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IMF Executive Board Approves €1.68 Billion (US$2.35 Billion) Stand-By Arrangement for Latvia

The Executive Board of the International Monetary Fund (IMF) today approved a 27-month SDR 1.52 billion (about €1.68 billion, or US$2.35 billion) Stand-By Arrangement for Latvia to support the country's program to restore confidence and stabilize the economy. The approval makes SDR 535.3 million (about €591.5 million, or US$826.3 million) immediately available and the remainder in nine installments subject to quarterly reviews. The Stand-By Arrangement entails exceptional access to IMF resources, amounting to about 1,200 percent of Latvia's quota, and was approved under the Fund's fast-track Emergency Financing Mechanism procedures.

The program is centered on maintaining Latvia's exchange rate peg while recognizing that this calls for exceptionally strong domestic policies and substantial international financial assistance. Key elements include:

- immediate measures to stem the loss of bank deposits and international reserves;
- steps to restore confidence in the banking system in the medium-term and to support private debt restructuring;
- fiscal measures to limit the substantial widening in the budget deficit, and prepare for early fulfillment of the Maastricht criteria; and
- incomes policies and structural reforms that will rebuild competitiveness under the fixed exchange rate regime.

The program is part of a coordinated international effort. The European Commission has participated fully in the preparation of the program, along with representatives from the ECB (in line with Latvia's ERM2 membership), Sweden and other Nordic countries. With substantial international support, these policies should allow the economy eventually to emerge from a period of slow growth, with fewer strains on corporate and household balance sheets.

The Fund's Stand-By Arrangement will fill just over 20 percent of the country's 2009-2011 net financing gap. The remainder will be met by the European Union, the European Bank for Reconstruction and Development, the World Bank and other bilateral creditors. As part of the program, foreign parent banks operating in Latvia have affirmed their commitment to provide their subsidiaries with adequate financing.

Following the Executive Board discussion on Latvia, Mr. Dominique Strauss-Kahn, Managing Director and Chairman, said:

"Latvia faces severe economic challenges. Pressures on liquidity and on international reserves are intense, in part caused by the global financial crisis. These pressures have come at a time of growing concern over the sustainability of Latvia's external debt and increasing vulnerabilities associated with the unsustainable credit and growth boom that followed Latvia's accession to the EU. Very high wage growth in recent years, far outstripping productivity gains, have severely undermined Latvia's competitiveness and contributed to large external imbalances.

"The Latvian authorities have developed a program with the exceptionally strong policies needed to address these challenges. Their program is centered on their determination to maintain the current exchange rate peg in order to lay the groundwork for Latvia's entry into the euro area as soon as possible. For this reason, and given the need to improve competitiveness, a lengthy period of price compression, including wage reductions, will be unavoidable. A deep recession and a drawn-out recovery appear inevitable.

"Sustaining the government's large fiscal adjustment will be critical to the success of the program. Given the government's difficulties in borrowing and the likely additional budgetary burden associated with the costs of bank restructuring, measures to contain the budget deficit are unavoidable. Sizable expenditure cuts will be a central part of the fiscal adjustment. Spending on public investment will be maintained, and social spending protected.

"Financial sector reform to strengthen the banking system will also be key. The government's actions to take control and install new management in a major domestic bank are an essential step for stabilization. For the banking sector in general, enhancing the market regulator's ability to monitor the financial system, and clarifying procedures for providing emergency liquidity assistance, will help promote financial stability.

"The Latvian authorities' program is an appropriately ambitious response in the current circumstances. Determined implementation of this program—supported by the 27-month Stand-By Arrangement under the IMF's exceptional access policy and the very substantial financial assistance expected from Latvia's European Union, Nordic and other international partners—will help address Latvia's immediate balance of payments needs. For the future, the program should contain and reverse the increase of external debt, improve competitiveness and return Latvia to a sustainable growth path," Mr. Strauss-Kahn said.

ANNEX

Recent Economic Developments

The current global financial crisis has brought Latvia's vulnerabilities to a head. Years of unsustainably high growth and large current account deficits have coalesced into a financial and balance of payments crisis.

Since end-August, private sector deposits have fallen by 10 percent, led by a run on Parex Bank (the second largest bank, and largest domestically owned) which encountered severe liquidity problems after it lost more than a quarter of its deposits. Attempts by the government to negotiate a partial take over of this bank, while allowing the main shareholders to retain significant influence, failed to restore confidence. From end-August to end-November, official reserves fell by almost 20 percent to €3.4 billion, one third of short-term external debt and just over 100 percent of base money (from 127 percent in September), as the central bank sold foreign currency to defend the peg.

Despite this substantial intervention, since early October the exchange rate has remained at its upper (depreciated) band, while interbank spreads have spiked. Concerns over the financial system and external debt sustainability increased, and the exchange rate peg came under threat.

Program Summary

The authorities' program aims to stem the current liquidity crisis and then ensure long-term external stability, while maintaining the exchange rate peg:

The immediate three objectives of the program are to stabilize the financial sector, restore depositor confidence, and to avoid the disorderly adjustment that would follow if the exchange rate peg were abandoned.

To maintain the peg, the program includes measures that ring fence and resolve the immediate problems in Parex Bank, to prevent contamination to the rest of the system. It also draws on substantial outside international financial assistance to meet the demand for foreign exchange.

For the medium-term, the program includes measures to promote economic adjustment and strengthen the peg. The program includes measures to restore confidence in the broader financial system, to halt the drain of external liquidity. Substantial fiscal policy tightening will reduce financing needs, foster real depreciation, and make room for potentially large contingent financial sector liabilities. The program's aim is to meet the Maastricht deficit criteria to facilitate adoption of the euro. This exit strategy should help prevent a recurrence of the current difficulties.

The program includes strong incomes policies to reduce inflation and improve competitiveness, and structural policies that should boost productivity growth and help generate the much-needed shift from non-tradables to tradables production. Private sector debt restructuring will also likely be needed.

The IMF also supports the protection of social spending embedded in the program. Latvia's social spending will increase under the program from 21 to 25 percent of the budget, or by 1½ percent of GDP between 2008 and 2009, to bring it closer with EU and OECD averages. Additional measures to improve the targeting of the social benefits system should be included in the second supplementary budget for 2009.

The unequivocal commitment of the authorities, and of the other stakeholders to the exchange rate peg has determined their choice of program strategy. Though this commitment augurs well for program ownership, the authorities also recognize that their choice brings difficult consequences, including the need for fiscal tightening and the possibility that recession could be protracted.

Latvia joined the IMF on May 19, 1992; its quota is SDR 126.80 million (about €140.1 million, or US$195.7 million), and has no outstanding use of IMF credits.

Republic of Latvia: Selected Economic Indicators

	2005	2006	2007	2008	2009
(Annual percent change, unless otherwise stated)					
Real Economy					
Real GDP	10.6	12.2	10.3	-2.0	-5.0
Unemployment rate (in percent, period average)	8.7	6.8	6.2	6.7	9.0
HICP (Period average)	6.9	6.6	10.1	15.5	5.9
HICP (end of period)	7.1	6.8	14.0	11.9	3.3
Public Finance					
General government balance (in percent of GDP)	-1.1	-0.9	0.7	-3.0	-4.9
General government debt (in percent of GDP)	11.6	9.9	8.3	14.3	33.7
Money and credit					
Reserve money	41.1	66.5	9.9	1.0	-28.1
Broad money	38.9	37.4	12.6	0.8	-3.0
Domestic credit (non-government)	64.3	58.4	34.2	13.0	-0.5
Balance of payments					
Goods and non-factor services balance (in percent of GDP)	-15.2	-22.2	-21.8	-13.9	-7.3
Current account balance (in percent of GDP)	-12.5	-22.5	-23.8	-14.8	-7.3
International reserves (in months of imports)	2.3	3.2	3.7	4.0	3.8
Exchange rate					
Exchange rate regime	←Pegged to the Euro →1/				
Exchange rate (lats per US$; period average)	0.565	0.560	0.514	0.477	0.525
Real effective exchange rate (2000=100) 2/	90.1	92.6	100.1	105.3	…
Quota at the Fund					
	SDR 126.8 million				

Sources: Latvian authorities and IMF staff estimates.
1/ On January 1, 2005 the lats was repegged to the euro.
2/ CPI-based, period average