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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 8.1.2009
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Recommendation for a

COUNCIL DECISION

Granting mutual assistance for Latvia

and

Proposal for a

COUNCIL DECISION

Providing EU medium-term financial assistance for Latvia

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EXPLANATORY MEMORANDUM

1. INTRODUCTION

The Latvian economy has accumulated major imbalances in recent years as rapid expansion has been fuelled by easy credit conditions and an overly-expansionary fiscal stance, against advice given by the Commission and Council, notably in Opinions on successive Latvian convergence programmes. The situation has been greatly accentuated by the global financial market crisis and the general hardening in sentiment towards emerging market economies, making access to credit increasingly difficult and expensive. Latvian capital and financial markets came under significant pressure from October onwards, reflecting increased concerns about the sustainability of the country's economic and financial situation. Particular worries related to the health of the banking sector, and especially the viability of the country's largest domestically-owned bank (Parex), heavily reliant on external funding, which was consequently taken into state ownership and control. In sum, Latvia has been confronted by an abrupt and severe banking sector and external financing crisis.

Against this background, the Latvian authorities approached the EU and the IMF for financial support. The Commission together with the Council Presidency announced on 22 November that the EU was ready to participate with the IMF in a coordinated financing package to underpin Latvia's balance of payments sustainability. However, it was stressed that a financial assistance package would only be provided subject to a strong commitment by the Latvian authorities to implement a rigorous and credible economic adjustment programme. Based on discussions with the Commission and IMF, on 12 December the Latvian Parliament adopted the authorities' proposal for an "Economic Stabilisation and Growth Revival Programme" (hereafter the programme). The key objectives of the programme are to maintain domestic and international confidence in the financial system, to contribute directly and indirectly to arresting and reversing the deteriorating trend in cost competitiveness and inflation 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.

2. RECENT MACROECONOMIC DEVELOPMENTS

Following a sustained period of high growth since the end-1990s, largely based on domestic demand, Latvia's real GDP increased at double-digit rates in 2005-2007. Growth was primarily driven by a powerful credit expansion boosting private consumption and real estate investment, but this ended by mid-2007, as overvalued real estate prices could no longer be sustained. During these years, the structure of the economy shifted from the tradeable sector to the non-tradeables, undermining the external sustainability of the economy and resulting in serious overheating pressures.

GDP growth fell sharply during the first three quarters of 2008, a trend expected to continue, driven mainly by a contraction in private consumption and private investment. Private consumption has been hit by high inflation, falling real estate prices, increased debt service payment, reduced loan availability and worsened employment and income expectations. Fixed investment in construction is falling in line with the ending of the boom in the real estate market and investment in equipment given the poor demand outlook both domestically and abroad. The corporate sector is under heavy cost pressure, due to labour cost increases, and financing is increasingly constrained. EU-funded projects and generally public projects will provide some cushion against a sharp drop in other investment. However, GDP is expected to contract for a considerable period with very weak domestic demand insufficiently counterbalanced by an expansion of net exports.

Labour market conditions have only recently started to ease, but the reaction on the labour market to the drop in domestic demand will be significant. Unemployment has already increased from 6.3% in Q2 to 7.2% in Q3 2008 and nominal wage growth is moderating, but from very high rates. The Latvian labour market is presumed to be fairly flexible, which should limit the output and employment costs associated with a realigning of wages with productivity.

After peaking in May 2008 at 17.7%, HICP inflation fell to 11.8% in November. Core inflation[1] (11.0% in November) and services price inflation are falling steadily, as demand pressure wanes. Prospects for a further strong decrease in inflation are good, given the outlook for sharply weaker domestic demand, lower public sector wages (see Section 6) leading to private sector wage restraint, and decreases in global commodity prices.

External imbalances have been very large with an unsustainable build-up of external liabilities, but in 2008, with falling domestic absorption, external borrowing declined substantially. The balance of payments and external investment position is discussed in Section 5 below.

3. PUBLIC FINANCES

Public finance has a heightened responsibility in Latvia due to the limited scope of monetary policy under a quasi-fixed exchange rate regime[2]. Nevertheless, Latvia pursued a pro-cyclical fiscal policy during the domestic demand boom years of 2005-2007, in spite of improving

1 Defined as the overall index excluding energy and unprocessed food.

2 Latvia has a long tradition of pegging the exchange rate of its currency, the lats, from 1994 to the SDR and from 2005 to the euro. In May 2005, Latvia entered ERM II, unilaterally adopting a +/- 1% fluctuation corridor around the central parity.

headline budgetary outturns and against repeated advice given in Council Opinions on successive updates of Latvia's convergence programme. Windfall revenues were typically spent through the process of intra-year supplementary budgets and no reserves were created for worse times. Public sector wage growth became a driver of private sector wage increases, with comparable wage levels higher in the public sector. In Latvia over 30% of the employed work in the public sector and, given that the service sector is proportionally large, around 75% of GVA, public sector wage-setting plays a large role in influencing private sector wages.

During the first ten months of 2008, VAT revenues slowed dramatically (down by 3% y-o-y), driven by a steep fall in private consumption. Revenues from other major tax categories initially held out relatively well on the back of high inflation, but these favourable effects have also started to fade. The Latvian Treasury estimates that the 2008 consolidated state budget deficit, which includes the central government and the social security fund budget, may be around 2½ to 2¾% of GDP[3]. Taking into account the possibility that in current circumstances the local government sector might show a small deficit (despite limits intended to result in the sub-sector maintaining balance or surplus), the 2008 deficit of the general government sector appears to be close to 3% of GDP.

The budget for 2009 as passed by Parliament on 14 November targeted a consolidated central government deficit of 1½% of GDP, but based on an unrealistic output contraction of only 1%. It included substantial direct tax reductions and expenditure increases. It was then already clear that output would decline by a significantly larger amount and that in the absence of countervailing measures the deficit risked widening to very large figures. Including a very small deficit of local governments, the general government deficit was projected by the authorities to be 1.8% of GDP with a primary deficit of 1.1% of GDP. In view of tax collection data in the last months of 2008 and deteriorating economic prospects for 2009, the outlook for the general government balance became significantly worse than the Commission services' autumn forecast projection of a 5.6% of GDP deficit. By contrast, the end-2007 general government debt ratio, 9.5%, was one of the lowest in the EU.

4. FINANCIAL MARKETS

Latvia's financial system is almost exclusively dominated by the banking sector, which has developed very quickly over the last ten years. Two segments can clearly be identified. On the one hand, foreign-owned banks, principally funded directly through loans from parent companies, share about 70% of the market. On the other hand, domestic banks are funded principally through foreign syndicated loans and non-resident deposits. The importance of non-resident deposits, which stood at 43.5% of all deposits other than from monetary and financial institutions (MFIs) at the beginning of November 2008, is a particularly salient feature. Latvia's financial system relies therefore primarily on external financing, whether it comes from parent companies, non-resident deposits, or foreign syndicated loans. The resulting very high and increasing level of foreign liabilities has its counterpart in loans to residents, predominantly in foreign currency (close to 90% of all loans). Domestic credit has risen from 10% of GDP in 1997 to 90% in 2007. It appears, therefore, that the two main risks that affect Latvia's banking system are liquidity and credit risks.

Liquidity risk has already materialised through sustained liquidity pressures since October 2008. Expecting repayment difficulties, two foreign syndicates clearly implied that they might

[3] Figure in national methodology, excluding local governments

request early payment of loans to Parex Bank totalling 0.8bn EUR due in February and June 2009. This prompted the partial nationalisation of the bank on 10 November 2008. However, the public loan guarantees thereby granted were deemed insufficient, leading to the full nationalisation of Parex at the beginning of December and the imposition of limits on deposit withdrawals (50,000 EUR/month for individuals). Despite these measures, Parex and domestic banks with similar business models have since experienced very substantial non-resident deposit withdrawals, of which only a small part has been redeposited with other banks in Latvia. The systemic liquidity pressure prompted the Bank of Latvia on 13 November to announce further reductions of its required reserve ratio from 7% to 5% for short-term liabilities and from 5% to 3% for liabilities with a maturity of over 2 years, thereby freeing liquidity (these decisions took effect in two 1pp steps on 24 November and 24 December). However, the drain on reserves has continued, and the net international investment position of the Bank of Latvia deteriorated by 0.9bn EUR in the period from the beginning of October 2008 to the end-year. Resident and non-resident deposits in foreign-owned banks increased over the same period, and, crucially, liquidity support from parent companies seems secured.

Credit risk has not yet materialised substantially, but is expected to increase in the coming months. While overdue loans have already increased, non-performing loans so far remain below 1% of total loans, also due to the ongoing restructuring of problem loans. However, the negative impact of the expected prolonged recession on residents' income and therefore on their ability to repay debts will clearly mount. Solvency ratios will decrease, and may approach the regulatory minimum, in which case capital injections may be needed.

The current and future position of the banking sector is dependent on objective factors but also on credibility and confidence-related expectations. It is key at the current juncture to ensure confidence so as to stabilise the deposit base and ease liquidity pressures going ahead. Given constrained public finances, restoring confidence in the financial sector through government intervention would only be credible if accompanied by strong international financial support.

5. BALANCE OF PAYMENT AND EXTERNAL FINANCING REQUIREMENTS

Latvia's economic boom until 2007 was characterized by the emergence of large external imbalances and an unsustainable build-up of external liabilities. Gross external debt exceeded 135% of GDP at the end of 2007 (with net external debt at 52% of GDP). The international investment position at end-2007 widened to net liabilities of 79% of GDP, with net liabilities at the end of the second quarter of 2008 estimated to have widened to 82% of GDP.

In 2008, with falling domestic absorption, external borrowing has declined substantially. According to the preliminary estimates of the Bank of Latvia, the current account deficit fell to about 12½% of GDP in the third quarter of 2008 (from a peak of over 27% of GDP in the fourth quarter of 2006). In 2009 the goods trade deficit is expected to remain around 10% of GDP (as in last months of 2008), but, given a positive services balance and improving income account, the current account deficit would be narrower. In order to ensure that the basis of GDP growth switches from shrinking domestic demand to increasing exports, there is a need to realign wages more closely with productivity and to progress with structural reforms that strengthen the economy's supply side.

While a correction of the current account deficit from its unsustainable levels of recent years is a critical element in re-establishing a sound balance-of-payments situation, in itself it will not be enough to achieve external sustainability, taking into account the country's large stock of debt, most of it short-term. External financing is expected to remain under significant pressure for some time, with the availability of foreign credit being reduced, potential drains on non-resident as well as resident deposits, and a worsened outlook for inward investment. A further drain on foreign currency reserves (which decreased by around 25% between the beginning of October and early December 2008) would jeopardise the viability of Latvia's exchange rate peg. Against this background, external financial assistance, backed up by a strong policy programme, will be required to ease liquidity constraints in the short term while supporting an orderly external adjustment in the medium term.

In light of the above, the Commission is of the opinion that there is a serious threat to the Latvian balance of payments. The Commission thus recommends to the Council a decision granting mutual assistance.

6. LATVIA'S "ECONOMIC STABILISATION AND GROWTH REVIVAL PROGRAMME": MACROECONOMIC AND FINANCIAL SYSTEM MEASURES

Ongoing discussions between the Latvian authorities and potential contributors to a coordinated package of international financial assistance led to the adoption by the authorities of an ambitious policy programme (as noted above, submitted to Parliament and approved by it on 12 December). The programme is based on maintaining the existing peg of the lats, which will remain a key policy anchor going forward. The programme aims to address financial sector vulnerabilities, correct fiscal imbalances and improve competitiveness while maintaining the narrow-band exchange rate. It includes an immediate and sustained fiscal consolidation, a comprehensive bank resolution strategy, a strengthened crisis management capacity of regulatory authorities, comprehensive structural reforms, as well as other important measures. It assumes a macroeconomic scenario of GDP contractions of 5% in 2009 and a further 3% in 2010, giving way to weak recovery of 2% in 2011. The fiscal strategy targets a general government deficit of not more than 3% of GDP by 2011, aiming to meet the Maastricht deficit criterion in that year.

The financial assistance negotiations with the EU, IMF and other parties, which highlighted serious future budget deficits, led the government to adopt an amended outline budget for 2009; this was passed by Parliament on 12 December consistently with the emergency economic stabilisation programme. The amended budget, based on the revised GDP forecast of a 5% contraction in 2009, takes into account the recent deterioration in the economic outlook and targets a general government fiscal deficit of below 5% of GDP[4], implying only slight structural adjustment compared with the estimated 2008 outturn (but much higher compared with the budget passed in November). In addition, a fully-fledged supplementary budget law for 2009 consistent with the December budget outline should be adopted by end-March 2009.

On the expenditure side, consolidation is centred on a large reduction of public sector wages (by 15% in average compensation relative to the original 14 November 2008 budget - but which only partially reverses the large real increases registered in recent years) and further

[4] This assistance programme acknowledges that Latvia will be in EDP in 2009.

staff reductions; in addition there is a large planned reduction in non-personnel current costs. A reduction of subsidies (excluding social support) and in expenditure on goods and services and tightening of local governments' spending, are among the other significant measures planned. In this regard, national co-financing for EU-funded projects will be maintained at the planned level and help move the economy towards the tradable sector. On the revenue side, it comprises a 3pp increase in the standard VAT rate to 21%, an increase from 5% to 10% in the reduced VAT rate applicable to a much narrower tax base (principally medicines), increased excise tax on fuel (achieving EU *acquis*), and some partial offset by a 2pp reduction in the personal income tax rate.

Further fiscal consolidation is planned for 2010, and the medium-term fiscal framework is anchored on the ambition of achieving in 2011 a general government deficit of no more than 3% of GDP, consistent with the Maastricht fiscal convergence criterion. Imposition of further expenditure restraint in 2010, introduction of a capital income tax (10%); increase in real estate and property tax by removing exemptions in order to broaden the tax base will produce further consolidation in that year. Furthermore, measures will be taken to strengthen the design and implementation of budgetary procedures by the adoption of a new fiscal framework and budgetary reform law.

In addition to the fiscal package described above, as a pre-condition for any external financial support, a resolution is being sought for Parex Bank under which the existing shareholders no longer hold any ownership interest. Following a first audit, the government has already taken control of over 85% of the equity of the bank. Management has been replaced. The new management is developing a resolution plan, consistent with minimising losses to the state. It will seek a firm commitment in the near future from external parties to renew Parex's syndicated funding.

Other measures aim to guarantee wider banking sector stability in the medium to longer term. As a first step, the authorities will aim to restore confidence in the banking system. Targeted examinations will be conducted in the banking system to ensure that all banks are solvent and sufficiently capitalized. Viable banks in need of capital increases will be required to seek private restructuring via outside investors or mergers, or capital support from parent banks.

Almost all current external debt is owed by the private sector. In order to bring debt levels in line with sustainable growth in the future, and in addition to prudential, supervisory and monetary policy measures, debt restructuring is an important component of the programme. The appropriate legal basis for maturity and currency restructuring of existing debt will be strengthened. Facilitating insolvency procedures and quick implementation of rehabilitation plans will also be made a priority.

The economic policy programme also includes structural reform measures supported in the context of the Lisbon strategy, such as the active labour market and life long learning policies, greater involvement of private sector actors in R&D and innovation activities, export promotion measures and removal of administrative burdens for businesses.

7. EU SUPPORT UNDER THE BALANCE OF PAYMENTS FACILITY PART OF INTERNATIONAL EFFORT

In the light of the serious balance of payments difficulties being experienced by Latvia, and conditional on the Latvian authorities' firm commitment to implement a major programme of economic adjustment, the Commission, following consultation with the Economic and Financial Committee on 12 January 2009, recommends to the Council the granting of the mutual assistance foreseen by Article 119 of the Treaty.

Furthermore, the Commission, following consultation with the Economic and Financial Committee, proposes that, after adopting the above-mentioned decision of the Council to provide mutual assistance to Latvia on a recommendation from the Commission, the Council adopts a decision providing under the EU facility for Member States (as governed by Council Regulation (EC) No 332/2002 of 18 February 2002) a medium-term financial assistance to Latvia of up to EUR 3.1 billion to underpin its balance of payments sustainability.

Medium-term financial assistance would intervene at a moment when Latvia is seriously threatened with loss of domestic and international confidence in its financial system, has a worsening fiscal situation, and faces substantial financing pressures in the near term. Overall, the assistance is to facilitate necessary external and internal adjustments. Total estimated financing needs in the period up to first quarter of 2011 are 7.5bn EUR. This sum comprises allowance for the expected external (current and capital) account deficit, deposit withdrawals, incomplete rollover of maturing loans, errors and omissions in the balance of payments and international reserve accumulation to a prudential level.

The support would be provided in conjunction with the IMF and other multilateral and bilateral support. It would be disbursed in six instalments and linked to economic policy conditions. The proposed decision would expire three years after its entry into force. The economic policy conditionality attached to EU loan disbursements will be set out in a Memorandum of Understanding to be concluded with the Latvian authorities; principal elements of this conditionality are the following:

A major fiscal consolidation over the period to 2011. Relative to the original 14 November 2008 budget, a very large fiscal consolidation is planned for 2009, targeting a budget deficit of no higher than 5% of GDP, with further consolidation in 2010. Underpinning budgetary measures include: notably, (i) adoption of a clearly-set medium-term fiscal programme designed to reduce the general government budget deficit to lower than Treaty reference level of 3% of GDP by 2011; (ii) within medium-term budgetary ceilings, the reduction of average public sector remuneration in nominal terms by approximately 15% in 2009; this should also apply to local governments, government agencies and state-owned companies; (iii) the elimination of bonuses and similar payments; (iv) a reduction of at least 5% in public sector and local government employment; (v) substantial reductions in subsidies (excluding social support) and expenditure on goods and services; (vi) implementation of EU-funded projects at previously planned levels.

Financial conditionality measures aiming to guarantee wider banking sector stability in the medium to longer term. As a first step, the authorities will aim to restore confidence in the banking system. Targeted examinations will be conducted in the banking system to ensure that all banks are solvent and sufficiently capitalized. Viable banks in need of capital increases will be required to seek private restructuring via outside investors or mergers, or capital support from parent banks. An important stage in this process was the separate announcements on 18 December 2008 by three major foreign parent bank groups of their commitment to remain in Latvia and support their operations there.

Debt restructuring in the private sector in order to reducing vulnerabilities from high debt levels (almost all the external debt is owed by the private sector), and in addition to prudential, supervisory and monetary policy measures. The appropriate legal basis for maturity and currency restructuring of existing debt should be strengthened. Facilitating insolvency procedures and quick implementation of rehabilitation plans must also be made a priority. This includes amending the insolvency law to facilitate workouts between viable enterprises and their creditors and improving the personal bankruptcy framework.

Structural measures in the area of incomes policies, fiscal discipline and budget process and management. The Budget and Financial Management law will be amended to strengthen provisions on financial responsibility, transparency and accountability and the medium term budgetary framework will be made operational. A special committee will be established to monitor wage restraint and to issue recommendations to ensure that wages evolve in a way to restore competitiveness.

Structural reform measures supported inter alia in the context of the Lisbon strategy, such as the active labour market and lifelong learning policies, greater involvement of the private sector in R&D and innovation activities, export promotion measures and the reduction of administrative burdens for businesses.

To ensure the necessary flexibility in the current market context, it is proposed to allow the option of using interest rate swaps for the borrowing operation which finances the loan. In order to safeguard the EU budget, the counterparties of a potential swap would have to be of the highest credit quality.

Recommendation for a

COUNCIL DECISION

Granting mutual assistance for Latvia

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 119,

Having regard to the recommendation from the Commission made after consulting the Economic and Financial Committee,

Whereas:

(1) Against a background of very high external financing needs, Latvian capital and financial markets have recently come under pressure, reflecting a general deterioration in market sentiment, and increasing concerns about the health of the Latvian economy given its large imbalances in terms of wide external deficit and very large external debt, weakening public finances and high rates of cost and price inflation. The Latvian banking sector has experienced serious liquidity and confidence problems. The level of foreign currency reserves has decreased as the central bank intervened to preserve the currency peg.

(2) The Council regularly reviews the economic policies implemented by Latvia, in particular in the contexts of Latvia's convergence programme and National Reform Programme, as well as in the context of Convergence Reports.

(3) Latvia's total external financing needs up to the first quarter of 2011 are estimated at EUR 7.5 billion.

(4) The Latvian authorities have requested substantial financial assistance from the EU and other international financial institutions and countries to support balance of payments sustainability.

(5) There is a serious threat to the Latvian balance of payments which justifies the urgent granting of mutual assistance by the Community in conjunction with the IMF and other contributors.

(6) The financial assistance package would be provided subject to a strong commitment from the Latvian authorities to implement an ambitious fiscal, financial system and structural reform programme to facilitate the necessary external and internal adjustments, to stabilize the economy and to restore economic policy credibility. The Commission will review regularly and closely, in collaboration with the EFC, that the economic policy conditions attached to the assistance are fully implemented.

HAS ADOPTED THIS DECISION:

Sole article

The Community shall grant mutual assistance to Latvia.

This Decision is addressed to the Member States.

Done at Brussels,

For the Council
The President

Proposal for a

COUNCIL DECISION

Providing Community medium-term financial assistance for Latvia

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 332/2002[5] of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balance of payments and in particular Article 3(2),

Having regard to the proposal from the Commission made after consulting the Economic and Financial Committee (EFC),

Whereas:

(1) On [….] the Council decided to grant mutual assistance for Latvia.

(2) Against a background of very high external financing needs, Latvian capital and financial markets have recently come under pressure, reflecting a general deterioration in market sentiment, and increasing concerns about the health of the Latvian economy given its large imbalances in terms of wide external deficit, weakening public finances and high rates of cost and price inflation. The Latvian banking sector has experienced serious liquidity and confidence problems. The level of foreign currency reserves has decreased as the central bank intervened to preserve the currency peg.

(3) Latvia's total external financing needs up to the first quarter of 2011 are estimated at EUR 7.5 billions.

(4) It is appropriate to provide Community support to Latvia of up to EUR 3.1 billion under the Facility providing medium-term financial assistance for Member States' balance of payments established by Regulation (EC) No 332/2002. 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 and Norway) are to contribute EUR 1.8 billion together, the World Bank - EUR 0.4 billion, the European Bank of Reconstruction and Development, the Czech Republic, Poland and Estonia - a total of EUR 0.5 billion, bringing the total to EUR 7.5 billion over the period to the first quarter of 2011.

(5) The Community assistance should be managed by the Commission. The specific economic policy conditions agreed with the authorities of Latvia after consultation of the EFC should be laid down in a Memorandum of Understanding. They should include inter-alia measures intended to stem immediate liquidity pressures, to restore

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5 OJ L 53 23.2.2002, p.1.

long-term stability by strengthening the banking sector, to correct fiscal imbalances and to adopt domestic policies that will improve competitiveness. The measures should include an immediate and sustained fiscal consolidation, a comprehensive bank resolution strategy, a strengthened crisis management capacity of regulatory authorities, comprehensive structural reforms, as well as other important measures. The detailed financial terms should be laid down by the Commission in the Loan Agreement.

(6) The assistance should be provided with a view to stemming immediate liquidity pressures and conditional on policies to restore long-term stability by strengthening the banking sector, correcting fiscal imbalances and adopting domestic policies that will improve competitiveness, while maintaining the narrow-band exchange rate at its existing central rate.

HAS ADOPTED THIS DECISION:

Article 1

1. The Community shall make available to Latvia a medium-term loan amounting to a maximum of EUR 3.1 billion, with a maximum average maturity of five years.

2. The Community financial assistance shall be made available during three years starting from the first day after the entry into force of this Decision.

Article 2

1. The assistance shall be managed by the Commission in a manner consistent with Latvia's undertakings and recommendations by the Council. Those conditions shall be laid down in a Memorandum of Understanding. The detailed financial terms shall be laid down by the Commission in the Loan Agreement.

2. The Commission shall, in collaboration with the EFC, verify at regular intervals that the economic policy conditions attached to the assistance are fulfilled. The Commission shall keep the EFC informed of possible refinancing of the borrowings or restructuring of the financial conditions.

3. Latvia shall be ready to adopt and implement additional consolidation measures to stabilize the economy, in case such measures will be necessary during the assistance programme. The Latvian authorities shall consult the Commission in advance of the adoption of any such additional measures.

Article 3

1. The Community financial assistance shall be made available by the Commission to Latvia in a maximum of six instalments, the size of which will be laid down in the Memorandum of Understanding.

2. The first instalment shall be released subject to the entry into force of the Loan Agreement and Memorandum of Understanding.

3. If required in order to finance the loan, the prudent use of interest rate swaps with counterparties of highest credit quality shall be permitted.

4. The Commission shall decide on the release of further instalments after having obtained the opinion of the EFC.

5. The disbursement of each further instalment shall be made on the basis of a satisfactory implementation of the new economic programme (Economic Stabilisation and Growth Revival Programme) of the Latvian Government, included in the convergence programme, and, more particularly, of the specific economic policy conditions laid down in the Memorandum of Understanding. These shall include, inter alia:

   (a) Adoption of a clearly-set medium-term fiscal programme designed to lower by 2011 the general government deficit to not more than the Treaty reference level of 3% of GDP.

   (b) Execution of the budget for 2009 as amended by the supplementary budget adopted 12 December 2008 (and to be amended in detail during the first quarter of 2009), targeting a general government deficit of no higher than 5% of GDP.

   (c) 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.

   (d) Reduction during 2009 of at least 5% in public sector and local government employment.

   (e) Strengthening the design and implementation of budgetary procedures by the adoption of a fiscal framework and budgetary reform law.

   (f) Introduction of a clear and transparent wage payment system for direct public administration employees and establishment of a single human resource planning and management system for public administration institutions.

   (g) Mechanisms to ensure wider banking sector stability in the medium to longer term, including a wide range of supervisory, prudential and monetary policy measures. These should limit credit growth to sustainable levels and avoid heavy reliance on unsecured foreign funding. Targeted examinations shall be conducted in the banking system to ensure that all banks are solvent and sufficiently capitalized.

   (h) Appropriate measures regarding private sector debt restructuring. The appropriate legal basis for maturity and currency restructuring of existing debt shall be strengthened. Facilitating insolvency procedures and quick implementation of rehabilitation plans shall also be made a priority.

   (i) Ensuring that the remaining minority shareholders of Parex Bank do not benefit from the resolution of the bank and measures to enhance financial stability, by means of fully nationalising Parex Bank.

   (j) Structural reform measures supported in the context of the Lisbon strategy and implemented in Latvia's National Reform Programme, including active labour market and lifelong learning policies, greater involvement of private sector actors in R&D and innovation activities, export promotion measures and removal of administrative burdens for businesses.

(k) Implementation of EU-funded projects at the planned level to help improve the contribution of the tradeable sector to economic growth.

(l) Measures to improve access to financing for companies and entrepreneurs, whose applications for Structural Funds have been approved, or who may be planning to apply for Structural Funds.

This Decision is addressed to the Republic of Latvia. It shall be published in the *Official Journal of the European Union.*

Done at Brussels,

For the Council
The President

BUDGETARY IMPACT STATEMENT

(cf. Article 16 of the Internal Rules)

POLICY AREA: TITLE 01 – ECONOMIC AND FINANCIAL AFFAIRS

ACTIVITY: FINANCIAL OPERATIONS AND INSTRUMENTS

TITLE OF ACTION: EU MEDIUM-TERM FINANCIAL ASSISTANCE FOR LATVIA

1. **NAME OF THE PROPOSAL: BUDGET HEADING CONCERNED AND TITLE**
   01 04 01 01 EC guarantee for Community loans raised for balance-of-payments support
2. **LEGAL BASIS:**
   Art. 119; Council Regulation N° 332/2002 of 18 February 2002.
3. **OVERALL FIGURES FOR THE FINANCIAL YEAR (IN EUROS)**
   This item constitutes the structure for the guarantee provided by the European Union. It will enable the Commission to service the debt (principal, interest and other costs) should the debtor (Latvia) default.
   The budget entry ("p.m.") reflecting the budget guarantee will be activated only in the case of an effective call on the guarantee. It is expected that normally the budget guarantee will not be called.

   3a – Current year
   Not applicable

		CA
Initial appropriation for the financial year (budget)		
Transfers		
Additional appropriation		
Total appropriation		
Appropriations already set aside by another work programme		
Balance available		
Amount for the action proposed		

3b – Carry overs

Not applicable

		CA
Carry-overs		
Appropriations already set aside by another work programme		
Balance available		
Amount for the action proposed		

3c – Next financial year

Not applicable

		CA
Initial appropriation for the financial year (budget)		p.m.
Transfers		
Additional appropriation		
Total appropriation		
Appropriations already set aside by another work programme		
Balance available		
Amount for the action proposed		p.m.

4. DESCRIPTION OF THE ACTION

The proposed medium-term financial assistance to Latvia consists of a Community loan (to be financed by Community borrowings in the international capital markets) in the amount of EUR 3.1 billion. It will be provided in the context of an international financing package, and in particular by an IMF loan of SDR 1.5 billion (around EUR 1.7 billion) supported by the stand-by facility. The Nordic countries contribute with EUR 1.8b. and Estonia, Czech Republic, Poland and EBRD have also committed a total of EUR 0.5 billion.

The assistance reflects the willingness to support Latvia, whose capital and financial markets have come under pressure due to general deterioration in market sentiment towards emerging markets. The Community medium-term financial support to Latvia is intended to stem immediate liquidity pressures, to restore long-term stability by strengthening the banking sector, to correct fiscal imbalances and to adopt domestic policies that will improve competitiveness, while maintaining the narrow-band exchange rate. The economic policy package hereby supported includes an immediate and sustained fiscal consolidation, a comprehensive bank resolution strategy, a strengthened crisis management capacity of regulatory authorities, comprehensive structural reforms, as well as other important measures.

The assistance managed by the Commission in consultation with the Economic and Financial Committee is a way to ensure that the EU remains closely involved in the shaping of economic policies in Latvia and that those policies are consistent with Latvia's undertakings in the EU and recommendations by the Council, in particular as concerns the implementation of the National Reform Programme, as well as of the convergence programme.

The Community borrowings raised on the capital markets or from financial institutions for the purpose of extending the loan to Latvia are covered by the Community guarantee. The loan is raised on the capital markets or from financial institutions. The amount in principal of loans which will be granted to Latvia amounts to EUR 3.1 billion.

The structure for the guarantee provided by the European Union will enable the Commission to service the debt should Latvia default.

In order to honour its obligations, the Commission may draw on its cash resources to service the debt provisionally. In this case, Article 12 of Council Regulation (EC, Euratom) No 1150/2000 of 22 May 2000 implementing Decision 2000/597/EC, Euratom on the system of the Communities' own resources (OJ L 130, 31.5.2000, p. 1) will apply.

5. METHOD OF CALCULATION ADOPTED

Not applicable.

6. PAYMENT SCHEDULE (IN EURO)

Not applicable.

Heading	**Appropriations**		**Payments**				
			Year n	Year n+1	Year n+2	Year n+3	Subsequent financial years
	Year n						
	Year n+1						
	Year n						
	Year n+1						
	Total						