LATVIJAS BANKA

BANK OF LATVIA: ANNUAL REPORT 2005

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In Charts, the dots indicate the actual data, and the lines reflect the smoothing approximation of the data. The smoothing approximation of the daily data is more distinguished than the curve of the actual data.

Details may not add because of rounding-off.

– *no transactions or no outstanding amounts in the period.*
x *no data available or no computation of indicators possible.*
0 *the indicator is below 0.5 but over 0, or the result of the computation of the indicator is 0.*

Works of art from the collection of the Bank of Latvia have been used in the design.
Photos by Gunta Andersone and Indriķis Stūrmanis.

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ABBREVIATIONS

BIS	Bank for International Settlements
CEBS	Committee of European Banking Supervisors
CIF	cost, insurance and freight at the importer's border
CIS	Commonwealth of Independent States
CSB	Central Statistical Bureau of Latvia
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EFC	Economic and Financial Committee
EKS	Electronic Clearing System
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism II
ESCB	European System of Central Banks
EU	European Union
EU10	countries which joined the EU on May 1, 2004
EU15	EU countries before May 1, 2004
FCMC	Financial and Capital Market Commission
FOB	free on board at the exporter's border
FRS	US Federal Reserve System
GDP	gross domestic product
IMF	International Monetary Fund
ISO	International Organization for Standardization
JSC	joint stock company
KMAS	Customer Payments Processing System
LCD	Latvian Central Depository
M0	monetary base
M1	narrow monetary aggregate
M2	intermediate monetary aggregate
M2X	broad money
M3	broad monetary aggregate
MFI	monetary financial institution
NATO	North Atlantic Treaty Organisation
OECD	Organisation for Economic Co-operation and Development
OFIs	other financial intermediaries, except insurance corporations and pension funds
Plc	public limited company
RIGIBID	Riga Interbank Bid Rate
RIGIBOR	Riga Interbank Offered Rate
RSE	Riga Stock Exchange
SAMS	Interbank Automated Payment System
SEPA	single euro payments area
SDR	Special Drawing Rights
SSIA	State Social Insurance Agency
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
US	United States of America
VAT	value added tax

FOREWORD OF THE GOVERNOR

In 2005, Latvia remained the EU Member State reporting the highest GDP growth, which was supported by domestic demand and rapidly expanding exports. The GDP growth was driven also by foreign direct investment inflows. Latvia's export growth rate exceeded 30% and was higher than that of the imports. More than $^3/_4$ of Latvia's exports were to the EU Member States. A large part of Latvian businesses cooperate with partners in the euro area and countries whose currency is pegged to the euro; therefore, successful repegging of the lats to the euro provided them with well-considered business development opportunities, without having to worry about foreign exchange risk.

Latvia's buoyant economic growth in 2005 was related to its further integration with the EU, as the lats was repegged from the SDR basket of currencies to the euro on January 1, 2005. In the coming years, the main challenge in the area of macroeconomics for the Latvian Government and the Bank of Latvia will be curbing the inflation and ensuring compliance with the Maastricht criteria, while promoting balanced economic development and readiness for the euro changeover.

In Latvia, as in the majority of the new Member States, accession to the EU boosted the foreign trade flows and provided an opportunity to use EU funding and gain better access to more liquid and developed financial markets, while causing a decline in the risk premiums. These factors resulted in lower interest rates and more active inflows of financing in the form of domestic loans and foreign direct investment, thus accelerating economic growth. These are positive developments, yet the low interest rates and the resulting expansion of domestic consumption and investment during the uplift of the economic cycle, when the economy is developing rapidly, also aggravates the pressure of high purchasing power related demand on inflation.

Monetary policy decisions of the Bank of Latvia were aimed at dampening the inflation and promoting balanced long-term economic growth. From January 2005, the minimum reserve base of banks was expanded to include banks' liabilities to foreign banks. The Council of the Bank of Latvia changed the banks' minimum reserve ratio by 2.0 percentage points on two occasions, to stand at 8% at the end of the year. The euro has become the most popular loan currency in Latvia; therefore, December 2005 and March 2006 decisions of the ECB to raise the key interest rates and the expected future tightening of the monetary policy in the euro area could help Latvia to mitigate the risks of imbalanced development.

Following the repegging of the lats to the single European currency, the lats and the euro have become perfectly interchangeable in Latvia. As one of the key monetary policy instruments, interest rates have lost their effectiveness in cases requiring adjustment of macroeconomic trends, as more than a half of loans to residents have been granted in euro. Thus, the impact and effectiveness of the traditional monetary policy instruments of the central bank has substantially weakened and the macroeconomic adjustments have to be made mostly in the fiscal policy area. Therefore, the Bank of Latvia actively advocated the need for a tighter fiscal policy during the upswing of the economic cycle. The Bank of Latvia also urged to evaluate the risk arising as a result of mismatch between the loan currency and the borrowers' income currency.

By repegging the lats to the euro, Latvia started heading towards implementation of the single European currency. In May 2005, the next required step was taken: in compliance with the Government's plan, Latvia joined the ERM II, unilaterally preserving the fluctuation band of the lats exchange rate (±1%) established several years ago. The Bank of Latvia's experts participate in the Steering Committee established by the Latvian Government with a view to ensuring effective euro changeover in Latvia, including the development of the euro changeover strategy and action plan. The Bank of Latvia is responsible for the areas of the euro cash changeover, payment systems and financial statistics.

Six collector coins have been minted in 2005. Continuing to diversify the design of the Latvian money by minting limited issues of 1-lats coins, the Bank of Latvia released the coins *Pētergailis* and *Pretzel* into circulation. The Bank of Latvia established a new tradition of organising annual public opinion polls about the coin of the year. The *Coin of Time* became "Latvia's Coin of the Year 2004".

The Bank of Latvia believes that promoting public awareness of its operation, decisions made and Latvia's economic development is one of its most important duties. Therefore, the most topical issues of 2005 (hiking of prices and aggravation of the macroeconomic risks) became the themes of reports and discussions at the Bank of Latvia's annual conference held in September 2005. The above and other issues concerning the central bank operations can be clarified at the Visitors Centre "Money World" opened in March 2005. This interactive financial information and education centre has quickly earned well-deserved popularity. Winning "The Best Reconstruction" award at the competition "Best Construction Site of the Year 2005" organised by the Latvian Builders Association is a proof to the excellence of the architectural solution used in the Centre.

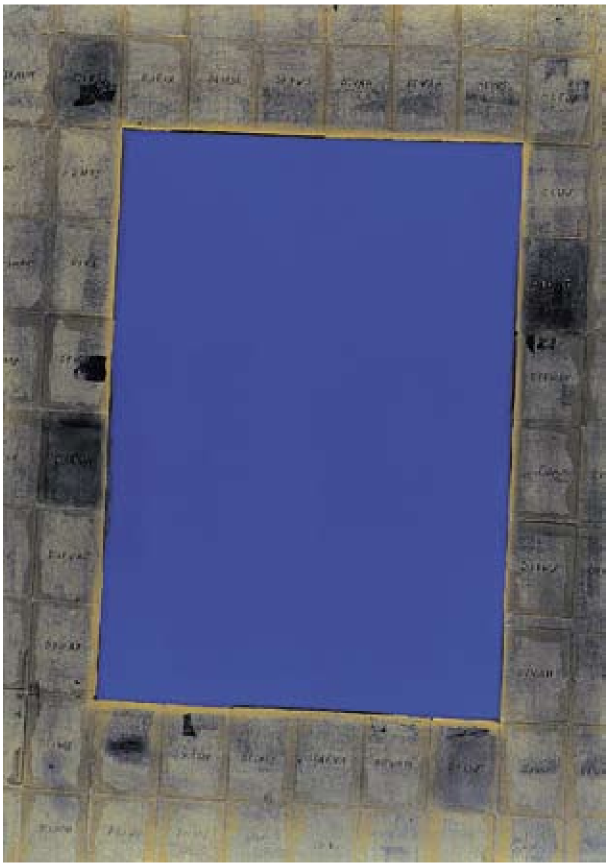
Hereby I would like to express my deep gratitude to the Council and the Board of the Bank of Latvia for successful organisation of work and to each employee of the Bank for creativeness and conscientious everyday work, facilitating implementation of the Bank of Latvia's tasks.

May the Annual Report enable everyone to examine and evaluate the Bank of Latvia's accomplishments!

Ilmārs Rimšēvičs
Governor, Bank of Latvia
Riga, April 11, 2006

Ilmārs Blumbergs

THE HORIZONTAL RIVER. 1995–1996
THE BLUE WINDOW. 1995–1996
THE VERTICAL RIVER. 1995–1996
Mixed technique on cardboard. 100 x 70 cm



NATIONAL ECONOMY DEVELOPMENTS AND MONETARY POLICY

GLOBAL ECONOMIC ENVIRONMENT

In 2005, the global economy developed successfully. It posted robust growth in EU10 as well as Asian countries, China in particular. Economy in the US and Japan expanded at a moderate rate. Euro area growth rates accelerated. With the economic activity recovering, the central banks of the major countries reduced monetary stimuli. The FRS continued the cycle of raising federal funds rate initiated in 2004, and the ECB also started pursuing a more restrictive monetary policy.

With the global economy developing robustly, financial markets showed increased interest in investment in corporate shares. Overall, the global stock markets were more successful in 2005. A particular activity boost and a rise in stock prices was observed in the second half of the year, and it was driven by the strong corporate financial performance and improving economic activity outlook in several parts of the world. In 2005, the European stock market index Dow Jones EURO STOXX 50 and the Japanese stock market index Nikkei 225 increased by 21.3% and 40.2%, respectively. Robust growth was observed also in other Asian stock markets. The stock market growth in the euro area and Japan was also supported by the low interest rates on borrowings. The US stock market development, however, was hampered by the rising interest rates. The US stock market index S&P 500 and the technology-dominated NASDAQ Composite edged up by only 3.0% and 1.4%, respectively. A particularly sizeable pickup in stock prices was observed in the Russian stock market, with the stock market index RTS surging up 83.3%, mostly as a result of a price rise for energy corporation shares.

In 2005, the rapid pickup in oil prices had a negative impact on the global economic growth. The rise was supported by the growing global demand for oil products, particularly in Asian countries, and by concerns that the oil extraction and processing reserve capacity would fail to satisfy the rising demand. In early 2005, the oil price was 40 US dollars per barrel, surging to a record high of almost 70 US dollars per barrel in the middle of summer. The rise was fuelled by damages caused to the US oil sector by the tropical hurricanes. In autumn, with the US oil sector extraction and processing sector gradually overcoming damages caused by the hurricanes, the oil prices dropped to 55–60 US dollars per barrel. In 2005, a considerable price rise was observed also for non-ferrous and precious metals.

With the US economic growth rate remaining strong and employment improving, the FRS continued to pursue a tightening of the monetary policy commenced in 2004. In 2005, each meeting of the FRS resolved to raise the federal funds rate by 25 basis points, reaching 4.25% by the end of the year. In view of the impact of the high energy prices on production costs in the euro area and the improving economic activity, the ECB resolved to raise the key rate by 25 basis points (to 2.25%). On August 4, the Bank of England reduced its base rate from 4.75% to 4.50% to facilitate the economic growth. The Bank of Japan left its base rate unchanged at 0.10% in 2005.

With the short-term interest rates rising, long-term debt securities yields also moved up. In 2005, the increase in government medium-term bond yields exceeded that of government long-term bond yields. The yield curves were hence less steep. Yields on 2-year US government bonds rose from 3.1% to 4.4%, while those on 10-year government bonds edged up from 4.3% to 4.4%. Yields on 2-year German government bonds rose from 2.5% to 2.9%, while those on 10-year government bonds dropped from 3.7% to 3.3%.

In 2005, in contrast to the developments in 2004, the US dollar appreciated against several major currencies. Particular acceleration was recorded in the first half of the year when the US dollar appreciated against the euro by 11%. It was supported by the positive indicators of the US economy as well as by the market participant projections regarding interest rate developments in the region. Overall, the euro depreciated against the US dollar from 1.36 to 1.18 in 2005.

The US GDP increased by 3.5% in 2005 (by 4.2% in 2004). Owing to still considerable private demand at the beginning of the year, the US economy posted higher growth, with the rate of increase of GDP reaching 3.8% in the first quarter. In the second quarter, the economic activity moderated somewhat. Despite the rapidly rising oil prices in summer and the negative impact of the hurricane Katrina that resulted in creating an energy supply shock at the end of the third quarter, the US economy growth accelerated as a result of high private demand in the third quarter. Nevertheless, at the end of the year the economic activity dampened again mostly as a result of a slowdown in the construction sector activity due to the severe winter. The rate of increase in private demand also declined. Raising the interest rates affected the activity in the housing market at the end of the year, hence sales of new houses dropped in the reporting period.

Following a lengthy period of slow growth, positive developments were observed in the euro area economy in 2005. The increase in domestic demand in 2005 gradually accelerated, supporting further balanced development of the euro area economy. The strengthening of the domestic demand was on account of a considerable increase in investment. Favourable financing conditions and the upward trend of corporate profitability in the third quarter ensured the highest growth in the last five years. The depreciation of the euro against the US dollar since early 2005 had a favourable effect on the competitiveness of financial institutions and non-financial corporations of the euro area, and the second half of the year saw the highest increase in exports since 2000. Both statistical data and business confidence surveys reflected growth in industry and services sector in 2005. Inflation stood at 2.2% in the euro area, exceeding the reference value of the ECB inflation rate. Hence, in view of the improving economic situation in the euro area, the ECB Council resolved to raise the key rates after more than two years of unchanged monetary policy.

In 2005, the economic growth of EU10 countries continued. In most countries, the economic activity was predominantly driven by an increase in domestic demand and investment. The economic growth rate of the Baltic States remained higher than the average for the region. Strong export growth was observed in all EU10 countries except Malta. Industrial production continued to expand in several countries. The highest increase was observed in sectors manufacturing export goods. The role of the services sector became increasingly important, and considerable reallocation of resources (inter alia foreign direct investment and labour) from the industrial production sector to the services sector took place. The unemployment rate continued to decline. Poland recorded the highest unemployment rate in the EU (17.3% at the end of 2005), while Estonia posted the lowest one (2.7%). Most of the countries were successful in suspending the rise in consumer prices related to the accession to the EU. Nevertheless, inflation in the Baltic States remained high also in 2005, and the average annual increase in consumer prices in all three countries was more sizeable than in 2004. The economic growth in Poland moderated in 2005, with the GDP increasing by 3.2% (5.3% in 2004). The drop in the GDP growth was driven by a decline in the domestic demand. The economic development was mostly supported by exports, though the Polish zloty appreciated substantially. The strong inflow of investment fuelled increase in the industrial output. Foreign investment in Hungary also supported considerable growth in industrial production, construction and exports. In most EU10 countries, the rise in wages and salaries exceeded that in consumer prices, contributing to the strengthening of domestic demand. High current account deficit persisted in the Baltic States.

Estonia's GDP increased by 9.8% in 2005. The economic growth was fuelled by rapidly expanding exports and robust domestic demand, supported by a rise in personal income and lending. The most pronounced growth was observed in trade and construction. The increase in the volume of industrial output, export goods in particular, was primarily driven by higher external demand. The most notable growth in industry was observed in the manufacture of products of radio, television and communication equipment and apparatus (51.0%) and other electric appliances (39.2%). Consumer prices rose at an average annual rate of 4.1%, predominantly on account of higher fuel and administered prices.

GDP in Lithuania grew by 7.5% in 2005. All major sectors contributed to the economic growth, except agriculture and mining and quarrying. The highest growth was observed in transport, storage and communication, construction, manufacturing, trade, and hotels and restaurants. A rise in personal income promoted the increase in domestic demand. In 2005, the average gross wage and salary rose by 12.2%. The unemployment rate dropped to 4.1%. The rise in consumer prices (an annual average of 2.7%) resulted from an increase in oil prices as well as due to higher prices for transportation services and health care.

The Japanese economy continued its recovery, with the GDP increasing by 2.7%. Domestic demand was the key driving force of growth. Private consumption and fixed investment posted a rapid increase while exports edged up slightly. In 2005, the deflation trend increasingly diminished, with the Consumer Price Index shrinking only by 0.3%.

Russia's GDP increased by 6.4% in 2005 (by 7.2% in 2004). Moderation of the economic growth resulted from a slower rate of increase of exports. A rise in oil prices, weaker external demand, and the deficiencies of the investment environment negatively affected the development of oil exports, the major driving factor of Russia's rapid growth. Raising export duties also had a negative impact on the income from oil exports, hence oil companies increased oil processing in Russia. With personal income strengthening, the contribution of domestic demand to the positive economic development became increasingly pronounced. Private consumption continued to grow rapidly, despite the persistently high inflation. The average annual growth in consumer prices reached 12.7% in 2005.

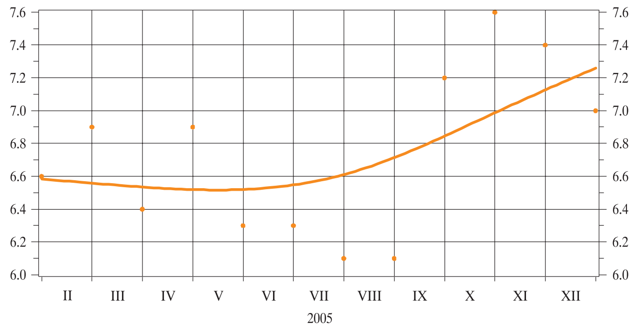
INFLATION AND PRICES

In 2005, changes in consumer prices in Latvia were more pronounced than in the previous year. The average annual inflation reached 6.7%, with the price rise for goods and services being approximately the same (6.8% and 6.5% , respectively). In December 2005, the annual consumer price inflation stood at 7.0% year-on-year (see Chart 1). Prices of many major groups of goods and services (except clothing, footwear and communication services) posted a rise. Inflation for the most part was attributable to supply side factors, and the rate of core inflation also was fairly high (5.5%).

At the beginning of 2005, the excise tax on tobacco, as well as fuel excise tax rates were recalculated in line with the appreciation of the euro in the second half of

Chart 1

ANNUAL CONSUMER PRICE INFLATION
(year-on-year basis; %)



Source: CSB.

2004. Moreover, in the first few months of 2005, the effect of changes made in fuel excise tax rates in May 2004 could still be felt. In 2005, oil prices also reported a considerable rise, increasing the impact of fuel prices on inflation. Hence, price changes for the above two groups of goods contributed 0.2 percentage point and 1.1 percentage points to the average annual inflation, respectively.

The impact of administered prices on inflation expanded gradually as their changes took effect (on April 1, 2005 – for patient fees and rent; on August 1 – for gas tariffs, resulting in a rise in heating prices in the new heating season). The impact of administered prices on the average annual inflation was 0.7 percentage point.

In 2005, a rise in food prices (9.2%) made a considerable contribution to inflation. It was mostly caused by cost factors (higher energy and purchase prices) and the unfavourable weather conditions during the harvesting season. It was impossible to harvest all crop, and in the fourth quarter bread prices posted a considerable pickup of 14.6%.

In 2005, the rise in the prices of unprocessed food exceeded that for processed food (10.4% and 8.7%, respectively); however, their rate of increase was considerably stronger than the growth rate of other components of core inflation. For example, with the impact of the exchange rate of the euro on prices of imported goods abating, prices for clothing and footwear fell somewhat (by 0.2%) in 2005. Prices of household appliances and some electrical appliances related to recreation and culture also dropped (by 1.0% and 5.7%, respectively). It was also partly affected by competition (suggested by long-term price stability or even a price decline in these groups of goods).

In the services group, only telephone services posted a notable price drop, mostly as a result of tightening competition. Prices of other services rose considerably. As a result of growing demand, the price rise for food and energy translated into higher prices for catering services (by 10.6%). Thus the overall inflation increased by 0.5 percentage point. However, the annual rate of increase of prices for several smaller services groups was even higher (prices of financial services escalated by 18.1%, those for hotel services moved up 12.0%).

In 2005, the annual rise in producer prices in industry was 7.8% on average, including a price increase for goods sold on the domestic market and exported goods of 7.3% and 8.5%, respectively. A pickup in the manufacture of transport equipment (27.2%), machinery and equipment n.e.c. (17.1%), fabricated metal products (except machinery and equipment; 16.1%) and other non-metallic mineral products (13.3%) made the most pronounced impact on the average price rise.

In 2005, the average monthly gross wage and salary and the average monthly net wage and salary of persons employed in the national economy were LVL 245.75 (an increase of 16.5%) and LVL 175.87 (an increase of 17.0%), respectively. In view of a rise in consumer prices, the real monthly gross wage and salary in the national economy increased by 9.2%. The rise in wages and salaries was promoted by the robust economic growth, the legalisation of wages and salaries in the private sector, wage and salary adjustments in view of inflation, the labour outflow (in some sectors with shortage of employees the employers had to raise wages), as well as convergence of wages and salaries to EU level.

As a result of an increase in workers' wages and salaries (16.1%), costs of machinery and mechanical appliance maintenance (13.8%) and building materials (9.6%), construction costs posted a considerable rise (11.4% on average).

Although the increase in the export unit value moderated somewhat year-on-year (from 13.4% in 2004 to 10.3% in 2005), price rises for all commodities dominating exports were substantial. A considerable rise was recorded for prices of mineral products (24.4%), prepared foodstuffs (13.5%), textiles and textile articles (13.4%), machinery and mechanical appliances, electrical equipment (11.0%), and wood and articles of wood (8.6%). The expanding volume accounted for ²/₃ and the rising prices for ¹/₃ of the overall export growth.

The import unit value continued to increase year-on-year (by 12.6%; by 8.1% in 2004) mostly due to the global rise in oil prices. Higher import prices were reported for mineral products (by 40.0%), transport vehicles (by 12.8%) and base metals and articles of base metals (by 9.0%). Prices of agricultural and food products also moved up considerably. The growth in imports was equally driven by both the expanding volume and higher prices.

In 2005, terms of trade did not improve since the rise in import prices exceeded that of exports.

GROSS DOMESTIC PRODUCT

In 2005, the Latvian economy posted record high growth. It was driven by the ample domestic demand (both consumption and investment) along with a considerable increase in external demand. In terms of current prices, GDP amounted to 8.9 billion lats, with the real GDP exceeding last year's indicator by 10.2% (see Table 1).

Table 1

GROSS DOMESTIC PRODUCT AND GROSS VALUE ADDED
(at constant prices; year-on-year basis; %)

	2004	**2005**
GDP	8.5	**10.2**
Goods-producing sector	8.2	**7.9**
Services sector	8.7	**11.2**

Source: CSB.

With loans granted to households and total household disposable income growth accelerating, the private consumption growth was 8.8% in real terms in the first nine months of 2005. Several factors accounted for the rise in total household income: an increase in employment, real average wages and salaries, the amount of paid social benefits and pensions.

Both the sustained high level of final consumption and the rapid increase in investment contributed substantially to the GDP growth. The favourable financial performance of financial institutions and non-financial corporations of previous periods, relatively low lending interest rates and a rise in real estate prices promoted investor activity, hence investment in fixed assets grew by 21.5% in the first nine months of 2005.

The increase in exports in the first nine months of 2005 reached a ten-year high (20.9%). Successful Latvian business development and expansion in external markets was further facilitated by the EU membership and investment in sectors manufacturing export goods. Nevertheless, owing to expanding domestic demand and demand for goods needed for the manufacture of exports the growth rate of imports of goods and services also remained high.

The services sector posted a more rapid increase, with that in trade (17.4%) and transport, storage and communication (16.2%) being particularly pronounced.The gain in retail trade turnover was fuelled by disposable income and lending growth, as well as expectations of further price rises. The turnover of retail companies (including sale of motor vehicles and retail trade in automotive fuel) at constant prices expanded by 25.1%, with the surge in motor vehicle sales (40.1%) providing the major contribution. The demand for new vehicles (manufactured in the last two years) was particularly pronounced, and in 2005 the number of new vehicle registrations was twice higher year-on-year.

In respect of transport, storage and communication, the volume of both passenger and cargo transportation (freight transit in particular) increased notably. The volume of rail freight posted a year-on-year growth of 7.4%, including a rise of 24.9% in transit freight. Overall, freight turnover at Latvian ports expanded by 4.6% in comparison with 2004.

The growth in the goods-producing sector was hindered by the fall in manufacturing of certain products in the first quarter. In the second quarter, however, the downturn was over and with the domestic and external demand posting a marked increase, the contribution of manufacturing to the gross value added in real terms expanded by 6.3% in 2005.

In 2005, construction developed very successfully, growing by 15.5%. It also promoted an increase in the output in a number of industrial sectors: manufacture of other non-metallic mineral products (24.2%), manufacture of rubber and plastics products (19.7%), fabricated metal products (except machinery and equipment; 12.4%). A rise in exports and domestic demand promoted growth in the manufacture of food products and beverages (5.0%), wood and of products of wood and cork (2.6%), chemicals, chemical products and man-made fibres (13.8%), as well as several other sectors.

The robust economic growth was driven by a substantial investment in the production development. Non-financial investment at constant prices amounted to 1 819.1 million lats (a year-on-year increase of 14.0%). The largest investment was made in manufacturing (356.7 million lats), electricity, gas and water supply (239.1 million lats), trade (251.7 million lats) and transport, storage and communication (274.6 million lats).

In 2005, the registered unemployment rate dropped considerably (from 8.6% in January to 7.4% in December). Unemployment declined throughout Latvia. It resulted from a decline in the economic activity of the population: making use of the opportunity to work in other EU countries, part of the unemployed sought job abroad. The registered unemployment was also pushed down by the rapid upsurge in the number of registered vacancies (58.5% year-on-year). In 2005, the unemployment/vacancy ratio (the number of the registered unemployed per vacancy) dropped to 11.7 (19.9 in 2004).

As a result of economic reorganisations, structural unemployment was observed in Latvia; nevertheless, regional disproportion of the registered unemployment rate was maintained. At the end of 2005, the lowest unemployment rate was recorded in Riga (4.1% of the economically active population), with the highest in Latgale (16.3%). In recent years the number of job seekers shrank in Latgale, with the unemployment rate still remaining high. The number of the unemployed in this region of Latvia decreased as a result of the economically active rural population seeking jobs in other EU countries. A significant share of the population has become economically inactive.

At the end of 2005, the number of the long-term unemployed stood at 20.6 thousand (26.2% of the total number of the unemployed). More negatively, the share of the long-term unemployed in the total number of the unemployed was gradually expanding (to 26.8% on average; 25.9% on average in 2004).

FOREIGN TRADE AND THE BALANCE OF PAYMENTS

The economic growth in Europe, mostly in EU10 countries, was the driving force behind the strengthening demand for Latvian goods in external market. Competitiveness of goods was sustained overall, and Latvian exports expanded rapidly. In 2005, the foreign trade deficit was 7 721.5 million lats (see Table 2). Despite the moderating annual export growth rate in the second half of the year due to the high base effect the increase in exports of goods (33.8%) exceeded that in imports of goods (27.3%). The excess of imports over exports shrank from 77.0% in 2004 to 68.4% in 2005.

Table 2

LATVIA'S FOREIGN TRADE
(exports in FOB prices; imports in CIF prices; in millions of lats)

	2004	**2005**
Exports	2 150.0	**2 877.1**
Imports	3 805.3	**4 844.4**
Balance	–1 655.2	**–1 967.3**

Source: CSB.

In 2005, the highest foreign trade deficit was recorded for the groups of machinery and mechanical appliances, electrical equipment, mineral products and transport vehicles since the year-on-year expansion of imports of the above commodity groups twice exceeded that of exports. The trade surplus of wood and articles of wood edged up somewhat whereas the trade balance of miscellaneous manufactured articles (furniture) turned negative as their imports surged. Foreign trade deficit with all groups of countries increased, except that of "other countries". Imports from EU15 countries posted the highest growth. Of the major trade partners, Latvia retained a positive foreign trade balance with the United Kingdom (198.5 million lats), widened its trade surplus with Ireland, the US and Denmark, and the trade deficit with Estonia contracted.

In 2005, wood and articles of wood (24.8% of total exports), base metals and articles of base metals (13.1%), agricultural and food products (12.3%), mineral products (9.2%), machinery and mechanical appliances, electrical equipment (9.2%), as well as textiles and textile articles (8.7%) were Latvia's major export goods. The largest growth was recorded for exports of mineral products, agricultural and food products, machinery and mechanical appliances, electrical equipment, base metals and articles of base metals, as well as transport vehicles and wood and articles of wood. Rising prices contributed to the increase in exports of wood and articles of wood, miscellaneous manufactured articles (furniture) and textiles and textile articles. The rise in exports of mineral products, prepared foodstuffs, machinery and mechanical appliances, electrical equipment, base metals and articles of base metals, as well as transport vehicles was affected by an increase in volume. In a number of commodity groups (further processed wood, various machinery and electrical equipment, as well as transport vehicles) the growth was on account of higher value added.

In 2005, 76.3% of total exports went to EU countries, with the volume expanding by $^1/_3$ year-on-year. Exports to EU10 countries (mainly Estonia, Lithuania and Poland) contributed the principal share to export growth, with exports to Malta, Cyprus and Hungary also posted a considerable increase. Finland, Denmark and Germany dominated in the export growth to EU15 countries. Wood and articles of wood (29.0% of total exports to the EU), base metals and articles of base metals (13.4%), agricultural and food products (11.2%), mineral products (9.1%) and textiles and textile articles (8.7%) were Latvia's major export goods to EU countries. Exports expanded also to CIS countries, primarily Russia, and other countries (Norway, the US and Switzerland). Exports to CIS countries were dominated by agricultural and food products (21.0% of total exports to this group of countries), machinery and mechanical appliances, electrical equipment (20.8%), products of the chemical and allied industries (15.6%), whereas wood and articles of wood (21.3%), base metals and articles of base metals (19.1%), mineral products (17.9%) and agricultural and food products (10.1%) were major exports to other countries. Latvia's principal export partners for goods were Lithuania (10.9% of total exports), Estonia (10.8%), Germany (10.2%), the United Kingdom (10.2%), Russia (7.9%) and Sweden (7.8%).

Though a gradual rise in the real effective exchange rate of the lats was recorded in 2005, its average value was 1.7% lower than in the previous year. With the nominal effective exchange rate of the lats losing its impact on changes in competitiveness in euro area markets due to the lats repeg to the euro, the former was affected by price rise differential to a greater extent. The price rise differential between Latvia and its major trade partners widened by 3.5%, with the developed countries recording a 4.8% increase.

Compared to 2004, the changes in the real effective exchange rate of the lats against currencies of individual countries were favourable for the exporters' competitiveness in the markets of Russia and Poland (10.9% and 11.6% decrease of the rate, respectively). As regards currencies of other principal trade partners, the real effective exchange rate posted a slight fall or increased somewhat against them. Foreign trade data indicated accelerated export growth to EU10 markets and Russia in comparison with the euro area where the rate of increase in imports exceeded that of exports contrary to general trade flow trends.

In 2005, major import goods were machinery and mechanical appliances, electrical equipment (19.8% of total imports), mineral products (15.6%), agricultural and food products (11.7%), transport vehicles (10.8%), and base metals and articles of base metals (9.2%). Mineral products, machinery and mechanical appliances, electrical equipment, agricultural and food products, and transport vehicles were the largest contributors to import growth. Of mineral products, oil product imports rose markedly under the impact of rising oil prices in the world. Imports of machinery and mechanical appliances, electrical equipment and prepared foodstuffs expanded on account of the growing volume, while the growth in imports of base metals and articles of base metals, and transport vehicles was affected by both factors.

Three fourths to total imports came from EU countries (machinery and mechanical appliances, electrical equipment, agricultural and food products and transport vehicles). Mineral products, base metals and articles of base metals, and wood and articles of wood dominated import growth from CIS countries. Machinery and mechanical appliances, electrical equipment, products of the chemical industry, and agricultural and food products were the major goods imported from other countries. Latvia's principal import partners for goods were Germany (13.8%), Lithuania (13.7%), Russia (8.5%), Estonia (7.9%) and Poland (6.4%).

In 2005, the current account deficit of the balance of payments reached 12.5% of GDP (12.9% in 2004). The current account deficit was persistently high, although the goods and income deficit ratio to GDP shrank over the year, along with the ratio of the surplus of services and current transfers to GDP.

In 2005, the services surplus increased by only 15.9 million lats year-on-year, this growth being underpinned by a larger expansion of services rendered than received. Transportation services contributed to more than one half of the growth in services rendered, whereas travel services accounted for one half of the expansion of services received. Hence, the surplus of transportation services and the deficit of travel services increased. Both exports and imports of other services expanded at a similar extent.

The surplus of transportation services increased by 93.5 million lats, primarily on account of expanding exports of freight transportation services by road and by rail as well as other transportation-related services by sea. As regards total services, the contribution of passenger transportation increased somewhat, with that of freight transportation declining. Of total services, the share of transportation by air grew while that of transportation by sea shrank. The deficit of travel services, in turn, picked up 77.6 million lats, as the spending of Latvia's travellers abroad grew notably despite a 1.7 times larger increase in the number of foreign visitors to Latvia than Latvian travellers abroad, according to data of the CSB. Likewise, the total spending of Latvian travellers abroad (322.0 million lats) in 2005 was considerably higher than that of foreign visitors in Latvia. Visitors from Germany and Russia spent more money in Latvia than other travellers, while Lithuania and Estonia provided the largest number of them.

In the group of other services, a notable rise was recorded in imports of other business, advertising, trade mediation and financial services, while construction services decreased at the same time. The growth in other services imports, on the other hand, was determined by an increase in other business and advertising services as well as information and computer services.

In 2005, income deficit narrowed by 48.3 million lats year-on-year. The contraction was driven by higher income earned by residents abroad, with compensation of employees rising by 91.4 million lats and income from investment (primarily as other investment) picking up 72.6 million lats. Income earned by non-residents in Latvia (mainly from direct investment and other investment) grew by 111.9 million lats.

The surplus of current transfers dropped 37.1 million lats due to government contributions to the EU budget growing to a larger extent than the EU funds received and reported under this item).

In 2005, net inflow of the capital and financial account amounted to 1 251.5 million lats. As the financing received from the EU funds exceeded the amount of the previous year, the surplus of the capital account posted a pickup of 31.0 million lats. The current account deficit was covered by long-term capital (of which one fourth was foreign direct investment).

Net inflow of foreign direct investment (277.5 million lats or 3.1% of GDP) fell 13.8% below the level of the previous year. Primarily in the form of reinvested earnings and equity capital, foreign direct investment inflows from Estonia, Denmark, Russia, Lithuania, Sweden and Norway (in financial intermediation, retail and wholesale trade, electricity, gas and water supply, construction and manufacturing) posted an increase.

Portfolio investment recorded a net outflow of 69.1 million lats. Latvian banks expanded their foreign debt securities portfolios more than non-residents increased their portfolios of securities issued by Latvian banks.

Net inflow of other investment (1 272.7 million lats) in 2005 increased twofold over the previous year. This development was mainly driven by transactions within the banking sector (a net inflow of 1 505.3 million lats). Banks engaged primarily in long-term borrowings from parent banks (1 259.7 million lats). Demand deposits of non-residents with Latvian banks shrank somewhat (by 158.6 million lats). Banks' foreign claims decreased, with banks primarily cutting down their short-term loans to non-residents. The corporate sector pushed up the volumes of demand deposits abroad and short-term trade credit.

With the Bank of Latvia mainly purchasing foreign currency, reserve assets grew by 294.1 million lats in 2005.

FISCAL POLICY

In 2005, the general government consolidated budget posted a surplus of 15.2 million lats or 0.2% of GDP based on the accrual principle used for evaluating compliance with the Maastricht criterion. The financial deficit of the general government consolidated budget, calculated according to the cash flow principle, stood at 113.3 million lats or 1.3% of GDP. In 2005, the ratio of the financial deficit to GDP was lower than in 2004 (1.5% of GDP) and also lower than projected in the budget (1.9% of GDP). It was mostly due to the increase in tax revenue resulting from the high economic growth.

In 2005, the general government consolidated budget revenue reached 3.2 billion lats or approximately 36.0% of GDP. The revenue increased by 675.4 million lats over the year, with its ratio to GDP posting a 1.9 percentage point annual rise. Tax revenue grew by 25.7% in 2005, and payments received from the EU budget surged by 59.2%.

Tax revenue posted an annual increase of 520.7 million lats in 2005. A notable pickup in private consumption fuelled accelerated growth in indirect tax revenue. VAT revenue increased by 190.4 million lats or 39.1%, due to both the rapid rise in private consumption and the low base in 2004 when VAT revenue edged up only 6.0% as a result of amendments to the Latvian legislation. In 2005, excise tax revenue expanded by 77.1 million lats or 32.5% year-on-year. The rise was fuelled by strong private consumption as well as amendments to the legislation (in January 2005 higher excise tax rates on oil products and tobacco products took effect).

Of the direct tax group, the most pronounced growth (41.3%) was observed in corporate income tax revenue resulting from the surging corporate profits. As of January 2005, the monthly untaxed minimum of personal income tax payers and tax relief for a dependent person were raised from 21 lats to 26 lats and from 10.5 lats to 18 lats, respectively; however, due to a notable wage and salary rise in both the public and the private sectors, the personal income tax revenue also picked up (by 73.9 million lats or 17.0%). An increase in wages and salaries also fostered a significant growth in social security contribution revenue (109.8 million lats or 17.1%). In 2005, non-tax revenue edged up by only 19.9 million lats or 9.6% year-on-year.

In 2005, the general government consolidated budget expenditure reached 3.3 billion lats or 37.2% of GDP (a rise of 679.4 million lats or 1.7 percentage points, respectively). The general government consolidated budget expenditure increased notably as a result of a rise in grants to institutions, organisations and enterprises (279.5 million lats or 84.5%). This was a result of disbursements to the EU funding beneficiaries in the private sector, as well as the health care system reform. A considerable increase (133.9 million lats or 53.9%) was observed in capital investment expenditure, partly owing to public investment in projects co-financed by the EU funds. With wages and salaries in the public sector (including teaching staff salaries) increasing, overall wages and salaries posted a considerable rise (102.2 million lats or 19.3%). The pension indexation performed in April and October 2005 and raising the childcare benefit in January 2005 underpinned an increase in grants to the population in the amount of 97.0 million lats or 14.2%.

In 2005, the financial surplus of the central government social security fund stood at 91.1 million lats, including a surplus of 80.4 million lats of the state pension fund resulting from an increase in social security contributions that exceeded the amount of pensions paid.

At the end of 2005, the total debt of the general government stood at 1 046.6 million lats, with a yearly decline of 19.7 million lats. The drop was on account of a 17.6 million lats decrease in external debt due to partial repayment of several World Bank loans and full repayment of Export-Import Bank of Japan rehabilitation loan. Domestic debt shrank by 2.3 million lats. Due to convergence, interest rates on long-term transactions declined, enabling the Government to expand the amount of long-term debt by 15.6 million lats, reducing the medium-term and short-term debt (by 14.9 million lats and 2.9 million lats, respectively).

BANKING SECTOR DEVELOPMENTS

In 2005, all major bank performance indicators continued to improve rapidly, including assets (excluding trust assets), which expanded by 39.4% (to 10 942.9 million lats), loans (including transit credit) and deposits, which grew by 58.9% (to 6 960.3 million lats) and 21.7% (to 6 200.4 million lats), respectively. Banks' profit totalled 193.1 million lats (66.4% higher than in 2004). The banks' equity grew by 32.5%, amounting to 833.5 million lats at the end of the reporting period.

In 2005, loans continued to gain importance in the structure of the banks' assets, reaching 63.6% (lending to households accounted for 22.8% of the banks' assets), whereas the share of claims on MFIs contracted (to 17.6%).

At the end of 2005, the banks' liquid assets (vault cash, claims on the Bank of Latvia and other MFIs, Government securities) accounted for 26.7% of total assets, ensuring adequate liquidity to settle depositors' claims. Of liquid assets, 43.9% were claims on MFIs of the OECD countries.

Compared to the end of 2004, the share of long-term loans granted to non-MFIs (with a maturity of over 5 years) increased from 45.6% to 48.3% of the loan portfolio, whereas the share of short-term loans (with a maturity of up to 1 year) declined from 16.5% to 15.3%.

In 2005, the share of non-MFI deposits in the banks' liabilities declined by 8.8 percentage points (56.7% at the end of 2005), whereas liabilities to MFIs grew by 8.8 percentage points (to 29.9%).

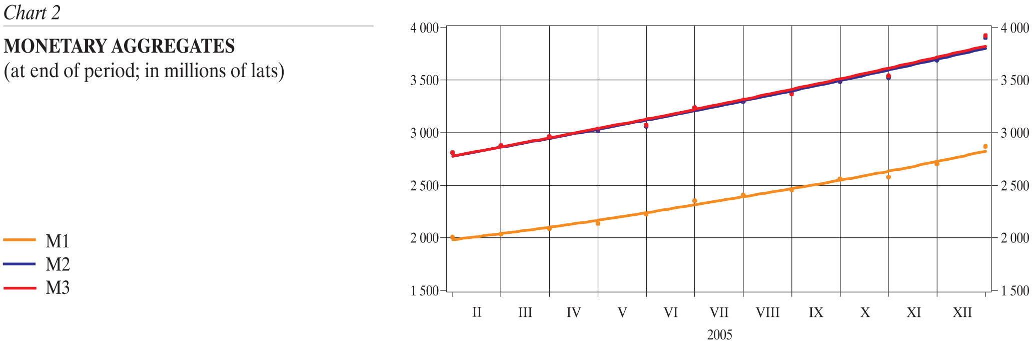
Non-MFI deposits with banks expanded at a much lower rate than loans in 2005. With the share of short-term deposits in total deposits attracted by banks growing (from 22.5% to 23.7%), overnight deposits decreased by 1.6 percentage points (to 70.6%), whereas medium-term deposits (1 to 5 years) remained unchanged (4.7%).

MONEY SUPPLY

The principal monetary aggregates of Latvia's MFIs (including the Bank of Latvia) are reflected in Appendix 1 of the Report. In 2005, money supply M3 increased by 39.3% (by 26.7% in 2004), amounting to 3 925.4 million lats at the end of the year (see Chart 2). The growth of the money supply accelerated as a result of buoyant economic growth and persistent inflation rate. The growth rate of broad money picked up gradually over the year (in the first half of 2005, M3 increased by 15.0%; by 21.1% in the second half of 2005), with an especially rapid expansion (215.5 million lats or 5.8%) observed in December, when deposits of MFIs (except the Bank of Latvia) increased significantly and the seasonal factors pushed up the demand for cash.

Chart 2

MONETARY AGGREGATES
(at end of period; in millions of lats)



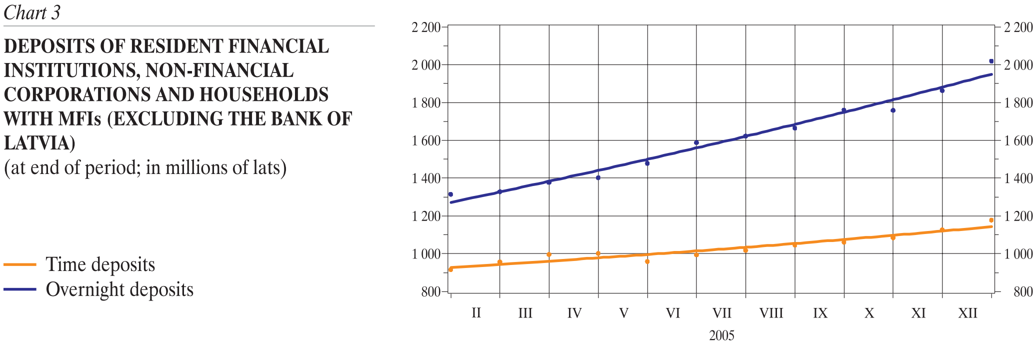
The monetary aggregate M1 grew by 43.5% in 2005. This was supported by expansion of currency outside MFIs by 141.0 million lats or 21.8% and a rise in overnight deposits with MFIs in all currencies by 729.1 million lats or 53.8%. M2 increased by 38.7%, with deposits redeemable at a period of notice of up to and including three months made in all currencies and deposits with an agreed maturity of up to and including two years in all currencies held with MFIs growing by 34.8 million lats or 48.4% and 184.4 million lats or 24.8%, respectively. Additional components comprised in M3 remained low. Money market fund shares/units amounted to 16.1 million lats at the end of the year, whereas debt securities of a maturity of up to and including two years issued by MFIs to 3.4 million lats. So far, the Latvian banks have conducted no repos meeting the M3 definition.

Rapid lending expansion notwithstanding, the money multiplier decreased to stand at 2.91 in December 2005 (2.94 in December 2004). Economic stability and growing savings facilitated deceleration of the velocity of money from 2.6 in 2004 to 2.3 in 2005.

Growth of deposits was supported by several factors, including higher real income of the population, MFI development and increasing application of electronic payment instruments, overall economic growth and rapid lending expansion. Thus, deposits of resident financial institutions, non-financial corporations and households increased by 975.8 million lats or 43.9% in 2005 (see Chart 3; by 564.8 million lats or 34.1% in 2004). Although currency outside MFIs expanded considerably (in 2005, its growth rate exceeded that of 2004 almost three times), the cash component of the broad money M3 declined to 20.0% at the end of 2005 (22.9% at the end of 2004), with deposits growing accordingly. The share of overnight deposits in total deposits rose to 63.2% (58.3% at the end of 2004), the share of deposits with an agreed maturity of up to six months also increased slightly, whereas that of longer-term deposits contracted from 23.9% to 18.8%. The share of household deposits in resident deposits continued to grow, amounting to 58.2% of all resident deposits (57.9% at the end of 2004). Household deposits accounted for 68.0% of time deposits and 52.6% of overnight deposits.

Chart 3

DEPOSITS OF RESIDENT FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS WITH MFIs (EXCLUDING THE BANK OF LATVIA)
(at end of period; in millions of lats)



Although lats deposits had slightly higher yield rates in 2005, foreign currency deposits expanded more intensively, with the annual increase of deposits in lats and foreign currencies amounting to 38.4% and 52.9%, respectively. The growing significance of the euro in the Latvian economy, its dominance in lending and the fixed exchange rate against the lats contributed to a notable increase in deposits made in this particular currency. In 2005, resident non-MFI deposits made in euro grew by 65.6%. The US dollar exchange rate volatility and persistently narrowing use of this currency in domestic transactions underlay an annual rise in the US dollar deposits by a mere 17.9%. At the end of 2004, deposits in the US dollars accounted for 42.0% of resident non-MFI deposits made in foreign currencies, whereas at the end of 2005 their share was 34.1%. The share of deposits made in euro grew accordingly (from 55.8% to 63.6%). Overall, deposits made in lats constituted 59.4% of all deposits at the end of 2005 (61.8% at the end of 2004).

Growth of the overall money supply and the monetary aggregate M2X calculated according to the Bank of Latvia's methodology (38.9%; 27.0% in 2004) was broadly similar to the M3 developments.

Negative net foreign assets of MFIs grew by 1 095.6 million lats in 2005, although the Bank of Latvia's net foreign assets continued to expand, reaching an all-time-high of 1 390.2 million lats at the end of the year. The negative net foreign assets increased, as loans received from non-resident banks (mainly parent banks) were used to grant domestic loans. In 2005, foreign liabilities of MFIs (excluding the Bank of Latvia) grew by 1 812.0 million lats, including an increase of 1 594.4 million lats in liabilities to non-resident MFIs (of which, liabilities to associated and affiliated MFIs rose by 1 088.8 million lats) and a rise of 176.6 million lats in non-resident non-MFI deposits. The increase in foreign assets of MFIs (excluding the Bank of Latvia) was considerably lower (365.5 million lats), with claims on foreign MFIs expanding by 240.2 million lats (including an increase of 156.4 million lats and 54.0 million lats in outstanding loans and investment in private sector debt securities, respectively). Claims on non-resident MFIs grew by 103.8 million lats (including investment in debt securities of foreign MFIs by 120.3 million lats and overnight deposits by 85.3 million lats). Thus, the negative net foreign assets of MFIs (excluding the Bank of Latvia) grew by 1 446.5 million lats at the end of 2005 year-on-year.

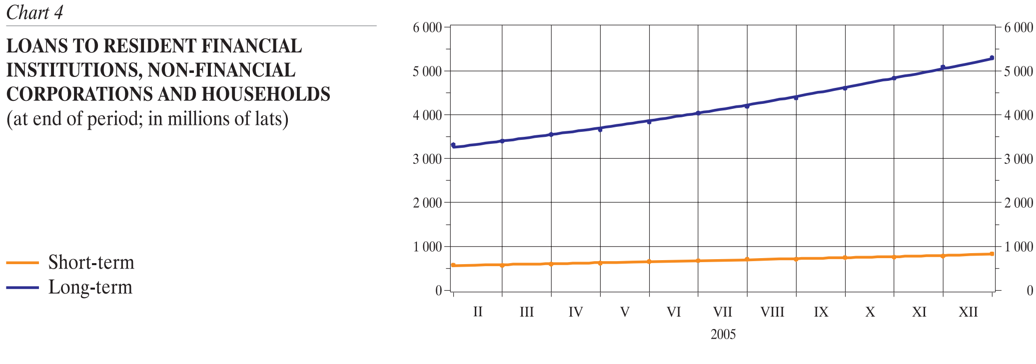
Growth of the money supply was increasingly more driven by the expansion of domestic lending. In 2005, loans granted to residents increased by 2 409.3 million lats or 57.6%, including loans granted to financial institutions, non-financial corporations and households by 2 402.7 million lats or 64.3% (1 194.5 million lats or 47.0% in 2004). This is the highest annual growth rate of lending since 1997. The rapid lending development has supported a persistently high inflation rate and current account deficit of the balance of payments by stimulating a notable build-up of domestic demand, thus causing concerns about aggravation of risks caused by imbalanced economic development. At the end of 2005, MFI (excluding the Bank of Latvia) exposure to resident financial institutions, non-financial corporations and households reached 56.0% (47.6% at the end of 2004).

With the general government consolidated budget deficit growing, net MFI claims on the Government increased by 53.6% (to 266.3 million lats).

With the real estate market continuing to develop buoyantly and the level of prices rising, mortgage lending remained the most significant type of lending and the main determinant of the predominance of long-term loans in total loans in 2005. Long-term loans granted to resident financial institutions, non-financial corporations and households increased by 2 116.3 million lats or 66.4%, whereas the same short-term loans expanded by 286.9 million lats or 52.2% (for monthly amounts outstanding, see Chart 4). At the end of 2005, long-term loans accounted for 86.4% of total loans granted (85.3% at the end of 2004).

Chart 4

LOANS TO RESIDENT FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS
(at end of period; in millions of lats)

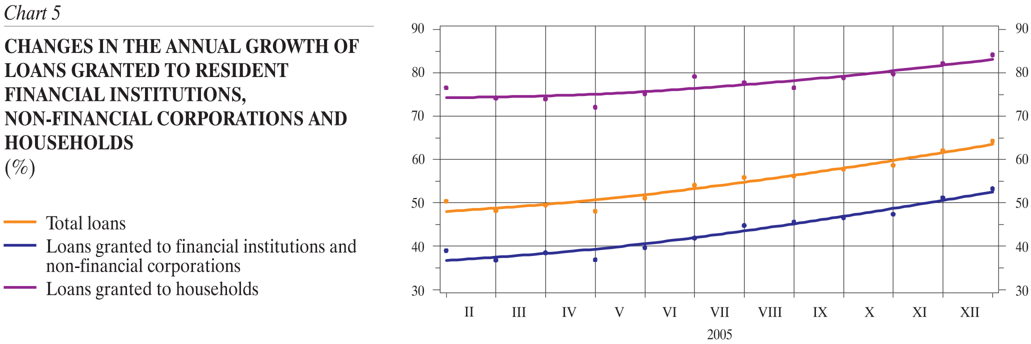


The annual growth rate of mortgage lending climbed to 101.6% in 2005 (80.2% in 2004), whereas the outstanding mortgage loans increased by 1 414.6 million lats (to 2 806.8 million lats or 45.7% of total outstanding loans). Commercial credit grew by 617.4 million lats or 61.7% in 2005 (by 30.1% in 2004). In 2005, industrial credit also expanded significantly (by 284.1 million lats or 39.5%; by 36.3% in 2004) as did consumer credit (by 71.9 million lats or 37.2%; 34.7% in 2004). The growth rate of commercial credit and consumer credit was affected by a change in statistics methodology whereby, from 2005 onward, the overdraft facilities of financial institutions and non-financial corporations fall within the category of commercial credit, whereas household overdraft is classified as consumer credit.

Both lending to businesses (financial institutions and non-financial corporations) and lending to households expanded at a rapid but even pace (see Chart 5). The annual growth rate of loans granted to financial institutions and non-financial corporations grew from 35.1% in 2004 to 53.3% in 2005. The corresponding rate for household loans increased from 74.8% to 84.2%. The rise in loans granted to financial institutions and non-financial corporations (1 282.1 million lats) was 161.5 million lats higher than that in loans granted to households. The persistently high growth rate of lending to households was primarily driven by the significant expansion of loans for house purchase (1.9 times). At the end of 2005 those loans amounted to 1 749.7 million lats or 71.4% of total loans granted to households (69.3% at the end of 2004).

Chart 5

CHANGES IN THE ANNUAL GROWTH OF LOANS GRANTED TO RESIDENT FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS
(%)



Corporate loans expanded mainly on account of real estate, renting and business activities (an increase of 499.2 million lats or 2.2 times) and financial intermediation (313.1 million lats or 1.8 times), comprising 43.7% of the total loans at the end of 2005. Loans grew significantly in construction (by 128.8 million lats or 1.7 times), manufacturing (by 98.2 million lats or 26.4%) and trade (by 78.6 million lats or 17.7%).

Lower lending rates determined the dominance of euro denominated loans in total loans. In 2005, resident non-MFI loans in the national currency increased by 383.8 million lats or 25.8% (by 27.7% in 2004), whereas loans granted in euro expanded by 2 436.0 million lats or 3.0 times (2.4 times in 2004). Growing interest rates an the repegging of the lats from the SDR basket of currencies to the euro resulted in a sharp decline in the US dollar denominated loans, which contracted by 387.9 million lats or 35.7% in 2005. Thus the share of resident non-MFI loans granted in lats declined by 9.1 percentage points in 2005 (30.1% at the end of 2005) and those granted in the US dollars by 17.3 percentage points (to 11.2%), whereas the share of loans granted in euro increased by 26.7 percentage points and amounted to 58.6% of outstanding loans.

LOAN AND DEPOSIT INTEREST RATES

Overall, interest rates on lats loans granted to resident non-financial corporations and households and on deposits received from this particular customer group were lower in 2005 than in 2004. Interest rates on foreign currency loans and deposits followed opposite trends, with euro transaction rates diminishing and US dollar transaction rates growing. Interest rates on loans and deposits in lats underwent a particularly sharp decline in the second quarter and continued to shrink also in the second half of 2005, albeit at a more moderate rate (see Charts 6 and 7). The decrease in the interest rates on lats transactions is underpinned by the lats repegging to the euro and the lats interest rates convergence with the euro interest rates. As a result, the lats money market indices, to which the interest rates on the majority of lats loans are linked, declined. Interest rates on foreign currency loans and deposits developed in line with the trends on the respective foreign exchange markets. Overall, weighted average interest rates on new foreign currency loans shrank in 2005, as the majority of the new loans were granted in euro. Weighted average interest rates on new deposits followed on an upward trend, as the growth of the interest rates on the US dollar deposits outpaced the decline in interest rates on euro deposits. The increase of the interest rates on the US dollar deposits was supported by the tight monetary policy implemented by the FRS by regularly raising the federal funds rates.

Chart 6

WEIGHTED AVERAGE INTEREST RATES ON NEW LOANS TO RESIDENT NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS
(%)

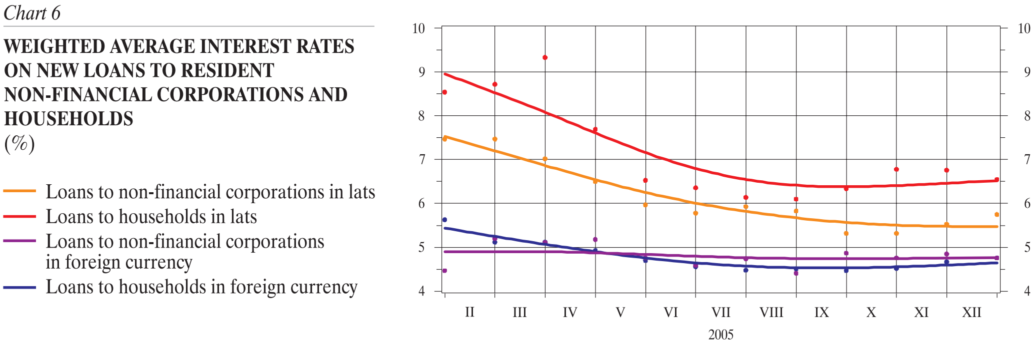
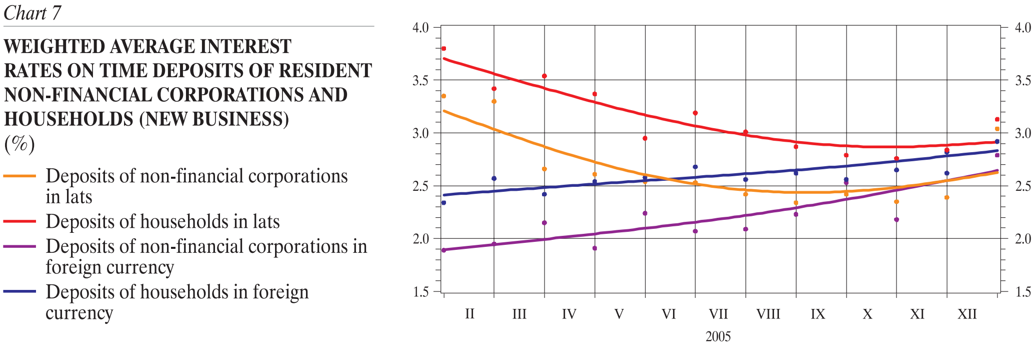


Chart 7

WEIGHTED AVERAGE INTEREST RATES ON TIME DEPOSITS OF RESIDENT NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS (NEW BUSINESS)
(%)



In 2005, the downslide of the lending rates was fuelled by bank competition causing the banks to offer increasingly better lending conditions, including lower bank margins on loans. In 2005, bank margins decreased for loans in all currencies. Interest rates applied by MFIs in deposit and lending transactions with households were generally higher than those applied in transactions with non-financial corporations.

Weighted average interest rates on new lats loans granted to resident non-financial corporations and households decreased by 1.6–2.9 percentage points (from 7.3% in December 2004 to 5.7% in December 2005 and from 9.5% to 6.6% for non-financial corporations and households, respectively).

Weighted average interest rates on new foreign currency loans, in turn, were 0.4–0.5 percentage point lower in December 2005 year-on-year (4.8% for both loans granted to non-financial corporations and households). By currency, interest rates on euro-denominated loans decreased by 0.6 percentage point for both non-financial corporations and households, whereas those on the US dollar loans grew by 1.3 and 2.3 percentage points, respectively.

In 2005, the majority of new loans (about 90%) were again granted with a floating interest rate and initial interest rate fixation period of up to one year. After re-pegging of the lats to the euro and diminishing of the lats foreign exchange risk vis-à-vis the euro, the share of euro loans in new loans expanded notably (to about 60%), partly driven by changing the loan currency of the previously granted US dollar and lats loans to the euro. As a result, the share of the lats and US dollar denominated loans in new loans contracted.

In the first eleven months of 2005, interest rates on time deposits received from resident non-financial corporations and households decreased by 0.9 percentage point and 1.4 percentage points (to 2.4% and 2.8%), respectively; nevertheless, in December they rebounded significantly (to 3.0% and 3.1%, respectively). The increase of the deposit rates in December was related to the growing lats interest rates on the money market, supported by the Bank of Latvia gradually raising the banks' reserve ratio.

Weighted average interest rates on foreign currency time deposits increased by 0.5–0.7 percentage point in 2005 (to 2.8% on deposits from non-financial corporations and to 2.9% on household deposits). By currency, interest rates on time deposits in the US dollars received from non-financial corporations and households grew by 1.8 percentage points during the year, whereas those on time deposits in euro declined by 0.5 and 0.4 percentage point, respectively.

Most new time deposits of resident non-financial corporations and households (about 97%) were with a maturity of up to one year. About a half of them were time deposits made in lats.

With inflation remaining rather high, real interest rates on the lats loans with a floating interest rate and initial interest rate fixation period of up to one year contracted sharply and became negative, whereas those on loans with initial interest rate fixation period of over one year decreased by 0.4 percentage point (to 2.5%). Real interest rates on time deposits in lats remained negative in 2005.

INTERBANK MARKET

In 2005, the amount of interbank loans granted to domestic banks grew by 24.8% (to 15.6 billion lats). With the Latvian financial market remaining stable, the share of transactions with a maturity of over one day increased from 17.2% in 2004 to 21.2% in 2005.

After a rather considerable increase in 2004 resulting from significant interventions by the Bank of Latvia on the foreign exchange market, in 2005 domestic interbank transactions in lats remained on the level of the previous year. This was related to a considerable increase in the banks' minimum reserve requirements, resulting in a rise in lats deposits to be held by banks on accounts with the Bank of Latvia. After repegging the lats to the euro, euro loans granted on the domestic interbank market grew 1.9 times, whereas transactions in the US dollars increased 1.5 times. The share of lats in the domestic interbank loans amounted to 44.0% and that of the US dollars and euro to 35.0% and 18.0%, respectively.

The growth of non-resident MFI loans (by 14.1%; to 160.5 billion lats) decelerated.

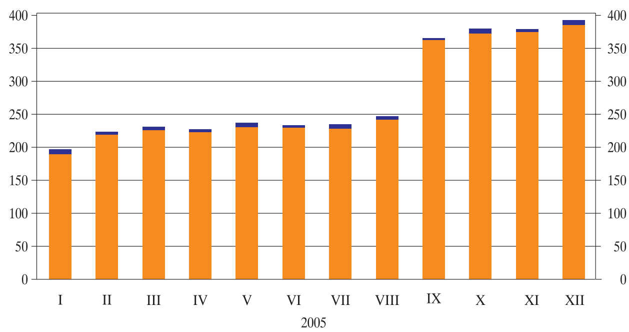
After repegging of the lats to the euro at the beginning of 2005, the influence of the euro money market interest rates on the lats money market interest rates strengthened. Therefore, the domestic interbank market rates on the lats transactions shrank and the weighted average annual interest rate on the marginal lending facility was 2.53% or 0.73 percentage point lower than in 2004. The ECB's decision to raise the base rate to 2.25%, priced into longer-term euro money market instruments in advance, dampened the interest about comparable lats instruments. In December 2005, RIGIBOR for transactions with a 3-month maturity was 3.16%, whereas that on transactions with a 6-month maturity stood at 3.21% (1.23 and 1.12 percentage points lower than in 2004, respectively).

MONETARY BASE

With the Bank of Latvia raising the banks' reserve ratio and expanding the reserve base and deposits with banks growing, minimum reserves held by banks on reserve accounts with the Bank of Latvia increased significantly (see Chart 8). Thus, deposits from MFIs and other financial institutions held by the Bank of Latvia grew by 243.6 million lats or 2.1 times in 2005 (1.8 times in 2004). Demand for cash also rose rapidly (currency in circulation grew by 149.9 million lats or 20.6% in 2005; by 6.6% in 2004). As a result, the central bank's money supply or monetary base M0 increased at a considerably quicker pace than in 2004 (by 41.1% in 2005) and totalled 1 350.7 million lats at the end of the period (see Chart 9), whereas

Chart 8

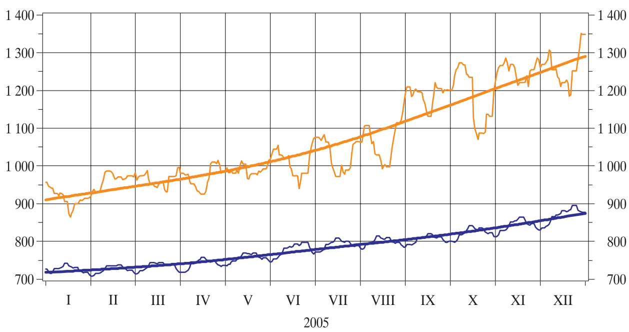
BANK RESERVES WITH THE BANK OF LATVIA
(in millions of lats)



Minimum reserves with the Bank of Latvia
Excess reserves

Chart 9

MONETARY BASE
(in millions of lats)



Monetary base
Currency in circulation

the cash component of the monetary base shrank to 65.0% (76.0% at the end of 2004).

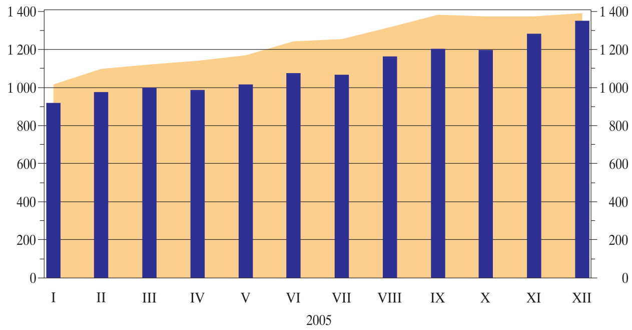
The growth in the monetary base was mainly underpinned by an increase in net foreign assets of the Bank of Latvia (350.9 million lats or 33.8%), with the Bank of Latvia purchasing foreign currency in the total amount of 351.8 million lats. Extensive sales of foreign currency to the Bank of Latvia were related to several factors. The demand for lats was determined by the growing share of euro loans in new loans after repegging of the lats and their subsequent conversion into the lats, as well as by the Bank of Latvia raising the minimum reserve requirements for banks by increasing the minimum reserve ratio in the second half of 2005 first from 4% to 6% and then from 6% to 8%, in order to dampen the excessively rapid growth of lending. Moreover, foreign currency sales to the Bank of Latvia were boosted by foreign investment and foreign financial assistance inflows in the economy and a positive spread between interest rates on transactions in lats and those in euro.

The Bank of Latvia offered the banks foreign exchange swaps; however, there was no demand. At the end of 2005, the Bank of Latvia's net foreign assets covered goods imports of about 3.5 months (of 3.3 months at the end of 2004), while the backing of the national currency with the Bank's net foreign assets reached 102.9% (see Chart 10; 108.6% at the end of 2004).

Chart 10

BACKING OF THE NATIONAL CURRENCY
(in millions of lats)

Net foreign assets of the Bank of Latvia
Monetary base



Overall, the changes in the Bank of Latvia's net domestic assets were less pronounced (their negative value decreased by 42.6 million lats), as domestic loans expanded. In the domestic loan portfolio, lending to banks increased slightly (by 10.4 million lats), mainly on account of growing net credit to the Government (Government deposits with the Bank of Latvia contracted by 38.8 million lats, whereas the Government securities portfolio held by the central bank expanded by 5.6 million lats).

As banks provided liquidity mainly by selling foreign currencies, the demand for the Bank of Latvia's loans weakened. The central bank's total loans to MFIs (230.8 million lats) were 9.4 times smaller than in 2004, with the demand for repo loans sharply deteriorating (11.3 times) and the amount of Lombard loans decreasing 1.9 times.

Of the Bank of Latvia's loans to MFIs, repo loans accounted for 79.0% (94.7% in 2004) and the share of demand Lombard loans was 21.0% (for monthly average amounts outstanding, see Table 3). There was no demand for automatic Lombard loans. Mainly repo loans of 7-day and 28-day maturities were granted (in the amount of 122.1 million lats and 60.2 million lats, respectively).

Table 3

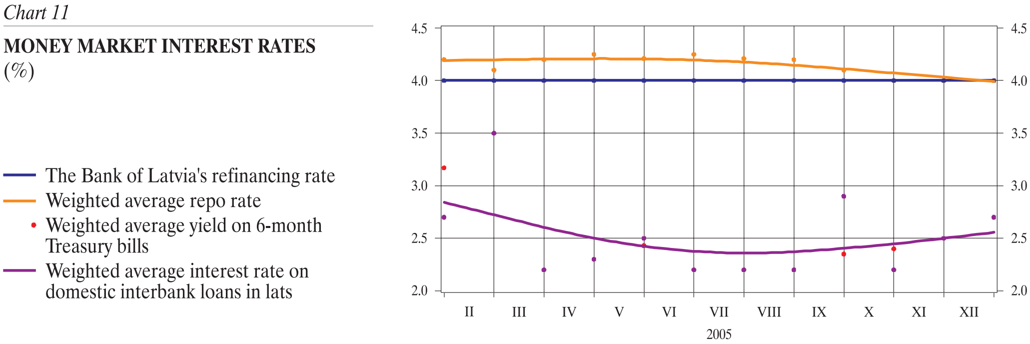
THE BANK OF LATVIA'S LOANS TO MFIs
(average balances; in millions of lats)

	2004	**2005**
January	55.9	**8.9**
February	39.7	**12.9**
March	61.3	**8.6**
April	50.4	**9.7**
May	19.2	**10.5**
June	10.0	**7.4**
July	23.2	**5.6**
August	71.7	**3.7**
September	67.6	**9.2**
October	96.3	**4.0**
November	38.6	**2.8**
December	28.1	**4.2**

The Bank of Latvia did not change the refinancing rate in 2005 (4.0%). Weighted average repo rate was broadly similar with the refinancing rate: 4.2%–4.3% in the first half of the year and 4.0% in the last months of 2005 (see Chart 11).

Chart 11

MONEY MARKET INTEREST RATES
(%)



THE FOREIGN EXCHANGE MARKET AND LATVIA'S EXTERNAL DEBT

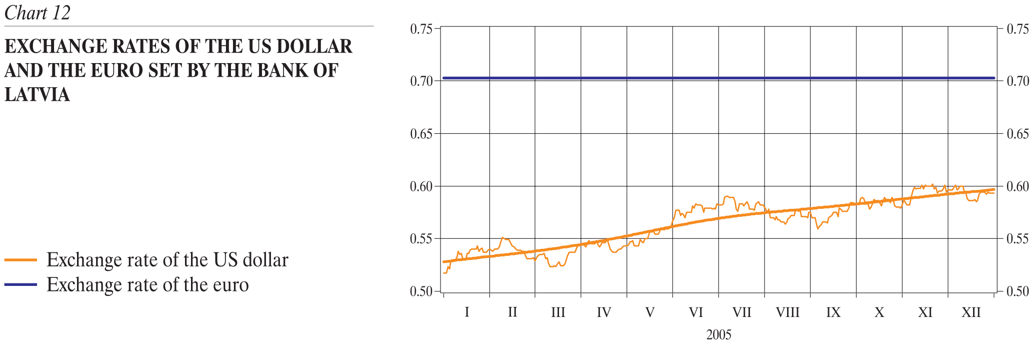
In 2005, the US dollar appreciated against other major currencies on the global foreign exchange market, mainly as a result of growing short-term interest rates on the US interest rate market, relatively successful economic development and repatriation of the foreign earnings of the US commercial corporations. The EU Member States reported rather sluggish growth rates. Following a longer period of stagnation, the Japanese economy continued the recovery trend observed in the last few years, which could cause deflation turn into inflation in the nearest future. With private spending falling, the GDP growth rate in the UK decelerated considerably and the current account deficit increased rapidly in the second half of 2005.

In 2005, the euro depreciated by 12.6% against the US dollar (from 1.3554 at the end of 2004 to 1.1849 at the end of 2005), reaching its low on November 15 (1.1640). The US dollar appreciated by 14.7% against the Japanese yen (from 102.63 at the end of 2004 to 117.75 at the end of 2005), reaching its high on December 5 (121.40). The British pound sterling depreciated by 10.2% against the US dollar in 2005 (from 1.9181 at the end of 2004 to 1.7230 at the end of 2005), reaching its low on November 28 (1.7049).

The US dollar appreciated against the lats on the domestic foreign exchange market (from 0.5155 at the end of 2004 to 0.5877 at the end of 2005; a 14.0% increase). The US dollar peaked on November 15 (0.5983), whereas the lowest exchange rate was recorded on January 3 (0.5131) (for the most significant developments of the exchange rates as set by the Bank of Latvia, see Chart 12 and Appendix 5).

Chart 12

EXCHANGE RATES OF THE US DOLLAR AND THE EURO SET BY THE BANK OF LATVIA



According to the international investment position data, Latvia's external debt to non-residents increased by 2 124.0 million lats in 2005, totalling 9 000.2 million lats (101.1% of GDP) at the end of the year. Foreign assets totalled 5 810.5 million lats and net external debt amounted to 3 189.7 million lats (35.8% of GDP). In 2005, Latvian Government and central bank's liabilities to non-residents decreased by 26.5 million lats, the banking sectors' liabilities grew by 1 846.6 million lats, those of the other sectors by 225.1 million lats and debt-related direct investment by 78.9 million lats. Consequently, the external debt composition by sector changed, with the share of banks' liabilities in the total external debt increasing to 67.7% (61.8% in 2004) and that of the Latvian Government and the central bank as well as other sectors debt shrinking to 6.6% and 17.2% (9.0% and 19.2% in 2004), respectively.

The breakdown of the external debt by instrument changed in 2005, with loans expanding from 39.1% to 49.9% and the share of other debt instruments shrinking. At the end of 2005, debt-related direct investment, debt securities, currency and deposits and other investment amounted to 8.6%, 5.9%, 28.1% and 7.5% of the external debt, respectively. At the end of the 2005, long-term and short-term debt totalled 4 557.2 million lats and 4 443.0 million lats, respectively.

The banking sector's external debt amounted to 6 092.7 million lats at the end of 2005. The maturity profile of the banks' foreign liabilities changed considerably, with the banks increasing the attracted long-term financing (by 133.9%) to amount to 2 363.5 million lats or 38.8% of the banks' external debt at the end of 2005 (23.8% at the end of 2004). Although the share of currency and deposits remained high (41.4%; 56.7% at the end of 2004), loans from parent corporations expanded considerably (to 32.9%; 21.6% at the end of 2004). Net external debt of the banking sector amounted to 2 793.0 million lats at the end of 2005.

At the end of 2005, the external debt of other sectors was 1 544.5 million lats (including long-term liabilities in the amount of 835.9 million lats and short-term liabilities in the amount of 708.6 million lats). Although foreign liabilities increased by 17.1% in 2005, their structure remained broadly unchanged. The other sectors attracted foreign financial funds primarily through loans (59.1% of other sectors' external debt) and trade credit (39.4%). Other sectors' and banks' debt liabilities to direct investors increased gradually as well. In 2005, they amounted to 769.7 million lats.

According to the Treasury data, the Government external debt in foreign currencies declined by 17.6 million lats over 2005 and amounted to 534.4 million lats (6.0% of GDP) at the end of the year. The Government received foreign financing in the amount of 24.8 million lats in 2005. 72.4 million lats, equalling 1.7% of annual exports, were used to service foreign debt (including 27.9 million lats for early repayment of the World Bank and Export-Import Bank of Japan loans). The euro liabilities of the Government continued to grow (from 89.2% to 92.8%), whereas the US dollar liabilities shrank (from 9.2% to 7.1%).

SECURITIES MARKET

Since July 2005, the primary placement of the Latvian Government securities is organised exclusively by the RSE (previously, competitive multi-price auctions were held by the Bank of Latvia).

In 2005, the amount of securities supplied by the Treasury on the domestic primary market was broadly the same as in 2004. Government securities were supplied in the amount of 108.0 million lats at competitive multi-price auctions. The banks' bids amounted to 298.4 million lats (39.8% higher year-on-year). The amount of securities allotted at competitive multi-price auctions (87.7 million lats) was 20.0% higher than in 2004. Demand from banks increased as a result of the high lats money market liquidity, with both the total amount of Government and private securities still remaining relatively low in Latvia.

At fixed rate auctions, the supply totalled 27.0 million lats, bids 67.2 million lats, and the allotted amount 25.2 million lats (all figures higher than in 2004).

Overall yield rates of the Government securities decreased also as a result of the convergence of the lats money market rates with the euro interest rates. In the second half of 2005, interest rates increased under the impact of the Bank of Latvia's monetary policy decisions to raise the minimum reserve ratio as well as increasing of the euro base rate.

The weighted average discount rate of 6-month Treasury bills dropped from 3.46% in 2004 to 2.37% in 2005. The weighted average discount rate of 12-month Treasury bills declined from 3.56% to 2.61%, respectively. The average yield on 10-year bonds declined from 4.86% to 3.62%, whereas the average yield on 5-year bonds, which was 4.65% in 2003, dropped to 3.40% in 2005. The lowest level of interest rates at primary auctions of securities was observed during the summer months of 2005, whereas at the end of the year they picked up again (e.g. the weighted average discount rate on 12-month Treasury bills, the instrument with the highest number of auctions organised in 2005, increased by 36 basis points in December over July).

In 2005, the amount of Government securities outstanding decreased by 0.6% (to 423.0 million lats). Government securities holdings of Latvian banks shrank from 50.5% to 40.4% of total outstanding amount at the end of 2005 year-on-year, whereas the share of the Bank of Latvia's Government securities portfolio increased from 23.5% to 27.3%, the share Government securities held by other residents from 21.8% to 27.4% and that held by non-residents from 4.2% to 4.9%.

Publicly traded corporate debt securities, denominated in lats and registered with the LCD, grew by 6.3% (to 81.1 million lats) in 2005. Two issues of the State JSC *Latvijas Hipotēku un zemes banka* and JSC *SEB Latvijas Unibanka* bonds amounting to 10.9 million lats matured. Three new issues of the JSC *SEB Latvijas Unibanka* deposit certificates totalling 3.6 million lats and maturing in 2006 were launched as well as one issue of the State JSC *Latvijas Hipotēku un zemes banka* (3 million lats), one of the JSC Baltic Trust Bank (3 million lats) and one of the JSC *Parex banka* (5 million lats) bonds. The last three bond issues have maturities of 3–5 years; two issues were launched with a floating interest rate and one with a fixed interest rate. As the lats long-term interest rates declined considerably in 2005, some banks attempted to attract long-term lats liquidity by issuing bonds.

In 2005, the turnover of debt securities on the RSE was 5.1 million lats (103.0 million lats in 2004). Government securities in the amount of 2.9 million lats, State JSC *Latvijas Hipotēku un zemes banka* mortgage bonds in the amount of 0.9 million lats, JSC Baltic Trust Bank and JSC *Parex banka* debt securities in the amount of 0.7 million lats and 0.6 million lats, respectively, were traded. 5-year Government bonds posted the highest turnover: the third issue of 5-year bonds was traded in the amount of 1.1 million lats, whereas the fourth issue in the amount of 0.7 million lats.

Shrinking of the turnover of debt securities on RSE primarily reflected two factors: implementation of the new common trading platform SAXESS in September 2004 and an increase in the debt securities held by pension funds. SAXESS is more suitable for stock trading, and after its implementation the market participants' willingness to trade in debt securities within the RSE system diminished. The expansion of pension funds determines the increase of the share of lats-denominated debt securities in the assets of those funds. As pension funds are generally long-term investors, this decreases the debt securities available for free trading.

In 2005, the bid rate quoted for 10-year Treasury bonds (maturing in 2014) shrank from 4.45% to 3.42%, whereas the bid rate for 12-month Treasury bills from 3.38% to 2.77%. The bid rate on 10-year bonds of the State JSC *Latvijas Hipotēku un zemes banka* (maturing in 2013) diminished from 5.25% to 4.80%.

The rates contracted as a result of decreasing yield rates of long-term Government securities at primary auctions and convergence process with the euro yield rates. In 2005, the yields of the euro area 10-year Government securities shrank, whereas those of the 5-year Government securities increased.

The bid rate quoted for Latvian eurobonds (maturing in 2014) decreased from 3.84% to 3.40% in the 2005. The spread between the Latvian eurobonds and same maturity German eurobonds narrowed from 25 to 20 basis points.

In 2005, the stock market continued to develop buoyantly, with the RSE capitalisation index OMX Riga (previously RIGSE) rising by 63.5% (to 676.4 points). Overall, Latvian stock market capitalisation grew by 643 million lats (to 1 492 million lats). The growth of the Baltic States stock index BALTIX was a bit more moderate (49.9%; to 604.5 points). Latvian stock market growth was supported by sound corporate financial results and the future development plans of those corporations. Some corporations raised additional funds by issuing shares and thus facilitating investment into development and increasing the potential liquidity of the respective shares.

RSE stock market turnover was 8.0% lower year-on-year (54 million lats). The most actively traded shares was that of the JSC *Grindeks* (12 million lats) and JSC *Latvijas Kuģniecība* (11 million lats).

At the end of 2005, shares of 45 corporations were quoted on the RSE, including five corporations were listed on the Main list, seven corporations were included on the I-List, and 33 corporations on the Free list. JSC *Grindeks* was moved from the I-List to the Main list of the RSE, while one corporation was crossed off and seven corporations included on the Free list. The Liquidity providers list was supplemented with the JSC *SEB Latvijas Unibanka*. Thus, four financial intermediation corporations have undertaken to provide liquidity for the shares of 11 corporations quoted on the RSE.

Ieva Iltnere
TWO LETTERS. 1998
Oil on canvas. 80 x 93 cm

CENTRAL BANK OPERATIONS AND ACTIVITIES

THE BANK OF LATVIA IN THE EUROPEAN SYSTEM OF CENTRAL BANKS

In 2005, the Bank of Latvia continued to operate within the ESCB. The Governor of the Bank of Latvia participated in the ECB General Council meetings on a regular basis. In compliance with the Statute of the ESCB and ECB, the ECB General Council meetings discussed macroeconomic, monetary and financial developments in the EU, reports on functioning of the ERM II, further elaborated the framework for preparation of the future convergence reports as well as addressed other issues concerning the central banks of all EU Member States.

The Bank of Latvia representatives continued to participate in 12 ESCB committees (see Appendix 8) and more than 30 working groups, dealing with issues related to monetary policy, banking supervision, euro banknotes, statistics, accounting, market operations, payment systems, international relations and other issues.

The Bank of Latvia, FCMC and Ministry of Finance of the Republic of Latvia along with the central banks, supervisory authorities and ministries of finance of other EU countries signed the Memorandum of Understanding on co-operation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations (in effect as of July 1, 2005). This Memorandum of Understanding establishes a set of principles and procedures providing for the exchange of information, views and assessments, in order to enable the involved public institutions to maintain the stability of the financial system.

The Bank of Latvia experts also participated on several committees and working groups of the Council of the EU and the EC. Sitting on the Economic and Financial Committee of the EU Council and its sub-committees, the representatives of the Bank of Latvia regularly participated in the decision-making concerning the economic and financial development of the EU, discussed the preparation of the EU10 countries for the euro changeover, relations with the third countries and policies of international financial institutions as well as drafted proposals addressing the economic policy strategy and instruments in conjunction with other EU Member States.

The Bank of Latvia representatives continued to work on the EC and Eurostat working groups dealing with the issues of euro coins, payment systems, economic forecasting and statistics and also participated in the CEBS, preparing joint banking supervision standards for the EU Member States.

In compliance with the provisions of the Statute of the ESCB and ECB, the Bank of Latvia ensured preparation for publishing in Latvian of the ECB Annual Report 2004 and translation of the quarterly version of the ECB's Monetary Bulletin (published on the Internet).

FOREIGN EXCHANGE POLICY AND FOREIGN RESERVES

On January 1, 2005, the lats was repegged from the SDR currency basket to the euro at the peg rate of EUR 1 = LVL 0.702804. This was also the lats central parity rate when Latvia officially joined the ERM II (a multi-lateral arrangement for promotion of exchange rate stability and coordination in Europe) on May 2, 2005. Participation in the ERM II is a pre-condition for Latvia to become a full-fledged member of the EMU and implement the euro. The Maastricht criteria specify that for at least two years prior to the euro changeover the lats is to be pegged to the euro, with the fluctuation of the lats exchange rate against the euro not exceeding ±15% against the central parity rate of the lats vis-à-vis the euro. The Bank of Latvia has unilaterally ensured the lats exchange rate fluctuations against the euro within ±1% of the central parity rate. In 2005, the euro exchange rate against the lats remained broadly unchanged and fluctuated in a tight range just above and to the lower limit of the intervention band set by the Bank of Latvia (EUR 1 = LVL 0.6958).

The Bank of Latvia's foreign reserves, which include gold, convertible foreign currencies and SDR, amounted to 1 399.8 million lats at the end of 2005 (1 043.4 million lats at the end of 2004). In 2005, the Bank of Latvia conducted significant interventions on the foreign exchange market, with net foreign currency purchases increasing by 63.3% over 2004. The Bank of Latvia generated income by investing its foreign reserves on the financial markets in compliance with the guidelines approved by the Bank of Latvia's Council. Government deposits in foreign currencies with the Bank of Latvia shrank notably.

The Bank of Latvia manages its foreign reserves in compliance with the Bank of Latvia's Council guidelines. Since January 1, 2005, the base currency of the benchmark portfolio is the euro and the benchmark assets are composed of 50% of euro-denominated assets, 40% of US dollar-denominated assets and 10% of Japanese yen-denominated assets.

The Bank of Latvia invests its foreign reserves in safe and liquid financial instruments, primarily in debt securities issued by governments and government agencies of the euro area countries and the US and international organisations, as well as in highly rated bank and corporate debt securities, asset-backed securities and callable bonds. Interest rate futures are used to manage the duration of the reserves. For the purpose of implementing yield curve strategies on the interest rate market, interest rate swaps are used, whereas to ensure the optimal currency composition of the foreign reserves foreign exchange forwards are applied.

The gold reserves of the Bank of Latvia were invested into short-term deposits with highly rated foreign credit institutions. Foreign exchange forwards and interest rate swaps were also used in the management of the gold reserves.

In 2005, the Bank of Latvia resorted to the services of 3 external reserve managers from the United Kingdom and the US. They manage a share of the Bank of Latvia's foreign reserves pursuant to the guidelines set by the Bank of Latvia's Council.

In foreign reserve management much attention is paid to risk management and control. Foreign reserve portfolio compliance with the guidelines is checked on a daily basis and the risk allocation by various investment decisions is managed.

MONETARY POLICY INSTRUMENTS

The Bank of Latvia continued to pursue its monetary policy to maintain economic stability in Latvia.

The Bank of Latvia's refinancing rate remained unchanged (after raising it from 3.00% to 4.00% in 2004). Although the ECB raised the euro base rate from 2.00% to 2.25% on December 6, 2005, the spread between the lats and the euro base rates remained relatively high and did not warrant raising of the Bank of Latvia's refinancing rate. Interest rates on time deposits from banks and Lombard loans also remained unchanged. Interest rates on standing facilities were the following in 2005: the interest rate on 7- and 14-day time deposits was 2.00% and 2.25%, respectively, whereas the interest rate on Lombard loans with a maturity of up to 10 days, 11–20 days and over 20 days was 5.00%, 6.00% and 7.00%, respectively.

In order to dampen the excessively high growth rates of lending, the minimum reserve base for banks was expanded as of January 24, 2005 to include also the banks' liabilities to foreign banks; therefore, the reserve requirements increased by 21.6 million lats. As the lending growth rates still remained high, the Bank of Latvia raised the reserve ratio from 4% to 6% as of August 24 and to 8% as of December 24. With the amount of funds attracted by banks and reserve ratio increasing, the minimum reserve requirements grew 2.7 times in 2005 (to 508.9 million lats). At the end of 2005, 22 banks and one branch of a foreign bank were subject to the minimum reserve requirements.

In 2005, the Bank of Latvia purchased the historically highest amount of the euro by issuing the lats (351.8 million lats net). Banks sold foreign currencies to offset the lats liquidity deficit resulting from higher minimum reserve requirements. Liquidity remained ample on the lats money market throughout 2005, as the banks had purchased more lats from the central bank than necessary to meet the minimum reserve requirements. Only in February the average end-of-day balance of banks' time deposits with the Bank of Latvia fell below 1 million lats; in other months it exceeded 20 million lats. The end-of-day balance of banks' time deposits averaged 60.7 million lats in 2005 (a year-on-year increase of 16.9 times). The use of 14-day time deposits expanded; in 2004, they comprised 52.8% of the total outstanding time deposits from banks, whereas in 2005 already 97.9%.

Interest rate convergence and capital inflows, active selling of the euro to buy the lats, build-up of a liquidity surplus on the interbank lats money market supported a decline in the short-term interest rates on transactions in lats to the level of time deposit interest rates set by the Bank of Latvia.

In 2005, the demand for repo loans dropped considerably under the impact of notable currency interventions and the lats surplus on the money market. In 2004, the total bids for repo loans amounted to 2 683.0 million lats and the total amount allotted to 2 053.2 million lats, whereas in 2005 to 189.0 million lats and 182.3 million lats, respectively. The Bank of Latvia offered repo agreements with a 7- and 28-day maturity. In 2005, the 7-day repo loans accounted for 67.0% of total repo loans (94.9% in 2004). The average end-of-day balance of repo agreements was only 7.1 million lats in 2005 (46.5 million lats in 2004). The weighted average interest rate on 7-day repo loans rose to 4.01% (3.54% in 2004), reflecting the raising of the Bank of Latvia's refinancing rate in November 2004.

In 2005, banks concluded no currency swap agreements with the Bank of Latvia. The last currency swaps concluded in 2004 matured in January and February; therefore, the end-of-day balance of currency swaps averaged only 0.6 million lats in 2005 (24.1 million lats in 2004).

The average end-of-day balance of Lombard loans was 0.2 million lats in 2005 (two times lower year-on-year). Demand Lombard loans were granted in April and September, when there was a short-lived rise in the demand for lats to meet the reserve requirements. The weighted average interest rate on Lombard loans was 5.00% in 2005.

In 2005, Government securities in the amount of 17.8 million lats held by the Bank of Latvia matured. The average end-of-day balance of the Bank of Latvia's Government securities portfolio amounted to 98.1 million lats in 2005.

As in 2004, no reverse repo agreements for Government securities were concluded in 2005.

The Bank of Latvia continued to quote RIGIBID (deposit rates on the interbank market) and RIGIBOR (lending rates on the interbank market) in accordance with the Bank of Latvia's "Regulation for the Calculation of RIGIBID and RIGIBOR", including those banks in quotation list that were active on the interbank market and able to conduct market operations at the quoted money market rates on transactions in lats. The list of the banks whose money market quotes are used in RIGIBID and RIGIBOR calculations, comprising JSC Baltic Trust Bank, JSC *Hansabanka*, JSC *Latvijas Krājbanka*, JSC *SEB Latvijas Unibanka* (former JSC *Latvijas Unibanka*), JSC *Parex banka*, JSC HVB Bank Latvia (former JSC *Vereinsbank Rīga*) and the Latvia Branch of *Nordea Bank Finland Plc*, was not changed in 2005.

CASH MANAGEMENT

In 2005, currency in circulation increased by 20.6% (from 727.4 million lats to 877.3 million lats). Over the last five years, currency in circulation has grown 2.1 times.

Banknotes and coins received from the banking sector were checked for authenticity and fitness for circulation by using automated cash processing systems. In 2005, the amount of processed cash (2 201.3 million lats) exceeded that of currency in circulation 2.5 times (2.6 times in 2004). Of the amount processed, 322.0 million lats or 14.6% were withdrawn from circulation (250.3 million lats or 13.3% in 2004).

The total nominal value of counterfeits detected in 2005 (18.1 thousand lats) accounted for only 0.002% of the currency in circulation.

In 2005, by issuing a 1-lats silver collector coin *Rainis* (in circulation as of November 17, 2005), the Bank of Latvia started the implementation of the third series *People* of the national coin program *Latvia. Times and Values*. Taking into account the expected major sports events and the popularity of coins dedicated to sports, three 1-lats silver coins were released in 2005: *2006 FIFA World Cup Germany* (in circulation as of February 7, 2005), *Olympic Winter Games 2006* (in circulation as of September 9, 2005) and *Ice Hockey World Championship Riga 2006* (in circulation as of November 14, 2005). In order to diversify the subjects of Latvian coins, a special 100-santims nominal silver coin (in circulation as of May 23, 2005) was released to mark the 285th birthday of Baron Münchhausen. Already the fifth Bank of Latvia 1-lats silver coin *Koknese* (in circulation as of October 27, 2005) was issued within the framework of the international coin program *Hansa Cities*. The Bank of Latvia also continued participation in the international program *The Smallest Gold Coins of the World* by issuing a 1-lats gold collector coin *Art Nouveau. Riga* (in circulation as of December 13, 2005).

New 1-lats coins *Pētergailis* (in circulation as of May 25, 2005) and *Pretzel* (in circulation as of December 14, 2005) replenished the stock of circulation coins.

PREPARATION FOR THE EURO CHANGEOVER

Since the EU accession, Latvia together with other EU10 countries has also joined the EMU, which is the supreme stage of the economic integration of the EU Member States having a single currency – the euro. The EU10 countries, including

BANK OF LATVIA'S COINS STRUCK IN 2005

1 SANTIMS

Measurements: diameter – 15.65 mm, weight – 1.60 g
Metal: copper-clad steel
Struck by *Rahapaja Oy* (Finland)
Artists: Gunārs Lūsis (graphic design), Jānis Strupulis (plaster model)

Obverse
The small coat of arms of the Republic of Latvia in the center, encircled by the inscription LATVIJAS REPUBLIKA • 2005.
Reverse
The numeral 1 is centered on the coin. The inscription SANTĪMS is placed in a semicircle beneath the numeral. Above the numeral, five arcs that stand for the span of a working day join two diamond-shaped suns, which are located on either side of the numeral.
Edge. Plain.

SPECIAL CIRCULATION COINS OF LIMITED BATCH

PĒTERGAILIS

Face value: 1 lats
Measurements: diameter – 21.75 mm, weight – 4.80 g
Metal: cupro-nickel
Struck by *Royal Mint* (United Kingdom)
Artists: Valdis Villerušs (graphic design), Ligita Franckeviča (plaster model)

PRETZEL

Face value: 1 lats
Measurements: diameter – 21.75 mm, weight – 4.80 g
Metal: cupro-nickel
Struck by *Münze Oesterreich* (Austria)
Artists: Laimonis Šēnbergs (graphic design), Jānis Strupulis (plaster model)

COIN ISSUED WITHIN THE SERIES *PEOPLE* OF THE NATIONAL COLLECTOR COIN PROGRAM *LATVIA. TIMES AND VALUES*

RAINIS

Face value: 1 lats
Measurements: diameter – 38.61 mm, weight – 31.47 g, metal: 925° silver, quality: proof
Struck by *Koninklijke Nederlandse Munt* (Netherlands)
Artists: Arta Ozola-Jaunarāja (graphic design), Ligita Franckeviča (plaster model)

COLLECTOR COINS

BARON MÜNCHHAUSEN

Face value: 1 lats (100 santims)
Measurements: diameter – 38.61 mm, weight – 31.47 g
Metal: 925° silver, quality: proof
Struck by *Koninklijke Nederlandse Munt* (Netherlands)
Artists: Arvīds Priedīte (graphic design), Jānis Strupulis (plaster model)

OLYMPIC WINTER GAMES 2006

Face value: 1 lats
Measurements: diameter – 38.61 mm, weight – 31.47 g
Metal: 925° silver, quality: proof
Struck by *Staatliche Münze Berlin* (Germany)
Artists: Henrihs Vorkals (graphic design), Jānis Strupulis (plaster model)

ICE HOCKEY WORLD CHAMPIONSHIP RIGA 2006

Face value: 1 lats
Measurements: diameter – 38.61 mm, weight – 31.47 g
Metal: 925° silver, quality: proof
Struck by *Staatliche Münze Berlin* (Germany)
Artists: Artis Rutks (graphic design), Ligita Franckeviča (plaster design)

COIN ISSUED WITHIN THE INTERNATIONAL COIN PROGRAM *THE SMALLEST GOLD COINS OF THE WORLD*

ART NOUVEAU. RIGA

Face value: 1 lats
Measurements: diameter – 13.92 mm, weight – 1.2442 g
Metal: .9999 gold, quality: proof
Struck by *Valcambi SA* (Switzerland)
Artists: Guntars Sietiņš (graphic design), Ligita Franckeviča (plaster model)

COIN ISSUED WITHIN THE INTERNATIONAL COIN PROGRAM *HANSA CITIES*

KOKNESE

Face value: 1 lats
Measurements: diameter – 38.61 mm, weight – 31.47 g
Metal: 925° silver, quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists: Gunārs Krollis (graphic design), Jānis Strupulis (plaster model)

Latvia, have been granted the status of a country with a derogation until the euro changeover.

On December 9, 2003, the Latvian Government approved a preparation schedule for the euro changeover fixing the target dates for the lats' repegging and implementation of the Maastricht criteria (January 1, 2005 and January 1, 2007, respectively). The euro changeover calendar developed by the Government provides for Latvia's full-fledged participation in the EMU starting from January 1, 2008. A simultaneous euro cash and euro non-cash changeover is planned in Latvia.

Latvia's monetary system has to operate within the ERM II for at least two years after joining it, but the precise duration of this period will depend on fulfilment of the Maastricht criteria. Latvia has to maintain exchange rate stability and meet several economic requirements pertaining to inflation, interest rates, Government deficit and debt. Compliance with the inflation criterion is the most serious challenge to implementation of the current euro changeover calendar faced by the Latvian Government.

In order to ensure an effective euro implementation process in Latvia, the Latvian Government established a Steering Committee on July 19, 2005, whose main tasks comprise the development of the euro changeover strategy and action plan. After examining the experience of several euro area countries, 5 working groups were established within the framework of the Steering Committee to accomplish specific tasks in pre-determined areas (public administration, money and payment systems, financial system, non-financial corporations and consumers, and public awareness and communication).

The central bank is actively involved in the work of the Steering Committee and working groups. The Deputy Governor of the Bank of Latvia is a member of the Steering Committee and the Chairperson of the Money and Payment Systems working group. This group will be in charge of the euro cash changeover, payment systems and financial statistics issues, which will be the main areas of responsibility of the Bank of Latvia in the euro changeover process. The Bank of Latvia representatives are included also on other working groups.

The action plan for implementation of the single European currency in Latvia developed by the Steering Committee highlights the main areas for action. Euro Settlements Implementation Working Group established in the Bank of Latvia has drafted and is updating a detailed plan for implementation of the euro settlements and ensuring the internal processes of the Bank of Latvia after the euro changeover.

STATISTICS

In 2005, methodology improvements in the areas of preparing Latvia's balance of payments and financial statistics in order to comply with the ECB requirements continued, with the main attention being focussed on implementation of the amendments to the Bank of Latvia regulations approved in 2004 and better quality of the statistical data.

The Bank of Latvia started the preparation of the MFI (including the central bank) balance sheet statistics indicators in accordance with the requirements of the ECB Regulation (EC) No. 2423/2001 concerning the consolidated balance sheet of the monetary financial institutions sector (ECB/2001/13) applicable to the euro area countries, thus considerably expanding the range of the so far compiled statistical data. In order to send these statistical data to the ECB, the Bank of Latvia joined the ESCB data transmission system *ESCB Net*. In the process of implementing the new requirements set by the Bank of Latvia's "Regulation for Compiling the Monthly Financial Position Report of Monetary Financial Institutions and Its Appendices" amended in 2004 (effective as of January 1, 2005), new participants of the MFI sector were identified (one money market fund and two electronic money institutions) and included on the list of MFIs, as well as compilation of the statistical data was commenced.

Continuing the ECB's OFI statistics project, the Bank of Latvia conducted two surveys to identify investment fund statistics collection possibilities, significance of specific data and the potential costs incurred by respondents in providing the statistical data. In addition, the scope of information compiled by other institutions was identified and overall data preparation costs and potential for establishing a full list of investment funds was evaluated.

New ECB methodology was studied and introduced, and data compilation in two new statistical areas (structural and payment system statistics) started. The above statistical data and their time series were prepared for the ECB's report *EU Banking Structures* and publication *Blue Book*.

For the needs of the ECB, the Bank of Latvia examined certain aspects of financial instruments (e.g. syndicated loans, credit card products, loans, securitisation) and accounting principles in Latvia.

The Bank of Latvia's web site was supplemented with a description of methodology on classification of economic sectors used in banking and monetary statistics.

At the beginning of 2005, a new quarterly report on foreign investment was introduced reporting the data on direct investment, portfolio investment and other investment based on outstanding amounts as well as the flow data (changes arising from transactions, price developments, exchange rate fluctuations etc) in compliance with international standards. The Bank of Latvia continued to participate also in the development of the ECB's Centralised Securities Database, commencing regular transmissions of data received from the LCD to the ECB and engaging in quality control of the issuer data received from the ECB.

In 2005, with a view to improving the quality of the prepared government financial statistics the Bank of Latvia's experts participated on a cross-institutional working group for preparation of notification on government deficit and debt and cross-institutional working groups for preparation of the Republic of Latvia Cabinet Regulations: "Regulation on Financing Classification for Budgets", "Regulation on General Government Debt Classification" and "Regulation on Classification of Institutional Sectors".

The Bank of Latvia continued participation in meetings and workshops held by the ECB and Eurostat working groups in the area of statistics. Work on the Balance of Payments Committee established by Eurostat also commenced. One of its main tasks is monitoring compliance with the requirements set for the EU balance of payments, international trade of services and foreign direct investment data compilation.

The Bank of Latvia continued cooperation in the field of statistics also with other international institutions. It launched statistical data transmissions to the BIS, using the BIS data transmission software and direct connection to the BIS databank. The Bank of Latvia continued participation in the IMF project for preparation of financial stability data in the capacity of the project coordinator in Latvia and preparing specific indicators and methodology descriptions. The Bank of Latvia proceeded with dissemination of financial and balance of payments statistics via its regular publications and the Bank's website, IMF publications *International Financial Statistics* and *Balance of Payments Statistics Yearbook*, with the help of the BIS and Eurostat, and also within the IMF Special Data Dissemination Standard. The Bank of Latvia continued to provide a summary of economic developments for the ECB publication *Green Book* and information on specific macroeconomic indicators for the ECB publication *Orange Book*.

PAYMENT SYSTEMS AND FINANCIAL STABILITY

The Bank of Latvia continued to ensure the operation of two payment systems (the SAMS ensuring settlements of both interbank and urgent customer payments, and the EKS executing only retail payment processing and clearing).

At the end of 2005 (as at the end of 2004), 22 banks, one branch of a foreign bank and the Bank of Latvia were the participants of the Bank of Latvia's payment systems. In 2005, payments processed within the SAMS increased by 11.9%, reaching 166.1 thousand, while their total value was 37.1 billion lats (an increase of 7.1% over 2004). This increase resulted mainly from a higher volume and value of customer payments in the SAMS (a 26.6% and 51.0% rise, respectively). The volume and value of bank payments remained broadly unchanged. With the volume of customer payments growing to 94.8 thousand, their share reached 65.8%. The value of customer payments totalled 8.5 billion lats (24.6% of all SAMS payments).

The volume of payments processed in the EKS in 2005 reached 21.8 million (26.6% higher than in 2004). Starting from July, the volume of payments grew rapidly. This was mainly the result of the new procedure for benefit disbursements to the SSIA customers (effective as of July 1, 2005), stipulating that individual transfers are to be made to each SSIA customer from the Treasury's accounts with the Bank of Latvia. The value of payments processed by the EKS rose by 23.2% (to 8.4 billion lats).

Within the framework of the SAMS and the EKS oversight, the significance of the SAMS and the EKS for lats payments was evaluated. In 2005, 83.7% of the banks' interbank payments in lats were made via the SAMS (77.8% in 2004). Their value amounted to 87.9% of the banks' interbank credit transfers made in lats (90.0% in 2004). The EKS processed 77.2% of the volume of customers' interbank payments in lats and 72.2% of the value of those payments (72.5% and 73.6% in 2004, respectively).

In order to ensure efficient processing of a large volume of payments resulting from the budgetary payments made by the Treasury increasing significantly in the second half of 2005 (the average daily volume of payments processed in the EKS grew from 8 074 to 34 272), the Bank of Latvia introduced improvements to the EKS and the KMAS maintained by the Bank of Latvia. The Bank of Latvia improved customer services by introducing a new customer account monitoring system enabling the Bank of Latvia's customers to monitor the balance of their accounts and view the transactions made in the account in real-time.

At the end of 2004, amendments to the "Law on Credit Institutions" took effect, introducing several requirements for issuance and servicing of electronic money; therefore, the Bank of Latvia amended the "Regulation for Issuance and Maintenance of Electronic Money" accordingly (effective as of April 1, 2005).

The Bank of Latvia's staff continued to participate on the ESCB working groups dealing with issues related to payment systems, including the emerging TARGET2. The working groups completed the functional specification of TARGET2 and the price structure for TARGET2 core services. In 2005, several meetings of the banks' TARGET2 project working group were convened to discuss the progress achieved in project development, time schedule, system testing etc. The importance of those meetings grew after Latvia was included in the group of countries forming the first wave of migration to the new system at the end of 2007. The Bank of Latvia's staff participated in TARGET2 technical workshop organised by the system developer bank, where experts from central banks were introduced to detailed system structure and operational principles. At the end of 2005, strategy for implementation of TARGET2 in Latvia was completed and discussed at the Payments Committee of the Association of Latvian Commercial Banks.

In 2005, the Bank of Latvia participated in the current ECB survey to collate information on correspondent banking transactions made in euro. 21 banks and a branch of a foreign bank participated in the survey. They provided information on the number of their correspondent banks and average daily volume and value of transfers in the relevant correspondent bank accounts. In order to assess more accurately the overall payment flow in Latvia within the framework of Latvian payment system oversight, in addition to information on euro transactions the Bank of Latvia also collated data on transactions made by correspondent banks in lats and other foreign currencies. The significance of correspondent banking transactions in services provided by each bank was characterised by the ratio of loro account turnover to the bank's equity, an indicator proposed by the ECB. According to the survey, the average ratio in Latvian banks was 25%. Daily volume of all transfers made in loro accounts of all banks averaged 1 685, whereas the average value was 187.8 million lats. Comparing correspondent banking transactions in lats, euro and other currencies, the survey concluded that 56.7% of the volume of loro account transfers and 44.6% of the value of loro account transfers were made in lats or euro.

With a view to providing as full as possible information on servicing of payment cards in Latvia based on the new ECB methodology, the Bank of Latvia conducted a bank survey on card payments by the type of card, transactions in Latvia and abroad using payment cards issued in Latvia and also on transactions in Latvia by payment cards issued abroad. All Latvian banks issuing and servicing payment cards (i.e. 21 banks and 1 branch of a foreign bank) participated in the survey. At the end of the first half of 2005, 1.4 million of payment cards issued in Latvia were debit cards and 84.8 thousand were credit cards. According to the survey data, 17.3 million payments with the value of 217.5 million lats were made using debit cards, and 1.4 million payments with the value of 72.9 million lats were made with credit cards. 17.7 million local payments with the value of 187.9 million lats and 860.1 thousand payments abroad with the value of 91.3 million lats were made using payment cards issued in Latvia. In the first half of 2005, 471.8 thousand payments with the value of 22.7 million lats were made in Latvia by payment cards issued abroad (2.6% and 10.8% of the volume and value of all payments made in Latvia, respectively).

On November 1, 2005, Financial Stability Division was established in the Monetary Policy Department of the Bank of Latvia to deal with the macro-prudential monitoring of banks, in order to detect and evaluate macro-risks posing potential threats to the banks' stability in due time. Twice a year an evaluation of the financial stability is published in the *Financial Stability Report* prepared in close cooperation with the FCMC.

Special attention was paid to the assessment of risks associated with the high growth rates of lending, particularly mortgage lending. Expanding household debt pointed to risk aggravation in this segment, whereas the corporate sector displayed no signs of growing credit risk as a result of buoyant economic growth, low interest rates and high credit quality in the major sectors.

Information on loan-to-value ratio and lending interest rate margins suggested that with the outstanding loans growing fast, conservative (tight) credit standards were maintained. Stress test results of the banks' loan portfolios under several scenarios confirmed the resilience of the Latvian banking sector to potential shocks; nevertheless, the banks' shock absorption capacity had slightly deteriorated. Much will depend on further real estate debt developments, bank investment in this segment and changes in the quality of the respective loans.

The repegging of the lats to the euro reduced the banks' foreign exchange risk considerably. Value-at-Risk method and stress tests were applied in measuring the direct foreign exchange risk. The estimates suggested that even considerable exchange rate volatility would have a negligible effect on the banks' profitability (the effect weakened in comparison with 2004).

The results of interest rate risk analysis pointed to a limited impact of interest rate developments on the banks' performance results. Analysing the stability of the financial sector, a current bank survey of key risks faced by large banks and their annual developments was conducted.

INFORMATION SYSTEMS

In 2005, development and implementation of the information system for securities accounting and evaluation was completed, ensuring aggregation and evaluation of data on market prices of securities prior to being used in the monetary operations of the Bank of Latvia.

The information system of the Register of Debtors was further expanded to include new participants (insurance corporations and leasing and factoring companies).

The information system for preparation of the national balance of payments was improved significantly, enabling a much more detailed aggregation of the quarterly information from companies and creating a database of reporting companies, as well as improving the functionality of the information system used by non-banks to submit the required information electronically.

The Bank of Latvia has provided the Treasury and other customers with a remote monitoring facility for their accounts with the Bank of Latvia, significantly simplifying the management of funds contained on those accounts.

Complementary security systems were implemented to protect the Bank of Latvia's computer network and information system environment against the latest threats including computer viruses, malicious codes and disruptive programmes and other external or internal threats.

A project for modernisation of the Bank of Latvia's centralised system for data storage and management was implemented successfully, ensuring quick and quality processing of the constantly growing information volume.

Development of an information system for economic and financial statistics was commenced, in order to provide the Latvian financial sector and international institutions with more detailed and accurate statistical information.

INFORMATION TO THE PUBLIC

The Bank of Latvia's publications, the Internet, the press, television and radio as well as workshops and conferences organised by the Bank of Latvia were the media used by the Bank to inform the public about its activities and developments in the Latvian economy in 2005.

After the Bank of Latvia joined the ESCB, its cooperation with the ECB and other central banks of the EU Member States became even closer and richer in information.

The Bank of Latvia regularly releases several publications containing comprehensive information on the Latvian financial sector and economy with a view to ensuring public awareness of the progress achieved in implementation of its policy and development of monetary and economic indicators. At the beginning of 2005, the Bank of Latvia published its Annual Report 2004 to provide information on its operations and financial results for that year. Latvia's economic development was analysed in the context of the global economic development. The Bank of Latvia's *Monetary Review*, *Monetary Bulletin*, *Latvia's Balance of Payments*, *Latvia's Balance of Payments (Key Items)* and *Financial Stability Report* play an important role in providing information. The bulletin *Averss un Reverss* analyses the progress made by the three Baltic States towards the EMU, macroeconomic development trends of Latvia, Lithuania and Estonia and their differences, compliance with the Maastricht criteria, particularly the reasons behind the consumer price increase and its impact on the economic growth rates. The bulletin also addresses international activities of the Bank of Latvia and the nation, also within the framework of the IMF, enabling an assessment of Latvia's economy in a global context and, through that, a more targeted participation in this international organisation. Analysts, students and other interested parties have benefited from several working papers prepared by the Bank of Latvia's staff (see Appendix 9).

The mass media received regular information on resolutions passed by the Bank of Latvia's Council and Board and the Bank's activities. The Bank's experts prepared materials on issues falling within the competence of the central bank to be published in the press both in Latvia and abroad. The most topical issues of 2005 were the price hike and the underlying factors as well as the aggravation of the macroeconomic risks in Latvia.

The Bank of Latvia's Governor informed the mass media about resolutions passed by the Bank's Council and the economic developments, followed by question and answer sessions at the Bank of Latvia's press conferences.

In September 2005, the Bank of Latvia held its annual conference "Sustainable Development of the Latvian Economy: Issues, Risks, Solutions". The Bank of Latvia's experts together with representatives from other national and international institutions, businesses, finance specialists and representatives from academic circles discussed the economic development of Latvia on the road towards the set objective of euro implementation. Public and private sector representatives expressed their views as to the potential risks to balanced economic development and measures to contain those risks.

At the beginning of 2005, the Bank of Latvia announced the third competition for student research papers with a view to encouraging the future economists to engage in economic analysis and promoting interest about researching topical finance and economics subjects. In their papers, students were asked to evaluate Latvia's macroeconomic development and impact of the EU integration on various areas of the national economy. The authors of the best papers received money awards from the Bank of Latvia.

Cooperation in preparing the TV broadcast *Kā bankā* and the radio broadcast *Lata spogulī* provides numerous opportunities for addressing a vast audience. These broadcasts educate the public about monetary policy and other economic issues, analysing the gains and losses after Latvia's first year in the EU, inflation expectations, how dangerous they are, innovative business ideas for Latvia and other topical issues.

At the beginning of the year, the Bank of Latvia Visitors Centre "Money World" was opened in the Bank of Latvia's main building at K.Valdemāra iela 2A, Riga, on the premises of the former vault. Thus, the building which celebrated its 100th anniversary in 2005 was opened to the general public. The "Money World" has smoothly become an instrument used in the Bank of Latvia's work in the field of financial and economic education. Its three main areas of activities are assistance in teaching economics at secondary schools, encouraging macroeconomic research at universities and promoting general public awareness of the central banking and finance issues. In 10 months, the "Money World" has been visited by more than 6.6 thousand visitors, mainly students from comprehensive and secondary vocational schools.

In order to facilitate an exchange of opinions on the content, methods and organisational development issues concerning visitors centres, the Bank of Latvia hosted an international seminar "Opportunities and Solutions for Central Bank Visitors Centres" on October 6–7, 2005. At this seminar, employees of visitors centres and museums of 12 European central banks, representatives from the International Council of Museums and Latvian schools and universities discussed the opportunities of creating modern information centres.

The Bank of Latvia poll "Latvia's Coin of the Year 2004" on collector coins minted in 2004 gained wide public support. More than 5 000 people took part in the poll, and with an overwhelming majority of votes the *Coin of Time* (graphic design by Laimonis Šēnbergs and plaster model by Jānis Strupulis) became the "Latvia's Coin of the Year 2004". Detailed information was prepared about all collector coins and special circulation coins of the Bank of Latvia minted in 2005.

All Bank of Latvia's publications are available on the Bank of Latvia's website. The information on the Bank of Latvia, its regulations, financial statistics, payment and settlement systems, Latvian money, and other areas of interest was regularly complemented and updated on the website. In 2005, the section on publications and statistical information was expanded in order to comply with the requirements of the ECB and other international institutions. A special section has been developed on the Bank of Latvia web site dedicated to the Bank of Latvia Visitors Centre and an electronic registration and accounting system of visitors.

ORGANISATIONAL DEVELOPMENT

The composition of the Council of the Bank of Latvia, as at the end of 2005, was as follows:

– Governor	**Ilmārs Rimšēvičs**;
– Deputy Governor	**Andris Ruselis**;
– Members of the Council:	**Harry Bush**, **Leonīds Gricenko**, **Vita Pilsuma**, **Arvils Sautiņš**, **Aivars Skopiņš**, **Valentīna Zeile**.

The Board of the Bank of Latvia, as at the end of 2005, was as follows:

– Chairperson of the Board	**Māra Raubiško**;
– Deputy Chairmen of the Board:	**Reinis Jakovļevs**, **Helmūts Ancāns**;
– Members of the Board:	**Māris Kālis**, **Andris Ņikitins**, **Harijs Ozols**.

On July 14, 2005, the Council of the Bank of Latvia appointed Andris Ņikitins, the Head of the Technical Support Department, a member of the Board of the Bank of Latvia, since Roberts L. Grava resigned from this office and left the Bank of Latvia.

At the end of 2005, the number of the Bank of Latvia's employees was 648, of which 23 were employees with a fixed term job contract (698 and 22 employees at the end of 2004, respectively). Of the Bank's staff, as at the end of 2005, 57% were males and 43% were females.

To ensure exchange of information between the Bank of Latvia and the EU institutions, the Bank of Latvia's special attaché at the Latvia's Mission to the EU continued his work in 2005.

Structural improvements continued at the Bank of Latvia. In order to improve strategic management processes, the Bank of Latvia appointed the Manager of the Strategic Management Process of the Bank of Latvia, whereas to ensure management of the business continuity process the Manager of the Bank of Latvia's Business Continuity was appointed.

Following Latvia's accession to the EU and joining the EMU, a special attention was paid to strategic research and analysis and the issues of financial stability. Therefore, within the framework of structural changes, Financial Stability Division was established in the Monetary Policy Department in 2005.

In order to maintain and improve the System of the Register of Debtors, Register of Debtors Division was established in the Payment Systems Department at the beginning of 2005.

With a view to optimise further maintenance and development of the bank information system *Globus*, Bank Information System Maintenance and Development Division was established in the Information Systems Department.

In order to reflect expansion of the scope of work which now includes financial market statistics related issues, the name of a Division of the Statistics Department was changed (see Annex 6).

Against the background of expanding cooperation with the IMF and the EU institutions, including the ECB, the number of economists employed by the International Department and the number of editors and translators employed by the Communications Department was increased.

In 2005, the Bank of Latvia Visitors Centre "Money World" was opened, which is an interactive financial education and information centre.

Improved security systems and work organisation resulted in a reduction in the number of security staff. The number of technical staff implementing support functions was reduced due to more extensive use of outsourcing.

The Bank of Latvia employees continued with their academic studies as well as additional professional training, participating in seminars, workshops, courses and conferences in Latvia and abroad to obtain the latest information in the fields of monetary policy, financial stability, macroeconomics, econometrics, foreign exchange operations, payment systems, statistics, bank accounting and information technologies. A number of the Bank's employees successfully participated in international professional certification programmes.

In 2005, 3.6% of total expense on wages, salaries and other personnel costs was used for the needs of the Bank's personnel training (3.3% in 2004).

In the Bank of Latvia's personnel training, particular attention was still paid to developing skills necessary for successful cooperation of the Bank's personnel with the ECB and the national central banks of other EU countries. The personnel involved in the ESCB's committees and working groups had an opportunity to improve their business English writing skills and to enhance their skills organising meetings in an international context. In-depth studies in the fields of business presentations, communication, interaction psychology and efficient time management, business etiquette, stress management continued as did computer skills and foreign language training. Development programme for various level managers included training in effective personnel and meetings management as well as conflict psychology.

Staff training was often organised on the premises of the Bank of Latvia's Training and Recreation Centre equipped with high quality technical aids for training. Two seminars delivered by foreign presenters were held in the Training and Recreation Centre in 2005. One was delivered to executive staff of the central banks of the Baltic States and focussed on improvement of international meetings and presentation skills, whereas the second focussing on legal English was delivered to the lawyers of the Bank of Latvia and the FCMC.

Special seminars were held for recently hired employees to inform them about the Bank's tasks and its organisational units fulfilling these tasks. Employees of the International Department presented topical information about the EU institutions, cooperation with the ECB, the ESCB and other international financial institutions to the Bank of Latvia's staff. Experts of the Market Operations Department delivered two seminars outlining the business areas and contents of their Department.

The Bank of Latvia's employees could apply for temporary short-term positions at the ECB and Eurostat. In 2005, two Bank's employees used the opportunity to improve their professional skills on short-term assignments at the ECB, one employee participated in the ESCB's staff exchange program and one employee continued her secondment to act as an expert within Eurostat.

After Latvia's accession to the EU, the Bank of Latvia's staff may also participate in workshops organised by the ESCB. This kind of participation provides knowledge about topical ESCB issues and processes. In 2005, the Bank of Latvia had to organise the second part of the ESCB seminar "Changing Leadership in a European Context" (first part organised by the Italian central bank) for the first time. Executives from the central banks of 10 EU Member States participated in the seminar.

RISK AND QUALITY MANAGEMENT

In 2005, the Bank of Latvia's Board continued to develop risk management in line with the core principles stipulated in the "Bank of Latvia's Security Policy", taking into consideration the development of the financial market and the Bank of Latvia's operation. Alongside with approving the "Bank of Latvia's Security Policy", the Bank of Latvia's Council set also a procedure for its oversight. Oversight is the function of the Bank of Latvia's Security Supervision Commission comprising four members of the Bank of Latvia's Council.

The Bank of Latvia's financial risks are managed in line with the "Guidelines for Managing the Bank of Latvia's Foreign Reserves", which the Council of the Bank of Latvia reviews and, if necessary, amends at least once a year.

An in-depth risk analysis of all essential information systems of the Bank of Latvia was conducted on the basis of adapted Information Security Forum's methodology. The Bank of Latvia took part in the Information Security Forum's survey, conducted every two years and assessing the compliance and security of the information systems environment of the members of the above organisation, and received a very high evaluation.

The management of the Bank of Latvia's core operational risks was coordinated by the Bank's Risk Management Working Group. The Working Group assessed and summarised risk reports developed by the Bank's organisational units and classified the risks, thereby maintaining and updating the Bank of Latvia's risk matrix.

In April 2005, the Bank of Latvia's Board reviewed and approved the Bank's risk report as well as reported to the Bank of Latvia's Council on the situation in the area of risk management. Personnel training in the field of information and information system security was also organised.

In 2005, the following business continuity improvement measures were implemented in the Bank of Latvia: documents governing business continuity management procedure were prepared, organisational procedures were introduced and a person in charge of the business continuity process was appointed. Overall, these measures currently form the business continuity management system of the Bank of Latvia, ensuring timely detection and prevention of incidents and emergencies, preparation of proposals for incident and emergency prevention in the future, staff training as well as testing and updating of action plans for ensuring the business continuity.

The Bank's quality management system has been functioning since 2000. In 2005, two internal audits of the Bank of Latvia's quality management system and two external oversight audits of the Bank of Latvia's quality management system were conducted. Oversight audits found no incompliance with the ISO 9001:2000 standard.

INTERNAL AND EXTERNAL AUDIT

Internal audits provides the Bank of Latvia's management with an independent and objective evaluation of and consultations about the efficiency of the Bank's business processes. The internal audit of the Bank of Latvia is conducted by the Internal Audit Department. An Audit Committee operates in the Bank of Latvia, supervising and helping to improve internal audit.

The internal audit is organised and conducted, taking into consideration the "Internal Audit Policy of the Bank of Latvia" approved by the Bank of Latvia's Council, "International Standards for the Professional Practice of Internal Auditing" and "Code of Conduct" developed by the Institute of Internal Auditors as well as the standards established by the Control Objectives for Information and Related Technology (CobiT) and the Information System Audit and Control Association (ISACA).

The internal audit addresses all operational areas of the Bank of Latvia. Audit engagements are planned and conducted on the basis of risk assessment and the audit plan of the ECB. The results of each internal audit are reported to the Bank of Latvia's Governor. On a quarterly basis, the Bank of Latvia's Audit Committee is informed about the findings of the conducted internal audit engagements, recommendations and their implementation. Once a year the findings of the conducted internal audits and the most relevant conclusions are reported to the Bank of Latvia's Council.

In 2005, the Internal Audit Department participated in the work of the Internal Audit Committee (IAC) of the ECB and conducted the internal audits of the Bank of Latvia planned by the ECB.

In compliance with the Law "On the Bank of Latvia", the Bank of Latvia's business activities and financial statements for the reporting year are audited by an Audit Commission, whose composition is approved by the State Audit Office of the Republic of Latvia. In order to comply with the ECB's requirements and further specify the criteria and conditions for the auditor's selection, the Bank of Latvia's Council approved the "Guidelines for Selection of and Cooperation with an External Auditor of the Bank of Latvia's Business Activities and Financial Statements".

ACCOUNTING AND BUDGET MANAGEMENT

The Bank of Latvia's accounting system has been established and managed in line with the "Bank of Latvia Accounting Manual" approved by the Board of the Bank of Latvia and the other regulations of the Bank, in compliance with the Law "On the Bank of Latvia" and other laws and regulations binding on the Bank of Latvia.

The Bank of Latvia publishes a monthly balance sheet, annual financial statements and other financial information. This information is also available on the Bank of Latvia's website. The integrated information system of the Bank ensures standardised, automated, safe and efficient execution of the Bank of Latvia's financial transactions, their uniform accounting and financial reporting. The management of the Bank of Latvia and other employees receive information about the Bank of Latvia's financial position, performance results and budget implementation on a daily basis. The Council and the Board of the Bank of Latvia assess, on a regular basis, changes in the Bank of Latvia's assets and liabilities as well as income and expenditure, paying particular attention both to the results from managing foreign currency and gold reserves as well as to the consistency of operating costs and long-term investment with the Bank's approved budget.

In 2005, the Bank's expenses were incurred and long-term investments made in accordance with the 2005 budget as approved by the Bank of Latvia's Council. The Bank of Latvia's Board, together with the heads of the relevant units of the Bank, made sure, on a regular basis, that the expenses were incurred and long-term investments made in accordance with the approved budget, and reported to the Council and Budgetary Commission of the Bank of Latvia on the execution of the 2005 budget. The Bank of Latvia's expenses and long-term investment for the year 2005 did not exceed the budgeted amount.

The management of the Bank of Latvia's budget for the year 2005 proceeded in compliance with the "Regulation for Managing the Bank of Latvia's Budget" approved by the Council of the Bank of Latvia and aimed at ensuring the spending efficiency. The Regulation provides for the procedure of drafting, approving and monitoring the execution of the Bank's budget. In 2005, the principles of the Bank of Latvia's budget management remained broadly unchanged.

COOPERATION WITH INTERNATIONAL ORGANISATIONS

The Bank of Latvia, the coordinating institution for the IMF affairs in Latvia, continued to represent the Republic of Latvia interests at the meetings of the IMF Board of Governors as well as in daily matters.

Latvia's interests in the IMF were represented in the Nordic-Baltic Constituency, including Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. One Executive Director represented this constituency on the IMF Executive Board, with a total of 3.52% votes.

Representatives of the Bank of Latvia continued to participate in the work of the Nordic-Baltic Monetary and Financial Committee, established for developing strategies and guidelines and preparing a joint opinion on operational issues of the IMF.

Cooperation with the IMF, based on consultations under Article IV of the IMF Articles of Agreement, continued. On July 27, 2005, the IMF Executive Board reviewed a report on implementation of the Latvian economic, monetary and financial policy.

In 2005, Latvia continued its activities as a member of the International Bank for Reconstruction and Development, the International Development Association, the International Finance Corporation and the EBRD. The Bank of Latvia continued its participation in the activities within the BIS.

COOPERATION WITH FOREIGN CENTRAL BANKS AND TECHNICAL ASSISTANCE

In 2005, the Bank of Latvia continued its cooperation with the central banks of other countries, exchanging expertise and information.

In March, experts from the Monetary Policy Department and Market Operations Department visited the central bank of Belarus to provide technical assistance in the areas of monetary policy and pegging of the national currency. The Internal Audit Department hosted a visit of experts from the central bank of Moldova to share its experience regarding issues concerning the internal audit of IT systems.

In May, experts of the Accounting Department, Legal Department and Payment Systems Department participated in the annual seminar of the central banks of the Baltic States.

Continuing the previous cooperation, classes were held for a group of MA course students from the Banking College of Uzbekistan in the Bank of Latvia Visitors Centre "Money World" in June. The visitors examined exhibits and held a discussion about them, benefited from lectures concerning the areas of monetary policy, payment systems and internal audit and were acquainted with the euro changeover strategy developed by the Bank of Latvia.

In July, representatives from the *Lietuvos bankas* visited the Statistics Department and the Public Relations Department to share experience in the field of preparing the quarterly accounts and public relations, respectively, and were also introduced to with the contents and technical solutions of the Bank of Latvia Visitors Centre's exhibits, the process and organisation of developing the Centre.

In September, a representative of the Payment Systems Department provided an insight in the area of payment systems development at the seminar "Payment Systems as a Core Element of the Financial System" hosted by the central bank of Kazakhstan.

In October, experts of the Internal Audit Department organised a seminar for the internal audit staff of the central banks of Georgia, Kazakhstan, Lithuania, Moldova, Montenegro and Russia. Under the IMF technical assistance programme, an expert from the Accounting Department advised the central bank of Belarus on issues related to accounting and financial reporting.

The Bank of Latvia organised several international meetings. In April, a meeting of Nordic-Baltic Monetary and Financial Committee was held in Riga to discuss strategic IMF policy issues. In August, the Bank of Latvia organised the annual meeting of the Nordic-Baltic central banks about payment and securities settlement systems. Representatives of eight Nordic-Baltic central banks as well as representatives from the FCMC participated. The meeting discussed the participation of the Baltic States in the TARGET system, cooperation among the financial market supervision and system oversight institutions, the tasks of the EU10 countries pertaining to participation in the SEPA and euro area, Nordic-Baltic securities market integration and changes in the EU legislation concerning securities settlement.

International financial institutions and foreign central banks extended support to the Bank of Latvia, providing opportunities to participate in the workshops and courses hosted by these institutions as well as to obtain consultations on issues related to the central bank operations.

Within the framework of this programme, in summer 2005 experts from the *Oesterreichische Nationalbank* delivered an international seminar on monetary policy issues in the context of the EMU expansion on the premises of the Bank of Latvia's Training and Recreation Centre. Experts from the central banks of Latvia, Lithuania and Estonia participated.

The Bank of Latvia's employees also participated in a number of courses held by the ECB, the IMF Institute and the Joint Vienna Institute as well as seminars organised by the central banks of the Czech Republic, France, Germany, Italy, the Netherlands, Switzerland and the United Kingdom.

Sandra Krastiņa
THE BALANCE. 1998
Acrylics on canvas. 110 x 175 cm

THE BANK OF LATVIA'S FINANCIAL STATEMENTS FOR THE YEAR ENDED DECEMBER 31, 2005

THE BANK OF LATVIA'S BALANCE SHEET

(at the end of the year; in thousands of lats)

ASSETS	Notes[1]	**2005**	2004
FOREIGN ASSETS		**1 513 427**	1 170 605
Gold	4	76 170	56 901
Special Drawing Rights	6	85	77
Convertible foreign currencies	5	1 323 520	986 458
International Monetary Fund	6	107 633	101 144
Participating interest in the European Central Bank	7	760	760
Participating interest in the Bank for International Settlements	8	1 763	1 000
Other foreign assets	9	3 496	24 265
DOMESTIC ASSETS		**159 487**	145 283
Loans to credit institutions	10	23 300	12 880
Government securities	11	98 817	93 208
Fixed assets	12	34 878	35 931
Other domestic assets	13	2 492	3 264
TOTAL ASSETS		**1 672 914**	1 315 888

[1] The accompanying notes set out on pages 64 to 93 are an integral part of these financial statements.

(cont.) (at the end of the year; in thousands of lats)

LIABILITIES, CAPITAL AND RESERVES	Notes	**2005**	2004
FOREIGN LIABILITIES		**123 196**	131 291
Convertible foreign currencies	14	3 295	2 445
International Monetary Fund	6	107 875	101 773
Other international institution deposits in lats	15	1 105	21 515
Foreign bank deposits in lats		486	396
Non-convertible currencies		40	36
Other foreign liabilities	16	10 395	5 126
LATS IN CIRCULATION	17	**877 274**	727 354
DOMESTIC LIABILITIES		**578 680**	362 500
Balances due to credit institutions	18	502 669	228 872
Balances due to the Government	19	68 389	107 156
Balances due to other financial institutions		2 004	1 300
Other domestic liabilities	20, 21	5 618	25 172
CAPITAL AND RESERVES		**93 764**	94 743
Nominal capital	22	25 000	25 000
Reserve capital	22	54 898	48 089
Valuation account	23	13 333	21 121
European Union grant		533	533
TOTAL LIABILITIES, CAPITAL AND RESERVES		**1 672 914**	1 315 888
MEMORANDUM ITEMS	30		

These financial statements, which are set out on pages 58 to 93, were authorised by Board of the Bank of Latvia on March 2, 2006.

BOARD OF THE BANK OF LATVIA

Māra Raubiško

Reinis Jakovļevs

Helmūts Ancāns

Māris Kālis

Andris Ņikitins

Harijs Ozols

THE BANK OF LATVIA'S PROFIT AND LOSS STATEMENT

(in thousands of lats)

	Notes	**2005**	2004
INTEREST AND SIMILAR INCOME			
Foreign operations			
Interest on deposits with foreign credit institutions and other foreign financial institutions		2 452	1 504
Income from debt securities		31 021	20 076
Dividends on shares in the Bank for International Settlements		200	180
GROSS foreign interest and similar income		**33 673**	21 760
Domestic operations			
Interest on loans to credit institutions		308	1 698
Income from transit credits		–	8
Income from government securities		4 772	5 299
GROSS domestic interest and similar income		**5 080**	7 005
INTEREST EXPENSE			
Foreign operations			
Interest on deposits		9	8
GROSS foreign interest expense		**9**	8
Domestic operations			
Interest on deposits of credit institutions		6 954	1 120
Interest on government deposits		3 032	4 134
Interest on deposits of other financial institutions		32	28
GROSS domestic interest expense		**10 018**	5 282
NET INTEREST AND SIMILAR INCOME	24	**28 726**	23 475

(cont.) (in thousands of lats)

	Notes	**2005**	2004
OTHER OPERATING INCOME		**577**	447
OTHER OPERATING EXPENSE			
Salaries, wages and other personnel costs		9 294	9 497
Social security costs		1 788	1 880
Depreciation and amortisation charges	12, 13	2 780	2 645
Maintenance of information systems		1 059	896
Costs of financing the Financial and Capital Market Commission	25	600	960
Banknote production and coinage costs		296	888
Other operating expense	26	3 760	3 867
TOTAL other operating expense		**19 577**	20 633
PROFIT BEFORE APPROPRIATION		**9 726**	3 289
APPROPRIATION OF PROFIT			
Profit appropriated to the State budget		2 918	987
Increase in reserve capital		6 808	2 302

THE BANK OF LATVIA'S STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

(in thousands of lats)

	Notes	**2005**	2004
RESULT ON REVALUATION			
Increase in market value of gold reserves	4	19 242	1 358
Result on revaluation of assets and liabilities denominated in foreign currencies	23	–13 666	1 402
Increase/decrease (–) in fair value of non-traded financial derivative contracts	23	–5 128	1 990
Decrease in fair value of securities	23	–8 236	–3 341
NET RESULT ON REVALUATION		**–7 788**	1 409
PROFIT BEFORE APPROPRIATION		**9 726**	3 289
TOTAL		**1 938**	4 698

THE BANK OF LATVIA'S CASH FLOW STATEMENT

(in thousands of lats)

	Notes	**2005**	2004
Net cash and cash equivalents inflow arising from operating activities	27 (1)	**57 401**	37 609
Purchase of the shares in the capital of the European Central Bank		**–**	–760
Purchase of the shares in the capital of the Bank for International Settlements		**–763**	–
Acquisition of fixed assets		**–1 058**	–3 719
Acquisition of intangible assets		**–321**	–452
Net cash and cash equivalents inflow	27 (2)	**55 259**	32 678

NOTES TO THE BANK OF LATVIA'S FINANCIAL STATEMENTS

1. PRINCIPAL ACTIVITIES

The Bank of Latvia is the central bank of Latvia. It was established on July 31, 1990 and operates under the Law of the Republic of Latvia "On the Bank of Latvia".

The primary goal of the Bank of Latvia is to maintain price stability in Latvia. Pursuant to the Law "On the Bank of Latvia", its primary tasks are as follows:
– establishment and implementation of monetary policy;
– management of foreign currency and gold reserves;
– issue of the national currency, both banknotes and coins;
– organisation and management of the interbank payment system and promotion of a smooth functioning of the payment system in Latvia;
– compiling and publishing of financial statistics and Latvia's balance of payments;
– representation of Latvia in foreign central banks and international financial institutions;
– acting as a financial agent for the Latvian Government.

In the execution of its tasks, the Bank of Latvia is not subject to decisions and instructions by the Government or other institutions. The Bank of Latvia is independent in setting and implementing policy under its legal mandate. The Bank of Latvia is supervised by the Parliament *(Saeima)* of the Republic of Latvia.

The Bank of Latvia does not engage in any commercial activity, and its operation related to the execution of its tasks is mainly financed from income received from foreign currency and gold reserves management.

The Head Office of the Bank of Latvia is situated in Riga, K. Valdemāra Street 2A. The Bank of Latvia ensures storing, processing and circulation of cash via its Riga Branch and the regional branches in Daugavpils, Liepāja and Rēzekne.

2. RISK MANAGEMENT

The main risks associated with the Bank of Latvia's activities are financial risks and the operational risk. Therefore, the Board of the Bank of Latvia has established a risk management framework under the principles and guidelines set forth by the Council of the Bank of Latvia, which is continuously improved in line with the developments in financial markets and the Bank of Latvia's operation. Management of the Bank of Latvia's financial and operational risk is reviewed by the Internal Audit Department and is monitored by the Security Supervision Commission and Audit Committee of the Bank of Latvia, which are comprised of members of the Council of the Bank of Latvia.

FINANCIAL RISKS
Market (price, interest rate and currency risks), credit and liquidity risks are the most significant financial risks to which the Bank of Latvia is exposed in its daily activities.

The Bank of Latvia manages financial risks related to foreign currency and gold reserves (hereinafter, foreign reserves) in accordance with the "Guidelines for Managing the Bank of Latvia's Foreign Reserves" (hereinafter, the Guidelines), as approved by the Council of the Bank of Latvia. Managing of foreign reserves is conducted in compliance with the basic principles set out in the Guidelines, including preserving the value of foreign reserves, ensuring their liquidity and earning income within the framework of acceptable risk without contradicting to the Bank of Latvia's monetary policy objectives.

Foreign reserves are managed by classifying them into different investment portfolios. Portfolios of borrowed funds include foreign reserves, which correspond to the Bank of Latvia's liabilities in foreign currencies to other institutions. Separate investment portfolios are for gold reserves, foreign currency reserves managed by the Bank of Latvia, and foreign currency reserves managed by external asset managers.

Parameters for a benchmark portfolio reflecting the return target and acceptable level of financial risks, as well as the target structure of investments are set out for each portfolio type in the Guidelines. On a working day basis, the Risk Management Division of the Market Operations Department monitors the compliance of foreign reserves with the requirements set out in the Guidelines.

For the purpose of financial risk management, the Investment Committee of the Bank of Latvia that develops the investment management strategy, approves the investment tactics and sets detailed limits for financial risks in accordance with the Guidelines has been established. The Investment Committee of the Bank of Latvia reviews the investment strategy once a quarter, and on a weekly basis receives and reviews reports and forecasts for developments in financial markets, which are prepared by foreign reserves investment portfolio managers, and approves the investment management tactics for the forthcoming week.

MARKET RISK

Market risk is exposure to losses due to adverse changes in financial markets (for example, movements in interest rates or exchange rates). The Bank of Latvia manages interest rate risk inherent mainly in financial instruments sensitive to interest rate fluctuations by using a modified duration limit set individually for each investment portfolio.

The Bank of Latvia monitors the currency risk by determining open currency position limits. For foreign reserves portfolios, except for portfolios of borrowed funds, the benchmark portfolio currency is euro. For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with parameters of respective liabilities. Deviations from the benchmark currency structure give rise to the open currency position. Every working day, the Risk Management Division of the Market Operations Department monitors the compliance of the modified duration limits and open currency positions with the Guidelines and the related resolutions passed by the Investment Committee of the Bank of Latvia.

The aggregated market risk of foreign reserves portfolios, except for portfolios of borrowed funds, is managed by determining the portfolio tracking error limit. It is calculated as the annualised standard deviation of the difference in return between the investment portfolio and a respective benchmark portfolio.

The Bank of Latvia manages interest rate risk arising from foreign reserves by investing only in financial instruments denominated in the currencies of the OECD countries.

The Bank of Latvia does not hedge interest rate risk, which is related to domestic financial assets in order to avoid a conflict with the monetary policy objectives pursued by the Bank.

Exposure of the Bank of Latvia to market risk (as at the end of 2005) is provided in Notes 32 and 33.

CREDIT RISK
Credit risk is exposure to losses resulting from a counterparty's default. The Bank of Latvia's exposure to credit risk results mainly from investments in foreign debt securities and short-term cash and gold deposits, as well as short-term lending to domestic credit institutions.

The Bank of Latvia manages exposure to credit risk related to investments made in foreign debt securities and short-term cash and gold deposits by establishing limits on investments of different credit quality in the Guidelines. Credit quality is evaluated on the basis of ratings assigned by the international rating agencies *Fitch Ratings*, *Moody's Investors Service* and *Standard & Poor's*. Limits are set also on the maximum investment in financial instruments of the same class and counterparty, as well as in financial instruments of one issuer. In order to monitor the Bank's exposure to credit risk associated with its foreign operations, the Risk Management Division of the Market Operations Department is involved in monitoring of the Bank of Latvia's compliance with the Guidelines on a working day basis.

Short-term loans granted to domestic credit institutions are secured by collateral of Latvian Government securities and such private sector debt securities, which have been included on the list of securities approved by the Chairperson of the Board of the Bank of Latvia and whose issuers' ratings assigned by international rating agencies are not below the rating thresholds established by the Council of the Bank of Latvia in respect of the issuers' long-term liabilities in foreign currencies. The Monetary Policy Department reviews the compliance of ratings assigned to issuers of securities on the list referred above with the requirements of the Council of the Bank of Latvia and monitors the adequacy of collateral on a regular basis. Exposure of the Bank of Latvia to credit risk (as at the end of 2005) is provided in Notes 34 to 36.

LIQUIDITY RISK
Liquidity risk is associated with a failure to meet liabilities timely and to dispose of assets close to fair value. The Bank of Latvia manages liquidity risk by investing foreign exchange reserves in liquid debt securities and other financial instruments issued by international institutions, foreign governments and the corporate sector, while investing its gold reserves in short-term deposits with foreign financial institutions. Investments are made so as to ensure timely meeting of the Bank of Latvia's liabilities. The structure of the Bank of Latvia's cash and its equivalents is provided in Note 27.

The Bank of Latvia manages liquidity risk also by setting limits on the maximum investment in financial instruments of the same class and in financial instruments of the same issuer.

OPERATIONAL RISK
Operational risk is exposure to financial and non-financial losses resulting from an unexpected interruption of operation, unauthorised use of information or physical threats to the employees of the Bank of Latvia, its information and information systems, or material values. To minimise the operational risk related to security and information systems, the Operational Risk Expert Group whose main task is to provide opinion to the Board of the Bank of Latvia on operational risks identified and initiate activities that would minimise these risks, and the Committee for Managing the Bank of Latvia's Information Systems to review, on a regular basis, the management system of information system related operational risk have been established at the Bank of Latvia.

In order to ensure continuous and secure completion of the activities of the Bank of Latvia, in 2005, the Council of the Bank of Latvia approved "The Security Policy of the Bank of Latvia", which determines the goal and framework of security policy of the Bank of Latvia and covers management of risks, continuity of operations, security of information and information systems, and physical security.

The Board of the Bank of Latvia has adopted the "Regulation for Managing the Bank of Latvia's Risks", which lays down the procedure for identifying, documenting, assessing and minimising risks. The management of the Bank of Latvia's operational risk is coordinated by the Risk Management Working Group.

Under the internal control system, information and relevant technical resources are classified to ensure confidentiality, availability and integrity of information. The Bank of Latvia has appointed owners of information and information systems who are responsible for classification, risk analysis and protection of particular information or information systems, and determination of the access rights and their application procedure.

In 2005, activities to improve the operational continuity of the Bank of Latvia were implemented. The aggregate activities form the management system of continuity of the Bank of Latvia's operations, which ensures that incidents and emergency situations are timely identified and prevented, proposals for avoiding incidents and emergency situations in the future are developed, training and education of employees are provided, and action plans for ensuring the continuity of operations are tested and updated.

In 2005, the Council of the Bank of Latvia approved "The Procedure for Managing the Continuity of the Bank of Latvia's Operations", in which the general procedures for managing the continuity of operations are stated. In order to ensure timely identification of incidents and emergency situations, and to coordinate effective actions of the Bank of Latvia departments in managing incidents and emergency situations, in 2005, the Board of the Bank of Latvia approved "The Procedure for Managing Incidents and Emergency Situations at the Bank of Latvia".

The Bank of Latvia's functions whose forced discontinuity may endanger the execution of the Bank of Latvia's tasks, the maximum permissible duration of their forced delay and the critical resources to be used in the implementation of these functions have been determined by the Bank of Latvia. On a regular basis, the Bank of Latvia's management reviews the adequacy and availability of the resources for ensuring the continuity of the Bank's operations in case of emergency.

In order to improve the organisation of the Bank of Latvia's operational activities and to mitigate operational risk, the Bank of Latvia has designed and is continuously developing a quality management system in compliance with the quality management system standard ISO 9001:2000.

Within the framework of measures for managing total operational risk, the Bank of Latvia has been insured against certain types of operational risk.

3. PRINCIPAL ACCOUNTING POLICIES

A summary of the principal accounting policies adopted by the Bank of Latvia in the preparation of these financial statements is set out below. The adopted accounting policies have been applied consistently in the preparation of financial statements for the years ended December 31, 2005 and December 31, 2004.

BASIS OF PRESENTATION

These financial statements have been prepared in accordance with the historical cost basis of accounting, modified for revaluation of certain assets and liabilities as referred to in the accompanying notes.

USE OF ESTIMATES

Estimates and assumptions have been made in the preparation of the financial statements that affect the amounts of certain assets, liabilities and contingent liabilities reported in the financial statements. Future events may affect the above mentioned estimates and assumptions. The effect of a change in such estimates and assumptions is reported in the financial statements of the reporting period and each particular future period to which it refers.

FOREIGN CURRENCY TRANSLATION

Transactions denominated in foreign currencies are recorded in lats at the exchange rates quoted by the Bank of Latvia for the day of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into lats at the exchange rates set by the Bank of Latvia at the end of the reporting period. Non-monetary items measured at cost or amortised cost are translated into lats at the exchange rate for the respective foreign currency set by the Bank of Latvia on the day of the transaction. As of 2005, the Bank of Latvia sets the exchange rates taking into account the lats peg to the euro on the basis of the exchange rate of the US dollar against the euro, and the exchange rates of other currencies against the US dollar as quoted in the information system *Reuters* (until the end of 2004, the official exchange rates of the lats against foreign currencies as quoted by the Bank of Latvia were determined taking into account the peg of the lats to the SDR basket of currencies). Gains and losses resulting from the translation of monetary assets and liabilities denominated in foreign currencies into lats are credited or charged to the balance sheet caption "Valuation account".

The principal exchange rates of foreign currencies and gold set by the Bank of Latvia and used in the preparation of the balance sheet for the year ended December 31, 2005 and the year ended December 31, 2004 are as follows:

(at the end of the year)

	2005	2004	Changes (%)
EUR	**0.702804**	0.703	0
USD	**0.593**	0.516	14.9
GBP	**1.021**	0.996	2.5
JPY	**0.00504**	0.00499	1.0
XAU	**306.27**	228.90	33.8
XDR	**0.851**	0.7997	6.4

RECOGNITION AND DERECOGNITION OF FINANCIAL ASSETS AND LIABILITIES

Financial assets and financial liabilities are recognised in the balance sheet when the Bank of Latvia becomes an involved party in the respective financial transaction. A regular way purchase or sale of financial assets is recognised and derecognised on the settlement day.

A financial asset is derecognised when the contractual rights to cash flows arising from the respective financial asset expire or are transferred, hereby risks and rewards related to the particular asset are transferred, and the Bank of Latvia does not retain control over the asset. Financial liabilities are derecognised when the respective obligations are settled.

FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES
Fair value is the estimated amount at which financial assets could be exchanged, or financial liabilities settled in a transaction on an arm's length basis between knowledgeable and willing parties.

Fair value of financial assets and financial liabilities is obtained from quoted market prices or discounted cash flows. Discounted cash flows are modelled on the basis of financial instruments' quoted market prices and money market interest rates.

Fair value of the Bank of Latvia's financial assets and financial liabilities at the end of 2005 and 2004 did not differ materially from the reported book value of the respective assets and liabilities.

OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES
Financial assets and financial liabilities are offset and the net amount in the financial statements reported only in cases when there is a legally enforceable right to set off the recognised amounts, and there is an intention to settle on a net basis, or dispose the asset and settle the liability simultaneously.

GOLD
Gold reserves are recorded at market value in the balance sheet. Any surplus or deficit arising from the revaluation of gold reserves is credited or charged to the balance sheet caption "Valuation account".

SECURITIES
Debt securities of foreign issuers and Latvian Government securities are stated at fair value in the balance sheet. Adjustments to the value of securities arising from revaluation of these financial instruments are reported in the balance sheet caption "Valuation account" until their disposal. Upon disposal of such securities and on the basis of weighted average cost, the accumulated revaluation result is transferred from the balance sheet caption "Valuation account" to the relevant profit and loss statement caption.

REVERSE REPURCHASE AGREEMENTS
Reverse repurchase agreements are accounted for as financing transactions. Securities purchased under reverse repurchase agreements are not included in the Bank of Latvia's balance sheet. The related funding provided to the counterparty is included in the Bank of Latvia's balance sheet at nominal value as claims on domestic credit institutions or foreign credit institutions and other foreign financial institutions, as appropriate.

The difference between the purchase and resale price of securities is treated as interest income and recognised in the profit and loss statement over the term of the agreement.

REPURCHASE AGREEMENTS
Repurchase agreements are accounted for as financing transactions. Securities sold under repurchase agreements are retained in the Bank of Latvia's balance sheet along with other securities that are not involved in these transactions. Funding received from such sales is included in the balance sheet at nominal value as a liability to the counterparty.

The difference between the sale and repurchase price of securities is treated as interest expense and recognised in the profit and loss statement over the term of the agreement.

LOANS TO CREDIT INSTITUTIONS, DEPOSITS AND SIMILAR FINANCIAL CLAIMS AND FINANCIAL LIABILITIES

Loans granted to credit institutions, deposits and similar financial claims and liabilities are recorded at nominal value in the balance sheet.

PARTICIPATING INTEREST

Participating interest includes long-term investments of the Bank of Latvia in equity instruments. The Bank of Latvia has no control or significant influence in any institution, therefore participating interest is not accounted for as an investment in a subsidiary or an associate. As these equity instruments do not have a market price quoted in an active market and their fair value cannot be reliably measured, they are reported in the balance sheet at cost.

FINANCIAL DERIVATIVES

The Bank of Latvia enters into commitments involving forward exchange rate contracts, currency and interest rate swap arrangements, interest rate future contracts and options, which are reported in off-balance sheet accounts at their contract or notional amount. Subsequent to initial recognition, financial assets and financial liabilities arising from these derivative financial instruments are revalued on a regular basis and reported in the balance sheet at fair value.

Realised gains or losses arising from a change in fair value of interest rate future contracts are transferred to the profit and loss statement upon settlement. Any surplus or deficit arising from a change in fair value of other financial derivatives is credited or charged to the balance sheet caption "Valuation account".

ACCRUED INTEREST INCOME AND EXPENSE

Accrued interest income on debt securities of foreign issuers and Latvian Government securities are reported under the balance caption "Convertible foreign currencies" or "Government securities", respectively. Accrued interest income and expense on other financial instruments are reported under relevant balance sheet captions of other assets or other liabilities.

FIXED ASSETS

Fixed assets are tangible long-term investments costing not less than 50 lats and with the useful life over one year. These assets are used in the provision of services as well as in the maintenance of other fixed assets and for the Bank of Latvia's administrative purposes.

Fixed assets are recorded at cost less accumulated depreciation.

Depreciation is provided using the straight-line method over the useful life of the asset. Assets under construction or development, land and works of art are not depreciated.

The following depreciation rates have been applied on an annual basis:

(%)

	2005	2004
Buildings	**1–3**	1–3
Transport vehicles	**10–20**	20
Office furniture	**10**	10
Computer equipment	**20–33**	25–33
Other office equipment	**20**	20
Cash processing equipment	**10–20**	20
Tools	**50**	50
Other fixed assets	**10–20**	14–20

In accordance with generally accepted principles for hedge accounting, the cost of individual fixed assets includes an effective result arising from financial instruments designated as hedges of exchange risk associated with development of the respective fixed assets.

Costs associated with the maintenance and repairs of fixed assets are recognised in the profit and loss statement when incurred.

Loss on disposal of fixed assets is determined on the basis of the carrying amount of the fixed assets as at the time of disposal and is reported under the profit and loss statement caption "Other operating expense".

INTANGIBLE ASSETS

Intangible assets, which include information system software application rights and other rights, are reported in the balance sheet at cost less accumulated amortisation.

Acquisition costs of such rights are amortised over the period of the licensed use as specified in the relevant agreements using the straight-line method; however, this period may not exceed 10 years.

Costs related to software development by the Bank of Latvia are recognised in the profit and loss statement as expense on the maintenance of information systems when incurred. Expense on the maintenance of information systems software is recognised in the profit and loss statement for the relevant period.

IMPAIRMENT OF ASSETS

The Bank of Latvia's organisational units assess the quality of the Bank of Latvia's assets on a regular basis. When an impairment of an asset is identified, adequate provisions for a relevant asset are established. Such provisions are recognised in the profit and loss statement with the respective reduction in the asset carrying amount.

LATS IN CIRCULATION

Lats banknotes and coins in circulation issued by the Bank of Latvia, except for gold circulation coins, are included in the balance sheet caption "Lats in circulation" at nominal value. The balance sheet caption "Lats in circulation" reports the Bank of Latvia's liabilities to holders of the respective banknotes and coins.

GOLD CIRCULATION COINS

Gold circulation coins (fineness .999) held in the vaults of the Bank of Latvia are included in the balance sheet caption "Other domestic assets", as their nominal value is directly supported by their content of gold. These coins are stated in the balance sheet at the market value of their content of gold.

When gold circulation coins are issued, they are excluded from the balance sheet caption "Other domestic assets". The respective coins in circulation are not included in the balance sheet caption "Lats in circulation", as their nominal value is directly supported by their content of gold.

COLLECTOR COINS

The issued collector coins that represent the Bank of Latvia's liability to holders of these coins are included in the balance sheet caption "Lats in circulation". The issued collector coins that are not circulation coins are not included in the balance sheet caption "Lats in circulation".

CASH AND CASH EQUIVALENTS

For the purposes of the cash flow statement, cash and cash equivalents are defined as the amounts comprising convertible foreign currency in cash, demand deposits with foreign credit institutions and other foreign financial institutions, foreign debt securities, which are readily convertible to cash close to their fair value within twenty-four hours less demand deposits from foreign institutions, Latvian Government, domestic credit institutions, and other domestic financial institutions.

INTEREST AND SIMILAR INCOME AND EXPENSE

Interest income and expense are recognised in the profit and loss statement on an accrual basis. Dividends are recognised when received.

Interest and similar income includes interest on bonds purchased, loans granted and deposits made, as well as the result on disposal of debt securities, the result on changes in the fair value of interest rate future contracts and dividends on BIS shares.

Interest expense includes interest on deposits received from the Latvian Government, domestic credit institutions and other financial institutions, and loans of foreign financial institutions.

FEES

Fees are charged or credited to the profit and loss statement on an accrual basis.

BANKNOTE PRODUCTION AND COINAGE COSTS

Banknote production and coinage costs are charged to the profit and loss statement when incurred.

4. GOLD

Movements in gold reserves during 2005 were as follows:

	Troy ounces	Amount in thousands of lats
As at December 31, 2004	248 583	56 901
Net changes resulting from gold deposits and their withdrawals	118	27
Increase in gold market value	x	19 242
As at December 31, 2005	**248 701**	**76 170**

5. CONVERTIBLE FOREIGN CURRENCIES

Convertible foreign currency assets of the Bank of Latvia are invested primarily in debt securities of high liquidity.

The carrying amount of interest bearing debt securities include both interest income purchased at the date of acquisition and interest income accrued subsequent to the date of acquisition of the securities (18 610 thousand lats at the end of 2005 and 12 225 thousand lats at the end of 2004).

At the end of the year, the balance sheet asset caption "Convertible foreign currencies" was comprised of the following assets:

(in thousands of lats)

	2005	2004
Debt securities of foreign governments, financial institutions and non-financial corporations	**1 255 689**	803 601
Demand deposits with foreign central banks, credit institutions and international institutions	**67 632**	165 565
Time deposits with foreign credit institutions and other foreign financial institutions	**–**	16 718
Foreign currency in cash	**199**	574
Total	**1 323 520**	986 458

6. INTERNATIONAL MONETARY FUND

Claims on the IMF include SDR and Latvia's quota in the IMF. SDR is an international reserve asset created by the IMF and used in transactions between the IMF and its members. The quota in the IMF reflects the subscription in the IMF of respective members and is expressed in SDR. Latvia's quota in the IMF is secured by the Latvian Government promissory note issued to the IMF and is recorded as an asset denominated in SDR. Part of Latvia's quota in the IMF is recognised in the balance sheet in the amount of 126 478 thousand SDR (107 633 thousand lats). The total Latvian quota in the IMF is 126 800 thousand SDR.

Liabilities to the IMF consist of the IMF holdings in lats, which are the resources at the disposal of the IMF held on its accounts with the Bank of Latvia and used in the IMF transactions.

At the end of the year, net claims on the IMF were as follows:

	(in thousands of lats)		(in thousands of SDR)	
	2005	2004	**2005**	2004
Total Latvian quota in the IMF	**107 907**	101 402	**126 800**	126 800
IMF holdings in lats	**–107 875**	–101 371[1]	**–126 762**	–126 762
incl. No. 2 Account	**15**	14	**17**	17
Reserve position in IMF	**47**	45	**55**	55
Special Drawing Rights	**85**	77	**100**	97
Net claims on IMF	**132**	122	**155**	152

[1] The amount differs from the lats equivalent amount reported in the balance sheet, which is stated in lats at the respective IMF SDR exchange rate.

The reserve position in the IMF is a difference between the total Latvian quota in the IMF and the IMF holdings in lats, excluding No. 2 Account, which is used for the IMF administrative expenditure and receipts.

Claims on and liabilities to the IMF are expressed in lats at the SDR exchange rate set by the Bank of Latvia at the end of the year.

7. PARTICIPATING INTEREST IN THE EUROPEAN CENTRAL BANK

When Latvia joined the EU, the Bank of Latvia became the subscriber of the capital of the ECB. The share of the Bank of Latvia in the ECB's capital is 0.2978%, which corresponds to 16 572 thousand euro. In accordance with the Statute of the ESCB and the ECB, the share of the Bank of Latvia in the ECB's capital was calculated on the basis of population and GDP data and is adjusted every five years. As Latvia does not participate in the euro area, pursuant to the transitional provisions of the Statute of the ESCB and the ECB, the Bank of Latvia paid up a minimal 7% contribution of its total subscribed capital in the ECB amounting to 1 160 thousand euro or 760 thousand lats (see also Note 31).

8. PARTICIPATING INTEREST IN THE BANK FOR INTERNATIONAL SETTLEMENTS

At the end of 2005, the Bank of Latvia owned 1 070 shares in the BIS (1 000 shares at the end of 2004), which corresponds to 0.20% of the total subscribed and paid-up BIS capital. In accordance with the amendments to the BIS Statutes in 2001 to restrict shareholding in the BIS to central banks, the BIS had withdrawn privately owned shares and held them in treasury. In January, 2005, the BIS offered the central banks, including the Bank of Latvia, to purchase the unsold shares. In March, 2005, the Bank of Latvia decided to purchase 70 BIS shares (at the price of 23 977.56 Swiss francs per share). These shares were purchased in May, 2005. This step shows the Bank of Latvia's support to the operation of the BIS and enables it to maintain its pro rata shareholding in the BIS.

The nominal value of the Bank of Latvia's shareholding in the BIS is 5 350 thousand SDR (the nominal value per share is 5 thousand SDR), paid up in the amount of 25% or 1 338 thousand SDR (see also Note 31). The paid-up share of this holding as at December 31, 2005 is reported in the Bank of Latvia's balance sheet in the amount of 1 763 thousand lats.

9. OTHER FOREIGN ASSETS

At the end of the year, other foreign assets consisted of the following items:

(in thousands of lats)

	2005	2004
Non-traded financial derivative contracts with foreign financial institutions	**3 281**	23 805
Spot exchange rate contracts with foreign financial institutions	**–**	207
Prepaid expense	**207**	182
Other foreign assets	**8**	71
Total	**3 496**	24 265

10. LOANS TO CREDIT INSTITUTIONS

At the end of the year, credit facilities provided to domestic credit institutions were as follows:

(in thousands of lats)

	2005	2004
Repo loans by original maturity		
7-day	**23 300**	5 980
28-day	**–**	6 900
Total	**23 300**	12 880

11. GOVERNMENT SECURITIES

At the end of the year, the Bank of Latvia held Latvian Government securities with the following residual maturity:

(in thousands of lats)

Residual maturity	**2005**	2004
Up to 3 months	**36 030**	20 062
3 to 6 months	**1 255**	272
6 to 12 months	**4 819**	–
1 to 3 years	**25 146**	53 568
Over 3 years	**31 567**	19 306
Total	**98 817**	93 208

12. FIXED ASSETS

The following changes in fixed assets took place in 2005:

(in thousands of lats)

	Buildings and land	Furniture and office equipment	Cash processing equipment	Transport vehicles	Other fixed assets	Total
As at December 31, 2004						
Cost	31 401	6 078	3 857	1 176	4 454	46 966
Accumulated depreciation	–1 676	–3 959	–1 939	–689	–2 772	–11 035
Net book value	29 725	2 119	1 918	487	1 682	35 931
During 2005						
Additions	50	582	270	55	101	1 058
Change in classification	–213	58	–	–	155	0
Disposals	–114	–469	–27	–21	–194	–825
Net change in cost	–277	171	243	34	62	233
Depreciation charge	–441	–649	–233	–93	–604	–2 020
Change in classification	2	–6	–	–	4	0
Accumulated depreciation on disposals	31	463	27	21	192	734
Net change in accumulated depreciation	–408	–192	–206	–72	–408	–1 286
As at December 31, 2005						
Cost	31 124	6 249	4 100	1 210	4 516	47 199
Accumulated depreciation	–2 084	–4 151	–2 145	–761	–3 180	–12 321
Net book value	**29 040**	**2 098**	**1 955**	**449**	**1 336**	**34 878**

In 2005, the Bank of Latvia changed annual depreciation rates for specific fixed asset groups. Because of the increase in useful life of certain fixed asset groups, depreciation expense was 369 thousand lats less in 2005 than if calculated according to the previously effective annual depreciation rates. Overall, depreciation expense of fixed assets and amortisation expense of intangible assets increased by 135 thousand lats in 2005 mainly due to the acquisition of cash processing equipment and investment in intangible assets in 2004.

13. OTHER DOMESTIC ASSETS

At the end of the year, other domestic assets consisted of the following items:

(in thousands of lats)

	2005	2004
Intangible assets	**2 243**	2 682
Currency swap arrangements with domestic credit institutions	**–**	183
Spot exchange rate contracts with the Treasury	**–**	141
Prepaid expense	**142**	159
Other domestic assets	**107**	99
Total	**2 492**	3 264

Intangible assets include the rights to use specialised software for information systems acquired by the Bank of Latvia and other rights.

The following changes in intangible assets took place in 2005:

(in thousands of lats)

As at December 31, 2004	
Cost	4 078
Accumulated amortisation	–1 396
Net book value	2 682
During 2005	
Additions	321
Disposals	–281
Net change in cost	40
Amortisation charge	–760
Accumulated amortisation on disposals	281
Net change in accumulated amortisation	–479
As at December 31, 2005	
Cost	4 118
Accumulated amortisation	–1 875
Net book value	**2 243**

14. CONVERTIBLE FOREIGN CURRENCIES

Convertible foreign currency liabilities consist of funds on the EC account for settlements in euro as well as liabilities to other institutions; the respective account is used by the EC for the distribution of EU budgetary funds (see also Note 15).

At the end of the year, the balance sheet liability caption "Convertible foreign currencies" consisted of the following items:

(in thousands of lats)

	2005	2004
European Commission demand deposits	**2 844**	2 313
Other liabilities in convertible foreign currencies	**451**	132
Total	**3 295**	2 445

15. OTHER INTERNATIONAL INSTITUTION DEPOSITS IN LATS

Deposits of other international institutions in lats consist of funds on the EC account for settlements in lats, which is used for effecting Latvian Government payments to the EU budget (see also Note 14) and liabilities to other international institutions.

At the end of the year, the breakdown of deposits of other international institutions in lats was as follows:

(in thousands of lats)

	2005	2004
European Commission demand deposits	**571**	21 185
Other deposits	**534**	330
Total	**1 105**	21 515

16. OTHER FOREIGN LIABILITIES

At the end of the year, other foreign liabilities consisted of the following items:

(in thousands of lats)

	2005	2004
Non-traded financial derivative contracts with foreign financial institutions	**10 193**	4 476
Spot exchange rate contracts with foreign financial institutions	**–**	391
Accrued expense	**202**	238
Other foreign liabilities	**0**	21
Total	**10 395**	5 126

17. LATS IN CIRCULATION

At the end of the year, the following units of lats (LVL) and santims (s) were in circulation:

Nominal	Amount (in thousands of lats)		Number (in thousands of units)		Percentage (%)	
	2005	2004	**2005**	2004	**2005**	2004
Banknotes						
LVL 500	**145 212**	128 188	**290**	256	**16.5**	17.6
LVL 100	**166 744**	147 413	**1 667**	1 474	**19.0**	20.3
LVL 50	**47 826**	44 294	**957**	886	**5.5**	6.1
LVL 20	**344 418**	249 473	**17 221**	12 474	**39.3**	34.3
LVL 10	**72 385**	70 627	**7 239**	7 063	**8.3**	9.7
LVL 5	**59 120**	52 347	**11 824**	10 469	**6.7**	7.2
Total banknotes	**835 705**	692 342	**x**	x	**95.3**	95.2
Coins						
LVL 100	**395**	359	**4**	4	**0**	0
LVL 10	**144**	144	**14**	14	**0**	0
LVL 5	**92**	88	**18**	18	**0**	0
LVL 2	**7 187**	6 585	**3 594**	3 293	**0.8**	0.9
LVL 1	**18 762**	14 551	**18 762**	14 551	**2.1**	2.0
50 s	**5 757**	5 261	**11 514**	10 522	**0.7**	0.7
20 s	**3 234**	2 799	**16 167**	13 995	**0.4**	0.4
10 s	**2 027**	1 749	**20 264**	17 493	**0.2**	0.3
5 s	**1 472**	1 315	**29 430**	26 298	**0.2**	0.2
2 s	**1 373**	1 200	**68 665**	60 004	**0.2**	0.2
1 s	**1 126**	961	**112 641**	96 158	**0.1**	0.1
Total coins	**41 569**	35 012	**x**	x	**4.7**	4.8
Total lats in circulation	**877 274**	727 354	**x**	x	**100.0**	100.0

At the end of 2005, the total nominal value of gold circulation coins (fineness .999) issued, with the denomination of LVL 100, was 1 984 thousand lats (1 981 thousand lats at the end of 2004). The respective coins in circulation are not included in the balance sheet caption "Lats in circulation", since their nominal value is directly supported by their content of gold.

Among coins in circulation, there were also collector coins that did not represent any liability of the Bank of Latvia to holders of these coins, and their total nominal value was 1 024 thousand lats at the end of 2005 (994 thousand lats at the end of 2004). These coins are not included in the balance sheet caption "Lats in circulation".

18. BALANCES DUE TO CREDIT INSTITUTIONS

Balances due to credit institutions include balances on the settlement accounts of domestic credit institutions opened with the Bank of Latvia, as well as time deposits in lats received from the above financial institutions. The respective credit institutions place their funds with the Bank of Latvia in order to comply with its minimum reserve requirement, as well as to effect interbank and customer payments, the Bank of Latvia's monetary policy operations and other settlements in the Bank of Latvia's payment systems.

At the end of the year, balances due to credit institutions consisted of the following items:

(in thousands of lats)

	2005	2004
Demand deposits in lats	**471 669**	228 872
Time deposits in lats	**31 000**	–
Total	**502 669**	228 872

The increase in the demand deposit balances due to the domestic credit institutions was inter alia affected by the Bank of Latvia's decisions on a gradual increase of the minimum reserve ratio from 4% to 8% in 2005 (in 2004, the minimum reserve ratio was increased from 3% to 4%).

19. BALANCES DUE TO THE GOVERNMENT

Latvian Government deposits consist of the Treasury demand deposits and time deposits in lats and foreign currencies received by the Bank of Latvia acting as the financial agent of the Latvian Government.

At the end of the year, the breakdown of Latvian Government deposits was as follows:

(in thousands of lats)

	2005	2004
Demand deposits in lats	**8 022**	677
Demand deposits in foreign currencies	**45 481**	58 174
Time deposits in lats	**–**	32 000
Time deposits in foreign currencies	**14 886**	16 305
Total	**68 389**	107 156

20. OTHER DOMESTIC LIABILITIES

At the end of the year, other domestic liabilities consisted of the following items:

(in thousands of lats)

	2005	2004
Bank of Latvia's profit appropriated to the State budget	**2 918**	987
Accrued expense and similar liabilities	**1 943**	1 475
Deferred liabilities to constructors	**688**	766
Tax liabilities	**59**	133
Forward exchange rate contracts with the Treasury	**–**	20 970
Spot exchange rate contracts with the Treasury	**–**	207
Currency swap arrangements with domestic credit institutions	**–**	121
Other domestic liabilities	**10**	513
Total	**5 618**	25 172

21. TAXES

In 2005, the Bank of Latvia calculated and paid the following taxes:

(in thousands of lats)

	Liabilities at the end of the year	Paid	Decrease in deferred liabilities	Calculated	Liabilities at the end of the year
	2005				2004
Personal income tax	**–**	1 982	–	1 982	–
Compulsory social security contributions (by employer)	**6**	1 791	–3	1 788	6
Compulsory social security contributions (by employee)	**2**	676	–	676	2
Tax on real estate	**–**	443	–	443	–
Value added tax	**51**	354	–	280	125
Other taxes	**0**	1	0	1	0
Total	**59**	5 247	–3	5 170	133

In addition to the tax payments indicated herein, the Bank of Latvia transfers a part of the profit for the reporting year and the payment for the usage of State capital (2 918 thousand lats in 2005; 987 thousand lats in 2004; see Notes 20 and 22) to the State budget.

22. NOMINAL CAPITAL AND RESERVE CAPITAL

The nominal capital of the Bank of Latvia is comprised of the State allotted resources and the Bank of Latvia's profit allocations. The authorised and paid-up nominal capital of the Bank of Latvia amounts to 25 million lats as prescribed by the Law "On the Bank of Latvia".

The Law "On the Bank of Latvia" establishes that a part of the Bank of Latvia's annual profit, calculated by applying the tax rate set for residents by the Law "On Enterprise Income Tax", and a payment in the amount of 15% of the profit earned during the reporting year for the usage of State capital shall be transferred to the State budget. At the end of 2005 and 2004, the enterprise income tax rate applicable to residents of Latvia was 15%. Hence, 30% of the Bank of Latvia's profit earned during 2005 shall be transferred to the State budget.

The Bank of Latvia's profit remaining after making the above deductions shall be transferred to the reserve capital. The reserve capital shall be formed to cover potential losses.

23. VALUATION ACCOUNT

At the end of the year, the valuation account comprised the following items:

(in thousands of lats)

	2005	Change	2004
Surplus on revaluation of assets and liabilities in foreign currency and gold	**34 948**	5 576	29 372
Deficit on revaluation of securities	**–14 658**	–8 236	–6 422
Spot exchange rate contracts revaluation result	**–**	250	–250
Deficit on revaluation of forward exchange rate contracts	**–7 765**	–5 063	–2 702
Surplus on revaluation of interest rate swap arrangements	**808**	–254	1 062
Currency swap arrangements revaluation result	**–**	–61	61
Total	**13 333**	–7 788	21 121

24. NET INTEREST AND SIMILAR INCOME

In 2005, the Bank of Latvia's net interest and similar income amounted to 28 726 thousand lats (23 475 thousand lats in 2004). The income was mainly derived from investing foreign currency reserves, and income from Latvian Government securities and money market transactions.

Interest and similar income from foreign operations increased by 11 913 thousand lats in comparison with 2004. Although the interest rate rise in financial markets of the US, euro area and Japan in 2005 had a negative impact on the market value of debt securities, the increase in income was primarily achieved by the Bank of Latvia's significant interventions in foreign currency markets (as a result, the Bank of Latvia's foreign reserves increased by 352 million lats in 2005).

Interest income on loans to domestic credit institutions decreased by 1 390 thousand lats, because of a decrease in the amount of repo transactions, as the bank demand for lats resources was met by selling the euro to the Bank of Latvia in spot transactions. As a result, repo transactions decreased year-on-year. In 2005, income from Latvian Government securities decreased by 527 thousand lats due to the disposal of securities with a decreased fair value, which was previously recognised in the balance sheet caption "Revaluation account", with no significant changes recorded for investment in Latvian Government securities or for the return on these securities.

At the end of the year, the breakdown of interest and similar income was as follows:

(thousand lats)

	2005	2004
Foreign operations		
Interest on demand deposits	**1 825**	1 000
Interest on time deposits	**746**	593
Fixed income from debt securities	**40 121**	29 012
Result on disposal of debt securities	**–9 725**	–7 188
Result on interest rate futures	**1 094**	–1 311
Dividends on shares in the Bank for International Settlements	**200**	180
Expense related to the management of foreign reserves	**–588**	–526
Domestic operations		
Interest on loans to credit institutions	**308**	1 698
Income from transit credits	**–**	8
Fixed income from government securities	**5 869**	5 213
Result on disposal of government securities	**–1 097**	86
Total	**38 753**	28 765

Interest expense (10 027 thousand lats; 5 290 thousand lats in 2004) was largely comprised of interest on deposits of domestic credit institution and the Latvian Government. The increase in interest expense on credit institution deposits by 5 834 thousand lats was mainly caused by the significant growth in minimum reserves deposited with the Bank of Latvia as a result of higher reserve requirement. The Bank of Latvia received a smaller amount of Latvian Government funds as deposits than in 2004, therefore interest expense on Government deposits decreased by 1 102 thousand lats in the reporting year.

25. COSTS OF FINANCING THE FINANCIAL AND CAPITAL MARKET COMMISSION

Pursuant to Article 5 of the Transition Rules of the Law "On the Financial and Capital Market Commission", the operation of the FCMC shall be financed from payments made by financial and capital market participants, the State budget and the Bank of Latvia. In 2005, the Bank of Latvia covered expenses pertaining to the supervision of credit institutions in the amount of 600 thousand lats (960 thousand lats in 2004). The Bank of Latvia is to make such payments also in 2006 in the amount of 240 thousand lats.

26. OTHER OPERATING EXPENSE

In 2005, the Bank of Latvia's other operating expense decreased by 107 thousand lats year-on-year. Compared to 2004, the expense for the maintenance of buildings, territory and equipment increased primarily due to a rise in cash processing equipment maintenance expense. Legal and other professional services expense increased due to representation of the Bank of Latvia's interests in court. In 2005, other expense decreased or remained at about the same level as in the previous year.

Other operating expense was as follows:

(in thousands of lats)

	2005	2004
Maintenance of buildings, territory and equipment	**589**	349
Tax on real estate	**443**	446
Business travel	**436**	473
Municipal services and rent	**365**	404
Telecommunications services	**320**	351
Information and public relations	**268**	369
Insurance	**187**	212
Acquisition of low value office supplies	**154**	190
Legal and other professional services	**154**	45
Personnel training	**148**	155
Maintenance of transport vehicles	**90**	103
Renovation and repair costs	**53**	278
Other operating expense	**553**	492
Total	**3 760**	3 867

27. CASH FLOW STATEMENT

(1) Reconciliation of profit before appropriation to net cash and cash equivalents inflow arising from operating activities

(in thousands of lats)

	2005	2004
Profit before appropriation	**9 726**	3 289
Adjustments		
Depreciation of fixed assets and amortisation of intangible assets	**2 780**	2 645
Loss on disposal of fixed assets	**91**	4
Net change in balance sheet items		
Net increase in gold	**–27**	–
Net increase in Special Drawing Rights	**–3**	–2
Net increase in foreign debt securities and other foreign investments	**–65 082**	–7 020
Net increase (–)/decrease in loans to domestic credit institutions	**–10 420**	46 440
Decrease in transit credits	**–**	3 018
Net increase in Latvian Government securities	**–4 958**	–32 426
Net decrease in other assets	**47**	238
Net decrease in liabilities to the International Monetary Fund	**–**	–3 049
Net increase in foreign bank and other international institution deposits in lats	**47**	0
Net increase in lats in circulation	**149 920**	45 209
Net increase in time deposits of domestic credit institutions	**31 000**	–
Net decrease in Latvian Government time deposits	**–33 419**	–16 270
Net decrease in time deposits of other financial institutions	**–100**	–570
Net decrease in other liabilities	**–22 201**	–3 897
Net cash and cash equivalents inflow arising from operating activities	**57 401**	37 609

(2) Analysis of balances and movements in cash and cash equivalents

(at the end of the year; in thousands of lats)

	2005	Change	2004
Assets			
Convertible foreign currencies in cash	**199**	–375	574
Demand deposits with foreign credit institutions and other foreign financial institutions	**67 632**	–97 933	165 565
Foreign debt securities, which are readily convertible to cash within twenty-four hours	**999 150**	372 304	626 846
Liabilities			
Demand deposits from foreign institutions	**–4 472**	19 516	–23 988
Demand deposits from domestic credit institutions	**–471 669**	–242 797	–228 872
Demand deposits from the Latvian Government	**–53 503**	5 348	–58 851
Demand deposits from other domestic financial institutions	**–1 804**	–804	–1 000
Total cash and cash equivalents	**535 533**	55 259	480 274

28. TRANSACTIONS WITH THE LATVIAN GOVERNMENT

The Bank of Latvia is fully owned by the Republic of Latvia and acts as the financial agent of the Latvian Government. The Bank of Latvia carries out transactions with the Treasury as well as conducts Government securities transactions in the secondary securities market in order to implement monetary policy. In the above transactions, the Bank of Latvia is not subject to the decisions and orders of the Government or its institutions, and is independent in making its own decisions.

At the end of the year, the breakdown of the Bank of Latvia claims on and liabilities to the Latvian Government and the respective interest rates were as follows:

	Amount (in thousands of lats)		Yield (%)	
	2005	2004	**2005**	2004
Assets				
Government securities	**98 817**	93 208	**3.82–4.65**	3.82–7.04
Spot exchange rate contracts	**–**	141	**x**	x
Total assets	**98 817**	93 349	**x**	x
Liabilities				
Demand deposits	**53 503**	58 851	**2.00–3.94**	1.83–2.00
Time deposits	**14 886**	48 305	**2.25–2.30**	2.06–4.05
Bank of Latvia's profit appropriated to the State budget	**2 918**	987	**x**	x
Tax liabilities	**59**	133	**x**	x
Accrued interest expense	**10**	37	**x**	x
Forward exchange rate contracts and spot exchange rate contracts	**–**	21 177	**x**	x
Total liabilities	**71 376**	129 490	**x**	x

At the end of 2005, the Bank of Latvia had not concluded any foreign exchange contracts with the Treasury. At the end of 2004, the Bank of Latvia had concluded the following foreign exchange rate contracts with the Treasury:

(in thousands of lats)

	Claims		Liabilities	
	2005	2004	**2005**	2004
Spot exchange rate contracts	**–**	233 818	**–**	233 884
Forward exchange rate contracts	**–**	212 848	**–**	233 818
Total foreign exchange contracts	**–**	446 666	**–**	467 702

In 2005 and 2004, the breakdown of the Bank of Latvia's income and expense related to the Latvian Government, as well as the Bank of Latvia's profit appropriated to the State budget was as follows:

(in thousands of lats)

	2005	2004
Income		
Income from Government securities	**4 772**	5 299
Income from transit credits	**–**	8
Total income	**4 772**	5 307
Expense and the Bank of Latvia's profit appropriated to the State budget		
Interest on Government deposits	**3 032**	4 134
Taxes	**5 170**	5 498
Bank of Latvia's profit appropriated to the State budget	**2 918**	987
Total expense and the Bank of Latvia's profit appropriated to the State Budget	**11 120**	10 619

29. PLEDGED ASSETS

Securities in the carrying amount of 2 947 thousand lats at the end of 2005 (2 568 thousand lats at the end of 2004) have been pledged to provide collateral for interest rate future contract transactions. These securities are included in the balance sheet asset caption "Convertible foreign currencies".

30. OFF-BALANCE SHEET ACCOUNTS

The Bank of Latvia enters into forward and spot exchange rate contracts, interest rate swap arrangements, interest rate future contracts and options in order to manage interest rate and exchange exposure associated with the Bank of Latvia foreign reserves. As part of its monetary policy, the Bank of Latvia also engages in currency swap arrangements. The Treasury enters into forward and spot exchange rate contracts with the Bank of Latvia in order to manage the foreign exchange exposure of Latvian Government funds.

At the end of the year, the Bank of Latvia's off-balance sheet account profile was as follows:

(in thousands of lats)

	Contract or notional amount		Fair value			
			Assets		Liabilities	
	2005	2004	**2005**	2004	**2005**	2004
Non-traded financial derivative contracts and spot exchange rate contracts						
Spot exchange rate contracts						
with foreign financial institutions	**–**	300 849	**–**	207	**–**	391
with the Treasury	**–**	233 884	**–**	141	**–**	207
Forward exchange rate contracts						
with foreign financial institutions	**783 045**	1 006 938	**2 418**	22 743	**10 183**	4 476
with the Treasury	**–**	233 818	**–**	–	**–**	20 970
Currency swap arrangements						
with domestic credit institutions	**–**	8 274	**–**	183	**–**	121
Gold interest rate swap arrangements						
with foreign financial institutions	**39 203**	43 949	**818**	1 062	**10**	–
Other interest rate contracts						
with foreign financial institutions	**7 259**	–	**45**	–	**–**	–
Total non-traded financial derivative contracts and spot exchange rate contracts						
with foreign financial institutions	**x**	x	**3 281**	24 012	**10 193**	4 867
with domestic credit institutions and the Treasury	**x**	x	**–**	324	**–**	21 298
Traded financial derivative contracts						
Interest rate future contracts						
with foreign financial institutions	**199 163**	413 796	**113**	421	**217**	797
Other transactions						
Agreements concluded on a regular way purchase and sale of securities	**–**	6 757	**x**	x	**x**	x
Agreements concluded on a regular way receipt and placement of time deposits	**3 479**	3 044	**x**	x	**x**	x
Contracted commitments related to acquisition and rent of fixed assets	**71**	7	**x**	x	**x**	x

31. CONTINGENT LIABILITIES AND COMMITMENTS

In May 2005, JSC *BDO Invest Rīga* as the liquidator of the bankrupt JSC *Banka Baltija* filed a claim against the Bank of Latvia on behalf of the creditors of JSC *Banka Baltija* in the Riga Regional Court for the recovery of losses in the amount of 185.6 million lats. The claimant alleges that the Bank of Latvia, as the institution in charge of banking supervision at that time, is responsible for losses arising from the bankruptcy of JSC *Banka Baltija* in 1995. The Bank of Latvia is confident that the claim is without merits, therefore no provision is made in the financial statements. The final ruling on the case is not expected until 2007.

The Bank of Latvia has not paid up 93% of the Bank of Latvia's share in the ECB subscribed capital, which is payable following the decision of the ECB. At the end of 2005, the Bank of Latvia's unpaid share in the ECB subscribed capital was 15 412 thousand euro (10 831 thousand lats).

The Bank of Latvia's uncalled portion of the BIS shares is 75% of their nominal value. These shares are callable following the decision of the BIS Board. At the end of 2005, the uncalled portion of the BIS share holding was 4 013 thousand SDR (3 415 thousand lats).

32. CURRENCY PROFILE

At the end of 2005 and 2004, the net position of the Bank of Latvia's assets, liabilities and memorandum items within the limits stipulated by the Guidelines corresponded to the euro profile.

At the end of the year, the currency profile of the Bank of Latvia's assets, liabilities and memorandum items was as follows:

(in thousands of lats)

	LVL	XDR	USD	EUR	GBP	JPY	Gold	Other	Total
As at December 31, 2005									
Foreign assets									
Gold	–	–	–	–	–	–	76 170	–	76 170
Special Drawing Rights	–	85	–	–	–	–	–	–	85
Convertible foreign currencies	–	–	519 838	738 689	14 454	29 237	–	21 302	1 323 520
International Monetary Fund	–	107 633	–	–	–	–	–	–	107 633
Participating interest in the European Central Bank	–	–	–	760[1]	–	–	–	–	760
Participating interest in the Bank for International Settlements	–	1 763[1]	–	–	–	–	–	–	1 763
Other foreign assets	3 317	–	44	27	107	–	1	–	3 496
Domestic assets									
Loans to credit institutions	23 300	–	–	–	–	–	–	–	23 300
Government securities	98 817	–	–	–	–	–	–	–	98 817
Fixed assets	34 878	–	–	–	–	–	–	–	34 878
Other domestic assets	2 485	–	–	7	–	–	–	–	2 492
TOTAL ASSETS	**162 797**	**109 481**	**519 882**	**739 483**	**14 561**	**29 237**	**76 171**	**21 302**	**1 672 914**
Foreign liabilities									
Convertible foreign currencies	–	–	451	2 844	–	–	–	–	3 295
International Monetary Fund	107 875[2]	–	–	–	–	–	–	–	107 875
Other international institution deposits in lats	1 105	–	–	–	–	–	–	–	1 105
Foreign bank deposits in lats	486	–	–	–	–	–	–	–	486
Non-convertible currencies	–	–	–	–	–	–	–	40	40
Other foreign liabilities	10 192	–	137	66	–	–	–	–	10 395
Lats in circulation	877 274	–	–	–	–	–	–	–	877 274
Domestic liabilities									
Balances due to credit institutions	502 669	–	–	–	–	–	–	–	502 669
Balances due to the Government	8 022	85	11 491	48 789	–	2	–	–	68 389
Balances due to other financial institutions	1 980	–	22	2	–	–	–	–	2 004
Other domestic liabilities	4 957	–	2	659	–	–	–	–	5 618
TOTAL LIABILITIES	**1 514 560**	**85**	**12 103**	**52 360**	**–**	**2**	**–**	**40**	**1 579 150**

[1] The respective assets are recorded in the balance sheet at cost and the Bank of Latvia is not exposed to currency risk related to these assets.
[2] The Bank of Latvia is exposed to the SDR currency risk related to IMF holdings in lats based on changes in the underlying SDR balances determined in accordance with the exchange rate set by the IMF.

(cont.) (in thousands of lats)

	LVL	XDR	USD	EUR	GBP	JPY	Gold	Other	Total
Net position on balance sheet	–1 351 763	109 396	507 779	687 123	14 561	29 235	76 171	21 262	93 764
Net position on financial instruments' off-balance sheet accounts	–	–	–503 841	638 276	–14 759	–27 733	–76 228	–22 627	–6 912
Net position on balance sheet and off-balance sheet accounts	–1 351 763	109 396	3 938	1 325 399	–198	1 502	–57	–1 365	86 852
Net position on balance sheet and off-balance sheet accounts exposed to currency risk	–1 241 365	–242	3 938	1 324 639	–198	1 502	–57	–1 365	86 852
Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%)	x	–0.02	0.30	99.73	–0.01	0.11	0	–0.10	100.0
As at December 31, 2004									
TOTAL ASSETS	169 294	102 221	372 678	582 281	735	31 661	56 907	111	1 315 888
TOTAL LIABILITIES	1 143 243	77	167	77 618	–	–	–	40	1 221 145
Net position on balance sheet	–973 949	102 144	372 511	504 663	735	31 661	56 907	71	94 743
Net position on financial instruments' off-balance sheet accounts	8 323	–	–375 768	451 271	–760	–31 136	–56 822	3 063	–1 829
Net position on balance sheet and off-balance sheet accounts	–965 626	102 144	–3 257	955 934	–25	525	85	3 134	92 914
Net position on balance sheet and off-balance sheet accounts exposed to currency risk	–862 093	–629	–3 257	955 174	–25	525	85	3 134	92 914
Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%)	x	–0.07	–0.34	100.02	0	0.05	0.01	0.33	100.0

33. REPRICING MATURITY AND TRACKING ERROR

(in thousands of lats)

	Interest bearing					Non-interest bearing	Total
	Up to 3 months	3–6 months	6–12 months	1–3 years	Over 3 years		
As at December 31, 2005							
Foreign assets							
Gold	16 854	–	–	–	–	59 316	76 170
Special Drawing Rights	85	–	–	–	–	–	85
Convertible foreign currencies	223 553	17 218	128 865	751 957	201 366	561	1 323 520
International Monetary Fund	–	–	–	–	–	107 633	107 633
Participating interest in the European Central Bank	–	–	–	–	–	760	760
Participating interest in the Bank for International Settlements	–	–	–	–	–	1 763	1 763
Other foreign assets	–	–	–	–	–	3 496	3 496
Domestic assets							
Loans to credit institutions	23 300	–	–	–	–	–	23 300
Government securities	36 030	1 255	4 819	25 146	31 567	–	98 817
Fixed assets	–	–	–	–	–	34 878	34 878
Other domestic assets	–	–	–	–	–	2 492	2 492
TOTAL ASSETS	**299 822**	**18 473**	**133 684**	**777 103**	**232 933**	**210 899**	**1 672 914**
Foreign liabilities							
Convertible foreign currencies	–	–	–	–	–	3 295	3 295
International Monetary Fund	–	–	–	–	–	107 875	107 875
Other international institution deposits in lats	–	–	–	–	–	1 105	1 105
Foreign bank deposits in lats	414	–	–	–	–	72	486
Non-convertible currencies	–	–	–	–	–	40	40
Other foreign liabilities	–	–	–	–	–	10 395	10 395
Lats in circulation	–	–	–	–	–	877 274	877 274
Domestic liabilities							
Balances due to credit institutions	502 669	–	–	–	–	–	502 669
Balances due to the Government	68 389	–	–	–	–	–	68 389
Balances due to other financial institutions	1 369	–	–	–	–	635	2 004
Other domestic liabilities	–	–	–	–	–	5 618	5 618
TOTAL LIABILITIES	**572 841**	**–**	**–**	**–**	**–**	**1 006 309**	**1 579 150**
Net position on balance sheet	–273 019	18 473	133 684	777 103	232 933	x	x
Assets on financial instruments' off-balance sheet accounts	779 136	19 817	–	–	20 221	x	x
Liabilities on financial instruments' off-balance sheet accounts	826 086	–	–	–	–	x	x

(cont.) (in thousands of lats)

	Interest bearing					Non-interest bearing	Total
	Up to 3 months	3–6 months	6–12 months	1–3 years	Over 3 years		
As at December 31, 2004							
TOTAL ASSETS	294 536	29 502	28 909	611 090	147 917	203 934	1 315 888
TOTAL LIABILITIES	203 394	–	–	–	–	1 017 751	1 221 145
Net position on balance sheet	91 142	29 502	28 909	611 090	147 917	x	x
Assets on financial instruments' off-balance sheet accounts	1 764 251	15 182	14 863	15 104	15 090	x	x
Liabilities on financial instruments' off-balance sheet accounts	1 811 097	15 222	–	–	–	x	x

The table above reflects the sensitivity of the Bank of Latvia's assets, liabilities and memorandum items to a change in interest rates. Items reported in this table are stated at carrying amounts, categorised by the earlier of contractual interest repricing or residual maturity dates.

The exposure of foreign reserves portfolios to credit risk and aggregated market risk, except for the gold portfolio and portfolios of borrowed funds, can be characterised by the tracking error, which is measured as the annualised standard deviation of the difference in return between the investment portfolio and a respective benchmark portfolio. For foreign reserves portfolios, except for the gold portfolio and portfolios of borrowed funds, the benchmark portfolio is pledged to the weighted 1–3 year government securities index of the euro area countries, US and Japan in euro, eliminating the currency risk.

In 2005 and 2004, the average weighted tracking error of the Bank of Latvia's foreign reserves portfolios, except for the gold portfolio and portfolios of borrowed funds, was 31 and 26 basis points respectively, and it lay within the following basis points intervals during the year:

Tracking error (in basis points)	Number of working days	
	2005	2004
10–20	**1**	2
20–30	**135**	193
30–40	**69**	58
40–50	**48**	1
Total	**253**	254

34. SECTORAL PROFILE OF ASSETS

The sectoral profile of the Bank of Latvia's assets at the end of the year was as follows:

	Amount (in thousands of lats)		Percentage (%)	
	2005	2004	**2005**	2004
Claims				
Foreign central governments and other governmental institutions	**590 804**	514 852	**35.3**	39.1
Foreign local governments	**62 107**	16 807	**3.7**	1.3
Foreign central banks and credit institutions	**376 010**	393 578	**22.5**	29.9
Other foreign financial institutions	**286 874**	73 287	**17.1**	5.5
Foreign non-financial corporations	**57 589**	38 080	**3.4**	2.9
International institutions	**138 531**	133 874	**8.3**	10.2
Latvian central government	**122 125**	106 242	**7.3**	8.1
Domestic credit institutions	**17**	201	**0**	0
Unclassified assets	**38 857**	38 967	**2.4**	3.0
Total	**1 672 914**	1 315 888	**100.0**	100.0

For the purposes of credit risk analysis, claims arising from securities purchased under reverse repurchase agreements are classified herein according to the issuer of the security. As a result, claims arising from government securities purchased under agreements to resell to domestic credit institutions in the amount of 23 300 thousand lats (12 880 thousand lats at the end of 2004) and the related accrued interest income in the amount of 8 thousand lats (13 thousand lats at the end of 2004) are reported as exposure to the Latvian central government.

35. FOREIGN ASSETS BY THEIR LOCATION OR THE COUNTERPARTY'S DOMICILE

At the end of the year, the Bank of Latvia's foreign assets broken down by their location or the counterparty's domicile were as follows:

	Amount (in thousands of lats)		Percentage (%)	
	2005	2004	**2005**	2004
EU	**873 878**	527 356	**57.7**	45.0
US	**337 601**	265 028	**22.3**	22.6
Japan	**65 093**	28 011	**4.3**	2.4
Other countries	**98 324**	216 336	**6.5**	18.6
International institutions	**138 531**	133 874	**9.2**	11.4
Total	**1 513 427**	1 170 605	**100.0**	100.0

36. ASSETS BY CREDIT RATINGS ASSIGNED TO THE COUNTERPARTY

At the end of the year, the Bank of Latvia's assets broken down by categories of credit ratings assigned to the counterparty were as follows:

	Credit rating	Amount (in thousands of lats)		Percentage (%)	
		2005	2004	**2005**	2004
FOREIGN ASSETS					
Gold	AAA	**39 351**	34 586	**2.4**	2.6
	AA	**36 819**	22 315	**2.2**	1.7
Special Drawing Rights	AAA	**85**	77	**0**	0
Foreign debt securities	AAA	**934 021**	599 789	**55.8**	45.5
	AA+	**45 996**	61 957	**2.7**	4.7
	AA	**41 384**	32 748	**2.5**	2.5
	AA–	**122 269**	48 236	**7.3**	3.6
	A+	**33 303**	20 817	**2.0**	1.6
	A	**70 442**	33 408	**4.2**	2.5
	A–	**8 274**	6 646	**0.5**	0.5
Deposits with foreign financial institutions	AAA	**52 727**	152 514	**3.2**	11.6
	AA+	**42**	1 605	**0**	0.1
	AA	**2 778**	12 999	**0.2**	1.0
	AA–	**4 391**	5 227	**0.3**	0.4
	A+	**3 037**	1 008	**0.2**	0.1
	A	**1 068**	1 401	**0.1**	0.1
	A–	**3 589**	7 529	**0.2**	0.6
Foreign currency in cash	AAA	**199**	574	**0**	0.0
International Monetary Fund	AAA	**107 633**	101 144	**6.4**	7.7
Participating interest in the European Central Bank	AAA	**760**	760	**0**	0.1
Participating interest in the Bank for International Settlements	AAA	**1 763**	1 000	**0.1**	0.1
Derivative financial instruments	AAA	**44**	–	**0**	–
	AA+	**197**	19	**0**	0
	AA	**173**	6 163	**0**	0.5
	AA–	**1 362**	4 819	**0.1**	0.4
	A+	**1 072**	12 999	**0.1**	1.0
	A–	**433**	12	**0**	0
Accrued interest income	Different	**1**	45	**0**	0
Other foreign assets	Different	**214**	208	**0**	0
DOMESTIC ASSETS					
Loans to credit institutions	Different	**23 300**	12 880	**1.4**	1.0
Government securities	A–	**98 817**	93 208	**5.9**	7.1
Other	Different	**37 370**	39 195	**2.2**	3.0
TOTAL		**1 672 914**	1 315 888	**100.0**	100.0

At the end of the year, the Bank of Latvia's foreign assets broken down by major categories of credit ratings assigned to the counterparty were as follows:

	Credit rating category	Amount (in thousands of lats)		Percentage (%)	
		2005	2004	**2005**	2004
Foreign assets	AAA	**1 136 583**	890 444	**75.1**	76.1
	AA	**255 411**	196 088	**16.9**	16.7
	A	**121 218**	83 820	**8.0**	7.2
	Different	**215**	253	**0**	0
Total		**1 513 427**	1 170 605	**100.0**	100.0

Based on *Standard & Poor's* credit ratings or other equivalent credit ratings assigned by other international credit rating agency to the counterparty, the above tables show the breakdown of the Bank of Latvia's assets as at the end of the year. The rating "AAA" is the highest possible long-term creditworthiness rating, which indicates an extremely strong capacity of the counterparty to meet its financial commitments. The rating "AA" confirms the counterparty's very strong capacity and the rating "A" the counterparty's strong capacity to meet its financial commitments in the long term. Ratings below "AAA" are modified by marks "+" or "–" to show the relative standing within the major categories of an international agency's ratings.

REPORT OF THE AUDIT COMMISSION TO THE COUNCIL OF THE BANK OF LATVIA

We have audited the balance sheet of the Bank of Latvia as at 31 December 2005, and the related statements of profit and loss, total recognised gains and losses, and cash flows for the year then ended and the accompanying notes (hereinafter, the financial statements). These financial statements, which are set out on pages 58 to 93, are the responsibility of the Bank of Latvia's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing issued by the International Federation of Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank of Latvia as at 31 December 2005, and the results of its operations and its cash flows for the year then ended in conformity with the accounting principles adopted by the Bank of Latvia and the Law "On the Bank of Latvia".

ERNST & YOUNG

THE STATE AUDIT OFFICE
OF THE REPUBLIC OF LATVIA

Riga
2 March 2006

RESOLUTION OF THE COUNCIL OF THE BANK OF LATVIA

On April 27, 2006, the Bank of Latvia's Council passed Resolution No. 126/1 "On the Bank of Latvia's Annual Report for 2005".

Having reviewed the results of the audit of the Bank of Latvia's economic activity in 2005, the Bank of Latvia's Council resolves:

1. To approve the Bank of Latvia's Annual Report for 2005, including the balance sheet, profit and loss statement, statement of recognised gains and losses and cash flow statement.

2. To appropriate the Bank of Latvia's profit for 2005 in the following way:
2.1 2 918 thousand lats to be transferred to the state revenue.
2.2 6 808 thousand lats to be transferred to the Bank's reserve capital.

ILMĀRS RIMŠĒVIČS
GOVERNOR
BANK OF LATVIA

Edvards Grūbe
RHYTHMS. 1997
Oil on canvas. 146 x 114 cm

APPENDICES

Appendix 1

MONETARY INDICATORS IN 2005

(at end of period; in millions of lats)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
BANK OF LATVIA												
M0	918.7	975.3	997.7	988.4	1 016.3	1 075.2	1 068.5	1 164.0	1 202.7	1 198.5	1 284.3	**1 350.7**
Currency in circulation	712.3	718.7	717.8	736.7	749.3	766.7	788.6	784.8	800.6	813.7	830.8	**877.3**
Deposits with the Bank of Latvia	206.4	256.6	280.0	251.7	267.1	308.5	279.9	379.3	402.1	384.7	453.5	**473.5**
Currency vs monetary base (%)	77.5	73.7	71.9	74.5	73.7	71.3	73.8	67.4	66.6	67.9	64.7	**65.0**
Net foreign assets	1 015.9	1 097.2	1 120.6	1 140.2	1 169.8	1 244.4	1 254.8	1 317.8	1 382.4	1 372.6	1 373.4	**1 390.2**
Net domestic assets	–97.2	–121.9	–122.9	–151.9	–153.5	–169.1	–186.3	–153.8	–179.7	–174.1	–89.1	**–39.5**
Credit	–33.9	–59.3	–32.3	–26.9	–67.3	–40.6	–41.9	–61.7	–77.6	–72.3	–0.3	**53.7**
To MFIs	10.9	8.3	8.5	8.5	8.2	8.5	3.5	4.5	4.7	3.0	2.9	**23.3**
To central government (net)	–44.8	–67.6	–40.8	–35.4	–75.5	–49.1	–45.4	–66.2	–82.3	–75.3	–3.2	**30.4**
Other items (net)	–63.3	–62.6	–90.6	–124.9	–86.1	–128.5	–144.5	–92.1	–102.1	–101.8	–88.8	**–93.2**
BANKING SYSTEM												
M1	2 006.6	2 034.5	2 086.1	2 137.6	2 225.3	2 354.2	2 407.6	2 457.1	2 562.1	2 578.6	2 703.8	**2 870.2**
M2	2 811.2	2 878.3	2 964.1	3 019.8	3 061.5	3 224.9	3 297.2	3 369.1	3 487.9	3 525.9	3 692.0	**3 905.8**
M3	2 811.2	2 878.3	2 964.1	3 033.9	3 073.5	3 240.2	3 311.4	3 385.8	3 503.2	3 542.7	3 709.9	**3 925.4**
M2X	2 863.3	2 925.8	3 013.8	3 066.0	3 107.8	3 272.8	3 349.1	3 418.6	3 539.8	3 574.9	3 735.7	**3 984.7**
Currency outside MFIs	632.3	639.8	640.0	661.2	669.7	689.6	707.8	707.2	717.1	730.5	745.1	**786.4**
Deposits of resident financial institutions, non-financial corporations and households	2 231.1	2 285.9	2 373.8	2 404.8	2 438.1	2 583.2	2 641.3	2 711.5	2 822.7	2 844.4	2 990.6	**3 198.3**
In foreign currencies	864.9	887.8	908.9	925.3	971.7	1 030.6	1 080.8	1 114.0	1 190.5	1 162.6	1 223.4	**1 299.2**
Net foreign assets	–358.5	–350.4	–397.6	–485.2	–572.8	–536.5	–631.3	–690.3	–784.1	–995.0	–1 158.1	**–1 326.6**
Net domestic assets	3 221.8	3 276.2	3 411.4	3 551.2	3 680.6	3 809.3	3 980.4	4 108.9	4 323.9	4 569.9	4 893.8	**5 311.2**
Loans to resident financial institutions, non-financial corporations and households	3 897.4	3 972.3	4 150.7	4 285.6	4 496.8	4 717.0	4 902.8	5 095.7	5 353.1	5 592.5	5 875.5	**6 139.7**
Bank of Latvia refinancing rate (at end of period; %)	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	**4.0**
Weighted average interest rates on transactions in lats (%)												
Interbank loans	2.7	3.5	2.2	2.3	2.5	2.2	2.2	2.2	2.9	2.2	2.5	**2.7**
Loans to non-financial corporations and households with a floating interest rate and an initial rate fixation of up to 1 year (new business)	7.4	7.5	7.3	6.4	5.8	5.7	5.5	5.5	5.4	5.5	5.6	**5.7**
Time deposits of non-financial corporations and households (new business)	3.5	3.3	2.9	2.8	2.6	2.8	2.6	2.5	2.5	2.5	2.5	**3.1**

Appendix 2

THE BANK OF LATVIA'S MONTH-END BALANCE SHEETS FOR 2005

(at the end of month; in thousands of lats)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
FOREIGN ASSETS	1 157 168	1 216 036	1 241 507	1 261 370	1 305 626	1 376 037	1 382 318	1 439 896	1 509 652	1 495 653	1 512 611	**1 513 427**
Gold	57 231	57 321	57 522	58 445	58 489	63 074	61 523	62 440	68 122	68 222	73 881	**76 170**
SDR	79	79	80	80	82	84	83	84	84	83	84	**85**
Convertible foreign currencies	992 312	1 047 933	1 076 389	1 094 624	1 135 650	1 200 336	1 208 252	1 264 180	1 329 102	1 313 734	1 325 808	**1 323 520**
IMF	103 712	103 080	103 459	103 965	105 356	107 886	106 368	106 621	106 747	106 242	106 621	**107 633**
Participating interest in the ECB	760	760	760	760	760	760	760	760	760	760	760	**760**
Participating interest in the BIS	1 000	1 000	1 000	1 000	1 763	1 763	1 763	1 763	1 763	1 763	1 763	**1 763**
Other foreign assets	2 074	5 863	2 297	2 496	3 526	2 134	3 569	4 048	3 074	4 849	3 694	**3 496**
DOMESTIC ASSETS	143 161	139 982	145 840	146 148	145 662	146 280	140 054	141 086	141 541	139 893	138 521	**159 487**
Loans to credit institutions	10 930	8 290	8 500	8 500	8 200	8 500	3 500	4 500	4 700	3 000	2 900	**23 300**
Government securities	93 387	92 969	98 730	99 053	99 232	99 581	98 451	98 582	99 004	99 226	98 159	**98 817**
Fixed assets	35 694	35 533	35 444	35 291	35 141	35 264	35 150	35 116	35 008	34 941	34 865	**34 878**
Other domestic assets	3 150	3 190	3 166	3 304	3 089	2 935	2 953	2 888	2 829	2 726	2 597	**2 492**
TOTAL ASSETS	1 300 329	1 356 018	1 387 347	1 407 518	1 451 288	1 522 317	1 522 372	1 580 982	1 651 193	1 635 546	1 651 132	**1 672 914**
FOREIGN LIABILITIES	141 283	118 833	120 912	121 132	135 841	131 687	127 513	122 091	127 211	123 045	139 230	**123 196**
Convertible foreign currencies	7 430	7 571	2 664	1 262	3 730	2 762	3 565	2 940	2 719	9 218	7 551	**3 295**
IMF	103 945	103 311	103 691	104 198	105 593	108 128	106 607	106 860	106 987	106 480	106 860	**107 875**
Other international institution deposits in lats	15 442	418	5 343	10 378	8 353	2 144	6 821	7 054	1 202	1 611	7 745	**1 105**
Foreign bank deposits in lats	503	445	389	414	418	401	407	653	673	608	449	**486**
Non-convertible currencies	38	38	38	38	39	40	40	40	40	40	40	**40**
Other foreign liabilities	13 925	7 050	8 787	4 842	17 708	18 212	10 073	4 544	15 590	5 088	16 585	**10 395**
LATS IN CIRCULATION	712 268	718 710	717 764	736 691	749 259	766 682	788 624	784 756	800 627	813 743	830 756	**877 274**
DOMESTIC LIABILITIES	350 642	423 731	454 050	449 735	465 191	520 975	507 933	575 595	628 155	609 765	593 009	**578 680**
Balances due to credit institutions	202 938	251 581	308 977	309 572	284 078	364 460	351 846	399 803	433 263	420 004	476 863	**502 669**
Balances due to the Government	138 181	160 589	139 506	134 490	174 779	148 726	143 801	164 771	181 340	174 544	101 373	**68 389**
Balances due to other financial institutions	3 783	5 307	1 282	1 971	1 595	2 038	4 215	1 648	2 059	2 424	3 047	**2 004**
Other domestic liabilities	5 740	6 254	4 285	3 702	4 739	5 751	8 071	9 373	11 493	12 793	11 726	**5 618**
CAPITAL AND RESERVES	96 136	94 744	94 621	99 960	100 997	102 973	98 302	98 540	95 200	88 993	88 137	**93 764**
Nominal capital	25 000	25 000	25 000	25 000	25 000	25 000	25 000	25 000	25 000	25 000	25 000	**25 000**
Reserve capital	48 090	48 090	48 090	48 090	48 090	48 090	48 090	48 090	48 090	48 090	48 090	**54 898**
Valuation account	22 513	21 121	20 998	26 337	27 374	29 350	24 679	24 917	21 577	15 370	14 514	**13 333**
EU grant	533	533	533	533	533	533	533	533	533	533	533	**533**
TOTAL LIABILITIES, CAPITAL AND RESERVES	1 300 329	1 356 018	1 387 347	1 407 518	1 451 288	1 522 317	1 522 372	1 580 982	1 651 193	1 635 546	1 651 132	**1 672 914**

Appendix 3

THE BANK OF LATVIA'S YEAR-END BALANCE SHEETS FOR THE YEARS 2001–2005

(at end of year; in thousands of lats)

	2001	2002	2003	2004	**2005**
FOREIGN ASSETS	881 489	894 613	937 526	1 170 605	**1 513 427**
Gold	44 443	51 025	55 543	56 901	**76 170**
SDR	54	41	75	77	**85**
Convertible foreign currencies	732 799	737 313	774 834	986 458	**1 323 520**
IMF	101 144	101 144	101 144	101 144	**107 633**
Participating interest in the ECB	–	–	–	760	**760**
Participating interest in the BIS	1 043	1 197	1 000	1 000	**1 763**
Other foreign assets	2 006	3 893	4 930	24 265	**3 496**
DOMESTIC ASSETS	98 121	146 321	162 716	145 283	**159 487**
Loans to credit institutions	18 833	30 690	59 320	12 880	**23 300**
Transit credits	18 612	11 749	3 018	–	**–**
Government securities	24 715	64 382	62 273	93 208	**98 817**
Fixed assets	32 819	32 798	34 200	35 931	**34 878**
Other domestic assets	3 142	6 702	3 905	3 264	**2 492**
TOTAL ASSETS	979 610	1 040 934	1 100 242	1 315 888	**1 672 914**
FOREIGN LIABILITIES	122 306	116 778	113 545	131 291	**123 196**
Convertible foreign currencies	–	–	149	2 445	**3 295**
IMF	116 012	110 388	104 423	101 773	**107 875**
Other international institution deposits in lats[1]	42	257	268	21 515	**1 105**
Foreign bank deposits in lats[1]	412	422	409	396	**486**
Non-convertible currencies	41	37	36	36	**40**
Other foreign liabilities	5 799	5 674	8 260	5 126	**10 395**
LATS IN CIRCULATION	556 003	622 632	682 145	727 354	**877 274**
DOMESTIC LIABILITIES	226 374	209 676	213 521	362 500	**578 680**
Balances due to credit institutions	82 433	134 223	123 810	228 872	**502 669**
Balances due to the Government	119 587	62 079	80 254	107 156	**68 389**
Balances due to other financial institutions	3 441	3 012	1 670	1 300	**2 004**
Other domestic liabilities	20 913	10 362	7 787	25 172	**5 618**
CAPITAL AND RESERVES	74 927	91 848	91 031	94 743	**93 764**
Nominal capital	10 100	25 000	25 000	25 000	**25 000**
Reserve capital	5 512	37 928	45 787	48 089	**54 898**
Other reserves	38 224	–	–	–	**–**
Valuation account	20 567	28 389	19 712	21 121	**13 333**
EU grant	524	531	532	533	**533**
TOTAL LIABILITIES, CAPITAL AND RESERVES	979 610	1 040 934	1 100 242	1 315 888	**1 672 914**

[1] Other international institution deposits in lats were reported under the caption "Foreign bank deposits in lats" in the financial statements for the years 2001–2003.

Appendix 4

THE BANK OF LATVIA'S PROFIT AND LOSS STATEMENTS FOR THE YEARS 2001–2005

(in thousands of lats)

	2001	2002	2003	2004	**2005**
INTEREST AND SIMILAR INCOME					
Foreign operations	35 985	30 762	27 327	21 760	**33 673**
Domestic operations	6 340	5 550	5 984	7 005	**5 080**
INTEREST EXPENSE					
Foreign operations	44	127	8	8	**9**
Domestic operations	2 797	3 688	2 651	5 282	**10 018**
NET INTEREST AND SIMILAR INCOME	39 484	32 497	30 652	23 475	**28 726**
OTHER OPERATING INCOME	520	605	994	447	**577**
OTHER OPERATING EXPENSE	17 850	18 668	19 738	20 633	**19 577**
PROFIT BEFORE APPROPRIATION	22 154	14 434	11 908	3 289	**9 726**

Appendix 5

THE BANK OF LATVIA'S EXCHANGE RATES FOR THE BRITISH POUND STERLING, THE JAPANESE YEN AND THE US DOLLAR

(LVL vs foreign currency)

2005	GBP				100 JPY				USD			
	Maximum	Average	Minimum	At end of period	Maximum	Average	Minimum	At end of period	Maximum	Average	Minimum	At end of period
I	1.0200	1.0051	0.9930	1.0200	0.5270	0.5171	0.4990	0.5220	0.5430	0.5343	0.5170	0.5390
II	1.0300	1.0190	1.0100	1.0200	0.5250	0.5154	0.5050	0.5050	0.5510	0.5405	0.5310	0.5320
III	1.0200	1.0148	1.0100	1.0200	0.5100	0.5058	0.5000	0.5060	0.5440	0.5314	0.5230	0.5430
IV	1.0400	1.0276	1.0200	1.0400	0.5130	0.5056	0.5010	0.5130	0.5500	0.5432	0.5370	0.5430
V	1.0400	1.0271	1.0200	1.0200	0.5210	0.5187	0.5150	0.5200	0.5610	0.5529	0.5430	0.5610
VI	1.0590	1.0492	1.0300	1.0590	0.5360	0.5314	0.5240	0.5300	0.5830	0.5766	0.5670	0.5830
VII	1.0510	1.0241	1.0080	1.0150	0.5290	0.5217	0.5130	0.5180	0.5900	0.5835	0.5760	0.5820
VIII	1.0380	1.0246	1.0090	1.0310	0.5240	0.5166	0.5070	0.5190	0.5800	0.5720	0.5640	0.5750
IX	1.0450	1.0372	1.0270	1.0310	0.5200	0.5162	0.5110	0.5160	0.5840	0.5730	0.5590	0.5830
X	1.0400	1.0307	1.0200	1.0330	0.5160	0.5099	0.5020	0.5020	0.5890	0.5845	0.5780	0.5790
XI	1.0470	1.0350	1.0240	1.0240	0.5110	0.5035	0.4980	0.4990	0.6020	0.5948	0.5820	0.5940
XII	1.0440	1.0353	1.0210	1.0210	0.5080	0.4994	0.4910	0.5040	0.6010	0.5929	0.5850	0.5930

Appendix 6

THE BANK OF LATVIA'S ORGANISATIONAL UNITS AT THE END OF 2005

1. ACCOUNTING DEPARTMENT
(Head of Department, Chief Accountant – Māris Kālis; Deputy Chief Accountants – Jānis Caune, Leo Ašmanis)
1.1 Financial Statements and Accounting Policy Division (Head of Division – Maija Kurpniece)
1.2 Internal Banking Operations Division (Head of Division – Anita Jakāne)

2. CASHIER'S AND MONEY OPERATIONS DEPARTMENT
(Head of Department – Veneranda Kausa; Deputy Head of Department – Vilnis Kepe)
2.1 Cash Operations Division (Head of Division – Oskars Zaltans)
2.2 Money Operations Division (Head of Division – Alite Grobiņa[1])
2.3 Coin Division (Head of Division – Maruta Brūkle)
2.4 Money Expertise and Equipment Maintenance Division (Head of Division – Andris Tauriņš)

3. COMMUNICATIONS DEPARTMENT
(Head of Department – Aina Raņķe)
3.1 Publications Division (Head of Division, Deputy Head of Department – Aija Grīnfelde)
3.2 Library (Manager of Library, Deputy Head of Department – Dace Gasiņa)
3.3 Archive (Manager of Archive – Baiba Blese)
3.4 Clerical Office (Head of Clerical Office – Svetlana Petrovska)
3.5 Division for Translation and Protocol (Head of Division – Gundega Vizule)

4. GOVERNOR'S OFFICE
(Head of Office – Guntis Valujevs)

5. INFORMATION SYSTEMS DEPARTMENT
(Head of Department – Harijs Ozols; Deputy Head of Department – Ivo Odītis)
5.1 System Design and Programming Division (Head of Division – Ilgvars Apinis)
5.2 Computer Network and Server Systems Division (Head of Division, Deputy Head of Department – Egons Bušs)
5.3 Bank Information System Maintenance and Development Division (Head of Division – Valdis Spūlis)
5.4 Information Systems Security Division (Head of Division – Ilona Etmane)
5.5 Information Systems Quality Assurance Division (Head of Division – Askolds Kālis)
5.6 Systems Maintenance Division (Head of Division – Edvīns Mauriņš)

6. INTERNAL AUDIT DEPARTMENT
(Head of Department – Modris Briedis)
6.1 Operational Audit Division (Head of Division, Deputy Head of Department – Anita Hāznere)
6.2 Information System Audit Division (Head of Division – Juris Ziediņš)

7. INTERNATIONAL DEPARTMENT
(Acting Head of Department – Guntis Valujevs; Deputy Head of Department – Aleksandra Bambale)

[1] As of January 13, 2006, Ms. Ruta Strēle.

Appendix 6
(cont.)

8. LEGAL DEPARTMENT
(Head of Department – Ilze Posuma; Deputy Heads of Department – Edvards Kušners, Bruno Mačs)

9. MARKET OPERATIONS DEPARTMENT
(Head of Department – Raivo Vanags)
9.1 Trading and Investment Division (Head of Division, Deputy Head of Department – Kārlis Bauze)
9.2 External Debt Management Division (Head of Division – Agita Birka)
9.3 Risk Management Division (Head of Division – Daira Brunere)
9.4 Analysis Division (Head of Division, Deputy Head of Department – Aigars Egle)
9.5 Payments and Settlements Division (Head of Division – Una Ruka)

10. MONETARY POLICY DEPARTMENT
(Head of Department – Helmūts Ancāns; Deputy Heads of Department – Ēriks Āboliņš, Zoja Medvedevskiha)
10.1 Macroeconomic Analysis Division (Head of Division – Vilnis Purviņš)
10.2 Financial Market Analysis Division (Head of Division – Mārtiņš Prūsis)
10.3 Monetary Research and Forecasting Division (Head of Division – Mārtiņš Bitāns)
10.4 Securities Settlement Division (Head of Division – Anda Kalniņa)
10.5 Financial Stability Division (Head of Division – Jeļena Zubkova)

11. PAYMENT SYSTEMS DEPARTMENT
(Head of Department – Egons Gailītis; Deputy Head of Department – Agnija Hāzenfuss)
11.1 Payment Systems Policy Division (Head of Division – Anda Zalmane)
11.2 Payment Systems Operations Division (Head of Division – Natālija Popova)
11.3 Account Service and Maintenance Division (Head of Division – Andra Gailīte)
11.4 Register of Debtors Division (Head of Division – Laura Ausekle)

12. PERSONNEL DEPARTMENT
(Head of Department – Inta Lovnika; Deputy Head of Department – Elita Lukina)

13. PUBLIC RELATIONS DEPARTMENT
(Head of Department, Press Secretary – Mārtiņš Grāvītis; Deputy Head of Department – Kristaps Otersons)

14. SECURITY DEPARTMENT
(Head of Department – Romualds Namnieks; Deputy Head of Department – Oļegs Rītiņš)
14.1 Analytical Unit (Head of Unit[1])
14.2 Armament Unit (Head of Unit – Juris Kušķis)
14.3 Central Division (Head of Division – Māris Dzelme[2])
14.4 Riga Division (Head of Division – Sandis Mackēvičs)
14.5 Daugavpils Division (Head of Division – Ilmārs Suhockis)
14.6 Liepāja Division (Head of Division – Gints Liepiņš)
14.7 Rēzekne Division (Head of Division – Andrejs Gugāns)

[1] Vacancy. As of January 2, 2006, Mr. Māris Dzelme.
[2] As of January 2, 2006, vacancy. As of February 1, 2006, Mr. Guntars Ezeriņš.

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(cont.)

15. STATISTICS DEPARTMENT
(Head of Department – Agris Caune; Deputy Head of Department – Ilmārs Skarbnieks)
15.1 Financial Market and Monetary Statistics Division (Head of Division – Zigrīda Aušta)
15.2 Balance-of-Payments Statistics Division (Head of Division – Daiga Gaigala-Ližbovska)
15.3 General Economic and Financial Statistics Division (Head of Division – Iveta Salmiņa)

16. TECHNICAL SUPPORT DEPARTMENT
(Head of Department – Andris Ņikitins)
16.1 General Service Division (Head of Division, Deputy Head of Department – Einārs Cišs)
16.2 Building Systems Division (Head of Division – Jānis Kreicbergs)
16.3 Security Systems Division (Head of Division – Viesturs Balodis)

17. RIGA BRANCH
(Branch Manager – Jānis Strēlnieks; Deputy Branch Manager – Gunārs Vīksne)

18. DAUGAVPILS BRANCH
(Branch Manager – Jolanda Mateša; Deputy Branch Manager – Bernarda Kezika)

19. LIEPĀJA BRANCH
(Branch Manager – Gundars Lazdāns; Deputy Branch Manager – Ieva Ratniece)

20. RĒZEKNE BRANCH
(Branch Manager – Anna Matisāne; Deputy Branch Manager – Gintauts Senkans)

21. TRAINING AND RECREATION CENTRE
(Director[1] – Dace Miķilpa)

[1] As of April 1, 2006, Head of Centre.

Appendix 7

THE BANK OF LATVIA'S STRUCTURE AT THE END OF 2005

COUNCIL
Governor
Ilmārs Rimšēvičs

Deputy Governor
Andris Ruselis

Governor's Office
Guntis Valujevs

Internal Audit
Department
Modris Briedis

BOARD
Chairperson of the
Board
Māra Raubiško

Deputy Chairmen
of the Board
Reinis Jakovļevs
Helmūts Ancāns

Information Systems
Department
Harijs Ozols

Monetary Policy
Department
Helmūts Ancāns

Public Relations
Department
Press Secretary
Mārtiņš Grāvītis

Payment Systems
Department
Egons Gailītis

Market Operations
Department
Raivo Vanags

Legal Department
Ilze Posuma

Statistics Department
Agris Caune

Accounting Department
Māris Kālis

International
Department
Guntis Valujevs

Communications
Department
Aina Raņķe

Personnel Department
Inta Lovnika

Security Department
Romualds Namnieks

Technical Support
Department
Andris Ņikitins

Cashier's and Money
Operations Department
Veneranda Kausa

Training and Recreation
Centre
Dace Miķilpa

Daugavpils Branch
Jolanda Mateša

Riga Branch
Jānis Strēlnieks

Liepāja Branch
Gundars Lazdāns

Rēzekne Branch
Anna Matisāne

Appendix 8

REPRESENTATION OF THE BANK OF LATVIA IN INTERNATIONAL ORGANISATIONS

EUROPEAN UNION

Economic and Financial Committee (EFC)

Helmūts Ancāns, Deputy Chairman of the Bank of Latvia's Board, Head of Monetary Policy Department (together with Valentīna Andrējeva[1], State Secretary of the Ministry of Finance of the Republic of Latvia)

Committee of Alternates (EFC): Jeļena Zubkova, Head of Financial Stability Division, Monetary Policy Department (together with Inta Vasaraudze[2], Deputy State Secretary of the Ministry of Finance of the Republic of Latvia)

EFC's Euro Coin Sub-Committee (ECSC)

Maruta Brūkle, Head of Coin Division of Cashier's and Money Operations Department

EFC's Sub-Committee on IMF and related issues (SCIMF)

Guntis Valujevs, Head of Governor's Office, Acting Head of International Department

Committee on Monetary, Financial and Balance of Payments Statistics (CMFB)

Agris Caune, Head of Statistics Department

Committee of European Banking Supervisors (CEBS)

Vita Pilsuma, Member of the Bank of Latvia's Council (Banking Supervisory Institution is represented by Jānis Placis, Member of the Council of FCMC)

Eurostat Balance of Payments Committee

Daiga Gaigala-Ližbovska, Head of Balance of Payments Statistics Division, Statistics Department

Republic of Latvia Mission to the EU

Aldis Austers, Special Attaché of the Bank of Latvia

EUROPEAN CENTRAL BANK

General Council

Ilmārs Rimšēvičs, Governor of the Bank of Latvia

Accounting and Monetary Income Committee (AMICO)

Māris Kālis, Member of the Bank of Latvia's Board, Chief Accountant of the Bank of Latvia

Jānis Caune, Deputy Chief Accountant of the Bank of Latvia

Banking Supervision Committee (BSC)

Zoja Medvedevskiha, Deputy Head of Monetary Policy Department (Banking Supervisory Institution is represented by Uldis Cērps, Chairman of FCMC)

Banknote Committee (BANCO)

Veneranda Kausa, Head of Cashier's and Money Operations Department

Vilnis Kepe, Deputy Head of Cashier's and Money Operations Department

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[1] As of September 1, 2006, Ms. Inta Vasaraudze, Deputy State Secretary of the Ministry of Finance of the Republic of Latvia.

[2] As of September 1, 2006, Ms. Daina Ispodkina, Head of European Union Affairs Division, European Union and International Affairs Department of the Ministry of Finance of the Republic of Latvia.

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(cont.)

Eurosystem/ESCB Communications Committee (ECCO)
Mārtiņš Grāvītis, Head of Public Relations Department
Aina Raņķe, Head of Communications Department

Information Technology Committee (ITC)
Harijs Ozols, Member of the Bank of Latvia's Board, Head of Information Systems Department
Egons Bušs, Deputy Head of Information Systems Department, Head of Computer Network and Server Systems Division

Internal Auditors Committee (IAC)
Modris Briedis, Head of Internal Audit Department
Anita Hāznere, Deputy Head of Internal Audit Department, Head of Operational Audit Division

International Relations Committee (IRC)
Andris Ruselis, Deputy Governor of the Bank of Latvia
Guntis Valujevs, Head of Governor's Office, Acting Head of International Department

Legal Committee (LEGCO)
Ilze Posuma, Head of Legal Department
Iveta Krastiņa, Legal Adviser, Legal Department

Market Operations Committee (MOC)
Raivo Vanags, Head of Market Operations Department
Aigars Egle, Deputy Head of Market Operations Department, Head of Analysis Division

Monetary Policy Committee (MPC)
Helmūts Ancāns, Deputy Chairman of the Bank of Latvia's Board, Head of Monetary Policy Department
Santa Bērziņa, Chief Economist of Macroeconomic Analysis Division, Monetary Policy Department

Payment and Settlement Systems Committee (PSSC)
Egons Gailītis, Head of Payment Systems Department
Ēriks Āboliņš, Deputy Head of Monetary Policy Department

Statistics Committee (STC)
Agris Caune, Head of Statistics Department
Ilmārs Skarbnieks, Deputy Head of Statistics Department

INTERNATIONAL MONETARY FUND
Board of Governors
Ilmārs Rimšēvičs, Governor of the Bank of Latvia

Nordic-Baltic Monetary and Financial Committee (NBMFC)
Andris Ruselis, Deputy Governor of the Bank of Latvia

Nordic-Baltic Monetary and Financial Committee, Group of Alternates (NBMFC Alternates)
Guntis Valujevs, Head of Governor's Office, Acting Head of International Department

Appendix 8
(cont.)

Nordic-Baltic IMF Office in Washington
Juris Kravalis, Senior Advisor to the Executive Director of the Nordic-Baltic Constituency of the IMF, Latvia's representative in IMF

Appendix 9

THE BANK OF LATVIA'S 2005 PUBLICATIONS

This list contains publications prepared and issued by the Bank of Latvia in 2005. These publications are free of charge and available both on the Bank's website (www.bank.lv) and in print at the Bank of Latvia. It is also possible to receive the publications by mail sending a request to the address indicated on the last page of this publication.

REGULAR PUBLICATIONS

Bank of Latvia: Annual Report 2004
Monetārais Apskats. Monetary Review (3, 4/2004 and 1, 2/2005)
Latvijas Maksājumu Bilance. Latvia's Balance of Payments (3, 4/2004 and 1, 2/2005)
Financial Stability Report (2/2004 and 1/2005)
Monetary Bulletin (12/2004 and 1–11/2005)
Latvia's Balance of Payments (Key Items) (11, 12/2004 and 1–10/2005)

WORKING PAPERS

Ajevskis, V.; Pogulis, A. "Repegging of the Lats to the Euro: Implications for the Financial Sector".
Dāvidsons, G. "Modelling Long-Term Competitiveness of Latvia".
Grundīza, S.; Stikuts, D.; Tkačevs, O. "Cyclically Adjusted Balance of Latvia's General Government Consolidated Budget".
Meļihovs, A.; Rusakova.S. "Short-Term Forecasting of Economic Development in Latvia Using Business and Consumer Survey Data".
Zasova, A.; Meļihovs, A. "Assessment of Labour Market Elasticity in Latvia".

Appendix 10

2005 HIGHLIGHTS OF RESOLUTIONS AND REGULATIONS ADOPTED IN PURSUIT OF THE BANK OF LATVIA'S MAIN TASKS

January 13
The Council of the Bank of Latvia passed the Resolution "On Changing the Title of and Making Amendments to the "Regulation for Compiling the 'Report and Projections on Long-Term Foreign Loans by Credit Institutions' "" (in effect as of April 1, 2005).

The Council of the Bank of Latvia approved the "Regulation for Reproducing the Bank of Latvia Banknotes" (in effect as of February 1, 2005). The Council of the Bank of Latvia passed the Resolution "On Amendments to the "Regulation for Compiling the 'Report on Net Open Foreign Exchange Position' "" (in effect as of April 1, 2005).

The Council of the Bank of Latvia passed the Resolution "On Changing the Title of and Making Amendments to the "Regulation for Compiling 'Interest Rate Reports of Credit Institutions' "" (in effect as of April 1, 2005).

The Council of the Bank of Latvia passed the Resolution "On Amendments to the "Regulation for Compiling the 'Report on Money Market Transactions' "" (in effect as of April 1, 2005).

The Council of the Bank of Latvia passed the Resolution "On Amendments to the "Regulation for Compiling the 'Report on Adjustments in Respect of Write-Offs/ Write-Downs of Loans and Price Revaluations of Securities' "" (in effect as of April 1, 2005).

The Council of the Bank of Latvia revoked the Resolution "On Approval of the 'Regulation for Receiving a Cash Collection Licence' ".

March 21
The Council of the Bank of Latvia approved a revised "Regulation for the Register of Debtors" (in effect as of September 1, 2005).

The Council of the Bank of Latvia passed the Resolution "On Amendments to the 'Regulation for Issuance and Maintenance of Electronic Money' " (in effect as of April 1, 2005).

May 19
The Council of the Bank of Latvia made amendments to the "Regulation for the Securities Settlement System Organised by the Bank of Latvia" (in effect as of July 1, 2005).

June 16
The Board of the Bank of Latvia passed the Resolution "On Adopting a Revised 'Procedure for Conducting Securities-Related Operations between the Bank of Latvia and the JSC Latvian Central Depository' " (in effect as of July 1, 2005).

July 14
The Council of the Bank of Latvia passed the Resolution "On the Bank Minimum Reserve Ratio", increasing the minimum reserve ratio for banks and foreign bank branches from 4% to 6% (in effect as of August 24, 2005).

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(cont.)

November 17
The Council of the Bank of Latvia passed the Resolution "On the Bank Minimum Reserve Ratio", increasing the minimum reserve ratio for banks and foreign bank branches from 6% to 8% (in effect as of December 24, 2005).

Appendix 11

GLOSSARY

Automatic Lombard loan – a Lombard loan granted to a bank or a branch of a foreign bank registered in the Republic of Latvia, holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement system organised by the Bank of Latvia, until the next business day for the purpose of eliminating an overdraft resulting from interbank settlements.

Balance of payments – a statistical report that summarises Latvia's economic transactions with other countries. This report reflects transactions related to goods, services, income and transfers and net transactions imposing financial claims ("Assets") or financial liabilities ("Liabilities") to other countries.

Bank for International Settlements (BIS) – an international organisation, founded in May 1930, to facilitate international monetary and financial cooperation. The BIS acts as a bank for central banks.

Central government – public institutions, including ministries, embassies, representative offices, agencies, councils, educational, healthcare, law enforcement, cultural and other public institutions whose competence covers the whole economic territory of a country. Central government includes state non-profit institutions managed and financed by the central government.

Clearing – the process of transmitting, processing and reconciling payment documents prior to settlement, resulting in establishment of the multilateral net position of each bank by netting all payment documents submitted by the bank, i.e. establishing net cash liabilities to or claims on other banks.

Credit institution – a corporation whose business is to receive deposits or other repayable funds from the public and to grant credits on its own account and provide other financial services, or electronic money institutions issuing means of payment in the form of electronic money. The credit institutions of the Republic of Latvia (banks and electronic money institutions) have been included on the "List of Monetary Financial Institutions of the Republic of Latvia".

Credit risk – the risk to incur losses as a result of a counterparty failing to settle an obligation.

Debt securities – securities representing an obligation and promise on the part of the issuer (i.e. the borrower) to make one or more payment(s) to the holder (the lender) of the securities at a specified future date or dates. Such securities usually carry a specific rate of interest (the coupon) or are sold at a discount to the amount that will be repaid at maturity. Debt securities issued with an original maturity of more than one year are classified as long-term debt securities.

Demand Lombard loan – a Lombard loan granted upon request of a bank or a branch of a foreign bank registered in the Republic of Latvia, holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement system organised by the Bank of Latvia, for an agreed period which does not exceed 30 consecutive days.

Deposits redeemable at notice – cash assets deposited with an MFI without any specified maturity, with the possibility of withdrawing on demand either subject to notifying the MFI within an agreed period of notice or subject to payment of a substantial penalty.

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Deposits with agreed maturity – cash assets deposited with an MFI that cannot be withdrawn prior to maturity or can be withdrawn only subject to payment of a small penalty. This category also encompasses some non-marketable debt instruments, such as non-marketable (retail) certificates of deposit.

Direct investment – investment (net transactions and outstanding amounts) made by a foreign investor in order to obtain a lasting interest (ownership of at least 10% of the ordinary shares or the right of voting) in a Latvian company ("Direct investment in Latvia") or by a Latvian investor in a foreign company ("Direct investment abroad"). It comprises direct investment in the form of equity capital, reinvested earnings and other capital.

Economic and Financial Committee (EFC) – a committee for economic and financial issues established by the EU Council, comprising representatives of the governments and central banks of the EU Member States, as well as representatives of the EC and ECB.

Economic and Monetary Union (EMU) – the Treaty establishing the European Community (often referred to as the Treaty of Rome, as amended) describes the process of achieving the EMU in the EU in three stages. Stage One of the EMU started on July 1, 1990 and ended on December 31, 1993. It was mainly characterised by the dismantling of all barriers to the free movement of capital within the EU. Stage Two of the EMU began on January 1, 1994. It provided for the establishment of the European Monetary Institute, prohibition of financing of the public sector by the central banks, prohibition of privileged access to financial institutions by the public sector and avoidance of excessive government budget deficits. Stage Three started on January 1, 1999 with the transfer of monetary competence to the ECB and the introduction of the euro. The euro cash changeover on January 1, 2002 completed the process setting up the EMU.

Electronic clearing system (EKS) – the Bank of Latvia's net settlement system, which is used to process bulk retail payments and ensure the settlement of net positions.

Equities – securities representing ownership of a stake in a commercial company. They comprise listed and unlisted equities (e.g. quoted shares, unquoted shares and other forms of equity) and usually produce income in the form of dividends.

Euro area – the area encompassing the EU Member States which have adopted the euro as their single currency in accordance with the Treaty establishing the European Community (often referred to as the Treaty of Rome, as amended) and in which a single monetary policy is conducted under the responsibility of the Governing Council of the ECB. As at the end of 2005, the euro area comprised Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

European Central Bank (ECB) – the central institution of the ESCB and the Eurosystem having a legal personality under the Community law. It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through the ECB's own activities or through those of the national central banks, pursuant to the Statute of the ESCB and ECB. The ECB is governed by the Governing Council and the Executive Board, and, as a third decision-making body, by the General Council.

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European System of Central Banks (ESCB) – includes the European Central Bank (ECB) and the national central banks of the EU Member States. The national central banks of those Member States which have not adopted the euro implement independent monetary policy according retain their powers in the field of monetary policy according to national law and are thus not involved in the conduct of the monetary policy of the Eurosystem.

Eurosystem – comprises the ECB and the national central banks of the Member States of the euro area. The decision-making bodies of the Eurosystem are the Governing Council and the Executive Board of the ECB.

Exchange rate mechanism II (ERM II) – the exchange rate arrangement that ensures exchange rate policy cooperation between the euro area countries and the EU Member States not participating in Stage Three of EMU. A central parity exchange rate vis-à-vis the euro is established for each ERM II member currency, against which the ERM II fluctuation band is defined. As at the end of 2005, Denmark, Estonia, Cyprus, Latvia, Lithuania, Malta, Slovakia and Slovenia were members of the ERM II.

Financial auxiliaries – financial corporations that are primarily engaged in auxiliary financial activities, i.e. activities that are closely related to financial intermediation but are not financial intermediation themselves, e.g. investment brokers who do not engage in financial intermediation services on their own behalf, corporations that provide infrastructure for financial markets, institutions that supervise MFIs, financial institutions and the financial market. The FCMC and the RSE shall be regarded as financial auxiliaries.

Financial institutions – other financial intermediaries, excluding insurance corporations and pension funds (OFIs), financial auxiliaries, insurance corporations and pension funds.

Fixed rate instrument – a financial instrument for which the coupon is fixed throughout the life of the instrument.

Floating rate instrument – a financial instrument for which the coupon is periodically reset relative to a reference index to reflect changes in short-term or medium-term market interest rates. Floating rate instruments may have a coupon determined either on the basis of the reference index at a certain date before the start of the coupon accrual period or during the coupon accrual period.

Foreign exchange swap – a simultaneous spot purchase/sale and forward sale/purchase of one currency against another.

General Council of the ECB – one of the decision-making bodies of the ECB, comprising the President and the Vice-President of the ECB and the Governors of all EU national central banks.

General government – public institutions engaged in production of non-market goods and services intended for individual and collective consumption or public institutions engaged in redistribution of national income or wealth. General government in the Republic of Latvia includes central government and local government.

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Gross settlement system – a transfer system in which the cash settlement or the transfer of securities occurs on an instruction-by-instruction basis.

Households – natural persons or groups of natural persons whose principal activity is consumption and who produce goods and services exclusively for their own consumption. The following are also regarded as households in the Republic of Latvia: persons engaged in individual entrepreneurship, provided that they have not registered their activity with the Commercial Register of the Enterprise Register of the Republic of Latvia. When aggregating data, the household sector usually includes also the data of non-profit institutions serving households.

Interbank automated payment system (SAMS) – the Bank of Latvia's real-time gross settlement system used for interbank settlements in real-time.

International investment position – a statistical report reflecting the value and structure of outstanding amounts of Latvia's financial claims ("Assets") and financial liabilities ("Liabilities") to other countries.

International Monetary Fund (IMF) – an international organisation, founded in July 1944, to facilitate international monetary cooperation, exchange rate stability, national economic growth and employment growth, and ensure short-term financial assistance, should any of the IMF Member States need to solve balance-of-payments related problems.

Liquidity risk – the risk that an obligation will not be settled when due and it will be impossible to dispose of assets close to their fair value.

Local government – public institutions, whose competence covers only a local economic territory. Local government includes state non-profit institutions managed and financed by the local government. In the Republic of Latvia, the local government level is comprised of the local authorities.

Lombard loan – a short-term loan of the Bank of Latvia granted to a bank or a branch of a foreign bank registered in the Republic of Latvia, holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement system organised by the Bank of Latvia, in exchange for an unencumbered securities collateral owned by the bank or the branch of a foreign bank. The Bank of Latvia grants automatic Lombard loans and demand Lombard loans.

M0 (monetary base) – this monetary aggregate is calculated on the basis of the Bank of Latvia's methodology and comprises the lats banknotes and coins issued by the Bank of Latvia and demand deposits of resident MFIs and financial institutions (overnight deposits) with the Bank of Latvia.

M1 (narrow monetary aggregate) – this monetary aggregate is calculated on the basis of the ECB methodology and comprises the lats banknotes and coins issued by the Bank of Latvia (less vault cash of MFIs) and overnight deposits in lats and foreign currencies held with MFIs by resident financial institutions, non-financial corporations, households and non-profit institutions serving households and local governments.

M2 (intermediate monetary aggregate) – this monetary aggregate is calculated on the basis of the ECB methodology and comprises M1 and deposits redeemable at a period of notice of up to and including three months (i.e. short-term savings deposits) and deposits with an agreed maturity of up to and including two years (i.e. short-term time deposits) in lats and foreign currencies held with MFIs by resident financial institutions, non-financial corporations, households and non-profit institutions serving households and local governments.

M2X (broad money) – this monetary aggregate is calculated on the basis of the Bank of Latvia's methodology and comprises the lats banknotes and coins issued by the Bank of Latvia (less vault cash of MFIs) and overnight deposits and term deposits in lats and foreign currencies (including deposits redeemable at notice and repos) held with MFIs by resident financial institutions, non-financial corporations, households and non-profit institutions serving households. M2X incorporates deposits of local governments as a net item on the demand side.

M3 (broad monetary aggregate) – this monetary aggregate is calculated on the basis of the ECB methodology and comprises M2, repurchase agreements, debt securities with a maturity of up to and including two years issued by MFIs, and money market fund shares and units.

Market risk – the risk to incur losses as a result of adverse changes in financial market factors (e.g. interest rates or exchange rates).

Monetary financial institutions (MFIs) – institutions forming the money-issuing sector, i.e. credit institutions and financial corporations whose business is to receive deposits or close substitutes for deposits from customers other than MFIs and, on their own account, to grant credits and invest in securities, and the national central banks. The Bank of Latvia compiles and regularly updates the "List of Monetary Financial Institutions of the Republic of Latvia". The ECB regularly publishes the "List of MFIs of the EU Member States".

Non-financial corporations – economic entities producing goods or providing non-financial services with the aim of gaining profit or other yield. In the Republic of Latvia, sole proprietorship registered with the Commercial Register of the Enterprise Register of the Republic of Latvia is also regarded as non-financial corporation.

Operational risk – the risk of incurring financial or non-financial losses as a result of an unexpected disruption of operations, unsanctioned use of information, non-compliance with security requirements and other internal or external circumstances relating to gaps in the internal control system.

Original maturity – in accordance with the terms and conditions agreed at the beginning of a financial operation, time from the issue date of a debt instrument to its maturity date or from the lending date to the maturity date or from the start date to the final date, of any other financial operation.

Other financial intermediaries, except insurance corporations and pension funds (OFIs) – financial institutions primarily engaged in financial intermediation by incurring liabilities in forms other than currency, deposits and close substitutes for deposits to their customers other than MFIs, or insurance technical reserves. OFIs are financial corporations engaged in lending (e.g. financial leasing companies, factoring companies, export/import financing companies), investment funds, investment brokerage companies, financial vehicle corporations, financial

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holding corporations, venture capital corporations, as well as other financial institutions provided that their activity complies with the given definition.

Portfolio investment – investment (net transactions and positions) made by residents of Latvia in securities issued by residents of other countries ("Assets") and by residents of other countries in securities issued by residents of Latvia ("Liabilities"). Portfolio investment includes equity securities (providing for ownership of up to 10% of the ordinary shares or the right of voting) and debt securities, excluding securities recorded in foreign direct investment or reserve assets.

Real-Time Gross Settlement (RTGS) system – a settlement system in which processing of payments and settlement take place on an order-by-order basis (without netting) in real time.

Repos – operations whereby a tender participant (a bank or a branch of a foreign bank registered in the Republic of Latvia, holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement system organised by the Bank of Latvia) sells securities owned by it to the Bank of Latvia and repurchases them from the Bank of Latvia at a specified price upon maturity.

Reserve base – the sum of the balance sheet items which constitute the basis for calculating the reserve requirements of banks and branches of foreign banks registered in the Republic of Latvia.

Reserve holdings – holdings of banks and branches of foreign banks registered in the Republic of Latvia on their reserve accounts which serve to fulfil reserve requirements.

Reserve ratio – the percentage share of the reserve base defined by the Bank of Latvia. Central banks may also define a ratio for each category of balance sheet items included in the reserve base. The ratios are used to calculate reserve requirements.

Reserve requirement – requirement for banks and branches of foreign banks registered in the Republic of Latvia to hold an amount of reserves compliant with the reserve ratio on their reserve accounts with the Bank of Latvia.

Residual maturity – time remaining until the maturity date of a debt instrument or loan or time remaining until the final date of any other financial operation.

Reverse repos – operations whereby a tender participant (a bank or a branch of a foreign bank registered in the Republic of Latvia or a foreign bank, international foreign exchange, financial or credit institution holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement system organised by the Bank of Latvia) purchases securities owned by the Bank of Latvia from the Bank of Latvia and resells them to the Bank of Latvia at a specified price upon maturity.

RIGIBID (Riga Interbank Bid Rate) – the index of Latvian interbank interest rates on deposits reflecting the money market interest rates in lats set by banks included on the quotation list at which these banks are willing to borrow cash assets in lats from other banks. The Bank of Latvia calculates this index for transactions with an overnight maturity, a maturity of 1 day (starting with the next working day), 1 week, 1 month, 3 months, 6 months and 12 months.

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RIGIBOR (Riga Interbank Offered Rate) – the index of Latvian interbank lending interest rates reflecting the lats money market interest rates set by banks included on the quotation list at which these banks are willing to lend cash assets in lats to other banks. The Bank of Latvia calculates this index for transactions with an overnight maturity, a maturity of 1 day (starting with the next business day), 1 week, 1 month, 3 months, 6 months and 12 months.

TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system – a real-time gross settlement system for the euro. It is a decentralised system consisting of 16 national RTGS systems, the ECB payment mechanism and the Interlinking mechanism at the end of 2005.

Time deposit with the Bank of Latvia – cash assets in lats accepted by the Bank of Latvia for a fixed term and with a fixed interest rate from a bank registered in the Republic of Latvia, including a bank which has been rendered insolvent or to undergo liquidation, or from a branch of a foreign bank registered in the Republic of Latvia, repaid by the Bank of Latvia to the above counterparties upon maturity together with interest.

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