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

the European Community and the Republic of Latvia

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 are helping the Latvian authorities 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, maintaining a medium-term perspective of qualifying for accession to the euro area. 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 of the EU assistance, which amounts to EUR 1.2 billion. The Latvian authorities sent to the Commission a Compliance Statement on 26 June, which reports on the progress achieved with respect to the criteria mentioned above. Based on the findings of the Commission 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 broadly fulfilled or not applicable any more in view of the larger-than-expected deterioration in the economic situation. In particular, while the original fiscal deficit target has become unachievable due to worsening recession, significant progress has been made with the adoption of the supplementary budget, which is expected to limit a substantial 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 I 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 II, while the modalities for the release of funds from the sub-account for banking sector support are spelled out in Annex III.

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 government's 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 no more than 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 public 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 , the authorities stand ready to take additional measures to achieve improvement in the deficit by another LVL 500 million (ca. 4% of GDP) 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% of cadastral values, implementing a unified public sector wage grid to address the large income differences across central government institutions, revising the pension and benefit systems, 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. The Latvian authorities intend to continue with such sizeable adjustment every year until the budget deficit is below the 3% of GDP Maastricht threshold.

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 ESA95 terms no more than 10 %, 8.5% 6% of GDP, 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 banking sector support measures and shall only be released subject to approval of the FCMC, the Ministry of Finance and the Bank of Latvia, after a positive opinion by the Commission, according to the modalities established in Annex III.

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

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	*Joaquín Almunia*
The Prime Minister	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

(Amendments and Additions to Annex I of the MoU)

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 no more than 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:

<u>Third instalment [2009Q4]</u>

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 no more than 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 and Cohesion Fund 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), agencies and beneficiaries, and by empowering it to reallocate budgetary resources away from underperforming activities.

- Establish separate, special state budget sub-programmes for each EU funds' intermediate body by the next budgetary year, as well as a separate special Treasury account as soon as possible for the cash management of all EU funds to which any State Budget revenue from the European Commission related to EU funds (advance payments, interim payments) would be automatically transferred and withdrawn only for financing the 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, sustain appropriate human resources in institutions dealing with management of EU funds. EU funding for Structural funds and Cohesion Fund related technical assistance activities shall be used to full extent and budgeted appropriately.

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.

- Undertake steps to address the high indebtedness of the private sector.

- 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 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 .

- 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 no more than 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.

- Launch the evaluation of results and impact of EU funded investments, in particular in key sectors of education, active labour market measures and support to businesses during the period of 2004-2008 in order to streamline further investments in these areas.

ANNEX II

MONITORING AND REPORTING SYSTEM

(Amendments and Additions to Annex II of the MoU)

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) and state owned companies' 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).
- Monthly report on banking sector stabilization measures.

Monitoring structural reforms

- Monthly data on budget allocations to and appropriations of line ministries for financing of EU Structural funds and Cohesion fund projects (including which programming period they are related to).
- Monthly data on the amounts disbursed to final beneficiaries for project implementation, by ministry and by EU Structural funds and Cohesion fund projects (including which programming period they are related to).
- Monthly data on the amounts spent by state budget financed entities as final beneficiaries on EU Structural funds and Cohesion fund project implementation, by ministry and by EU fund (including which programming period they are related to).
- Monthly financial reports on reaching the Structural Funds and Cohesion Fund expenditure targets by the Managing Authority.
- Quarterly qualitative assessment reports on reaching the Structural Funds and Cohesion Fund 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.