an improvement of around 8% of GDP from the current position. The adjustment of LVL 500 million would include the effect on 2010 of the supplementary measures taken in 2009. This effect is unfortunately very difficult to quantify so far, given all the implementation and downside risks in 2009 highlighted in this note. According to the authorities, the adjustment would mainly take place from the expenditure side, where the sum of additional measures and the effect of the 2009 consolidation would lead to a reduction of expenditure by over 700 million LVL. On the revenue side, the increase by 300 million LVL includes the effect of the VAT increase as well as more than 30 million LVL additional dividends which appear uncertain at this stage.

While these measures provide the basis to achieve a significant further correction in 2010, there may be a need to identify further means to cover the gap, should the impact of ongoing measures be more limited than expected, or if it proves necessary, to improve the design of some of those measures.

IV. The budgetary adjustment until 2012 and sustainability of Latvian public finances

The Latvian authorities have stated that they intend to continue with sizeable fiscal adjustment every year until the budget deficit is below the 3% of GDP Maastricht threshold. The new fiscal strategy, if implemented rigorously and the economy recovers as forecast, is expected to reduce the deficit below 3% in 2012. This section assesses the implications of this strategy for the future years, also presenting the deficit figures according to the ESA 95 methodology.

The table below presents the evolution of the deficit between 2008 and 2012, taking into account a joint baseline macro- and fiscal- projection used during the June review mission[5]. Such baseline (line 1 in the Table) envisaged a deterioration of the fiscal balance over 2010 and 2011, reflecting to some extent the shrinking revenue base due to the economic recession. As discussed in section I.1), adjustments to such initial baseline have been made to incorporate additional information since the review mission (line 2), leading to a baseline deficit of 16.5% of GDP in 2009 (line 3). Taking into account the implication of the measures presented by the Latvian authorities with the June 2009 package and assessed by the Commission in the previous sections, and assuming a net consolidation of LVL 500m per year until the 3% of GDP Maastricht reference value is reached, line 4 presents the adjustment implied by the consolidation strategy.[6]

[5] The macroeconomic baseline includes the expected negative impact of fiscal consolidation on the economy.

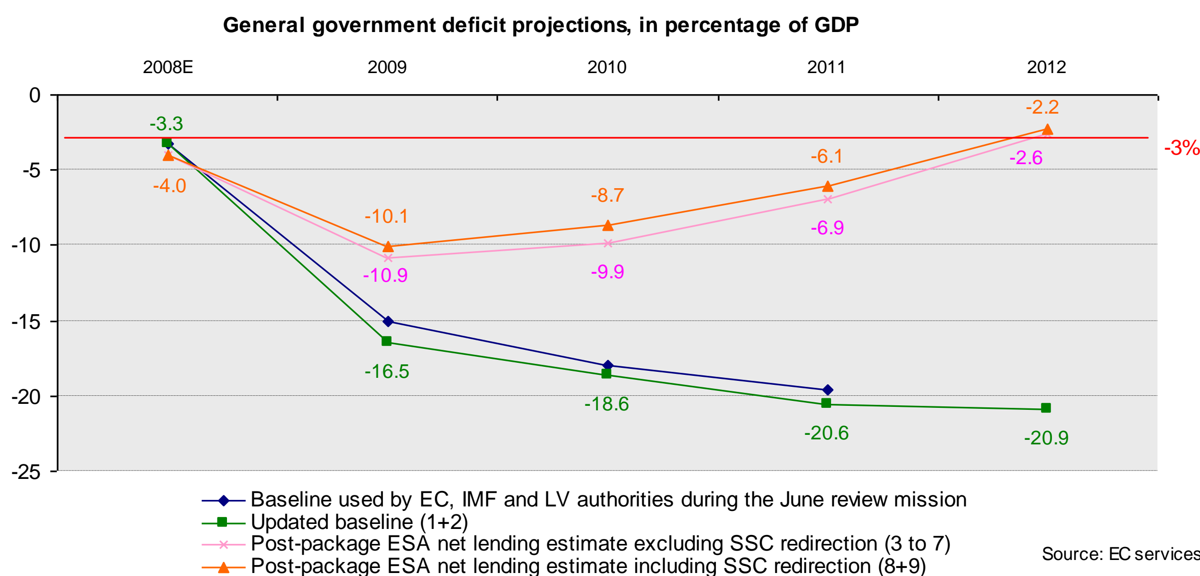
[6] Given the structure of budgetary tables and the lack of detailed multi-annual fiscal planning, the full year impact of the 2009 package could not be accurately assessed. Therefore, in line with the commitments made in Latvia's Stabilization Programme, it was assumed that the net consolidation impact of discretionary policy action will be LVL 1 billion in 2010

A number of further adjustments are needed in order to identify the ESA 95 figures for net lending of the general government. This includes taking into account the Southern-Bridge project, the effect on interest payments of lower debt levels and the exclusion of contingent liabilities, state loans and capital increases. The latter measures, while potentially having an impact on cash, may not increase net lending in ESA terms. Nevertheless, these items represent a risk to the deficit figures which the government should try to minimise.

General government deficit (net lending) projections, in percentage of GDP	2008E	2009	2010	2011	2012
1 Baseline used by EC, IMF and LV authorities during the June review mission	**-3.3**	**-15.0**	**-18.0**	**-19.6**	**n.a.**
2 Total update to baseline		-1.5	-0.6	-1.0	-1.1
3 Updated baseline (1+2)	**-3.3**	**-16.5**	**-18.6**	**-20.6**	**-20.9**
4 Package size		4.4	8.4	12.6	16.1
5 Interest impact		0.1	0.5	1.1	2.1
6 Southern-Bridge project		-0.4	-0.1	-0.1	0.0
7 Potential state budget loans and LMB capital increases		1.5	n.a.	n.a.	n.a.
8 Post-package ESA net lending estimate excluding SSC redirection (3 to 7)	**-4.0**	**-10.9**	**-9.9**	**-6.9**	**-2.6**
9 Impact of social contribution (SSC) redirection		0.8	1.2	0.8	0.4
10 Post-package ESA net lending estimate including SSC redirection (8+9)	**-4.0**	**-10.1**	**-8.7**	**-6.1**	**-2.2**
Source: EC services					

Finally, a particular note should be made as concerns a measure which is not part of the June 2009 package, as it has been taken already in Spring. This regards the **redirection of social contribution payments from the 2nd pillar** pension system. The Latvian authorities' have decided to revert the planned increase to 9-10% in social contributions to the 2nd pillar pension system over the 2009-10 period, and instead to reduce them to 2% of gross wage. This ratio is now planned to increase to 4% in 2011 and to 6% in 2012. Over the 2009-12 period, this decision represents a significant redirection of funds, which while improving revenues and the cash situation of the government in the short run, creates additional pension liabilities on the 1st pillar. Given the assessment by the Commission and IMF on the quality of this measure, the calculation of the baseline general government net lending projections for 2009 and following years has excluded its impact. However, this measure will improve the EDP net borrowing figure if it is not reversed (see line 9).

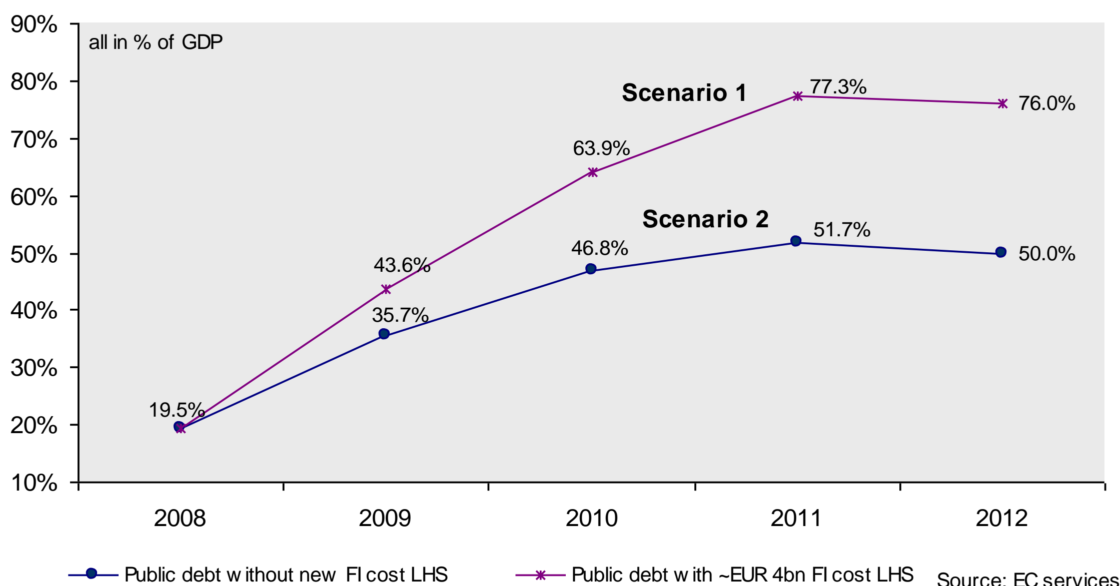
Taking into account the corrections above, and assuming that the government will not reverse the decisions on social contributions, the net lending resulting from the package in ESA terms corresponds to 10.1% of GDP in 2009 and, assuming the budgetary consolidation continues as envisaged and a recovery in revenues by 2012, would decrease to 8.7% in 2010, 6.1% in 2011 and 2.2% in 2012. The chart below presents the evolution of the various definitions of the deficit and net lending just described.



The budgetary targets for 2009 and subsequent years have been established in the Supplemental Memorandum of Understanding on the basis of the projections above. Should the government decide to reverse its decision on the redirection of social contributions, the targets to be considered in the SMoU should be based on line 8 of the table above, hence leading to somewhat higher deficits over the period. However, it is highly recommended that the Latvian authorities identify additional savings to replace this measure as soon as possible, thereby improving the quality of the fiscal consolidation.

Finally, the following chart presents the development of general government debt under the above described fiscal consolidation path (Scenario 1). These projections assume that the bank restructuring will add to the general government debt LVL 1bn in 2009, LVL 0.93bn in 2010 and LVL 0.85bn in 2011, - i.e. altogether LVL 2.8bn or almost EUR 4 bn[7]. In case the Latvian State would not assume any further debt due to financial system stabilization needs (Scenario 2), the general government debt could stay below 60% of GDP.

[7] This amounts to 44% of the total outstanding loans of Latvian households or about 19% of total loans to Latvian residents, - i.e. it is a rather conservative estimate, - even if one assumes that the financial sector stabilization costs will fully be carried by the Latvian State. These assumptions also lead to some additional interest spending, which has already been included in the baseline figure for the deficit.



4. Fiscal governance reform

A two-week Public Finance Management Technical Assistance Mission took place on 29 April-7 May to assist with supplementary budget formulation and the needed immediate and more medium-term adjustments to the PFM system. Moreover, in July and September two joint IMF/EC technical assistance missions on revenue administration and on budgeting are planned (the latter would focus on 2010 budget preparation and medium term issues). In addition, a possibility of sending for an extended period a fiscal expert to Riga to monitor the implementation of technical assistance missions' recommendations and the execution of the budget is being explored (with possible financing from EU structural funds). It is now up to the Latvian managing authorities to give specific proposals in this regard.

As regards the other MoU fiscal governance conditions:

(i) draft amendments to the Budget and Financial Management Law still need to be prepared with assistance from the EU and IMF experts and following the upcoming technical assistance missions, inter alia the fully-fledged IMF/ EC technical assistance mission on budgeting planned for the end of July or beginning of September;

(ii) the Ministry of Finance's macroeconomic forecasts are being prepared taking the Commission's forecast as a benchmark;

(iii) the condition to reduce compensation levels for boards of publicly-owned enterprises appears to have been met, as the government has recently decided to eliminate most of the boards altogether;

(iv) the implementation of the State Audit Office September 2008 recommendations regarding the assessment of implementation of the 2007 State budget is ongoing and will require additional time.

5. **Financial sector regulation and supervision**

Banks' audits were finalized by the 31 March deadline and so far the FCMC sees no imminent risks to the financial system. According to the conditions in the Memorandum of Understanding, the FCMC was expected to send a report to the Commission on the assessment of the banking and financial system by end-June. The report was received on 12 June and is very satisfactory. The banking sector supervisor is fully aware of underlying risks and has taken all possible steps to guarantee sufficient levels of capital in banks and to strengthen monitoring of financial conditions. Banks too seem aware of the serious deterioration of their balance sheets and realize the need for further capital increases in light of growing provisions for impaired loans. To illustrate, the share of loans past due more than 90 days in the total loan portfolio almost doubled from 3.6% in Q4 2008 to 7.1% in Q1 2009.

There is also an indication that Swedish daughter banks may be repaying loans to their parent banks, creating significant EUR outflows: this could undermine the Swedish banks' earlier public reassurances about their commitment to support their Latvian subsidiaries. The financial stability report by the Bank of Latvia shows that in Q1 2009, banks' liabilities to foreign MFI decreased by 832 m LVL (ca. 1.18 bn EUR). According to the report, the outflow of foreign MFI funding reflected a decrease in liabilities to associated and affiliated (mostly parent) MFI, as well as repayments of syndicated loans. The successful implementation of the program may be compromised if euro liquidity is drained out of the country. This risk needs to be properly addressed at a meeting with the Swedish parent banks which would commit to maintaining their level of exposure to Latvia.

As regards the Parex Bank, the situation seems to have stabilized with the EBRD involvement and further capital injections by the state. The proposed EBRD facility has two components: (i) €82 million for the purchase of shares (representing 25% plus one share of Parex's capital and voting rights) and (ii) a subordinated loan of up to EUR 22 million. The transaction was finalized on 16 April and will enable Parex Bank to strengthen its balance sheet, restructure operations and refocus on lending to the real economy. In addition, on 22 May, the government transformed 200 m LVL from its deposit with the bank into equity, further strengthening Parex's capital adequacy ratio, which is currently above 11%. Parex is negotiating with its largest depositors to convert their on-demand deposits into longer term deposits, so that restrictions on capital flows could be lifted any time soon.

After the state capital increase, the share of minority shareholders is being diluted from around 15% previously to around 3% afterwards; however, this is still not in line with what the Riksbank wants: no gain to existing shareholders. Also, Parex Bank has successfully finalized negotiations with syndicated lenders, reaching an agreement on the terms of the repayment. The first payment, 30% or €232.5 million and cumulative interest was made on 19 March, with funds raised from the State Treasury. The second payment, 40% or €310 million will be made in February 2010 and the remaining 30% or €232.5 million will be repaid in May 2011.

There are concerns regarding the recent significant loss of international reserves (more than 1 bn. EUR fall since the beginning of the year) and the shortage of lat liquidity among banks. The high demand of euro has resulted in an almost full depletion of banks excess reserves at the Bank of Latvia. Constrained by the minimum of required reserves and their preference for holding euro, banks began to lack lats, which resulted in increasing

overnight interest rates. The lack of lat liquidity has even resulted in a substantial reversion of previous exchange rate interventions by the Bank of Latvia. As a matter of fact, banks sold to the Bank of Latvia 160 m EUR during the second week of June, thereby inverting the decrease in the Bank's foreign reserves.

The Riksbank and the ECB entered in a swap agreement for 3 b EUR on 10 June. This is expected to release liquidity tensions in Latvia, as mother banks will probably see their euro liquidity improved. In addition, the Riksbank decided on 8 May to prolong for three months the swap agreement entered into with the Latvian central bank in December 2008. The swap agreement gives the Bank of Latvia the right to borrow up to EUR 500 million against LVL if and when the need arises. The Bank of Latvia is currently not drawing on this credit line, which shows that the most recent tensions on the Bank's reserves are seen as a temporary phenomenon.

Conditions with respect to financial sector supervision and regulation are met, in the context of a volatile and risky environment.

6. Structural reforms

(i) the Ministry of Economy, in consultation with the National Tripartite Council, have drafted a comprehensive export promotion strategy for 2010-2016. A specific action plan for 2010-2011 will be submitted to the Cabinet of Ministers by 1 July. However, the implementation of an export promotion strategy will largely depend on availability of export credit guarantees and the budgetary situation.

(ii) the European Investment Fund-managed Holding Fund has been slow in taking necessary steps to ensure an effective access to financing for SMEs, by providing high-risk loans, risk capital funds and other financial support instruments. The EIF is still negotiating with banks on specific conditions for providing financing, thus, overall, the progress can be deemed weak.

(iii) there has been significant progress in implementing the MoU condition on increasing the efficiency and transparency of public procurement procedures. The authorities are working closely with industry associations and IT providers to develop standardized procurement processes, centralize part of central and local governments' procurements and improve e-procurement application.

7. Progress under the IMF stand-by agreement

While the authorities' programme supported by the EU BoP financial assistance and the IMF stand-by arrangement is the same and the review was conducted in parallel by the two institutions, the conditionality under the two loan arrangements is consistent but not identical. The IMF staff has not yet concluded its first review mission that was interrupted in February following the fall of the Latvian Government. This IMF first review mission has been conducted in parallel with the EU first review mission from 27 May to 17 June.

The Board is expected to discuss informally on 24 June the developments under the current review, and it is still unclear how it will proceed thereafter.

8. Disbursement

According to the current schedule, the second instalment, is foreseen to reach the Latvian account in the week of 27 July.

Updated estimates of the **financing gap** indicate that Latvia is likely **in no need of additional external assistance on top of the €7½ billion in the programme**, despite the worsening economic situation and deteriorating public finances. The main reason is the substantial improvement in the current account deficit, which reduces Latvia's gross financing requirements. (See Annex 3)

Under the current circumstances, the amount which is scheduled for payment, i.e. 1.2 billion EUR is exceeding the budgetary needs of Latvia in the short run. Against this background, an increased coverage of reserves at the Bank of Latvia would be useful to deter further speculative attacks, and to create a buffer in case financial sector problems would arise.
The 1.2 billion EUR would be divided into two sub-accounts, one available to the government to cover the cash needs of the budget, the other for potential financial sector and foreign reserves necessities which is only accessible to the Bank of Latvia. This latter account would only be accessible to the Bank of Latvia. The precise modalities and the rules for moving funds between the two accounts will be identified in the SMoU.

The latest available information from the Treasury suggests that ring-fencing of 600 million EUR out of the 1.2 billion of the disbursement should well cover budgetary cash flow needs up to November when the next instalment would be foreseen. If only 600 million EUR (corresponding to 442 million LVL) would be made available for the Treasury, taking account of the disbursements planned by all donors until the end of the year, and assuming both a conservative scenario for cash needs and no additional borrowing from the Treasury, the cash balance of the latter would still be positive until the end of the 2009.

Finally, in view of the developments, it is proposed to review the calendar of instalments which was tentatively set in the MoU. Given the significant amounts of funds disbursed with the second instalment, against smaller financing need, it is suggested to delay the third and fourth instalments by one quarter, hence to 2009Q4 and 2010Q1 respectively. This will provide sufficient time to the Commission and the EFC to assess progress with the consolidation strategy by the government, in particular with respect to the implementation of the 2009 budget and the adoption of the 2010 budget, without jeopardising the financial situation of the country.

9. Conclusions

All in all, it can be considered that the authorities conditions laid out in the MoU with respect to the second instalment are fulfilled. In particular, on the budgetary front, while the original deficit target has become unachievable due to the recession, significant progress has been made with the adoption of the supplementary budget, which has reversed a very strong deterioration of the public finances and has helped to improve confidence regarding the commitment and capacity of the government to undertake appropriate policy responses, in particular by tackling key areas of public spending such as remuneration and pensions.

Among the other conditions, progress has been made as concerns fiscal governance, notably with the new powers attributed to the Minister of Finances, and more clearly so as concerns the Financial sector regulation and supervision. Mixed progress has been achieved related to structural reforms.

On the basis of this overall assessment, it is proposed to go ahead with the second instalment of 1.2 billion EUR within the Balance of Payment assistance for Latvia

Annex 1: Latvia: financing contributions and profile (as established in December 2008)

{ SHAPE * MERGEFORMAT }

Annex 2

The MoU Conditions for the Second Instalment

According to the MoU, at the time of the review by the Commission that will precede the decision on the disbursement of each installment, the authorities are committed to have accomplished substantial progress in fiscal consolidation and expenditure control, in particular, reduction of public sector wages and employment, fiscal governance reform, banking sector stability, financial sector regulation and supervision reforms, as well as structural reforms, and in particular the following actions:

A: *Fiscal consolidation*	*Importance*		**Has the condition been met/progress?**	**To be included in the SMoU?**	**To revise in the SMoU?**
	High	Adoption by the Parliament of the fully fledged supplementary budget law for 2009, including a 5% contingency reserve, defining further allocation of spending appropriations among spending agencies and ministries and identifying clearly programs that should be rationalised	YES, Supplementary budget was adopted on 16 June, with the inclusion of additional measures The contingency reserve, previously at 10%, was removed altogether	NO	NO,
	High	Progress with the achievement of the revised 2009 general government cash flow deficit of below 5% of GDP and 5.3% in ESA 95 terms	NOT ACHIEVABLE, Significant deterioration of the macro-situation, but also insufficient control of expenditures New target will need to be set with a view on medium-term	YES	YES, Expenditure ceilings, including intra-year, could be introduced and deficit target could be set nominally(500 million LVL), on top of the figures in % of GDP
	High	Progress in public sector nominal wage and employment cuts, including in local governments, state agencies and other public institutions	YES, Significant in some sectors (central government), but limited evidence for others (e.g. state owned enterprises) Further 20% cut is planned for the central government staff	YES	YES, Target could be made more tight, in line with new proposals, - the circle of significant wage cuts has to be extended
B: Fiscal governance reform					
	High	Adoption of measures to strengthen public financial management: improving the budget formulation process, strengthening Ministry of Finance's spending controls (especially the wage bill at general government level), making the medium-term budget framework operational and increasing budgetary transparency and external oversight. Draft amendments to the	PARTIALLY/ONGOING The powers of the Minister of Finance have been increased. Technical assistance is being provided by the EC and other parties, further missions will take place Fiscal disciplinary Committee was set up	YES	YES

		Budget and Financial Management Law to be prepared with assistance from EU and IMF experts			
	High	The Ministry of Finance's macroeconomic forecasts should be reviewed by the Ministry of Economy and the Bank of Latvia in consultation with external experts. The Commission forecast should be taken as a benchmark	YES, MoF uses benchmarks, although the outlook changed very quickly and the budget has been revised taking into account the agreed baseline.	Yes	NO
	Low	Secure commitments of all boards of publicly owned enterprises to deliver reduction in compensation level similar to the one in the public administration	YES, Suppressed most of the boards	Possibly	MORE TARGETED
	Low	Implementation of the State Audit Office September 2008 recommendations regarding the assessment of implementation of the 2007 State budget and budgets of local governments to achieve additional public expenditure savings	PARTIALLY, Savings achieved on operational expenditures of ministries Progress with standardizing accounting methodology	Possibly	further progress with standardizing accounting methodology of different ministries might need follow up
C: Financial sector regulation and supervision					
	Low	Ensuring that the remaining minority shareholders of Parex Bank do not benefit from the resolution of the bank and enhancing financial stability, if necessary, by means of fully nationalising Parex bank	PARTIALLY, Ownership titles of the previous major shareholders of Parex Banka have been successfully removed. However, they remain interested in the Bank as holders, directly or through family relations, of subordinate debt, i.e. as creditors to the Bank. It remains to be assessed whether this constitutes or not a breach of the condition.	YES	YES
	High	Strengthen financial sector supervision by the Financial and Capital Market Commission (FCMC) through: (i) continuous implementation of adequate credit risk analyses on the basis of	COMPLETED, External audits have been conducted on each individual bank. Their results, fully satisfactory, have been presented in a report sent to the European	NO	NO

		disaggregated data from individual banks at the appropriate frequency; (ii) close monitoring of banks' foreign currency exposure both directly and indirectly through their clients' credit risk and (iii) enhanced risk analysis of links between banking and non-banking financial sectors. Results shall be made available in a due report	Commission on 12 June.		
	High	Take measures to ensure that the banking system is adequately provisioned with capital, based on i) prudent capital requirement risk weights and ii) supervisory capital provisioning that would take into account both the general macroeconomic risk and the particular evolution of each bank's balance sheet. Targeted examinations and analyses shall be conducted by the FCMC to ensure that these measures have been correctly implemented, and that consequently banks are sufficiently capitalized. Results shall be made available in a due report	COMPLETED, The Supervisory Authority has taken appropriate measures in the direction suggested in the MoU. Detailed results have been presented during the Review Mission and the English translation of the due report is expected soon.	NO	NO
D: Structural reforms					
	High	The Latvian authorities in consultation with the National Tripartite Council shall develop and adopt a comprehensive and credible export promotion strategy	PARTIALLY, Latvia has launched an LVL 680mn business support program in May, within it there is progress with setting up an export guarantee system	YES	MORE TARGETED, There is a need to follow up on the efficiency of the new programme
	Low	Within the framework of European Investment Fund-managed Holding Fund activities, take necessary steps without undue delay to ensure an effective access to financing for SMEs, using for example export credit guarantees, high-risk loans, risk capital	NO	YES	MORE TARGETED

	funds and financial support instruments for business activity			
High	Set up a systematic and comprehensive system for the evaluation of the impact of European Union Funds' interventions. Take capacity building measures for public administration involved in the implementation of European Union Funds, in particular to improve project selection and take necessary steps to complete preconditions for approval of major infrastructure investments (including technical studies, plans)	MIXED/ONGOING	YES	MORE TARGETED
Low	Develop inter alia a standardized methodology for formal eligibility requirements in public procurement procedures, explore the scope for centralizing public and municipality procurements and broaden the utilization of e-procurement system to improve efficiency and transparency	MIXED/ONGOING	YES	MORE TARGETED
Low	Increase availability of active labour market policies including training, re-qualification and activation measures	PARTIALLY	YES	YES

Annex 3:

Update of the external financing gap (status 22 June)

The updated estimate of Latvia's external financing gap takes into account Q1 2009 balance-of-payments and Q-4 2008 external debt statistics, revised debt amortisation projection schedules, latest internal DG ECFIN forecast (*inter alia* the balance on the current and capital account and the government deficit[8]), and adjusts some assumptions to make them even more cautious (see below). The calculations assume that financial assistance from international lenders will proceed with full disbursements in 2009 and 2010. For 2009, the calculations cover the period Q2-Q4.

Overall, the updated estimate of the financing gap indicates that Latvia is likely in no need of additional external assistance on top of the €7½ billion in the programme, despite the worsening economic situation and deteriorating public finances. The main reason is the substantial improvement in the current account deficit, which reduces Latvia's gross financing requirements. According to ECFIN's projections, the current account is now forecast to record a surplus of some €900 million over 2009 and 2010. This is an improvement by around €3.8 billion for 2009-2010 vis-à-vis the calculations in the ECFIN programme scenario in December.

Given the deteriorating public finance situation and potential knock-on effects on the confidence of residents and non-residents, the calculations are based on more cautious assumptions about the behaviour of deposits. Non-resident deposits (non-MFIs) are assumed to decline by around 25% in 2009 and by 20% in 2010, which is a more cautious assumption than in the Dec-2008 programme scenario (22% and 12%, respectively). The more cautious assumption is motivated by the worsening economic situation, deteriorating public finances and observed flows. In the first three months of 2009, according to official statistics, non-resident deposits declined by 6% which implies an annualised rate of some 24%. The possible lifting of restrictions on non-resident deposits in Parex could also have an impact on non-resident deposit outflows, although the bank is negotiating with its main depositors to avoid such large-scale outflows.

Similarly, the calculations take a very cautious approach to the internal (resident) drain on reserves. The stock of resident domestic-currency deposits is assumed to decline by 35% in 2009 and 30% in 2010. In the first quarter of 2009, domestic-currency deposits declined by 8% (annualised rate of decline by 30%-35%). However, in the same period, the stock of resident foreign-currency deposits – almost exclusively in euro – rose by 12%, suggesting (i) that the preference for euro-denominated deposits among Latvian residents is persisting, and (ii) that the major share of resident deposits in the first quarter of 2009 stayed within the country's banking system. Nevertheless, the calculations very cautiously assume that the stock of resident foreign-currency deposits does not increase throughout the year but remains constant at last year's level, which implies a larger internal drain on reserves.

These cautious assumptions notwithstanding, foreign exchange reserves are progressively increased to ensure coverage of 65% and 95% of short-term debt at the end of 2009 and 2010, respectively.

[8] The deteriorating public finance situation is integrated in the external financing gap estimate. The government's budget deficit has an indirect influence on the financing gap via the current account and via changes in official reserve assets.

LV - Financing Gap until 2010

in mio euro, (+) increase in financing gap

This version: 22/06/2009
Latest available data: 2008Q4/2009Q1

	Central scenario			Assumptions
	Q2-Q4-2009	2010	SUM	
A. Current account deficit	**-299**	**-631**	**-930**	CA deficit according to the latest internal DG ECFIN forecast
B. Debt liabilities	**2,050**	**1,867**	**3,917**	ST debt at original maturity plus 20% of LT debt
of wich general government	233	292	525	roll-over: 20% in 2009 and 25% in 2010
of which central bank	0	0	0	roll-over: 100% in 2009 and 2010
of which other MFI (excluding non-resident deposits)	1,326	1,186	2,511	roll-over: 60% in 2009 and 65% in 2010
of which other sectors	490	389	880	roll-over: 75% in 2009 and 80% in 2010
C. Equity liabilities	**-241**	**-381**	**-622**	Inflows decrease by 20% in 2009 and 10% in 2010 compared to average 2008q2-2009q1
D. External buffers	**-1,911**	**-1,026**	**-2,937**	
of which equity sec., financial deriv.	-86	-53	-139	reimbursement equity securities 10% in 2009 and 5% in 2010, financial derivatives 30% in 2009 and 20% in 2010
of which general government	-9	-5	-14	reimbursement bonds, loans+other assets 20% in 2009 and 10% in 2010
of which central bank	-1	0	-1	reimbursement bonds, loans+other assets 20% in 2009 and 10% in 2010
of which other MFI	-1,013	-540	-1,553	reimbursement bonds, loans+other assets 20% in 2009 and 10% in 2010
of which other sectors	-802	-428	-1,230	reimbursement bonds, loans+other assets 20% in 2009 and 10% in 2010
E. Foreign exchange reserve buffer	**1,052**	**1,222**	**2,274**	target A: 65% of ST debt in 2009 and 95% in 2010
F. Capital account flows	**-288**	**-423**	**-712**	Capital account inflows according to the latest internal DG ECFIN forecast
G. Drains on currency and deposits	**2,043**	**1,610**	**3,654**	currency in circulation: 10% in 2009 and 2010, residents' LAT-denomnated desposits: 35% in 2009 and 30% in 2010, non-resident deposits: 25% in 2009 and 20% in 2010
Financing gap	**2,406**	**2,238**	**4,644**	
Financing gap (% of GDP in 2009)	**13.2%**	**12.2%**	**25.4%**	
International financial assistance	**2,500**	**3,000**	**5,500**	

ANNEX 4

DRAFT

SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING

(First addendum to the Memorandum of Understanding)

BETWEEN

THE EUROPEAN COMMUNITY

AND

THE REPUBLIC OF LATVIA

SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING

(First addendum to the Memorandum of Understanding)

between

1. On 20 January 2009 the Council of the European Union adopted a decision to make available to Latvia medium-term financial assistance of up to EUR 3.1 billion, with a maximum average maturity of seven years. Community assistance should be provided in conjunction with a loan from the International Monetary Fund of SDR 1.5 billion (1200% of Latvia's IMF quota, around EUR 1.7 billion) under an IMF Stand-by arrangement approved on 23 December 2008. The Nordic countries (Sweden, Denmark, Finland, Norway and Estonia) are to contribute EUR 1.9 billion together, the World Bank - EUR 0.4 billion, the European Bank of Reconstruction and Development, the Czech Republic and Poland - a total of EUR 0.4 billion, bringing the total to EUR 7.5 billion over the period to the first quarter of 2011.

2. The Memorandum of Understanding ("the Memorandum"), laying down the economic policy criteria linked to each instalment and the reporting and monitoring conditions of the loan, was signed on 28 January 2009. These specific economic policy conditions will help the country to continue and enhance the fiscal consolidation efforts, to make progress with fiscal governance, financial sector regulation and supervision reforms and other measures to support a prudent, stability-oriented, and sustainable economic policy, laying the groundwork for sustainable convergence and Latvia's goal of entry to the euro area as soon as possible. The first instalment of EUR 1 billion was disbursed on 25 February 2009 following the entry into force of the Loan Agreement and the Memorandum of Understanding (MoU), and the fulfilment of conditions related to the 2009 budget. Subsequent instalments were tentatively scheduled for the second, third and fourth quarters of 2009, respectively, and in the fourth quarter of 2010 and the first quarter of 2011. In view of the more favourable developments in the balance of payment needs and following the disbursement of the second instalment, it is appropriate to postpone the third and fourth instalments to the fourth quarter of 2009 and the first quarter of 2010, respectively.

3. The Commission services carried out a review mission in cooperation with the IMF staff from 27 May to 17 June 2009 to assess progress made with respect to the specific conditions attached to the second instalment, which amounts to EUR 1.2 billion. The Latvian authorities sent to the Commission a Compliance Statement on 25 June, which reports on progress achieved with respect to the criteria mentioned above. Based on the findings of the mission, the compliance note of the authorities and, after having consulted with the Economic and Financial Committee, the economic policy criteria for the second instalment, as laid down in the Memorandum of Understanding, are considered to be fulfilled. In particular, while the original deficit target has become unachievable due to recession, significant progress has been made with the adoption of the supplementary budget, which has reversed a very strong deterioration of the public finances and has helped to improve confidence regarding the commitment and capacity of the government to undertake appropriate policy responses, in particular, by tackling key areas of public spending such as remuneration and pensions. Among the other conditions, progress has been made as regards fiscal governance, notably with the new

powers attributed to the Minister of Finance, as well as the financial sector regulation and supervision. Mixed progress has been achieved regarding structural reforms.

4. In light of the latest strong deterioration in the international and domestic economic environment, the growth outlook underlying the economic programme of the Government, as modified in the context of the previous review mission, appears outdated, as GDP growth is now expected to decline by 18%, against the forecast of a 5% decline in December 2008. Against this background, the authorities revised their economic programme on 16 June 2009. The new strategy implies a larger-than-planned fiscal effort compared to the December plans, following a significant deterioration of the budgetary situation also reflecting the sharp economic contraction, as well as a series of additional structural measures, in particular in the areas of pension, remuneration and local government systems. It also comprises a commitment to further reduce the deficit by LVL 500 million in 2010.

5. To ensure consistency with the revised economic policy programme based on the updated macroeconomic outlook, the conditions attached to the next instalments of the financial assistance need to be adjusted. The additional specific economic policy criteria are laid out in the Annex 1 to this Supplemental Memorandum of Understanding, which is the first addendum to the Memorandum of Understanding. Moreover, to improve the flow of information regarding the compliance with economic policy conditions, additional reporting is introduced in Annex 2.

6. Based on the fulfilment of the criteria indicated in the Memorandum, the second instalment shall be released after the signature of the first Supplemental Memorandum by the parties following the consultation of the Economic and Financial Committee.

7. The articles and the economic policy criteria as laid down in the Memorandum remain valid, with the exception of paragraph 2., which will be replaced by the following:

   "EU financial assistance will be disbursed in six instalments. The amount of the first instalment released in February was EUR 1 billion. The second instalment of EUR 1.2 billion shall be released subject to the entry into force of the Loan Agreement and this revised Supplementary Memorandum of Understanding, which will be considered for approval after consultation with the Economic and Financial Committee (EFC), and is based on the amended budget for 2009 adopted by the Latvian Parliament on 16 June 2009 and on key measures indicated by the Latvian authorities in order to complete the consolidation over the next years.

   The medium-term fiscal strategy is designed to reduce the general government budget deficit to not more than the Treaty reference level of 3% of GDP by 2012, notably by: (i) targeting a 2009 general government deficit of 10% of GDP in ESA 95 terms; (ii) within medium-term budgetary ceilings, reducing average public sector remuneration in nominal terms in 2009 by at least 15% relative to the December 2008 budget; this should also apply to local governments, government agencies and state-owned companies; boards of state owned companies to be liquidated (iii) continue measures started in 2008 to reduce employment in central government ensuring a total reduction of 10% by the end of 2009; (iv) reducing ministries' expenditures by around LVL 270 million (close to 2% of GDP); (v) reducing expenditure on goods and services by 2.5%; (vi) ring-fencing the co-financing of EU Structural Funds and improving the implementation of EU-funded projects; (vii) reducing pension outlays by 10% and

pensions of working pensioners by 70%; (viii) reducing family benefits by 10% and maternity benefits for working parents by 50%; (ix) on the revenue side, reduction of non-taxable PIT threshold from LVL 90 to LVL 35, increase in dividends from state owned companies and the Bank of Latvia, increase of excise tax on beer and alcohol, and a number other smaller measures. For 2010 and onwards, the authorities stand ready to take additional measures to achieve improvement in the deficit by another LVL 500 million (ca. 4% of GDP) per year by, inter alia, introducing capital gains tax and tax on interest income from deposits, introducing residential real estate tax and empowering the local governments to increase real estate tax up to 3%, implementing a unified public sector wage grid to address the large income differences across central government institutions, reducing further pensions and benefits, and considering a gradual pension reform by increasing retirement age. VAT rate shall be increased from 21% to 23%, unless a compensating amount of measures can be found."

8. The budget deficit targets for 2009, 2010 and 2011 referred to in Annex 1 of the MoU shall be replaced by new targets in ESA terms of 10 %, 8.5% and 6%, respectively.

9. The Annexes form an integral part of this Supplemental Memorandum.

10. The Ministry of Finance of Latvia (the Treasury) shall open a special account with the Bank of Latvia for the management of the Community medium-term financial assistance. This special account will be a sub-account of the euro-account of the Treasury within the Bank of Latvia. Within this special account an amount of EUR 600 million out of EUR 1.2 billion instalment shall be reserved for possible banking sector support measures and foreign exchange interventions and shall only be released subject to decision [of the Governor of the Bank of Latvia and the FCMC Chair, as appropriate]. The Commission shall be consulted prior to such decisions.

11. All notices in relation with the present Supplemental Memorandum shall validly be given if in writing and sent to:

For the European Community

Commission of the European Communities
Directorate General for Economic and
Financial Affairs
B-1049 Brussels
Fax No.: (+32-2) 296.48.85

For the Prime Minister

State Chancellery
Brīvības boulevard 36
Rīga, LV-1520
Fax No.: (+37 1) 67280469

For the Ministry of Finance of Latvia

Ministry of Finance of Latvia
Smilšu iela 1, Rīga LV-1919
Fax No.: (+37 1) 67 09 55 03

For the Bank of Latvia

Bank of Latvia
K.Valdemāra iela 2A, Rīga LV-1050
Fax No.: (+37 1) 67 02 24 20

For Financial and Capital Market Commission

LIMITED

Financial and Capital Market Commission
Kungu street 1
Rīga, LV-1050
Fax No.: (+37 1) 67 22 57 55

LATVIA	**EUROPEAN COMMUNITY**
Represented by	Represented by EUROPEAN COMMISSION
Valdis Dombrovskis The Prime Minister	*Joaquín Almunia* Member of the European Commission
Einārs Repše Minister of Finance	
Ilmārs Rimšēvičs Governor of the Bank of Latvia	
Irēna Krūmane Chairwoman of the Financial and Capital Market Commission	

ANNEX 1

SPECIFIC ECONOMIC POLICY CRITERIA

At the time of the review by the Commission services that will precede the decision on the disbursement of each instalment, the Latvian authorities are committed to have accomplished substantial progress in fiscal consolidation and expenditure control, in particular, reduction of public sector wages and employment, fiscal governance reform, banking sector stability, financial sector regulation and supervision reforms, as well as structural reforms, and in particular the following actions:

In view of the significant further deterioration in the economic outlook in the context of the global financial crisis, the deficit targets referred to in the Memorandum of Understanding of January 2009, as far as the conditions for the release of the subsequent instalments of the Community assistance is concerned, shall be replaced by new targets. Accordingly, the budget deficit targets for 2009, 2010 and 2011 shall be replaced by new targets of below 10%, 8.5% and 6% of GDP in ESA 95 terms, respectively. The objective is to achieve a deficit below 3% of GDP in 2012.

Thus progress shall be monitored against this basis and reviewed before the release of the next instalments.

Furthermore, the specific economic policy criteria spelled out in the Memorandum of Understanding concerning the third and following instalments will be augmented by the following actions:

Third instalment [2009Q4]

A: Fiscal consolidation

- Progress with the preparation of the 2010 budget law entailing a further improvement in the budget balance by 500 million LVL, thereby targeting a 2010 general government deficit of below 8.5% of GDP in ESA 95 terms.
- All significant Cabinet decisions or other decisions with a fiscal impact, including on social security or any guarantee scheme, shall be announced and undertaken only after discussions with the EC and the IMF.
- Increase financing for local governments to meet the raising social needs (GMIs, housing allowances, etc). Speed up claims of disbursements of EU structural funds from the Commission so as to increase revenues before the end of the year.

B: Fiscal governance reform

- Strengthen the powers and analytical capacities of the Ministry of Finance to control the preparation and execution of the budget; introduce a system to control contingent and implicit liabilities. Effective sanction procedures shall be put in place for individual misuses of public funds (i.e., State Secretaries, Heads of

Institutions). Prepare amendments to the Budget and Financial Management Law with assistance from EU and IMF experts.

- With technical assistance from international organizations, adopt a unified public sector wage grid, providing the basis for career patterns and remuneration linked to performance.

- Strengthen the capacity of the Structural Funds' Managing Authority to control and decide on EU funding spending, inter alia by increasing the accountability of line ministries (e.g., quarterly financial flow forecasts, monitoring meetings, etc), and by empowering it to reallocate budgetary resources away from underperforming programmes.

- Establish a separate, special Treasury account for EU funds' project financing, whereby any State Budget revenue from the European Commission related to EU funds (advance payments, interim payments) would be automatically introduced at the same level on the expenditure side of the Budget for implementation of EU co-financed projects. The rule should be introduced that allow roll-over of these commitments to the next budgetary year.

- When drafting the 2010 budget law, ensure appropriate human resources in institutions dealing with management of EU funds. EU funding for Structural funds-related technical assistance activities shall be ring-fenced.

D: Structural reforms

- Take necessary steps to ensure an effective access to financing for private companies, in particular SMEs, involved in implementation of EU co-financed projects.

- In view of surging unemployment levels, as a matter of priority, increase funding of active labour market policies including training, re-qualification and activation measures through the national budget, as well as ESF-related programs. Strengthen the capacities of the State Employment Agency to cope with the growing demand for services.

- The Ministry of Finance and the Managing Authority shall coordinate and mobilize international and national expertise under the ESF-co-financed initiative for administrative capacity building (indicative areas: strategic reorganization of the Ministry of Finance, budgetary planning and execution, reform of public sector remuneration system, implementation of structural reforms, etc).

- In cooperation with the relevant organized business organizations, the Small Business Act shall be implemented by providing a special program for the support of small and micro companies. The activities include lowering of start-up costs (e.g. registration fee for enterprises), changes in taxation and bookkeeping laws (e.g. frequency of reporting) and access to microcredit financing (e.g. introduction of JASMINE program).

- Develop a standardized methodology for formal eligibility requirements in public procurement procedures; increase centralizing of public and municipality

procurements and broaden the utilization of e-procurement system to improve efficiency and transparency.

Fourth instalment [2010Q1]

A: Fiscal consolidation

- Implement the unified public sector wage grid.
- Enactment of the 2010 budget law and progress with the achievement of a 2010 general government deficit below 8.5% of GDP in ESA 95 terms.
- Progress in public sector nominal wage and employment cuts, including in local governments, state agencies and other public institutions. Wage and employment reductions shall be applied to municipal companies, as well as to subsidiaries of state and municipal companies.

C: Structural reforms

- Operations of state and local government-owned companies and their subsidiary companies shall be assessed against the criteria set in the Latvian State Administration Law (performing publicly important functions) and, where appropriate, shall be privatized or restructured.
- Set up a systematic and comprehensive system for the evaluation of results and impact of the European Union Funds' interventions.

ANNEX II

MONITORING AND REPORTING SYSTEM

During the implementation of the Community assistance, the below indicators and reports shall be made available to the Commission by the relevant authorities (in addition to the requested reporting as set out in the original Memorandum of Understanding of January 2009).

Furthermore, ***reporting information provided to other multilateral and bilateral lenders*** *involved in the program of financial assistance, of which the assistance provided by the Community forms part,* ***shall at the same time also be provided to the Commission****:*

Monitoring fiscal developments

- Monthly revenue and expenditure break-down of social budget, including data on social benefits' hand-outs (unemployment, family, etc).
- Monthly state basic budget expenditure breakdown per type of expenditure for each ministry or other relevant budget entity.
- Monthly revenue and expenditure break-down of local governments, including data on GMI hand-outs and other benefits included in category "other social support".
- Monthly information on debt stocks and flows and guarantees given on new debt, contracted by the (i) consolidated central, local and general governments and (ii) public enterprises.
- Monthly data on new contingent liabilities of the consolidated central, local and general governments.
- Monthly data on state budget loans and PPP projects.
- Monthly information on central government (i.e., ministries and agencies) staff and remuneration levels, institution-by-institution, showing last months'/years' trends.
- Monthly data on general government arrears, including to suppliers.
- Bi-weekly Treasury cash-flow assessment of central government financing needs.

Monitoring financial developments

- Monthly statements of the operations on the special account.
- Monthly report on the amount of mortgage loans converted from EUR to LVL.

- Monthly report on outstanding loans split by currency and detailed to households (housing, consumer, other) and non-financial corporations (by sector).

- Notify DG ECFIN whenever there is a consultation process with DG COMP related to financial sector stabilization (i.e., Parex).

Monitoring structural reforms

- Monthly data on EU project grants (reimbursements and advances), capital expenditures and subsidies covered by EU advances or eligible for EU reimbursement by ministry and by EU fund (including which programming period it is related to), identifying whether the payment is an advance payment or a reimbursement.

- Monthly data on the amounts received by final beneficiaries for project implementation, by ministry and by EU fund (including which programming period it is related to), identifying whether the payment is an advance payment or a reimbursement.

- Monthly data on the amounts spent by final beneficiaries on EU project implementation, by ministry and by EU fund (including which programming period it is related to), identifying whether the payment is an advance payment or a reimbursement

- Monthly financial reports on reaching the Structural Funds expenditure targets by the Managing Authority.

- Quarterly qualitative assessment reports on reaching the Structural Funds expenditure targets by the Managing Authority.

- Quarterly assessment of policy options taken by the government regarding poverty, health and pensions.

A copy of all information requests and reports shall be sent to the to DG ECFIN mailbox (ecfin-lv-bop-data@ec.europa.eu), as well as to current recipients of the reporting system.