LATVIA: LETTER OF INTENT

Riga, July 27, 2009

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

Dear Mr. Strauss-Kahn:

1. **We are responding to the economic challenge facing Latvia with difficult but strong policy measures.** Since the announcement of Latvia's macroeconomic program—supported by the EU, the IMF, and regional partners—the economic environment has deteriorated sharply. 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.

2. **Since December, we have taken key steps to safeguard the financial system**.

- **Intervention capacity has been strengthened**. A new Law on Bank Takeovers, amendments to the Law on Credit Institutions, Deposit Guarantee Law and the Financial and Capital Market Commission (FCMC) Law, as well as to the Bank of Latvia's regulations on emergency liquidity support have enhanced our capacity for bank intervention.

- **We have improved supervision and monitoring**. A targeted examination of all banks completed in March 2009 revealed no immediate solvency issues. The FCMC has enacted new regulations on asset quality assessment and provisioning, and issued supervisory guidance on banks' internal capital adequacy assessment processes—shoring up capital buffers. The FCMC has also stepped up its monitoring of individual banks and enacted new reporting requirements.

- **Stabilizing Parex**. We have made progress towards stabilizing the second-largest bank, Parex. An agreement reached in March rescheduled the bank's syndicated loans. The government and the EBRD agreed in April on EBRD's investment of 25 percent of Parex equity and a subordinated loan. The state recapitalized Parex in May.

3. **We have also made considerable progress towards improving the legal framework to facilitate orderly and efficient debt restructuring.** Recent amendments to the Insolvency Law, which entered into force on July 1, 2009, will facilitate out-of-court workouts by providing the incentive to restructure corporate debt and support rehabilitation of household debtors where needed. We have also developed a strategy to raise public awareness of the refined insolvency framework and to train government and private stakeholders to optimize out-of-court restructurings. Finally, we streamlined foreclosure procedures in March 2009 to speed up the debt resolution process. We have also developed a comprehensive private sector debt restructuring strategy, although without fiscal space a planned household debt restructuring scheme has been put on hold.

4. **The Bank of Latvia (BoL) comfortably met foreign currency reserve and monetary targets under the program.** After falling sharply in the first quarter—a fall that culminated in consultation with staff on the basis of the program's consultation clause— net international reserves stabilized somewhat. The current account is now in surplus. But balance of payments pressures resulted from non-resident deposit outflows and the lower-then-expected rollover of external debt. Meanwhile, residents switched from local- to foreign-currency deposits. Uncertainty about the exchange rate peg ahead of June's local elections renewed pressure on reserves. We addressed this in June through the adoption of a supplementary budget—a measure that helped boost confidence and allowed the central bank to start purchasing foreign exchange.

5. **However the depth of the economic contraction has sharply reduced government revenues**. This has made it impossible to fulfill fiscal targets without exacerbating already painful dislocations. On the basis of the 2009 corrective measures detailed below (¶13-15) and our plans for the future (¶20-24), we request waivers for the non-observance of the end-March 2009 performance criterion on the fiscal deficit, and the continuous performance criterion on nonaccumulation of domestic arrears by the general government. And in light of the change of government in March, additional time was needed to prepare the supplementary budget. We are therefore also requesting a waiver for the end-March 2009 structural performance criterion on its submission to the Saeima.

6. **Against this background and given the commitments we make below, we request completion of the First Review and Financing Assurances Review under the Stand-by Arrangement.**

- **Rephasing**. We also request rephasing of the remaining purchases under the program—and smoothing of missed purchases over the program period owing to the slippage of reviews—with quantitative performance criteria for the Second Review to be assessed against end-September data and for the Third Review to be assessed against end-December data, with a return to quarterly reviews in 2010. As such, the second and third reviews are expected to be completed on or after November 15, 2009 and February 15, 2010, respectively.

- **Monitoring**. The program will continue to be monitored through quantitative performance criteria and indicative targets, as well as a continuous performance criterion on the non-accumulation of domestic and external debt arrears of general government. Performance criteria and benchmarks through end-December 2009 are set out in Tables 2 and 3, as well as in the attached Technical Memorandum of Understanding.

I. Macroeconomic Framework for 2009–10

7. **The recession is much deeper than envisaged when the program was first agreed.** With the bursting of the earlier bubble, there appears to have been a permanent negative shift in the level of potential output; domestic demand has collapsed; construction and consumer durables spending are particularly weak. Latvia's main trading partners are projected to contract by 5 percent in 2009, compared with previously envisaged modest growth. As a result, in the first quarter of 2009 real GDP fell 18 percent year-on-year. Registered unemployment has increased to 11 percent, but labor force survey estimates are higher at 14 percent.

8. **However, internal wage and price adjustment has begun, providing the beginnings of a much-needed competitiveness boost**. Headline inflation has fallen from 18 percent year-on-year mid-2008 to 3 percent in June 2009. Excluding VAT and excise increases, monthly inflation has been close to zero or negative for at least six months. Costs are falling. Gross wages per worker—after several years of rapid increases—fell 2 percent (seasonally adjusted) on end-2008 in the first quarter of 2009, compared with a 20 percent increase in 2008.

9. **We project that recovery will begin late 2010, albeit with further output losses before then.** Of course, there is considerable uncertainty around this. Real GDP is now projected to decline by 18 percent in 2009, compared with 5 percent in the original program. For 2010, in forming our economic program, we project a further (year-average) contraction of 4 percent. However, we hope that economic conditions will improve faster than this. We also project falling wages through this period, though they remain unchanged as a share of national income. Falling domestic demand and wages will bring modestly falling prices: we expect the headline 12-month inflation rate to turn negative end-2009, and to average -3½ percent in 2010.

II. Policies for 2009–11

10. **Our macroeconomic strategy reflects our goal of euro adoption in 2014**. This strategy helps address risks to households, enterprises, and banks from high levels of financial euroization. We recognize that meeting the Maastricht criteria for euro adoption requires difficult policy choices: 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.

A. Fiscal Policy

11. **The 2009 supplementary budget was a critical first step towards sustainable public finances**. On June 16, Parliament adopted a supplementary budget, based on consultations with our social partners, intended to keep the 2009 fiscal deficit to 10 percent of GDP (ESA basis), or around 12 percent (general government net borrowing, GGNB; including net lending, but without bank restructuring costs). We remain committed to bringing the general government deficit down to 3 percent of GDP in 2012—satisfying the Maastricht criterion for euro adoption. Given the deterioration in macroeconomic conditions which will likely cause further increases in the deficit, this will require an additional fiscal measures beyond 2009 of about 12-15 percent of GDP over 3 years. However, we recognize that this adjustment path is ambitious and, depending on events, may need to be revisited.

2009 Supplementary Budget

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

- **Revenue increases (about ½ percent of GDP)**. We have increased dividends from state-owned companies; raised excise taxes on beer and alcohol; reduced the non-taxable personal allowance from 90 to 35 lats per month; and increased the gambling tax.

- **Net cuts in expenditure and net lending (about 3 percent of GDP)**.We have significantly reduced the budgets of ministries and state agencies where we are implementing structural reforms which draw in part on earlier World Bank recommendations. However, given the size of the necessary adjustment, we have also had to introduce additional across the board cuts, beyond these recommended structural reforms, which seek to increase the efficiency and quality of education, strengthen efficiency and targeting of healthcare services, make limited and targeted pension reductions, and reduce less targeted social spending. At the same time, the budget provides additional spending on unemployment benefits and protects EU-related spending.

13. **Safeguarding local government resources, social safety nets, EU-related expenditure and other financial assistance is crucial.** We will monitor local government budgets closely, especially those more resource-constrained municipalities outside larger cities, to ensure they can provide social assistance. To prevent undue social hardships, and in light of possible overruns from the implementation of 2009 budget, the fiscal deficit performance criterion includes a 1 percent of GDP cushion and is set at 13 percent of GDP.

14. **We will provide funding of some 1½ percent of GDP in 2009 to expand social safety nets and accelerate the absorption of EU funds and other foreign financial assistance**:

- **Additional social safety net.** We are working closely with the World Bank to design a comprehensive social safety net strategy. We will ensure appropriate funding of the measures by setting aside 1 percent of GDP of budget resources before mid-September. In this context, as necessary, we will increase budget appropriations for unforeseen events, with the approval of the Parliamentary budget and finance (taxation) committee. Our plan includes:

  - Safeguarding appropriate financing of the guaranteed minimum income (GMI). We intend to increase the levels of GMI payments from LVL 37 to LVL 40 per adult and from LVL 37 to LVL 45 per child;

  - Covering patient copayments for healthcare services and pharmaceuticals in full for the most vulnerable, and partially for households earning less than half of the minimum wage;

  - Increasing funds for emergency housing support;

  - Ensuring the successful implementation of the new curriculum for 5 and 6 year olds;

  - Arranging temporary transportation solutions for children in communities affected by the education reform, pending permanent adjustments to our transport network in 2010;

  - Implementing active labor market policies and temporary public employment programs. We will organize public works programs for between 50,000 and 100,000 people for up to two years starting in the last quarter of 2009. In this context, we will reallocate 20 million lats from the European Social Fund (ESF).

- **EU-financed expenditure and other foreign financial assistance:**

  - **We have ringfenced cash resources of some 6½ percent of GDP to ensure implementation by central and local governments of EU-funded projects in 2009**. Net lending to local governments will be increased by LVL 51 million in 2009 as compared with 2008 to pre-finance EU and other foreign financed projects, and by LVL 10 million for near completed investment. In addition, LVL 5 million will be provided for heating subsidies. We intend to make full use of a new provision in the supplementary budget that allows local governments to enter multi-year commitments for EU projects subject to the approval of the Ministry of Finance.

- **We are developing a comprehensive plan to strengthen safeguards and increase efficiency in the use of EU funds**.

15. **We will take immediate actions to reduce our level of commitments to help minimize risks to medium-term fiscal sustainability:**

- We have closed down the privatization fund and suspended the long term stabilization reserve for the duration of program; no extra-budgetary fund remains;

- We will not launch any new PPPs in 2009, except for four kindergarten building projects representing a total cost of LVL 10 million for their duration;

- We will not provide any net lending outside local governments, except for implementing EU- and other foreign financed projects or in the context of bank restructuring operations carried out in close consultation with EC and IMF staff;

- Similarly, with the exception of one-off guarantees currently committed or planned in the budget to Mortgage and Land Bank and Parex-related operations, we will permanently cap outstanding public guarantees at the level of the June supplementary budget (performance benchmark). Additional guarantees will only be issued if required for bank restructuring operations, and would then be issued after consultation with EC and IMF staff. Under this ceiling we will: (i) limit the liabilities of the Rural Development Fund below LVL 44 million and 3.5 times its capital level, and carefully control its guarantee policy; and (ii) tighten control over the Latvian guarantee agency. In addition, before September 1, 2009, we will review our risk assessment policy of guarantees to determine the size of appropriations required to cover these risks in time for the 2010 budget.

16. **We will take all legal amendments and administrative measures necessary to implement the above decisions before end-September**.

17. **We will considerably strengthen the powers of the Minister of Finance and improve the capacity of the Finance Ministry; in addition, we will seek international assistance to strengthen implementation of our program.** This includes:

- **Technical assistance**. We will set a medium-term TA plan in conjunction with EC, IMF, World Bank and other bilaterals covering: social safety nets, tax policy and administration, macroeconomic forecasting, public financial management, pension reform, liquidity management, debt and banking sector restructuring, deposit insurance, and civil service reform.

- **Revenue administration**. We are expanding the large taxpayer unit operations to cover about 1,100 taxpayers representing 60-70 percent of domestic revenues collected by the State Revenue Service before September 30, 2009. We have also developed a plan to anticipate emerging risks to the tax system, assist distressed businesses to meet their tax obligations, and contain the rise in noncompliance.

- **Public financial management** will be strengthened through the following steps:

  - **Commitment controls systems**. We have already taken steps to strengthen the powers of the Minister of Finance to control budget execution. Before end-December 2009, we will also: (i) amend the Law on Budget and Financial Management to allow the Ministry of Finance to exercise ex ante control of commitments on central government expenditure; (ii) take a cabinet decision that will help us to standardize commitment control systems across line ministries and institutions; and (iii) streamline the work of the Fiscal Discipline Management Committee to focus on commitments as well as cash. We will also work with local authorities to set standards on commitment control and budget execution procedures at the local government level.

  - **Cash management**. We will take steps to improve cash management, including for EU funds.

  - **Other**. Effective sanction procedures—besides those established by the Penal Code—will be introduced in law for any individual misuse of public money. The analytical capacity of the budget department of the Ministry of Finance will be significantly strengthened. Finally, we have granted veto powers to the Minister of Finance on any government decisions with a fiscal effect.

18. **We acknowledge that the 2009 deficit will require significant domestic financing**. We will also design new instruments in response to investor demand. We will not allow arrears to emerge, and our program includes a performance criterion to reflect this.

19. **We also recognize that the 2009 budget is subject to implementation risks.** 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. This approach underlies the margins that we have built into the fiscal performance criteria for 2009.

2010 Budget

20. **We will implement measures to ensure a lower fiscal deficit in 2010 compared to this year.** We are working closely with social partners to prepare whatever measures are necessary for this purpose. As explained in greater detail below, we will present to Parliament a 2010 budget consistent with this goal, along with any necessary legislation to implement the measures required (end-October structural benchmark). Our commitment is to

limit the general government deficit to 8.5 percent of GDP (ESA basis) in line with the recommendation of the ECOFIN Council.

21. **We have already committed ourselves to introducing LVL 500 million (4 percent of GDP) in targeted expenditure cuts and tax measures.** To this end, we will implement the following measures and identify any further measures necessary to meet this objective as part of the 2010 budget process:

- A comprehensive plan to broaden the tax base of the personal income tax as of 2010, to include all capital income (including capital gains from real estate transactions), is under preparation. We will significantly reduce or remove most exemptions, including to farmers. We will reduce disparities in allowances across all sources of income, including pensions and wages. Together, these measures will yield 1 percent of GDP in revenues in 2010;

- We will abolish the special self-employed income tax regime, and bring the self-employed into the standard personal income tax system from 2010. This will support tax compliance;

- We will design a comprehensive reform, allowing means-tested exemptions, to expand the base of the real estate tax to include all residential properties, on the basis of updated cadastral values. We believe that this could yield significantly more revenue (about ¾-1 percent in GDP from 2011 onwards) than previously envisaged, be less distortionary, and more socially just. A transitory regime is required in 2010, as no means-tested exemptions will be available, but a flat tax will yield about ½ percent of GDP in revenues. We will request international assistance to prepare this reform before December 31, 2009;

- We will carry out a broad public service reform. We will harmonize remunerations across ministries and institutions, significantly reducing wage inequalities by reviewing employment classifications (job families) and significantly tightening the wage grid. This reform should allow us to generate savings of at least 1/2 percent of GDP in 2010 while retaining and appropriately compensating the most skilled public employees. We will also work with local governments to extend this reform to their own employees, creating a special law for remuneration system in local governments;

- We will not index pensions in 2010, pending the pension reform described below;

- We will carry out a number of structural reforms prepared by a series of functional audits to generate sustainable savings of about 2 percent of GDP including in the following areas:

- further consolidating agencies and line ministries' subordinated institutions, including in the economy (Public Utility Commission and the Competition Council), justice, and vocational and higher education sectors.
- agriculture, environment and regional development: consolidating institutions and reducing state support, agricultural subsidies, and other miscellaneous subsidies including excise tax repayments to farmers;
- culture: renegotiating the contract for the National Library project;
- defense: cutting procurement and real estate costs, and reducing the size of the National Armed Forces; this will reduce the defense budget from 1.4 to about 1 percent of GDP;
- foreign affairs: optimizing our network of embassies;
- reducing Parliament's discretionary expenditure, for example the NATO Parliamentary Assembly in 2010;
- social benefits: reduce the levels of social benefits while expanding social safety nets;
- transport: reducing road maintenance and better targeting of public transport subsidies.

22. **We have broadly identified additional measures totaling 2½ percent of GDP, and will implement measures of this scale as necessary as part of the 2010 budget to meet our objectives as laid out in paragraph 20.** To this end, to the extent that the measures described in paragraph 21 above are insufficient, as part of the 2010 budget process we will identify and implement measures—including the following—which would be effective January 1, 2010, and estimated to yield 2½ percent of GDP:

- Increase the headline **VAT** rate from 21 to 23 percent effective January 1, 2010 (estimated to yield about ½ percent GDP);
- Make the **personal income tax** system more progressive effective January 1, 2010, by raising the average effective tax rate to around 25 percent for people earning more than LVL 500 per month, through a graduated increase in the marginal rate (yielding ½ percent of GDP);
- **Secure an additional 1½ percent of GDP of expenditure cuts** during the budget process, including fundamental revisions in line ministries' budget bases.

23. **We are prepared to take further measures to meet our fiscal objectives**, in particular those objectives specified in paragraph 20.

2011 and Beyond

24. **We intend to further reduce the deficit in 2011 and beyond, mostly through expenditure restraint.** Our goal is to reach a deficit of 3 percent of GDP in 2012 (ESA basis), although we recognize that a more gradual adjustment path may be necessary. We will avoid further increases in the taxation of labor income so as not to undermine competitiveness. We have identified two areas where substantial further spending cuts are needed:

- Building on the public service reform in 2010, we will keep the public sector wages and salaries below 7 percent of GDP through further targeted wage cuts.

- In order to preserve the sustainability of the three pillars of our pension system, we will also prepare a pension reform with international assistance and in close cooperation with social partners before July 1, 2010. In this context, we will review all special pension regimes. It will be implemented from January 1, 2011.

B. Monetary and Exchange Rate Policy

25. **The fixed (narrow band) exchange rate of the lats will remain the anchor for monetary policy until we adopt the euro.** The credibility of the quasi currency board necessitates a conservative approach to monetary policy, and we will maintain existing limits to market operations and ensure that the BoL's liquid liabilities remain fully backed by its net international reserves. Further changes in official interest rates and minimum reserve requirements will be undertaken after prior consultation with IMF staff.

26. **Monetary policy will respond to the Treasury's new policy of exchanging program financing exclusively off market at the BoL**. To ensure this does not lead to excessive volatility in liquidity and interest rates, we will activate our available instruments, including deposit auctions, where necessary. In cooperation with international experts, we will continue to enhance our approach to liquidity management, adding new instruments where necessary and if consistent with the constraints posed by the quasi currency board. Finally, the Bank of Latvia intends to lower wages in line with market developments.

C. Financial Sector

27. **The FCMC will complete forward-looking assessments to ensure banks maintain adequate liquidity and solvency buffers throughout the program period**. These assessments will build on the recent focused examination, and involve both top-down (performed by BoL and FCMC) and bottom-up (performed by banks after half-year financial results audits) stress tests. These stress tests will be based on extreme but realistic macroeconomic scenarios, agreed with IMF and World Bank staff. Results will be used to

assess potential increases in own funds to build banks' solvency and liquidity buffers. Moreover, given the significant presence of foreign subsidiaries in Latvia, we recognize the need for close cooperation with the home authorities of these banks.

28. **We will accelerate our development of a comprehensive bank resolution strategy** (end-August 2009 structural benchmark). The strategy will set out: (i) responsibilities of various government agencies; (ii) the decision-making process, including options and methods for intervening in various sub-groups of banks; and (iii) plans for individual state-owned and private banks based on the forward-looking assessments noted above. We will discuss drafts with IMF and EC staff.

29. **In the event that capital increases are necessary, we will seek private solutions for banks where possible—especially in view of fiscal constraints.** Bank owners should be the primary providers of resources to cover losses. But we will encourage them to explore opportunities for co-financing capital increases through funding offered by the February 2009 joint EBRD, EIB and World Bank Group Joint Action Plan for CEE banks. We will also develop contingency plans for dealing with bank failures where shareholders cannot recapitalize banks.

30. **The FCMC will introduce a more risk-oriented approach to supervision and regulation**, including by:

- **Strengthening off-site monitoring and analytical capacity** (end-August 2009 structural benchmark). We will seek international assistance to refine our stress testing methodology. The BoL will share regular stress-test results, including methodologies with the FCMC; while these scenarios will be developed jointly between the BoL and FCMC. The FCMC will be given adequate resources to effectively carry out these tasks, and will incorporate stress testing results into off-site supervision and analytical activities.

- **Addressing vulnerabilities**. We will rigorously enforce newly enacted regulations. By revising liquidity regulations in line with best international practice, we will revisit our tolerance of liability concentrations and banks' reliance on short-term external funding. We will enforce best international practice for loan review systems and provisioning in banks, as well as prudential treatment of special entities set up by banks for the management of seized property and other problem assets.

31. **We will continue our efforts to resolve Parex's problems**. Priority will be given to ensuring adequate capitalization and stable management. To this end, the government has selected an international investment bank as its transaction advisor. The FCMC will continue monitoring Parex's liquidity, ensuring that management's restructuring plans do not entail undue risks. The government will engage the EBRD on assistance for bank restructuring.

32. **We remain committed to a fair and equitable treatment of depositors and creditors in the Latvian banking system.** Under our deposit insurance system, we are committed to respect the rights of all depositors, both resident and non-resident. We will remove the partial freeze limiting withdrawal amounts from deposits in Parex as conditions stabilize. We continue good-faith efforts to facilitate the settlement of affected depositors' claims arising from this exchange measure.

33. **We will refocus the Mortgage and Land Bank on core activities**. Commercial banking operations will be minimized as we focus the bank on activities crucial for the economy at this time—financing SMEs, business start-ups, infrastructure, and other national development projects. By end-September we will devise an appropriate strategy to maximize the bank's effectiveness in this task, we will establish an inter-institutional task force as well as seek international assistance. Until the strategy is finalized, the bank will refrain from assuming new foreign borrowing.

34. **We will refine our contingency planning and crisis management capacity**:

- **Contingency planning**. Meetings will discuss financial sector vulnerabilities with particular attention to contingency plans for specific institutions.

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

- **Bank resolution**. A comprehensive review of our bank resolution framework will guide legislative changes needed to bring the framework in line with best international practice. We will focus on ensuring that FCMC regulations and procedures are in line with recently enacted legislation.

- **Deposit guarantee**. International assistance will be sought to improve operational aspects of the Deposit Guarantee Fund; e.g., by setting up an autonomous department and designating trained staff to perform its functions.

D. Private Debt Restructuring

35. **We recognize the need for a debt restructuring strategy compatible with fiscal constraints.** Our strategy for resolving and recapitalizing banks will increase their capacity to restructure debts and provision and recapitalize accordingly. We thus intend to base our strategy on restructuring corporate and household debt on a market-based approach. We are considering offering subsidized loans to qualifying household borrowers for their restructured mortgage loans in order to help them cope with economic distress, prevent

foreclosures and create incentives for banks to provide debt relief when necessary. However, we are acutely aware of the lack of fiscal space, and will study further, in consultation with EC and Fund staff, how such a scheme could be financed, the degree to which its costs could be accommodated within the envelope of unavoidable bank restructuring costs, and how to ensure the scheme is optimally targeted.

36. **We will further improve the legal framework to help address widespread debt distress in the corporate and household sectors.** With limited prior debt restructuring experience in Latvia, we will issue by mid-August 2009 a set of guidelines on out-of-court corporate debt restructuring to set out general principles and process in line with international best practice. In addition, a further review of the Insolvency Law and other credit enforcement laws is underway with international assistance. Revisions will, *inter alia,* streamline liquidation procedures to facilitate rapid exit of non-viable firms, and further improve the foreclosure process by addressing remaining inefficiencies that hinder debt resolution. We will submit to Parliament the relevant amendments to these laws by end-October 2009 (structural benchmark).

E. Other issues

37. **Reforming the wage-setting mechanism is a priority.** We will review the new public-sector wage grid to minimize discrepancies in pay between similar positions and skill levels across institutions by narrowing salary ranges for specific grades. In addition, we will monitor public-sector wage cuts to encourage an equitable burden of adjustment across all public sector institutions. A comprehensive report on proposed revisions to the public-sector wage grid and the relative wage adjustment across public institutions since end-December will be published by end-October 2009 (structural benchmark). We will also reform the Committee to Promote Wage Restraint by involving the social partners and outside labor market experts by end-August (structural benchmark). Its mandate will be amended to: (i) monitor private-sector wage developments, as well as the implementation of public sector wage cuts; and (ii) issue recommendations to ensure future compensation evolves in line with productivity. The committee will be subordinated to the National Tripartite Co-operation Council. Its monthly reports will be presented to the Prime Minister and Parliament, and published.

38. **We will implement in full the conclusions of the recent Safeguards Report. We recently** adopted a memorandum of understanding between the Treasury and BoL requiring the Treasury to deposit all major foreign exchange holdings with the BoL. Henceforth, as noted earlier, the Treasury will exchange all international support from the Fund and other program partners off-market. In addition, to increase transparency, all long-term funds under the program will be disbursed to special sub-accounts of the Treasury's euro-account at the BoL, with one account ring-fenced for banking sector support and the other for budget support. We will report daily on the balances in these accounts, and the accounts of other

program partners. Should the program accounts intended for budget support fall by more than EUR 250 million in any 30-day period, the Ministry of Finance will consult with IMF staff.

III. IMF Arrangement

39. **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. We will consult with the IMF (and other program partners) on the adoption of these measures and in advance of any revisions to the policies contained in this Letter in accordance with the IMF's policies on such consultation. In addition, we will supply such information as the IMF requests on policy implementation and achievement of program objectives.

40. **We authorize the IMF to publish this Letter of Intent and its attachments (including the Technical Memorandum of Understanding), and the related staff report.**

Sincerely Yours,

Valdis Dombrovskis /s/
Prime Minister

Einars Repše /s/
Minister of Finance

Ilmārs Rimšēvičs /s/
Governor of the Bank of Latvia

Irēna Krūmane /s/
Chairwoman
Financial and Capital Market Commission

Ģirts Valdis Kristovskis /s/
Civic Union

Roberts Zīle /s/
For Fatherland and Freedom

Solvita Āboltiņa /s/
New Era

Mareks Segliņš /s/
People's Party

Mārtiņš Roze /s/
Union of Greens and Farmers