SUPPLEMENTAL MEMORANDUM OF UNDERSTANDING
(Second addendum to the Memorandum of Understanding)

between the European Union 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. The European Union (EU) 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 last 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. 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, and the fulfilment of conditions related to the 2009 budget.

3. A first review mission was carried out by the Commission services in cooperation with IMF staff from 27 May to 17 June 2009. Based on the findings of the Commission mission, a Compliance Note sent by the authorities on 26 June 2009 and in consultation with the Economic and Financial Committee, the economic policy criteria for the second instalment, as laid down in the Memorandum, were considered to be broadly fulfilled or not applicable in view of the larger-than-expected deterioration in the economic situation. A Supplemental Memorandum of Understanding was signed on 13 July 2009, including new conditions, in particular new budget deficit targets for 2009-2012, in ESA95 terms, of no more than 10 %, 8.5%, 6% and below 3% of GDP, respectively. The second instalment of EUR 1.2 billion was disbursed on 27 July 2009.

4. The Commission services carried out the second review mission in cooperation with the IMF staff from 2 to 14 December 2009 to assess progress made with respect to the specific conditions attached to the third instalment of the EU assistance, which amounts to EUR 0.5 billion. Based on the findings of the Commission mission, a Compliance Note sent by the authorities on 11 December 2009 and in consultation with the Economic and Financial Committee, the economic policy criteria for the third instalment, as laid down in the Memorandum of Understanding and the Supplemental Memorandum of Understanding, are considered to be broadly fulfilled. In particular, the adoption of the 2010 budget by the Parliament on 1 December 2009 entails a further improvement in the budget balance by 500 million LVL (over 4.2% of GDP), which is considered as the most important economic policy criterion fulfilled and should be sufficient to respect the 8.5% of GDP deficit target set for 2010, despite the fiscal costs related to the recent Constitutional Court ruling (21 December 2009), stating that pension cuts introduced with the June 2009

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supplementary budget were not in accordance with certain procedural principles deriving from the Constitution. The budget improves substantially the public finance outlook and has helped to strengthen confidence regarding the commitment and capacity of the government to undertake appropriate policy responses. Compliance with conditionality in the area of structural reform has been uneven, but with good progress in the implementation of reforms in the education and health sector, as well in consolidating the public sector, in terms of both structures and management. The Commission had expected greater progress with key structural reforms such as reform of welfare benefits, strengthening the public finance framework, and improving business environment and SME access to financing. On the positive side, appropriations for EU-funded projects have increased substantially and processes have been simplified, although a higher overall absorption of EU funds could be pursued in the future and some management issues need further progress. Significant financial system stabilisation measures have been taken, although solvency and liquidity risks remain issues for the banking system and close monitoring of domestic banks is warranted. The Bank of Latvia and the State Treasury have taken measures to increase coordination of liquidity management.

5. Since the last review mission the 2009-2010 macroeconomic outlook has remained broadly unchanged and the policy programme, including the 2010-2012 fiscal consolidation path, remains realistic. The outlook regarding external financing suggests no need for additional international medium-term financial assistance in external financing on top of what is envisaged in the programme (total amount of EUR 7.5 billion). Nevertheless, this does not exclude the possibility that Latvia's central government raises additional funds in the international capital markets.

6. The paragraphs laid down in the Memorandum and the first Supplemental Memorandum remain valid, with the exception of paragraph 2. of the Memorandum, which will be replaced by the following:

"2. EU financial assistance will be disbursed in six instalments. The amount of the first instalment released on 25 February 2009 was EUR 1 billion, while the second instalment of EUR 1.2 billion was released on 27 July 2009. The third instalment of EUR 0.5 billion shall be released subject to the signature of this Second Supplemental Memorandum of Understanding. In particular, fulfilment of the specific economic policy criteria related to the third instalment is based on the measures included in the 2010 budget adopted by the Latvian Parliament on 1 December 2009, and on key measures indicated by the Latvian authorities in order to complete the consolidation over the medium term. The adopted budget implies a fiscal consolidation by about 500 million LVL (over 4.2% of GDP) in line with the 104.7 recommendations and the first Supplemental Memorandum.

On the revenue side, the 2010 package amounts to around 275 million LVL. Among the measures, there are important reforms that make the personal income tax and social security contributions more neutral, including the broadening of the tax base to capital income (capital gains, dividends, and interests), removal of special exemptions in tourism and agricultural activities, taxing fringe benefits-in-kind and gifts (excluding within the family), and increasing the self-employed tax rate to the same level as for employees. These measures amount to almost 100 million LVL. In addition, an increase of the personal income tax rate from 23% to 26% should raise more than 90 million LVL. Taxation of wealth has been increased, through increasing real estate taxes and, notably, broadening them to include

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residential property. The concept of a progressive residential real estate tax is also introduced, though as currently designed it would generate additional income of only around ½ million LVL. Overall, the broadening of the tax base to residential buildings consequently raises only 8 million LVL, but other measures have been taken, including increasing from 1% to 1.5% the rate applying to land and business real estate, broadening the tax base to include private-owned civil engineering structures, and increasing the rate to 3% for uncultivated agricultural lands. Consequently, the overall additional amount for real estate tax should reach 30 million LVL. However, the government also introduced additional progressive car taxation measures (based on the stock of cars) that should bring almost 20 million LVL; this is another form of property tax, complementing the real estate tax, as in both cases the tax base is a form of wealth. Other revenue measures consist of additional excise taxes on gas and tobacco, bringing around 12 million LVL, and additional non tax revenues for almost 20 million LVL.

On the expenditure side, the 2010 budget stipulates significant expenditure cuts based to a large extent on structural reforms, notably the merger or abolition of agencies and institutions in the Ministries of Agriculture, Culture, Education, and Defence. Such measures will bring savings in 2010 and in the longer term. Some other measures raised concerns as to their expected impact, in particular, cuts in the welfare budget expiring in 2012. Therefore, during 2010, considering economic and demographic forecasts, a review of social insurance benefits' and pension systems will be undertaken and proposals for these systems' medium-term reform will be adopted. This is all the more necessary after the recent Constitutional Court ruling, which stated that the pension system "should be guided not only towards present receivers of pensions, but also towards ensuring security of the following generations". The authorities have also committed to allocate appropriate financing, or increase state co-financing for local governments to meet increased social needs.

Concerning the implementation of the 2010 budget, the authorities will take measures to increase the efficiency of the State Revenue Service and combat the grey economy. In the beginning of each quarter, in cooperation with the IMF, the World Bank and the Commission, social safety net policies taken in the previous quarter will be assessed by the government and, if deemed appropriate, an increase in funding will be considered (up to 0.5% of GDP for 2010 as a whole). Close cooperation of the World Bank and the Commission with the authorities will be sought to implement the social safety net strategy. Progress will be sought as concerns the strengthening of the fiscal framework and the integration of the institutions in charge of the management and planning of human resources within the public administration.

Looking beyond 2010, significant additional measures will be needed to meet the Maastricht criteria by 2012, and achieve euro entry by 2014. The Latvian authorities have demonstrated their resolve by implementing a cumulative fiscal adjustment in 2009-10 of 10½ percent of GDP (over 9½ taking into account the need to reimburse the pension cuts). Because of the success of policies so far, it is now estimated that somewhat fewer measures than previously anticipated will be needed to achieve fiscal deficit targets of no more than 6 percent of GDP in 2011 and below 3 percent of GDP in 2012 (ESA methodology). Maintaining a prudent approach to policies, preliminary estimates suggest that further adjustment of around LVL 800-900 million spread over two years, with some frontloading, will be needed to deliver these deficit targets. To this end, significant expenditure savings will be necessary, notably linked to structural reforms, including through changes in the pension and benefit systems ensuring their sustainability. On the revenue side, further tax adjustments may prove necessary to support the consolidation, including through further real estate and car tax reform and if necessary rises in the VAT rates. This could yield significantly more revenue than currently, be less distortionary and more socially acceptable."

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7. The fourth instalment is expected to take place during the third quarter of 2010, the fifth by the first quarter of 2011, and the sixth by end-2011.

8. The specific economic policy criteria attached to the next instalments of the financial assistance are laid out in the Annex I to this Supplemental Memorandum of Understanding, which is the second addendum to the Memorandum of Understanding, and replaces the previous Annex I. Moreover, reporting introduced in Annex II of this Supplemental Memorandum of Understanding replaces the previous Annex II. The Annexes form an integral part of this Supplemental Memorandum.

9. All notices in relation with the present Supplemental Memorandum shall validly be given if in writing and sent to:

For the European Union

European Commission
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

Represented by

Valdis Dombrovskis

The Prime Minister

Einars Repše

Minister of Finance

Ilmārs Rimšēvičs

Governor of the Bank of Latvia

Irēna Krūmane

Chairwoman of the Financial and Capital Market Commission

EUROPEAN UNION

Represented by

EUROPEAN COMMISSION

Olli Rehn

Member of the European Commission

22-02-2010

ANNEX I

SPECIFIC ECONOMIC POLICY CRITERIA

At the time of the Commission services' review that will precede the decision on the disbursement of future instalments, the Latvian authorities are committed to have accomplished substantial progress in fiscal consolidation and expenditure control, fiscal governance reform, banking sector stability, financial sector measures, as well as structural reforms, in line with the conditions below. Each review will assess the degree of achievement of the relevant conditions according to the specified deadlines.

General Programme Conditions

- The general government budget deficit targets for 2010, 2011 and 2012 in ESA95 terms are set at no more than 8.5%, 6% and below 3% of GDP, respectively.

- All significant Cabinet decisions or other decisions with a fiscal impact, including on social security or any guarantee scheme, shall be announced and undertaken after discussions with the EC and the IMF, and in consultation with the National Tripartite Cooperation Council.

- Any additional revenue or savings achieved relative to deficit targets should be used to achieve a lower-than-targeted budget deficit or, after consultation with the EC and IMF, to accelerate EU funds expenditure within the budgetary deficit targets set above or increase funding for active labour market and social safety net measures. EU budgetary funding, including for technical assistance activities, related to Structural funds and Cohesion Fund shall be used to the full extent and be budgeted appropriately. Appropriate technical assistance resources shall be ensured for the management and implementation of EU funds and other foreign financial assistance, in particular if their absorption is increased in 2010, and allocated to the respective Managing Authority, Audit Authority, Certifying Authority and the Intermediate Bodies.

- The Ministry of Finance's macroeconomic forecasts used as a basis for the budget preparation should be reviewed by the Bank of Latvia in consultation with external experts. The Commission services' forecast should be taken as a benchmark.

Specific Conditions

A: Fiscal consolidation

- By end-March 2010, in consultation with international organizations and the National Tripartite Cooperation Council, extend job (position) catalogue including local government and ensure that wages of local government do not exceed upper limits of the public sector wage grid. Local governments should secure a reduction in the 2010 local government wage bill consistent with the projected savings in the fiscal consolidation package.

- By end-March 2010, specify how to implement the September 2009 recommendations by the State Audit Office regarding the assessment of implementation of the 2008 State budget and budgets of local governments to achieve additional public expenditure savings in 2010 and onwards.

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- Preparation for the 2011 budget should be started in the first half of 2010. The Latvian authorities will continue their in-depth technical engagement with programme partners, and will consider options for future fiscal adjustment by mid-year. By end-October 2010, technical proposals producing savings or additional revenues, based on structural reforms in key sectors, for a total amount significantly larger than the fiscal consolidation needed in 2011 shall be submitted to the EC and IMF. Among others, these will include a car tax reform based on environmental and wealth considerations, and a comprehensive reform of real estate tax allowing means-tested exemptions.

- By end-June 2010, in consultation with international organizations and relevant stakeholders, prepare a policy paper on long-term tax reform, taking into account the needed fiscal consolidation and implications for the competitiveness of the Latvian economy.

- By end-June 2010, with technical assistance from international organizations and in cooperation with social partners, prepare changes in the pension system to be implemented in 2011 in order to preserve future sustainability and adequacy of the three pillars of the pension system. In this context, all special pension regimes and retirement ages will be reviewed.

- By end-June 2010, considering economic and demographic forecasts, review the social insurance benefits system, so that appropriate changes can be implemented after 2012.

B: Fiscal governance reform

- By end-March 2010, within the framework of the Law on Disciplinary Responsibility of State Civil Servants, put in place effective sanction procedures for individual misuses of public funds.

- During 2010, strengthen the capacity of the Authorities managing EU funds and other foreign financial assistance to control and decide on EU and other foreign financial assistance 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 them to reallocate budgetary resources away from underperforming activities according to the procedures stipulated in the Law on Budget and Financial Management.

- By end-April 2010, prepare a strategy on how to integrate the institutions and human resources management experts in charge of the management and planning of human resources within the public administration. By end-2010, based on the adopted unified public sector wage grid and with technical assistance from international organizations, strengthen the following components of the human resource management system: (i) career development, (ii) system of annual official and employee assessment based on competences and performance, and (iii) performance-based remuneration, thereby creating incentives for the most skilled public sector employees.

- By end-May 2010, complete the review of the budget preparation, as well as budgetary control and monitoring procedures, with assistance from the EU and IMF experts, by end-June 2010 prepare a new Fiscal Responsibility Law (i.e., by setting up a binding medium-term budgetary framework, establishing limits on budget revisions during the year, laying out fiscal rules in order to improve budgetary implementation, etc).

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- By end-September 2010, in consultation with relevant stakeholders and with technical assistance from international institutions, improve the analytical methodology and perform analysis of all functions and services provided by the public institutions and their respective costs, to support decisions on whether the provision of the public service should be continued or, alternatively, modified, suspended or outsourced.

C: Financial sector measures

- The FCMC will continue to ensure close monitoring and coordinate supervisory actions concerning cross-border institutions. In addition, the Latvian authorities, together with the other participants in the European Banking Co-ordination Initiative, will make progress towards requesting more specific individual commitments from banks, as agreed at an initial meeting in Stockholm in September 2009. The FCMC, with the BoL, will ensure monitoring of foreign banks' exposure and share information with foreign supervisors and central banks and communicate its results to the EC and the IMF.

- By end-March 2010, the restructuring plan of Parex Banka should be spelt out in further quantitative details and submitted to the European Commission. Priority will be given to ensuring adequate capitalization and stable management of the restructured bank and to maintaining financial stability and depositor confidence. By the same date, the Government should submit to the Parliament the necessary legal measures in order to discontinue interest payments on subordinated debt contracted by Parex Banka prior to the government's entry into the bank's capital.

- By end-March 2010, a debt restructuring strategy compatible with fiscal constraints will be launched, while continuing to work on market-based approaches to restructuring. To ensure public money is well spent, access to the scheme will be capped at 82 million LVL of the issued guarantees for the whole period of the implementation of the scheme with estimated fiscal cost of up to 31 million LVL per year (including administrative costs) and will be reviewed by end-December 2010 to determine if adjustments are needed to enhance its effectiveness or ensure that costs are contained.

- By end-May 2010, a comprehensive action plan for implementation of the medium-term strategy for the Mortgage and Land Bank (MLB) should be adopted, after consultation with the EC and IMF.

D: Structural reforms

- During 2010, strengthen the capacities of the State Employment Agency. By end-March 2010, have a strategy in place to progressively replace the temporary ESF-financed emergency public works programme. To this end, make full use of the existing ESF-financed measures and develop and implement appropriate active labour market programmes to prepare workers to take up new jobs, by allowing continuous implementation of training, re-qualification and activation measures, including self-employment activities.

- In 2010 demonstrate efficient expenditure (paid by the intermediate bodies) of at least 66 million EUR from the European Social Fund, 185 million EUR under the Cohesion Fund and 291 million EUR under the European Regional Development Fund.

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

- The Ministry of Finance shall continue coordinating and mobilising international and national expertise under the ESF-co-financed initiative for administrative capacity building (indicative areas: budgetary planning and execution, reform of public sector remuneration system, implementation of structural reforms, etc).

- By end-February 2010, take measures to improve effectiveness and scope of public procurement, including by applying standardized methodologies and guidelines, inter alia for formal eligibility requirements, centralising public and municipality procurements, and by using Electronic Procurement System E-catalogues across central and local government institutions.

- By end-March 2010, adopt the proposals as regards tackling the grey economy and undeclared work through, inter alia, significantly increasing the intensity of controls and improved coordination among relevant authorities, and applying sufficiently dissuasive administrative fines in case of non-compliance.

- By end-March 2010, the special programme for the support of small and micro companies shall be operational (i.e., changes in taxation and bookkeeping laws, access to microcredit financing). An effective access to financing for private companies, in particular SMEs and those involved in implementation of EU co-financed projects, should be ensured. In this context, SME lending programmes, financed by the EIB or by other international donors, shall be operational as soon as possible and be fully extended by the end of 2010.

- By end-April 2010, take measures to approve all the regulations for the ERDF (OP Entrepreneurship and Innovation) financing for RTD activities for the full period until 2013 and start signing project agreements by end-2010, and implement them in 2011. If additional financing for EU funded projects is agreed with the EC and IMF during the course of 2010, the RTD projects should receive the highest priority and be started without undue delay.

- By end-May 2010, review state and local government-owned companies and their subsidiary companies against the criteria set in the Latvian State Administration Law (performing publicly important functions) with a view to a possible restructuring.

- By end-June 2010, in cooperation with the relevant organized business organizations, take steps to improve the business environment, including by: a) making an inventory of authorisations and permits which companies need to seek in relation to, inter alia, registering property, operating a business and construction works and propose a roadmap for simplification; b) introducing one-stop agencies at the regional (municipal) level providing front-office services to the customers, with back-office functions centralised and to the extent possible outsourced to private partners; c) ensuring a wider application of e-governance services and promoting the use of e-signature both by the public and private sector.

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ANNEX II

MONITORING AND REPORTING SYSTEM

(This Annex replaces Annexes II of the MoU and the First SMoU)

During the implementation of the European Union assistance, the following 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 and Supplemental Memorandum).

*Furthermore, **reporting information provided to other multilateral and bilateral lenders** involved in the program of financial assistance, of which the assistance provided by the European Union forms part, **shall at the same time also be provided to the Commission**:*

Monitoring fiscal developments

- Bi-weekly Treasury cash-flow assessment of central government financing needs.
- 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 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.
- Quarterly 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.
- Bi-Monthly data on new contingent liabilities of the consolidated central, local and general governments.
- Bi-Monthly data on state budget loans and PPP projects.

Monitoring financial developments

- Monthly statements of the operations on the special account.
- 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.

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- Monthly report on banking sector stabilization measures.

- Monthly report on the evolution of the parent banks' exposure towards Latvia, which encompasses all forms of debt instruments and capital as well as net deposits provided to banks in Latvia.

- By end-May 2010, the Financial and Capital Market Commission will present to the EC the next of its regular six-month reports on the implementation of its strengthened supervisory and monitoring framework, focusing on developments in banks' loan portfolios, provisions for losses, liquidity and capitalisation, to be closely watched by means of, inter alia, regular on-site inspections and stress tests.

- By end-May 2010, the government will report on the improvement in the design and the implementation of the legal framework for insolvency and liquidation procedures in line with the best international practice. As a result, a significant reduction in the duration of court dealings is to be achieved.

Monitoring structural reforms

Structural Funds and Cohesion Fund

- Monthly data on budget allocations to and appropriations of line ministries for financing of EU Structural funds and Cohesion fund projects (including which programme and 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 activities (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).

- At the middle of each quarter, qualitative assessment reports by the Managing Authority on reaching the Structural Funds and Cohesion Fund expenditure targets.

- At the end of each quarter, report on the management capacities of the SF Managing Authority, Audit Authority, Certifying Authority and the Intermediate Bodies: number of staff and total remuneration by body.

Active Labour Market and Social Policies

- Quarterly flash reports on the implementation of the active labour market measures by the Ministry of Welfare, Ministry of Economy and Ministry of Education including number of participants, (total planned/the total unemployed, unemployed exiting the Workplaces with stipend programme), problems encountered and solutions proposed.

- At the end of each quarter, report on the capacity of the State Employment Agency (SEA): number of clients per staff member, time allocated for a client, frequency of client contacts including comparison with 2009 and previous quarters.

- In the beginning of every quarter, assessment of policy options taken by the government during the previous quarter regarding poverty, health and pensions (including data on allocations for GMIs and also in comparison to previous years).

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.

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