

Flash Comment

Latvia cannot ignore the IMF

- The European Commission published a Supplemental Memorandum of Understanding between the Latvian government and the EU.
- The MoU shows that half of the instalment of the EU loan to Latvia is earmarked for the financial sector. This leaves less money to cover the gap in the central government budget.
- Therefore, the Latvian government might not be able to meet its funding needs for the rest of the year unless the country gets the next instalment of its IMF loan.

Yesterday the European Commission (EC) published a Supplemental Memorandum of Understanding (MoU) between the Latvian government and the EU (See [here](#)). It is interesting reading. Most notable is that out of the EUR 1.2bn that the EU is paying out to Latvia as the second instalment on the EU loan, half has been earmarked for propping up the financial sector. We had – wrongly – assumed that all or most of the money would go directly into the budget. The fact that half of the money will have to be used to prop up the banking sector leaves less money to cover the gap in the central government budget and means that the Latvian government might very well be running out of money if it fails to get the next instalment on its IMF loan.

A back of the envelope calculation illustrates this. In June, central government spent about EUR 125m more than came in revenues and funding. Assuming that this “burn rate” continues for the rest of the year (August-December) then that adds up to EUR 625m for the rest of the year. Furthermore, during the rest of the year EUR 715m worth of t-bills are maturing which need to be rolled over. Hence, the refinancing of maturing debt and the monthly cash burn adds up to EUR 1,340m. In our assessment the Latvian state treasury probably has EUR 540m in liquidity at the moment. That leaves the Latvian central government with a funding need of EUR 799m. This is why it is important that the EC in the Supplemental MoU ties up half of the EUR 1.2bn instalment for the financial sector, as the amount that will be “free” to cover the budget deficit will be less than the funding need (EUR 600m vs EUR 799m).

Hence, basically the Latvian government will be around EUR 200m short by the end of the year – unless it is able to roll over more than half of the maturing debt which would require sustained perfect conditions for issuance in the local money markets for the rest of the year (given that the international markets are more or less closed). An additional risk factor is that the cash-burn is higher than in our calculation; moreover, some sort of cash balance (EUR 100m or so) is needed to assure day-to-day operation of the government. All in all, we find it hard to see the Latvian government securing funding to cover the accumulated budget deficit for the remainder of the year unless the next instalment of the IMF loan is paid out.

An alternative is of course further measures to cut the budget deficit. In Supplemental MoU, the EC suggests a number of measures to improve the budget situation in Latvia. On the revenue side it is proposed to raise the VAT rate from 21% to 23%, introduce a residential real estate tax and capita gain tax. On the expenditure side a unified public

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sector wage framework is proposed, once again revising social benefits and increasing the pension age. The latter measures would improve the public deficit at least by 4% of GDP. Almost all of these measures have previously been recommended by the IMF, but rejected by the Latvian government.

Concluding, we don't believe that the Latvian government can ignore the IMF and the country badly needs the funding from the IMF. Furthermore, it is obvious that further fiscal measures are needed to get the budget back on a sustainable track. Finally it noteworthy that the "ideological" differences between the EC and the IMF concerning how to handle the Latvian question is smaller than some observers until now have noted, and to us it seems pretty clear that both institutions have a relatively similar assessment of the difficulties facing Latvian public finances.

Disclosure

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