MEMORANDUM OF UNDERSTANDING

between

THE EUROPEAN COMMUNITY

and

THE REPUBLIC OF LATVIA

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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. The EU financial assistance is provided in support of the Latvian authorities' Economic Stabilization and Growth Programme ("Programme") to maintain domestic and international confidence in the financial system, to contribute directly and indirectly to arresting and reversing the worsened cost competitiveness and inflationary pressures by reductions in public sector wage costs as a centrepiece of a much tighter fiscal stance, and to strengthen the economy’s growth potential by a range of structural reforms. Implementation of the measures proposed in the Programme would support the further unwinding of accumulated imbalances, including the wide current account deficit and high cost and price inflation, and lay the groundwork for sustainable convergence and Latvia's goal of entry to the euro area as soon as possible.

2. EU financial assistance will be disbursed in six instalments. The amount of the first instalment is EUR 1 billion and shall be released subject to the entry into force of the Loan Agreement and the present Memorandum of Understanding, which will be considered for approval after consultation with the Economic and Financial Committee (EFC), and will be based on the Latvian authorities' economic stabilisation programme ("Economic stabilisation and growth revival programme") and amended budget for 2009, both adopted by the Latvian Parliament on 12 December 2008 (a detailed supplementary budget will be submitted to Parliament by the end of March 2009). These set a medium-term fiscal programme designed to reduce the general government budget deficit to not more than the Treaty reference level of 3% of GDP by 2011, notably including: (i) targeting a 2009 general government cash flow deficit of below 5% of GDP and 5.3% in ESA 95 terms; (ii) within medium-term budgetary ceilings, reduction of average public sector remuneration in nominal terms in 2009 by at least 15% relative to the original 14 November 2008 budget and a further 2% in 2010-2011; this should also apply to local governments, government agencies and state-owned companies; (iii) continue measures started in 2008 to reduce employment in central government ensuring at least 5% reduction by the end of 2008 and total reduction of 10% by the end of June 2009; (iv) the elimination of general bonuses, performance bonuses, vacation bonuses, management contracts, additional payments for work in high intensity conditions, and similar such payments; (v) reduction of subsidies (excluding social

support) and expenditure on goods and services; (vi) implementation of EU-funded projects at the planned level; (vii) on the revenue side, the amended 2009 budget stipulates increases in the standard and reduced rates of VAT from 18% to 21% and from 5% to 10% respectively, along with excise tax increases on alcohol, tobacco, petrol, and certain non-alcoholic beverages and coffee (these indirect tax increases being partly offset by a 2% cut in the headline rate of the personal income tax). The Latvian authorities stand ready to take additional measures if required.

3. In addition, measures are to be taken to strengthen fiscal governance, increase transparency and improve public financial management including strengthening the budget formulation process, reinforcing the Ministry of Finance's spending controls, and making operational the medium-term budget framework. This should help avoid inappropriately expansionary policies in the future. The Budget and Financial Management Law will be amended to strengthen the design and implementation of budgetary procedures.

4. Financial sector conditionality measures, in addition to implementation of the Parex Bank resolution plan, should aim at guaranteeing wider banking sector stability in the medium to longer term. As a first step, the authorities will take action to restore confidence in the banking system, by developing a comprehensive bank resolution strategy. Targeted examinations will be conducted in the banking system to ensure that all banks are solvent and sufficiently capitalized. Viable banks, which will need capital increases, should be encouraged to seek private restructuring via outside investors or mergers, or capital support from parent banks.

5. In order to reduce debt vulnerabilities in the future, in addition to prudential and supervisory measures, debt restructuring is an important component of the programme. Facilitating insolvency procedures and quick implementation of rehabilitation plans must be made a priority. This includes necessary amendments to the insolvency law that would facilitate workouts between viable enterprises and their creditors, and improvements in the personal bankruptcy framework. A framework for facilitating maturity and credit restructuring of bank loans should be introduced. In addition, further cooperation with foreign supervisors should be sought in order to ensure a timely and adequate recapitalisation of Latvian subsidiaries by their foreign parent banks.

6. Monetary policy will have to take into account the need to preserve the credibility of the exchange rate peg. An adequate backing of base money by international reserves should be ensured. The current strategy of adjusting the required reserve ratio on the basis of inflation forecasts and credit growth trends should be maintained in consultation with international institutions.

7. The economic policy programme will include structural reform measures supported in the context of the Lisbon strategy, such as active labour market and lifelong learning policies, greater involvement of private sector actors in R&D and innovation activities, export promotion measures, removal of administrative burdens for businesses and facilitating their access to financing.

8. The European Commission shall decide on the release of the second and subsequent instalments after having obtained the opinion of the EFC. A second instalment shall be made in the amount of up to EUR 1.2 billion, followed by four subsequent instalments of smaller amounts. The disbursement of the six instalments is tentatively foreseen in respectively each of the four quarters of 2009, in the third quarter of 2010 and finally in the first quarter of 2011. The disbursement of each

further instalment shall be made on the basis of the implementation of the Latvian authorities' economic stabilisation programme, which is also backed by the IMF stand-by arrangement, with the stabilisation programme also forming the basis for subsequent annual updates of Latvia's convergence programme and be taken full account of in Latvia's National Reform Programme (Lisbon strategy). More particularly, the release of the funds will be based on a positive evaluation of progress made with respect to specific economic policy criteria detailed in Annex I of the present Memorandum.

9. The effective payment of the Loan instalments shall be subject to the signature and entry into force of the corresponding legal commitment (Loan Agreement) by the parties.

10. The disbursement date of each loan instalment or tranche will be agreed by the two parties in accordance with the Loan Agreement.

11. Prior to the release of each instalment, the EFC shall be kept informed by the Commission of the fulfilment of the conditionality attached to the instalment in question. The EFC shall be kept informed by the Commission of possible refinancing of the borrowings or restructuring of the financial conditions.

12. The European Central Bank will act as an agent to the Commission and shall transfer the proceeds of the Loan instalments or tranches to a euro account of the Ministry of Finance of Latvia (the Treasury) held at the Bank of Latvia (“the Agent”).

13. During the implementation of the assistance, the Latvian authorities shall make available to the Commission without delay all the relevant information for the monitoring of its economic and financial situation and for the assessment of progress in economic conditions and reform measures as specified in Annex I. Prior to the release of the second and subsequent instalments by the Commission, the Latvian authorities shall provide the Commission with Compliance Statements on the fulfilment of the conditionality attached to the instalment in question.

14. Investigation and satisfactory treatment of any suspected and actual cases of fraud, corruption or any other illegal activity in relation to the management of the European Community balance of payments assistance shall be ensured. All such cases as well as measures related thereto taken by national competent authorities shall be reported to the Commission without delay.

15. The European Court of Auditors shall have the right to carry out financial controls or audits that it considers necessary in relation to the management of this assistance. The Commission, including the European Anti-Fraud Office, shall have the right to send its own agents or duly authorised representatives to carry out technical or financial controls or audits that it considers necessary in relation to the management of this assistance as long as the Loan has not been fully repaid.

16. An independent ex-post evaluation of the assistance may be carried out by the Commission or its duly authorised representatives. The Latvian authorities are committed to supply relevant information for the evaluation. The draft evaluation report will be made available to them for comments.

17. The Latvian authorities will ensure, as appropriate, close co-operation with the European Commission and the EFC.

18. This Community financial assistance shall be made available during three years starting from the first day after the entry into force of the Council Decision 5255/09 of 20 January 2009.

19. The Annexes form an integral part of this Memorandum.

20. All notices in relation with the present 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 the Financial and Capital Market Commission

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

21. For Latvia the Memorandum shall become effective after completion of internal procedures required under the Laws of Latvia. The Memorandum may be amended upon mutual agreement of the parties in form of an Addendum. Any such Addendum will be an integral part of this Memorandum and will become effective according to the same procedures as the Memorandum.

Done in Brussels on………… and Riga on ………….in five originals in English language.

LATVIA	**EUROPEAN COMMUNITY**
Represented by	Represented by EUROPEAN COMMISSION
Ivars Godmanis The Prime Minister	*Joaquín Almunia* Member of the European Commission
Atis Slakteris Minister of Finance	
Ilmārs Rimšēvičs Governor of the Bank of Latvia	
Irēna Krūmane Chairwoman of the Financial and Capital Market Commission	

ANNEX I

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:

Second instalment [2009Q2]

A: Fiscal consolidation

- Adoption by the Parliament of the fully fledged supplementary budget law for 2009, including a 5 percent contingency reserve, defining further allocation of spending appropriations among spending agencies and ministries and identifying clearly programmes that should be rationalised.
- 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.
- Progress in public sector nominal wage and employment cuts, including in local governments, state agencies and other public institutions.

B: Fiscal governance reform

- 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 Budget and Financial Management Law to be prepared with assistance from EU and IMF experts.
- 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.
- Secure commitments of all boards of publicly owned enterprises to deliver reduction in compensation level similar to the one in the public administration.
- 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.

C: Financial sector regulation and supervision

- 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.
- 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 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.

- 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.

D: Structural reforms

- The Latvian authorities in consultation with the National Tripartite Council shall develop and adopt a comprehensive and credible export promotion strategy.
- 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 funds and financial support instruments for business activity.
- 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).
- 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.
- Increase availability of active labour market policies including training, re-qualification and activation measures.

Third instalment [2009Q3]

A: Fiscal consolidation

- 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.
- Progress in public sector nominal wage and employment cuts, including in local governments, state agencies and other public institutions.

B: Fiscal governance reform

- Further improve wage payment system for direct public administration employees; this should provide unified principles in setting and planning wages; payment determination should be streamlined and set on strict conditions.
- Establishment of a single human resource planning and management system for public administration institutions; develop and implement a single system of annual official and employee assessment based on competences.

- Enactment of a Law on Public Private Partnership (PPP) consistent with the IMF and EU recommendations. A Law on PPP is to be adopted prior to undertaking any large PPP infrastructure projects additional to those initiated by end-2008.

C: Financial sector supervision and regulation

- Take measures to strengthen cross-border supervision and communication between the supervisory authorities in home and host countries. This requires a structured exchange of information between the FCMC and the supervisory authorities of the home countries of the major foreign banks present in Latvia, including in the context of colleges of supervisors, as well as regular meetings to review the situation in each bank, including joint stress tests and onsite inspections as needed.
- A framework shall be introduced that enables banks' clients to require debt maturity and currency restructuring of outstanding loans on market conditions. In addition, facilitating insolvency procedures and quickly implementing rehabilitation plans shall be made a priority for legislators.

D: Structural reforms

- Review the economy-wide wage-setting mechanisms to foster employee compensation evolvement in line with the constraints imposed by a fixed exchange rate.
- Improve the VAT overpayment refund system considering the recommendations of international institutions.
- Take measures to avoid further delays in implementation of the Operational Programme "Human Resources and Employment" in line with the agreed programming documents, reviewed if necessary, and through effective commitment and contracting.

Fourth instalment [2009Q4]

A: Fiscal consolidation

- Enactment of the amended Budget and Financial Management Law.
- Progress with the achievement of the revised 2009 general government cash flow deficit target of below 5% of GDP and 5.3% in ESA 95 terms. Enactment of the 2010 budget law targeting a 2010 general government deficit of below 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.

B: Financial sector supervision and regulation

- Take additional actions to further strengthen financial sector supervision and regulation through: (i) measures to ensure prudent loan-to-income ratios for household credit and prudent loan-to-value ratios for mortgage loans if revealed necessary by a due analysis of banks' condition carried out by the FCMC; ii) higher capital provisioning requirements for foreign currency loans in the context of pillar 2 of the Basel II agreement and iii) enhanced credit risk management standards, with special emphasis on the responsibility of senior management.

- Implement measures to further strengthen Bank of Latvia and the FCMC's capacity to assess and address solvency and liquidity concerns in banks in a timely manner. This would notably involve: (i) establishing a mechanism for early remedial actions, including effective emergency powers for the FCMC; ii) enhancing stress-testing and contingency planning, including periodic stress-testing according to the FCMC scenario; iii) establishing prudent minimum liquidity requirements taking into account the funding structure of each bank and (iv) improving the efficiency of the bank resolution regime to facilitate the payments to depositors in case of need.
- Improvement of the personal bankruptcy framework.

C: Structural reforms

- The number of public R&D priorities should be reduced to provide more resources to relevant research fields. Take measures to reform the R&D system encouraging better links to the business sector. Take measures to ensure that financing for R&D and innovation activities in 2010 and onwards is maintained as planned in Operational Programmes with a special emphasis on applied R&D and promotion of skills and resources that enable companies to apply existing technologies.
- Within the framework of the 2009 budget law, have committed enough budgetary resources for implementation of the planned Structural Funds co-financed programmes. By the end of 2009 Latvia should be able to demonstrate efficient expenditure (paid by the intermediate bodies) of at least 60 million EUR from the European Social Fund, 170 million EUR under the Cohesion Fund and 270 million EUR under the European Regional Development Fund.
- Review and take necessary steps to implement the lifelong learning action programme for 2008-2010 and ensure in the programme that development of relevant labour market skills and qualifications is strengthened.

Fifth instalment [2010Q3]

A: Fiscal consolidation

- Progress with the achievement of the 2010 general government deficit target of below 5% of GDP in ESA 95 terms.
- Any additional revenue relative to budget plans (except EU funds) should be used to achieve a lower-than-targeted budget deficit. The agreed total general government expenditure figure cannot be increased.
- Progress in public sector nominal wage and employment limitation, including in local governments, state agencies and other public institutions.

B: Fiscal governance reform

- Progress with the implementation of the amended Budget and Financial Management Law.

C: Financial sector supervision and regulation

- The Bank of Latvia should closely monitor developments in credit markets and real economy and use its minimum reserve requirements to aim at banks' credit expansion being in line with other sectors' growth. Should any sign of overheating risks reappear, action should be taken in this respect.

Sixth instalment [2011Q1]

A: Fiscal consolidation

- Enactment of the 2011 budget law targeting a general government deficit of not more than Treaty reference level of 3% of GDP.
- Any additional revenue relative to budget plans (except EU funds) should be used to achieve a lower-than-targeted budget deficit. The agreed total general government expenditure figure cannot be increased.
- Verification of progress in public sector nominal wage and employment limitation, including in local governments, state agencies and other public institutions.

B: Structural reforms

- Within the framework of the 2010 budget law, have committed enough budgetary resources for implementation of the planned Structural Funds co-financed programmes. In 2010 Latvia should be able to demonstrate efficient expenditure (paid by the intermediate bodies) of at least 66 million EUR from the European Social Fund, 185 million EUR under the Cohesion Fund and 291 million EUR under the European Regional Development Fund.
- Within the framework of the 2011 budget law, commit enough budgetary resources for implementation of the planned Structural Funds co-financed programmes. In 2011 Latvia should target annual expenditure (paid by the intermediate bodies) of at least 72 million EUR from the European Social Fund, 201 million EUR under the Cohesion Fund and 318 million EUR under the European Regional Development Fund.

ANNEX II

MONITORING AND REPORTING SYSTEM

During the implementation of the Community assistance, the following indicators and reports shall be made available to the Commission by the relevant authorities on a monthly, quarterly or annual basis. In general, reporting information provided to other multilateral and bilateral lenders involved in the programme of financial assistance of which the assistance provided by the Community forms part shall at the same time also be provided to the Commission, unless the Commission has indicated that this is not specifically required:

Monitoring fiscal developments

- Upon request, latest daily budget execution report from the Treasury.
- Regular (monthly) reports on budgetary execution, covering the entire general government (including local governments) with a view to assessing progress with respect to the agreement.
- Regular quarterly reports on the evolution of general government debt.
- Upon request, and regularly for the bi-annual forecast rounds of the Commission services, revenue and expenditure projections of the Ministry of Finance for the general government sector under ESA in the format of Table 10 of the Commission services' forecast. Upon request, revenue and expenditure projections of the Ministry of Finance for the general government sector in cash flow terms.
- Inform the Commission monthly of important decisions of the Fiscal Discipline Monitoring Committee.
- Inform the Commission of the Ministry of Finance discussions with the Latvian Association of Local and Regional Governments regarding additions to the October 2008 "Additional Agreement to the Statement of Disagreement and Understanding".
- The Commission shall be informed of activities and decisions of the newly-established Committee to Promote Wage Restraint.

Monitoring financial sector developments

- Regular quarterly report (data and short analysis) on the evolution of financial stability indicators, to be provided by the Bank of Latvia.
- Regular weekly reports with summary information on the evolution of banks' liquidity, to be provided by the FCMC.
- The Commission shall be informed of the progress of cooperation with foreign supervisors.

Reporting on monetary policy

- Bi-weekly statements by the Bank of Latvia on its balance sheet.
- Interventions by the central bank or stock of net international reserves
- Monthly and quarterly BOP financial account data.
- Projections for external payments of the banking and corporate sector as well as government falling due in the next four quarters (for medium and long term loans).