



LETTER OF INTENT WITH THE INTERNATIONAL MONETARY FUND

On August 27, 2009, the Executive Board of the IMF approved the second installment of loan to Latvia in the amount of EUR 200 million. This approval was based on a Letter of Intent which had been signed by the government of Latvia one month earlier on July 27th. The full text of the Latvian government's Letter of Intent has now been published and can be found at:

http://www.fm.gov.lv/prezes_relizes/dok/Letter_of_Intent_2_July_2009.pdf.

Summary of main points in Latvia's Letter of Intent

Government takes 'difficult but strong policy measures'

"While policy implementation is hugely challenging, we are committed to containing external and fiscal imbalances, and preserving the long-standing exchange rate peg until our goal of euro adoption by 2014. Building on progress towards stabilizing the financial sector, our most urgent focus is on structural reforms needed to restore the public finances to health."

Steps taken since December

- ✓ Intervention capacity strengthened.
- ✓ Improved supervision and monitoring.
- ✓ Stabilization of Parex bank.
- ✓ Legal framework improved to facilitate orderly and efficient debt restructuring.

Bank of Latvia has met foreign currency reserve and monetary targets. Net international reserves have stabilized and the current account is now in surplus. A supplementary budget was adopted in June to initiate structural reforms, cut budget expenditure and boost public confidence.

Macroeconomic framework for 2009-10

Despite a deeper recession than envisioned in December, internal wage and price adjustments have begun, providing a boost to competitiveness. Inflation has fallen from 18% in 2008, to 3% in June 2009. Recovery is projected in late 2010, despite a real GDP decline by 18% in 2009. Falling domestic demand and wages will bring modestly falling prices: the 12-month inflation rate is expected to turn negative end-2009, and to average -3½ percent in 2010.

Policies for 2009-11

The macroeconomic strategy reflects a goal of euro adoption by 2014. The strategy helps address risks to households, enterprises, and banks from high levels of financial euroization. This will require double-digit fiscal consolidation to close a large structural general government deficit; tight monetary policy, consistent with the exchange rate peg; stronger financial sector supervision; and structural reforms to sustain economic recovery.

Fiscal Policy

On June 16, the Parliament adopted a supplementary budget, a critical first step towards sustainable public finances. The government remains committed to bringing the general

government deficit down to 3 percent of GDP in 2012—satisfying the Maastricht criterion for euro adoption.

2009 Supplementary Budget

The 2009 supplementary budget is ambitious and includes a wide range of measures:

- ✓ revenue increases from state-owned companies' increase of excise and gambling taxes and reduction of non-taxable personal allowance;
- ✓ structural reforms and significant budget reductions have been implemented in ministries and state agencies;
- ✓ limited and targeted pension reductions, additional spending on unemployment benefits.

Safeguarding local government resources, social safety nets, EU-related expenditure and other financial assistance

- ✓ Funding of some 1½ percent of GDP in 2009 will be provided to expand social safety nets and accelerate the absorption of EU funds and other foreign financial assistance.
- ✓ A comprehensive social safety net strategy is being developed with the World Bank.

All legal amendments and administrative measures necessary to implement the above decisions will be taken before the end of September, while the powers of the Minister of Finance will be strengthened and capacity improved.

Letter of Intent states: *“We believe our across-the-board cuts are feasible, and our comprehensive social safety net strategy will mitigate the social risks associated with large scale reforms. In addition, we will consider reallocations or, as a last resort, providing additional funding where undue hardship emerges. Our resolve to continue fiscal adjustment next year and beyond will keep us on track even should we need to make small adjustments this year.”*

2010 Budget

Measures will be implemented to ensure a lower fiscal deficit in 2010 compared to 2009. The government is committed to limit the general government deficit to 8.5 percent of GDP and introducing LVL 500 million (4 percent of GDP) in targeted expenditure cuts and tax measures. These include:

- ✓ carrying out of a broad public service reform and structural reforms based on functional audits;
- ✓ a comprehensive plan to broaden the tax base of the personal income tax as of 2010, reduce or remove exemptions and reduces disparities in allowances;
- ✓ abolishment of the special self-employed income tax regime, bringing the self-employed into the standard personal income tax system from 2010;
- ✓ design a comprehensive reform, allowing means-tested exemptions, to expand the base of the real estate tax to include all residential properties.

2011 and Beyond

The government intends to further reduce the deficit in 2011 and beyond, mostly through expenditure restraint. The goal is to reach a deficit of 3 percent of GDP in 2012. Further tax increases in labor income will be avoided so as not to undermine competitiveness.

Monetary and Exchange Rate Policy

The fixed (narrow band) exchange rate of the lats will remain the anchor for monetary policy until the euro is adopted.

Financial Sector

- ✓ The Financial and Capital Market Commission (FCMC) will complete forward-looking assessments to ensure banks maintain adequate liquidity and solvency buffers.
- ✓ The development of a comprehensive bank resolution strategy will be accelerated.
- ✓ The FCMC will introduce a more risk-oriented approach to supervision and regulation.

- ✓ Efforts will continue to resolve Parex's problems with priority given to ensuring adequate capitalization and stable management.

Private Debt Restructuring

- ✓ The government strategy for resolving and recapitalizing banks will increase their capacity to restructure debts and provision and recapitalize accordingly. It will be based on restructuring corporate and household debt on a market-based approach.
- ✓ Further improvement of the legal framework to help address widespread debt distress in the corporate and household sectors.

Concluding remark

The final comment of the Letter of Intent establishes: *"We believe the policies described above will achieve the goals of our economic program: maintenance of the exchange rate peg; macroeconomic stability; and staying the course for euro adoption. Nevertheless, we stand ready to take additional measures needed to keep the program on track."*

THE LATVIAN INSTITUTE

The Latvian Institute (Latvijas institūts) was established by the Latvian state to provide a wide range of information about Latvia, its society, culture and history.

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